

**POHNPEI ECONOMIC DEVELOPMENT AUTHORITY
AUDIT REPORT
YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

POHNPEI ECONOMIC DEVELOPMENT AUTHORITY

FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT

YEARS ENDED SEPTEMBER 30, 2002 AND 2001

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April 12, 2004

The Honorable Johnny P. David, Governor, State of Pohnpei
The Honorable Nelson N. Pelep, Speaker, State of Pohnpei
The Honorable Members of the Pohnpei State Legislature
The Honorable Joseph E. Felix, Chairman, Board of Developers,
Economic Development Authority
The Honorable Board of Developers, Economic Development Authority
Mr. Alfonso L. Ada, Acting Executive Director, Economic Development Authority

EXECUTIVE SUMMARY

We are pleased to submit the audit report of Pohnpei Economic Development Authority (the Authority), as of and for the years ended September 30, 2002 and 2001. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the Comptroller General of the United States. The audit was also performed pursuant to Article 11, Section 8 (2) of the Pohnpei State Constitution and Pohnpei State Law No. 1L-10-79, and such other laws promulgated thereafter.

The highlights of the report are as follows:

1. We have qualified our opinion on the Authority's financial statements based on the following:

- The carrying values of the donated fishing boats namely, Senyavin, Usuhan, Miss Pohnpei, Boat 1 and 2 and the cold storage facilities have remained unvalued and unrecorded as assets of the Authority. The documents and records on these assets are not available.
- We are uncertain that an investment of \$500,000 is appropriately recorded in the Authority's books, because of the Attorney General's opinion stating that dividends from the investment accrue to the Pohnpei State General Fund.

2. The Authority's deficit has increased to more than \$3.80M in fiscal year 2001. In fiscal year 2002, it increased to about \$4.14M. The increase is attributed to losses incurred from cold storage operation and the cost of administration.

3. Our tests of the Authority's compliance with laws and regulations disclosed three (3) instances of noncompliance, which are presented in the Schedule of Findings and Questioned Costs of our report, pages 15 - 32 as finding numbers 02-7, 02-12 and 02-14. We consider finding numbers 02-7 and 02-12 as material instances of noncompliance.

4. Of the eleven (11) reportable conditions identified in our report (pages 15 to 23, 25 through 29 and page 31), nine (9) are considered material weaknesses. The material findings are presented as finding numbers 02-2 through 02-5, 02-8 to 02-11 and 02-13.

As is customary, we have discussed the draft report with the management of the Authority and have requested for their response to our findings. Hence, the Authority's response is included as part of this report as Exhibit I. The Auditee's response necessitates the auditor's reply for clarity. Such reply is also included in the report.

As required by the provisions of Pohnpei State Law No. 5L-08-00, an amendment to the law that created the Office of the Pohnpei State Auditor (OPSA), the Authority is required to submit a monthly report to OPSA indicating its progress in clearing deficiencies cited in the audit report, which period shall not exceed six months.

In closing we would like to extend our sincere appreciation to the management and staffs of the Authority for their cooperation and assistance during the course of our audit.

Annes H. Leben
Pohnpei State Auditor

INDEPENDENT AUDITOR'S REPORT

The Board of Developers
Pohnpei Economic Development Authority:

We have audited the accompanying balance sheets of the Pohnpei Economic Development Authority (the Authority), a component unit of the State of Pohnpei, as of September 30, 2002 and 2001, and the related statements of revenues, expenses and changes in fund equity and cash flows for the years then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As more fully described in note 6, documentation supporting the carrying values of certain donated assets has not been provided to the Authority and therefore, these assets have not been recorded in the accompanying financial statements. We were unable to determine the effect of this omission on the accompanying financial statements.

In addition, as described in note 2, a Pohnpei State Attorney General's letter dated June 1, 1994, stated that dividends from a \$500,000 investment accrue to the General Fund. This determination has raised doubt as to whether the underlying investment is properly recorded on the Authority's financial statements. The ultimate outcome of this matter is not currently predictable.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to assure ourselves as to the propriety of donated assets and whether the \$500,000 investment should be recorded in the financial statements, the aforementioned financial statements present fairly, in all material respects, the financial position of the Pohnpei Economic Development Authority, as of September 30, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 30, 2003 on our consideration of the Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Annes H. Leben
Pohnpei State Auditor
September 30, 2003

POHNPEI ECONOMIC DEVELOPMENT AUTHORITY

Statement of Cash Flows
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Operating loss	\$ (409,263)	\$ (154,799)
Adjustments to reconcile net operating loss to net cash used for operating activities:		
Bad debts	46,088	23,949
Depreciation	88,516	83,218
Increase in accounts receivable	91,501	(24,389)
Decrease (increase) in advance	1,015	(28,890)
Increase in security deposit	-	(750)
Decrease in inventory	4,472	4,950
Increase in due to/from primary government	10,000	35,000
Increase in accounts payable	222,269	44,923
Increase in accrued and other liabilities	24,839	6,959
Increase in advance from client	34,691	-
	<u>(68,875)</u>	<u>(9,829)</u>
Net cash provided by operating activities		
Cash flows from noncapital financing activities:		
Operating transfers in	21,789	13,660
Other income	37,376	3,926
Interest income	193	2,001
	<u>59,358</u>	<u>19,587</u>
Cash provided by noncapital financing activities		
Cash flows from capital financing activities:		
Payments for acquisition of fixed assets	<u>(61,342)</u>	<u>55,160</u>
Net cash and equivalents decrease for the year	70,859	45,402
Cash and equivalents at beginning of year	<u>40,357</u>	<u>85,759</u>
Cash and equivalents at end of year	\$ <u><u>(30,502)</u></u>	\$ <u><u>40,357</u></u>

See accompanying notes to financial statements.

