



# FEDERATED STATES OF MICRONESIA

## Office of The National Public Auditor

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Friday, July 14, 2006

Honorable Members of the FSM Congress  
His Excellency Joseph J. Urusemal, FSM President  
Joint Trust Fund Committee Members

### **RE: Inspection of the Compact Trust Fund**

We have conducted an inspection of the Compact Trust Fund covering the period from August 2004 until May 2006. The objective of this inspection was to evaluate whether the Trust Fund Committee (TFC) is effectively and efficiently complying with the administrative requirements as stated in the Agreement implementing sections 215 and 216 of the Compact, as amended (referred to as the Agreement). The inspection was conducted in accordance with the US President's Council on Integrity and Efficiency (PCIE)/Executive Council on Integrity and Efficiency (ECIE) Quality Standards for Inspections released in January 2005.

We found that the TFC has not provided needed leadership, communication, and coordination to meet the requirements of the Agreement. Specifically, the TFC was established months after funds were deposited in a Trust Fund account. Also, key positions outlined in the Agreement were not appointed in a timely manner. Finally, various administrative functions were not performed or were performed in an untimely manner. These actions resulted in a lower than expected income for the first years of the Trust Fund. Specifically, for Fiscal Years 2004 and 2005 the Trust Fund only earned a 2.23 percent rate of return, while even a conservative investment strategy in 2003 forecasted a 6 percent rate of return. These actions can also lead to the potential underperformance of the Trust Fund assets and potential loss earnings. The findings and recommendation are described in greater detail in the attachment to this letter.

We provided the TFC members with a copy of the draft report for their review and comments by July 14, 2006. No responses were received on that date.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Haser Hainrick".

Haser Hainrick  
National Public Auditor

Attachment

**Office of the National Public Auditor  
Inspection of the Compact Trust Fund  
ONPA 2006-03**

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**TABLE OF CONTENTS**

BACKGROUND.....	2
SCOPE, OBJECTIVE AND METHODOLOGY .....	2
FINDINGS AND RECOMMENDATION.....	3
Untimely establishment of the TFC .....	3
Delay in the Appointment of Key Positions .....	3
Administrative Requirements Not Met or Not Timely .....	4
PUBLIC AUDITOR’S COMMENTS .....	6
ONPA CONTACT AND STAFF ACKNOWLEDGEMENT .....	7

**Office of the National Public Auditor  
Inspection of the Compact Trust Fund  
ONPA 2006-03**

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## **BACKGROUND**

The Amended Compact of Free Association between the Government of the United States of America (US) and the Government of the Federated States of Micronesia (FSM) provides for the establishment of a Trust Fund. The purpose of the Trust Fund is to contribute to the economic advancement and long-term budgetary self-reliance of the FSM by providing an annual source of revenue after Fiscal Year 2023. These funds are intended for assistance in the sectors described in Section 211 of the Compact, as amended, or other sectors mutually agreed by the US and the FSM Governments, with priorities in education and health care.

In accordance with the Sections 215 and 216 of the Compact, as amended (referred to as the Agreement), the FSM contributed \$30.3 million to the Trust Fund in 2004 and the US contributed \$32.2 million in 2004 and \$16.4 million in 2005. The Trust Fund is to be governed by the provisions of the Agreement and administered by a Joint Trust Fund Committee (TFC). The composition of the TFC shall be three voting members appointed by the government of the US, which shall include the Chairman; and two voting members appointed by the FSM. Other voting or non-voting members may be appointed, provided that the US maintains the majority vote in the TFC.

The functions of the TFC include overseeing:

- a. The operation, supervision, and management of the Trust Fund;
- b. The investment and distribution of resources of the Trust Fund;
- c. The conclusion of agreements and arrangements with subsequent contributors and other organizations.

## **SCOPE, OBJECTIVE AND METHODOLOGY**

The objective of this inspection was to evaluate whether the TFC is effectively and efficiently complying with the administrative requirements of the Agreement.

