

**ASIAN DEVELOPMENT BANK**

**TAR: FSM 36368**

**TECHNICAL ASSISTANCE**  
(Financed by the Japan Special Fund)

**TO THE**

**FEDERATED STATES OF MICRONESIA**

**FOR**

**STRENGTHENING PUBLIC SECTOR AUDIT FUNCTION**

**December 2004**

## ABBREVIATIONS

ADB	–	Asian Development Bank
APIPA	–	Association of Pacific Islands Public Auditors
FSM	–	Federated States of Micronesia
MOU	–	memorandum of understanding
OJT	–	on-the-job-training
OPA	–	Office of the Public Auditor
TA	–	technical assistance

## TECHNICAL ASSISTANCE CLASSIFICATION

<b>Targeting</b>	–	General intervention
<b>Classification</b>	–	Law, economic management, and public policy
<b>Sector</b>	–	Public finance and expenditure management
<b>Subsector</b>	–	Governance
<b>Theme</b>	–	Financial and economic governance
<b>Subtheme</b>	–	

## NOTES

- (i) The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2005 ends on 30 September 2005.
- (ii) In this report, "\$" refers to US dollars.

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## I. INTRODUCTION

1. The Country Programming Mission of the Asian Development Bank (ADB) in June 2002 identified the weakness and ineffectiveness of the public sector audit function of the Federated States of Micronesia (FSM). The Government therefore requested technical assistance (TA) from ADB to support the strengthening of its public sector audit function. An ADB fact-finding mission visited FSM in September 2004. Discussions were held with representatives of the Government and other concerned parties, and an understanding was reached on the objectives, scope, implementation and other arrangements of the proposed TA. The TA framework is in Appendix 1.<sup>1</sup>

## II. ISSUES

2. The FSM economy is dominated by the public sector, and a major financing source to support the public sector is the economic assistance under the Compact of Free Association<sup>2</sup> between FSM and the United States. Under the amended Compact, FSM is required to manage funds in a more accountable and transparent manner. Government audit offices should play a critical role in fulfilling this requirement.

3. The Office of the Public Auditor (OPA) is an independent audit office for the national Government. Currently, OPA conducts operational audits and fraud investigations, while single audits are outsourced through an external audit firm. The mandate of OPA is to audit government departments and agencies as well as publicly-owned enterprises. In recent years, OPA conducted audits of the FSM Postal Services, the Rural Development Authority, the Pohnpei outer island airport, and the national biodiversity strategy action plan, among others. OPA is a member of the South Pacific Association of Supreme Audit Institutions and the Association of Pacific Island Public Auditors (APIPA). In addition to OPA as the national audit office, a state audit office exists in each state, in accordance with state constitutional mandates.

4. The coverage of the audit work is still very limited, due to insufficient institutional and human resources capacities. A few years ago, when the national public auditor position was vacant, only one audit each year could be achieved. Currently, four audits and 11 investigations are ongoing at the national level. The frequency of audits is insufficient to serve as a deterrent that would encourage politicians and civil servants to comply with regulations and guidelines and prevent these individuals from participating in fraud-related activities. The audit office has the authority to audit all public legal entities and nonprofit organizations receiving funds from the national Government. However, lack of human resources means that the office has to be selective in its annual work plan.

5. The public auditor undertakes investigative work based on tips from confidential informants as well as requests from various government agencies. However, most complaints relate to the misuse and misappropriation of government assets. With only two people in the office trained to investigate financial fraud, the number of investigation requests to which the audit office can respond to is limited. The absence of a chief investigator resulted in increased time requirements to complete investigations, which resulted in inefficiency.

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<sup>1</sup> The TA first appeared in *ADB Business Opportunities* (Internet edition) on 14 September 2004.