POHNPEI ECONOMIC DEVELOPMENT AUTHORITY

Statement of Revenues, Expenses, and Changes in Fund Equity
Years Ended September 30, 2002 and 2001

	2002	2001
Revenues:		
Provisioning and ship agency services	\$ 353,503	\$ 169,062
Transshipment services	348,983	400,679
Storage and rental income	145,738	142,639
Ice sales	36,138	3,474
Fish sales	-	143
	<u>884,362</u>	<u>715,997</u>
Operating expenses:		
Selling and administration expenses	444,670	242,212
Factory overhead	205,584	211,219
Ship agency services	192,747	57,461
Direct labor – cold storage	117,294	80,400
Transshipment overhead	79,632	78,785
Direct labor – transshipment	67,955	91,478
Cost of goods sold	58,035	-
Provisioning services	49,307	60,759
Provisioning and ship agency overhead	26,698	14,606
Direct labor – provisioning and ship agency	25,170	23,410
Fisheries expenses	17,532	10,466
Other personnel	9,003	-
	<u>1,293,626</u>	<u>870,796</u>
Operating loss	(409,263)	(154,799)
Nonoperating revenues:		
Operating transfers in (note 11)	21,789	13,660
Other income	37,376	3,926
Interest income	193	2,001
	<u>60,358</u>	<u>19,587</u>
Net loss	(349,905)	(135,212)
Deficit at beginning of year	(3,807,897)	(3,699,843)
Add depreciation on fixed assets acquired by capital grants that reduces contributed capital from capital grants	14,492	27,158
Deficit at end of year (note 12)	(4,143,310)	(3,807,897)
Contributed capital at beginning of year	4,321,014	4,348,172
Depreciation charged against contributed fixed assets	<u>(14,492)</u>	<u>(27,158)</u>
Contributed capital at end of year	<u>4,306,522</u>	<u>4,321,014</u>
Fund equity at end of year	\$ <u>163,212</u>	\$ <u>513,117</u>

See accompanying notes to financial statements.

POHNPEI ECONOMIC DEVELOPMENT AUTHORITY

Statement of Revenues, Expenses, and Changes in Fund Equity
Years Ended September 30, 2002 and 2001

ASSETS

	2002	2001
Current assets:		
Cash and equivalents	\$ (30,502)	\$ 40,357
Advances, net (note 3)	(898)	28,563
Account receivable, net (note 4)	140,320	66,460
Loans receivable (note 5)	40,000	40,000
Security deposit	750	750
Inventory	140	4,612
Total current assets	149,810	180,742
Property and equipment, net (note 6)	172,846	221,699
Construction in progress (note 7)	21,628	-
Investments (note 2)	500,500	500,500
	\$ 844,784	\$ 902,941

LIABILITIES AND FUND EQUITY

Current liabilities:		
Accounts payable (note 8)	\$ 507,106	\$ 284,837
Due to primary government (note 9)	85,000	75,000
Advance from client	41,691	7,000
Payroll liabilities	47,775	22,987
Total liabilities	681,572	389,824
Fund equity:		
Contributed capital	4,306,522	4,321,014
Deficit	(4,143,310)	(3,807,897)
Total fund equity	163,212	513,117
Commitments (note 10)	\$ 844,784	\$ 902,941

See accompanying notes to financial statements.

POHNPEI ECONOMIC DEVELOPMENT AUTHORITY
Notes to Financial Statements
September 30, 2002 and 2001

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Pohnpei Economic Development Authority (the Authority) was established in 1978 by Pohnpei District Law 4L-159-78 for the purposes of promoting economic development through expansion of agriculture, marine resources, tourism, industry, energy development, banking, transportation and community development in Pohnpei. The Authority was also designated to succeed the Pohnpei District Fishing Authority as the sole entity to promote, develop, and support commercial utilization of living marine resources as provided in Public Law No. 7-110 of the Trust Territory Code. The Authority is a component unit of the State of Pohnpei.

All functions and powers of the Authority are vested in and exercised by the Board of Developers appointed by the Governor with the advice and consent of the Legislature. The establishing legislation also places responsibilities for the administration of the Authority's day-to-day operations with the Executive Director, an ex-officio member of the board, who is appointed by the Governor with the advice and consent of the Pohnpei State Legislature.

The Authority is a component unit (a discretely presented proprietary fund) of the Pohnpei State Government. The financial statements in this report do not represent the financial position, results of operations or cash flows of the State of Pohnpei as a whole. The financial statements of the Authority have been prepared in conformity with generally accepted accounting principles (GAAP) as applied to government units. Government Accounting Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting", requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989.

B. Fund Structure, Measurement Focus and Basis of Accounting

The accounts of the Authority are organized as a proprietary fund type of the Pohnpei State Government. Proprietary fund types are used by governmental units to account for operations that are financed and operated in a manner similar to private business enterprises. The purpose of a proprietary fund type is to provide periodic determination of revenues, expenses and net income, with maintenance of capital. Proprietary fund types accounted for on a flow of economic resources measurement focus, whereby all assets and liabilities associated with the operations of the funds are included on the balance sheet. Fund equity (i.e., net total assets) is segregated into contributed capital and retained earnings components. Operating statements present increases (i.e., revenues) and decreases (i.e., expenses) in net total assets.

Basis of accounting refers to when revenues and expenses are recorded in the accounts and reported in the financial statements. The Authority uses the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when cash is received or payment is made.

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

C. Budget

The enabling legislation does provide the Authority the power to expend revenues generated by projects maintained by the Authority. Such expenditures must, however, be in accordance with the provisions of the Financial Management Act and other applicable laws and regulations.

