

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

**FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT**

YEAR ENDED SEPTEMBER 30, 2007

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

FINANCIAL STATEMENTS
YEAR ENDED SEPTEMBER 30, 2007

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INDEPENDENT AUDITORS' REPORT

Honorable Wesley Simina
Governor, State of Chuuk
Federated States of Micronesia:

We have audited the accompanying statement of net assets of the governmental activities, and the governmental funds balance sheet for each major fund and the aggregate remaining fund information of the State of Chuuk (the State) as of September 30, 2007. These financial statements, as set forth in Section II of the foregoing table of contents, are the responsibility of the management of the State.

Except as discussed in the following paragraphs, 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 statements are 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 State'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 opinions.

While detailed property records exist, prior-year records and supporting data were not made available for our audit concerning the underlying costs for capital assets or the bases supporting the stated carrying values. Therefore, we are not able to satisfy ourselves about the amounts at which capital assets and related accumulated depreciation are recorded for the governmental activities in the accompanying statement of net assets at September 30, 2007.

Because of inadequacies in the accounting records, detailed records regarding land acquisitions payable and the underlying supporting documentation evidencing the validity of land acquisition expenditures/expenses for the primary government had not been maintained and were not made available for our audit. Therefore, we are not able to satisfy ourselves about the amounts at which the liabilities for the governmental activities and the General Fund are recorded in the accompanying statement of net assets and governmental funds balance sheet at September 30, 2007.

As discussed in Note 9 to the financial statements, the State has not recorded a liability for land leases and other claims payable in the governmental activities and the General Fund and, accordingly, has not recorded an expenditure/expense for the current period change in that liability. Accounting principles generally accepted in the United States of America require that liabilities incurred attributable to services already rendered and that are not contingent upon a specific event that is outside of the control of the State be accrued as liabilities and expenditures/expenses, which would increase the liabilities, decrease net assets, and change the expenses of the governmental activities and increase the liabilities, increase fund deficit, and change the expenditures of the General Fund. The amount by which this departure would affect the liabilities, net assets and expenses of the governmental activities and the liabilities, fund deficit, and expenditures of the General Fund is not reasonably determinable.

We were engaged to audit the State's financial statements for the year ended September 30, 2006; however, the system of financial accounting and reporting in operation for the State for the year ended September 30, 2006 was inadequate. Detailed records regarding cash and cash equivalents, receivables due from the FSM National Government, accounts payable, the reserve for continuing appropriations, and the reserve for encumbrances for the primary government were not maintained and were not made available for audit. Furthermore, the underlying supporting documentation evidencing the validity of expenditures/expenses for the primary government was not maintained and was not made available for audit. Therefore we were not able to satisfy ourselves about the account balances presented within the statement of net assets of the governmental activities, and the governmental funds balance sheet for each major fund and the aggregate remaining fund information of the State as of September 30, 2006. The statement of net assets of the governmental activities, and the governmental funds balance sheet for each major fund and the aggregate remaining fund information enter into the determination of results of operations of the State for the year ended September 30, 2007.

Because of inadequacies in the accounting records, detailed records regarding cash and cash equivalents, receivables, capital assets, accounts payable, and other liabilities and accruals for the Chuuk Public Utilities Corporation have not been maintained and certain supporting data were not made available for our audit. The financial activities of the Chuuk Public Utilities Corporation are included in the State's basic financial statements as a discretely presented component unit and represent 68% and 70% of the assets and revenues, respectively, of the State's aggregate discretely presented component units.

The financial statements of the Chuuk State Housing Authority have not been audited, and we were not engaged to audit these financial statements as part of our audit of the State's basic financial statements. The financial activities of the Chuuk State Housing Authority are included in the State's basic financial statements as a discretely presented component unit and represent 17% and 2% of the assets and revenues, respectively, of the State's aggregate discretely presented component units.

Because of the significance of the matters discussed in the sixth through eighth paragraphs above, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements of the aggregate discretely presented component units, the statement of activities for the governmental activities, the governmental funds statement of revenues, expenditures, and changes in fund balances (deficits), and the reconciliation of the statement of revenues, expenditures, and changes in fund balances of governmental funds to the statement of activities for the year ended September 30, 2007.

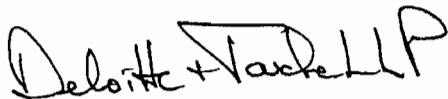
In our opinion, except for the effects of not recording a liability for land leases and our inability to examine evidence supporting other claims payable in the governmental activities and the General Fund, as discussed in the fifth paragraph above, and except for the effects of such adjustments, if any, as might have been determined to be necessary had prior-year records concerning capital assets for governmental activities been adequate, and had the accounting records been adequate for us to satisfy ourselves about land acquisitions payable recorded for the governmental activities and the General Fund, as discussed in the third and fourth paragraphs above, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the State as of September 30, 2007, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis, on pages 4 through 9, as well as the Schedule of Revenues, Expenditures, and Changes in Deficit - Budget and Actual - General Fund and notes thereto, on pages 44 through 46, are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the management of the State. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

As discussed in Note 1 to the financial statements, the beginning net assets of the governmental activities within the accompanying financial statements has been restated.

The combining and individual fund financial statements, as set forth in Section IV of the foregoing table of contents, which are also the responsibility of the management of the State, are presented for purposes of additional analysis and are not a required part of the basic financial statements of the State. Such additional information has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole. Because of the significance of the matter discussed in the sixth paragraph above, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the additional information in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 10, 2008, on our consideration of the State's internal control over financial reporting and on 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 an 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.

A handwritten signature in black ink that reads "Deloitte + Tatchell LLP". The signature is written in a cursive, stylized font.

June 10, 2008

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2007

This analysis, prepared by the Department of Administrative Services, Division of Treasury, offers readers of the Chuuk State Government's (Chuuk State) financial statements a narrative overview of the activities of the government for the fiscal year ended September 30, 2007. We encourage readers to consider this information in conjunction with Chuuk State's financial statements, which follow. Fiscal year 2006 comparative information has been included, where appropriate. This analysis is required by the Governmental Accounting Standards Board, (GASB) which provides guidelines on what must be included and excluded from this analysis.

FINANCIAL HIGHLIGHTS

- For the fiscal year ended September 30, 2007, Chuuk State's total net assets increased by \$5.27 million (or 9.04%) from \$58.27 million in the prior year to \$63.54 million. This increase is primarily attributable to reduction of prior year liabilities and recovery of previously written off accounts receivables.
- During fiscal year 2007, Chuuk State's revenues of \$31.58 million exceeded total expenses (\$29.39 million) by \$2.2 million. Both revenues and expenses decreased from fiscal year 2006, by \$1.94 million (or 5.8%) and \$9.64 million (or 24.7%), respectively. The revenue decreases were attributable to the decline of U.S. Federal grant revenues when the FSM national government began processing the State's federal grant transactions in May 2007. The expense decline also reflects the decreased processing of federal grant transactions as well as a decrease in expenses for Municipal governments and non-sector funded programs.
- The General Fund incurred an operating deficit in its budget in fiscal year 2007: actual revenue collections of \$7.0 million were less than budgeted revenues of \$7.14 million by \$0.14 million (or 1.96%) primarily as a result of declines in revenue sharing proceeds. The expenditure budget also reflected a negative budget variance. General fund expenditures of \$8.99 million were \$1.45 million (or 19.23%) less than general fund appropriations of \$7.54 million.
- During fiscal year 2007, Chuuk State's general fund balance deficit decreased by \$6.41 million (or 53%); decreasing from \$18.53 million in the prior year to \$12.12 million. The decrease is the result of other financing sources off-setting the operating deficit and extraordinary write-offs of prior year medical referral and other liabilities as well as recovery of previously written off receivables..

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to Chuuk State's basic financial statements, Chuuk State's basic financial statements comprise three components: 1) governmental-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information in the form of budgetary schedules, which are prepared on the budgetary basis of accounting, and other optional supplementary information, in addition to the basic financial statements themselves, which includes combining statements for governmental funds and component units.

Government-Wide Financial Statements

The government-wide statements report information about Chuuk State as a whole using accounting methods similar to those used by private-sector companies. It provides both long-term and short-term information about Chuuk State's financial status.

The statement of net assets includes all the government's assets and liabilities. The difference in the two is called net assets. Over time, increases or decreases in Chuuk State's net assets serve as indicator to measure Chuuk State's financial position.

The statement of activities, on the other hand, account for Chuuk State's current year's revenues and expenses regardless of when cash is received or paid.

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The government-wide financial statements of Chuuk State are divided into two categories:

- **Governmental Activities** - Most of Chuuk State's basic services are included here, such as education, health, special appropriations, finance, judiciary, and general administration. Compact sector and other federal grants finance most of these activities.
- **Component Units** - Chuuk State includes the operating results of the Chuuk State Health Care Plan, the Chuuk Public Utility Corporation, and the Chuuk Housing Authority in its report. Although legally separate, these "component units" are important because Chuuk State is financially accountable for them.

Fund Financial Statements

The fund financial statements provide more detailed information about Chuuk State's significant funds. Funds are accounting devices that Chuuk State uses to keep track of specific sources of funding and spending for particular services. The State uses fund accounting to comply with financial and related legal requirements. The fund financial statements present a balance sheet and a statement of revenues, expenditures, and changes in fund balances for its major and aggregated non-major funds.

Most of Chuuk State's basic services are included in governmental funds, which focus on (1) how cash and other financial assets that can be readily converted to cash flow in and out and (2) the balances left at year-end that are available for spending. Consequently, the governmental funds statements provide a detailed short-term view that helps you determine whether there are more or fewer financial resources that can be spent in the near future to finance Chuuk state programs. Because this information does not encompass the additional long-term focus of the government-wide statements, we provide additional information at the bottom of the governmental funds statement, or on the subsequent page, that explains and reconciles the relationship (or differences) between them.

Chuuk State maintains individual governmental funds, which are categorized as major and non-major. The major funds comprise the General Fund, the Compact Sector Grants Fund, the U.S. Federal Grants Fund, and the permanent Compact Trust Fund.

FINANCIAL ANALYSIS OF CHUUK STATE AS A WHOLE

Net assets may serve over time as a useful indicator of a government's financial position. At the end of fiscal year 2007, Chuuk State's assets exceeded liabilities by \$63.54 million. However, all these net assets are restricted as to the purposes they can be used for or are invested in capital assets. Chuuk State uses these capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although Chuuk State's investment in capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provide from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. The following summary of Chuuk State's net assets as of September 30, 2007, with comparable balances for fiscal year 2006, discloses this relationship.

	<u>2007</u>	<u>2006</u> <u>Restated</u>
Current and other non-capital assets	\$ 23,650,670	\$ 23,265,364
Capital assets	<u>67,391,235</u>	<u>66,849,232</u>
Total assets	<u>91,041,905</u>	<u>90,114,596</u>
Long-term liabilities	7,761,051	6,578,420
Other liabilities	<u>19,732,711</u>	<u>25,261,408</u>
Total liabilities	<u>27,493,762</u>	<u>31,839,828</u>
Net assets:		
Invested in capital assets, net of related debt	67,391,235	66,849,232
Restricted	21,932,518	17,231,084
Unrestricted	<u>(25,779,315)</u>	<u>(25,805,547)</u>
Total net assets	\$ <u>63,544,438</u>	\$ <u>58,274,769</u>

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At the end of fiscal year 2007 Chuuk State's unrestricted assets showed a deficit of \$25.78 million, a decrease of \$0.026 million (or 0.10%) from the prior year. This deficit is the result of having current and long-term commitments that are greater than currently available resources. Specifically, Chuuk State did not include in past annual budgets the full amounts needed to finance its current liabilities to vendors and others or its long-term liabilities arising from Asian Development Bank (ADB) loans and unused employee leave balances. Chuuk State will include these amounts in future years' budgets as funding permits.

Net assets increased \$5.27 million (or 9.04%) from the prior year. Key elements of the increase and the differences from the prior year are shown in the following schedule:

	<u>2007</u>	<u>2006</u> <u>Restated</u>
Revenues:		
Program revenues:		
Charges for services	\$ 896,227	\$ 739,451
Operating grants and contributions	23,219,888	25,261,810
Capital Grants and contributions	1,267,090	488,690
General revenues:		
Taxes	3,864,578	4,656,670
Unrestricted investment earnings	1,851,965	788,228
Other	<u>483,938</u>	<u>1,591,748</u>
Total revenues	<u>31,583,686</u>	<u>33,526,597</u>
Expenses:		
General government	4,625,740	8,323,336
Health services	5,825,991	5,966,124
Education	11,150,145	11,436,624
Economic development	713,593	1,087,780
Public safety	1,428,484	1,312,862
Public works and transportation	2,323,457	2,347,198
Community affairs	302,304	287,572
Boards and commissions	611,387	788,324
Judiciary	553,728	541,678
Payments to components	205,545	275,307
Municipal affairs	633,208	4,176,643
Other	<u>1,021,515</u>	<u>2,487,909</u>
Total expenses	<u>29,395,097</u>	<u>39,031,357</u>
Special Items:		
Recovery on previously written off receivables	1,049,602	-
Write-down of investments	(1,202,005)	-
Write-off liabilities	<u>3,233,483</u>	-
Total special items	<u>3,081,080</u>	-
Change in net assets	5,269,669	(5,504,760)
Net assets at the beginning of the year	<u>58,274,769</u>	<u>63,779,529</u>
Net assets at the end of the year	\$ <u>63,544,438</u>	\$ <u>58,274,769</u>

Total revenues in fiscal year 2007 of \$31.58 million decreased \$1.94 million (or 6%) from the prior year's \$33.53 million primarily due to the transfer of US federal grant transaction processing from Chuuk State to the FSM national government. US Federal grant revenues of \$1.45 million in FY-07, were down \$3.1 million (69%) from \$4.5 million in fiscal year 2006.

Total expenses of \$29.39 million in fiscal year 2007 decreased \$9.64 million (or 25%) from \$39.03 million of expenses in fiscal year 2006. The decline was particularly severe in the non-sector funded programs of the general government, public works and municipal operations.

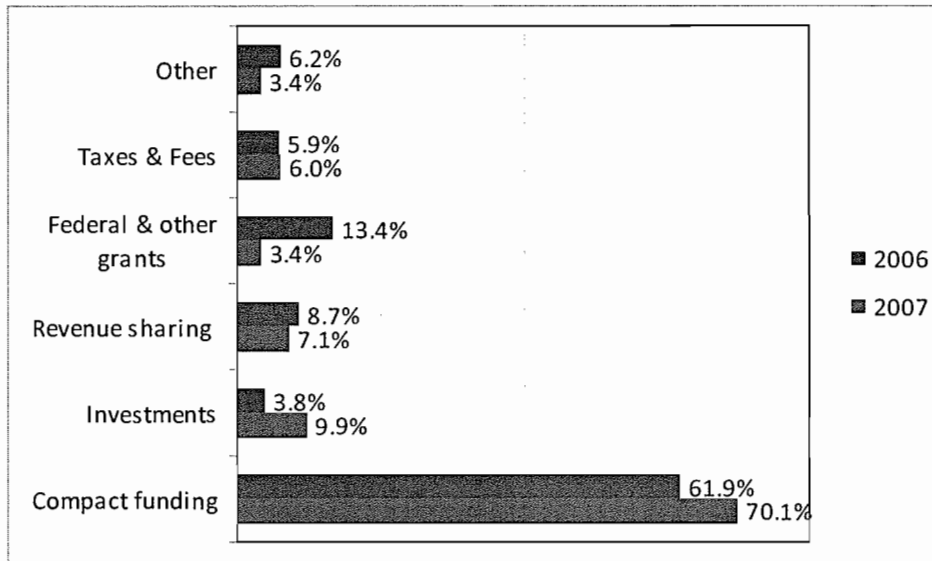
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FEDERATED STATES OF MICRONESIA**

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September 30, 2007

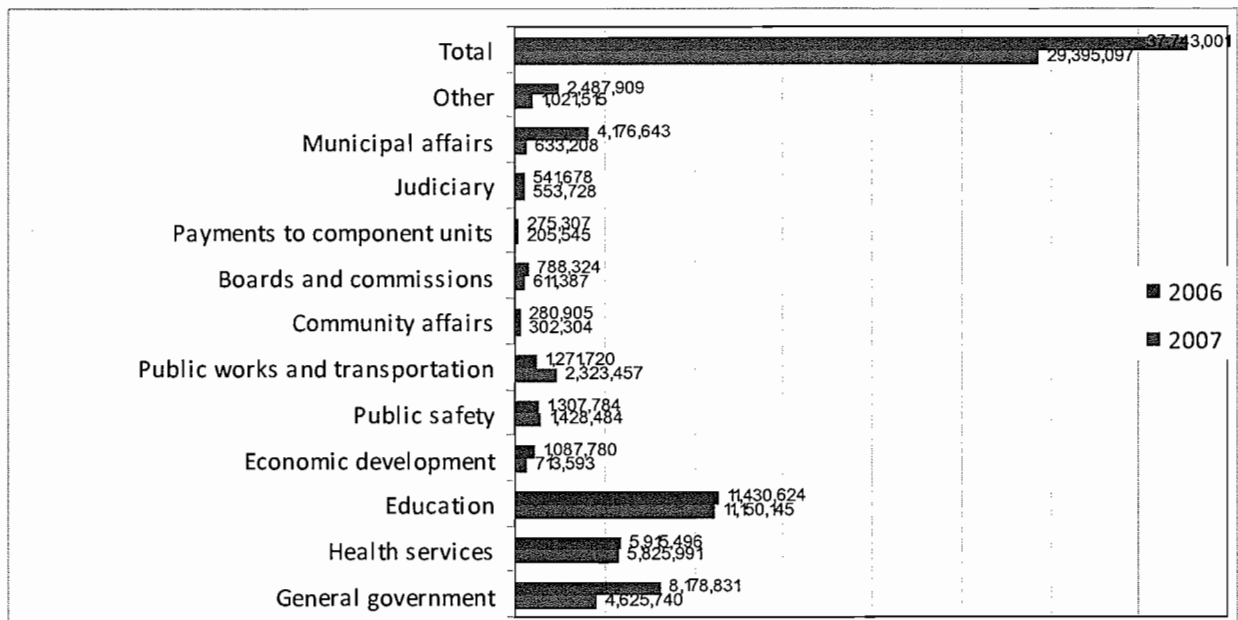
Of particular significance in fiscal year 2007 was the State's efforts to analyze its financial position and take measures to more accurately record its accounts receivables and liabilities from prior years. Towards this end the State collected on old accounts receivables and wrote off prior year medical referral and other liabilities. These special items accounted for most of the \$5.27 million increase in net assets in fiscal year 2007.

The following graphs show the major components of revenues and expenditures of governmental funds for the year ended September 30, 2007.

CHUUK REVENUE SOURCES



CHUUK STATE COST OF GOVERNMENTAL SERVICES



**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2007

FINANCIAL ANALYSIS OF CHUUK STATE'S FUNDS

As noted earlier, Chuuk State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. As of the end of fiscal year 2007, Chuuk State's governmental funds reported a combined fund balance of \$4.47 million which represents a \$6.1 million increase (or 376%) from the \$1.62 million deficit fund balance recorded at the end of fiscal 2006. This increase is attributable to the reduction of the unreserved general fund deficit. Of this total combined fund balance, \$27.24 million is reversed to indicate that it is not available for new spending because it has already been committed: 1) to generate income for future operations (\$8.5 million); 2) to liquidate contracts and purchase orders of the prior period (\$4.76 million) or; 3) to fund specific general fund-related activities (\$13.98 million). These reserved fund balances are off-set by a combined deficit of \$22.86 million, a decrease of \$4.78 million (or 17%) from fiscal year 2006.

GENERAL FUND BUDGETARY HIGHLIGHTS

During the course of the fiscal year, management and elected officials of Chuuk State revised the General Fund budget. The revised budget included an increase in overall revenue projections of \$0.69 million with a corresponding increase in budgetary appropriations. The actual revenues collected fell short of the projected revenues by \$0.1 million, and the actual expenditures exceeded the budgetary appropriations by \$1.20 million, resulting in a budgetary deficit of \$1.34 million. Offsetting the general fund deficiency of revenues under expenditures were other funding sources of loans and other transfers to the general fund of \$4.13 million and special adjustments to prior year receivables and liabilities of \$4.28 million. When combined with the operating deficit these positive offsets reduced the general fund deficit by \$6.67 million.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

Chuuk State's investment in capital assets for the primary government as of September 30, 2007, amounted to \$89.24 million, net of accumulated depreciation of \$ 21.85 million, leaving a net book value of \$67.39 million. This represents a net increase of \$0.54 million (or 0.81%) from fiscal year 2006. In fiscal year 2007 the State adjusted its fixed asset records to retroactively include certain capital assets in the amount of \$1.99 million heretofore not included; primarily vehicles and boats. Most of these assets were fully depreciated and had no significant effect on net book values of the State's capital assets. No other significant fixed asset additions or retirements occurred in fiscal year 2007, but incremental additions were made to land, buildings, and vehicles. The table below summarizes Chuuk State's capital assets:

	<u>2007</u>	<u>2006</u> <u>Restated</u>
Land	\$ 24,392,433	\$ 24,129,857
Airport Facilities	24,014,767	24,729,925
Buildings	6,159,482	4,530,572
Seaport Facilities	5,205,514	5,490,634
Vehicles / other equipment	1,226,878	1,165,802
Infrastructure	<u>6,392,162</u>	<u>6,802,442</u>
	\$ <u>67,391,235</u>	\$ <u>66,849,232</u>

Additional information on Chuuk State's capital assets can be found in Note 5 to the accompanying financial statements.

