
October 2003

COMPACT OF FREE ASSOCIATION

Single Audits Demonstrate Accountability Problems over Compact Funds





Highlights of GAO-04-7, a report to congressional requesters

Why GAO Did This Study

In 1986, the United States entered into a Compact of Free Association (Compact) that provided about \$2.1 billion in U.S. assistance from 1987 through 2003 to the Pacific Island nations of the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI). GAO has issued a number of reports raising concerns about the effectiveness of this assistance. GAO was asked to review possible FSM and RMI misuse of Compact funds. We reviewed single audits for 1996 through 2000 and this report summarizes the audit results.

What GAO Recommends

GAO recommends that the Secretary of the Interior delegate responsibility to and hold the Office of Insular Affairs accountable for monitoring and reporting on FSM and RMI actions to address Compact-related single audit findings and initiating appropriate actions when the FSM or the RMI do not implement appropriate and adequate actions to correct Compact-related single audit findings in a timely manner.

In commenting on this report, the Office of Insular Affairs of the Department of the Interior, FSM, and RMI agreed with our findings or conclusions and recommendations. They also cited the amended Compacts as mechanisms that should result in improved financial management over Compact assistance.

www.gao.gov/cgi-bin/getrpt?GAO-04-7.

To view the full product, including the scope and methodology, click on the link above. For more information, contact McCoy Williams at (202) 512-6906 or williamsm1@gao.gov or Susan Westin at (202) 512-4128 or westins@gao.gov.

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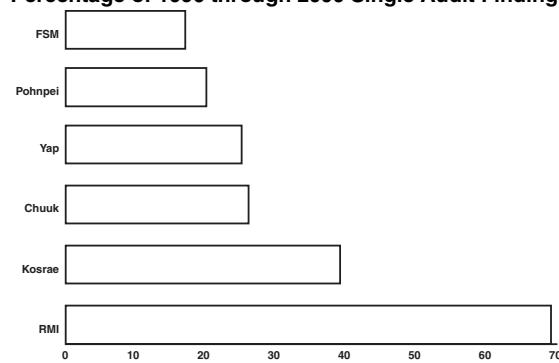
Single Audits Demonstrate Accountability Problems over Compact Funds

What GAO Found

GAO's review of 30 single audit reports for the FSM, 4 FSM states, and the RMI for the years 1996 through 2000 identified pervasive and persistent noncompliance with Compact requirements and financial statement-related audit findings. These single audit reports identified 458 audit findings relevant to the Compact. Significant numbers of these audit findings occurred during each year of the 5-year period and at each of the auditees. In addition, successive single audits identified recurring audit findings over the 5-year period despite corrective action plans prepared by the auditees. While none of the audit findings specifically discussed misuse of Compact funds, they did describe noncompliance with Compact requirements and financial management problems in areas that GAO considers highly susceptible to misuse, such as poor control over cash and equipment. When considered in conjunction with the qualified opinions or disclaimers of opinion on the financial statements in all 30 reports and for 60 percent of the Schedules of Expenditure of Federal Awards required by the Single Audit Act, the audit findings reveal one thing: overall poor accountability of Compact funds.

In responding to GAO's previous reviews of the original Compact, Interior officials expressed concerns about the U.S. government's limited ability to enforce accountability over Compact funds due to certain provisions of the Compact and the related fiscal procedures agreement (FPA). Recently, an Interior official noted that departmental officials have been frustrated with the lack of tools to administer or track federal assistance in a manner that could reasonably ensure that such assistance is having its intended effect. GAO found that the amended Compacts and related FPAs, which are scheduled to become effective upon legislative approval in the three countries, include many strengthened reporting and monitoring measures that could improve accountability, if diligently implemented. For example, funds could be withheld for noncompliance with Compact terms and conditions. In addition, joint economic committees and an Interior oversight team will focus on monitoring and overseeing Compact funds.