<sup>2</sup> The Compact came into effect in 1986. Under the Compact, FSM received assistance over 15 years, until 2001, with a transition provision for an extension of 2 years, until October 2003. The Compact was renegotiated between the two countries and the amended Compact is now in effect for 20 more years, until FY2023. Under the amended Compact, the United States will provide a \$76 million sector grant and a \$16 million contribution to the Compact Trust Fund during FY2004. The contribution to the trust fund will increase by \$0.8 million annually, while the grant will be reduced annually by a similar amount.

6. An external quality control review of OPA for FSM was conducted by APIPA in 2002, in accordance with the standards and guidelines in the Quality Control Review Guide established by APIPA. This peer review revealed the weaknesses and issues of the audit office and concluded that OPA was not in compliance with general audit standards and field work standards for performance audits.

7. The peer review pointed out that OPA needs to improve its audit standards in the areas of audit staff qualifications, audit organization's independence, individual auditor's independence, exercise of due professional diligence in conducting the audit and preparing related reports, and presence of quality controls.

8. With regard to staff qualifications, few professionally qualified staff members are in the audit offices, and most staff members do not have sufficient educational and/or professional background related to audit work. Therefore, OPA is currently relying on foreign staff members to manage and supervise audits. Key staff member turnover is high, which results in constraints and inefficiency. The staff members in the audit offices have reasonable opportunities to obtain the necessary hours of continuing education through classroom training. The United States Department of Agriculture Graduate School is the major educational institution providing a wide area of audit training, ranging from basic auditing and accounting standards to auditing for fraud. Some other institutions providing audit training to a lesser extent are the Institute of Internal Audit, the Association of Government Accountants, and the South Pacific Association of Supreme Audit Institutions.

9. However, the peer review concluded that despite these short-term training courses, staff members need to significantly improve performance auditing skills, particularly in gathering evidence and documenting audit findings. The peer review stressed that on-the-job training (OJT) will be able to enhance performance audit skills of staff members. Recently, a few auditors received OJT for about 2 months at the Office of the Inspector General, United States Department of Interior. The OJT modality was well received by trainees. Longer periods of OJT could have increased the effectiveness of the training program. While these training courses are available to staff members in audit offices, a technically and financially sustainable training program tailored to auditors and investigative auditors in the country needs to be developed to effectively use the training opportunities.

10. Quality controls over the audit work in FSM were insufficient. The general audit standard requires each audit organization to have an appropriate internal quality control system in place. Sufficient audit performance tools are not available to staff members. Internal control, compliance, and performance audit manuals do not exist. A manual for investigation is also not available. These manuals and sample audit files could be used as references for best audit practices, providing practical guides for local staff members to upgrade their audit standards. A financial audit manual is currently available in OPA; however, the quality of the manual does not reach the generally accepted standard. The manual has only about 20 to 30 pages, as opposed to a few thousand pages for one in the United States. Reports indicate that the available manual was not used in the audits. The general audit standards also require a periodic external quality control review. However, OPA did not receive such a review within an appropriate time interval.

11. With regard to fieldwork standards for performance audits, the peer review pointed out that the need to further improve planning, management controls, evidence, and reporting standards. The audits under the peer review had initial audit planning without a careful plan to gather data and information required for the audit. Without sufficient data and/or evidence, the

recommendations tended to be general and less effective. Due to weak management control over the audits, audit report quality was less than satisfactory. Audit objectives were often not answered in the actual audit reports. Evidence was sometimes insufficient to support the conclusions and elements of findings.

12. With increasing importance of accountability and transparency in FSM public sector management, it is critical to reengineer the management and control mechanism over FSM audit offices, both at the national and state levels.

### III. THE TECHNICAL ASSISTANCE

#### A. Purpose and Output

13. The goal of the TA is to assist the Government in increasing its accountability and transparency at the national and state levels. To achieve this goal, the TA will focus on enhancing the audit and administrative processes of audit offices necessary to effectively carry out productive and efficient audits.