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Long –Term Debt

The following schedule shows Chuuk State's long-term debt for fiscal year 2007 and comparable amounts for fiscal year 2006.

	<u>2007</u>	<u>2006</u>
ADB Early Retirement Loan	\$ 5,300,000	\$ 5,300,000
ADB Private Sector Reform Program Loan (1873)	650,000	458,176
ADB Private Sector Reform Program Loan (1874)	523,083	183,363
ADB Basic Social Services Program Loan (1816)	<u>241,957</u>	<u>-</u>
	\$ <u>6,715,040</u>	\$ <u>5,941,539</u>

Long-term debt increased by \$0.77 million (or 13%) in fiscal year 2007 as the result of new participation in the ADB Basic Social Services Program Loan and increases in the liability for the ADB Private Sector Reform Program Loans.

Additional information on Chuuk State's long-term debt obligations can be found in Note 8 to the accompanying financial statements.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET

Late in fiscal year 2007, Chuuk State management entered into a memorandum of understanding (MOU) with the FSM National Government to adopt fiscal reform measures to address its deteriorating financial position. Significant progress had been made by May 31, 2008:

- A \$3.5 million grant from the People's Republic of China was used to pay off delinquent payroll allotment liabilities, notably to the FSM Social Security administration, FSM Revenue and Tax department, and the local lending institutions.
- Chuuk State adopted reduction in force (RIF) legislation that had resulted in the elimination of 389 positions with potential annual savings of \$2.56 million.
- General Fund operating results for the first eight (8) months of fiscal year 2008 indicated the State was maintaining expenditures within revenue collections, even though the latter were below budget.

The sustainability of these reforms for the remainder of fiscal year 2008 and beyond remains a primary goal of the State's financial restructuring efforts. Other challenges are faster implementation of the sector infrastructure grants, better utilization of existing sector operating grants, and greater local revenue collections. Even after the positive special item adjustments to receivables and payables taken in fiscal year 2007, the remaining general fund liabilities (\$23.8 million) and fund balance deficit (\$12.12 million) are unacceptably large and need to be further reduced. This indicates that financial reform will be a multi-year task and must engage the entire Chuuk State and FSM National Government leadership in order to be successful.

CONTACTING CHUUK STATE'S FINANCIAL MANAGEMENT

The financial report is designed to provide our citizens, taxpayers, customers, and investments and creditors, a general overview of Chuuk State's finances to demonstrate its accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Director, Office of Administrative Services, P.O. Box 189, Weno, Chuuk FM 96942.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Statement of Net Assets
September 30, 2007

	Primary Government	Component Units
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 14,125	\$ 155,554
Time certificates of deposit	-	876,283
Equity interest in internal investment pool	2,360,561	-
Receivables, net of allowance for uncollectibles	1,818,995	1,338,436
Inventories	-	195,861
Prepayments	454,894	188,484
Restricted assets:		
Cash and cash equivalents	2,726,679	-
Total current assets	7,375,254	2,754,618
Noncurrent assets:		
Restricted assets:		
Investments	13,801,916	-
Investments	2,473,500	-
Capital assets, net of accumulated depreciation	67,391,235	4,115,252
Total noncurrent assets	83,666,651	4,115,252
Total assets	\$ 91,041,905	\$ 6,869,870
<u>LIABILITIES</u>		
Current liabilities:		
Bank overdraft	\$ 127,814	\$ 54,555
Current portion of long-term debt	106,000	879,401
Notes payable	1,554,332	-
Accounts payable	7,434,213	518,349
Land acquisition payable	9,039,705	-
Medical claims payable	673,726	-
Compensated absences payable	449,797	-
Other liabilities and accruals	350,829	1,677,011
Deferred revenue	-	230,695
Total current liabilities	19,736,416	3,360,011
Noncurrent liabilities:		
Noncurrent portion of long-term obligations	6,609,040	3,318,811
Compensated absences payable, net of current portion	1,152,011	-
Total noncurrent liabilities	7,761,051	3,318,811
Total liabilities	27,497,467	6,678,822
<u>NET ASSETS</u>		
Invested in capital assets, net of related debt	67,391,235	(82,960)
Restricted for:		
Nonexpendable:		
Future operations	8,499,574	885,469
Expendable:		
Compact related	6,938,985	-
Debt service	5,302,342	-
Other purposes	1,191,617	-
Unrestricted	(25,779,315)	(611,461)
Total net assets	63,544,438	191,048
Total liabilities and net assets	\$ 91,041,905	\$ 6,869,870

See accompanying notes to basic financial statements.

STATE OF CHUUK
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Statement of Activities
Year Ended September 30, 2007

Functions/Programs	Program Revenues				Net (Expenses) Revenues and Changes in Net Assets	
	Expenses	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Primary Government	Component Units
Primary government:						
Governmental activities:						
General government	\$ 4,625,740	\$ 255,647	\$ 4,277,052	\$ -	\$ (93,041)	\$ -
Health services	5,825,991	-	5,891,669	-	65,678	-
Education	11,150,145	-	11,169,955	-	19,810	-
Economic development	713,593	-	467,781	-	(245,812)	-
Public safety	1,428,484	-	811,391	-	(617,093)	-
Public works and transportation	2,323,457	640,580	-	-	(1,682,877)	-
Community affairs	302,304	-	-	-	(302,304)	-
Boards and commissions	611,387	-	338,463	-	(272,924)	-
Judiciary	553,728	-	-	-	(553,728)	-
Payments to component units	205,545	-	132,358	-	(73,187)	-
Municipal affairs	633,208	-	-	-	(633,208)	-
Future operations	-	-	-	1,267,090	1,267,090	-
Other	1,021,515	-	131,219	-	(890,296)	-
Total primary government	<u>\$ 29,395,097</u>	<u>\$ 896,227</u>	<u>\$ 23,219,888</u>	<u>\$ 1,267,090</u>	<u>(4,011,892)</u>	<u>-</u>
Component units:						
Chuuk State Health Care Plan	\$ 1,022,253	\$ 872,263	\$ -	\$ -	-	(149,990)
Chuuk Public Utility Corporation	4,094,937	2,151,578	398,640	-	-	(1,544,719)
Chuuk State Housing Corporation	611,752	54,968	49,000	-	-	(507,784)
Total component units	<u>\$ 5,728,942</u>	<u>\$ 3,078,809</u>	<u>\$ 447,640</u>	<u>\$ -</u>	<u>-</u>	<u>(2,202,493)</u>
General revenues:						
Taxes:						
Revenue sharing					2,254,793	-
Excise taxes					1,609,785	-
Unrestricted investment earnings					1,851,965	-
Other					483,938	9,225
Total general revenues					<u>6,200,481</u>	<u>9,225</u>
Special items:						
Recovery on previously written off receivables					1,049,602	-
Write down of investments					(1,202,005)	-
Write off of liabilities					3,233,483	-
Total special items					<u>3,081,080</u>	<u>-</u>
Change in net assets					5,269,669	(2,193,268)
Net assets at the beginning of the year, as restated					58,274,769	2,384,316
Net assets at the end of the year					<u>\$ 63,544,438</u>	<u>\$ 191,048</u>

See accompanying notes to basic financial statements.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Balance Sheet
Governmental Funds
September 30, 2007

	General	Special Revenue Compact Sector Grants	Capital Projects Compact Capital Projects	Permanent Compact Trust	Other Governmental Funds	Total
ASSETS						
Cash and cash equivalents	\$ 14,125	\$ -	\$ -	\$ -	\$ -	\$ 14,125
Equity interest in internal investment pool	2,360,561	-	-	-	-	2,360,561
Investments	-	-	2,473,500	-	-	2,473,500
Receivables, net:						
FSM National Government	784,456	77,478	37,272	-	919,789	1,818,995
Prepayments	-	454,894	-	-	-	454,894
Due from other funds	496,422	4,634,931	-	-	1,176,743	6,308,096
Restricted assets:						
Cash and cash equivalents	2,726,679	-	-	-	-	2,726,679
Investments	5,302,342	-	-	8,499,574	-	13,801,916
Total assets	<u>\$ 11,684,585</u>	<u>\$ 5,167,303</u>	<u>\$ 2,510,772</u>	<u>\$ 8,499,574</u>	<u>\$ 2,096,532</u>	<u>\$ 29,958,766</u>
LIABILITIES AND FUND BALANCES						
Liabilities:						
Bank overdraft	\$ 127,814	\$ -	\$ -	\$ -	\$ -	\$ 127,814
Accounts payable	6,357,015	625,941	-	-	451,257	7,434,213
Medical claims payable	673,726	-	-	-	-	673,726
Accrued liabilities	237,680	113,149	-	-	-	350,829
Land acquisition payable	9,039,705	-	-	-	-	9,039,705
Note payable	1,554,332	-	-	-	-	1,554,332
Due to other funds	5,811,674	-	-	-	496,422	6,308,096
Total liabilities	<u>23,801,946</u>	<u>739,090</u>	<u>-</u>	<u>-</u>	<u>947,679</u>	<u>25,488,715</u>
Fund balances (deficits):						
Reserved for:						
Related assets	2,726,679	-	2,510,772	8,499,574	1,176,743	14,913,768
Encumbrances	446,952	4,200,315	-	-	113,314	4,760,581
Continuing appropriations	2,266,198	-	-	-	-	2,266,198
Debt service	5,302,342	-	-	-	-	5,302,342
Unreserved:						
General fund	(22,859,532)	-	-	-	-	(22,859,532)
Special revenue funds	-	227,898	-	-	(141,204)	86,694
Total fund balances (deficits)	<u>(12,117,361)</u>	<u>4,428,213</u>	<u>2,510,772</u>	<u>8,499,574</u>	<u>1,148,853</u>	<u>4,470,051</u>
Total liabilities and fund balances	<u>\$ 11,684,585</u>	<u>\$ 5,167,303</u>	<u>\$ 2,510,772</u>	<u>\$ 8,499,574</u>	<u>\$ 2,096,532</u>	
Amounts reported for governmental activities in the statement of net assets are different because:						
Capital assets used in governmental activities are not financial resources and, therefore, reported in the funds						
						67,391,235
Long-term liabilities, including loans payable, are not due and payable in the current period and, therefore, are not reported in the funds. The liabilities include:						
					(6,715,040)	
					(1,601,808)	
						(8,316,848)
Net assets of governmental activities						<u>\$ 63,544,438</u>

See accompanying notes to basic financial statements.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures, and Changes in Fund Balances (Deficits)
Governmental Funds
Year Ended September 30, 2007

	General	Special Revenue Compact Sector Grants	Capital Projects Compact Capital Projects	Permanent Compact Trust	Other Governmental Funds	Total
Revenues:						
Compact funding	\$ -	\$ 22,134,194	\$ -	\$ -	\$ -	\$ 22,134,194
Net increase in the fair value of investments	1,851,965	-	-	1,267,090	-	3,119,055
Federal contributions and other grants	-	-	-	-	1,085,694	1,085,694
Revenue sharing	2,254,793	-	-	-	-	2,254,793
Excise taxes	1,609,785	-	-	-	-	1,609,785
Fees and charges	205,451	-	-	-	94,360	299,811
Departmental charges	596,416	-	-	-	-	596,416
Other	483,938	-	-	-	-	483,938
Total revenues	<u>7,002,348</u>	<u>22,134,194</u>	<u>-</u>	<u>1,267,090</u>	<u>1,180,054</u>	<u>31,583,686</u>
Expenditures:						
Current:						
General government	4,293,989	988,408	-	-	378,433	5,660,830
Health services	-	5,641,444	-	-	250,225	5,891,669
Education	603	10,712,919	-	-	457,036	11,170,558
Economic development	245,812	467,781	-	-	-	713,593
Public safety	637,967	811,391	-	-	44,164	1,493,522
Public works and transportation	1,118,264	-	-	-	-	1,118,264
Community affairs	277,789	-	-	-	-	277,789
Boards and commissions	272,924	338,463	-	-	-	611,387
Payments to component units	73,187	132,358	-	-	-	205,545
Judiciary	553,728	-	-	-	-	553,728
Municipal affairs	633,208	-	-	-	-	633,208
Other	890,296	131,219	-	-	-	1,021,515
Total expenditures	<u>8,997,767</u>	<u>19,223,983</u>	<u>-</u>	<u>-</u>	<u>1,129,858</u>	<u>29,351,608</u>
Excess (deficiency) of revenues over (under) expenditures	<u>(1,995,419)</u>	<u>2,910,211</u>	<u>-</u>	<u>1,267,090</u>	<u>50,196</u>	<u>2,232,078</u>
Other financing sources (uses):						
Loan proceeds	773,501	-	-	-	-	773,501
Transfers in from other funds	3,639,440	-	-	-	284,872	3,924,312
Transfers out to other funds	(284,872)	-	(1,164,712)	-	(2,474,728)	(3,924,312)
Total other financing sources (uses), net	<u>4,128,069</u>	<u>-</u>	<u>(1,164,712)</u>	<u>-</u>	<u>(2,189,856)</u>	<u>773,501</u>
Special items:						
Recovery on previously written off receivables	1,049,602	-	-	-	-	1,049,602
Write down of investments	-	-	(1,202,005)	-	-	(1,202,005)
Write off of liabilities	3,233,483	-	-	-	-	3,233,483
Total special items	<u>4,283,085</u>	<u>-</u>	<u>(1,202,005)</u>	<u>-</u>	<u>-</u>	<u>3,081,080</u>
Net change in fund balances (deficit)	6,415,735	2,910,211	(2,366,717)	1,267,090	(2,139,660)	6,086,659
Fund balances (deficits) at the beginning of the year	<u>(18,533,096)</u>	<u>1,518,002</u>	<u>4,877,489</u>	<u>7,232,484</u>	<u>3,288,513</u>	<u>(1,616,608)</u>
Fund balances (deficits) at the end of the year	<u>\$ (12,117,361)</u>	<u>\$ 4,428,213</u>	<u>\$ 2,510,772</u>	<u>\$ 8,499,574</u>	<u>\$ 1,148,853</u>	<u>\$ 4,470,051</u>

See accompanying notes to basic financial statements.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Reconciliation of the Statement of Revenues, Expenditures,
and Changes in Fund Balances of Governmental Funds
to the Statement of Activities
Year Ended September 30, 2007

Amounts reported for governmental activities in the statement of activities on page 11 are different because:

Net change in fund balances (deficit) - total governmental funds from page 13	\$ 6,086,659
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the current period, including increases to construction in progress	542,003
Some expenses reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds. For the current year, these activities consist of: Compensated absences	(585,492)
The issuance of long-term debt (e.g. bonds, leases) provides current financial resources to governmental funds, while the repayment of principal of long-term debt consumes the current financial resources of governmental funds. Neither transaction has any effect on net assets. This amount is the net effect of these differences in the treatment of long - term debt and related items	<u>(773,501)</u>
Change in net assets of governmental activities as presented on page 11	\$ <u>5,269,669</u>

See accompanying notes to basic financial statements.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

DISCRETELY PRESENTED COMPONENT UNITS
Combining Statement of Net Assets
September 30, 2007

<u>ASSETS</u>	Chuuk State Health Care Plan	Chuuk Public Utility Corporation	Chuuk State Housing Corporation	Total
Current assets:				
Cash and cash equivalents	\$ 73,116	\$ 1,314	\$ 81,124	\$ 155,554
Time certificates of deposit	700,000	-	176,283	876,283
Receivables, net:				
General	287,056	283,627	152,232	722,915
Loans	-	-	615,521	615,521
Inventories	-	195,861	-	195,861
Prepayments	446	188,038	-	188,484
	<u>1,060,618</u>	<u>668,840</u>	<u>1,025,160</u>	<u>2,754,618</u>
Total current assets				
Noncurrent assets:				
Capital assets, net of accumulated depreciation	25,743	3,971,652	117,857	4,115,252
	<u>25,743</u>	<u>3,971,652</u>	<u>117,857</u>	<u>4,115,252</u>
Total assets	\$ <u>1,086,361</u>	\$ <u>4,640,492</u>	\$ <u>1,143,017</u>	\$ <u>6,869,870</u>
<u>LIABILITIES AND NET ASSETS</u>				
Current liabilities:				
Bank overdraft	\$ -	\$ 54,555	\$ -	\$ 54,555
Current portion of long-term debt	-	879,401	-	879,401
Accounts payable	175,149	342,782	418	518,349
Accrued liabilities	-	1,677,011	-	1,677,011
Deferred income	-	230,695	-	230,695
	<u>175,149</u>	<u>3,184,444</u>	<u>418</u>	<u>3,360,011</u>
Total current liabilities				
Noncurrent liabilities:				
Noncurrent portion of long-term debt	-	3,318,811	-	3,318,811
	<u>-</u>	<u>3,318,811</u>	<u>-</u>	<u>3,318,811</u>
Total noncurrent liabilities				
Total liabilities	175,149	6,503,255	418	6,678,822
	<u>175,149</u>	<u>6,503,255</u>	<u>418</u>	<u>6,678,822</u>
Net assets:				
Invested in capital assets, net of related debt	25,743	(226,560)	117,857	(82,960)
Restricted	885,469	-	-	885,469
Unrestricted	-	(1,636,203)	1,024,742	(611,461)
	<u>911,212</u>	<u>(1,862,763)</u>	<u>1,142,599</u>	<u>191,048</u>
Total net assets				
Total liabilities and net assets	\$ <u>1,086,361</u>	\$ <u>4,640,492</u>	\$ <u>1,143,017</u>	\$ <u>6,869,870</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

DISCRETELY PRESENTED COMPONENT UNITS
Combining Statement of Revenues, Expenses, and Changes in Net Assets
Year Ended September 30, 2007

	Chuuk State Health Care Plan	Chuuk Public Utility Corporation	Chuuk State Housing Corporation	Total
Operating revenues:				
Charges for services	\$ 834,562	\$ 2,131,785	\$ 54,968	\$ 3,021,315
Other	37,701	19,793	-	57,494
Total operating revenues	<u>872,263</u>	<u>2,151,578</u>	<u>54,968</u>	<u>3,078,809</u>
Operating expenses:				
Cost of services	779,597	2,068,993	-	2,848,590
Depreciation	5,786	1,025,563	18,384	1,049,733
Administration and general	236,870	764,586	593,368	1,594,824
Total operating expenses	<u>1,022,253</u>	<u>3,859,142</u>	<u>611,752</u>	<u>5,493,147</u>
Operating loss	<u>(149,990)</u>	<u>(1,707,564)</u>	<u>(556,784)</u>	<u>(2,414,338)</u>
Nonoperating revenues (expenses):				
Contributions from primary government	-	398,640	49,000	447,640
Other income	-	9,225	-	9,225
Interest expense	-	(235,795)	-	(235,795)
Total nonoperating revenues (expenses), net	<u>-</u>	<u>172,070</u>	<u>49,000</u>	<u>221,070</u>
Net loss	<u>(149,990)</u>	<u>(1,535,494)</u>	<u>(507,784)</u>	<u>(2,193,268)</u>
Net assets at the beginning of the year	1,061,202	(327,269)	1,650,383	2,384,316
Net assets at the end of the year	<u>\$ 911,212</u>	<u>\$ (1,862,763)</u>	<u>\$ 1,142,599</u>	<u>\$ 191,048</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies

The accompanying financial statements of the State of Chuuk (the State) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Governmental Accounting Standards Board (GASB) is the recognized standard-setting body for establishing governmental accounting and financial reporting principles. The more significant of the State's accounting policies are described below.

A. Reporting Entity

The State is one of the four states that make up the Federated States of Micronesia (FSM), along with the states of Kosrae, Pohnpei and Yap. The State is a constitutional government comprised of three branches: the Legislative Branch, consisting of the Senate (10 members elected for a term of four years by qualified voters of their respective election districts with the President of the Senate as its highest officer) and the House of Representatives (28 members elected for a term of two years by qualified voters of their respective election districts with the Speaker as its highest officer); the Executive Branch, headed by the Governor and Lt. Governor who are primarily responsible for executing the laws and administering state government services; and the Judiciary Branch made up of the State Supreme Court, which consists of a Chief Justice and four Associate Justices, such inferior courts that may be created by law, and the municipal courts.

For financial reporting purposes, the State has included all funds, organizations, agencies, boards, commissions and institutions. The State has also considered all potential component units for which it is financially accountable as well as other entities for which the nature and significance of their relationship with the State are such that exclusion would cause the State's financial statements to be misleading or incomplete. The criteria to be considered in determining financial accountability include whether the State, as the primary government, has appointed a voting majority of an organization's governing body and either has the ability to impose its will on that organization or there is potential for the organization to provide specific financial benefits to or impose specific financial burdens on the State. Financial accountability also exists if an organization is determined to be fiscally dependent on the primary government, although the primary government does not appoint a voting majority of the organization's governing board.

Each blended and discretely presented component unit of the State has a September 30 year-end.