D. Cash and Equivalents

For the purpose of the balance sheet and statement of cash flows, cash and equivalents are defined as cash in checking accounts, savings accounts and cash on hand. Of these amounts, \$100,000 is insured through the FDIC, with the remaining balance exceeding insurable limits. The Authority does not require collateralization of its deposits by its banks. Therefore, the amounts which exceed the FDIC insurable limits are characterized as uncollateralized.

E. Inventory

Inventory is stated at the lower of cost or market using the first-in, first-out (FIFO) costing method.

F. Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation is based on the straight-line method over the estimated useful lives of the respective assets. (See note 6)

G. Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefit accrues to employees. In accordance with the provisions of FASB Statement No. 43-Accounting for Compensated Absences, no liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The related sick pay expense is recorded when the benefit is actually taken.

H. Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the

reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

I. Risk Management

The Authority does not purchase commercial insurance covering its potential risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

J. Investments

The Authority's equity investments are carried at cost when the equity ownership position comprises less than 20% or on the equity method when the ownership percentage exceeds 20% but is less than 50%.

(2) INVESTMENTS

In fiscal year 1993, the Authority recorded an investment of 50,000 shares of common stock in Bank of the Federated States of Micronesia (BFSM) of \$500,000. A capital contribution from Pohnpei State was simultaneously recorded for this investment.

A Pohnpei State Attorney General's letter dated June 1, 1994 stated that dividends from the aforesaid investment should be deposited in the General Fund. This action has raised doubt as to whether the underlying investment is properly recorded in the Authority's financial statements. However, pending the resolution of this matter, the Authority's Board of Developers adopted a resolution on March 20, 1995 that this investment be maintained and recorded in its financial statements. This investment is recorded at cost since the Authority's ownership percentage is less than 20%. The market value of this investment is difficult to determine since the BFSM is not publicly traded and since respective governments comprising the Federated States of Micronesia have a controlling interest.

In 1996, the Authority made an investment of \$500 in Pacific Tuna Venture Incorporation, a development stage enterprise, in exchange for a one-third equity interest. This investment is carried at cost as the enterprise has not commenced operations.

The Authority also has an investment in Caroline Fisheries Corporation, Inc. (See note 10).

(3) ADVANCES, NET

A summary of the Authority's advances, net as of September 30, 2002 and 2001 is as follows:

2002

2001

Advances to customers	\$ 28,305	\$ 28,305
Advances to employees and others	<u>24,726</u>	<u>25,741</u>
Total advances	53,031	54,046
Less allowance for doubtful accounts	<u>53,929</u>	<u>25,483</u>
Advances, net	\$ <u><u>(898)</u></u>	\$ <u><u>28,563</u></u>

(4) ACCOUNTS RECEIVABLE, NET

Accounts receivable, net at September 30, 2002 and September 30, 2001 are as follows:

	<u>2002</u>	<u>2001</u>
Accounts receivable trade	\$ 1,125,862	\$ 1,044,907
Accounts receivable employees and others	<u>14,656</u>	<u>4,109</u>
Total receivables	1,140,518	1,049,017
Less allowance for doubtful accounts	<u>(1,000,198)</u>	<u>(982,557)</u>
Accounts receivable, net	\$ <u><u>140,320</u></u>	\$ <u><u>66,460</u></u>

(5) LOANS RECEIVABLE

As of September 30, 2002 and September 30, 2001, the Authority's outstanding loan receivable from Pohnpei Fisheries Corporation (PFC), a component unit-proprietary fund of Pohnpei State Government, is \$40,000.

The amount of the loan was used to assist in liquidating PFC's account with a major vendor. This interest-free loan was due on March 1998.

(6) PROPERTY AND EQUIPMENT

A summary of the Authority's property and equipment is as follows:

	Estimated Useful Life	<u>2002</u>	<u>2001</u>
Buildings	15 years	\$ 12,833	\$ 12,833
Transportation equipment	3 – 5 years	207,012	201,712
Furnitures and fixtures	3 years	69,764	63,563
Fishing vessels	10	1,352,300	1,352,300

	years		
Building improvements	3 years	33,590	29,200
Other assets	2 – 10 years	279,308	267,639
Office equipment	3 years	22,928	20,440
Heavy equipment	5 years	<u>31,624</u>	<u>22,504</u>
		2,009,360	1,970,192
Less accumulated depreciation		<u>(1,836,514)</u>	<u>(1,748,493)</u>
Property and equipment, net		\$ <u>172,846</u>	\$ <u>221,699</u>

The fishing vessels were valued by a marine surveyor in October 1994 with a resulting write-down of the original cost by \$618,936. Consequently, at that time, management changed the estimated useful life of these vessels from 20 to 10 years.

(6) PROPERTY AND EQUIPMENT, CONTINUED

The Authority does not have cost data for five fishing boats and a cold storage facility contributed to the Authority by Pohnpei State. Additionally, the Authority does not have supporting documents for a moisture balance tester used by the defunct Pohnpei State Department of Conservation and Resource Surveillance. Therefore, these assets and the related depreciation expense are not included in the accompanying financial statements.

(7) CONSTRUCTION IN PROGRESS

In fiscal year 2002, the Authority invested about \$21,628 in the construction of a new building planned for commercial center. The building is incomplete and the completion date is not known due to unavailability of funds.

(8) ACCOUNTS PAYABLE

The Authority's payables in fiscal year 2001 totaled \$284,837 and increased in fiscal year 2002 to \$507,106. The most significant of the payables are amount owed to the Pohnpei Utilities Corporation, a component unit of Pohnpei State Government, with 86% and 60% of the total payable amounts for fiscal years 2001 and 2002 respectively.

(9) DUE TO PRIMARY GOVERNMENT

The Authority has received cumulative dividends of \$85,000 and \$75,000 as of September 30, 2002 and September 30, 2001, respectively from its investment of \$500,000 (50,000 shares of stock at \$10 a share) in the bank of the Federated States of Micronesia. The Attorney General's opinion issued in June 1994 stated that the dividends should be deposited to the Pohnpei State general fund, see note 2, and thus the Authority recorded the dividends as due to primary government.