To meet this objective, we reviewed laws and agreements relating to the Trust Fund; interviewed Committee members and the FSM Office of Compact Management staff; and reviewed audit reports by other auditors for issues relating to the Trust Fund.

In addition, we attempted to contact the other committee members, i.e., those from the US including the current chairman. However, the chairman declined to comment on our inquiry in an e-mail stating that he was “awaiting legal advice as to whether permitted to respond...” in March 2006. In May of 2006, he stated that he has not received clearance from the State Department and still could not talk with us or provide requested information. Finally, we requested minutes of committee meetings, but we were told that none were developed.

Fieldwork for this engagement began in March 2006 after the intent to inspect the Trust Fund was communicated to the TFC members and ended in May 2006. The inspection was conducted

**Office of the National Public Auditor  
Inspection of the Compact Trust Fund  
ONPA 2006-03**

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in accordance with the US President's Council on Integrity and Efficiency (PCIE)/Executive Council on Integrity and Efficiency (ECIE) Quality Standards for Inspections released in January 2005.

## **FINDINGS AND RECOMMENDATION**

In summary, we found that the TFC has not provided needed leadership, communication and coordination to meet the requirements of the Agreement. Specifically, the TFC was established months after funds were deposited in a Trust Fund account. Also, key positions outlined in the Agreement (such as, a Trustee, an Investment Advisor, Money Manager(s), and an Auditor) were not appointed in a timely manner. Finally, various administrative functions were not performed or were preformed in an untimely manner.

These actions resulted in a lower than expected income for the first years of the Trust Fund and eventually could lead to potential underperformance of the Trust Fund assets and potential loss earnings. Specifically, for Fiscal Years 2004 and 2005 the Trust Fund only earned a 2.23 percent rate of return, while even a conservative investment strategy in 2003 forecasted a 6 percent rate of return. This 6 percent rate of return is comparable with the Congressional Budget Office's 2003 average forecasted return for long-tem U.S. government bonds of 5.8 percent.

### **Untimely establishment of the TFC**

The Agreement states that there shall be a TFC composed of voting, and, when applicable, non-voting members to administer the Trust Fund. Although the Agreement does not list a deadline for forming the TFC, prudent business practice dictates that the TFC should have been formed either before, or at least at the same time as the Trust Fund was established.

The TFC was established in July 2005, approximately one year after the Amended Compact was signed and almost ten months after the initial contribution of over \$30 million was made. The lack of oversight by both Governments to the Agreement permitted the delay of establishment of the TFC. The belated establishment of the TFC resulted in the delay in appointing key positions in a timely manner leading to lower than expected rate of return for Fiscal Years 2004 and 2005.

### **Delay in the Appointment of Key Positions**

According to the Agreement, key positions should be appointed including a Trustee, an Investment Advisor, Money Manager(s), and an Auditor.

- Either the US Government or the TFC, whoever establishes the Trust Fund account should also appoint one or more initial Trustees.
- The TFC, at any time and from time to time, should select one or more Investment Advisor(s) to advise and recommend one or more Money Managers.
- The TFC should select one or more Money Managers who will invest the assets of the Fund to produce a diversified portfolio.

**Office of the National Public Auditor  
Inspection of the Compact Trust Fund  
ONPA 2006-03**

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- The TFC should appoint an independent auditor to audit the Trust Fund at appropriate intervals and include in the audit report information on the performance of the Trustee and Money Manager(s).

The appointments to key positions have been delayed and other key positions are still vacant.

- Since the U.S. Government established the Trust Fund account (in consultation with the FSM government in August 2004), the Agreement specified that it should also appoint a Trustee. However, when the TFC was formed in July 2005, no Trustee had been appointed. Therefore, the TFC conducted a search and selected a Trustee. But, as of May 2006, the contract with the Trustee has not been signed.
- In September 2005, about 3 months after the TFC was formed, TFC selected a company to act as an Investment Advisor for the Trust Fund.
- Neither a Money Manager nor and Auditor has been appointed by the TFC as of May 2006.