14. The main outputs of the TA are (i) strategic plans of audit offices, (ii) performance audit tools necessary to perform accurate and efficient audit, (iii) strengthened human resources management system, (iv) an FSM resource-sharing program among the national and state audit offices, and (v) the resulting reform plan of the national audit office adopted, as appropriate, by the state audit offices.

#### B. Methodology and Key Activities

15. The TA adopts a two-phase approach. The first phase is to plan and implement the reengineering process of audit management and administration of a pilot audit office, and the second phase will help other audit offices adopt such reform done by the pilot audit office.

16. **Phase 1: Pilot Project.** The following activities will be carried out under the first phase of the TA:

- (i) **Strategic planning.** OPA will be the pilot office to introduce various reform agendas, including introducing strategic planning, developing performance audit tools, and strengthening human resources management. In the first phase, the TA will focus on reengineering processes within OPA. First, a strategic planning session will be held in OPA. The strategic planning process will be mission-oriented, with an emphasis on the vision for the future of OPA and the values (including principles, standards, beliefs, and actions) that members of OPA consider important and feel that OPA should represent. The planning process will also include a thorough situation analysis looking into, among others, OPA's strengths and opportunities. Financial and human resources implications will be examined. The mission statement and goals and objectives, as well as revolving audit plans, will be produced through the strategic planning process.
- (ii) **Performance audit tools.** Detailed audit manuals, such as an internal control audit manual, compliance audit manual, performance audit manual, and financial audit manual will also be developed in the first phase. These manuals will serve as step-by-step performance tools that ensure that stringent audit performance requirements are met and effective and efficient audits are completed. Clear and

concise documented procedures will be established for the yearly updating of these manuals. Each year, numerous rules, guidelines, pronouncements, and exposure drafts are released, and these must be incorporated into the audit manuals. The TA will also develop sample audit files for each audit type, which will serve as a training and compliance tool during the course of an audit. A detailed Compliance Investigation Division performance manual will be also developed. Due to the sensitive nature of this division and the high level of risk involved, a clear and concise operational manual should be designed to guide investigators through the investigation process.

- (iii) **Human resources management.** The current human resources management system for the audit office will be critically reviewed, and an employment performance evaluation methodology and employment promotion and incentive program will be introduced. A training needs assessment will be also conducted, and an employee training program will be developed. The training program will include in-country training at local educational institutions and overseas training (e.g., OJT at audit offices in relevant countries). The TA will explore the possibility of tying up with other bilateral development partners on the training program. As for human resources in the audit services in FSM, the TA will promote a staff resource-sharing program within FSM among the national and state audit offices. A memorandum of understanding among the national and state audit offices will be developed.

17. **Phase 2: Adoption of Pilot Results by State.** In the second phase, the result of the pilot test in OPA will be presented and discussed with state audit offices for possible adoption of such reform at the state level. The adoption of the reform plan by state audit offices will start from a series of strategic planning sessions and is not expected to be costly, as most outputs of the first phase will be easily modified to meet the needs of state audit offices.

### **C. Cost and Financing**

18. The TA is estimated to cost \$397,000 equivalent, with \$250,000 in foreign exchange costs and \$147,000 equivalent in local currency costs (Appendix 2). ADB will provide \$300,000 for the TA. The TA will be financed on a grant basis from the Japan Special Fund, funded by the Government of Japan. The Government will contribute \$97,000 equivalent to finance the remaining local currency cost. The detailed cost estimates and financing plan are in Appendix 2.

### **D. Implementation Arrangements**

19. OPA will be the Executing Agency for the TA. The Government will ensure that counterpart staff members in the national and state governments work closely with consultants, as part of institutional strengthening and capacity-building efforts in public sector audit function. A steering committee will be established comprising national and state public auditors and other officials, as deemed appropriate. The Government will also provide all available relevant information and will facilitate the collection of technical data necessary for the implementation of the TA.