(10) COMMITMENTS

On November 4, 1998, the shareholders of Caroline Fisheries Corporation (CFC) met, resolved and effectuated the transfer of 100% of FSM National Fisheries Corporation (a component unit of the Federated States of Micronesia) shares in CFC (1,500,000 shares) to Pohnpei State Government. Subsequent to the above transaction, the Authority and Pohnpei State Government became the sole shareholders of Caroline Fisheries Corporation.

Caroline Fisheries Corporation's liabilities are more than its assets by ratios of 3 to 1 as of September 30, 2001 and 1.7 to 1 as of September 30, 2002. CFC's deficit as of September 30, 2002 and September 30, 2001 are \$11,777,763 and \$12,268,544, respectively. The deficit has been the results of its substantial operating losses since inception, thus the Authority's carrying value of investment in Caroline Fisheries Corporation is stated at \$0.

(11) TRANSFERS IN

The Authority received from the Pohnpei State General Fund \$13,660 and \$21,789 in fiscal years 2001 and 2002 respectively, to defray the cost of the Executive Director's salary.

(12) DEFICIT

As of September 30, 2002, the Authority's deficit is \$4,143,310. In fiscal year 2001, it is \$3,807,897. The most significant costs of operation are from the administration and the cold storage. Management will attempt to return to profitability by reducing the cost of its operations.

**Pohnpei Economic Development Authority
Schedule of Findings and Questioned Costs
Years Ended September 30, 2002 and 2001**

Finding No. 02-1 Discounts Lost

Criteria: The Authority should have a policy in place to take advantage of discounts when offered.

Condition: The Authority did not ensure that discounts offered by its major supplier are availed. For example, our analysis of discounts that could have been availed for the Authority's dock and office past due balances and billings for the fiscal year 2001 show the following:

Source: Pohnpei Utilities Corporation's Billing & Payment History

Monthly Billing	Dock Meter	Office Meter
Balance a/o 10/1/00	7,046.32	330.89
10/10/00	1,219.05	229.17
11/12/00	1,510.81	230.15
12/12/00	1,384.87	200.59
01/12/01	2,152.93	350.06
02/12/01	1,529.80	257.02
03/12/01	1,656.27	262.44
04/12/01	1,535.72	333.98
05/12/01	1,436.56	322.60
06/12/01	1,857.04	411.14
07/12/01	1,080.65	426.80
08/12/01	1,276.79	563.67
09/12/01	1,342.64	500.84
Total	25,017.43	4,419.35
10% discount	2,501.74	441.94
Discount availed	919.27	75.79
Discount lost	1,582.47	366.15

The total discount that could have been availed by the Authority for its dock and office meter accounts for the fiscal year 2002 is \$267.74.

Cause: The loss of discounts is due to lack of good planning so that appropriate action is taken timely.

Effect: As a result, discounts that would have been availed were lost.

Recommendation: We recommend that the Authority should look out for and should take advantage of discounts if any are offered.

Auditee Response: Please see Exhibit I.

Finding No. 02-2 Unnecessary Travels and Other expenses

Criteria: Prudent management dictates that cost reduction measures should be instituted especially at times when operation is not profitable.

Condition: The Authority incurred forty-two (42) travels totaling \$57,246.36 for the fiscal years 2001 and 2002. Most of these travels were not included in the original budgets, and therefore supplement requests were made to cover the costs of these travels. For example, the Authority did not have any budget for travel in fiscal year 2001; yet, it incurred \$31,288.15 of travel expenses. Although some travels are important for the operation of the Authority, we firmly believe that because of financial considerations, incurring excessive travel expenses that were not originally planned is not prudent business practice.

In addition to travel, the Authority incurred other expenses that were not urgently needed and that the purchased of the items could have been delayed to much later time when the Authority is financially stable.

Examples of the travels and the other expenses are shown below:

1. The Authority's Administrative Manager went to Hawaii to do marketing research. Her job description does not include marketing research.
2. The Executive Director and the Comptroller attended the study tour upon endorsement of Small Business Guarantee & Finance Corporation. The tour includes visit to landmarks and other tourist sites in the Philippines. In addition, the Comptroller was advanced \$1,000 to purchase various supplies for the Authority while in the Philippines. Our review of the liquidation for the advance reveal that \$799.81 was used to cover the cost of the Executive Director's hospital room rental for four days and his medical executive check-up.
3. The Authority paid \$375 for annual membership fee to the Continental President's Club; although we are not sure as to what benefit the Authority would derive for being a member.
4. The Authority purchased three (3) cellular phones despite of the Governor's memorandum prohibiting purchases of such with government funds.
5. Excluding building/construction, the Authority acquired additional fixed assets that amounted to about \$55,159 in fiscal year 2001 and \$39,714 in fiscal year 2002. Most of the acquisitions are office equipment including computers.
6. The Authority has also spent about \$21,628 for the construction of a marine building that would serve as a commercial center but due to limited financial sources; the construction has been discontinued until funds become available.
7. The Board of Developers incurred more than \$18,400 for the board meeting allowances and other expenses in fiscal years 2001 and 2002. Of the above amount, more than \$8,000 was spent for meals, snacks and sakau during board meetings. The meeting allowance and representation budgets for both fiscal years totaled to \$9,520. The board has over spent its budgets by more than \$8,800.

8. The Authority also spent considerable amounts in business consultation fees amounting to more than \$19,000.

Cause: The board and management approved the above expenditures without careful review of the Authority's financial condition.

Effect: As a result, numerous supplemental budget requests were made and approved that further contributed to the Authority's deficit.