Once financial accountability has been determined for a potential component unit, that component unit is either blended into the primary government or discretely presented from the primary government. Potential component units that do not meet the financial accountability criteria, but where a voting majority of the governing board is appointed by the State, are deemed to be related organizations. The nature and relationship of the State's component units and related organizations are disclosed in the following section.

Blended component units are entities that are legally separate from the State, but are so related to the State that they are, in substance, the same as the State or entities providing services entirely or almost entirely to the State. The net assets and results of operations of the following legally separate entities are presented as part of the State's operations:

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

A. Reporting Entity, Continued

i. Discretely Presented Component Units

Chuuk State Housing Authority (CSHA): CSHA was created by TSL No. 3-30 and is responsible for monitoring the U.S. Department of Housing and Urban Development Section 8 and CDBG housing renovation loan programs. Additionally, CSHA monitors the GLF loan fund of the State which provides low cost housing loans to the general public. CSHA is governed by a five-member Board of Directors appointed by the Governor subject to the advice and consent of the Legislature.

Chuuk Public Utility Corporation (CPUC): CPUC was created by CSL No. 3-97-05 and is responsible for providing electrical services to the public through the operation and the maintenance of the State's electrical power system. CPUC is governed by a five-member Board of Directors appointed by the Governor subject to the advice and consent of the Legislature.

Chuuk State Health Care Plan (CSHCP): CSHCP was established under CSL No. 2-94-06 for the purpose of establishing a financial system to provide universal coverage of an essential level of health care for all eligible enrollees and to create a means for collection of health care premiums for additional coverage.

ii. Omitted Governmental Funds

The following funds are considered to be nonmajor governmental funds of the State but are not included in the accompanying basic financial statements due to absence of account balances and financial activities. The omission of these funds is not considered material to either the nonmajor other governmental funds or the governmental activities reporting units:

Development Authorities - The Northern Namoneas Economic Development Authority, the Southern Namoneas Development Authority, the Inner Faichuk Social and Economic Development Authority, the Outer Faichuk Development Authority, the Faichuk Transportation and Economic Development Authority, the Hall Islands Economic Development Authority, the Pattiw Islands Development Authority, and the Witto Resources and Development Authority. These development authorities were established to identify the development needs and promote economic development within the various municipalities, in coordination and cooperation with the State and the FSM National Government.

Chuuk Visitors Bureau (CVB) Fund - This fund was created by Chuuk State Law (CSL) No. 6-39 and is responsible for improving and developing the State's tourism industry. CVB is governed by a nine-member Board of Directors, five of whom are appointed by the Governor subject to the advice and consent of the Legislature and the remaining four of whom are appointed by the President and Speaker of the Legislature.

Representation Fund: This fund was established under CSL No. 3-95-09 for the use of members of the State Legislature to provide assistance to constituents' legitimate emergencies, educational, and civic needs not met by other appropriations.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

A. Reporting Entity, Continued

ii. Omitted Governmental Funds, Continued

Chuuk State Legislature Entertainment Fund: This fund was established under Title 21, Section 751 of the Truk District Code (TDC), for the use by the Legislature to entertain guests or other distinguished persons living in or visiting the State.

Legislature Emergency Fund: This fund was established under Truk District Law (TDL) No. 21-1 to defray salaries of personnel of the Legislature and office expenses of the Legislature during a period of time between the close of a fiscal year and the signing into law of an appropriation for salaries and expenses of the Legislature office and staff for the next succeeding fiscal year.

Chuuk State Travel Fund: This fund was established under TDL No. 22-27 to enable members of the Legislature, Magistrates of municipalities, members of municipal councils, and other leaders in the State to travel outside of the State for the purposes of attending functions prescribed by the enabling legislation.

Association of Pacific Island Legislatures Fund: This fund was established under TDL No. 24-9 for the purpose of funding donations or membership fees to the Association of Pacific Island Legislatures.

Municipal Operations and Projects Fund: This fund was established under TDL No. 25-23 for the purpose of funding operational expenses of municipalities in the State, and providing funds for municipal projects and programs.

Fire Disaster Relief Fund: This fund was established under 7 TDC Section 51 for the purpose of providing relief to persons suffering loss or damage to homes or furnishings as a result of accidental fires.

Economic Development Loan Fund: This fund was established under 13 TDC Section 1 for the purpose of providing loans to any private citizen of the State or any Chuukese corporation or cooperative, wishing to begin, operate, or improve business operations in the State.

Chuuk Farmers', Fishermen's, and Handicrafts Fair Fund: This fund was established under TDL No. 23-28 for the purpose of paying for supplies, materials, prizes and other expenses incurred in the preparation for and holding of the Chuuk Farmers', Fishermen and Handicrafts Fair.

Chuuk State Local Farmers Revolving Fund: This fund was established under TDL No. 21-25 for the purpose of purchasing agricultural supplies, livestock, feeds, assorted tools and other materials, for the use of local farmers in the State.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

A. Reporting Entity, Continued

ii. Omitted Governmental Funds, Continued

Chuuk State Hospital Transportation Fund: This fund was established under TDL No. 22-32 for the purpose of transporting patients of the State, who require periodic medical treatment and care, to the Chuuk State Hospital, to provide return transportation to their homes after treatment at the Chuuk State Hospital, and to provide for each of these patients a one dollar and fifty cents (\$1.50) noon meal during such travel, treatment and care.

iii. Omitted Component Units

The following component units have been omitted from the basic financial statements due to the lack of available financial information. The omission of these component units is not considered material to the aggregate discretely presented component unit reporting unit:

Chuuk State Coconut Authority (CSCA): CSCA was created by TSL No. 1-1-12 and is responsible for the manufacturing, processing, buying, collecting, marketing, selling, exporting and dealing with, in general, all products derived from the coconut tree. CSCA is governed by a five-member Board of Directors appointed by the Governor subject to the advice and consent of the Legislature.

Chuuk Public Fisheries Corporation (CPFC): CPFC was created by CSL No. 5-99-22 and is responsible for promoting the development of pelagic fisheries and related industries for the economic benefit of the people of the State. CPFC is governed by a five-member Board of Directors, which comprises of the Director of the Department of Marine Resources, the Director of the Department of Commerce and Industry, one member who is appointed by the Governor representing the Chamber of Commerce, and two members who are appointed by the President and the Speaker.

B. Government-Wide Financial Statements

The Statement of Net Assets and the Statement of Activities report financial information on all of the non-fiduciary activities of the primary government and its component units. For the most part, the effect of interfund activity has been eliminated from these statements except for other charges between the primary government and the discretely presented component units. Elimination of these charges would distort the direct costs and program revenues reported for the various functions concerned.

Primary government activities are defined as either governmental or business-type activities. Governmental activities, which normally are supported by taxes, intergovernmental revenues and other non-exchange revenues, are reported separately from business-type activities, which rely to a significant extent on fees charged to external parties for goods or services. As such, business-type activities account for operations similarly to a for-profit business. Likewise, the primary government is reported separately from certain legally separate component units for which the primary government is financially accountable. Discretely presented component unit activities are presented with their business-type focus.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

B. Government-Wide Financial Statements, Continued

The Statement of Net Assets presents all of the reporting entity's non-fiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- Invested in capital assets, net of related debt consists of capital assets, net of accumulated depreciation and reduced by outstanding balances for bonds, notes and other debt that are attributed to the acquisition, construction or improvement of those assets.
- Restricted net assets - nonexpendable consists of permanent funds in which donors or other outside sources have stipulated that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may either be expended or added to the principal.
- Restricted net assets - expendable consists of resources in which the State is legally or contractually obligated to spend resources in accordance with restrictions either externally imposed by creditors, grantors, contributors, and the like, or imposed by law.
- Unrestricted net assets consist of net assets, which do not meet the definition of the two preceding categories. Unrestricted net assets often are designated, (for example, internally restricted), to indicate that management does not consider them to be available for general operations.

The government-wide Statement of Net Assets reports \$21,932,518 of restricted net assets, of which \$1,176,743 is restricted by enabling legislation.

The Statement of Activities demonstrates the degree to which the direct expenses of given functions or segments are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function or segment. Program revenues include charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items not meeting the definition of program revenues are, instead, reported as general revenue.

C. Fund Financial Statements

The fund financial statements present a balance sheet and a statement of revenues, expenditures, and changes in fund balances for its major and aggregated non-major funds.

Major individual governmental funds are reported as separate columns in the fund financial statements pursuant to GASB reporting standards, with nonmajor governmental funds being combined into a single column.

The State reports its financial position and results of operations in funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

D. Measurement Focus and Basis of Accounting

The government-wide financial statements are reported using the economic resources management focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Governmental fund financial statements account for the general governmental activities of the State and are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as they become susceptible to accrual; generally when they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the State considers revenues to be available if they are collected within sixty days of the end of the current fiscal period.

Significant revenues susceptible to accrual include income and gross revenue taxes, federal grants, federal reimbursements and other reimbursements for use of materials and services. Miscellaneous revenues from other financing sources are recognized when received in cash because they are generally not measurable until actually received. Investment earnings are recorded as earned, since they are both measurable and available. Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Expenditures generally are recorded in the period in which the related fund liability is incurred, as under accrual accounting. However, debt service expenditures, as well as expenditures related to compensated absences and claims and judgments, are recorded only when payment is due.

Amounts reported as program revenue include 1) charges to customers or applicants for goods, services, or privileges provided, 2) operating grants and contributions, and 3) capital grants and contributions. Internally dedicated resources are reported as general revenues rather than as program revenues. General revenue is derived from taxation, investment income and other fees that are not allocated to specific programs.

Discretely presented component units distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. All other revenues are reported as nonoperating. Operating expenses includes the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

D. Measurement Focus and Basis of Accounting, Continued

The State reports the following governmental fund types:

i. General Fund

This fund is the primary operating fund of the State. It is used to account for all governmental transactions, except those required to be accounted for in another fund.

ii. Special Revenue Funds

These funds account for specific revenue sources that have been aggregated according to enabling legislation to support specific governmental activities.

iii. Capital Projects Funds

These funds account for the acquisition or construction of major State capital facilities financed primarily from loans and federal reimbursements.

iv. Permanent Fund

This fund accounts for resources that are legally restricted to the extent that only earnings, and not principal, may be used to support programs for the benefit of the government.

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - For State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - For State and Local Governments: Omnibus*, sets forth minimum criteria (percentage of the assets, liabilities, revenues or expenditures/expenses for either fund category or the governmental and enterprise combined) for the determination of major funds. Major individual governmental funds are reported as separate columns in the fund financial statements. The nonmajor funds are combined in a column in the fund financial statements and detailed in the combining statements. The State reports the following major funds:

Compact Sector Grants Fund, a Governmental Fund Type - Special Revenue Fund. This fund accounts for United States Congress appropriations under United States Public Law 99-239, as amended, Title II, Article I, Section 211(a) and approved by the FSM Congress to promote economic advancement and budgetary self-reliance. These appropriations are to be used for assistance in education, health care, the environment, public sector capacity building, and private sector development, or for other areas as mutually agreed, with priorities in the education and health care sectors.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

D. Measurement Focus and Basis of Accounting, Continued

Compact Capital Projects Fund, a Governmental Fund Type - Capital Projects Fund. This fund is used to account for financial transactions related to Compact Capital Account funds as provided under Section 211(a) of the Compact of Free Association.

Compact Trust Fund, a Governmental Fund Type - Permanent Fund. This fund accounts for United States Congress appropriations under United States Public Law 99-239, as amended, Title II, Article I, Section 215 and approved by the FSM Congress to provide for an additional source of revenue for the government budget that will be needed to substitute for the absence of Compact of Free Association funding. Earnings from funds invested would not be available for distribution until October 2023.

E. Reporting Standards

As allowed by GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, the State's discretely presented component units follow all GASB pronouncements and those Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement.

F. Cash and Cash Equivalents and Time Certificates of Deposit

Cash and cash equivalents include cash held in demand accounts as well as short-term investments in U.S. Treasury obligations with a maturity date within three months of the date acquired by the State. Deposits maintained in time certificates of deposit with original maturity dates greater than ninety days are separately classified on the statement of net assets/balance sheet.

G. Investments

Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

H. Receivables

In general, tax revenue is recognized on the government-wide statements, when assessed or levied and on the governmental fund financial statements to the extent that it is both measurable and available. Receivables are stated net of estimated allowances for uncollectible accounts. Reimbursements due to the State for expenditures on federally funded reimbursement and grant programs are reported as "receivables from federal agencies".

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

H. Receivables, Continued

Receivables of the primary government and discretely presented component units are primarily due from businesses and individuals residing in the State. The allowance for uncollectible accounts primarily represents estimated uncollectible amounts based on past collection experience and the aging of the accounts.

I. Prepaid Items

Certain payments made to vendors or persons for services reflect costs applicable to future accounting periods and are recorded as prepaid items in both government-wide and fund financial statements.

J. Interfund Receivables/Payables

During the course of its operations, the State records transactions between individual funds for goods provided or services rendered. Receivables and payables resulting from transactions between funds are classified as "due from other funds" or "due to other funds" on the governmental fund balance sheet.

These balances result from the time lag between the dates that 1) interfund goods and services are provided or reimbursable expenditures occur, 2) transactions are recorded in the accounting system, and 3) payments between funds are made, and are scheduled to be collected in the subsequent year.

K. Restricted Assets

Certain assets of the primary government are classified as restricted assets because their use is completely restricted through loan agreements or enabling legislation. Specifically, the State has collateralized Asian Development Bank loan proceeds and earnings for the Chuuk State Early Retirement Scheme with a cash account and investments recorded in the General Fund of \$2,726,679 and \$5,302,342, respectively. Furthermore, investments recorded in the Compact Trust Fund of \$8,499,574 are restricted in that they are not available to be used in current operations.

L. Capital Assets

Capital assets, which include property, plant, equipment and infrastructure assets (e.g. roads, bridges, docks, water and sewer lines, water catchments, and other similar items), are reported in the governmental activity column of the government-wide financial statements. Such assets, whether purchased or constructed, are recorded at historical cost or estimated historical cost. Donated capital assets are recorded at estimated fair market value at the date of donation.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

L. Capital Assets, Continued

The State currently holds no title to land. Machinery and equipment, other than vehicles and boats, are capitalized when the cost of individual items exceed \$50,000. Vehicles and boats, along with significant repair and maintenance qualifying as a betterment of such, are capitalized regardless of cost and depreciated. Buildings and infrastructure projects, along with significant improvements or reconstruction qualifying as a betterment of such, are capitalized when the cost of individual items or projects exceed \$100,000. The costs of normal maintenance and repairs that do not add to the value of the capital asset or materially extend capital asset lives are not capitalized.

Capital assets of the primary government and the component units are depreciated using the straight-line method over their estimated useful lives, with a full year's depreciation charged in the year of acquisition and disposal, regardless of date. Estimated useful lives are as follows:

Buildings	40 - 50 years
Infrastructure	25 - 50 years
Facilities	3 - 40 years
Machinery and equipment	3 - 25 years
Furniture and fixtures	3 - 10 years

M. Interfund/Intrafund Transactions

As a general rule, the effect of interfund activity has been eliminated in the government-wide financial statements. Exceptions to this rule are: 1) activities between funds reported as governmental activities and funds reported as business-type activities and 2) activities between funds that are reported in different functional categories in either the governmental or business-type activities column. Elimination of these activities would distort the direct costs and program revenues for the functions concerned.

Transfers are used to 1) move revenues from the fund that enabling legislation or budget requires to collect them to the fund that enabling legislation or budget requires to expend them, 2) use unrestricted revenues collected in the General Fund to finance various programs accounted for in other funds in accordance with budgetary authorizations, and 3) record reductions in interfund loans for amounts that are not expected to be repaid.

During the year ended September 30, 2007, the State recorded a transfer in the amount of \$284,872 from the General Fund to the Other Governmental Funds as a reimbursement for the Federal FEMA matching requirement.

During the year ended September 30, 2007, the State recorded transfers in the amount of \$1,164,712 from the Capital Projects Fund and \$2,474,728 from the Other Governmental Funds to the General Fund to assist in the elimination of the operating fund deficit.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

N. Deferred Revenue

In the government-wide financial statements, deferred revenue is recognized when cash, receivables or other assets are recorded prior to being earned. In the governmental fund financial statements deferred revenue represents monies received or revenues accrued which have not been earned or do not meet the "available" criterion for revenue recognition under the modified accrual basis of accounting. The deferred revenue in the governmental fund types has primarily resulted as federal funds are received in advance of eligible expenditures.

O. Compensated Absences

It is the government's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. There is no liability for unpaid accumulated sick leave since the government does not have a policy to pay any amounts when employees separate from service with the government. All vacation pay is accrued when incurred in the government-wide financial statements. A liability for these amounts is reported in governmental funds only if they have matured, for example, as a result of employee resignations and retirements. Annual leave accumulates at the rate of one working day per bi-weekly pay period.

P. Fund Equity

In the fund financial statements, governmental funds report reservations of fund balance for amounts that are not available for appropriation or are legally restricted by outside parties for use for a specific purpose. The unreserved fund balances for the governmental funds represent the amount available for budgeting future operations. The reserve for related assets as of September 30, 2007, is represented by the following assets:

	<u>General</u>	<u>Capital Projects</u>	<u>Permanent</u>	<u>Other Governmental Funds</u>	<u>Totals</u>
		<u>Compact Capital Projects</u>	<u>Compact Trust</u>		
Investments	\$ -	\$ 2,473,500	\$ -	\$ -	\$ 2,473,500
Due from other funds	-	-	-	1,176,743	1,176,743
Receivables:					
FSM National Government	-	37,272	-	-	37,272
Restricted assets:					
Cash and cash equivalents	2,726,679	-	-	-	2,726,679
Investments	-	-	8,499,574	-	8,499,574
	<u>\$ 2,726,679</u>	<u>\$ 2,510,772</u>	<u>\$ 8,499,574</u>	<u>\$ 1,176,743</u>	<u>\$ 14,913,768</u>

The continuing appropriations within the General Fund includes \$59,204 set aside for future payments of the Chuuk State Legislature Building Complex and \$2,206,778 set aside for future payments for Chuuk Municipal capital projects.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

Q. Risk Financing

The State is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. It is the policy of the primary government not to purchase commercial insurance for the risks of loss to which it is exposed. Instead, the State management believes it is more economical to manage its risks internally. In the event of claim settlements and judgments, the State reports all of its risk management activities in its General Fund. Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported. No losses have occurred as a result of these risks in any of the past three fiscal years.

R. Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenditures and expenses during the reporting period. Actual results could differ from those estimates.

S. Restatement of Primary Government Net Assets

Net assets, as previously reported at September 30, 2006	\$ 56,278,873
Understatement of capital assets, net of accumulated depreciation, previously reported for governmental activities	<u>1,995,896</u>
Net assets, as restated at September 30, 2006	\$ <u>58,274,769</u>

T. New Accounting Standards

For fiscal year 2008, the State will be implementing the following pronouncements:

- GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which establishes uniform financial reporting for other postemployment benefit plans by state and local governments.
- GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*, which establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. The statement also includes a provision that stipulates the governments should not revalue assets that are transferred between financial reporting entity components.
- GASB issued Statement No. 50, *Pension Disclosures an amendment of GASB Statements No. 25 and 27*, which more closely aligns the financial reporting requirements for pensions with those for other postemployment benefits.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(1) Summary of Significant Accounting Policies, Continued

T. New Accounting Standards, Continued

Management does not believe that the implementation of these pronouncements will have a material effect on the 2008 financial statements of the State.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pension*, which establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the State.

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the State.

In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the State.

U. Total Columns

Total columns are presented primarily to facilitate financial analysis. The Management's Discussion and Analysis includes certain prior year summarized comparative information in total. Such information does not include sufficient detail to constitute a full comparative presentation. Accordingly, such information should be read in conjunction with the State's financial statements for the year ended September 30, 2006 from which summarized information was derived.

V. Reclassifications

Due to the provisions of GASB Statement No. 34 *Basic Financial Statements – and Management's Discussion and Analysis – For State and Local Governments*, major funds presented in a previous year may not be major funds presented in the current year. Concurrently, major funds presented in the current year may not be major funds presented in the previous year. Accordingly, the State has presented the Federal Grants Fund as a major fund in the prior year whereas such was presented as a nonmajor governmental fund in the current year.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(2) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The State pools cash resources of its various funds in order to facilitate the management of cash. Unless otherwise required by law, interest income received on pooled cash accrues to the General Fund. Cash and cash equivalents applicable to a particular fund are readily identifiable. The State has invested the majority of its excess Compact Funds in a pooled investment fund which is managed under the control of the Federated Development Authority, an entity comprised of the FSM National Government and its four component states. Investment income originating from the pool accrues to the General Fund.

The deposit and investment policies of the State are governed by State legislation. The Treasurer is responsible for ensuring that deposits of the General Fund are maintained in commercial checking or savings accounts of any financial institution whose assets are at least \$1 billion and whose deposits are subject to Federal Deposit Insurance Corporation (FDIC) insurance. The Governor is responsible for the investment of any monies of the State that are deemed not necessary for immediate use.

