

VII. Accounting and Auditing Practices in RMI

1. Challenges and Responses

The Republic of the Marshall Islands (RMI) faces intense internal and external pressures regarding financial governance arrangements. Particular attention focuses on the prudence and effectiveness of government policies and accountability arrangements during the first 15-year CFA (1986-2001).

Financial governance challenges include: (i) improving basic public sector record keeping, internal controls and accountability; (ii) addressing low levels of efficiency in public service, weak government financial management, and a slow buildup of funds in the Marshall Islands Intergenerational Trust Fund (MIITF); (iii) renegotiating a favorable and effective CFA with the US; and (iv) being removed from the Financial Action Task Force on Money Laundering (FATF) list of Non-Cooperative Countries or Territories.

In response to these challenges, government has recently prepared *Vision 2018*, a strategic development framework for the second CFA period (2003-2018). *Vision 2018* sets 10 national goals and objectives, and presents broad strategies to meet them. It recognizes that sound financial management is essential to achieving and monitoring progress towards government's goals.

2. Accounting and Auditing in RMI

The 1979 *Constitution* prescribes rights and governance structures; it also sets out high-level budgetary arrangements and establishes the position of Auditor General. Private sector accounting laws are largely modeled on US corporate laws.

The private sector operates on the accrual basis of accounting. Government accounting is currently on a modified accrual accounting basis, but accounting standards require that government move to full accrual accounting starting with the financial year beginning on 1 October 2002.

There is an acute shortage of qualified bookkeepers and accountants in both the public and the private sectors. As of October 2001, there were no professionally qualified Marshallese accountants in RMI. This gap is only partly filled by foreign CPAs employed within the private sector and in government.

RMI laws and regulations are reasonably clear about financial reporting requirements and timeframes. However, public sector financial reports are often years overdue. Furthermore, they are sometimes unauditible due to deficiencies in basic record keeping and internal control arrangements. To this end, efforts have been made to improve the timeliness of financial reports, but more remains to be done.

The Auditor General—who heads the OAG—is appointed by the President, with the approval of the *Nitijela* (Parliament). Appointees to this position must either have a professional accounting qualification (with practical experience) or have extensive relevant knowledge and experience. With just seven staff, the OAG faces severe resource constraints. In this respect, the Auditor General's independence could be strengthened.

3. Professional Infrastructure

There are no professionally qualified Marshallese accountants in RMI; nor is there a professional accountancy body. In contrast, RMI law recognizes and regulates other professions and occupations including health care providers, nurses, land surveyors, notaries public and the legal profession.

4. Accounting and Auditing Standards

In RMI, US GAAP is used directly. US GAAP—as applied to the nongovernment (private) sector—represents a detailed framework of principles largely based on accounting standards and guidance issued by the US FASB. The requirement to report in accordance with US GAAP is enshrined in RMI law (although some laws are ambiguous or silent on this point). US GAAP—as applied to the nongovernment sector—is largely consistent with IAS.

US GAAP—as applied to the government sector—is based on statements issued by the Government Accounting Standards Board (GASB). Hence, RMI government financial statements must comply with GASB's new financial reporting model (NFRM) starting with the financial year that begins on 1 October 2002. Among other things, this will involve the introduction of full accrual accounting. It also has significant implications for budgetary documentation, accounting arrangements, accounting systems and financial reporting. However, (i) NFRM implementation activities will coincide with the introduction of new computerized information systems and changes brought about by the Fiscal and Financial Management Reform Program (FFMRP); (ii) NFRM budgetary

requirements will potentially conflict with those designed as part of the FFMRP; and (iii) comparative implementation progress lags other countries and jurisdictions that have implemented accrual accounting.

RMI audits must be conducted in accordance with US generally accepted auditing standards (GAAS). This requirement is enshrined in RMI law with regards to government auditing. However, in relation to nongovernment auditing, RMI law varies and can be ambiguous or silent on auditing standards.

5. Education and Training

The Marshallese education system faces funding pressures. Moreover, RMI's 4 percent birthrate is the Pacific region's highest creating further pressures. Finally, as of 2001, nearly half RMI teachers have secondary school diplomas as their highest qualification. Consequently, basic educational attainment levels are comparatively low, particularly in mathematics and English, subjects that are vital for developing accountancy skills.