Finding No. 02-2 Unnecessary Travels and Other Expenses, Continued

Recommendation: We recommend that the Board of Developers should be conscientious in its approval of expenses. Most importantly, expenses for travel, major renovation and research and development should be limited or avoided at all until funding sources are identified.

Auditee Response: Please see Exhibit I.

Auditor's Reply to Auditee's Response dated March 29, 2004: We acknowledge the power of the Board to approve and/or make re-programming of the budget, however, we emphasize that adequate planning and the Authority's financial condition must be reviewed carefully before funds are committed to travels or purchases that could be delayed. That is, the budget should have been carefully planned and the items of importance should have been considered and included in the original budget.

As the Authority admitted in its response for finding #1 and quote, "more often than not, EDA has no financial means to take advantage of discounts" and yet management could aggressively acquire fixed assets, renovate the office and attended numerous off-island travels. We failed to understand the rationale for such actions. As a result, the Authority had difficulty paying its obligations as evidenced by the tremendous increase in its payables.

Further, the Authority claimed that, "delaying the purchases would have contributed to the disruptions in EDA's operations." We reviewed the expenses again point by point as indicated in this finding, and to the contrary we do not believe that the delay of purchases of the subject items would cause disruptions of the Authority's operation, to wit:

1. We did not question the capability of the former Administrative Manager to do marketing research, the point we wanted to stress is that it would have been productive if the travel has been adequately planned for a marketing personnel.
2. This study tour was not planned and was not originally budgeted.

As for the portion of Comptroller's advance used to cover the Executive Director's medical check up, the documents supporting the liquidation of the advance indicated payments for executive check up and other medical

workouts, including professional fees of the doctors. The transaction was charged to travel expense instead of appropriate advance account. As of the exit conference, the Authority has not claimed reimbursement of the account from the FSM Health Insurance.

For the record, during the exit conference it was pointed out that the Executive director complained of back pain and not severe chest pain as the Authority now claimed.

3. The condition would have been acceptable if the Authority is the member of the Continental President's Club because it would entitle all employees/officers of the Authority to avail the benefits offered by the club. However, we do not believe that it is the case.

Finding No. 02-2 Unnecessary Expenses and Other Expenses, Continued

4. We acknowledge and respect the power of the Board of Developers, however, on the same token, the Board should ensure to the extent possible that all policies made by the Authority should be in line with the directives of the Governor, especially if it result in cost reduction.
5. The amount of purchases was so material and it appeared acquisitions were done without regard to the financial difficulty that the Authority is presently experiencing.
6. Given the fact that management and board did not originally budget for the building indicate shortage of funds and therefore construction could have been delayed until the Authority receive the funding for the project.
7. We recognized the importance of the Board's entertaining visitors/investors, however, in consideration of the Authority's financial condition, entertainment expenses should be limited. Our review of the board meeting expenses revealed that majority of the expenses, were incurred to accommodate the board during its meetings.
8. There is no question about the Board's authorization of acquiring the services of consultants. It would have been wiser though if the Authority has delegated the task to the Executive Assistant. The employee was originally hired as Special Project Consultant.

Because of the above, we maintain our finding and urge the Authority to implement our recommendation.

Finding No. 02-3 Fixed Assets Not Budgeted

Criteria: Prudent management dictates that cash flow should not be tied up to major fixed assets acquisition and construction that are not budgeted.

Condition: In our review of the Authority's Plant, Property and Equipment accounts for fiscal years 2001 and 2002, we compared the amount of fixed assets actually acquired to the budgeted amounts. We found that the fixed assets acquired exceeded the amounts approved in the budgets for fixed assets in both fiscal years, as follows:

	2001	2002	Total
Original budget approved	6,500.00	2,500.00	9,000.00
Supplement/amendment	39,528.00	30,150.61	69,678.61
Total budget	<u>46,028.00</u>	<u>32,650.61</u>	<u>78,678.61</u>
Total acquisition cost	<u>55,159.84</u>	<u>61,342.05</u>	<u>116,501.89</u>
Amount over budget	<u>9,131.84</u>	<u>28,691.44</u>	<u>37,823.28</u>

As indicated above, majority of the purchases were made through supplemental budget requests, the total of which is more than the original amount of the total budget for fixed assets. We also noted that some of the items were purchased prior to the board's approval of the supplemental requests.

Cause: This is due to lack of proper planning and aggressive improvement/replacement of assets without regard to budget or source of funds.

Effect: Unfavorable variances resulted from the above condition.

Recommendation: We recommend that management should practice and implement proper planning to ensure that all anticipated expenses are considered and included in the budget to avoid budget shortfall and excessive supplemental requests.

Auditee Response: Please see Exhibit I.

Auditor's Reply to Auditee's Response dated March 29, 2004: The finding shows that the supplemental budget request for fixed assets approved by the board for

fiscal year 2001 is about six times more than the original budget. In fiscal year 2002, it is more than twelve times the original budget. Clearly, it defeats proper planning and thus we maintain this finding. We further encourage management to implement our recommendation.

Finding No. 02-4 Excessive Supplemental Budget Requests

Criteria: The Authority’s budget is the board’s medium to control expenses and to measure management’s performance. Supplemental budget requests therefore should only be approved sparingly when (1) there is funds and (2) management prove that the expenses are essential to the continuation of operation and were not immediately foreseen during the budget preparation.