Percentage of 1996 through 2000 Single Audit Findings That Recurred 3 or More Years



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Abbreviations

CAP	corrective action plan
FPA	fiscal procedures agreement
FSM	Federated States of Micronesia
OMB	Office of Management and Budget
RMI	Republic of the Marshall Islands
U.N.	United Nations

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**United States General Accounting Office
Washington, D.C. 20548**

October 7, 2003

The Honorable Tom Lantos
Ranking Minority Member
Committee on International Relations
House of Representatives

The Honorable James A. Leach
Chairman
The Honorable Eni Faleomaveaga
Ranking Minority Member
Subcommittee on Asia and the Pacific
Committee on International Relations
House of Representatives

The Honorable Doug Bereuter
House of Representatives

In 1986, the United States entered into a Compact of Free Association (Compact) with the Pacific Island nations of the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI). Through the Compact, the United States has provided about \$2.1 billion in assistance to these nations in the form of direct funding and federal services and programs. Further, the Compact established U.S. defense rights and obligations in the region and allowed for migration from both nations to the United States. The Compact provisions that address economic assistance were scheduled to expire in 2001; however, they remained in effect while the United States negotiated amended Compacts with each nation.

Over the last several years, we issued reports that raised concerns about the effectiveness of the FSM and the RMI use of and accountability over U.S. assistance provided under the Compact.¹ In commenting on the accountability issues raised in our 2000 report, officials at the Department of the Interior, the agency responsible for overseeing the assistance program, pointed out the limited ability of the United States to enforce accountability over Compact funds because basic elements of federal grant management were lacking. They also noted that additional personnel and funding could have been committed to Compact oversight, but the United States would still have had almost no ability to influence fiscal decisions made by the FSM and the RMI. In recent testimony, an official from the Office of Insular Affairs, Department of the Interior, noted that the department was hampered by the fact that the Compact provided for large, loosely defined grants with no express enforcement mechanisms to ensure the efficient and effective expenditure of funds. This official also stated that departmental officials “have been greatly frustrated with the lack of tools to properly administer or track Federal assistance in a manner that could reasonably ensure that such assistance is having its intended effect.”²

In conjunction with our monitoring and reporting on Compact renegotiation efforts, you asked us to review possible FSM or RMI misuse of Compact funds. The annual single audits of the FSM and the RMI, which are required by the fiscal procedures agreement (FPA) for implementing the Compact, are a potential source of this information.³ While the single audit reports do not specifically use the phrase “misuse of Compact funds,” many of the problems they identify are in areas that are susceptible to the misuse of funds.

¹ U.S. General Accounting Office, *Foreign Assistance: Effectiveness and Accountability Problems Common in U.S. Programs to Assist Two Micronesian Nations*, GAO-02-70 (Washington, D.C.: Jan. 22, 2002); *Foreign Assistance: U.S. Funds to Two Micronesian Nations Had Little Impact on Economic Development*, GAO/NSIAD-00-216 (Washington, D.C.: Sept. 22, 2000); and *Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands*, GAO/RCED-00-67 (Washington, D.C.: May 31, 2000).

² Statement of David B. Cohen, Deputy Assistant Secretary of the Interior for Insular Affairs, before the Subcommittee on Asia and the Pacific, House Committee on International Relations, June 18, 2003.

³ The FPA provides for a financial and compliance audit within the meaning of the Single Audit Act. See 31 U.S.C. Chapter 75.

We obtained the 30 single audit reports for the years 1996 through 2000 for the national government of the FSM; the FSM state governments of Chuuk, Kosrae, Pohnpei, and Yap; and the national government of the RMI. We reviewed and summarized the audit findings contained in these reports, the most recently completed reports available at the start of our review, to identify instances of possible misuse of Compact funds. On February 12, March 12, and March 13, 2003, we briefed your staffs on our results. This report summarizes our briefing results regarding the single audit reports. In addition, it provides information on the enhanced accountability measures that are built into the amended or renegotiated Compacts. The amended Compacts⁴ and related FPAs, which are scheduled to become effective upon legislative approval in the United States, the FSM, and the RMI, include many strengthened reporting and monitoring measures that could improve accountability, if diligently implemented.⁵ (Further details on our scope and methodology are provided later in this report.)

Results in Brief

Single audits are intended to promote sound financial management, including effective internal control over federal awards. Our review of 30 single audit reports for the FSM, the four FSM states, and the RMI for the years 1996 through 2000 identified pervasive and persistent compliance-and financial statement-related audit findings. More specifically, the audit reports contained about 90 audit findings for each year of the 5-year period that we reviewed and a significant number of audit findings for each of the auditees. In total, they contained 458 audit findings. Further, these reports showed recurring audit findings over the 5-year period despite the fact that the corrective action plans prepared by the FSM, the four FSM states, and the RMI indicated more timely completion of actions to address these findings.

⁴ According to a Department of State official, while the original Compact was one document that applied to both the FSM and the RMI, an amended Compact has been prepared for each nation.