20. A team of international consultants will be engaged by ADB to provide 10 person-months of consulting services. The team will comprise (i) a team leader with extensive experience in audit management (8 person-months), and (ii) a human resources management specialist (2 person-months). The consultants will be individually selected and engaged by ADB in

accordance with the *Guidelines on the Use of Consultants by Asian Development Bank and Its Borrowers*. The detailed terms of reference are in Appendix 3.

21. The TA will be implemented over a period of 8 months, from February 2005 to September 2005. The team leader, to be assisted by a local counterpart provided by OPA, will be responsible for coordinating the work of team members. The consultants will contribute to the progress and final reports to be prepared by the team leader. Each consultant, will also prepare a final report on specific achievements and lessons learned under the TA, covering his or her particular area of expertise or responsibility.

#### **IV. THE PRESIDENT'S DECISION**

22. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$300,000 on a grant basis to the Government of the Federated States of Micronesia for Strengthening Public Sector Audit Function, and hereby reports this action to the Board.

### TECHNICAL ASSISTANCE FRAMEWORK

<b>Design Summary</b>	<b>Performance Indicators and Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<b>Goal</b> Assist the Government in increasing its accountability and transparency	Increase resolutions of critical audit findings to 75%	Annual public auditor's reports	
<b>Purpose</b> Enhance the effectiveness and quality of audit and administrative processes of audit offices	Pass peer review by 2007	Peer review paper by APIPA or any other relevant organization	The independent status of audit offices is maintained
<b>Outputs</b> 1. A strategic plan for the Office of the Public Auditor formulated  2. Performance audit tools necessary to perform accurate and efficient audit developed  3. Human resources management plan and/or system established  4. FSM resource-sharing program among the national and state audit offices developed  5. Reform plan of the national audit office adopted, as appropriate, by state audit offices	Strategic plan welcomed and accepted by more than 80% of audit office staff members (ownership of the plan)  Five manuals at the United States Government standard produced and endorsed by the national public auditor by the end of the fourth month  Individual staff member goal setting completed by the end of the fourth month  MOUs between the national and at least two state audit offices signed by the end of the eighth month  At least two state public auditors adopt, as appropriate, the reform plan for their offices	Survey at the end of the strategic planning process  Consultants' reports  Consultants' reports  Consultants' reports  Consultants' reports	Staff members are willing to accept reform efforts in the offices

<b>Design Summary</b>	<b>Performance Indicators and Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p><b>Activities</b></p> <p>1.1 Conduct strategic planning workshops</p> <p>1.2. Set goals and objectives of the Office of the Public Auditor</p> <p>1.3. Develop revolving audit plans</p> <p>2.1 Develop detailed audit manuals (internal control audit manual, compliance audit manual, financial audit manual, and administrative manual)</p> <p>2.2. Establish process for the yearly updating of manuals</p> <p>2.3. Develop sample audit files for each audit type</p> <p>2.4. Develop detailed Compliance Investigation Division performance manual</p> <p>3.1. Develop employee performance evaluation system</p> <p>3.2. Develop promotion and incentive program</p> <p>3.3. Conduct training needs assessment</p> <p>3.4. Develop employment training program</p>	<p>Accomplished by the fourth month</p> <p>Accomplished by the fourth month</p> <p>Accomplished by the fourth month</p>	<p>Consultants' reports and ADB review missions</p> <p>Consultants' reports and ADB review missions</p> <p>Consultants' reports and ADB review missions</p>	<p>Counterpart staff members are available to work with consultants</p>

<b>Design Summary</b>	<b>Performance Indicators and Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
4. Develop an MOU between the national and state offices  5.1. Conduct state-level workshops  5.2. Implement reform plan to state audit offices	Accomplished by the eighth month  Accomplished by the eighth month	Consultants' reports and ADB review missions  Consultants' reports and ADB review missions	
<b>Inputs</b> 1. ADB TA grant of \$300,000  2. Audit specialist  3. Human resources management specialist	8 person-months  2 person-months		

ADB = Asian Development Bank, APIPA = Association of Pacific Islands Public Auditors, MOU = memorandum of understanding, TA = technical assistance.

