OFFICE OF THE NATIONAL PUBLIC AUDITOR

FEDERATED STATES OF MICRONESIA

The FSM Trust Fund

ACTIONS ARE REQUIRED TO EFFECTIVELY AND EFFICIENTLY ACHIEVE THE GOALS OF THE FSM TRUST FUND

Report No. 2021-02

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December 02, 2020

His Excellency President David W. Panuelo
Honorable Members of the 21st Congress
Federated States of Micronesia

RE: PERFORMANCE AUDIT ON FSM TRUST FUND

We have completed the performance audit on the FSM Trust Fund. Our scope of work covered fiscal years 2015-2019; however information relating to fiscal year 2020 was also used to come up with findings, recommendations and conclusions.

The main focus of this performance audit was on governance; effectiveness of internal controls, risk management; efficient and effectiveness of operations; whether there is future sustainability; and of particular interest, on whether the set aside funds and investment return thereon will adequately suffice in maintaining minimum services that are currently almost 100% funded by development partners.

This performance audit was conducted as part of implementation of our Strategic Plan and Risk Based Audit Plan for fiscal year 2019-2021, and as part of our duties and responsibilities delineated under the Public Auditor's Act, Chapter 5 of Title 55 of FSM Code.

The audit objectives were on:

(i) Governance – To determine whether there is an effective governance processes in place for the administration of the FSM Trust Fund;

(ii) Internal Control – To determine if internal controls are in place and whether they are adequate and effective with regards to the administration of the FSM Trust Fund;

(iii) Risk Management – To determine whether the Fund has in place mechanisms to identify, monitor, report and manage its inherent and emerging risks; and

(iv) Sustainability – To determine whether the FSM government has financial and strategic plans in place with regards to the sustainability and earnings of the FSM Trust Fund.

This audit was conducted in accordance with the generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

Based on our review we concluded that Congress, Secretary of the Department of Finance and Administration (DOFA) and the Board of Trustees should:

(i) Improve its governance process by ensuring that Chapter 12 of Title 55 of the FSM Code reflect appropriately and sufficiently all issues relating to management, benefits and demise of the Fund;

(ii) Improve its internal controls processes by developing procedure manuals;

(iii) Improve its risk management process in order to be abreast with any uncertainty in the financial markets; and

(iv) Improve its operations by ensuring that Strategic Plan and Action Plans together with their milestones are developed, operationalized, monitored and teamwork environment is fostered; and capacity of management and members of the Board of Trustees improved in order to enable them to conduct their roles effectively and efficiently.

We discussed the findings and recommendations with Secretary, DOFA and requested for formal management response which is attached as part of the report.

Respectfully submitted,

Haser Hainrick

National Public Auditor

CC: Secretary, Department of Finance and Administration

Acting Chairman and Members, Board of Trustees, FSM Trust Fund

Director, Office of Personnel

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Abbreviations

Abbreviation	Meaning
$	United States Dollar
BNY/bony	Bank of New York
BOH/boh	Bank of Hawaii
DIIF	Division of Investment and International Finance
DOFA	Department of Finance and Administration
FMIS	Financial Management Information System
FSM	Federated States of Micronesia
FY	Fiscal Year
IIFO	Investment and International Finance Officer
PL	Public Law
PSSR	Public Service System Regulations

1.0 INTRODUCTION

This performance audit was conducted as part of implementation of our Strategic Plan and Risk Based Audit Plan for fiscal years 2019-2021, and as part of our duties and responsibilities delineated under the Public Auditor's Act, Chapter 5 of Title 55 of the FSM Code. Our scope of work covered fiscal years 2015-2019, however information relating to fiscal year 2020 was also used to come up with the findings, recommendations and conclusions.

2.0 BACKGROUND

The FSM Trust Fund (the Fund) was established under Chapter 12 of Title 55 of the FSM Code. The Fund was established through Public Law 10-150 on April 1999. The purpose of the Fund is to create a single investment Fund in which all levels of government may participate in order to contribute to the long term financial viability of the FSM by providing additional source of revenue and to enhance the capacity of the National Government to receive and effectively utilize external resources to:

(i) Assist the National Government and other participating governments to achieve greater financial autonomy in the management of their re-current budgets;
(ii) Enable the FSM at all levels of government to meet long term maintenance and operating cost of social and economic infrastructure; and
(iii) Enable the FSM at all levels of government, to improve existing levels of social and economic infrastructure.

The Fund is governed by Chapter 12 of Title 55 of the FSM Code and other applicable laws and regulations including the *Financial Management Act*. The oversight function is under an established Board of Trustees. Since its establishment in 1999 there was no Board of Trustees up to January 18, 2019, when the FSM President appointed and submitted four nominations for the Board of Trustees to the Congress of the FSM for the required review and consent.

On January 22, 2019, the 20th Congress of the FSM confirmed the President's nominations of four (4) members of the Board of Trustees. Per Public Law No. 10-150, a fifth member should be the administrator of the Fund, and this role should be held by the Secretary of the Department of Finance & Administration (DOFA).

The law establishing the Fund also requires the establishment of a separate bank account for depositing all funds appropriated by the Congress, state governments or other stakeholders. However, there was no specific account established for the Fund until September 2004, and all appropriations for the Fund were deposited in the FSM National Government General Fund. On June 20, 2007, the Fund account was opened at the Bank of Hawaii with an initial deposit of $500,000.

From FY2007 to FY2013 the National Government invested *$11 million* into the Fund. Additional deposits were made by Congress Resolution 15-88 in FY2008 and Congress Resolution 16-97 in FY2010, being contributions from the Chinese Government's Grants of *$1 million* each. By FY2014 Congress made a deposit of *$7 million* and this has been further increased with a *$38 million* investment in FY2015. From FY2016, through public law 18-107, the FSM Congress has committed to "*increase the state share of taxes collected from fifty percent (50%) to seventy percent (70%) with the additional twenty percent (20%) deposited by the National Government into the state sub-account 'A' of the FSM Trust Fund*". The FY2017 budget appropriation allowed for a *$17 million* into the Fund and the Fund principal balance plus investment return increased to *$115.1 million* as of September 30, 2017. With additional investment of $131.7 million in FY 2018 and 2019 and investment return during the period, the principal balance plus earning stood at *$266.9 million* as at September 30, 2019.

The status of the Fund based on our audit scope is shown in *Chart 01* and *Table 01* below.

Chart 01: Fund Growth Period of Fiscal Years 2015-2019

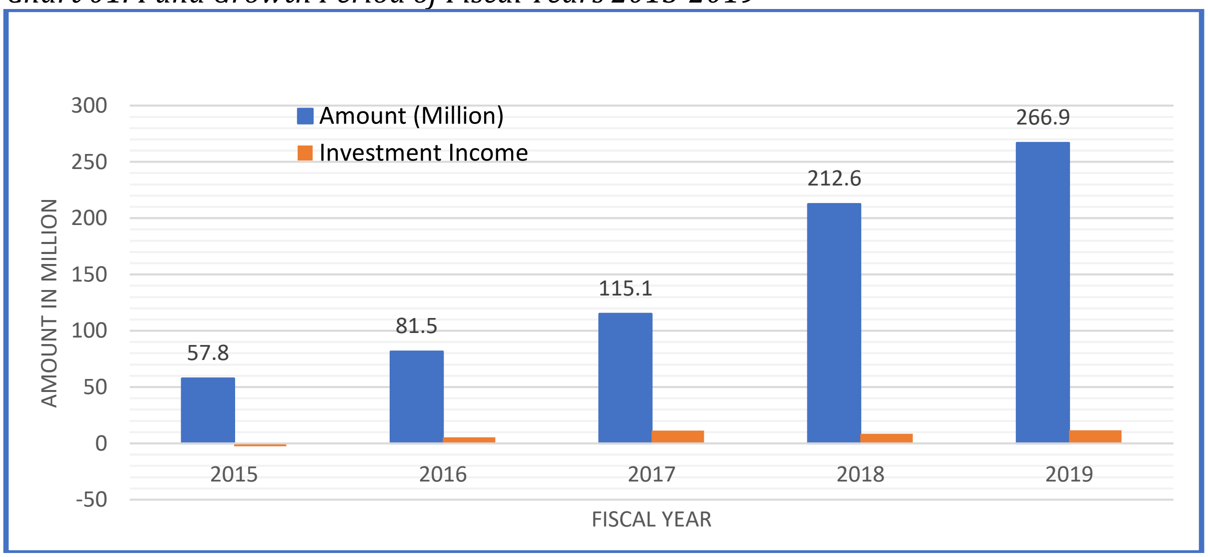


Table 01: FSM Trust Fund Balance ($ Million)

	FY2015	FY2016	FY2017	FY2018	FY2019
Net Assets, Beginning	22.4	60.9	81.5	115.1	212.6
Contributions	38.0	15.2	22.2	88.9	42.8
Investment Income	-2.6	5.5	11.4	8.4	11.6
Net Assets, Ending	**57.8**	**81.5**	**115.1**	**212.6**	**266.9**

Source: Investment quarterly reports

2.1. Contributions to the FSM Trust Fund

Contributions to the Fund are mainly through appropriations by the FSM Congress. For the FY2015 to FY2019 a total amount of $174.7 *million* was appropriated as shown in Table 02 (refer to Page 3). The Administrator through the Division of Investment and International Finance (IIF) would identify the source of funding either from Fishing Fees or Corporate Tax, which should be equivalent to the amount appropriated by

Congress. All funds for the Fund were deposited at a bank custodian which currently is the Bank of New York (BNY).

Table 02: Appropriations to the Fund for FY2015 to FY2019

	Initial Appropriation			Amended Appropriation		
Count	**PL No**	**Date**	**Amount (US $)**	**PL No**	**Date**	**Amount (US $)**
1	18-89	9/29/2014	10,000,000	19-09	07/24/2015	38,000,000
2	19-32	9/30/2015	10,000,000	19-122	10/06/2016	0
3	19-115	9/30/2016	2,260,000			2,260,000
4	19-117	9/30/2016	7,500,000	20-74	03/02/2018	14,500,000
5	20-42	9/27/2017	0	20-122	09/21/2018	83,000,000
6	20-130	9/20/18	26,955,878	21-81		26,955,878
7	20-131	9/27/2018	0	21-03	06/15/2019	10,000,000
					Grand Total	**174,715,878**

Source: FSM Congress Appropriation Laws

2.2. Investment Advisor and Money Managers

One of the responsibilities of the Board is to identify the Investment Advisor for the Fund and currently it is Wilshire Associates; an investment firm based in Santa Monica, California. The advisory services to be provided by the Investment Advisor according to the Agreement between Wilshire and the FSM government, consist of advising the FSM government on investment policy and asset allocation of the assets of each of the FSM government's funds. The Investment advisor had assisted in establishing the investment policy and is responsible for providing the client quarterly performance analysis, as well as identifying the money managers. Currently, there are twelve (12) money managers who are responsible for buying and selling underlying investment securities. The Investment Advisor closely monitors the overall performance and other responsibilities of the money managers, and makes recommendations on their appointment and termination.