The Federated Development Authority has selected investment managers who are given authority to buy and sell securities. These investment managers may invest in stocks, bonds and cash equivalents, for which minimum standards of quality of such investments at the time of purchase shall be as follows:

- i. Cash equivalents - the investment manager may engage in all normally accepted short-term investment practices including, but not limited to U.S. Treasury and government agency securities, bankers acceptances, certificates of deposit, commercial paper and repurchase agreements using any of the foregoing as collateral. The following restrictions apply: (1) Commercial paper must be rated A-1/P-1 or higher by Standard & Poor Corporation and Moody's Investor Services; and (2) Certificates of deposit must be from FDIC insured banks or FSLIC insured savings and loan associations, both of which must have assets in excess of \$2 billion. Deposits in smaller institutions are acceptable, but must not exceed the amount of the insurance, unless collateralized by U.S. Treasury obligations at 102%.
- ii. Stocks - A "B" rating by a national rating service. Non-rated stocks, such as banks or insurance companies, must be equal in quality or higher.
- iii. Bonds - Confined to issues rated "A" or higher by a national rating service, except in the case of U.S. Treasury or government agency obligations which are not rated.

The equity portfolio shall be diversified among issues and industry classifications. No more than 25% of the equity portfolio may be invested in any single classification, as described by the Standard and Poor 500 Index, unless prior approval is received from the Secretary of Finance.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(2) Deposits and Investments, Continued

No investment may be made in a single corporate entity which exceeds 5% of the total assets of the fund at the time of purchase without prior approval of the Secretary of Finance.

A. Deposits

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

Category 1 - Deposits that are federally insured or collateralized with securities held by the State or its agent in the State's name;

Category 2 - Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the State's name; or

Category 3 - Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the State's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the State'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 or held by the pledging financial institution but not in the depositor-government's name. Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. The State does not have a deposit policy for custodial credit risk or foreign currency risk.

As of September 30, 2007, the carrying amount of the primary government's total cash and cash equivalents were \$2,740,804 and the corresponding bank balances were \$2,819,125, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2007, bank deposits in the amount of \$200,000 were FDIC insured. The State does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

As of September 30, 2007, the carrying amount of the discretely presented component units' total cash and cash equivalents and time certificates of deposit were \$1,031,837 and the corresponding bank balances were \$824,455. Of the bank balance amounts, \$805,818 is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. The remaining amount of \$18,637 represents deposits maintained in Philippine Peso denominated bank accounts. Accordingly, these deposits are subject to foreign currency risk. As of September 30, 2007, bank deposits in the amount of \$234,738 were FDIC insured. The discretely presented component units do not require collateralization of their cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(2) Deposits and Investments, Continued

B. Investments

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

Category 1 - Investments that are insured or registered, or securities held by the State or its agent in the State's name;

Category 2 - Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the State's name; or

Category 3 - Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the State's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of September 30, 2007, the State's investments at fair value are as follows:

Fixed income securities:	
Domestic fixed income	\$ <u>1,508,401</u>
Other investments:	
Domestic equities	11,946,881
Cash management account	<u>2,707,195</u>
	<u>14,654,076</u>
	\$ <u>16,162,477</u>

As of September 30, 2007, the Compact Capital Projects Fund holds 16% of the shares of the Bank of the Federated States of Micronesia in the amount of \$1,500,000, 4.8% of the shares of the Pacific Islands Development Bank in the amount of \$250,000, 1% of the shares of the FSM Development Bank in the amount of \$300,000, and 0.01% of the shares of the Bank of Guam in the amount of \$423,500. As the fair market value of these investments is not readily available, such have been recorded at cost.

During the year ended September 30, 2007, the Compact Capital Projects Fund wrote down its investment in the joint venture with the National Fisheries Corporation of Chuuk Fresh Tuna, Inc. in the amount of \$1,202,005, which has been presented in the accompanying financial statements as a special item.

STATE OF CHUUK
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Notes to Financial Statements
September 30, 2007

(2) Deposits and Investments, Continued

B. Investments, Continued

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. With the exception of investments in U.S. government securities, which are explicitly or implicitly guaranteed by the United States government, all other investments must be rated in accordance with the State's investment policy.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the State will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The State's investments are held and administered by trustees. Based on negotiated trust and custody contracts, all of these investments were held in the State's name by the State's custodial financial institutions at September 30, 2007.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the State. As of September 30, 2007, the State did not hold an investment in any one issuer that represented more than 5% of the State's total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The State does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

As of September 30, 2007, the State's fixed income securities, including their Moody's Investors Service credit ratings, had the following maturities:

	Credit Ratings	Investment Maturities (In Years)				Fair Value
		Less Than 1	1 to 5	6 to 10	Greater Than 10	
U.S. government obligations	Aaa	\$ 52,369	\$ -	\$ 138,750	\$ 82,982	\$ 274,101
U.S. government agency obligations	Aaa	65,896	263,108	18,242	487,592	834,838
Corporate notes and bonds	A1	-	48,973	-	35,354	84,327
Corporate notes and bonds	A2	-	-	7,716	4,777	12,493
Corporate notes and bonds	A3	-	-	5,985	3,599	9,584
Corporate notes and bonds	Aa1	-	-	-	16,776	16,776
Corporate notes and bonds	Aa2	-	12,138	14,681	14,452	41,271
Corporate notes and bonds	Aa3	-	4,439	-	18,354	22,793
Corporate notes and bonds	AAA	-	54,166	-	-	54,166
Corporate notes and bonds	Baa1	-	-	21,841	10,238	32,079
Corporate notes and bonds	Baa2	-	7,554	14,858	-	22,412
Corporate notes and bonds	Baa3	-	31,427	-	9,981	41,408
Corporate notes and bonds	Not rated					
		<u>16,374</u>	<u>-</u>	<u>14,672</u>	<u>31,107</u>	<u>62,153</u>
		<u>\$ 134,639</u>	<u>\$ 421,805</u>	<u>\$ 236,745</u>	<u>\$ 715,212</u>	<u>\$ 1,508,401</u>

STATE OF CHUUK
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Notes to Financial Statements
September 30, 2007

(3) Receivables

Receivables as of September 30, 2007, for the primary government's individual major governmental funds and nonmajor governmental funds in the aggregate, including applicable allowances for uncollectible accounts, are as follows:

	<u>General</u>	Compact Sector <u>Grants</u>	Compact Capital <u>Projects</u>	Compact <u>Trust</u>	Nonmajor Governmental <u>Funds</u>	<u>Total</u>
Receivables:						
FSM National Government	\$ 1,489,825	\$ 77,478	\$ 37,272	\$ -	\$ 919,789	\$ 2,524,364
Less: allowance for uncollectible accounts	<u>(705,369)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(705,369)</u>
Net receivables	<u>\$ 784,456</u>	<u>\$ 77,478</u>	<u>\$ 37,272</u>	<u>\$ -</u>	<u>\$ 919,789</u>	<u>\$ 1,818,995</u>

During the year ended September 30, 2007, the State collected on previously written off receivables in the amount of \$1,049,602. Accordingly, such has been reflected as a special item within the accompanying financial statements.

Discretely Presented Component Units

Chuuk Public Utilities Corporation

Receivables as of September 30, 2007, for the Chuuk Public Utilities Corporation in the aggregate, including applicable allowances for uncollectible accounts, are as follows:

Receivables:	
Chuuk State Government	\$ 427,014
Other	<u>1,098,361</u>
	1,525,375
Less: allowance for uncollectible accounts	<u>(1,241,748)</u>
Net receivables	<u>\$ 283,627</u>

Chuuk State Health Care Plan

Receivables as of September 30, 2007, for the Chuuk State Health Care Plan in the aggregate, including applicable allowances for uncollectible accounts, are as follows:

Receivables:	
Premiums receivable	\$ 237,056
Other	<u>50,000</u>
	287,056
Less: allowance for uncollectible accounts	<u>-</u>
Net receivables	<u>\$ 287,056</u>

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(3) Receivables, Continued

Chuuk State Housing Corporation

Receivables as of September 30, 2007, for the Chuuk State Housing Corporation in the aggregate, including applicable allowances for uncollectible accounts, are as follows:

Receivables:	
Chuuk State Government	\$ 120,000
Loans Receivable	2,162,577
Other	<u>32,232</u>
	2,314,809
Less: allowance for uncollectible accounts	<u>(1,547,056)</u>
Net receivables	\$ <u>767,753</u>

(4) Interfund Receivables and Payables

Receivables and payables between funds reflected as due to/from other funds in the combined balance sheet at September 30, 2007, are summarized as follows:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Amount</u>
General	Nonmajor governmental funds	\$ 496,422
Compact Sector Grants	General	4,634,931
Nonmajor governmental funds	General	<u>1,176,743</u>
		\$ <u>6,308,096</u>

Interfund receivables not expected to be repaid within the next twelve months are summarized as follows:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Amount</u>
Nonmajor governmental funds: Chuuk Airport Authority	General	\$ <u>1,176,743</u>

(5) Fixed Assets

Capital asset activities of the primary government for the year ended September 30, 2007, are as follows:

	Balance October 1, 2006	Additions	Retirements	Balance September 30, 2007
Governmental activities:				
Capital assets, not being depreciated:				
Land	\$ 24,129,857	\$ 262,576	\$ -	\$ 24,392,433

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(5) Fixed Assets, Continued

	Balance October <u>1, 2006</u>	<u>Additions</u>	<u>Retirements</u>	Balance September <u>30, 2007</u>
Capital assets, being depreciated:				
Airport facilities	30,406,300	-	-	30,406,300
Buildings	9,439,947	1,795,375	-	11,235,322
Seaport facilities	7,718,305	-	-	7,718,305
Vehicles and other equipment	4,769,913	462,208	-	5,232,121
Infrastructure	<u>10,257,000</u>	<u>-</u>	<u>-</u>	<u>10,257,000</u>
 Total capital assets, being depreciated	 <u>62,591,465</u>	 <u>2,257,583</u>	 <u>-</u>	 <u>64,849,048</u>
 Less accumulated depreciation for:				
Airport facilities	(5,676,376)	(715,158)	-	(6,391,534)
Buildings	(4,909,375)	(166,465)	-	(5,075,840)
Seaport facilities	(2,227,671)	(285,120)	-	(2,512,791)
Vehicles	(3,604,110)	(401,133)	-	(4,005,243)
Infrastructure	<u>(3,454,558)</u>	<u>(410,280)</u>	<u>-</u>	<u>(3,864,838)</u>
	<u>(19,872,090)</u>	<u>(1,978,156)</u>	<u>-</u>	<u>(21,850,246)</u>
 Total capital assets, being depreciated, net	 <u>42,719,375</u>	 <u>279,427</u>	 <u>-</u>	 <u>42,998,802</u>
 Governmental activities capital assets, net	 <u>\$ 66,849,232</u>	 <u>\$ 542,003</u>	 <u>\$ -</u>	 <u>\$ 67,391,235</u>

Depreciation expense was charged to functions/programs of the primary government's governmental activities as follows:

General government	\$ 451,169
Health services	139,737
Education	44,261
Public safety	19,202
Public works and transportation	1,299,273
Community affairs	<u>24,515</u>
	<u>\$ 1,978,157</u>

(6) Payables

During the year ended September 30, 2007, the State reevaluated their payables and wrote off liabilities within the General Fund in the amount of \$3,233,483. Accordingly, such has been presented as a special item within the accompanying financial statements.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(7) Short-Term Debt

Note payable of the primary government is as follows:

General Fund:

Note payable to the FSM National Government, payable in quarterly installments of \$416,667, non-interest bearing with a service charge of 1% per annum, due on September 30, 2001.

\$ 1,554,332

No activity in short-term debt of the primary government occurred during the year ended September 30, 2007.

(8) Long-Term Obligations

Asian Development Bank (ADB) Early Retirement Program Loan

The State implemented an Early Retirement Scheme (ERS) in which employees holding certain nonessential positions as identified by the State were retired early with a payout of the equivalent of two-years' wages. This ERS program is funded by a \$5,300,000 loan from the ADB through the FSM National Government, non-interest bearing with a service charge of 1% per annum on the amount of the loan withdrawn from the Loan Account. The activities of the ERS Program are recorded in the General Fund.

The ADB loan has a grace period of ten years with the first payment due in February 2008 and the last payment in August 2037. However, pursuant to the terms of the Financing Agreement between the State and the FSM National Government, the State is required to deposit into the ERS Trust account held in the name of the State within the FSM National Government investment portfolio, 100% of the outstanding principal balance by September 30, 2002.

Funds for the repayment of the ERS loan are expected to be derived from the annual appropriations for salaries and wages earmarked for the positions abolished under the Early Retirement Scheme. The Financing Agreement requires the State to continue to appropriate salaries for the abolished positions and deposit the appropriate funds into the ERS Trust Account. These funds had not been deposited to the Trust Account as of September 30, 2007. As of September 30, 2007, the amount outstanding against this loan was \$5,300,000. This amount has been identified as future debt service payments and is included in the General Fund reserve for debt service of which \$5,302,342 is actually deposited in an investment account held jointly with the FSM National Government. That investment account is restricted for the repayment of this debt and other ADB related debt set forth below.

ADB Loan Number 1873 FSM (SF) - Private Sector Development Program Loan

ADB Loan Number 1873 FSM (SF) - Private Sector Development Program Loan (SDR 1,017,120), bearing interest at 1% per annum during the grace period and 1.5% thereafter. The loan is payable semiannually commencing May 15, 2010 in an amount of \$40,625 plus interest, with a maturity date of November 15, 2025. As of September 30, 2007, the amount outstanding against this loan was \$650,000.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(8) Long-Term Obligations, Continued

ADB Loan Number 1874 FSM (SF) - Private Sector Development Project Loan

ADB Loan Number 1874 FSM (SF) - Private Sector Development Project Loan (SDR 1,392,783), bearing interest at of 1% per annum during the grace period and at 1.5% thereafter. The loan is payable semiannually commencing May 15, 2010 in an amount of \$37,083 plus interest, with a maturity date of November 15, 2033. As of September 30, 2007, the amount outstanding against this loan was \$523,083.

ADB Loan Number 1816 FSM (SF) – Basic Social Services Project Loan

ADB Loan Number 1816 FSM (SF) – Basic Social Services Project Loan (SDR 1,829,927), non-interest bearing with a service charge of 1% per annum on the amount of the loan withdrawn from the Loan Account. The loan is payable semiannually commencing February 1, 2009 in an amount of \$76,247, at which time the service charge increases to 1.5% per annum, with a maturity date of August 1, 2032. As of September 30, 2007, the amount outstanding against this loan was \$241,957.

Annual debt service requirements to maturity for principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2008	\$ 106,000	\$ 67,150	\$ 173,150
2009	170,606	73,166	243,772
2010	170,606	67,150	173,150
2011	170,606	69,107	239,713
2012	170,606	67,078	237,684
2013 – 2017	992,318	302,457	1,294,775
2018 – 2022	1,366,340	236,650	1,602,990
2023 – 2027	1,369,890	155,772	1,525,662
2028 – 2032	1,138,063	87,488	1,225,551
2033 – 2037	<u>1,060,005</u>	<u>31,800</u>	<u>1,091,805</u>
	<u>\$6,715,040</u>	<u>\$1,161,805</u>	<u>\$7,876,845</u>

Other long-term liabilities will be liquidated in the future from governmental funds. During the year ended September 30, 2007, the following changes occurred in liabilities reported as part of the primary government's long-term liabilities in the statement of net assets:

	<u>Balance October 1, 2006</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance September 30, 2007</u>	<u>Due Within One Year</u>
Loan payable:					
ADB loans	\$ 5,941,539	\$ 773,501	\$ -	\$ 6,715,040	\$ 106,000
Other:					
Compensated absences	<u>1,016,317</u>	<u>785,067</u>	<u>(199,576)</u>	<u>1,601,808</u>	<u>449,797</u>
	<u>\$ 6,957,856</u>	<u>\$ 1,558,568</u>	<u>\$ (199,576)</u>	<u>\$ 8,316,848</u>	<u>\$ 555,797</u>

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(8) Long-Term Obligations, Continued

Discretely Presented Component Units

Chuuk Public Utilities Corporation

Note payable to a commercial bank, 90 day terms, interest at prime plus 2% on a \$150,000 line of credit. The loan is collateralized by a bank deposit and security interest in fixed assets, accounts receivable and inventories. \$ 81,921

Note payable to the FSM Development Bank, interest at 9%, due in monthly installments of \$4,000. The loan is collateralized by major machinery, equipment and assignment of income. 737,743

Note payable to the FSM National Government, interest at 6.82%, due in semi-annual installments commencing August 1, 2007. 3,378,548

\$ 4,198,212

Annual debt service requirements to maturity for principal and interest are as follows:

<u>Year ending</u> <u>September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2008	\$ 879,401	\$ 189,113	\$ 1,068,514
2009	59,737	185,019	244,776
2010	59,737	180,965	240,702
2011	59,737	176,891	236,628
2012	59,737	172,816	232,553
2013-2017	348,476	802,970	1,151,446
2018-2022	796,595	607,736	1,404,331
2023-2027	796,595	336,097	1,132,692
2028-2031	<u>1,138,197</u>	<u>76,095</u>	<u>1,214,292</u>
	<u>\$ 4,198,212</u>	<u>\$ 2,727,772</u>	<u>\$ 6,925,934</u>

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(8) Long-Term Obligations, Continued

Discretely Presented Component Units, Continued

During the year ended September 30, 2007, the following changes occurred in liabilities reported as part of the discretely presented component units long-term liabilities in the statement of net assets:

	Balance October 1, <u>2006</u>	<u>Additions</u>	<u>Reductions</u>	Balance September 30, 2007	<u>Due Within One Year</u>
Loans payable:	\$ 4,142,989	\$ 143,409	\$ (88,186)	\$ 4,198,212	\$ 879,401

(9) Contingencies

Sick Leave

It is the policy of the State to record expenditures for sick leave when leave is actually taken. Sick leave is compensated time for absence during working hours arising from employee illness or injury. The estimated accumulated amount of unused sick leave as of September 30, 2007 is \$3,396,836.

Insurance Coverage

The State does not maintain insurance coverage for a significant amount of fixed assets. In the event of a catastrophe, the State may be self-insured to a material extent.

Federal Grants

The State participates in a number of federally assisted grant programs. These programs are subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Cumulative questioned costs of \$9,272,323 relating to fiscal years 2002 through 2006 have been set forth in the State's Single Audit Report for the year ended September 30, 2007.

The ultimate disposition of these questioned costs can be determined only by final action of the respective grantor agencies. Therefore, no provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(9) Contingencies, Continued

Litigation

The State is a party to various legal proceedings. However, the State is currently negotiating with judgment creditors to arrive at settlement amounts favorable to both parties. Claims must be adjudicated and are not recognized as current liabilities of the State as they cannot be paid without an underlying appropriation from the State Legislature and a corresponding allotment from the Executive Branch. No appropriation currently exists to finance these judgments. The State's Attorney General indicates that pending land lease cases and other claims against the State exist at September 30, 2007 an amount that is material to the financial statements. Due to an inability to predict the ultimate outcome of these matters, no provision for these liabilities has been made in the accompanying financial statements.

Delinquent Taxes

The State is delinquent in remitting certain social security and withholding taxes. Management is of the opinion that no significant penalties or interest from this matter and that if any such changes occur, they will be accounted for prospectively.

Loan Guarantee

The State has guaranteed repayment of a note payable of Chuuk Public Utility Corporation to the Asian Development Bank. The loan additionally passed through the FSM National Government. At September 30, 2007, the loan balance is \$3,461,734.

General Fund Financial Position

The State's General Fund has sustained recurring operating deficits and has an unreserved fund deficit of \$22,859,532 at September 30, 2007. In addition, at September 30, 2007, the primary government's current liabilities exceed current assets by \$12,361,162.

Management of the State has entered into a memorandum of understanding with the FSM National Government to outline reform measures to address the deficit. The plan includes the following:

- The State will sell off its stock holdings or investments.
- The State will sell the Chuuk State Medical Referral House in Honolulu.
- The State will adopt measures to control General Fund expenditures. Such include moratorium of hiring, salary increases and other spending, such as travel.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2007

(9) Contingencies, Continued

General Fund Financial Position, Continued

- The State agreed to work to balance its proposed FY08 budget and to include a provision to reduce the budget deficit by \$1M.
- The State agreed to eliminate 400 positions from its operations budget. The elimination will involve two phases: 200 positions by March 31, 2008, and the other 200 by March 31, 2009.
- The State will work to restructure its state government to include restructuring the Chuuk Legislature into a unicameral legislature. The State agreed to make sure voting on the Legislature restructuring constitutional amendment is on the March 2009 General Ballot.
- The State will develop a public awareness program to educate the Chuukese people about the imminent need for reform.