Two post-secondary educational institutions offer accountancy courses: the College of the Marshall Islands and USP. However, very few accountancy students graduate from these institutions, or from other universities. In addition, the Graduate School (US Department of Agriculture, USDA) offers training in accounting and financial management, through the Pacific Islands Training Initiative (PITI). ADB and other donors support a range of other capacity-building initiatives.

6. Government Budgeting and Accounting

The public sector dominates the RMI economy. The national and local governments not only provide an important share of formal employment, but also own and control a large number of corporations and statutory bodies. Many government holdings have been corporatized over the years, and subsidies have been successfully reduced or eliminated in many cases, but public sector dominance of the economy remains.

The ADB-supported Public Sector Reform Program (PSRP), which began in 1997, targeted several economic policy issues. Program achievements included reducing the government payroll by 30 percent, privatizing domestic shipping services, streamlining Foreign Investment Board License applications, and establishing the MIITF to stabilize budget receipts.

Despite these measures, several issues remain, including low efficiency in the public service, weak government financial management, and a slow buildup of funds in the MIITF. RMI's fiscal problems can be directly linked to deficiencies in budgeting and financial management systems that are unable to handle the huge grants forthcoming from the CFA. The budget format provides little information on government expenditure patterns, which limits government's ability to make informed decisions about funding priorities and the public's ability to question these spending decisions. The budget is prepared with only the most basic projections on revenues, expenditures, and information on past expenditure trends.

The acute shortage of qualified bookkeepers and accountants in government cannot be overemphasized. Poor record keeping, inadequate internal controls and financial management are symptomatic of this underlying problem.

A new RMI government was elected in January 2000. It recognized that many current problems are linked to public financial management deficiencies. In response, government and ADB developed the FFMRP. The FFMRP, while stabilizing the immediate fiscal situation, aims primarily at longer-term issues of improving overall RMI financial management. The specific objectives are to (i) ensure a sustainable income flow for future generations, (ii) strengthen public sector financial and economic management, (iii) stabilize the fiscal position, (iv) enhance the policy environment for private sector development to maximize the benefits from future CFA assistance, and (v) increase the effectiveness of the public service. The FFMRP will also improve the annual budget format to internationally accepted practices, improve financial control mechanisms, accounting and reporting systems, and develop a medium-term framework for planning and performance evaluation.

7. Donor Assistance

RMI relies heavily on foreign assistance with US aid estimated at about \$80 million per annum. This includes direct budgetary support under the CFA to the national government and to the Kwajalein Atoll Development Authority, and payments to Kwajalein landowners, as well as other forms of assistance through US Federal Government programs.

ADB plays a significant role in improving financial management arrangements. Two program loans have supported fundamental government financial management reforms. Other loans have been provided to support education reforms. Furthermore, ADB has provided around a

dozen advisory and capacity-building TA grants in the financial management field.

8. Issues and Recommendations

The study identified issues and presents recommendations associated with gaps or weaknesses in accounting and auditing arrangements. These recommendations are intended to supplement and support existing strategies and projects, particularly *Vision 2018* and the FFMRP. Where actions are already planned or underway (e.g., upgrading information systems), no recommendations are made. Issues are separated into: (i) those that can be resolved without the need for external assistance; and (ii) those that can better be resolved with external assistance.

Recommendations are made regarding legal changes to remove legal ambiguities and inconsistencies, clarify the status of accountants and auditors, and clarify the application of accounting and auditing standards. The study also recommends deferring implementation of the new financial reporting model, preparing bookkeeping and accounting manuals, and strengthening the Auditor General's independence.

But the key constraint is the shortage of qualified bookkeepers and accountants. Improving financial management arrangements is impossible without them.

- In the **long term** (10-30 years), this will require an education system that produces numerate, literate and technologically-skilled students. Tertiary and vocational education would supplement this foundation with specialist financial management knowledge. *Vision 2018* and Ministry of Education initiatives intend to address this issue.
- In the **medium term** (three to 10 years), a cadre of Marshallese accountants must be established. To this end, several mutually-supporting recommendations are made regarding professional status and training, i.e., that professional bookkeeping and accountancy certifications be established, preferably as a Pacific-wide initiative.
- In the **short term** basic record keeping and internal control inadequacies must be addressed, and *Vision 2018* and the FFMRP must be effectively implemented. This cannot be done with existing or planned resources. This report recommends that at least six suitably qualified and skilled accountants be recruited to work with the MOF and other agencies to develop counterpart capacity, resolve existing problems and support the implementation of the FFMRP and *Vision 2018*.