2.3. The FSM Trust Fund as a stand-alone investment separate from the Trust Fund for the People of FSM (Compact Trust Fund)

For clarity purpose to the stakeholders, this audit report is specifically focused on the FSM Trust Fund which was established by the FSM National Government and is a totally separate investment from the Trust Fund for the People of FSM (commonly referred to as the Compact Trust Fund). The Compact Trust Fund was established in accordance with the Trust Fund Agreement between the United States and the Federated States of

Micronesia governments and is under the control and custody of the United States Government while the FSM Trust Fund is controlled internally by the FSM National Government.

For the Compact Trust Fund, as stated in Article 3 of the Trust Fund Agreement between the US and FSM, the purpose of the Trust Fund is to "contribute to the economic advancement and long-term budgetary self-reliance of the Federated States of Micronesia by providing an annual source of revenue, after Fiscal Year 2023, for assistance in the sectors described in Section 211 of the Compact, as amended, or other sectors as mutually agreed by the Original Parties, with priorities in education and health care". (Source: https://fsmcfatf.com/)

Key information:

	FSM Trust Fund	**(Compact) Trust Fund for the People of FSM**
Established by	FSM National Government	Trust Fund Agreement between the United States and the FSM
Overall control (currently)	FSM National Government	United States
Contributions	FSM National Government ($174.7 *million*)	United States ($406.5 *million*) & FSM ($30.3 *million*)
Net assets (End of Fiscal Year 2019)	$266.9 *million*	$689.5 *million*

3.0 OBJECTIVES, SCOPE AND METHODOLOGY

3.1. Objectives

The objectives of the audit were to determine whether:

(i) There are effective governance processes in place for the administration of the Fund.

(ii) Internal controls are in place and whether they are adequate and effective with regards to the administration of the Fund.

(iii) The Fund has in place mechanisms to identify, monitor, report and manage its inherent and emerging risks.

(iv) The FSM Government has financial and strategic plans in place with regards to the sustainability and earnings of the Fund.

3.2. Scope

The audit scope covered all Congress appropriations, all earnings, and all transfers from the Fund covering the period from FY2015 and up to September 30, 2019 (which was our audit cut-off date).

We performed the audit fieldwork at the Division of IIF, Division of National Treasury, and the Division of Budget of the Department of Finance & Administration in Palikir, Pohnpei.

We conducted this audit pursuant to the authority vested in the Public Auditor as codified under Chapter 5, Title 55 of the FSM Code, which states, in part; that:

> "*The Public Auditor shall inspect and audit transactions, accounts, books, and other financial records of every branch, department, office, agency, board, commission, bureau, and statutory authority of the National Government and of other public legal entities, including, but not limited to, States, subdivision thereof, and nonprofit organizations receiving public funds from the National Government*."

3.3. Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The audit procedures included the review of the appropriation laws and advice of allotments relating to the Fund. We also reviewed journal vouchers and bank statements from BNY, the fund custodian that provided information on the accounting of the invested funds for the Fund. Finally, we interviewed key staff and officials at both the Divisions of IIF and the National Treasury and also the former Chairman of the Board of Trustees.

4.0 PRIOR AUDIT COVERAGE

The last performance audit on the Fund covered the period from its inception in FY1997 up to March 31, 2014, of which Audit Report No. 2015-08 was issued on September 21, 2015.

During this audit, we identified prior audit findings and recommendations. Table 04 (on page 21) shows the *Status of Implementation* regarding our prior findings and recommendations.

5.0 CONCLUSION

Based on our audit, we concluded that the Congress, the Secretary DOFA and the Board of Trustees should:

(i) Improve its governance process by ensuring that Chapter 12 of Title 55 of the FSM Code reflect appropriately and sufficiently all issues relating to management, benefits and demise of the Fund;

(ii) Improve its internal controls processes by developing and operationalizing procedures manuals;

(iii) Improve its risk management process in order to be abreast with any uncertainty in the financial markets; and

(iv) Improve its operations by ensuring that Strategic Plan and Action Plans together with their milestones are developed, operationalized, monitored and teamwork environment is fostered; and improved capacity building for the management and members of the Board of Trustees in order to enable them to carry out their roles effectively and efficiently.

The findings and recommendations are discussed in details in the following pages.

6.0 FINDINGS AND RECOMMENDATIONS

6.1. FINDING NO. 01: The Main Objective of Establishing Trust Fund May not be Achieved in the Next Ten (10) Years with the Current Pace

According to the FSM Code Title 55 (Section 1204 of Chapter 12), the purpose of the Fund is to create a single investment Fund in which all levels of government may participate in order to contribute to the long term financial viability of the FSM by providing additional source of revenue and to enhance the capacity of the National Government to receive and effectively utilize external resources to:

(a) Assist the National Government and other participating governments to achieve greater financial autonomy in the management of their re-current budgets;

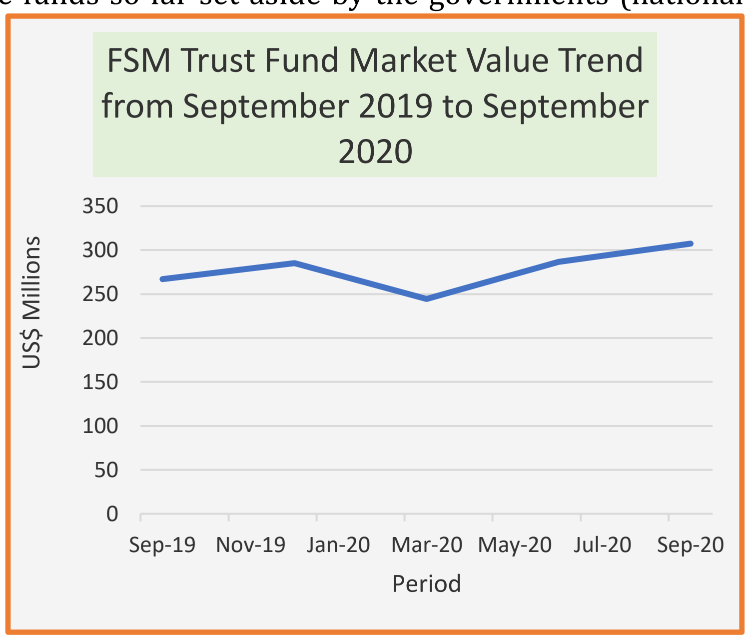
(b) Enable the FSM at all levels of government to meet long term maintenance and operating cost of social and economic infrastructure; and

(c) Enable the FSM at all levels of government to improve existing levels of social and economic infrastructure.

Our analysis and comments are based only on the National Government's revenue, expenditure and budget and did not include that for the States.

During our audit on the capacity to achieve the intended objectives/purposes of the Fund, we observed that:

(i) Since its establishment the funds so far set aside by the governments (national and states), contribution from development partners, and revenue generated have reached a total of *$266.9 million* as at September 30, 2019; and $285.01 *million* as at December 2019.



(ii) Subsequent events outside the scope of the Audit revealed that the Fund investments lost $40.6 *million* during the period from January 2020 to March 31, 2020 (fund balance of $244.4 *million*). This was due to the economic impact of the Coronavirus (covid-19) pandemic. However, positive results were noted for the period from April 2020 to June 30, 2020 as the total balance of the fund increased to $286.5 *million* and further increased to $307.3 *million* for the period from July to September 2020 – this reflects recovery of the loss for the 1st quarter 2020. According to the Investment Advisors's report for March 2020, "*Volatility is expected to remain elevated until the terminal impact of the virus can be measured accurately—a feat that remains out of grasp for the time being".*

(iii) The trend for the last four fiscal years, 2015-2018 shows a growth in deposits made to the Fund at an average of $41.1 *million* annually but in indescribable trend (amount wise) $38.0 *million*, $15.2 *million*, $22.2 *million* and $88.9 *million* (*Refer to Table 01 on page 2*). This trend was not consistent with revenue realised by the FSM National Government during the same period, where there was a steady growth in local revenue: $107.9 *million* (FY2015), $112.8 *million* (FY2016), $143.3 *million* (FY2017) and $206.5 *million* (FY2018).

(iv) The impact of foreign input to the FSM National Government recurrent expenditures, which is one of the major hazardous areas that led to the establishment of the Fund, for fiscal years 2015 to 2018 is shown below:

Table 03: Analysis on Foreign Input on FSM Budget Fiscal Years 2015 to 2018

Description	FY 2015		FY 2016		FY 2017		FY 2018	
	$	G/L%*	$	G/L%*	$	G/L%*	$	G/L%*
Revenue								
Local Revenue	*107,915,921*	***46%***	*112,843,897*	***49%***	*143,288,558*	***48%***	*206,474,744*	***33%***
Grants	*91,192,957*		*108,593,639*		*132,484,584*		*100,977,291*	
	199,108,878		*221,437,536*		*275,773,142*		*307,452,035*	
Recurrent Expenditure								
From Local Sources	*80,690,867*	***50%***	*91,795,222*	***49%***	*97,896,035*	***53%***	*112,048,536*	***46%***
From Grants	*80,867,906*		*87,919,963*		*109,616,517*		*95,863,465*	
	161,558,773		*179,715,185*		*207,512,552*		*207,912,001*	
Capital Expenditure								
From Local Sources	*0*	***100%***	*0*	***100%***	*0*	***100%***	***0***	***100%***
From Grants	*10,862,803*		*21,609,921*		*23,281,188*		*9,894,272*	
Total Expenditure	***172,421,576***		***201,325,106***		***230,793,740***		***217,806,273***	

**G/L% =Grant as percentage of total Source: FSM Government Audited Accounts FY2015 to FY2018*

B	**Main Expenditure Funded by Foreign Grants**				
	Description	***FY 2015***	***FY 2016***	***FY 2017***	***FY 2018***
(a)	Health	*30,837,974*	*31,359,383*	*32,716,884*	*38,932,722*
(b)	Education	*37,799,149*	*37,731,313*	*40,983,727*	*34,230,987*

B	**Main Expenditure Funded by Foreign Grants**				
	Description	***FY 2015***	***FY 2016***	***FY 2017***	***FY 2018***
(c)	Others	*12,230,783*	*18,829,267*	*35,915,906*	*22,699,756*
(d)	Capital (CIP)	*10,862,803*	*21,609,921*	*23,281,188*	*9,894,272*
	Total Foreign Funded Expenditure	***91,730,709***	***109,529,884***	***132,897,705***	***105,757,737***
	Foreign/Total Expenditure%	*53.2%*	*54.4%*	*57.6%*	*48.5*

Source of information: FSM Government Audited Accounts for FY2015 to FY2018

Financing Education and Health Budget may consume between 35.4% to 67.7% of annual FSM generated revenue

Between fiscal year 2015 to 2018, FSM total revenue ranged between $199.1 *million* to $307.4 *million* annually out of which between $91.2 *million* to $132.5 million was foreign input. Based on the highest foreign contribution to revenue of $132.5 *million*, the Sept-2019 balance of the Fund of $266.9 *million* could fill the void that may arise in the event of termination of such input for a period not exceeding ***2-fiscal years***, if there is 100% termination of foreign grants. However, if there is 50% cessation of foreign grants, the period will not exceed ***4-fiscal years*** *(assuming all economic and social factors remain the same)*. And the sectors that will be extremely affected will be health, education and infrastructure.