Condition: The Board of Developers is loose when it comes to its own policy. We noted constant amendment to the budget through supplemental requests. For instance, the Board of Developers approved two (2) supplemental budget requests by management in fiscal year 2001 totaling \$46,251.29 without adequate review. Again, in fiscal year 2002, management made ten (10) supplemental budget requests aggregating to \$155,109.99. The board did not perform adequate review either to ensure that there is actually matching revenues to cover the requested expenses. Yet, the supplemental budget requests by management were approved. The details of the requests are as follows:

Date	Purpose and Description	Amount
9/7/01	Supplemental request for salaries and benefits	29,508.00
9/28/01	Supplemental request for office furniture, electrical supplies, office repairs, rental, forklift tires, spare parts for boom truck.	16,743.29
	Total supplemental requests for fiscal year 2001	<u>46,251.29</u>
10/28/01	Supplemental request for trip to Fiji	1,000.00
12/6/01	Supplemental request for travel and Christmas party expenses	1,734.30
12/24/01	Supplemental request for Christmas party expenses	840.00

1/15/02	Supplemental request for blessing of and reception for the Micronesia Sunrise	1,500.00
1/30/02	Supplemental request for fixed assets, consumables, and travel	109,328.52
2/2/02	Supplemental request for contribution to U Fisherman's Ass. and study tour in the Philippines	5,918.00
5/8/02	Supplemental request for observing legal holiday	725.00
5/31/02	Supplemental request for saw mill and plane fares	2,500.00
6/20/02	Supplemental request to fund summer training program and staff retreat	5,244.52
9/18/02	Supplemental request for line of credit, trip to China and contribution to the funeral of the Authority's employee that passed away	26,319.65
		<hr/>
	Total supplemental request in fiscal year 2002	\$155,109.99
		<hr/> <hr/>

Finding No. 02-4 Excessive Supplemental Budget Requests, Continued

Cause: The board approved the supplemental budget requests because management is reporting "surplus" or increase in revenues. The board did not perform review to prove management reports.

Effect: As a result, the Authority incurred operating losses for both fiscal years 2001 and 2002.

Recommendation: We recommend that the Board of Developers should strictly control and limit amendments to the original budget, as it is the basis for controlling expenditures and measuring management performances. By constantly approving amendments to or supplemental budget requests, the essential purpose of having a budget in the first place is defeated.

Auditee Response: Please see Exhibit I.

Auditor's Reply to Auditee's Response dated March 29, 2004: The Authority's response did not explain why the items were not included in the original budget. However, we believe that the mere fact that the Authority lost revenues (transshipping) when the thirty six (36) long liners left Pohnpei, the more prudent the board should be in its deliberation and approval of supplemental budget request.

In fact, this action has been the concern of one of the board member. In a board meeting held on October 28, 2001 where management requested for a supplemental budget for travel, the board member stated his reluctance to "set a pattern of requesting money at the last minute without planning accordingly". He explained that he believes that "management and the board could easily make a habit of using urgency as an excuse to not plan carefully". He further stated that management and the board should try to "save money and cut costs," He did not support the trip but the full Board approved the travel nonetheless.

Finding No. 02-5 No Policy on Conflict of Interest

Criteria: There should be a policy in place to regulate related party transactions. Although an autonomous agency, the Authority is still a State Government enterprise and should avoid or limit the existence of related party transactions.

Condition: The Authority lacks appropriate control policies and procedures in place to identify and account for related party transactions. Our review revealed that the Authority incurred numerous transactions that could be viewed as related parties. Examples of these transactions are as follows:

1. On January 31, 2002, the Authority made a payment of \$180 per check number 28144 for hotel accommodations of certain individual and another guest. The individual is a related party of the Executive Director. The transaction was charged to administration representation.
2. There were several construction services or heavy equipment rentals that the Authority paid for during the periods. We noted that two of the construction companies that performed the services are related party transactions to the Executive Director and the Chairman of the Board of Developers.

Cause: The Authority does not have a policy on related party transactions and its policy on conflict of interest does not adequately cover the issue.

Effect: The above condition could be viewed as or could lead to conflict of interest.

Recommendation: We recommend that the board should establish a policy that governs related party transactions and conflict of interest. We also recommend that management should refrain from or limit the existence of related party transactions. For related party transactions that could not be avoided, disbursements should be approved appropriately and should include additional supporting documents with adequate explanations to justify their occurrence.

Auditee Response: Please see Exhibit I.

Auditor's Reply to Auditee Response dated March 29, 2004: Documents supporting the disbursements should be able to "stand alone" meaning that, disbursements construed as related party transactions should be fully explained. Moreover, the Authority did not provide the minutes of the board meetings evidencing its approval of the transactions. Therefore, we maintain the finding and urge management to implement our recommendation.

We have corrected the error that the Authority pointed out regarding the relationship of the "officially invited guest" and the Executive Director. Please refer to the finding.

Finding No. 02-6 Checking Accounts

Criteria: Purposes and benefits for opening one or more additional accounts should outweigh the costs involved in maintaining the accounts.

Condition: By approval of the Board of Developers, the Authority opened a second checking account in one of the three local banks in November 2001. Again, in July of 2002 the third checking account was also opened. In opening the accounts the Authority did not specify the purpose for the additional accounts except for establishing credits with the other banks. Disbursements were simultaneously made from the accounts. We noted constant transfers of funds between the accounts to cover disbursements. Due to the closing of business of one of the banks, the Authority maintains only two of the checking accounts with the two remaining banks. Some disbursements were not properly referenced, thereby creating difficulty in the audit trail.

Cause: The Board of Developers approved management request to maintain financial relationships with the local financial institutions and thus opening additional checking accounts.

Effect: The above condition can lead to numerous bank charges and possibly double payments if separation of transactions is not made.

Recommendation: We recommend that management should separate and specify the purpose of the accounts so that same transactions are disbursed from one bank account and vice versa. For example, one of the checking accounts could be designated as payroll account and the other is for the operation's disbursements. We also recommend that each bank account should be appropriately identified and allow separate accounting of the transactions, e.g., each account should have

separate schedule of disbursements to allow for ease of review and update of records.