⁵ Although the three governments have signed the amended Compacts, the Compacts have not been approved by the legislature of any country. Therefore, in this report, we describe the amended Compacts' requirements and potential impact conditionally, recognizing that the Compacts have not yet been enacted. The total possible cost to renew expiring assistance in fiscal year 2004 U.S. dollars would be \$3.8 billion on the basis of the Congressional Budget Office's forecasted inflation rate.

None of the audit report discussions of the 458 audit findings specifically cited misuse of Compact funds. However, they did discuss noncompliance with Compact requirements and financial management problems in areas that we consider highly susceptible to such misuse. For example, one finding noted that differences between the cash balance shown in the entity's financial records and the bank records amounted to over \$150,000. Further, the independent auditors issued qualified opinions or disclaimers of opinion on the entitywide financial statements in all 30 reports and for about 60 percent of the Schedules of Expenditures of Federal Awards required by the Single Audit Act.⁶ These opinions were frequently issued because the audited entity did not provide the auditor with all required financial reports and/or other financial records. Taken together, the audit findings of and the financial statement opinions rendered by the auditors demonstrate that the FSM, the 4 FSM states, and the RMI did not provide reasonable accountability over Compact funds and assurance that these funds were used as intended.

The amended Compacts and related FPAs, which are scheduled to become effective upon legislative approval in all three countries, include many accountability provisions that would strengthen reporting and monitoring, if diligently implemented. If so implemented, they would address most of the recommendations that we made in past reports regarding assistance accountability, fiscal control and accounting procedures, and standards for financial management systems. For example, under the amended Compacts, the annual reporting and consultation requirements would be expanded; funds could be withheld for noncompliance with Compact terms and conditions; and the FPAs call for the establishment of a joint economic management committee for each nation. These committees will consist of three members appointed by the United States, including the chairman, and two members appointed by FSM or RMI and will have significant oversight and monitoring responsibilities. In addition, Interior officials have stated that they are in the process of assembling a Compact oversight team of full-time employees that will focus exclusively on monitoring and oversight of Compact financial assistance. The successful implementation of these strengthened reporting and monitoring measures will require a sustained commitment and appropriate resources from the United States, the FSM and the RMI.

⁶ An audit of these schedules as part of the single audit is required by the Single Audit Act, as amended, 31 U.S.C. 7502(e)(2).

To help promote compliance with Compact requirements and sound financial management, we are recommending that the Secretary of the Interior delegate this responsibility to the Office of Insular Affairs and hold appropriate officials in that office accountable for (1) ensuring the adequacy of staff dedicated to Compact oversight and monitoring activities, (2) monitoring FSM and RMI progress in correcting Compact-related single audit report findings, (3) reporting on the FSM and the RMI actions to address Compact-related compliance and financial statement findings identified in single audit reports to the Secretary of the Interior or other appropriate high-level Interior official, (4) initiating appropriate actions if the FSM or the RMI do not implement timely and adequate actions to correct Compact-related single audit findings, and (5) investigating single audit findings that indicate possible violations of grant conditions or misuse of funds and taking appropriate actions when such problems are verified.

The Department of the Interior and the RMI concurred with the findings cited. The FSM noted that the report was constructive and useful as it continues to prepare for the implementation of the amended Compact and its related agreements. The FSM and RMI also provided technical comments and other information on current actions to address the financial management issues that the report raised.

Background

In 1947, the United Nations (U.N.) created the Trust Territory of the Pacific Islands. The United States entered into a trusteeship with the U.N. Security Council and became the administering authority of the current islands of the FSM and the RMI. The United States administered the islands under this trusteeship until 1986, when it entered into a Compact of Free Association with the FSM and the RMI, both of which are located in the Pacific Ocean.

The original Compact represented both a continuation of U.S. rights and obligations first embodied in the U.N. trusteeship agreement and a new phase in the unique and special relationship that had existed between the United States and these island nations. It also provided a framework for the United States to work toward achieving its three main goals of (1) securing self-government for the FSM and the RMI,⁷ (2) assisting the

⁷ The FSM and RMI are now independent nations and are members of international organizations such as the U.N.

FSM and the RMI in their efforts to advance economic development and self-sufficiency, and (3) ensuring certain national security rights for all of the parties.