(v) Between fiscal years 2015 to 2018 total recurrent expenditures for the FSM Government ranged from *$161.6 million to $207.9 million,* while foreign contribution to the total expenditures was between *$80.9 million to $109.6 million annually.* Based on the highest foreign grants given during the period, $109.6 *million*, it is obvious that in the event of 100% cessation of foreign grants to FSM budget, the current available funds in the Fund could suffice to fill the gap for a period of *2 to 4-fiscal years if the expenditures are maintained at the same level.* However, if cessation will be at 50%, the same could suffice to fill the void for about *5-fiscal years. [assuming all economic and social factors remain the same].*

It will take between 28 months to 60 months to exhaust FSM Trust Funds by filling the gap that maybe created by cessation of foreign grants

(vi) Appropriations to the Fund have been low and with no pre-determined (inconsistent) pattern. It was until fiscal year 2018 that Congress took a bold decision to enact a law (Public Law No.20-130) that guaranteed specific percentage from identified sources of funds to be set aside for investment.

(vii) Implementation of PL 20-130 started during the fiscal year 2019 whereby 20% of fishing fees and 50% of the tax on all premiums collected from captive insurance companies were transferred to the Fund: a total of *$42.8 million*.

6.1.1 Causes for the above conditions

(i) The Fund Administrator did not establish a strategic plan, risk management framework and register, capacity building plan, etc.

(ii) Delay in establishing the Board of Trustees (January 2019) almost ten (10) years after the establishment of the Fund in April 2009.

(iii) Secretary, DOFA did not appropriately guide the government on how to build a Trust Fund that could reasonably give assurance to the FSM Government and its citizen that there will be continuity of essential services even at the minimal required level.

(iv) The Legislative and Executive branches of governments did not act timely in identifying reliable sources of funds for the Fund, such as enactment of PL20-130 that was made effective in October 2018, which required 20% of fishing fee and 50% of the tax on all premiums collected from captive insurance companies to be transferred to the Fund for investment.

6.1.2 Potential Effects

(i) Inability to manage the Fund effectively and efficiently – it is almost impossible to manage effectively and efficiently an activity that management does not have expertise on and heavily rely on the external contractor.

(ii) Loss of funds due to inability to forecast prudently the expected return for each category of investment and stock market direction.

(iii) Risks of not achieving the mandated purpose of the Trust Fund including "greater financial autonomy in the management of re-current budgets" of all levels of governments.

6.1.3 Recommendations

We recommend that the Secretary, DOFA and the Board of Trustees should ensure that:

(i) A Strategic Plan, charting out the direction of the Fund with appropriate milestones, identifying existing and potential sources of funds, is established and operationalized;

(ii) Full (100%) reliance on contractors for management of Fund investment and the embedded risks are minimized to an acceptable level through conceited efforts that should include capacity building of the existing employees and members of the Board of Trustees; and

(iii) Management tools for managing the activities of the Fund are developed and enshrined in all existing and planned operations, e.g. strategic plan, risk management framework and register, training program for employees and members of the Board of Trustees.

6.2. FINDING NO. 02: Lack of Effective Governance and Risk Management Activities

The main purpose of the Fund, as delineated in Section 1204 of Chapter 12 of Title 55 of the FSM Code, is to contribute to the long-term financial viability of the five governments (national and the four states) based on the current federal structure (i.e. four state governments and one national government).

In order to ensure that there are effective governance risk management processes, the Act establishing the Fund took into account various issues relating to governance and risk management. During our audit on governance and risk management processes within the Fund we observed that:

(i) There is an Investment Policy Statement (IPS) that was established that forms part of the Fund's risk management strategy and is mainly focussed on managing the risks relating to the performance of the investment; leaving out operational risks related to the daily administration of the Fund.

(ii) The establishment of the Fund did not take into account federal risks including the possible eventuality of one state ceasing to be part of the federation or dissolution of the federal government. It was expected that the Act would take into account federal related risks, for example, where one state take a unilateral decision to pull out of the federation, what would be its share from the accumulated funds; how much will be apportioned to each state in the eventuality of an end of the federal government, (FSM) based on the fact that there are five governments that are running concurrently and all states are contributing directly and indirectly to the Trust Fund besides having their own Trust Funds. It is important that establishment of any federal institutions must take into consideration inherent risks – political risks, economical risks, etc.

(iii) The Secretary, DOFA who is also the Administrator of the Fund did not establish Risk Management Policies and Procedures and Risks Register to guide management, employees and the Board of Trustees in managing both the investment and operational risks to ensure that they carry out their duties effectively and efficiently.

Failure to appropriately manage investment risk could lead to losses for the FSM Trust Fund

6.2.1 Causes

(i) Lack of appropriate governance processes which may also be attributed by the absence of Board of Trustees for more than 10-years since the establishment of the Fund, which resulted in lack of monitoring and review mechanism that could have identified the deficiencies in the establishing Act.

(ii) Absence of Risk Management process within the DOFA and divisions under its purview, and for this case, Division of IIF; and

(iii) The DIIF that manage the Fund is highly dependent on information provided by the Investment Advisor (fund managers and fund custodian).

6.2.2 Potential Effects

(i) Failure of the Board of Trustees to act timely and prudently due to absence of appropriate and sufficient clauses in the establishment Act;

(ii) Lack of objectivity within the management and Board of Trustees of Fund, as decisions are highly influenced by contractors;

(iii) Limitation in identifying significant risks associated with financial markets and trend in world economy, specifically that of United States, which may lead to financial loss.

6.2.3 Recommendations

We recommend that the Secretary, DOFA and the Board of Trustees should:

(i) Initiate review and seek amendment of Chapter 12 of Title 55 of FSM Code in order to capture issues identified within this audit report; and

(ii) Ensure that risk management framework and risks register are established for guidance and reference to the Board of Trustees and staff of Division of IIF.

6.3. FINDING No. 03: Capacity Building of the Board and Management of the Trust Fund needs to be strengthened

Based on Section 1208 of Chapter 12 of Title 55 of the FSM Code:

(a) All powers of the Fund shall be vested in and exercisable by the Board;
(b) The functions of the Board shall include:
   (i) obtaining, along with others, contributions to the Fund;
   (ii) operation, supervision and management of the Fund; and
   (iii) investment and distribution of resources of the Fund.
(c) The Board shall establish its own bylaws and rules of procedure

Capacity building is an important tool in managing and overseeing the investments

Such roles require experience and exposure that is specifically related to investment, risk management, knowledge in monitoring of stock markets and world economy in order to make informed decisions. The Board of Trustees and staff overseeing the Fund are continually dealing with experts in the field who are either fund managers or fund custodians and thus a need to provide them specific capacity building on investment, in order to somehow match with these experts.

During our audit of activities carried out and forecasted for the financial years 2015-2021 we observed that:

(i) The Congress-approved Budget does not appropriately and sufficiently budget for capacity building activities for the Fund’s employees and members of the Board of Trustees;

(ii) The current professional and exposure of employees managing the Fund and members of the Board of Trustee need to be enhanced in order to meet the current and future needs of the Fund; and

(iii) There was no planned capacity building for the staff and members of the Board of Trustee relating to managing of the operation of the Fund especially on investment. Review of the Budgets for Financial Years 2019, 2020 and 2021 revealed that almost 100% of planned travel activities for management and employees at the Division of IIF (who are currently managing the affairs of the Fund) were and are for attending meetings and one-to-two days (due-diligence) training which are not adequate for building their capacity in managing the investment and other activities of the Fund.

6.3.1 Causes

(i) Delay in appointing Board of Trustees;

(ii) Secretary, DOFA who also served as the Administrator did not effectively and efficiently carry out her/his duties and responsibilities as required under the Chapter 12, Title 55 of FSM Code; and

(iii) Failure to plan based on the potential risks associated with operations of the Fund.

6.3.2 Potential Effects

(i) Reliance on the Investment Advisor (who uses information provided by the fund managers and fund custodian) for all information, especially on the forecasting and market suitability;

(ii) May lead to financial loss due to lack of effective monitoring by the management of the Fund; and

(iii) Lack of appropriately and sufficiently informed decisions on managing the investment of funds as most of the information are originating from contractors.

6.3.3 Recommendations

Based on the fact that the Fund is projected to be one of the lifelines for financial viability in the event of full termination or significant reductions in economic assistance under the Renewed Compact of Free Association, we recommend that the Secretary of DOFA and the Board of Trustees should ensure that:

(i) Appropriate and sufficient plans (on trust fund administration and management) are developed and operationalized for building the capacity of management and employees in the Division of IIF in order to enable them to effectively and efficiently carry out their duties as delineated in Chapter 12 of Title 55 of FSM Code;

(ii) The capacity of Members of the Board of Trustees to understand and interpret information relating to investment of funds is developed in order to enable them to make timely and informed decisions; and

(iii) Staff and management receive adequate training courses such as Certificate in Fund Administration.