Auditee Response: Please see Exhibit I.

Finding No. 02-7 Personnel Policy Not Properly Approved

Criteria: The Authority's enabling law as amended, D. L No. 4L – 159 – 78 section 7, requires that the board “shall establish personnel policy for its employees to be approved by the Resources and Development Committee of the Legislature.”

Condition: Although the board has approved the Authority's personnel policy in 2002, the manual has yet to be approved by the Resources and Development Committee of the Legislature.

Cause: The management has submitted the Authority's personnel policy to the Governor for transmittal to the Legislature.

Effect: As a result, the Authority's personnel policy may not be legal and may not be used yet in the operation.

Recommendation: We recommend that the Authority should work with its board to ensure that its personnel policy gets the required approval by the Resources and Development committee of the Pohnpei Legislature.

Auditee Response: Please see Exhibit I.

Finding No. 02-8 Overage in Cash Collections

Criteria: Cash collections should be handled in such a way that receipts are issued timely and recorded promptly to reflect accurate records of collections.

Condition: The cut off procedures we performed for the years ending September 30, 2001 and 2002 indicated the following:

- Cold Storage ice sales as of September 30, 2002 were over the receipts by \$3.00; while
- The logbook for the Madolenihmw Ice Plant showed overage in collection by \$ 8.25. Per logbook the total sales as of September 30, 2002 was \$ 45. However, the result of the auditors cash count showed that \$53.25 was collected from the sales of ice.

Control weakness over cash collections was also reported as a finding in the audit of Economic Development Authority for the fiscal year ended September 30, 2000. We cited the Authority for not receipting and depositing its cash collections timely.

Cause: The overage occurred because of not immediately receipting or recording cash collection at the time they are received. This is especially true for the Madolenihmw Ice Plant where receipts for ice sales are not issued to customers, but the sales are recorded in the logbook. It is possible that the custodian forgot to record the sales.

Effect: The above condition signifies persistent control weaknesses in the handling of cash collections, and non-resolution will give opportunity for employees to “borrow” or use the collection for personal gains.

Recommendation: We recommend that the Authority should ensure that cash receipts are issued at all times to document cash collection.

Auditee Response: Please see Exhibit I.

Finding No. 02-9 Deficit

Criteria: As an enterprise fund, the Authority operates similar to a commercial business and therefore management actions should be geared to maximizing profits and minimizing losses.

Condition: For years, the Authority suffered losses from its operations. In fiscal years 2001 and 2002, the Authority incurred losses again at \$135,212 and \$349,905 respectively. Although the Authority’s revenues were increased by 22% in fiscal year 2002, its expenses for the period increased also by 49%. Comparison of the Authority’s revenues and expenses for fiscal years 2001 and 2002 is as follows:

<u>Fiscal Year</u>	<u>Revenues*</u>	<u>Expenses</u>	<u>Net Loss</u>
2002	943,721	1,293,626	(349,905)
2001	735,584	870,796	(135,212)
Increase	208,137	422,830	(214,693)
Percent	22%	49%	159%

* Includes non-operating revenues

This condition was reported as a finding in the audit of Economic Development Authority for the fiscal years 1998, 1999 and 2000.

Cause: The cause of the above condition is attributable to the board and management actions such as: (1) aggressiveness to venture in capital expansion and development without identifying first the source of funds; (2) inability to control cost of operation particularly for the administration and cold storage, and (3) extending credits to clients without proper review and justification. For example, the Authority extended a loan to one of its client who already had difficulty in paying off its accounts. The Authority agreed to purchase fuel and provide cash advances for this customer. In turn when the business realizes revenues it will pay the Authority for the amount of the agreement and the past due balance owed to the Authority. The agreement was breached and now the Authority took legal action against the local business. The local business outstanding balance with the Authority as of September 30, 2002 including the loan is \$78,562 with the whole amount considered delinquent. The business refutes the amount reported by the Authority.

Effect: As a result, the Authority's net loss was increased by 159% from fiscal year 2001 to fiscal year 2002.

Recommendation: We recommend that the board and management should work hard to reduce the deficit of the Authority. The board should direct management to limit capital expansion and development until source of funds are identified; establish and implement measures to control administration and cold storage operation's costs, and stop extending credits to poor paying customers/clients. In addition, other unnecessary expenses should be avoided especially when the Authority's revenues are not sufficient to cover all costs of its operations.

Auditee Response: Please see Exhibit I.

Finding No. 02-09 Deficit, Continued

Auditor's Reply to Auditee Response dated March 29, 2004: We reiterate our position that until the Authority is financially capable, avoidable expenses should be ceased. Please refer also to our replies to finding numbers 2, 3, and 4.

Finding No. 02-10 No Detail Review of the Receivable Accounts

Criteria: Individual accounts should be reconciled with respective customers to ensure the accuracy of balances. In addition, the schedule of accounts receivable should be reviewed to assess its collectibility.

Condition: Our review of accounts receivable revealed the following instances which raise doubt as to the collectibility of accounts:

- Some of the customers are refuting the balance of their accounts;
- Some customers listed in the schedule of accounts receivable are no longer operating in Pohnpei and the Authority does not have their forwarding addresses;
- Supporting documents such as invoices are not complete; and,
- Owners of two of the business clients of the Authority are now deceased.

This condition was reported as a finding in the audit of Economic Development Authority for fiscal years 1999 and 2000.

Cause: Management has not taken appropriate action in a timely manner.

Effect: The non-resolution of the above condition will have the same impact in fiscal years 2001 and 2002 as in 2000, and will continue to raise doubts as to the collectibility of the Authority's accounts receivable.

Recommendation: We recommend that the Authority should review and reconcile its receivable accounts with respective customers. We also recommend that notices and/or statement of accounts should be sent regularly and that periodic review and verification of accounts should continue to ensure that balances reported are accurate and agree with customers' balances.