Each study recommendation—and the issues that it is intended to address—is summarized below. The RMI DSAA report provides further detail.

Recruit Qualified Accountants to Support Financial Management Improvements

As of October 2001 there were no professionally qualified Marshallese accountants in RMI. Not surprisingly, there is an acute shortage of qualified bookkeepers and accountants in government (although government employs several qualified expatriate accountants). Issues of poor record keeping, inadequate internal controls and financial management are symptoms of this underlying problem. It is understood that two qualified accountants will be contracted for the period of the FFMRP (from counterpart funds). However, these additional resources are unlikely to be sufficient to implement *Vision 2018* and FFMRP (for instance, to overhaul or implement computerized accounting information systems).

It is **recommended** that at least six additional expatriate qualified accountants be recruited to support the MOF and other government agencies in their efforts to improve basic record keeping and internal control arrangements, and implement *Vision 2018* and the FFMRP. To this end, the expatriates should assist suitable counterparts and understudies to move towards bookkeeping and accountancy certifications.

Establish Bookkeeping and Accountancy Certifications

There are no professionally qualified Marshallese accountants in RMI; nor is there a professional accountancy body. However, RMI law regulates other professions and occupations including healthcare providers under the Health Services Act 1983, nurses under the Nursing Practices Act 1995, land surveyors under the Land Surveyors Registration Act 1970, notaries public under the Notaries Public Act 1966, and the legal profession under the Legal Profession Act 1991.

Guam's professional accountancy body is relevant to RMI (as Guam also operates under US accounting arrangements). But becoming a Guam CPA requires a relevant graduate degree, two years' practical experience in a supervised environment, and successful completion of the AICPA uniform CPA examination. So in the short term, very few Marshallese are likely to attain a US qualification.

In the meantime, the establishment of suitable bookkeeping and accountancy certifications would provide stepping stones to the CPA

license, measures to gauge competence to undertake bookkeeping and accountancy tasks, and professional career targets.

It is **recommended** that suitable RMI bookkeeping and accountancy certifications be established and that these certifications focus upon public sector accounting. These certifications should, ideally, be developed as a Pacific-wide initiative.

Prepare and Introduce Bookkeeping and Accounting Manuals

In the absence of suitably qualified bookkeepers and accountants, normative manuals provide a sound starting point for improving basic accounting arrangements. Such manuals have been used in the past, but not for national government accounting. The successful implementation of the FFMRP and the new financial reporting model would be supported by these manuals and associated training programs. It is **recommended** that assistance be provided to develop bookkeeping and accounting manuals for national government organizations along with relevant training.

Defer Implementation of the New Government Financial Reporting Model

The *Financial Management Act 1990* governs public sector financial management. It stipulates that RMI government financial reporting shall be in accordance with the standards promulgated by the US GASB (Sec. 104). This study supports continuing the direct use of US GAAP by RMI. Alternatives include adopting IAS or developing national accounting standards. Neither option is desirable given existing RMI knowledge and experience with US GAAP, and likelihood that the US will require financial statements to be prepared in accordance with US GAAP, as a CFA requirement.

RMI government financial statements will have to comply with GASB's new financial reporting model, starting with the financial year beginning on 1 October 2002. Among other things, this will involve introducing full accrual accounting and will have significant implications for budgetary documentation, accounting arrangements and systems, and financial reporting. However:

- Its implementation will coincide with the introduction of new computerized information systems and changes brought about by the FFMRP.

- The budgetary requirements of the new model will potentially conflict with those designed as part of the FFMRP.
- Comparative implementation progress lags behind other countries and jurisdictions that have implemented accrual accounting.

Given the acute shortage of qualified government bookkeepers and accountants, and comparative implementation progress, it is difficult to envisage the NFRM being successfully implemented in the required timeframe. However, deferring implementation of GASB 34 and GASB 35 would provide enough time to improve fundamental accounting arrangements and prepare for the required introduction of accrual accounting.