6.4. FINDING No. 04: FSM Trust Fund Lack of Effective and Efficient Management

Section 1209 of Chapter 12 of Title 55 of the FSM Code states that *"The Secretary of Finance and Administration of the FSM, or his cabinet-level successor, shall serve as administrator of the Fund and all its accounts, and shall provide necessary administrative support to the Fund and its Board."*

During our audit, we found that the Fund was not properly administered and managed, which was evidenced by:

(i) Poor filing system – There were no properly documented records of communications between the Division of IIF, Fund Managers, Bank Custodian and/or National Treasury and other records pertaining to the Fund. Other pertinent records pertaining to the Fund are not manually filed (e.g. Journal Vouchers (JVs), manual accounting records of the Fund, etc.). Most of this information are only extracted from computer whenever requested or required for use.

(ii) Absence of operations manual – The Division of IIF did not develop and operationalize policies and procedures manuals for the Fund, except for the Investment Policy Statement (IPS).

(iii) Financial transactions are created based on financial information provided by contractors which is evidenced by lack of appropriate reconciliations – Reconciliations are only performed when transactions from bank statements are recorded in the books of accounts of the Fund and the same records are used for reconciliation.

(iv) Journal Vouchers (JVs) prepared by the Division of Treasury had vague narrations with regard to the purpose of the transactions. For example, one of the narrations which were termed comments, says: "*to record investment accts at boh and bony*". In justifying the style with which the JVs are prepared, the management of DOFA stated that, as long as the supporting documents have sufficient information, the JVs are okay the way they are. However, further verification of the supporting documents revealed that such do not have sufficient information to justify the vagueness of narrations in the JVs.

6.4.1 Causes

(i) The DIIF did not have internal policies and procedures in place to guide its operation in administering and managing the Fund;

(ii) The DIIF prepared its book of accounts based on information received by the BNY (Fund custodian); and

(iii) Negligence on the part of the management and staff of DOFA.

6.4.2 Potential Effects

(i) The setup currently in place has created an environment that is full of scope-creeps which may lead to lack of strategic direction, failure for goals and targets to be achieved and lack of effective monitoring mechanism to ensure that operations are run effectively and efficiently as planned; and

(ii) Lack of corporate memory which may result into a situation where smooth continuity of operations rely heavily on the presence of the current employees and management.

6.4.3 Recommendations

We recommend that the Secretary, DOFA in collaboration with the Board of Trustees should perform the following:

(i) Create awareness to management, staff and members of the Board of Trustees on the Investment Policy Statement (IPS) and other applicable laws pertaining to administering and managing of the Fund;

(ii) Review the establishing Act, Chapter 12 of Title 55 of FSM Code and where necessary recommend amendment or update; and

(iii) Develop and operationalize appropriate and sufficient internal policies and procedures to guide staff and management in carrying out their day-to-day activities.

6.5. FINDING NO. 05: The Management of FSM Trust Fund Did Not Appropriately Carry Out Accounts Reconciliations

The Generally Accepted Accounting Principles (GAAP) states that *"the purpose of account reconciliation is to provide accuracy and consistency in financial accounts. To ensure all cash outlays and inlays match between cash flow statements and income statements it is necessary to carry out accounts reconciliations."*

Our audit revealed that there was no appropriate reconciliation conducted as required since the source of information was one and the same. The following examples illustrate the issues concerning lack of reconciliation;

> *Accounts reconciliation help in detecting errors and differences*

(i) The Division of IIF did not reconcile its own books of account with the BNY's bank statements. Instead, the Division created its own records based on information obtained from the BNY bank statements, which resulted in perfectly matching figures.

(ii) Journal Vouchers (JVs) posted at National Treasury were not reconciled with those of the Division of IIF.

This irregularity on lack of reconciliations was also reported in our ONPA's prior performance audit report (Audit Report No. 2015-08, dated September 21, 2020).

6.5.1 Causes

(i) The Division of IIF did not establish and maintain its own books of account to document and record all activities incurred on the Fund for reconciling purposes; and

(ii) All the Fund's transactions are processed outside the FMIS.

6.5.2 Potential Effects

(i) Errors that were made by the BNY would not be easily detected, as the same information is copied into the books of accounts of the Fund; and

(ii) When errors and omissions are not discovered timely through normal reconciliations, the risks associated with misuse of resources, use of resources for unauthorized purposes, and making ill-advised decisions get even more pronounced.

6.5.3 Recommendations

We recommend that the Secretary, DOFA should ensure that the Assistant Secretary and the Investment Officer:

(i) Implement all prior audit recommendations;

(ii) Establish and maintain its own independent books of account to record and monitor every activity incurred on the Fund instead of updating their records based on the bank statements received from the BNY; and

(iii) Reconcile the Fund accounts and produce accurate reports regularly.

6.6. FINDING NO. 06: Unclear Duties and Responsibilities of Employees Administering and Monitoring the FSM Trust Fund

Chapter 1 of Title 52 of the FSM Code, requires that the Personnel Officer shall *"Establish and Maintain records of personnel employed in the Public Service System Regulations"* (PSSR).

Clear line of duties and responsibilities underpins all performance management processes

During our audit of Personnel Actions and Job Descriptions for staff administering and monitoring the

Fund, we found differences between what is stated in the job descriptions and what employees were actually performing. For example:

(a) The title stated in the job descriptions for the Assistant Secretary for Investment was Chief-International Finance Relations, which is different from her current title; and
(b) The current title for one of the employees handling the Fund is Investment and International Finance Officer (IIFO). However, there is no actual job descriptions for the current position; only a memorandum that described the duties and responsibilities of the IIFO.

6.6.1 Cause

Files and records at the Office of Personnel were not properly maintained and updated. For example:

(i) Records for the new Assistant Secretary for the Division of Investment were not in place and the effective date for the current title was November 2, 2017. However, the title stated in the personnel action and job description was still Chief-International Finance. Additionally, there was neither a resume or curriculum vitae in file nor a copy of the degree earned as stated in the application. However, we contacted the university and confirmed the earned degree.

(ii) As for the IIFO, the effective date was January 21, 2018. There was no approved job description except for the memorandum recommending additional duties and responsibilities for his/her current position.

6.6.2 Potential Effects

(i) It would be difficult to verify whether employees involved in the administration of the Fund were and are performing their duties and responsibilities effectively and efficiently; and

(ii) Absence of formal duties and responsibilities may result in lack of accountability.

6.6.3 Recommendations

We recommend the Director of the Office of Personnel and Secretary, DOFA should:

(i) Update the personnel files and records to match employees' current title and job descriptions; and

(ii) Amend the PSSR and Job Classifications and Qualifications to reflect new positions, titles and job descriptions.

6.7. FINDING NO. 07: Lack of Operating Manual for FSM Trust Fund Operations

An Operating Manual is the documentation by which an organization provides guidance for its employees to perform their functions correctly and efficiently. The Manual also serves to remind employees of how to do their job.

The Operating Manual helps the employees of the organization to reliably and efficiently carry out their tasks with consistent results. Having a good operational manual will reduce human error and inform everyone precisely what they need to do, who they are responsible to and what they are responsible for. It is a knowledge base for the organization, and should be available for reference whenever needed. The Operating Manual is a document that should be periodically reviewed and updated whenever appropriate to ensure that it remains current.

Operational Manual one of the most important Internal Control Tool

Section 1208, Chapter 12, Title 55 of the FSM Code requires that the Fund be treated as a *corporate body;* however based on our review of various documents; and particularly the budget books, it is treated as a line item under the Division of IIF.

During our audit, we found that:

(i) The Division of IIF does not have Operating Manuals in place to guide the operation of the Division; and

(ii) The Fund has not been treated as a *corporate body* as required by Section 1208 of Chapter 12 of Title 55 of FSM Code leading to its treatment as a line item under Division of IIF.

6.7.1 Cause

The Secretary, DOFA did not develop and operationalize an appropriate Operating Manual to assist and guide the employees to perform their duties and responsibilities correctly, effectively and efficiently.

6.7.2 Potential Effects

(i) Functions within the Division of IIF were not performed accurately and according to leading practices;
(ii) Lack of concerted efforts -where everyone determines what do, when and how;
(iii) Absence of detective and corrective controls due to lack of documented procedures; and
(iv) Scope creep – new employees will find it difficult to adapt to their new working environment especially where the old staff are no longer working with the Fund.

6.7.3 Recommendation

We recommend the Secretary, DOFA to establish an Operating Manual to guide the Division of IIF employees with their day-to-day operations.

6.8. FINDING NO. 08: The Sub-Accounts of the FSM Trust Fund Were Co-mingled in the Financial Management Information System (FMIS)

Section 1218 of Chapter 12 of Title 55 of the FSM Code clearly states the following:

- *Item (1): The Board shall cause the Fund managers to keep all proper books and records of account of the assets, property, liabilities, income and expenditure, and transactions of the Fund, and to produce these promptly in order to facilitate audit.*
- *Item (2): All records and reports of Fund returns shall clearly segregate and identify gross returns, management fees, and net returns.*
- *Item (3): The books and records of the Fund shall separately account for each government's account, including the pro rata application of expenses of the Fund.*

During our audit, we found that:

(i) There is no separate account for the States' sub-accounts as required by law (above) and as recorded in the BNY bank statements. The contributions made towards the National and the States sub-accounts are entered into the national government FMIS system using only one (1) account.
(ii) The National Treasury division does not maintain subsidiary ledgers in the FMIS for the Fund as to reflect the sub-accounts presented in the bank statements.

6.8.1 Cause

The Secretary, DOFA did not establish separate accounts to record transactions for each of the five governments.

6.8.2 Potential Effects

(i) Failure to account appropriately for return on revenue and expenditure for each investment;

(ii) Inefficiency in preparation of financial information for the Fund;

(iii) As a result, it is difficult to determine which funds belong to which of the five governments. This raises particular concerns about where the funds are invested, and where gains or losses from the investments must be allocated to; and

(iv) Detection and correction of errors for various transactions in respect of each investment may easily elude periodic review activities of the management and accounts staff.

6.8.3 Recommendations

We recommend the Secretary, DOFA and Board of Trustees should ensure that:

(i) Separate accounts are established to record the Fund for each of the five governments to avoid confusion and error in posting of transactions; and

(ii) Transactions are recorded based on the basic accounting principles, which include but not limited to matching, prudence, consistency, cost measurement, objectivity, etc.

6.9. Finding No. 09: FSM Trust Fund Management and Department of Finance and Administration Did Not Implement All Audit Recommendations issued in Audit Report no. 2015-08

Chapter 8.30 of the Government Auditing Standards states:

> *"Auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that are significant within the context of the audit objectives. When planning the audit, auditors should ask management of the audited entity to identify previous engagements or other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented…"*

The Secretary, DOFA in his response to the five (5) findings and nine (9) recommendations issued in the Audit Report no. 2015-08, concurred with all findings and gave a commitment of the department to implement all of them. However, based on our verification of the implementation status of all recommendations we noted that not all recommendations were implemented and some had an impression of being implemented while the underlying evidence show they are not.