Management of the State believes that the actions above will provide the State the opportunity to commence the process of reducing the General Fund deficit position.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

REQUIRED SUPPLEMENTARY INFORMATION

YEAR ENDED SEPTEMBER 30, 2007

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Schedule of Revenues, Expenditures and Changes in Deficit
Budget and Actual - General Fund
Year Ended September 30, 2007

	Budgeted Amounts		Actual - Budgetary Basis (see Note 1)	Variance with Final Budget - Positive (Negative)
	Original	Final		
Revenues:				
Local revenues	\$ 6,445,936	\$ 7,137,203	\$ 5,150,383	\$ (1,986,820)
Net increase in the fair value of investments	-	-	1,851,965	1,851,965
Total revenues	<u>6,445,936</u>	<u>7,137,203</u>	<u>7,002,348</u>	<u>(134,855)</u>
Expenditures:				
Current:				
General government	3,313,476	3,682,357	4,362,960	(680,603)
Health services	-	-	3,375	(3,375)
Education	-	-	5,038	(5,038)
Economic development	49,424	271,634	238,415	33,219
Public safety	583,724	623,724	641,029	(17,305)
Public works and transportation	1,183,817	1,033,817	1,159,327	(125,510)
Community affairs	-	-	277,114	(277,114)
Boards and commissions	233,584	261,584	278,738	(17,154)
Judiciary	419,816	601,992	557,277	44,715
Payments to component units	69,000	69,000	73,187	(4,187)
Municipal affairs	905,849	905,849	593,537	312,312
Other	88,300	88,300	553,042	(464,742)
Total expenditures	<u>6,846,990</u>	<u>7,538,257</u>	<u>8,743,039</u>	<u>(1,204,782)</u>
Deficiency of revenues under expenditures	<u>(401,054)</u>	<u>(401,054)</u>	<u>(1,740,691)</u>	<u>(1,339,637)</u>
Other financing sources:				
Loan proceeds	-	-	773,501	773,501
Transfers in from other funds	-	-	3,639,440	3,639,440
Transfers out to other funds	-	-	(284,872)	(284,872)
Total other financing sources	<u>-</u>	<u>-</u>	<u>4,128,069</u>	<u>4,128,069</u>
Special items:				
Recovery on previously written off receivables	-	-	1,049,602	1,049,602
Write off of liabilities	-	-	3,233,483	3,233,483
Total special items	<u>-</u>	<u>-</u>	<u>4,283,085</u>	<u>4,283,085</u>
Net change in deficit	<u>(401,054)</u>	<u>(401,054)</u>	<u>6,670,463</u>	<u>7,071,517</u>
Other changes in unreserved deficit				
Decrease in reserve for continuing appropriations	-	-	784,981	784,981
Unreserved deficit at the beginning of the year	<u>(30,314,976)</u>	<u>(30,314,976)</u>	<u>(30,314,976)</u>	<u>-</u>
Unreserved deficit at the end of the year	<u>\$ (30,716,030)</u>	<u>\$ (30,716,030)</u>	<u>\$ (22,859,532)</u>	<u>\$ 7,856,498</u>

See accompanying notes to required supplementary information - budgetary reporting.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Required Supplementary Information – Budgetary Reporting
September 30, 2007

(1) Budgetary Information

An annual appropriated budget is adopted by the State’s Legislature for the General Fund and Compact Programs through an Appropriations Act. However, additional appropriations and budget modifications occur throughout the year. The majority of unencumbered appropriations lapse as of year end unless specifically extended by the State’s Legislature. Budgets for special revenue funds, except the Compact Program Fund, are not included in the annual Appropriations Act. Accordingly, a budget to actual presentation for special revenue funds, except the Compact Program Fund, is not required or presented. Project-length financial plans are generally adopted for all capital project funds.

Encumbrance accounting is utilized for budgetary control purposes. Encumbrances outstanding at year-end are reported as reservations of fund balance and will be funded as expenditures in the ensuing year. Encumbrances remain as reservations of fund balance until becoming expended or canceled. If an encumbrance is subsequently canceled, the funds revert to the applicable unreserved fund balance unless otherwise required by law.

Budgetary expenditures, which are on a basis other than GAAP, represent current charges against appropriations; current charges consist of all current year liquidated and unliquidated encumbrances. Budgetary expenditures are therefore determined by subtracting both current year liquidations of prior year encumbrances and unliquidated prior year encumbrances from the combined total of current year. When reviewed in relation to respective budgets, budgetary expenditures provide the principal means of evaluating current year operating performance and management stewardship. Amounts included on the Statement of Revenues, Expenditures, and Changes in Deficit - Budget and Actual - General Fund (which are presented on a non-GAAP budgetary basis) are reconciled to unreserved deficit of the Combined Balance Sheet within the other charges in unreserved deficit section of that statement.

Encumbrance accounting is employed in governmental funds. For budgetary purposes, the encumbrances (i.e., purchase orders, contracts) are considered expenditures when incurred. For GAAP reporting purposes, encumbrances outstanding at year end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be reappropriated and honored during the subsequent fiscal year.

For the year ended September 30, 2007, expenditures of the General Fund exceeded budget at the program area level (i.e., legal level of budgetary control as follows):

<u>Program Area</u>	<u>Excess</u>
Public Safety	\$ 17,305
Public Works and Transportation	\$ 125,510
Community Affairs	\$ 277,114
Boards and Commissions	\$ 17,154
Payments to Component Unites	\$ 4,187
Other	\$ 510,506

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Notes to Required Supplementary Information – Budgetary Reporting
September 30, 2007

(2) Reconciliation - GAAP and Budgetary Bases of Accounting

Encumbrance accounting is employed in governmental funds. For budgetary purposes, the encumbrances (i.e., purchase orders, contracts) are considered expenditures when incurred. For GAAP reporting purposes, encumbrances outstanding at year end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be reappropriated and honored during the subsequent fiscal year.

Accounting principles used in developing data on a budgetary basis differ from those used in preparing the financial statements in conformity with GAAP. Amounts included on the Statement of Revenues, Expenditures, and Changes in Deficit - Budget and Actual - General Fund (which are presented on a non-GAAP budgetary basis) are reconciled to unreserved deficit of the Governmental Fund Balance Sheet within the other changes in unreserved deficit section of that statement. Furthermore, the net change in fund balance (deficit) to the net change in unreserved fund deficit for the General Fund is as follows:

Net change in fund balance (deficit)	\$ 6,415,735
Decrease in Encumbrances	<u>254,728</u>
Net change in unreserved fund deficit	\$ <u>6,670,463</u>

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

OTHER SUPPLEMENTARY INFORMATION

YEAR ENDED SEPTEMBER 30, 2007

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

GENERAL FUND

September 30, 2007

The general fund is used to account for resources traditionally associated with government which are not required legally or by sound financial management to be accounted for in another fund. The United States Compact of Free Association current account and inflation adjustment funds associated with the current account are accounted for in this fund in addition to local taxes and other revenues.

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function, and Changes in Deficit
General Fund
Year Ended September 30, 2007
(with comparative totals for the year ended September 30, 2006)

	<u>2007</u>	<u>2006</u>
Revenues:		
FSM revenue sharing	2,254,793	2,926,387
Excise taxes:		
Sales tax	1,121,973	1,182,811
Hotel	133,013	137,255
Tobacco	75,727	86,023
Alcoholic beverages	129,792	123,014
Delinquent tax collections	36,074	53,926
Other excise taxes	113,206	147,254
	<u>1,609,785</u>	<u>1,730,283</u>
Fees and charges:		
Licenses and permits	147,772	158,829
Leases and other rentals	57,679	29,641
	<u>205,451</u>	<u>188,470</u>
Departmental charges:		
Transportation collections	596,416	489,961
Net increase in the fair value of investments	1,851,965	788,228
Other revenues	483,938	1,591,748
Total revenues	<u>7,002,348</u>	<u>7,715,077</u>
Expenditures:		
Current:		
General government:		
Office of the Governor	530,147	752,582
State Legislature	2,524,932	3,205,914
Department of Planning and Statistics	130,607	-
Department of Treasury	1,108,303	151,412
	<u>4,293,989</u>	<u>4,109,908</u>
Education:		
Department of Education	603	-
Economic Development:		
Department of Agriculture	133,957	-
Department of Marine Resources	111,855	992
	<u>245,812</u>	<u>992</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function, and Changes in Deficit, Continued
General Fund
Year Ended September 30, 2007
(with comparative totals for the year ended September 30, 2006)

	<u>2007</u>	<u>2006</u>
Expenditures, continued:		
Current, continued:		
Public Safety:		
Office of the Attorney General	261,262	201,259
Department of Public Safety	<u>376,705</u>	<u>136,467</u>
	<u>637,967</u>	<u>337,726</u>
Public Works and Transportation:		
Department of Transportation	<u>1,118,264</u>	<u>1,237,222</u>
Community Affairs:		
Department of Public Affairs	<u>277,789</u>	<u>280,905</u>
Boards and Commissions:		
Chuuk Recreation Board	42,124	58,753
Land Commission	91,630	-
Environmental Protection Agency	-	99
Election Commission	88,961	95,136
Mortlocks Commission	13,943	24,990
Faichuk Commission	<u>36,266</u>	<u>19,841</u>
	<u>272,924</u>	<u>198,819</u>
Judiciary:		
State Court	<u>553,728</u>	<u>159,860</u>
Payments to component units:		
Chuuk Coconut Authority	24,577	50,255
Chuuk State Housing Authority	<u>48,610</u>	<u>52,178</u>
	<u>73,187</u>	<u>102,433</u>
Municipal Affairs:		
Payments to municipalities	<u>633,208</u>	<u>4,176,643</u>
Other:		
Small Business Development Center	-	1,688
Farmers Home Administration	38,209	50,525
Disaster assistance	2,580	19,108
Legal services	10,000	10,000
Red Cross	12,778	21,987
Peace Corps	7,250	7,575
Other	<u>819,479</u>	<u>2,265,287</u>
	<u>890,296</u>	<u>2,376,170</u>
Total expenditures	<u>8,997,767</u>	<u>12,980,678</u>
Deficiency of revenues under expenditures	<u>(1,995,419)</u>	<u>(5,265,601)</u>
Other financing sources:		
Loan proceeds	773,501	161,379
Transfers in from other funds	3,639,440	6,400,000
Transfers out to other funds	<u>(284,872)</u>	<u>-</u>
Total other financing sources	<u>4,128,069</u>	<u>6,561,379</u>
Special items:		
Recovery on previously written off receivables	1,049,602	-
Write off of liabilities	<u>3,233,483</u>	<u>-</u>
Total other financing sources	<u>4,283,085</u>	<u>-</u>
Net change in deficit	6,415,735	1,295,778
Deficit at the beginning of the year	<u>(18,533,096)</u>	<u>(19,828,874)</u>
Deficit at the end of the year	<u>\$ (12,117,361)</u>	<u>\$ (18,533,096)</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures and Changes in Deficit
Budget and Actual - General Fund
Year Ended September 30, 2007

	Budgeted Amounts		Actual	Variance with
	Original	Final	Budgetary Basis (see Note 1)	Final Budget Positive/(Negative)
Revenues:				
Local revenues	\$ 6,445,936	\$ 7,137,203	\$ 5,150,383	\$ (1,986,820)
Net increase in the fair value of investments	-	-	1,851,965	1,851,965
Total revenues	<u>6,445,936</u>	<u>7,137,203</u>	<u>7,002,348</u>	<u>(134,855)</u>
Expenditures:				
Current:				
General government:				
Office of the Governor	492,594	522,962	533,507	(10,545)
State Legislature	2,546,279	2,546,279	2,588,763	(42,484)
Department of Planning and Statistics	-	-	132,387	(132,387)
Department of Treasury	274,603	613,116	1,108,303	(495,187)
	<u>3,313,476</u>	<u>3,682,357</u>	<u>4,362,960</u>	<u>(680,603)</u>
Health Services:				
Department of Health Services	-	-	3,375	(3,375)
Education:				
Department of Education	-	-	5,038	(5,038)
Economic Development:				
Department of Marine Resources	49,424	211,634	111,855	99,779
Department of Agriculture	-	60,000	133,957	(73,957)
Department of Commerce and Industry	-	-	(7,397)	7,397
	<u>49,424</u>	<u>271,634</u>	<u>238,415</u>	<u>33,219</u>
Public Safety:				
Office of Attorney General	279,321	244,321	260,645	(16,324)
Department of Public Safety	304,403	379,403	380,384	(981)
	<u>583,724</u>	<u>623,724</u>	<u>641,029</u>	<u>(17,305)</u>
Public Works and Transportation:				
Department of Transportation	1,183,817	1,033,817	1,159,327	(125,510)
Community Affairs:				
Department of Public Affairs	-	-	277,114	(277,114)
Boards and Commissions:				
Chuuk Recreation Board	45,811	45,811	36,993	8,818
Election Commission	87,773	87,773	99,710	(11,937)
Land Commission	-	28,000	91,630	(63,630)
Mortlocks Commission	50,000	50,000	15,300	34,700
Faichuk Commission	50,000	50,000	35,105	14,895
	<u>233,584</u>	<u>261,584</u>	<u>278,738</u>	<u>(17,154)</u>
Judiciary:				
State Court	419,816	601,992	557,277	44,715
Payments to component units:				
Chuuk Coconut Authority	20,000	20,000	24,577	(4,577)
Chuuk State Housing Authority	49,000	49,000	48,610	390
	<u>69,000</u>	<u>69,000</u>	<u>73,187</u>	<u>(4,187)</u>
Municipal Affairs:				
Payments to municipalities	905,849	905,849	593,537	312,312
Other:				
Farmers Home Administration	-	-	38,209	(38,209)
Disaster assistance	-	-	2,211	(2,211)
Legal services	20,000	20,000	10,000	10,000
Red Cross	10,000	10,000	10,119	(119)
Peace Corps	10,800	10,800	7,250	3,550
Other	47,500	47,500	485,253	(437,753)
	<u>88,300</u>	<u>88,300</u>	<u>553,042</u>	<u>(464,742)</u>
Total expenditures	<u>6,846,990</u>	<u>7,538,257</u>	<u>8,743,039</u>	<u>(1,204,782)</u>
Deficiency of revenues under expenditures	<u>(401,054)</u>	<u>(401,054)</u>	<u>(1,740,691)</u>	<u>(1,339,637)</u>
Other financing sources:				
Loan proceeds	-	-	773,501	773,501
Transfers in from other funds	-	-	3,639,440	3,639,440
Transfers out to other funds	-	-	(284,872)	(284,872)
Total other financing sources	<u>-</u>	<u>-</u>	<u>4,128,069</u>	<u>4,128,069</u>
Special items:				
Recovery on previously written off receivables	-	-	1,049,602	1,049,602
Write off of liabilities	-	-	3,233,483	3,233,483
Total special items	<u>-</u>	<u>-</u>	<u>4,283,085</u>	<u>4,283,085</u>
Net change in deficit	<u>(401,054)</u>	<u>(401,054)</u>	<u>6,670,463</u>	<u>7,071,517</u>
Other changes in unreserved deficit:				
Decrease in reserve for continuing appropriations	-	-	784,981	784,981
Unreserved deficit at the beginning of the year	<u>(30,314,976)</u>	<u>(30,314,976)</u>	<u>(30,314,976)</u>	<u>-</u>
Unreserved deficit at the end of the year	<u>\$ (30,716,030)</u>	<u>\$ (30,716,030)</u>	<u>\$ (22,859,532)</u>	<u>\$ 7,856,498</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS - SPECIAL REVENUE FUNDS

September 30, 2007

Special revenue funds are used to account for specific revenues that are legally restricted for particular purposes. A brief discussion of the State's Nonmajor Governmental Funds - Special Revenue Funds as of September 30, 2007, follows:

Chuuk Airport Authority Fund

This fund accounts for funds received by the Airport Authority for the maintenance of Chuuk Airport.

CFSM Grants Fund

This fund accounts for activities received from FSM congressional appropriations utilized by the State to finance general governmental operations.

Compact Other Grants Fund

This fund accounts for the following funds received under the Compact of Free Association:

Compact Section 212 - Special Development Assistance Fund: This grant is restricted for special development assistance and is granted under the Compact of Free Association with the United States.

Compact 214(c) - Energy Grant Fund: This fund accounts for funds, granted under the Compact of Free Association with the United States, specifically restricted for energy programs.

Compact 216 (a)(2) Health and Medical Fund: This fund accounts for funds granted under the Compact of Free Association with the United States, specifically restricted for health and medical programs including referrals to hospital and treatment centers.

Compact Section 216(a)(3) Scholarship Fund: This fund accounts for funds granted under the Compact of Free Association with the United States to the FSM National Government which are subgranted to the State and are specifically restricted for educational scholarships at U.S. and Micronesian higher education institutions.

Compact Special Block Grant Section 221 (b) Fund

This fund accounts for funds granted under the Compact of Free Association with the United States, specifically restricted for health and education.

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
 FEDERATED STATES OF MICRONESIA
 NONMAJOR GOVERNMENTAL FUNDS
 SPECIAL REVENUE FUNDS

Combining Balance Sheet
 September 30, 2007

	US Federal Grants	Chuuk Airport Authority	CFSM Grants	Compact Other Grants	Compact Special Block Section 221(b)	Total
<u>ASSETS</u>						
Receivables	\$ 873,791	\$ -	\$ 45,998	\$ -	\$ -	\$ 919,789
Due from other funds	-	1,176,743	-	-	-	1,176,743
Total assets	<u>\$ 873,791</u>	<u>\$ 1,176,743</u>	<u>\$ 45,998</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,096,532</u>
<u>LIABILITIES AND FUND BALANCES</u>						
Liabilities:						
Accounts payable	\$ 441,625	\$ -	\$ 9,632	\$ -	\$ -	\$ 451,257
Due to other funds	417,292	-	79,130	-	-	496,422
Total liabilities	<u>858,917</u>	<u>-</u>	<u>88,762</u>	<u>-</u>	<u>-</u>	<u>947,679</u>
Fund balances:						
Reserved for:						
Related assets	-	1,176,743	-	-	-	1,176,743
Encumbrances	103,537	-	9,777	-	-	113,314
Unreserved (deficit)	(88,663)	-	(52,541)	-	-	(141,204)
Total fund balances	<u>14,874</u>	<u>1,176,743</u>	<u>(42,764)</u>	<u>-</u>	<u>-</u>	<u>1,148,853</u>
Total liabilities and fund balances	<u>\$ 873,791</u>	<u>\$ 1,176,743</u>	<u>\$ 45,998</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,096,532</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
 FEDERATED STATES OF MICRONESIA
 NONMAJOR GOVERNMENTAL FUNDS
 SPECIAL REVENUE FUNDS

Combining Statement of Revenues, Expenditures By Function,
 and Changes in Fund Balances (Deficit)
 Year Ended September 30, 2007

	US Federal Grants	Chuuk Airport Authority	CFSM Grants	Compact Other Grants	Compact Special Block Section 221(b)	Total
Revenues:						
Federal contributions and other grants	\$ 1,085,694	\$ -	\$ -	\$ -	\$ -	\$ 1,085,694
Fees and charges	-	48,362	45,998	-	-	94,360
Total revenues	<u>1,085,694</u>	<u>48,362</u>	<u>45,998</u>	<u>-</u>	<u>-</u>	<u>1,180,054</u>
Expenditures by function:						
Current:						
General Government	378,433	-	-	-	-	378,433
Health Services	250,225	-	-	-	-	250,225
Education	457,036	-	-	-	-	457,036
Public Safety	-	-	44,164	-	-	44,164
Total expenditures	<u>1,085,694</u>	<u>-</u>	<u>44,164</u>	<u>-</u>	<u>-</u>	<u>1,129,858</u>
Other financing sources (uses):						
Transfers in from other funds	284,872	-	-	-	-	284,872
Transfers out to other funds	-	-	-	(1,346,945)	(1,127,783)	(2,474,728)
Total other financing sources (uses), net	<u>284,872</u>	<u>-</u>	<u>-</u>	<u>(1,346,945)</u>	<u>(1,127,783)</u>	<u>(2,189,856)</u>
Net change in fund balances (deficits)	284,872	48,362	1,834	(1,346,945)	(1,127,783)	(2,139,660)
Fund balances (deficit) at the beginning of the year	<u>(269,998)</u>	<u>1,128,381</u>	<u>(44,598)</u>	<u>1,346,945</u>	<u>1,127,783</u>	<u>3,288,513</u>
Fund balances (deficit) at the end of the year	<u>\$ 14,874</u>	<u>\$ 1,176,743</u>	<u>\$ (42,764)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,148,853</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

COMPACT OF FREE ASSOCIATION
SECTION 211(a) SECTOR GRANT FUNDS

Combining Balance Sheet
September 30, 2007

	<u>Education Sector</u>	<u>Health Sector</u>	<u>Capacity Building Sector</u>	<u>Environment Sector</u>	<u>Private Sector Development</u>	<u>Supplemental Education</u>	<u>Total</u>
<u>ASSETS</u>							
Due from other funds	\$ 2,401,235	\$ 382,001	\$ 457,517	\$ 24,899	\$ 486	\$ 1,368,793	\$ 4,634,931
Receivables	-	-	-	-	77,478	-	77,478
Prepayments	-	389,339	18,731	38,180	506	8,138	454,894
	<u>\$ 2,401,235</u>	<u>\$ 771,340</u>	<u>\$ 476,248</u>	<u>\$ 63,079</u>	<u>\$ 78,470</u>	<u>\$ 1,376,931</u>	<u>\$ 5,167,303</u>
<u>LIABILITIES AND FUND BALANCES (DEFICITS)</u>							
Liabilities:							
Accounts payable	\$ 157,821	\$ 235,208	\$ 52,726	\$ 41,584	\$ 78,470	\$ 60,132	\$ 625,941
Accrued liabilities	113,149	-	-	-	-	-	113,149
Total liabilities	<u>270,970</u>	<u>235,208</u>	<u>52,726</u>	<u>41,584</u>	<u>78,470</u>	<u>60,132</u>	<u>739,090</u>
Fund balances:							
Reserved for:							
Encumbrances	2,280,972	953,224	259,009	76,750	84,442	545,918	4,200,315
Unreserved	(150,707)	(417,092)	164,513	(55,255)	(84,442)	770,881	227,898
Total fund balances	<u>2,130,265</u>	<u>536,132</u>	<u>423,522</u>	<u>21,495</u>	<u>-</u>	<u>1,316,799</u>	<u>4,428,213</u>
Total liabilities and fund balances	<u>\$ 2,401,235</u>	<u>\$ 771,340</u>	<u>\$ 476,248</u>	<u>\$ 63,079</u>	<u>\$ 78,470</u>	<u>\$ 1,376,931</u>	<u>\$ 5,167,303</u>

See Accompanying Independent Auditors' Report.