The Department of the Interior's Office of Insular Affairs was responsible for disbursing and monitoring Compact funds. For the 15-year period from 1987 through 2001, it provided funding at levels that decreased every 5 years. For 2002 and 2003, while negotiations to renew the expiring Compact provisions were ongoing, funding levels increased to equal an average of the funding provided during the previous 15 years. For 1987 through 2003, total U.S. assistance to the FSM and the RMI to support economic development is estimated, based on Interior data, to be about \$2.1 billion.

In addition, the Compact identified several services that U.S. agencies would supply to the FSM and the RMI and further stated that these agencies could provide direct program assistance as authorized by the Congress. This assistance included grants, loans, and technical assistance that, for fiscal years 1987 through 2001, totaled about \$700 million from 19 U.S. agencies. The Department of the Interior was responsible for supervising, coordinating, and monitoring program assistance, while the Department of State was responsible for directing and coordinating all U.S. government employees in foreign countries, except those under the command of U.S. area military commanders.

In 2000, we reported that one tool that should be used for ensuring accountability over Compact assistance was the annual audits required by the Compact. FPAs for implementing the Compact required that financial and compliance audits be conducted in accordance with the provisions of the Single Audit Act.⁸ This act is intended to, among other things, promote sound financial management, including effective internal controls, with respect to the use of federal awards. Entities that expend \$300,000 or more in federal awards in a year are required to comply with act's requirements. Further, the act requires entities to (1) maintain internal control over federal programs, (2) comply with laws, regulations, and the provisions of contracts or grant agreements, (3) prepare appropriate financial statements, including a Schedule of Expenditures of Federal Awards, (4) ensure that the required audits are properly performed and submitted

⁸ The Single Audit Act of 1984 was substantially amended by the Single Audit Act Amendments of 1996, which is codified in Chapter 75 of Title 31, United States Code.

when due, and (5) follow up and take corrective actions on audit findings. Deloitte Touche Tohmatsu, an independent public accounting firm, conducted the 30 single audits that we reviewed for the FSM; the 4 FSM states of Chuuk, Kosrae, Pohnpei, and Yap; and the RMI.

Objectives, Scope, and Methodology

Our objective was to review possible FSM and RMI misuse of Compact funds. One source of this type of information is the annual single audits that the fiscal procedures agreement for the implementation of the Compact requires the FSM and the RMI to obtain.

We obtained the single audit reports for the years 1996 through 2000, the most recent single audit reports available at the time of our review, for the national government of the FSM; the FSM state governments of Chuuk, Kosrae, Pohnpei and Yap; and the national government of the RMI. In total, this amounted to 30 single audit reports representing 5 years, a period that we considered sufficient for identifying misuse of funds and common or persistent compliance and financial management problems involving Compact funds. While these reports did not specifically identify any findings as instances of misuse of Compact funds, they did identify problems that could leave Compact funds susceptible to misuse, including poor control over cash and equipment.

We reviewed each report to identify and categorize the audit findings relevant to the Compact, paying particular attention to those involving assets or other financial accounts (i.e., cash and equipment) that we considered particularly susceptible to misuse. (We did not independently assess the quality of these audits or the reliability of the audit finding information. However, based on the fact that the audited entities developed corrective action plans for about 93 percent of the findings contained in the audit reports, we concluded that the audit findings provide an accurate representation of the problems reported.) We also reviewed the reports to identify auditee responses to the audit findings and their corrective action plans. These plans indicate auditee agreement or disagreement with the audit findings and the actions they planned to take or had taken to fix the findings. In addition, we reviewed the audit findings to determine if they recurred in successive single audits over the 5-year period. We completed our review of each single audit report by identifying and categorizing the auditor's opinions on the financial statements and the Schedules of Expenditures of Federal Awards.

In responding to our previous review of the Compact program, Interior officials expressed concerns about the U.S. government's limited ability to enforce accountability over Compact funds due to certain provisions of the original Compact and the related FPA. In light of these concerns, we reviewed the amended Compacts and related FPAs to determine if they included measures that could increase accountability over Compact funds. In addition, we supplemented our review of these documents with a discussion about the amended Compacts with Interior officials to determine if the new provisions addressed their prior concerns about limited actions available to them for holding the FSM and the RMI accountable.

Interior's Compact-related expenditures represented about 80 percent of the total expenditures of U.S. assistance made by the FSM, the 4 FSM states, and the RMI during the 5-year period. Because of the relatively small amount of funding from other federal agencies at these recipients, we did not discuss finding resolution with representatives of those agencies.