The implementation matrix below shows the implementation status of all recommendations that were issued in Audit Report No. 2015-08:

Table 04: Implementation Status Matrix as of June 30, 2020

#	Finding	Recommendation	Status of Implementation
(i)	The FSM Trust Fund lacks Board of Trustees as required by law.	The President and the Congress should establish a Board of Trustees as required or amend the law if a Board is not needed.	Fully Implemented
(ii)	Lack of timely reporting on the FSM Trust Fund status and operating results	The Secretary of the Department of Finance & Administration should;	
		(i) Annually submit a comprehensive status and operational reports on the Trust Fund to the President and Congress as required.	Being Implemented
		(ii) On a regular basis, prepare and submit a composite Fund Status Report to the President and Congress highlighting at a minimum the total amount funded, earnings (losses), and the current fund balance at the end of each fiscal quarter. Thus, reconciliations should be performed monthly to facilitate the quarterly Fund Status Reports (Refer to Finding No. 3).	Being implemented
		(iii) Arrange for an annual audit of the Trust Fund as required.	N/A
(iii)	The Trust Fund lacks reconciliations	The Secretary of the Department of Finance & Administration should ensure that the Assistant Secretary and the Accountant within the Investment Division reconcile the Trust Fund accounts and produce accurate reports thereof regularly	Not properly implemented
(iv)	The FSM Trust Fund's books of accounts not properly maintained.	The Board of Trustees and the Secretary of the Department of Finance and Administration should:	
		(i) maintain separate (from the General Fund) books and accounts of the FSM Trust Fund as required by the law;	Not properly implemented
		(ii) develop and implement an accounting procedure on how to record the trust fund transactions into the FMIS; and,	
		(iii) record the FSM Trust Fund transactions in the FMIS on monthly rather than on yearly basis.	
(v)	$10 *million* Transferred from the General Fund to the Trust Fund without allotment as required by law	The Secretary of Finance & Administration should observe and follow the requirement of the *Financial Management Act* that funds from the General Fund are obligated based on approved advice of allotment	Being Implemented

While the DIIF has taken various steps to implement the recommendations issued in ONPA's Audit Report No. 2015-08, there are three (3) cases where implementation was not as per generally accepted accounting practices, which are designed to mitigate errors of omission, incorrect transactions, transposition, fraud, etc. as indicated in the causes delineated in sub-section 6.9.1 below.

6.9.1 Causes

(i) The DIIF uses information provided in the bank statement to book their monthly transactions and afterward reconcile the same recorded transactions with the source of the recording, which is actually verification and not reconciliation; and

(ii) Lack of capacity within the DIIF on accounting and book-keeping as indicated by the actions carried out by staff responsible for recording financial transactions.

6.9.2 Potential Effects

The main purpose of reconciliation are (a) to identify areas of difference, e.g. transactions that were recorded by the Fund and were not recorded by the bank or vice-versa; and also, (b) to identify erratic transactions or track down the delay in recognizing or recording of transaction, especially where one of the major factors for return on investment is time. Absence of such internal controls' measures will lead to:

(i) failure to identify delays by the bank in investing the Fund's funds timely resulting in loss of income; and

(ii) failure to detect errors in the bank statement or books of accounts and thus no corrective actions.

6.9.3 Recommendations

We recommend that the Secretary, DOFA and the Board of Trustees should:

(i) Implement all audit recommendations identified in our Audit Report No. 2015-08 and where it is not possible, alternative methods should be used to correct the identified weakness; and

(ii) Ensure that staff who are assigned accounting and book-keeping duties and responsibilities are qualified and where there are deficiencies, capacity building intervention should be considered timely.

7.0 MANAGEMENT RESPONSE

Secretary of Finance
&
Administration

GOVERNMENT OF THE
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RECEIVED
Date 10/26/20
2:15 pm

October 23, 2020

Mr. Haser Hainrick
National Public Auditor
Office of the Public Auditor
FSM National Government
Palikir, Pohnpei FM 96941

Subject: Management Response to FSM Trust Fund Audit Report

I write to submit the attached Management Response to the FSM Trust Fund Audit Report transmitted with your letter dated October 6, 2020.

For further clarification, please contract Assistant Secretary Senny Phillip at Division of Investment and International Finance, FSM Finance

Thank you,

Eugene Amor
Secretary of Finance & Administration

Response to Public Auditor Report for FY2019

The Department of Finance and Administration ("Finance") has reviewed the Public Auditor's report (Performance Audit on the FSM Trust Fund) and would like to provide the following response:

2.2. Investment Advisor and Money Managers

The Board identify the Investment Advisor for the Fund and currently it is Wilshire Associates, who is based in Santa Monica, California. The Investment Advisor helps identify the kind of marketing pertaining to the Fund and at the same time, identify the money managers, who are specialized in different kinds of investment, and recommend to the Board for approval. Currently, there are twelve (12) money managers who are responsible for identifying the type of investment instruments which they will recommend to the Investment Advisor. Overall performance and other responsibility of the money managers are closely monitored by the Advisor, who also makes recommendation on appointment and termination of money managers.

Response:

Section 2.2 does not describe the role of Investment Advisor correctly. Wilshire's role is to determine the level of risk the Fund can take being a long-term institutional investor. Based on this determination, Wilshire forecast asset class returns and risks in the long run, with a rolling 10-year planning period. This forecast is discussed with the Board to collectively determine an appropriate asset allocation policy, which is documented in the Investment Policy Statement.

3.2. Scope

The audit scope covered all Congress appropriations, all earnings, and all transfers from the Fund covering the period from FY2015 and up to September 30, 2019 (which was our audit cut-off date).

Response:

Section 3.2 states that the report covers periods up to the end of FY 2019. However, in multiple paragraphs, the report referred to the investment losses sustained during the first 3 months of 2020 when the unprecedented COVID-19 pandemic impacted global financial markets, and all major trust funds sustained losses. Finance disagrees with the comments in the Report related to the FSM Trust Fund (the "Fund") performance from January to March of 2020 for the following reasons:

- Comments on the three (3) months period was taken out of context, without acknowledging the unprecedented circumstances nor the subsequent recovery.

- The premise stated in Section 6.2(iv) that an establishment of certain procedure would allow Finance (or its investment Advisors) to be able to forecast the onset of market events that may lead to portfolio losses is flawed and is not consistent with generally accepted investment principles.
- Section 6.1(v) proposes an unrealistic scenario of relaying on the Fund with 100% sensation of foreign grants. It is important not to confuse the Fund with the Compact Trust Fund, which has an obligation to replace a portion of the grants under bilateral agreement. There is a balance of making appropriation to the Fund vs. spending resources to improve the current living standards of the FSM citizens. Based on this, Finance find the conclusion in Section 6.1(iv) mis-guided.

Finding No 1. The main objective of Establishing Trust Fund May not be achieved in the Next Ten Year with current Face:

Response:

Performance period is outside of the stated audit time frame. Refer to factual clarifications below:

Response to Section 6.1

(ii) Subsequent events outside the scope of the Audit revealed that the Fund investments lost $ 40.6 million during the period from January 2020 to March 31, 2020. **This was due to the economic** impact of the Coronavirus (covid-19) pandemic.

Response:

The report sensationalizes the Fund Performance during a particular quarter when the impact to financial markets by the pandemic was taken out of context. The Fund stayed invested as any long term investor should have during periods of short term disruptions. It is important to note that the significant losses mentioned in the report have been fully recovered as a result of sound investment policy deployed.

6.1.2 Potential Effects

(i) Inability to manage the Funds effectively and efficiently – it is almost impossible to manage effectively and efficiently an activity that management does not have any expertise on and heavily rely on the external contractor.

(ii) Loss of funds due to inability to forecast prudently the expected return for each category of investment and stock market direction.

Response:

We disagree to this section in its entirety.

(i) The Trust Fund has been managed very effectively and efficiently, conforming to standards adopted by similar long-term institutions. Professional advisor, custodian and asset managers are engaged for best in class access of their expertise. The multiple checks and balances via a process of three-way reconciliation ensures sound control. The Department of Finance and the Board monitors outside advisors based on performance compared to similar entities. The Trust Fund has generated exceptional performance that ranks it at the top 20% of all Trust Fund as tracked by the Trust Universe Comparison Services (TUCS). The Trust Fund also compares favorably to the Compact Trust Fund.

(ii) It is an inaccurate statement about "loss of funds". It is a misinformed assertion that one can forecast short term stock market directions.

6.1.3 Recommendations

We recommend that the Secretary, Department of Finance and Administration and the Board of Trustees should ensure that:

(i) A Strategic Plan, charting out the direction of the Fund setting appropriate milestones, identifying existing and potential sources of funds, is established and operationalized;

(ii) Full (100%) reliance on contractors for management of Funds investment and the imbedded risks are minimized to acceptable level through conceited efforts that should include building the capacity of the existing employees and members of the Board of Trustees; and

(iii) Management tools for running the activities of the Funds are developed and enshrined in all existing and planned operations, e.g. strategic plan, risk management framework and register, training program for employees and members of the Board of Trustees.

Response:

The FSM Trust Fund's strategic goals are defined by the FSM Code. Finance is overseeing its investment management program. The investment management program adopts the following strategic goals and risk management tools:

- Investment strategic target return: 6% per annum. The Fund's actual achieved return was 7.14% since 2015 per annum net of fees and expenses, as of end of FY2019. This achieved return was above the strategic target return and was ranked among the top 30% of all public institutions of similar purpose, as reflected in the Trust Universe Comparison Services universe, a consortium of all major custodian banks.

Institutional fiduciaries have long adopted the Prudent Investor Rule as the main risk management tool. The Prudent Investor Rule stipulates that: market timing does not work; long term investors should rely on proper asset diversification as the main risk management tool.

The FSM Trust Fund has a long-term investment horizon and invests in 7 major asset classes to ensure proper diversification. The Fund's asset allocation conforms to the institutional asset management standard, based on survey's issued by Greenwich Associate, a major thinktank on institutional asset management.

Finance and The Trust Fund Board concur with the recommendation for a Strategic Plan. In response to this recommendation, the Board of Trustees will look beyond the strategic financial objectives of the Fund and see how development of a Strategic Plan will help provide a more focus approach to enhance and accelerate achievement of the Fund's stated goals pursuant to FSM Code Title 55 Chapter 12 through sustainable financing. One sure way of doing that is through Strategic Planning that will incorporate environmental, social, and governance (ESG) principles into business decisions, economic development, and investment strategies.