STATE OF CHUUK
FEDERATED STATES OF MICRONESIA

COMPACT OF FREE ASSOCIATION
SECTION 211(a) SECTOR GRANT FUNDS

Combining Statement of Revenues, Expenditures by Function,
and Changes in Fund Balances (Deficits)
Year Ended September 30, 2007

	<u>Education Sector</u>	<u>Health Sector</u>	<u>Capacity Building Sector</u>	<u>Environment Sector</u>	<u>Private Sector Development</u>	<u>Supplemental Education</u>	<u>Total</u>
Revenues:							
Compact funding	\$ 8,437,337	\$ 6,082,729	\$ 2,233,627	\$ 461,592	\$ 557,118	\$ 4,361,791	\$ 22,134,194
	<u>8,437,337</u>	<u>6,082,729</u>	<u>2,233,627</u>	<u>461,592</u>	<u>557,118</u>	<u>4,361,791</u>	<u>\$ 22,134,194</u>
Expenditures by function:							
Current:							
General government	-	-	988,408	-	-	-	988,408
Health services	-	5,614,294	27,150	-	-	-	5,641,444
Education	7,667,927	-	-	-	-	3,044,992	10,712,919
Economic development	-	-	-	174,240	293,541	-	467,781
Public safety	-	-	811,391	-	-	-	811,391
Boards and commissions	9,951	-	-	328,512	-	-	338,463
Payment to component units	-	-	-	-	132,358	-	132,358
Other	-	-	-	-	131,219	-	131,219
Total expenditures	<u>7,677,878</u>	<u>5,614,294</u>	<u>1,826,949</u>	<u>502,752</u>	<u>557,118</u>	<u>3,044,992</u>	<u>19,223,983</u>
Net change in fund balances	759,459	468,435	406,678	(41,160)	-	1,316,799	2,910,211
Fund balances at the beginning of the year	<u>1,370,806</u>	<u>67,697</u>	<u>16,844</u>	<u>62,655</u>	<u>-</u>	<u>-</u>	<u>1,518,002</u>
Fund balances at the end of the year	<u>\$ 2,130,265</u>	<u>\$ 536,132</u>	<u>\$ 423,522</u>	<u>\$ 21,495</u>	<u>\$ -</u>	<u>\$ 1,316,799</u>	<u>\$ 4,428,213</u>

See Accompanying Independent Auditors' Report.

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

Honorable Wesley Simina
Governor, State of Chuuk
Federated States of Micronesia:

We have audited the statement of net assets of the governmental activities, and the governmental funds balance sheet for each major fund and the aggregate remaining fund information of the State of Chuuk (the State) as of September 30, 2007 and have issued our report thereon dated June 10, 2008, which was qualified with respect to: 1) a liability for land leases and other claims payable in the governmental activities and the General Fund; 2) the inadequacy of records concerning capital assets for governmental activities; 3) the inadequacy of accounting records for land acquisitions payable recorded for the governmental activities and the General Fund, and stated that the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the financial statements of the aggregate discretely presented component units, the statement of activities for the governmental activities, the governmental funds statement of revenues, expenditures, and changes in fund balances (deficits), and the reconciliation of the statement of revenues, expenditures, and changes in fund balances of governmental funds to the statement of activities for the year ended September 30, 2007. 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.

For purposes of this report, our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grants, and other matters did not include the Chuuk State Health Care Plan, which was audited by us, the Chuuk Public Utility Corporation, which we were engaged to audit, and the Chuuk State Housing Corporation, which has not been audited. We have issued separate reports on our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters for the Chuuk State Health Care Plan and the Chuuk Public Utility Corporation. The findings, if any, included in those reports are not included herein.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the State's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State'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 would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A *control 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 misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying Schedule of Findings and Questioned Costs (pages 72 through 102) as items 2007-8, 2007-9, 2007-10, 2007-11, 2007-12, 2007-13, 2007-15, 2007-16, 2007-18, 2007-19, 2007-20 and 2007-21 to be significant deficiencies in internal control over financial reporting.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we believe that items 2007-8, 2007-9, 2007-10, 2007-11, 2007-12, 2007-13, 2007-15 and 2007-16 are material weaknesses.

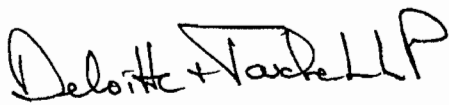
Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State's financial statements are 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 instances of noncompliance that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Questioned Costs as items 2007-5, 2007-6, 2007-7, 2007-14 and 2007-17.

We noted certain matters that we reported to management of the State in a separate letter dated June 10, 2008.

The State's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Questioned Costs. We did not audit the State's responses and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the management of the State, federal awarding agencies, pass-through entities, and the cognizant audit and other federal agencies and is not intended to be and should not be used by anyone other than those specified parties.


June 10, 2008

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

Honorable Wesley Simina
Governor, State of Chuuk
Federated States of Micronesia:

Compliance

We have audited the compliance of the State of Chuuk (the State) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended September 30, 2007. The State's major federal programs are identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (pages 72 through 102). Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the State's management. Our responsibility is to express an opinion on the State's compliance based on our audit.

As discussed in Note 2b to the Schedule of Expenditures of Federal Awards, the State of Chuuk's basic financial statements include the operations of certain entities whose federal awards are not included in the Schedule of Expenditures of Federal Awards for the year ended September 30, 2007. Our audit, described below, did not include the operations of the entities identified in Note 2b as these entities conducted separate audits in accordance with OMB Circular A-133, if required.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the State's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the State's compliance with those requirements.

As described in items 2007-2, 2007-3 and 2007-8 in the accompanying Schedule of Findings and Questioned Costs, the State did not comply with requirements regarding allowable costs/cost principles, procurement and suspension and debarment, and equipment and real property management that are applicable to its Compact of Free Association Sector Grants major program (CFDA # 15.875). Compliance with such requirements is necessary, in our opinion, for the State to comply with the requirements applicable to those programs.

In our opinion, except for the noncompliance described in the preceding paragraph, the State complied, in all material respects, with the requirements referred to above that are applicable to its Compact of Free Association Sector Grants major program (CFDA # 15.875) for the year ended September 30, 2007. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying Schedule of Findings and Questioned Costs as items 2007-1 and 2007-4.

Internal Control Over Compliance

The management of the State is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the State internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the State internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A *control deficiency* in an entity's internal control over compliance 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 noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying Schedule of Findings and Questioned Costs as findings 2007-1, 2007-2, 2007-3, 2007-4 and 2007-8 to be significant deficiencies.

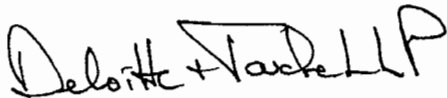
A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. However, we believe that the significant deficiencies described above are material weaknesses.

The State's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Questioned Costs. We did not audit the State's responses and, accordingly, we express no opinion on it.

Schedule of Expenditures of Federal Awards

We have audited the statement of net assets of the governmental activities, and the governmental funds balance sheet for each major fund and the aggregate remaining fund information of the State of Chuuk (the State) as of September 30, 2007 and have issued our report thereon dated June 10, 2008, which was qualified with respect to: 1) a liability for land leases and other claims payable in the governmental activities and the General Fund; 2) the inadequacy of records concerning capital assets for governmental activities; 3) the inadequacy of accounting records for land acquisitions payable recorded for the governmental activities and the General Fund, and stated that the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the financial statements of the aggregate discretely presented component units, the statement of activities for the governmental activities, the governmental funds statement of revenues, expenditures, and changes in fund balances (deficits), and the reconciliation of the statement of revenues, expenditures, and changes in fund balances of governmental funds to the statement of activities for the year ended September 30, 2007. The accompanying Schedule of Expenditures of Federal Awards (pages 62 through 68) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of the State. Because the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the statement of activities for the governmental activities, and the governmental funds statement of revenues, expenditures, and changes in fund balances (deficits), we do not express an opinion on the Schedule of Expenditures of Federal Awards.

This report is intended solely for the information and use of the State, federal awarding agencies, pass-through entities, and the cognizant audit and other federal agencies, and is not intended to be and should not be used by anyone other than those specified parties.

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is written in a cursive, flowing style.

June 10, 2008

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Summary Schedule of Expenditures of Federal Awards, by Grantor
Year Ended September 30, 2007

Agency/Program	Expenditures
U.S. Department of Agriculture	\$ 24,906
U.S. Department of the Interior	19,235,202
U.S. Department of Labor	7,715
U.S. Department of Homeland Security	334,594
U.S. Department of Education	457,035
U.S. Department of Health and Human Services	<u>248,702</u>
GRAND TOTAL	<u>\$ 20,308,154</u>
Reconciliation to the basic financial statements:	
U.S. Federal Grants Fund	\$ 1,085,694
Less: WHO Grant - Non-U.S. Federal Grants	<u>(1,523)</u> \$ 1,084,171
Compact Sector Grants Fund	<u>19,223,983</u>
	<u>\$ 20,308,154</u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2007

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF AGRICULTURE		
Urban & Com. Forestry Prog.	10.675	\$ 22,929
Forest Stewardship	10.675	<u>1,977</u>
U.S. DEPARTMENT OF AGRICULTURE TOTAL		<u><u>\$ 24,906</u></u>

Note: The above grants are received in a subrecipient capacity through the FSM National Government.

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2007

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF THE INTERIOR		
Economic, Social and Political Development of the Territories and the Freely Associated States:		
Compact Sector Grants - Capacity Build		\$ 1,826,949
Compact Sector Grants - Education		7,677,878
Supplemental Education Grant		3,044,992
Compact Sector Grants - Environment		502,752
Compact Sector Grants - Health		5,614,294
Compact Sector Grants - Private		<u>557,118</u>
Total Compact Sector Grants Fund	15.875	<u>19,223,983</u>
Historic Preservation	15.904	<u>11,219</u>
U.S. DEPARTMENT OF THE INTERIOR TOTAL		<u>\$ 19,235,202</u>

Note: The above grants are received in a subrecipient capacity through the FSM National Government.

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2007

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF LABOR		
WIA Youth Activities	17.259	\$ 7,885
WIA National Emergency/TS Chat	17.260	<u>(170)</u>
U.S. DEPARTMENT OF LABOR TOTAL		<u>\$ 7,715</u>

Note: The above grants are received in a subrecipient capacity through the FSM National Government.

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2007

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF HOMELAND SECURITY		
Public Assistance Project 1504	83.544	\$ 4,170
FEMA 1449 DR-FM PA (Pongsona)	83.544	298,371
FEMA 1427 DR-FM PA (Chaatan)	83.544	5,389
El Nino/ Drought Public Assistance	83.544	5,800
Hazard Mitigation#8 Agriculture Mitigation	83.544	5,640
Hazard Mitigation#13 Management Cost	83.544	<u>15,224</u>
U.S. DEPARTMENT OF HOMELAND SECURITY TOTAL		<u>\$ 334,594</u>

Note: The above grants are received in a subrecipient capacity through the FSM National Government.

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2007

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF EDUCATION		
BECLEPS (Bilingual Education)	84.290	\$ 28,488
Special Education	84.027B	<u>428,547</u>
U.S. DEPARTMENT OF EDUCATION TOTAL		<u>\$ 457,035</u>

Note: The above grants are received in a subrecipient capacity through the FSM National Government, except for the following, which are received directly from U.S. Department of Education: CFDA # 84.256A, CFDA # 84.290, and CFDA # 84.994.

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2007

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES		
Children's Oral Care	93.110	1,895
T.B. Elimination	93.116	19,015
Family Planning	93.217	23,425
Immunization	93.268	68,913
Tobacco Prevention	93.283	3,110
H.I.V. Care	93.917	8,567
AIDS Prevention	93.940	6,734
AIDS Surveillance	93.944	9,173
Substance Abuse Mental Health	93.959	58,650
System Based Diabetes	93.988	8,555
Community Health Promotion	93.991	520
MCH Programs	93.994	40,145
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES TOTAL		<u>\$ 248,702</u>
GRAND TOTAL		<u>\$ 20,308,154</u>

Note: The above grants are received in a subrecipient capacity through the FSM National Government.

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Notes to Schedule of Expenditures of Federal Awards
Year Ended September 30, 2007

1. Scope of Audit

The State is one of the four States of the Federated States of Micronesia. All significant operations of the State are included in the scope of the OMB Circular A-133 audit (the "Single Audit"). The U.S. Department of the Interior has been designated as the State's cognizant agency for Single Audit.

A. Programs Subject to Single Audit

Schedules of Expenditures of Federal Awards are presented for each federal program related to the following agencies:

- U.S. Department of Agriculture
- U.S. Department of the Interior
- U.S. Department of Labor
- U.S. Department of Homeland Security
- U.S. Department of Education
- U.S. Department of Health and Human Services

2. Summary of Significant Accounting Policies

A. Basis of Accounting

For purposes of this report, certain accounting procedures were followed which help illustrate the expenditures of the individual programs. All expenses and capital outlays are reported as expenditures on the accrual method of accounting.

B. Reporting Entity

For purposes of complying with The Single Audit Act of 1984, as amended in 1996, the State's reporting entity is defined in Note 1A to its September 30, 2007 basic financial statements; and all of the discretely presented component units are excluded. Accordingly, the accompanying Schedule of Expenditures of Federal Awards presents the federal award programs administered by the State, as defined above, for the year ended September 30, 2007.

C. Subgrantees

Certain program funds are passed through the State to subgrantee organizations. The Schedule of Expenditures of Federal Awards does not contain separate schedules disclosing how all the subgrantees outside of the State's control or utilize these funds.

D. Indirect Cost Allocation

The State does not receive any indirect cost allocation and does not charge indirect costs against federal programs.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Notes to Schedule of Expenditures of Federal Awards
Year Ended September 30, 2007

2. Summary of Significant Accounting Policies, Continued

E. CFDA #15.875

CFDA #15.875 represents the Office of Insular Affairs (OIA), U. S. Department of the Interior. Funding from this source is subject to varying rules and regulations since OIA administers the Compact of Free Association, which is a treaty, and is not a federal program. The Compact is comprised of various funded programs, each with separate compliance requirements. To maximize audit coverage of OIA funding, the OIG has recommended that programs administered under CFDA #15.875 be grouped by like compliance requirements and such groupings be separately evaluated as major programs.

3. Component Units

The State's component units are to separately satisfy the requirements of OMB Circular A-133. The following presents information concerning component units, which are to separately satisfy their A-133 requirements.

Chuuk Public Utilities Corporation

The Chuuk Public Utilities Corporation, (CPUC), a discretely presented component unit, is the recipient of various pass-through funds from Chuuk State and direct grants from the U.S. Department of the Interior. The CPUC is to separately satisfy its 2007 reporting responsibilities under the Single Audit Act.

Chuuk State Housing Authority

The Chuuk State Housing Authority (CSHA), a discretely presented component unit, is the recipient of various pass-through funds from Chuuk State and certain direct grants. The CSHA has yet to satisfy its 2007 reporting responsibilities under the Single Audit Act.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Programs Selected For
Audit in Accordance with OMB Circular A-133
Year Ended September 30, 2007

<u>Grantor Program Title</u>	<u>CFDA No.</u>	<u>2007 Fiscal Year Expenditures</u>
<u>U.S. Department of the Interior</u>		
Compact of Free Association:		
Compact Sector Grants	15.875	\$ <u>19,223,983</u>
Total U.S. Federal program expenditures selected		\$ <u>19,223,983</u>
Total U.S. Federal program expenditures		\$ <u>20,308,154</u>
% of total U.S. Federal expenditures covered by major programs		<u>95%</u>

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs
Year Ended September 30, 2007

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the statement of net assets of the governmental activities, and the governmental funds balance sheet for each major fund and the aggregate remaining fund information as of September 30, 2007 was qualified with respect to: 1) a liability for land leases and other claims payable in the governmental activities and the General Fund; 2) the inadequacy of records concerning capital assets for governmental activities; 3) the inadequacy of accounting records for land acquisitions payable recorded for the governmental activities and the General Fund, and disclaimed an opinion on the financial statements of the aggregate discretely presented component units, the statement of activities for the governmental activities, the governmental funds statement of revenues, expenditures, and changes in fund balances (deficits), and the reconciliation of the statement of revenues, expenditures, and changes in fund balances of governmental funds to the statement of activities for the year ended September 30, 2007.
2. Significant deficiencies in internal control over financial reporting were identified, some of which are considered to be material weaknesses.
3. Instances of noncompliance considered material to the basic financial statements were disclosed by the audit.
4. Significant deficiencies in internal control over compliance with requirements applicable to major federal award programs were identified, some of which are considered to be material weaknesses.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed a qualified opinion.
6. The audit disclosed findings required to be reported by OMB Circular A-133.
7. The State's major programs were:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
U.S. Department of the Interior – Compact of Free Association, Compact Sector Grants	15.875

8. A threshold of \$609,244 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. The State did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs
Year Ended September 30, 2007

Part II - Financial Statement Findings Section

<u>Reference Number</u>	<u>Findings</u>
2007-08	Fixed Assets
2007-09	Cash
2007-10	Investment Balance Reconciliation
2007-11	Accounts Receivable
2007-12	Reconciliation of Federal Grants Receivables
2007-13	Annual Leave Taken
2007-14	Employee Ceiling
2007-15	Accounting System Access
2007-16	Management Review and Approval for Journal Entries
2007-17	Potential Local Non-Compliance
2007-18	Revenue
2007-19	General/Local Payroll Expenditures
2007-20	Non-Payroll Expenditure
2007-21	Accounts Payable Maintenance

Part III - Federal Award Findings and Questioned Cost Section

<u>Reference Number</u>	<u>CDFA Number</u>	<u>Findings</u>	<u>Questioned Costs</u>
2007-01	15.875	Allowable Costs/Cost Principles	\$ 60,988
2007-02	15.875	Allowable Costs/Cost Principles and Procurement	\$472,412
2007-03	15.875	Procurement and Suspension and Debarment	\$716,252
2007-04	15.875	Procurement - Contract Provisions	\$ -
2007-05	83.544/97.036		
	84.027B/10.664	Cash Management	Undeterminable
2007-06	83.544/97.036	Allowable Costs/Cost Principles and Procurement	\$326,207
2007-07	84.290	Allowable Costs/Cost Principles	\$ 3,084
2007-08	15.875	Equipment and Real Property Management	\$ -

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-01
CFDA No.: 15.875
Program Name: Compact Sector Grants
Requirement: Allowable Costs/Cost Principles
Questioned Costs: \$60,988

Criteria: In accordance with applicable allowable costs/cost principles, payroll expenditures should be supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditure. Furthermore, such should be kept on file and made available for examination.

Conditions:

1. For 1 (or 1%) of 425 payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, the journal voucher and underlying supporting documents were not provided.

<u>FUNDORG</u>	<u>Fund Description</u>	<u>APV</u>	<u>Transaction Amount</u>
771401	Supplemental Education Grant	77JV5004	<u>\$37,422</u>

2. For 3 (or 1%) of 425 payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, no personnel action forms were provided.

<u>FUNDORG</u>	<u>Fund Description</u>	<u>PP#</u>	<u>Employee</u>	<u>Transaction Amount</u>
751159	Environment	6	60020	\$ 969
771401	Supplemental Education Grant	3	37234	421
751544		10		<u>1,086</u>
			Total	<u>\$ 2,476</u>

3. For 4 (or 1%) of 425 payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, no timesheets were provided.

<u>FundOrg</u>	<u>Fund Description</u>	<u>PP#</u>	<u>Employee</u>	<u>Transaction Amount</u>
751533	Conservation and Management	10D	25787	\$ 2,100
751533	Conservation and Management	10D	25787	183
761534	Marine Research & Dev.	10D	21879	2,319
761534	Marine Research & Dev.	10D	21879	<u>202</u>
			Total	<u>\$ 4,804</u>

4. For 67 (or 16%) of 425 payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, we noted differences in the recalculation of gross pay, as follows:

- a. 43 of 67 transactions resulted in an apparent overpayment of payroll expenditures.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-01, Continued

<u>FundOrg</u>	<u>PP#</u>	<u>Employee</u>	<u>Gross Pay Per Labor Cost</u>	<u>Gross pay Per DTT</u>	<u>Gross Pay Difference</u>
721411	26	22517	520	260	\$ 260
721411	26	612615	291	146	146
721421	24	24508	1,575	1,040	535
721421	JVD72008	45711	204	138	65
721411	26	1089	1,864	421	1,443
731205	23	40100	319	255	64
731206	22	1241	618	601	17
731201	23	53125	607	514	93
731201	24	606719	1,518	1,313	205
741105	23	600167	730	579	150
771401	23	37234	421	410	11
721411	6	27844	410	345	64
721411	6	32586	421	260	160
721421	1	21967	563	337	226
731206	2	260189	637	303	334
731201	2	50974	1,722	1,489	233
731206	4	229650	1,327	364	963
731201	1	611368	1,676	1,556	120
731206	4	229650	1,327	364	963
731206	4	602254	1,327	824	503
741624	1	53103	639	540	98
761955	2	47197	2,906	1,215	1,691
771401	2	72050	1,075	794	280
771401	5	39712	345	335	11
741105	1	99754	1,100	1,000	100
721421	3	610465	1,727	1,018	709
731201	1	14615	655	582	73
731206	4	53889	1,073	380	693
721411	13	54090	994	957	38
731206	10	16026	575	540	35
731206	8	606112	1,310	444	866
731206	11	75072	532	272	260
731201	11	57152	1,518	1,415	102
731205	10	40100	1,715	345	1,370
741624	25	38755	579	527	52
741621	25	94096	3,271	779	2,492
741624	25	38755	579	527	52
771401	13	23279	892	867	25
741624	22	609637	93	47	46
731221	3	25738	1,296	1,166	130
771401	14	611430	1,300	1,260	40
731221	15	25738	1,296	1,166	130
731221	18	621320	1,300	862	438
				Total	<u>\$16,286</u>

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-01, Continued

b. 24 of 67 transactions resulted in an underpayment of payroll expenditures.