Auditee Response: Please see Exhibit I.

Finding No. 02– 11 Donated Assets

Criteria: The generally accepted accounting principles (GAAP) require that donated capital assets should be valued and recorded accordingly.

Condition: The value of the Cold Storage facility and five fishing boats donated to the Authority for use in its operation were not recorded in its financial statements. Management represent that all attempt to seek assistance from various agencies to appraise the fair market values of the assets were not successful.

This condition was reported as a finding in the prior year audits of Economic Development Authority for fiscal year 1998, 1999 and 2000.

Cause: The management represents that no records were available to record the cost of the donated assets. In addition, there is no appraiser on the island who can perform the appraisal of the assets.

Effect: As a result of the above condition, the opinion on the Authority’s financial statements was qualified.

Recommendation: We recommend that the Authority’s management work closely with its board to determine the course of action to take and act accordingly.

Auditee Response: Please see Exhibit I.

Finding No. 02-12 Investment in a Private Banking Institution

Criteria: Policies and procedures should be in place to ensure that the intent or the purpose of laws and/or regulations is observed.

Condition: The enactment of SL No. 3L-25-92 authorized Economic Development Authority to invest up to \$5 million dollars in private banking institutions domestically chartered and located in the FSM, which have a majority ownership of Micronesian citizens. The law states that such stock is to be later sold to private FSM citizens who are “pweldaks” of Pohnpei as defined in Section 1 of Article 3 or the Constitution of Pohnpei. SL No. 3L-25-92 also states that the Authority shall begin the sale of stock after six months and shall be completed prior to five years after its passage. In addition, within four months, the Authority shall submit a plan to the Pohnpei Legislature for the sale of stock, which plans must be approved by the Legislature Resolution.

In accordance with the passage of the above-mentioned law, the Authority invested \$500,000 (50,000 shares of stock) in the Bank of the Federated States of Micronesia. The investment is still recorded in the name of the Authority as of the date of this report.

This condition was reported as a finding in the audit of Economic Development Authority for fiscal year 1999 and 2000.

Cause: The cause for this condition is that the Authority has not submitted a plan to the Pohnpei Legislature for the sale of the stock.

Effect: The effect of this condition is that the Authority has not fulfilled the intent of SL No. 3L-25-92.

Recommendation: We recommend that the Authority establish policies and procedures to ensure that the intent or the purpose of laws and regulations is observed. We also recommend that the Authority resolve with Pohnpei State Legislature the rightful disposition of the stock.

Auditee Response: Please see Exhibit I.

Finding No. 02-13 Scrapped Fixed Assets Still Reflected in the Accounting Records

Criteria: Physical inventory count of fixed assets should be conducted at least once every two years to determine the condition of the fixed assets. The result of the inventory count should be compared with the accounting records and adjustments if any should be made.

Condition: Although the Authority represent that physical inventory is being performed periodically, our inspection of ninety-three (93) fixed assets disclosed the following:

- Twenty eight (28) assets amounting to \$49,861.81 considered scrapped, are still recorded in the books;
- Four (4) assets with the total amount of \$5,866 are missing or lost; and,
- One (1) asset, which was purchased in fiscal year 2000, is now idle.

A condition wherein no inventory performed on the Authority's fully depreciated assets was reported as a finding in the audit of the Authority for the fiscal year 2000.

Cause: Except for one asset that has been approved by the board for deletion from the books, management has not taken appropriate action to the rest of the scrapped or missing assets.

Effect: The effect of this condition is that the fixed assets may be overstated in the financial statements and idle assets are not put to better use.

Recommendation: We recommend that the Authority should perform inventory count on its fixed assets at least once every two years. The result of the inventory count should then be compared with the accounting records and adjustments should be made to the records as appropriate. Fixed assets found to be scrapped or no longer used in the operation should be surveyed or removed from the accounting records.

Auditee Response: Please see Exhibit I.

Finding No. 02-14 Overtime Pay for Board Members

Criteria: The Authority should comply with the law.

Subsection 3 of Section 6 of District Law No. 4L-159-78 was amended by District Law No. 4L-204-79 to read as follows: “Members of Board, who are not regularly employed by the State Government shall be compensated at a rate of twenty dollars per day for attendance at Board meetings or while engaged in other services for the Authority as are authorized by the Board. Pohnpei State Government employees shall not be entitled to such compensation, but shall be granted administrative leave from their regular duties while in attendance of meetings and other activities of the Authority; PROVIDED that those Board members who are State Government employees earning less than twenty dollars a day shall be paid per day by the Authority the difference between their daily compensation and twenty dollars.”

Condition: Our review of board meeting allowances disclosed that the Authority is still paying its board members (who are also Pohnpei State Government employees) meeting allowances at the rate of time and half or overtime rate for attending board meetings that are held after working hours or non-working days. The allowances were calculated by using the members’ hourly rates at their respective employment.

This condition was reported as a finding in the audit of Economic Development Authority for the fiscal year 2000.

Cause: The cause of the condition is that the Office of the Attorney General opined that the board members who are also Pohnpei State Government employees may be paid allowances at overtime rates if the meeting was held on non-working day or after working hours.

Effect: The above condition is not in compliance with the Authority's enabling law as amended by D. L. No. 4L-204-79. It also resulted to disparity of board meeting allowances between board members. That is, a board member who is also a State Government employee is receiving more (when overtime rate is used) than a board member who is not a State Government employee (who receives twenty dollars \$20 per meeting).

Recommendation: We still maintain that the condition is not in compliance with the law and we recommend that the Authority comply with the law. In the event that the Attorney General's opinion conflict with the law, the law should prevail.

Auditee Response: Please see Exhibit I.