The Trust Fund is well-placed to play a key role in helping FSM achieve the SDGs and its commitment under the Paris Agreement and can take the lead in making sustainable development financing investments and catalyze investment by the private sector. The Strategic Plan should help map out how the Board of Trustees and Administration will work on the SDG Challenge from a number of different angles, including investments in technology, clean energy production, sustainable food production, among other disruptive initiatives. Such creativity and imagination will be necessary as the Board and Administration seek to find deals that will be able to simultaneously provide strong returns while also drive FSM towards the achievement of the SDGs.

Finding NO. 02: Lack of Effective Governance and Risk Management Activities

6.2. FINDING NO. 02: Lack of Effective Governance and Risk Management Activities

The main purpose of the Fund, as delineated in Section 1204 of Chapter 12 of Title 55 of FSM Code, is to contribute to the long-term financial viability of the five governments (national and the four states governments) based on the current federal structure (i.e. four state governments and one national government).

In order to ensure that there are effective governance risk management processes, the Act establishing the Fund took into account various issues relating to governance and risk management. During our audit on governance and risk management processes within the Fund we observed that:

Response:

We disagree with the claim that the Trust Fund "lack effective governance and risk management". The Trust Fund allocates investments in a diversified long term-oriented portfolio. The Trust Fund engages with world class institutions for services. These service providers have separation of duties which provides checks and balances. The Board has regular monitoring meetings and meet with all the vendors at least once a year for review. The Trust Fund has achieved superior performance.

The Trust Fund assets are custodied by US Federally registered banking organizations. They are the Trust Fund's official record keeper. It is impractical for DOFA to establish administration capabilities to record and settle the investment trades.

We disagree with the notion that short-term market losses can be avoided by market timing. Discussions of these sections are speculative and are against generally accepted investment principals for long term investors.

The Fund is properly diversified and conforms to the institutional risk management standard. Risk management should not be taken out of the context of the long-term investment horizon of the Fund. This means that the Fund can sustain short term volatility risks such as what happened during the first calendar quarter of 2020, because it has a long-term horizon to recover these temporary (non-permanent) asset value impairment. FY2020 has out performed FY2019.

Sections 6.2(i) and (ii) propose scenarios out of the scope of the law. Finance strongly opposes making these speculations part of the decision-making criteria for the Fund.

Section 6.8(i) states that there are no separate accounts set up for each government's accounts within the Fund. This is an inaccurate statement. The FSM Trust Fund is the collection of a total of 10 sub-accounts, each separately set up and has its own accounting history, and balances for all State sub-accounts are regularly reported to the leadership of National and State Governments.

Finding NO. 03: Capacity Building of the Board and Management of the Trust Fund

Response:

The Board was established during FY2019, and established by-laws and operating procedures subsequently.

The Board has conducted investment manager due diligence meetings and attended educational conference and meetings.

The day to day management of the Fund, similar to all public institutional funds of similar nature, is outsourced with multiple checks and balances. Annual financial audit has unqualified opinions and the governance structure is sound and conforms to institutional standards.

- The investment advisor monitors day to day management activities
- The Bank of New York as the official custodian and record-keeper
- KPMG as the month to month record auditor and

- Morgan Lewis as the legal counsel to review all money management contracts and activities.

The Board has held regular meetings with detailed minutes taking and decision-making documentation.

Having said this, the Board and DoFA staff will continue to seek capacity building opportunities to further enhance capacity going forward.

Finding NO. 04: FSM Trust Fund Lack of Effective and Efficient Management

(i) Poor filing system – There were no properly documented records of communications between the Division of IIF, Fund Managers, Bank Custodian and/or National Treasury and other records pertaining to the Fund. Other pertinent records pertaining to the Fund are not manually filed (e.g. Journal Vouchers (JVs), manual accounting records of the Fund, etc.). Most of this information are only extracted from computer whenever requested or required for use.

Response:

Utilization of electronic filing is not necessary a poor filing practice. All documents are scanned and filed in an electronic folder. We ensure that these files are safely kept by backing up the files every week. In addition, journal vouchers are referenced with JV number and filed at FSM Treasury after these documents are routed to FSM Treasury for processing. We retrieve these documents by referring to the JV numbers thus we have no need to file these documents within this Division as all JV numbers are referenced by FSM Treasury.

for use.

(ii) Absence of operations manual – The Division of IIF did not develop and operationalize policies and procedures manuals for the Fund, except for the Investment Policy Statement (IPS).

Response:

The Investment function is outsourced to professional companies: managers, custodian, auditor and advisor. Division of Investment & International Finance prepare reports required by law and process transactions in accordance to Financial Management Regulations. By law, withdrawal is prohibited until FY2030, Hence the most important guiding tool at this stage is the investment policy, ensuring that returns are maximized.

(iii) The Fund does not have any long-term and short-term plans although Section 1208 of Chapter 12 of Title 55 of FSM Code considers the Fund as a corporate body. The Secretary, Department of Finance and Administration and the Board of Trustees have not developed any Strategic Plan or any short-term plans thus leaving the Fund without pre-determined direction.

Response:

The Board sets, and the Fund manager follows the Investment Policy Statement which provides investment objectives, allocation policies, and investment guidelines which includes investment strategic plans. All investment plans include a duration or time period for funds to be invested whether it be long or short term. This is standard practice for investing funds. However, the most important thing to note here is that the FSM Trust objective is long term. No withdraws allowed until 2030 by law, hence there is no need for withdrawal procedures at this stage.

leaving the Fund without pre-determined direction.

(iv) Financial transactions are created based on financial information provided by contractors which is evidenced by lack of appropriate reconciliations – Reconciliations are only performed when transactions from bank statements recorded in the books of accounts of the Fund and then the same record are used for reconciliation.

Response:

We will continue to seek budget approval from Congress to ensure Finance has sufficient staff to strengthen reconciliation processes.

for reconciliation.

(v) Journal Vouchers (JVs) prepared by the Division of Treasury had vague narrations with regard to the purpose of the transactions. For example, one of the narrations which were termed comments, says: "*to record investment accts at boh and bony*". In justifying the style with which the JVs are prepared, the management of DoFA stated that, as long as the supporting documents have

6.5. FINDING NO. 05: The Management of FSM Trust Fund Did Not Appropriately Carry Out Accounts Reconciliations

Response:

Wilshire and the money managers establish a 3-way reconciliation on a monthly basis. Errors and omissions, if any, can be identified through this monthly process. While the Trust Fund's custodians are the official record keeper of all transactions and settlements, DoFA will continue to strengthen in-house reconciliation processes.

The Division of Investment and International Finance maintains the following records which are reconciled with bank statements and fundware:

Quarterly FSM Trust Fund Report – Contains all appropriations/contributions to the fund and track all deposits to the fund. This report is maintained on a quarterly basis.

Earnings Distribution Schedules – monthly records of deposits, interests, realized g/l, income earned, allocated expenses, change in realized g/l, interest income earned, dividend income earned, management fees, and unrealized earnings. This report is maintained monthly.

NGNet Worksheets – Records net earnings, accruals, and unrealized earnings at the end of year. This is maintained yearly

NG Summary – Summary of deposits, earnings, and unrealized earnings. This is maintained yearly.

We would like to understand why the word "failed" is used here. Our understanding from this finding is that we do not perform any reconciliation or keep account for the fund.

Finding NO. 06: Unclear Duties and Responsibilities of Staffs Administering and Monitoring the FSM Trust Fund

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6.6. FINDING NO. 06: Unclear Duties and Responsibilities of Employees Administering and Monitoring the FSM Trust Fund

Response:

All Staff have job descriptions and are clear on their roles with regards to the Trust Fund. We will work with our Administrative Officers and Personnel Office to update our records to provide the correct documents mentioned in the report. We also agree to amend the PSSR and Job Classifications and Qualifications as recommended for new positions, titles and job descriptions.

Finding NO. 07: Lack of Operational Manual for FSM Trust Fund Operations

6.7. FINDING NO. 07: Lack of Operating Manual for FSM Trust Fund Operations

Response:

We agree with the finding. An Operating Manual for the Division will be drafted.

Finding NO. 08: The FSM Trust Funds Were Co-mingled in the Financial Management Information System (FMIS)

Response:

This is an inaccurate statement. The FSM Trust Fund is the collection of a total of 10 sub-accounts, each separately set up and has its own accounting history. There are bank statements to support this.

The Co-mingled funds in the FMIS reflect the fact that no State Government has voluntarily made a contribution to the FSM Trust Fund. All contributions into the FSM Trust Fund are from the National Government. This has been made clear by the Congress laws that have made appropriations to the Fund. If a State voluntarily makes a contribution, the FMIS system will record that transaction separately.

We do have State Sub-accounts set up under the master custody agreement with BNY with monthly cashflows and investment performance separately tracked for each state, and regularly reported to the FSM National and State Government leadership as well as Congress.

Finding NO. 09: FSM Trust Fund Management and Department of Finance and Administration Failed to Implement All Audit Recommendations issued in Audit Report no. 2015-08

The Trust Fund lacks reconciliations

Response:

We agree that we need to improve internal reconciliation of the trust fund. We have requested new staff dedicated to Trust Fund and this request is pending budget approval by Congress.

The FSM Trust Fund's books of accounts not properly maintained (i) maintain separate (from the General fund) books and accounts of the FSM Trust Fund as required by law

Response:

The FSM Trust fund books are separate from the General Fund. The FSM Trust Fund and the General Fund have different fund numbers in the FMIS system.

8.0 ONPA EVALUATION OF MANAGEMENT RESPONSE

We provided a draft of the audit report to Management to review for the exit conference. At the exit (August 5th, 2020), we discussed our findings, conclusions and recommendations thoroughly with the Management (namely the Secretary, DOFA, the Assistant Secretary for the DIIF, and the Investment & International Finance Officer). We then made some changes to the report based on the discussion with the Management team at the exit conference. We also offered to do an exit with the Board of Trustee but they did not respond. A revised draft of the audit report was then provided to Management and the Board to review and provide their Management Response. The Management Response provided to us was from the Management Team and the Board of Trustees (the Board).

After providing the revised draft report, the Acting Chairman for the Board communicated with our office and expressed his disagreement with our description of the Board composition. We cited the laws and clarified it for the Chairman who then agreed with our description of the Board members appointment and composition.