<u>FundOrg</u>	<u>APV No.</u>	<u>Employee</u>	<u>Gross Pay Per Labor Cost</u>	<u>Gross pay Per DTT</u>	<u>Gross Pay Difference</u>
731205	26	19735	345	369	\$ (23)
721411	22	1089	369	421	(52)
721411	23	1089	369	421	(52)
721421	26	13218	345	369	(23)
721411	22	1089	369	421	(52)
731206	26	621124	279	289	(11)
731201	22	3023	1,108	1,313	(205)
721411	5	18156	554	830	(277)
771401	4	42810	394	438	(44)
721411	7	56367	957	994	(38)
721411	10	37348	957	1,018	(61)
721421	13	606061	291	859	(568)
721411	13	19752	475	505	(30)
731201	10	57152	1,518	1,621	(103)
731201	10	57152	1,518	1,621	(103)
771401	12	54278	1,243	1,322	(79)
771401	11	56414	1,032	1,228	(196)
771401	13C	618783	1,300	1,625	(325)
741604	2	600441	37	42	(5)
741624	10	64064	276	287	(11)
731201	17	14582	541	542	(2)
741621	20	22589	78	126	(48)
731206	20B	621124	250	255	(5)
741411	23	619768	138	154	(16)
				Total	<u><u>\$ (2,329)</u></u>

Cause: There appears to be weak internal controls over ensuring payroll expenditures are supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditure. Furthermore, there appears to be weak internal controls over ensuring record keeping of underlying supporting documents and that such are made available for examination.

Effect: The condition may result in potential noncompliance with applicable compliance requirements and potential misstatement of expenditures may exist. The (\$2,329) from condition 4b represents underpayment of payroll expenditures and is excluded in determining the final questioned cost amount. Therefore, questioned costs of \$60,988 result.

Recommendation: The State should strengthen internal controls over ensuring payroll expenditures are supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditure. Furthermore, the State should strengthen internal controls over retention of underlying supporting documents.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-01, Continued

Auditee Response and Corrective Action Plan: We generally agree with the finding and recommendation but note that the instances cited pertain to missing documentation rather than non-compliance with sound internal accounting controls over payroll expenditures. All sector payroll expenditures are verified before payment against appropriate timesheets and other authorizations and further checked by CFCC before checks are released. Moreover, in fiscal year 2008 substantial improvements were made in storage of personnel action forms and timesheets to allow for easier location and retrieval for auditors and others. The DAS staff will look for the missing documentation and attempt to clear the questioned costs with the auditors within 45 days.

**STATE OF CHUUK
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-02
CFDA No.: 15.875
Program Name: Compact Sector Grants
Requirement: Allowable Costs/Cost Principles and Procurement
Questioned Costs: \$472,412

Criteria: In accordance with applicable allowable costs/cost principles and procurement, non-payroll expenditures should be supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure and procurement method. Furthermore, such should be kept on file and be made available for examination.

Conditions:

1. For 25 (or 11%) of 234 non-payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, either no or insufficient procurement documentation was provided.

<u>FundOrg</u>	<u>Fund Description</u>	<u>APV</u>	<u>Transaction Date</u>	<u>Transaction Amount</u>
731201	Health	73JVD022	12/29/2006	\$ 1,033
761780	Private	760035001	11/1/2006	2,294
771401	Supplemental Education Grant	760023101	11/24/2006	2,983
771401	Supplemental Education Grant	700113401	12/12/2006	11,250
771401	Supplemental Education Grant	700094801	12/1/2006	3,300
771401	Supplemental Education Grant	700113301	12/8/2006	2,881
721776	Education	JVD72014	3/30/2007	4,997
731201	Health	700167401	1/12/2007	32,500
761780	Private	700263501	3/13/2007	2,915
771401	Supplemental Education Grant	760043601	1/18/2007	5,981
771401	Supplemental Education Grant	760065101	2/15/2007	5,400
771401	Supplemental Education Grant	760055801	1/31/2007	3,779
771401	Supplemental Education Grant	77JV6001	3/16/2007	14,016
771401	Supplemental Education Grant	700273401	3/22/2007	12,267
771401	Supplemental Education Grant	700192801	1/31/2007	9,850
721421	Secondary Education	700389901	5/17/2007	105,721
721403	Curriculum & Instruction	700389701	5/17/2007	94,335
721411	Elementary Education	700389801	5/17/2007	74,891
731206	Nursing	760112601	6/4/2007	2,886
741105	Accounting	760102001	5/10/2007	5,600
761780	Visitors Bureau	700312901	4/5/2007	4,360
771401	SEG	700329901	4/20/2007	9,850
771401	SEG	700445701	6/11/2007	3,300
731206	NURSING			500
731206	NURSING			687
			Total	\$ <u>417,576</u>

**STATE OF CHUUK
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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-02, Continued

2. For 9 (or 4%) of 234 non-payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, no receiving report were provided.

<u>FundOrg</u>	<u>Fund Description</u>	<u>APV</u>	<u>Transaction Date</u>	<u>Transaction Amount</u>
721776	Education	JVD72014	3/30/2007	\$ 4,997
731201	Health	700187401	1/25/2007	19,942
731201	Health	700292501	3/29/2007	18,998
731201	Health	700180701	1/31/2007	12,265
761780	Private	700263501	3/13/2007	2,915
771401	Supplemental Education Grant	760043601	1/18/2007	5,981
771401	Supplemental Education Grant	760085401	3/27/2007	3,631
771401	Supplemental Education Grant	77JV6001	3/16/2007	14,016
741105	Accounting	760102001	5/10/2007	5,600
Total				<u>\$88,345</u>

3. For 2 (or 1%) of 234 non-payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, no purchase requisitions or contracts were provided.

<u>FundOrg</u>	<u>Fund Description</u>	<u>APV</u>	<u>Transaction Date</u>	<u>Transaction Amount</u>
721776	Education	JVD72014	3/30/2007	\$ 4,997
771401	Supplemental Education Grant	77JV6001	3/16/2007	14,016
Total				<u>\$19,013</u>

4. For 1 (or 2%) of 234 non-payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, we noted a difference in recalculation of gross pay for the contractor.

<u>FundOrg</u>	<u>Fund Description</u>	<u>JV #</u>	<u>Transaction Date</u>	<u>Gross Pay Per System</u>	<u>Gross Pay Per DTT</u>	<u>Gross Pay Per System</u>
731201	Health	73JVD024	12/29/2006	\$ 1,246	\$ 1,385	\$ (139)

Cause: There appears to be weak internal controls over ensuring that expenditures are supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure or procurement method. Furthermore, there appears to be weak internal controls over retention of underlying supporting expenditure related documents.

Effect: The conditions may result in potential noncompliance with applicable compliance requirements and potential misstatement of expenditures may exist. Although the aggregate amount of all conditions listed above is \$524,795, a total of \$52,522 from conditions 2 and 3 has already been questioned at condition 1 and is excluded in determining the final questioned cost amount. The (\$139) from condition 4 represents underpayment of nonpayroll expenditure and is excluded in determining the final questioned cost amount. Therefore, a total questioned cost of \$472,412 exists.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-02, Continued

Recommendation: The State should strengthen internal controls over ensuring expenditures are supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure and procurement method. Furthermore, the State should strengthen internal controls over retention of underlying supporting documents.

Auditee Response and Corrective Action Plan: We do not agree with the finding and believe that State Finance is already in compliance with the recommendation. All sector non-payroll expenditures are supported by appropriate procurement documentation and this documentation is verified by CFCC before the State makes payment on its sector obligations. In fiscal year 2008, the DAS changed its filing system so that all supporting documents are filed with the check copy paid the vendor. We believe this will substantially cut down on reported instances of missing documentation. The DAS staff will look for the missing documentation and attempt to clear the questioned costs within 45 days.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-03
CFDA No.: 15.875
Program Name: Compact Sector Grants
Requirement: Procurement and Suspension and Debarment
Questioned Costs: \$716,252

Criteria: Procurements shall provide full and open competition among vendors, and allowable exceptions should be approved and be documented in procurement files.

Condition: For 11 (or 5%) of 234 non-payroll transactions tested for the Compact Sector Grants, CFDA No. 15.875, either no or insufficient procurement documentation was provided. The transactions appear to be asserted as being subject to emergency procurement procedures. We could not determine if such emergency existed due to a lack of planning or because of an emergency due to the occurrence of unanticipated events. Additionally, we were not provided evidence of a declared emergency and the basis therefore. The grantor agency authorized emergency procurement if a valid emergency exists and this finding does not contest this policy. At issue is whether State program management utilized emergency declarations (official or unofficial) to circumvent competitive procurement due to the absence of sufficient planning. Additionally, our examination of the items procured appear to indicate that such are ordinary supplies and medicines that are utilized in the day-to-day operations of the hospital and do not appear responsive to a specific emergency.

<u>Fund Org</u>	<u>Fund Description</u>	<u>Ref No.</u>	<u>Transaction</u>	
			<u>Date</u>	<u>P.O.Amount</u>
731201	Health	700180701	01/31/07	\$ 17,988
731201	Health	700180914	01/31/07	50,528
731201	Health	700180701	01/31/07	137,830
731201	Hospital & Management	700293214	4/4/2007	29,973
731201	Hospital & Management	700714602	9/13/2007	114,915
731201	Hospital & Management	73JVD099	9/30/2007	115,546
731201	Hospital & Management	73JVD101	9/30/2007	88,000
731201	Hospital & Management	73JVD118	9/30/2007	28,724
731201	Hospital & Management	73JVD126	9/30/2007	46,914
731201	Hospital & Management	JV730062	9/30/2007	55,097
731201	Hospital & Management	73JVD120	9/30/2007	<u>30,735</u>
			Total	<u>\$716,252</u>

Cause: There appears to be a lack of control over ensuring compliance with the criteria. Furthermore, it appears that emergency conditions may have risen due to a lack of adequate exercise over procurement options and due to a lack of planning. It is not apparent why medical supplies must be procured on a case by case basis, which may require or facilitate the issuance of an emergency declaration every time supplies run out. It is possible to engage in longer-term procurements that are based on past and projected activity. It is understood that certain emergencies may arise due to unique medical conditions or circumstances. However, the vast majority of the supplies acquired in the instances cited above do not appear to be unique and do not appear to be responsive to an emergency but instead appear to be responsive to a lack of planning and a lack of understanding of procurement processes. We appreciate the concerns of State management, but other States in the FSM appear to be able to conduct their operations without resorting to sole source procurement on a consistent basis and in such significant amounts. Therefore, we conclude that there is more than a reasonable doubt that the officially or tacitly declared emergencies may have been precipitated by other than an actual emergency contemplated by the grantor.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-03, Continued

Effect: The condition may result in disallowances and results in questioned costs.

Recommendation: The State should strengthen its internal controls to ensure compliance with the criteria. Furthermore, the State should ensure adequate planning is performed to prevent shortages of routine supplies. Additionally, we recommend follow up by the grantor agency, the FSM National Government and Chuuk State management into the rationale and reasons for the above condition.

Auditee Response and Corrective Action Plan: We agree with the finding in recommendation. In fiscal year 2007 there was an abuse of the emergency procurement process for the department of Health Services indicating poor planning and inventory control and improper resort to emergency procurements for non-extraordinary items. We concur with the Health Sector grant manager, OIA, who lineated in her memorandum of October 16, 2006 the extraordinary circumstances when emergency procurement might be acceptable:

- 1) Emergency purchases in cases where there is an absolute shortage or imminent outage of essential pharmaceuticals and medical supplies *despite "good faith" efforts to maintain adequate inventories.*
- 2) The emergency repair or immediate replacement of medical equipment deemed critical to clinical diagnosis and treatment
- 3) Emergency fuel purchases for in-state medical evacuations
- 4) The procurement of drugs that are not part of the regular hospital formulary but that are medically indicated for specialized treatment.

In fiscal year 2008 the use of emergency procurement was drastically curtailed and competitive procurement procedures strictly enforced. The ultimate goal of the Health Services department supported by the Department of Administrative Services is to utilize the U.S. DHHS Service Center at Perry Point, Maryland, in order to enjoy considerable cost savings and access to a complete inventory line of medical supplies and pharmaceuticals. Towards this end, the State paid most of its old liability to this vendor with the goal of fully paying them by September, 2008. The Directors of Health Services and Administrative Services will be responsible for implementing this change. Moreover, all quotes will be reviewed by CFCC to ensure compliance to proper procurement procedures.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-04
CFDA No.: 15.875
Program Name: Compact Sector Grants
Requirement: Procurement - Contract Provisions
Questioned Costs: \$0

Criteria: For all contracts the following provisions should be included, as applicable:

- (i) For contracts in excess of \$100,000, administrative, contractual, or legal remedies in instances where contractors violate or breach Contract terms, and the provision of such sanctions and penalties as appropriate;
- (ii) For contracts in excess of \$100,000, termination for cause and for convenience by the Grantee or Sub-Grantee including the manner by which it will be effected and the basis for settlement;
- (iii) Compliance with the local statutes regarding kickbacks and corrupt practices;
- (iv) Access by the Government of the Federated States of Micronesia and its Sub-Grantees, the Government of the United States, or any of their duly authorized representatives to any books, documents, papers, and records of the contractor which are directly pertinent to that specific Contract for the purpose of making audit, examination, excerpts, and transcriptions;
- (v) Retention of all required records for three years after Grantees or Sub-Grantees make final payments and all other pending matters are closed; and
- (vi) Compliance with all applicable standards, orders, or requirements issued under local environmental laws.

Condition: Noncompliance with the criteria occurred for the following contracts tested. The aggregate amount of these contracts was \$286,080.

<u>FundOrg</u>	<u>Transaction No.</u>	<u>Contract Reference No.</u>
721421	700433801	C70152
731201	700455401	C60052
771401	700329901	Lease agreement
771401	700445701	Lease agreement
771401	700340001	Lease agreement

Cause: There appears to be lack of internal control exercised over ensuring that compliance with the criteria occurs.

Effect: The State appears to be in noncompliance with the criteria.

Recommendation: We recommend that the State strengthen its control over ensuring that the abovementioned contract provisions and requirements are included, as applicable, in contracts.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The Office of the Attorney General will be requested to incorporate all required U.S. Federal contract provisions in Chuuk State contracts that utilize sector and other U.S. Federal Funds.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-05
CFDA No.: 83.544/97.036, 84.027B, 10.664
Program Name: Public Assistance Grants, Special Education Program, Cooperative Forestry Assistance Program
Requirement: Cash Management
Questioned Costs: Undeterminable

Criteria: In accordance with applicable cash management requirements, the time elapsed between the receipt of Federal funds and the clearance of disbursed checks should be minimized. The specified clearance pattern for Chuuk State is three days. Furthermore, any amount of interest from advances over \$100 should be returned to the Federal government.

Conditions:

1. For 9 (or 100%) of 9 transactions tested, totaling \$332,239, for the Public Assistance Program, CFDA No. 83.544/97.036, we were unable to perform required cash management tests as detailed federal draw downs and supporting reimbursements were not available for examination.
2. For 2 (or 100%) of 2 non-payroll transactions tested, totaling \$62,536, for the Special Education Program, CFDA No. 84.027B, we were unable to perform required cash management tests as detailed federal draw downs and supporting reimbursements were not made available for examination.
3. For 1 (or 100%) of 1 non-payroll transaction tested, totaling \$1,674, for the Cooperative Forestry Assistance Program, CFDA No.10.664, we were unable to perform required cash management tests as detailed federal draw downs and supporting reimbursements were not made available for examination.

Cause: There appears to be weak internal controls over ensuring compliance with applicable cash management requirements.

Effect: The State appears to be in noncompliance with applicable cash management requirements.

Recommendation: The State should comply with the criteria. However, in May 2007, the FSM National Government assumed the responsibility for program payments and also assumed the responsibility for cash management. Therefore, the matter has been resolved on a prospective basis.

Auditee Response and Corrective Action Plan: We agree with the finding. The prior pass-through arrangement of US Federal grants between the FSM national government and Chuuk State made it virtually impossible to control the lapse of time between receipt of federal funds and clearance of disbursement checks. As noted in the finding, the FSM Finance field office in Chuuk is now handling all US Federal grant disbursements so US federal cash management guidelines will no longer apply to the State.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-06
 CFDA No.: 83.544/97.036
 Program Name: Public Assistance Grants
 Requirement: Allowable Costs/Cost Principles and Procurement
 Questioned Costs: \$326,207

Criteria: In accordance with applicable allowable costs/cost principles and procurement, non-payroll expenditures should be supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure and procurement method. Furthermore, such should be kept on file and be made available for examination.

Conditions:

1. For 7 (or 78%) of 9 non-payroll transactions tested for the Public Assistance Grants, CFDA No. 83.544/97.036, no purchase requisitions, contracts, vendor's invoices, receiving reports, procurement documents, project worksheets, inspection or certification reports were provided.

<u>FundOrg</u>	<u>APV #</u>	<u>Transaction Date</u>	<u>Transaction Amount</u>
301037	700012501	10/13/06	\$ 22,649
301037	700147501	12/20/06	50,000
301037	700097001	12/18/06	5,000
301001	700054001	11/09/06	1,160
301037	700240901	03/14/07	28,784
301037	700147601	02/14/07	80,671
301037	700299501	03/29/07	<u>137,943</u>
		Total	<u>\$326,207</u>

Cause: There appears to be weak internal controls over ensuring that expenditures are supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure or procurement method. Furthermore, there appears to be weak internal controls over retention of underlying supporting expenditure related documents.

Effect: The conditions may result in potential noncompliance with applicable compliance requirements and potential misstatement of expenditures may exist. Furthermore, a total questioned cost of \$326,207 exists.

Recommendation: The State should strengthen internal controls over ensuring expenditures are supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure and procurement method. Furthermore, the State should strengthen internal controls over retention of underlying supporting documents.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-06, Continued

Auditee Response and Corrective Action Plan: We do not agree with the finding and believe the State is already in compliance with the recommendation. The expenditures in question pertain to those made by the Disaster Office from prior typhoon relief grants, primarily for repairs to the Weno dock. There is substantial documentation supporting payments under the dock contract and DAS staff will locate these documents for the auditors within 45 days.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-07
CFDA No.: 84.290
Program Name: BECLEPS (Bilingual Education)
Requirement: Allowable Costs/Cost Principles
Questioned Costs: \$3,084

Criteria: In accordance with applicable allowable costs/cost principles, payroll expenditures should be supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditure. Furthermore, such should be kept on file and made available for examination.

Condition: For 1 (or 100%) of 1 payroll transaction tested for the BECLEPS, CFDA No. 84.290, no timesheet was provided.

<u>FUNDORG</u>	<u>APV</u>	<u>Transaction Date</u>	<u>Employee</u>	<u>Transaction Amount</u>
301401	25B	12/10/06	35900	\$ 3,084

Cause: There appears to be weak internal controls over ensuring payroll expenditures are supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditure. Furthermore, there appears to be weak internal controls over ensuring record keeping of underlying supporting documents and that such are available for examination.

Effect: The conditions may result in potential noncompliance with applicable compliance requirements and potential misstatement of expenditures may exist. Furthermore, questioned costs of \$ 3,084 exist as the projected questioned costs exceed the threshold.

Recommendation: The State should strengthen internal controls over ensuring that payroll expenditures are supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditure. Furthermore, the State should strengthen internal controls over retention of underlying supporting documents.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. It is DAS's standard operating procedure that no employee will be paid without a properly authorized timesheet but as noted in other findings there have been problems with filing and retrieving some timesheets. In FY-08 new filing procedures were implemented for payroll documents that will prevent the recurrence of this particular problem.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No.: 2007-08
CFDA No.: 15.875
Program Name: Compact Sector Grants
Requirement: Equipment and Real Property Management
Questioned Costs: \$ 0

Criteria: The provisions of GASB Statement No. 34 were implemented in fiscal year 2003. The provisions include capitalization and depreciation of all long-lived assets, including infrastructure, MD&A requirements, and significant footnote changes, among others.