The delay in making these key appointments occurred because the TFC has not provided needed leadership, communication and coordination to meet the requirements of the Agreement. Delays in the appointments to these key positions have resulted in other key position appointments being delayed, in Compact required reports (audit and performance) not being completed which could lead to a potential qualification of the FSM Government single audit reports, and in Trust Fund assets not being invested to produce a diversified portfolio leading to underperformance of Trust Fund assets and potential lost earnings.

These actions already resulted in a lower than expected income for the first years of the Trust Fund. Specifically, in Fiscal Years 2004 and 2005 the Trust Fund only earned a 2.23 percent rate of return, while even a conservative investment strategy in 2003 forecasted a 6 percent rate of return.

#### Recommendation

We recommend that the TFC focus on enhancing oversight to ensure full compliance with the Agreement.

#### **Administrative Requirements Not Met or Not Timely**

The Agreement requires that various administrative functions be performed including developing rules of procedures, holding annual meetings, and producing an annual committee report.

- The Agreement requires that the TFC shall establish rules of procedure consistent with this Agreement. Although the Agreement does not list a deadline for forming the rules of procedure, it states that members have a fiduciary relationship to the Trust Fund.
- The Agreement states that the TFC shall meet at least annually or as deemed necessary.
- According to the Agreement, within six months of the end of each Fiscal Year, the TFC shall publish an annual report and submit it to both the US and FSM Governments. The report should summarize the activities and management of the Trust Fund including the operations of the accounts and effectiveness of the Trust Fund to accomplish its purpose.

**Office of the National Public Auditor  
Inspection of the Compact Trust Fund  
ONPA 2006-03**

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The annual report may include recommendations regarding improving the effectiveness of the Trust Fund from the audit reports of the Independent Auditor.

The TFC has not met the following requirements:

- The rules of procedures have not been developed as of May, 2006, according to a member of the TFC.
- TFC meetings have taken place in August 2005 and September 2005 but no minutes were provided to confirm if meetings took place or what was accomplished at the meetings, according to TFC members.
- A draft of the first annual report was circulated to the TFC for unanimous consent in May 2006. This report covers both Fiscal Years 2004 and 2005. Therefore, the annual report for Fiscal Year 2004 was over one year late, and the Fiscal Year 2005 report was 2 months late.

The TFC did not perform administrative functions because the TFC has not provided needed leadership, communication and coordination to meet the requirements of the Agreement. As a result, without rules of procedures, a clear statement of rights and responsibilities of the TFC are not laid out. Further, as a result of the TFC not ensuring proper documentation of the meetings, we could not verify whether required meetings achieved their intended purposes. Finally, delays in the completion of the required annual reports have resulted in the TFC and the US and FSM Governments having untimely information to effectively monitor the progress of the Trust Fund to ensure in meeting its objectives. This delay could also potentially result in the underperformance of the Trust Fund assets and lost earnings.

#### Recommendation

We recommend that the TFC should focus on enhancing oversight to ensure full compliance with the Agreement.

**Office of the National Public Auditor  
Inspection of the Compact Trust Fund  
ONPA 2006-03**

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**PUBLIC AUDITOR'S COMMENTS**

The Office of the National Public Auditor (ONPA) will do a follow-up review within the next 6 to 9 months to ensure that the TFC has taken corrective measures to address all findings and the recommendation provided in this report.

In conformity with general practice, we provided copies of the draft inspection report to the TFC Members for their review and comment. No responses were received on that date.

If you or your staff have any questions regarding this report, please contact me at 691-320-2862 or [hhainrick@fsmpublicauditor.fm](mailto:hhainrick@fsmpublicauditor.fm). Contact points for our Office may be found on the last page of this report. The ONPA staff who made major contributions to this report are listed on the last page.



Haser H. Hainrick  
National Public Auditor

July 14, 2006

## ONPA CONTACT AND STAFF ACKNOWLEDGEMENT

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ONPA CONTACT	Haser H. Hainrick, 691-320-2862
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ACKNOWLEDGEMENTS	In addition to the contact name above, the following staff made key contributions to this report:  Ann Walker, Audit Supervisor Limmanman Elanzo, Auditor In-Charge
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