We also found that Management did not agree with some of the findings and recommendations in the report. Therefore, we would like to clarify our position in response to some statements made in the management response pertaining to the sections of the audit report that are listed below:

8.1 Background (Paragraph 2.2 – Investment Advisor and Money Managers):

8.1.1 Trust Fund management response

Section 2.2 does not describe the role of Investment Advisor correctly. Wilshire's role is to determine the level of risk the Fund can take being a long-term institutional investor. Based on this determination, Wilshire forecast asset class returns and risks in the long run, with a rolling 10-year planning period. This forecast is discussed with the Board to collectively determine an appropriate asset allocation policy, which is documented in the Investment Policy Statement.

8.1.2 ONPA Evaluation:

We understand that the role stated in the report may not be the full role of the Investment Advisor as recorded in the Agreement between FSM and Wilshire; however, we had summarized in simple words (for the sake of the readers who are not familiar with technical investment terms) part of the role of the Investment Advisor (Wilshire). We therefore disagree to the response by Management as presented above that our description of the role of the Investment Advisor is not correct but rather it is incomplete. We have therefore updated the audit report to reflect the summary of key services that Wilshire was contracted to provide according to the Services listed in the Investment Advisory Agreement between Wilshire Associates Incorporated and the FSM Government Trust Fund.

8.2 Scope (Paragraph 3.2)

8.2.1 Trust Fund management response

Section 3.2 states that the report covers periods up to the end of FY 2019. However, in multiple paragraphs, the report referred to the investment losses sustained during the first 3 months of 2020 when the unprecedented COVID-19 pandemic impacted global financial markets, and all major trust funds sustained losses. Finance disagrees with the comments in the Report related to the FSM Trust Fund (the "Fund") performance from January to March of 2020 for the following reasons:

- Comments on the three (3) months period was taken out of context, without acknowledging the unprecedented circumstances nor the subsequent recovery.

- The premise stated in Section 6.2(iv) that an establishment of certain procedure would allow Finance (or its investment Advisors) to be able to forecast the onset of market events that may lead to portfolio losses is flawed and is not consistent with generally accepted investment principles.
- Section 6.1(v) proposes an unrealistic scenario of relaying on the Fund with 100% sensation of foreign grants. It is important not to confuse the Fund with the Compact Trust Fund, which has an obligation to replace a portion of the grants under bilateral agreement. There is a balance of making appropriation to the Fund vs. spending resources to improve the current living standards of the FSM citizens. Based on this, Finance find the conclusion in Section 6.1(iv) mis-guided.

8.2.2 ONPA Evaluation

We would like to clarify firstly that the generally accepted government auditing standards (section 8.09) that we use allows us to "refine or adjust the audit objectives, scope, and methodology as work is performed".

It should also be noted that section 1.1 of Introduction of the audit report had already indicated that "information relating to FY2020 were also used to come up with various findings, recommendations and conclusions". We understand that this supports the references we have made in the audit report pertaining to the performance of the Fund as at March 2020.

Finally, we would like to add that since the investment loss for the period January to March 2020 was the result of the global pandemic (coronavirus / covid-19), it is only responsible on our part that we exercise our advisory role to discuss the impact of the pandemic in our audit report considering that the Executive Summary of Investment Results for the Fund as at 06/30/2020 (prepared by Wilshire) clearly stated the following:

> *"While the market recovery thus far has been swift and juxtaposed to the economic data, the future remains as opaque as ever. Current market assumptions are partially pricing in hopes for a vaccine, indefinite monetary accommodation, and the potential for another wave of fiscal*

stimulus. Reviewing and staying disciplined to an investment strategy may prove to be even more critical now than before, as we all navigate through this ever-shifting landscape together"

8.3 Finding No.1 - The main objective of establishing the Trust Fund may not be achieved in the next ten years with the current pace

8.3.1 Trust Fund management response

The report sensationalizes the Fund Performance during a particular quarter when the impact to financial markets by the pandemic was taken out of context. The Fund stayed invested as any long term investor should have during periods of short term disruptions. It is important to note that the significant losses mentioned in the report have been fully recovered as a result of sound investment policy deployed.

8.3.2 ONPA Evaluation

We agree that this is indeed a long-term investment and we note the recovery reported in the Executive Summary of Investment Results for the Fund as at 06/30/2020. However, we would like to remind Management that the recovery is only for the period that is being reported. Looking ahead into the future, we believe it is important that management should not completely rely on the recovery of the recent loss but more importantly consider the fact that this global pandemic (coronavirus) is not over yet and as reported in the executive summary mentioned above (prepared by the Investment Advisor - Wilshire), "*While the market recovery thus far has been swift and juxtaposed to the economic data, the future remains as opaque as ever..".* For the long term, its best to plan and prepare for the worse.

We would also like to comment on the statement made in the management response above, stating that the significant losses mentioned in the audit report have been "fully recovered as a result of sound investment policy deployed". We acknowledge that the Investment Policy currently in place contains guidelines for the Fund. However, we would like to remind management that much of the recovery was attributed to other factors as mentioned in the Executive Summary of Investment Results (prepared by the Investment Advisor – Wilshire) as at 06/30/2020 as quoted below:

"Much of the recovery has been attributed to the speedy and accommodative responses of central banks' monetary programs, as well as fiscal programs in varying amounts around the world"

Based on the above, we would retain the relevant findings in our audit report and we have added a discussion in the report on the recovery of the investment loss.

8.4 Potential Effects (Para. 6.1.2 of Finding 1)

8.4.1 Trust Fund management response

We disagree to this section in its entirety.

(i) The Trust Fund has been managed very effectively and efficiently, conforming to standards adopted by similar long-term institutions. Professional advisor, custodian and asset managers are engaged for best in class access of their expertise. The multiple checks and balances via a process of three-way reconciliation ensures sound control. The Department of Finance and the Board monitors outside advisors based on performance compared to similar entities. The Trust Fund has generated exceptional performance that ranks it at the top 20% of all Trust Fund as tracked by the Trust Universe Comparison Services (TUCS). The Trust Fund also compares favorably to the Compact Trust Fund.

(ii) It is an inaccurate statement about "loss of funds". It is a misinformed assertion that one can forecast short term stock market directions.

8.4.2 ONPA Evaluation

We acknowledge that the Fund has been performing well as a standalone investment and when compared with similar trust funds as management has stated above. However, we wanted management to understand that our analysis was not based on the Fund's performance as compared to similar entities in the world market. Our analysis was based on contributions made to the Fund as compared to the actual financial performance of the National Government in terms of funding its re-current expenditures.

Based on the criteria we used (Section 1204 of Chapter 12 of the FSM Code Title 55), one of the purposes of establishing the Fund was to "*Assist the National Government and other participating governments to achieve greater financial autonomy in the management of their re-current budgets*". This was the basis of the analysis carried out by the audit team to assess the level of foreign input into the re-current expenditures of the National Government.

Referring specifically to Table 03 on page 8 (*Analysis on Foreign Input on FSM Budget Fiscal Years 2015 to 2018)* of the audit report, it must be noted that a significant percent of the re-current expenditure of the national government is funded by foreign input. This in our view should be an indicator for Management to advise the Board to start discussing and identifying strategies for increasing contributions to the Fund to ensure that it effectively implements its purpose.

We also understand that professional advisor and other contractors are engaged for their expertise, however we would like to remind Management that it cannot rely entirely on reports provided by the contractors and submit them to the Office of the President and the Congress but rather they should use those performance reports to carry out financial analysis (similar to that on Table 03 on page 8) on the impact of the Fund's performance on the national government's recurrent budget and long term budgets and provide the necessary advice to the leaders for their decision making.

Based on the above, we would retain the potential effects in our audit report.

8.5 Finding No. 2 – Lack of Effective Governance and Risk Management Activities

8.5.1 Trust Fund management response

We disagree with the claim that the Trust Fund "lack effective governance and risk management". The Trust Fund allocates investments in a diversified long term-oriented portfolio. The Trust Fund engages with world class institutions for services. These service providers have separation of duties which provides checks and balances. The Board has regular monitoring meetings and meet with all the vendors at least once a year for review. The Trust Fund has achieved superior performance.

The Trust Fund assets are custodied by US Federally registered banking organizations. They are the Trust Fund's official record keeper. It is impractical for DOFA to establish administration capabilities to record and settle the investment trades.

We disagree with the notion that short-term market losses can be avoided by market timing. Discussions of these sections are speculative and are against generally accepted investment principals for long term investors.

The Fund is properly diversified and conforms to the institutional risk management standard. Risk management should not be taken out of the context of the long-term investment horizon of the Fund. This means that the Fund can sustain short term volatility risks such as what happened during the first calendar quarter of 2020, because it has a long-term horizon to recover these temporary (non-permanent) asset value impairment. FY2020 has out performed FY2019.

Sections 6.2(i) and (ii) propose scenarios out of the scope of the law. Finance strongly opposes making these speculations part of the decision-making criteria for the Fund.

Section 6.8(i) states that there are no separate accounts set up for each government's accounts within the Fund. This is an inaccurate statement. The FSM Trust Fund is the collection of a total of 10 sub-accounts, each separately set up and has its own accounting history, and balances for all State sub-accounts are regularly reported to the leadership of National and State Governments.

8.5.2 ONPA Evaluation

We would like to clarify that the focus of this finding is on the internal governance and risk management processes within the DIIF which administers the daily operations of the Fund. We are not referring to the governance and risk management processes of the service providers / external stakeholders to the Fund (e.g. Wilshire and the Bank of New York or the money managers.). These contractors would definitely have check and balances as stated by Management above, but we did not find the same to be in place within the DIIF. During our audit we discovered that the DIIF was mostly relying on the BNY bank statements to update the Trust fund accounts in the FMIS and also used that same information from the bank statements to prepare reports (e.g. the Earnings distribution worksheet). Similarly, most of the performance reports were prepared by the Advisor (Wilshire) which were being submitted to Management, the Board, the Office of the President and the FSM Congress.

8.6 Finding No. 3 – Capacity Building of the Board and Management of the Trust Fund

8.6.1 Trust Fund management response

The Management concurred with our finding and recommendation to strengthen capacity building within the DIIF.

8.6.2 ONPA Evaluation

We would like to reiterate that our finding above is solely addressing capacity building for the Board and management who are directly responsible for the administration of and oversight for the Fund. We are not referring to the capacity needs of the contractors (BNY or Wilshire) which the management response referred to.