Condition: The State made progress during the year ended September 30, 2007 in expanding its inventory of capital assets, inclusive of infrastructure, to allow for the financial statement presentation required by GASB 34. The State has not been able to establish the basis of the carrying values of its assets, has not ensured compliance with federal equipment requirements and has yet to ensure whether all assets have been inventoried.

Cause: There appears to be inadequate controls exercised over ensuring that the State completes its duties and responsibilities associated with compliance with GASB 34 and federal equipment management requirements.

Effect: The condition results in a potential misstatement of fixed assets and an inability to conform to the GASB 34 presentation and disclosure requirements. The State is also in noncompliance with federal equipment management requirements.

Prior Year Status: This finding is reiterative of conditions identified in the prior year Single Audit.

Recommendation: The State should detail an action plan to allow for the timely resolution of GASB 34 requirements. If insufficient resources exist in the State to formulate and implement such a plan, the resources should be obtained through outside sources.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The Chuuk State DAS in conjunction with the FSM Secretary of Finance is taking steps to ensure full compliance with GASB 34. A retroactive restatement of fixed assets was made in fiscal year 2007 but several infrastructure assets have yet to be properly valued to support the costs carried on the fixed asset register. The completion of this project is schedule for September 30, 2008.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-09 – Cash

Criteria: Cash accounts should be reconciled in a timely manner. Additionally, the reconciliation should be made available for examination.

Condition: For the following accounts, no bank reconciliation was provided.

<u>Account No.</u>	<u>Amount</u>
10-107	\$ 36,425
10-121	714
10-135	586

Cause: While we noted substantial improvements in bank reconciliation maintenance after year end, it does not appear that the above accounts were reconciled.

Effect: The condition may result in a potential misstatement of cash.

Prior Year Status: The above conditions are reiterative of prior year findings.

Recommendation: The State should continue to strengthen internal controls over ensuring that monthly bank reconciliations are performed in a timely manner and that reconciling items are resolved and corrected in the following month.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. DAS management will ensure that all bank accounts are timely reconciled in fiscal year 2008.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-10 – Investment Balance Reconciliation

Criteria: Investment balances should be reconciled in a timely manner.

Condition: The State does not reconcile its investments during the year and appears to await the audit process to achieve this end.

Cause: There appears to be weak internal controls over ensuring investments are periodically reconciled.

Effect: The condition may result in a potential misstatement of investments and revenues as the State does not have knowledge as to the status of its investments or the related impact on its revenues until substantially after the fiscal year end.

Prior Year Status: This finding is reiterative of conditions identified in the prior year audits.

Recommendation: The State should strengthen internal controls to ensure proper reconciliations of its investments are performed on a monthly basis upon the receipt of the related investment account information from the trustees.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Chuuk Finance will consult with responsible employees at the FSMNG Investment division for the proper procedures to reconcile its investments using reports from the money managers.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-11 – Accounts Receivable

Criteria: Accounts receivables should be supported by aging detailed sub-ledgers and should be monitored for receivable validity, and all invalid receivables should be written off. Furthermore, documentation in support of the reconciliations should be maintained on file and be made available for review.

Conditions:

1. For Fund 10, Account 280, Travel Advances, we noted \$257,273 or 84% of the total accounts receivable of \$307,026, is outstanding greater than 90 days.
2. Fund 60, Account 250, represents funds administered by the FSM National Government on behalf of Chuuk State. During the fiscal year, the State made a transfer from the General Fund to the Federal Grants Fund in the amount of \$284,872 as the matching requirement for the Public Assistance Grants. Additionally, we were made aware of a matching requirement paid for by the FSM National Government, using Chuuk State Funds prior to fiscal year 2005. No detailed reconciliation was made available for examination to verify that the applicable matching requirements have been met.

Cause: There appears to be weak internal controls ensuring that accounts receivable are supported by detailed sub-ledgers and are monitored for receivable validity and that such are maintained on file and are made available for review.

Effect: The condition may result in a potential misstatement of accounts receivable.

Prior Year Status: The above conditions are reiterative of prior year findings.

Recommendation: The auditee should strengthen internal controls to ensure accounts receivable are supported by detailed sub-ledgers and are monitored for receivable validity, and all invalid receivables should be written off and the supporting sub-ledgers should be maintained on file and be made available for review.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In fiscal year 2007, all open travel advances from fiscal year 2005 and prior were written off. A detail subledger supports the general ledger balance. Moreover, the general ledger balance is fully reserved in the allowance for doubtful accounts.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-12 –Reconciliation of Federal Grants Receivables

Criteria: Receivables due from the federal government should be aggregated by CFDA number. Collections should be applied against a specific CFDA number/program. This detail can be maintained apart from the general ledger system but should be regularly reconciled with related general ledger balances. Abnormal balances should be timely identified and reconciled.

Condition: In the current year, effort has been made to reconcile and identify the federal grants receivables. Improvements occurred in this regard as current year receivable additions were identified per federal program. However, the beginning year totals with negative balances aggregating \$873,790 are still not reconciled and are recorded as payables.

Cause: It appears that although substantial effort has occurred to reconcile the federal receivable per CFDA number or by program, effort to reconcile the beginning balances has not been undertaken.

Effect: As a result of this condition, it becomes more difficult to determine the amount that should be provided for an allowance for doubtful accounts for the recorded. However, agreement was generally reached on the net amount of the receivable that would be subject to collection from the FSM National Government. Therefore, the net impact on the financial statements does not appear material.

Recommendation: We recommend that the efforts associated with identifying federal program receivables per CFDA number and by program continue and that collections be specifically applied against these receivables. The above beginning balances should be reconciled.

Auditee Response and Corrective Action Plan: We do not agree with the finding , noting that the \$873,790 balance due from the FSM national government is carried by Chuuk State as an accounts receivable and moreover agrees to a like amount booked by the FSMNG as an accounts payable. Moreover, the Secretary of Finance acknowledges this liability although it is unclear where the FSMNG will find the cash to liquidate it since most of the balance is now older than two years and the respective grants closed. The remaining balance will be reevaluated at September 30, 2008 and a determination made on whether to reserve an appropriate amount as a bad debt if it is not collectable.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-13 – Annual Leave Taken

Criteria: Per Chuuk State Public Service Regulation, all annual leave requests must be approved in advance by the employee's division head upon recommendation of employee's immediate supervisor. In a smaller organization, where divisions may not exist, the head of such organization shall approve annual leave.

Condition: For 9 of 9 (100%) transactions tested, the approved annual leave forms showing the annual leave hours taken during FY 2007 were not provided for examination.

<u>FundOrg</u>	<u>Employee</u>	<u>Annual Leave (Hrs)</u>	<u>Annual Leave (\$)</u>
101051	54474	358	1,293
721401	16448	406	2,528
721411	35447	516	957
721411	49088	412	1,384
721421	600143	472	1,018
731201	24287	518	5,288
731206	602254	642	1,149
741131	600167	192	1,542
771401	42810	414	1,969

Cause: There appears to be weak internal controls over ensuring that the annual leave taken is supported by approved annual leave request.

Effect: The condition may result in noncompliance with the criteria.

Recommendation: The State should ensure that approvals of annual leave taken are documented and readily available for verification.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. It is DAS's standard operating procedure to require all annual leave payments to be properly documented and approved. In fiscal year 2008, Chuuk State DAS implemented changes in its payroll filing system to ensure documents supporting annual leave are available for subsequent verification purposes.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-14 – Employee Ceiling

Criteria: The maximum number of positions at the State shall not exceed the positions as stated Per Public Law No. 8-06-07.

Condition: The number of positions for the following departments appear to have exceeded the maximum number allowed under public law (P.L.).

<u>Department</u>	<u>Dept. Total</u>	<u>Per P.L.</u>	<u>Excess</u>
Administrative services	176	160	16
Attorney General	16	13	3
EPA	17	15	2
Coconut authority	12	0	12
Education	1,401	1,107	294
Governor's office	29	16	13
Health services	481	436	45
Housing authority	7	0	7
Marine resources	64	63	1
Public safety	209	151	58

Cause: There appears to be weak internal controls over ensuring that the State is in compliance with the maximum positions allowed per public law.

Effect: The condition may result in unauthorized hiring of employees.

Recommendation: The auditee should strengthen internal controls to ensure that the government is in compliance with the maximum positions allowed per public law.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In fiscal year 2008, Chuuk State implemented a reduction in force (RIF) in which 390 budgeted positions were eliminated that included the termination of 195 employees who had been active in fiscal year 2007. Moreover, with the new Director of DAS, proper hiring procedures are being rigorously enforced to ensure only those employees authorized by public law are hired. This will substantially resolve excesses noted to authorize employee ceilings.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-15 – Accounting System Access

Criteria: The State should ensure that physical and user system accesses to the accounting system and supporting hardware are restricted based on employee position, title and division and be approved by management.

Condition: The State does not restrict access to the accounting system.

Cause: There appears to be weak internal controls over ensuring physical and user system access restrictions to the accounting system are performed.

Effect: The condition may result in potential unauthorized use or editing of accounting information and records.

Recommendation: The State should strengthen internal controls over ensuring that appropriate restrictions are imposed over the physical and user system access to the accounting hardware and accounting system.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. With the implementation of the new FMIS system in February 2008 all users were assigned security levels whereby they can only access accounting modules appropriate for their need. Additionally, physical access to the entire Finance department is now restricted to employees only.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-16 – Management Review and Approval of Journal Entries

Criteria: The State should ensure that journal entries are reviewed and approved by the Director of Finance (or a designee) prior to being recorded in the financial management system.

Condition: Per examination of Journal Voucher, 790022, we noted the Director of Finance (or their designee) did not review and approve the Journal Voucher.

Cause: There appears to be weak internal controls over ensuring proper review and approval of journal entries by the Director of Finance or an appropriate designee.

Effect: The condition may result in potential unauthorized recording and editing of accounting information and records.

Recommendation: The State should strengthen internal controls over ensuring that all journal entries are reviewed and approved by the Director of Finance or a designee.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Effective in fiscal year 2008, the Chief of Finance now signs all general journal entries.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-17 – Potential Local Non-Compliance

Criteria: The State should ensure that transfers to the General Fund from funds that were previously restricted for particular purposes, are supported by either law or an Attorney General opinion.

Condition: Per examination of the Compact Capital Accounts and the Other Governmental Funds, transfers to the General Fund aggregating \$3,639,440 were not supported by legal determinations.

Cause: Laws or an Attorney General opinion was not obtained to support the transfer.

Effect: The condition may result in potential local noncompliance.

Recommendation: The State should strengthen internal controls over ensuring that appropriate legal support is obtained to document the basis of transfers.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In fiscal year 2007, the State collapsed stagnant balances of special revenue and old Compact CIP fund to the general fund, resulting in a \$3.6 million transfer-in to the general fund and a corresponding reduction in the general fund unreserved fund deficit. This was an accounting determination made by the Director DAS under criteria established in GASB 34. The Director DAS will obtain legal approval of these transfers from the Attorney General who was supportive of the State's other deficit reduction measures.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-18- Revenue

Criteria: Revenues should be supported by and agree with underlying billings, cash receipts, bank validated deposit slips, contracts/leases and other valid documentation. Additionally, cash collections should be deposited in a timely manner and cash collections should reconcile with the underlying deposit in the bank statement. Furthermore, such should be kept on file and be available for examination.

Conditions:

- For 1 (or 2%) of 58 transactions tested for General Fund revenue, we noted that cash receipts in July 2005 were not deposited until October 2006.

<u>FUNDORG</u>	<u>Account</u>	<u>Transaction</u>	<u>Date Received</u>	<u>Date Deposited</u>	<u>Transaction Amount</u>
101101	7713	Other - Donations	07/21/05	10/23/06	\$ 18,591

- For 3 (or 5%) of 58 transactions tested for General Fund revenue, we noted that the amount per the treasury receipt did not agree with the bank deposit slip.

<u>FUNDORG</u>	<u>Account</u>	<u>Transaction</u>	<u>Per Treasury Receipt</u>	<u>Per Bank Deposit Slip</u>	<u>Difference</u>
101121	7312	Sales Tax	\$ 15,023	\$ 12,602	\$ 2,422
101121	7312	Sales Tax	126,104	125,829	275
101121	7312	Sales Tax	98,428	94,428	4,000

- For 3 (or 5%) of 58 transactions tested for General Fund revenue, there were many cash deposits that the State was not able to determine the applicable revenue account. These deposits were recorded as year end miscellaneous revenue. Furthermore, for 1 of 4 transactions tested, the balance recorded for revenue did not agree with the underlying bank statement.

<u>FUNDORG</u>	<u>Account</u>	<u>Transaction</u>	<u>Per G/L</u>	<u>Per Bank Statement</u>	<u>Difference</u>
101101	7999	Misc. Rev.	\$24,500	\$29,500	\$5,000

Based on tests performed of General Fund revenue, the State did not perform bank reconciliations on a monthly basis. As a result, there were many cash deposits that the State was not able to determine the applicable revenue account to charge and therefore, the deposit was charged to miscellaneous revenue at year end.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-18 – Revenue, Continued

4. For 1 (or 1%) of 58 transactions tested for General Fund revenue, we noted that interest income for a period ending 09/30/2006 was recorded as a current year interest income.

<u>FUNDORG</u>	<u>Account</u>	<u>Transaction</u>	<u>Amount</u>	<u>Interest for Period Ending</u>	<u>Date Recorded</u>
101121	7830	Interest Income	\$6,300	09/30/2006	10/11/2006

Cause: There appears to be weak internal controls over ensuring that revenues are supported by and agree with underlying billings, cash receipts, bank validated deposit slips, contracts/leases and other valid documentation and that cash collections are deposited in a timely manner and cash collections reconcile with the underlying deposit in the bank statement. Furthermore, such should be kept on file and be available for examination.

Effect: The condition may result in a potential misstatement of revenues.

Recommendation: The State should strengthen internal controls over ensuring that revenues are supported by and agree with underlying billings, cash receipts, bank validated deposit slips, contracts/leases and other valid documentation and that cash collections are deposited in a timely manner and cash collections reconcile with the underlying deposit in the bank statement. Furthermore, such should be kept on file and be available for examination. Monthly bank reconciliation should be performed and should be reviewed by a higher level of management.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In February 2008, a new FMIS system was implemented that includes a cash receipt system that updates in real time the general ledger when the receipt is given the customer. Cash receipts are now reconciled to deposits on a daily basis and there is now more timely entry of wire transfer deposits for sector and revenue sharing funds. Also in fiscal year 2007, all outstanding reconciling items for various cash accounts were booked to allow for a clean bank reconciliation process in fiscal year 2008. Bank reconciliations are now performed monthly. The Director DAS has prioritized enhancing internal controls and collection efforts of the Tax & Revenue division to not only remedy deficiencies noted in prior audits but to significantly increase the amount of local revenues collections.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-19 – General/Local Payroll Expenditures

Criteria: Payroll expenditures should be supported by employee personnel action forms, supporting timesheets and other underlying supporting documentation validating the expenditures. Furthermore, such should be kept on file and made available for examination.

Conditions: For 2 of 42 (or 5%) payroll transactions tested, we could not determine whether the gross salaries paid to the employees reflect the amount authorized because of unavailability of an updated Personnel Action Form.

<u>Emp No.</u>	<u>PP</u>	<u>F. Org</u>	<u>Rate per PAF</u>	<u>Rate per System</u>
609960	02A	101361	\$1.97	\$1.86
904164	20B	101451	Not available	8.03

Additionally, for 4 of 42 samples tested (or 10%), we could not determine whether the gross salaries paid to the employees reflect the amount authorized because of unavailability of Municipality Ordinances justifying the hours and pay-rates of Municipal employees.

<u>Emp No.</u>	<u>PP</u>	<u>F. Org</u>	<u>Rate per System</u>
10741	08M	101805	7.99
915503	10M	101824	0.00
613161	09M	101806	0.05
33532	03M	101830	0.20

Effect: The conditions may result in potential noncompliance with applicable compliance requirements and potential misstatement of expenditures may exist.

Recommendation: The State should strengthen internal controls over ensuring expenditures are supported by authorized and updated Personnel Action Forms, timesheets, and other documents justifying pay-rate and hours worked. Furthermore, the Chuuk State Government should strengthen internal controls over ensuring proper record keeping of underlying supporting documents and that such are made available for review.

Auditee Response and Corrective Action Plan: We generally agree with the finding and recommendation. Because of cash flow shortages in fiscal year 2007, municipal employees were partially paid flat amounts each quarter based on funds available and not by the authorized wage rates. To accommodate this process in the FOCUS software, the applicable rates were changed to back into the flat amount paid using the authorized quarterly hours. This practice has been discontinued in fiscal year 2008. The new payroll software implemented in February 2008 allows for flat amounts to be paid without adjusting either the default hours or default wage rates. Additionally, notwithstanding filing problems in the Personnel Office, the Chief of Finance is obtaining copies of missing Personnel Action Forms when it is noted they aren't available.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-20 – Non-Payroll Expenditure

Criteria: Non-payroll expenditures should be supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure. Furthermore, such should be kept on file and made available for examination.

For 2 (or 33%) of 6 encumbrance transactions tested (\$20,284 of the aggregate amount of \$170,890), no encumbrance documents were provided for examination.

<u>ORG</u>	<u>CC</u>	<u>PONO</u>	Transaction <u>Amount</u>
301037	TX7301	L70123	\$ 7,983
301037	TX7301	L70128	12,301

Cause: There appears to be weak internal controls over ensuring expenditures are supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure. [For revenues, cash receipts, bank slips, and other supporting documents] Furthermore, there appears to be weak internal controls over record keeping of underlying documents.

Effect: The conditions may result in potential noncompliance with applicable compliance requirements and potential misstatement of expenditures or revenues may exist.

Recommendation: The State should strengthen internal controls over ensuring expenditures are supported by purchase requisitions, purchase orders, vendor invoices, receiving reports, contracts, journal vouchers, procurement documents and other underlying supporting documentation validating the expenditure. Furthermore, the State should strengthen internal controls over record keeping of underlying documents and ensure that such are on file.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The new filing system implemented in fiscal year 2008 ensures that encumbrance documentation is filed with each expenditure. Moreover, the Purchasing and Supply division has been relocated to the State finance office so that missing documents can be more readily located.

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Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2007

Finding No. 2007-21 – Accounts Payable Maintenance

Criteria: Expenditures should be recorded in the correct accounting period

Condition: Eight of 54 (or 15%) General Fund expenditures tested were found to be unpaid; however, the expenditures were not recorded as accounts payable.

<u>ORG</u>	<u>DESC1</u>	<u>DATE</u>	<u>Check No</u>
101801	760144501	7/11/2007	34916
101801	760166301	8/30/2007	34916
101711	700639801	8/30/2007	34822
101711	700725801	9/14/2007	34979
101711	700186301	1/26/2007	101356
101711	700339601	4/17/2007	33523
101735	700207701	7/21/2007	101744
101801	700060401	11/15/2006	100493

Cause: The cause of this condition appears to be a lack of accounts payable maintenance.

Effect: A potential overstatement of 2007 expenditures results from this condition.

Recommendation: We recommend that the State engage in monthly accounts payable reconciliation and analysis.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In fiscal year 2007 cash flow problems and a fiscal deficit in the general fund, caused the DAS to fall behind in entering and paying accounts payable vouchers. In fiscal year 2008, the new Director DAS has exercised strict fiscal discipline over general fund expenditures and as a result, the State has enjoyed a small budgetary surplus. General fund vouchers are now entered and paid on a timely basis even though there are still significant unpaid vouchers from prior fiscal years. The new accounts payable software implemented in February 2008, has reports that detail open accounts payable vouchers by fund. The Chief of Finance will use this report to perform timely reconciliations and analyses of open invoices.

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Resolution of Prior Years' Findings and Questioned Costs
Year Ended September 30, 2007

For the year ended September 30, 2007, the following questioned costs were noted and prior questioned costs resolved:

	Questioned Costs Set Forth in Prior Audit Report <u>2006</u>	Questioned Costs Resolved for Fiscal Year <u>2007</u>	Questioned Costs at <u>September 30, 2007</u>
Unresolved Questioned Costs FY 99	\$ 28,619	\$ 28,619	\$ -
Unresolved Questioned Costs FY 00	241,908	241,908	-
Unresolved Questioned Costs FY 01	369,497	218,900	150,597
Unresolved Questioned Costs FY 02	154,072	-	154,072
Unresolved Questioned Costs FY 03	1,840,358	32,500	1,807,858
Unresolved Questioned Costs FY 04	4,101,675	726,976	3,374,699
Unresolved Questioned Costs FY 05	1,728,813	481,646	1,247,167
Unresolved Questioned Costs FY 06	<u>958,987</u>	<u>-</u>	<u>958,987</u>
	\$ <u>9,423,929</u>	\$ <u>1,730,549</u>	7,693,380
Questioned Costs FY 07			<u>1,578,943</u>
			\$ <u>9,272,323</u>

During the fiscal year ended September 30, 2007, the above resolved questioned costs, aggregating \$1,730,549, were resolved by the FSM National Government.