It is **recommended** that a realistic plan for implementing the requirements of GASB 34 and GASB 35 be prepared in consultation with the FFMRP. Given the far-reaching nature of these requirements, it is likely that the plan will indicate a necessity to defer implementation of these requirements until at least the financial year beginning on 1 October 2003. If this is the case, it is **further recommended** that:

- US DOI be consulted on deferring the NFRM implementation and the relevant government plans, and
- the *Financial Management Act 1990* be amended to state that implementation of GASB 34 and GASB 35 will not apply to the preparation of government financial statements until (at least) the financial year beginning on 1 October 2003.

Raise the Priority of Scholarships for Accountancy Students

Significant numbers of Marshallese accounting graduates will be required if skill shortages are to be addressed and financial management arrangements are to be sustainable (i.e., foreign accountants are to be replaced).

The *Scholarship Assistance Act 1979* established the eight-member RMI Scholarship Grant and Loan Board. The Board evaluates applications for scholarships and awards scholarship grants and loans. The Scholarship Fund Account is primarily financed by CFA monies [Article 1, Sec. 216(3)(a)]. Three primary factors guide the Board in awarding scholarship grants and loans: (i) demonstrated ability and potential; (ii) inability to pay costs; and (iii) Cabinet-approved priorities. With regards to the last criterion, some interviewees questioned whether Cabinet placed sufficient priority on accountancy education.

It is **recommended** that Cabinet raise the priority placed on accountancy courses as a criterion for awarding scholarship grants and loans.

Strengthen the Auditor General's Independence

The arrangements that support the Auditor General's independence do not appear to fully meet the criteria of the *Lima Declaration* regarding the mechanisms for ensuring that adequate resources are provided. For example, OAG staff numbers were reduced as part of the reduction-in-force exercise during the PSRP. Furthermore, arrangements regarding the Auditor General's annual budget do not support independence.

It is **recommended** that the Auditor General's independence be strengthened through legislative and administrative changes.

Clarify Laws Regarding Auditor Qualifications

An audit opinion is meaningful only if issued by a suitably-qualified auditor. However, RMI laws are sometimes ambiguous or silent regarding auditor qualifications. For instance: (i) a range of qualifications or experience is accepted for appointment as Auditor General; (ii) the *Cooperatives Act 1993* refers to an "experienced bookkeeper or accountant"; and (iii) the *Banking Act 1987* refers to an "independent financial auditor." Laws should explicitly state the acceptable qualifications of auditors.

It is **recommended** that all relevant RMI laws be amended so that they clearly and consistently state acceptable auditor qualifications.

Clarify Laws Regarding Accounting Standards

It is generally accepted that RMI financial statements must be prepared in accordance with US GAAP, but RMI laws are inconsistent in this respect. On one hand, some laws are absolutely clear as to the use of US accounting standards. For instance, the *Financial Management Act 1990* (which governs public sector financial management) stipulates that: "RMI policy is to provide full disclosure of financial operations and adequate financial information needed in the management of operations, and shall ensure effective control over revenues, multilateral and bilateral grants-in-aid including US federal grants, income, expenditures, monies and other assets, and shall be in accordance with the standards promulgated by the US GASB" (Sec. 104). Conversely, other laws, such as the *Trust Companies Act 1994* require all licensed trust companies, incorporated in RMI, to prepare annual profit and loss accounts and balance sheets (Sec. 220). No statement is made regarding the basis of preparation.

It is **recommended** that all relevant RMI laws be amended so that they clearly state that financial statements must be prepared in accordance with either US GAAP or the standards promulgated by the US GASB, as the case may be.

Clarify Laws Regarding Auditing Standards

It is generally accepted that RMI financial statement audits must be conducted in conformity with US GAAS, but RMI laws are not clear in this respect. On one hand, some laws are specific as to the use of US GAAS. For instance, the *Auditor General (Definition of Duties, Functions and Powers) Act 1986* stipulates that the relevant US auditing standards must be followed for public sector audits. More ambiguously, other laws, such as the *Banking Act 1987* require that financial statement audits must be conducted in “conformity with generally accepted auditing standards”.

It is **recommended** that all relevant RMI laws be amended so that they clearly state that audits of financial statements must be conducted in accordance with the relevant US auditing standards.