**COST ESTIMATES AND FINANCING PLAN**  
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
<b>A. Asian Development Bank Financing<sup>a</sup></b>			
1. Consultants			
a. Remuneration and Per Diem	208.0	0.0	208.0
b. International and Local Air Travel	10.0	10.0	20.0
c. Reports and Workshops <sup>b</sup>	0.0	12.0	12.0
2. Miscellaneous (including local transportation)	0.0	21.0	21.0
3. Contingencies	32.0	7.0	39.0
<b>Subtotal (A)</b>	<b>250.0</b>	<b>50.0</b>	<b>300.0</b>
<b>B. Government Financing</b>			
1. Office Accommodation	0.0	10.0	10.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	30.0	30.0
3. Domestic Travel by Counterpart Staff	0.0	30.0	30.0
4. Communications	0.0	10.0	10.0
5. Office Supplies and Equipment	0.0	4.0	4.0
6. Others	0.0	13.0	13.0
<b>Subtotal (B)</b>	<b>0.0</b>	<b>97.0</b>	<b>97.0</b>
<b>Total</b>	<b>250.0</b>	<b>147.0</b>	<b>397.0</b>

<sup>a</sup> Financed by the Japan Special Fund, funded by the Government of Japan.

<sup>b</sup> Strategic planning workshops for national and state audit offices.

Source: Asian Development Bank estimates.

## OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. The consultants will ensure that all work and outputs under the technical assistance fully comply with all relevant Asian Development Bank policies and guidelines. The consultants' work will include, but will not be limited to, the listed tasks.

2. **Audit Specialist** (international, 8.0 person-months). The consultant will have a strong background and experience in audit practices and audit management and will work closely with officials of the national and state audit offices and the human resources management consultant to reengineer the work of audit offices in the Federated States of Micronesia. More specifically, the consultant will carry out, but not be limited to, the following:

- (i) analyze the current strengths and weaknesses of audit offices, including financial and human resources constraints, and extract key issues to overcome to improve the effectiveness and efficiency of audit services;
- (ii) conduct strategic planning workshops to develop a strategic development plan and audit plans of the offices;
- (iii) develop detailed audit manuals, including internal control audit manual, compliance audit manual, performance audit manual, administrative manual, and Compliance Investigation Division performance manual;
- (iv) establish a process of yearly updating of manuals;
- (v) develop sample audit files for each audit type;
- (vi) disseminate the result of the pilot test at the national audit office to state audit offices through state-level workshops;
- (vii) help state audit offices adopt reforms;
- (viii) liaise with consultants for the Public Sector Capacity-Building Roadmap (the Roadmap) component under TA 4258-FSM: Strengthening of Public Sector Management and Administration, and provide them with necessary inputs for the preparation of the Roadmap, particularly in the area of audit; and
- (ix) prepare inception report 3 weeks after the inception, first phase report at the end of the fourth month, second phase report at the end of the eight month, final report at the end of the eight month, and brief monthly reports.

3. **Human Resources Management Specialist** (international, 2.0 person-months). The consultant will have a strong background and experience in human resources management and will work closely with officials of the national and state audit offices and the audit specialist to reengineer the human resources management and training programs of audit offices in the Federated States of Micronesia. More specifically, the consultant will carry out, but not be limited to, the following:

- (i) analyze the current human resources management and training of audit offices;
- (ii) develop an employee performance evaluation system;
- (iii) develop an employee promotion and incentive program;
- (iv) conduct training needs assessments of audit offices;
- (v) develop an employee training program;
- (vi) develop a memorandum of understanding between the national and state audit offices, to provide for the sharing of human resources among the offices;
- (vii) liaise with consultants for the Public Sector Capacity-Building Roadmap (the Roadmap) component under TA 4258-FSM: Strengthening of Public Sector Management and Administration, and provide them with necessary inputs for the preparation of the Roadmap, particularly in the area of audit; and
- (viii) prepare a human resources management report.