8.7 Finding No. 4 – FSM Trust Fund Lack of Effective and Efficient Management

8.7.1 Poor filing system (paragraph 6.4 (i))

8.7.1.1 Trust Fund management response

Response:

Utilization of electronic filing is not necessary a poor filing practice. All documents are scanned and filed in an electronic folder. We ensure that these files are safely kept by backing up the files every week. In addition, journal vouchers are referenced with JV number and filed at FSM Treasury after these documents are routed to FSM Treasury for processing. We retrieve these documents by referring to the JV numbers thus we have no need to file these documents within this Division as all JV numbers are referenced by FSM Treasury.

8.7.1.2 ONPA Evaluation

We would like to clarify that our audit finding on "poor filing system" was not focused entirely on Journal vouchers (JV) as discussed by management above but also on documented records of communications between the DIIF, Fund Managers, Bank Custodian and/or National Treasury and other records pertaining to the Fund.

In terms of communications, we have meeting minutes signed by the Assistant Secretary, DIIF, confirming that there were no formal meetings or communication between DIIF and the Advisor (Wilshire). However, we later learnt from our meeting with the former chairman of the Board that a Wilshire representative makes visits (sometimes twice a year) to the FSM and meet with the Board of trustees to discuss issues of priority. We were not provided any meeting minutes by DIIF until the audit team raised queries with the former chairman of the Board, who confirmed that meeting minutes with Wilshire should be in the custody of the administrator. In our view it is the DIIF that should be maintaining all records pertaining to the Trust Fund – whether they are financial records, meeting records or performance reports.

The same applied for Board meeting minutes which were only furnished to the audit team after we had met with the former chairman. It was not readily available at the DIIF which indicated poor filing system as those discussions with the Investment advisor and also the Board meetings are official records of the Trust Fund.

Based on the above, we would retain the relevant findings on poor filing system in our audit report.

8.7.2 Absence of operations manual (paragraph 6.4 (ii))

8.7.2.1 Trust Fund management response

The Investment function is outsourced to professional companies: managers, custodian, auditor and advisor. Division of Investment & International Finance prepare reports required by law and process transactions in accordance to Financial Management Regulations. By law, withdrawal is prohibited until FY2030, Hence the most important guiding tool at this stage is the investment policy, ensuring that returns are maximized.

8.7.2.2 ONPA Evaluation

We acknowledge once again that the Investment Policy Statement (IPS) for the Fund does exist for the purpose of documenting the investment guidelines as required by law for the Fund manager to follow. However, it's important for us to point out that an operations manual serves a different purpose altogether than that of the IPS (a policy and manual are two different documents). The operations manual which we are recommending should contain the step by step procedures for the day to day activities of the Fund. This is essential to guide the staff and management of the DIIF.

Based on the above, we would retain the above findings in our audit report.

8.7.3 The Fund does not have any long-term and short-term plans (paragraph 6.4 (iii))

8.7.3.1 Trust Fund management response

The Board sets, and the Fund manager follows the Investment Policy Statement which provides investment objectives, allocation policies, and investment guidelines which includes investment strategic plans. All investment plans include a duration or time period for funds to be invested whether it be long or short term. This is standard practice for investing funds. However, the most important thing to note here is that the FSM Trust objective is long term. No withdraws allowed until 2030 by law, hence there is no need for withdrawal procedures at this stage.

8.7.3.2 ONPA Evaluation

We understand that the IPS in place contains investment guidelines; however, the IPS is not expected to contain strategic plans in terms of what the Board plans to do and targets to achieve in the next 5 to 10 years. From our discussion with the former chairman of the Board, he shared with us that the Board's objective is to build the Fund up to $1 billion or more by the year 2020 which he stated would be attainable provided that all 5 FSM governments join hands in contributing and also seeking potential donors within and outside of the FSM. This is basically the reason we are recommending that the Management and the Board establish a Strategic Plan to document its activities and targets for the next 5 to 10 years.

Additionally, based on our interview with the Managing Director (Wilshire Associates) who is directly monitoring the Fund, a minimum annual contribution of $30m - $40m would be required to achieve the $1 billion target by the year 2030. According to the Director, these information have been shared with the Board during their August 2019 meeting. In our view, these monetary targets together with action plans should be documented in a strategic plan as recommended in our audit report.

Based on the above, we would retain the relevant findings in our audit report.

8.8 Finding No. 5 – The Management of FSM Trust Fund Did Not Appropriately Carry Out Accounts Reconciliations

8.8.1 Trust Fund management response

Wilshire and the money managers establish a 3-way reconciliation on a monthly basis. Errors and omissions, if any, can be identified through this monthly process. While the Trust Fund's custodians are the official record keeper of all transactions and settlements, DoFA will continue to strengthen in-house reconciliation processes.

The Division of Investment and International Finance maintains the following records which are reconciled with bank statements and fundware:

Quarterly FSM Trust Fund Report – Contains all appropriations/contributions to the fund and track all deposits to the fund. This report is maintained on a quarterly basis.

Earnings Distribution Schedules – monthly records of deposits, interests, realized g/l, income earned, allocated expenses, change in realized g/l, interest income earned, dividend income earned, management fees, and unrealized earnings. This report is maintained monthly.

NGNet Worksheets – Records net earnings, accruals, and unrealized earnings at the end of year. This is maintained yearly

NG Summary – Summary of deposits, earnings, and unrealized earnings. This is maintained yearly.

We would like to understand why the word "failed" is used here. Our understanding from this finding is that we do not perform any reconciliation or keep account for the fund.

8.8.2 ONPA Evaluation

We acknowledge that the DIIF maintains the records listed in the management response above, however, we would like to clarify that we were not provided any evidence of the reconciliations against the bank statements (as stated by management above). As long as the above mentioned Earnings Distribution Schedule was concerned, we were told that it was DIIF's records of reconciliations when in fact our verification revealed that the transactions in this schedule were directly inputted from the BNY (bank) statements (which they used at every month end) showing opening balances, transactions of principal and interests and closing balances. There was nowhere in these records that show reconciliations between the books of accounts of the DIIF against the bank statement balances.

We also would like to correct that we did not use the word "failed" for Finding No. 5 in the revised audit report that was provided to management prior to the management providing their response.

8.9 Finding No. 6 – Unclear Duties and Responsibilities of Employees Administering and Monitoring the FSM Trust Fund

Management agreed with our findings above.

8.10 Finding No. 7 – Lack of Operating Manual for FSM Trust Fund Operations

Management agreed with our findings above.

8.11 Finding No. 8 – The FSM Trust Fund were co-mingled in the Financial Management Information System (FMIS)

8.11.1 Trust Fund management response

This is an inaccurate statement. The FSM Trust Fund is the collection of a total of 10 sub-accounts, each separately set up and has its own accounting history. There are bank statements to support this.

The Co-mingled funds in the FMIS reflect the fact that no State Government has voluntarily made a contribution to the FSM Trust Fund. All contributions into the FSM Trust Fund are from the National Government. This has been made clear by the Congress laws that have made appropriations to the Fund. If a State voluntarily makes a contribution, the FMIS system will record that transaction separately.

We do have State Sub-accounts set up under the master custody agreement with BNY with monthly cashflows and investment performance separately tracked for each state, and regularly reported to the FSM National and State Government leadership as well as Congress.

8.11.2 ONPA Evaluation

We are fully aware of the 10 separate sub-accounts of the Fund as recorded in the BNY statements. Our finding is based on the fact that these sub accounts are not pre-recorded as subsidiary ledgers at the DIIF or within the FMIS as required by law (below):

Section 1218 of Chapter 12 of Title 55 of the FSM Code clearly states the following:

- *Item (1): The Board shall cause the Fund managers to keep all proper books and records of account of the assets, property, liabilities, income and expenditure, and transactions of the Fund, and to produce these promptly in order to facilitate audit.*
- *Item (2): All records and reports of Fund returns shall clearly segregate and identify gross returns, management fees, and net returns.*
- *Item (3): The books and records of the Fund shall separately account for each government's account, including the pro rata application of expenses of the Fund.*

The justification provided above by management on the basis for co-mingled funds in the FMIS could not be verified in the above mentioned law. Our understanding, according to the provisions of the FSM Code above, is that there should be separate accounts for each government's account which is currently not practiced in the FMIS as there is only one (1) general ledger account for the Fund in the FMIS that records all the transactions pertaining to the 10 separate sub-accounts of the Fund.

Moreover, based on our interview with the Assistant Secretary, National Treasury and the former Accounting Advisor, they confirmed that the DIIF maintains the subsidiary ledgers for the Fund. We agree that it is only right that DIIF records the subsidiary ledgers for the Fund since the FMIS only has one general ledger account. However, from our review, we discovered that DIIF does not record transactions as and when the transfers (such as for contributions) take place; rather they wait for the monthly bank statements from BNY before updating their records which defeats the purpose of reconciliation. The right practice should be that the DIIF reconcile the transactions in the subsidiary ledgers (which they should have recorded and updated as and when the transactions take place) against the transactions in the bank statements that are received monthly from BNY.

8.12 Finding No. 9 – FSM Trust Fund Management and Department of Finance and Administration Did Not Implement All Audit Recommendations issued in Audit Report no. 2015-08

8.12.1 Trust Fund management response

The FSM Trust fund books are separate from the General Fund. The FSM Trust Fund and the General Fund have different fund numbers in the FMIS system.

8.12.2 ONPA Evaluation

We agree that the Trust Fund is a separate account from the General fund in the FMIS, however, we will maintain the implementation status “Not appropriately Implemented” based on the lack of subsidiary ledgers as required by law and as recorded in the BNY statements.

9.0 NATIONAL PUBLIC AUDITOR COMMENTS

We would like to thank the management and staff of the Department of Finance and Administration and the Board of Trustees for their assistance and cooperation during the course of the audit.

We have provided copies of the final audit report to the President and members of the 21st FSM Congress for their use and information. Furthermore, we will make copies available to other interested parties upon request.

If there any questions or concerns regarding this report, please do not hesitate to contact our office. Contact information for the office can be found on the last page of this report along with the National Public Auditor and staff that made major contributions to this report.

Haser H. Hainrick
National Public Auditor

December 02, 2020

10.0 ONPA CONTACT ANDSTAFF ACKNOWLEDGEMENTS

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ACKNOWLEDGEMENTS	In addition to the contact named above, the following staff made key contributions to this report: Miriama Naivalu, Acting Audit Manager / Audit Supervisor Keller Phillip, Auditor-In-Charge Rosadelima Alfons, Staff Auditor Brenda Carl, Staff Auditor Christopher Delcampo, Staff Auditor
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