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June 30, 2011

Honorable Rose N. Nakanaga
Acting Secretary of Finance and Administration
Federated States of Micronesia:

Dear Acting Secretary Nakanaga:

In planning and performing our audit of the financial statements of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Federated States of Micronesia (FSM) National Government as of and for the year ended September 30, 2010 (on which we have issued our report dated June 30, 2011), in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered the FSM National Government's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the FSM National Government's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of FSM's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to the FSM National Government's internal control over financial reporting and other matters as of September 30, 2010 that we wish to bring to your attention.

We have also issued a separate report to the President, His Excellency Emmanuel Mori, also dated June 30, 2011, on our consideration of the FSM National Government'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 definition of a deficiency is also set forth in the attached Appendix I.

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

This report is intended solely for the information and use of the management of the FSM National Government and the Office of the National Public Auditor and is not intended to be and should not be used by anyone other than these specified parties. However, this report is also a matter of public record.

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

We wish to thank the staff and management of the FSM National Government for their cooperation and assistance during the course of this engagement.

Very truly yours,

Deloitte & Touche LLP

SECTION I – OTHER MATTERS

We identified, and have included below, other matters involving the FSM National Government's internal control over financial reporting as of September 30, 2010 that we wish to bring to your attention:

1. Bank Deposits

   Comment: Certain collections were not timely deposited the following business day.

   Recommendation: Timely deposits of collections should occur.

2. Cash Accounts

   Comment: Certain outstanding checks tested, as well as certain checks included in the outstanding check listing, were stale-dated and had been outstanding in excess of 180 days.

   Recommendation: The National Government should monitor long outstanding reconciling items as to validity.

3. Monitoring of Cash Receipts

   Comment: There were gaps noted in tax receipts and the Government was not able to provide the whereabouts of those receipts. Missing receipt numbers were not accounted for in the control log and we were therefore unable to determine if the cash receipts were voided or missing. Additionally, receipts were not used in sequence. It does not appear to be a current procedure of CTA and the National Treasury to consistently account for the completeness of receipts and to undertake corrective action relative to missing cash receipts.

   Recommendation: The National Government should account for the completeness of cash receipts and missing receipts should be timely investigated. Receipts should be used sequentially. Cash receipt numbers used by a state should also be keyed in the system and such should be used to account for the completeness of the series. Additionally, original copies of voided receipts should be kept on file.

4. Formalize Loan Agreement

   Comment: A formal loan agreement has not been prepared supporting a loan extended to a component unit. An immaterial difference in the outstanding loan amount exists between the two parties.

   Recommendation: The Government should formalize the loan agreement and resolve the current difference.

5. Accounts Receivable

Comment: Significant collections of receivables from NOAA do not appear to have occurred. Additionally, the same appears to be the case for vendors billed for overtime charges of National Government employees and other miscellaneous receivables.

	AR	Allowance	Net
General	$ 1,366,033	$ 1,366,033	$ -
NOAA	1,370,113	806,699	563,414
	$ 2,736,146	$ 2,172,732	$ 563,414

Recommendation: Aggressive efforts should occur to collect these receivable. As for NOAA, as it is a reimbursable federal program, the National Government may wish to revisit the cost of administering the program considering the amount of potential losses being incurred.

6. Missing Documents

Comment: Certain underlying documentation requested for non-U. S. federal transactions could not be located. The dollar value of the unlocated items was considered to be immaterial to the financial statements.

Recommendation: The National Government should maintain sufficient documentation on file to substantiate recorded costs.

7. Timely Submission of Cash Receipts

Comment: Certain collections made by CTA were not timely submitted to the National Treasury Field Offices.

Recommendation: The National Government should ensure that cash received by the CTA offices is timely submitted to the Treasury office.

8. Justification/Referencing

Comment: Referenced justifications for certain transactions were incorrect.

Recommendation: The National Government should ensure that references and justifications are appropriately documented.

9. Procurement

Comment: For certain non-U.S. federal transactions, procurement procedures did not appear to conform to established requirements.

Recommendation: The National Government should ensure that appropriate procurement procedures are applied.

10. Deferred Revenue

Comment: For certain non-US Grants tested, no movement in recorded deferred revenue occurred during the year and the applicable award was silent as to the return of funds upon project completion. There was insufficient documentation (cash receipt or grant award) to fully determine the validity of the recorded balances. Additionally, several deferred revenue accounts have not yet been transferred to Fundware.

Recommendation: The continuing validity of the deferred revenue accounts should be assessed.

11. Pre-numbered Documents

Comment: It is normally best practice to use pre-numbered documents (i.e. checks, cash receipts) to minimize the duplication of documents and to provide a control to account for their completeness. In Fundware, cash receipts and check numbers are system assigned. If documents are pre-numbered, the documents should be used in sequence (such as CTA cash receipts). We noted instances of duplicate check numbers.

Recommendation: The National Government may consider using pre-numbered documents to deter and to minimize fraudulent reproduction of documents. If pre-numbered documents are used, they should be used in sequence.

12. Code of Ethics

Comment: FSM Department of Finance and Administration, Division of Personnel maintain the Code of Conduct which was adopted on June 14, 1999; however, it appears that the Code may not have been appropriately disseminated to Government personnel.

Recommendation: The Government should disseminate the code to Government personnel. The Government may communicate the existence of this manual during the hiring process and such communication should be reduced to writing.

13. Reconciliation

Comment: Discrepancies were noted in various accounts that were confirmed by the states.

Recommendation: An accurate and timely reconciliation of accounts between the states and the FSM National Government should occur.

SECTION II – DEFINITIONS

The definition of a deficiency that is established in AU 325, *Communicating Internal Control Related Matters Identified in an Audit*, is as follows:

A *deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

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

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

Management's Responsibility

FSM National Government management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

Objectives of Internal Control over Financial Reporting

Internal control over financial reporting is a process affected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

Inherent Limitations of Internal Control over Financial Reporting

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