We conducted our audit from August 2002 through May 2003 in accordance with generally accepted government auditing standards. We requested written comments on a draft of this report from the governments of the FSM and the RMI and the Secretary of the Interior. Their comments are discussed in the section entitled Government and Agency Comments and Our Evaluation and are reprinted in appendixes I, II, and III. Further, we considered all comments and made changes to the report, as appropriate.

Pervasive Audit Findings Demonstrate Poor Accountability over Compact Funds

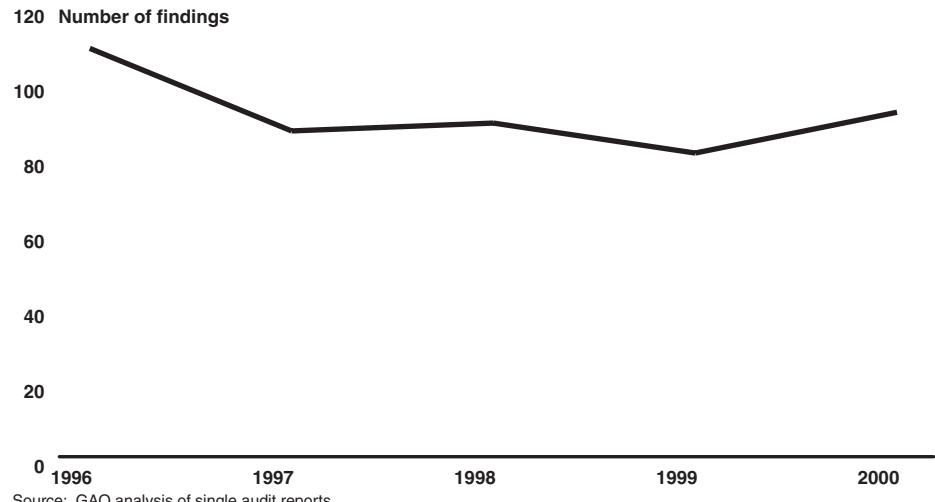
Single audits of the FSM, the four FSM states, and the RMI identified pervasive audit findings involving noncompliance with Compact requirements and financial statement problems in areas that we consider highly susceptible to misuse. In addition, the independent auditor performing the single audits issued qualified opinions or disclaimers of opinion on the financial statements in all 30 single audit reports reviewed and for 60 percent of the Schedules of Expenditures of Federal Awards. Taken together, these findings and opinions demonstrate that the FSM, the four FSM states, and the RMI did not provide reasonable accountability over Compact funds and assurance that these funds were used for their intended purposes.

Single Audit Reports Identify Pervasive Audit Findings Involving Compact Funds

The 30 single audit reports that we examined contained about 90 audit findings for each year of the 5-year period covered by our review. In total, they contained 458 audit findings relevant to Compact funds and significant numbers of findings for each of the auditees for which we reviewed single audit reports. Further, successive single audits during the 5-year period contained recurring audit findings despite corrective action time frames established by the auditees and our conclusion that few of the findings involved significant issues, such as implementing an accounting system, that could be expected to require more than 2 years to correct.

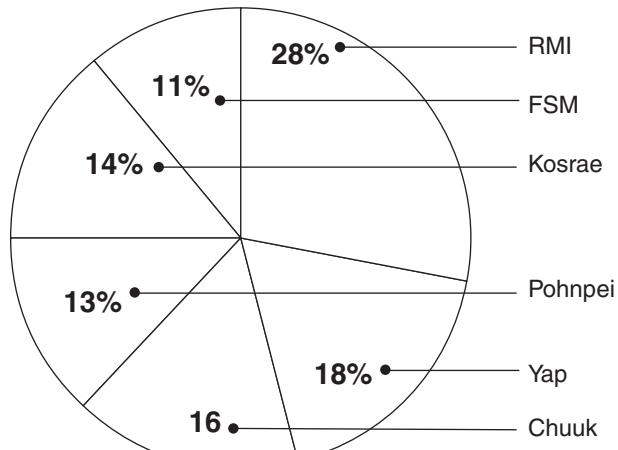
Figure 1 shows the number of audit findings reported annually from 1996 through 2000. It demonstrates that the auditors performing the 30 single audits in our review identified a significant number of audit findings both in total and in each year of the 5-year period of our review.

Figure 1: Number of Audit Findings Reported Annually from 1996 through 2000



In addition, the 30 audit reports identified a significant number of audit findings for each of the auditees. Figure 2 shows the percentages of the 458 audit findings related to Compact funds for each auditee.

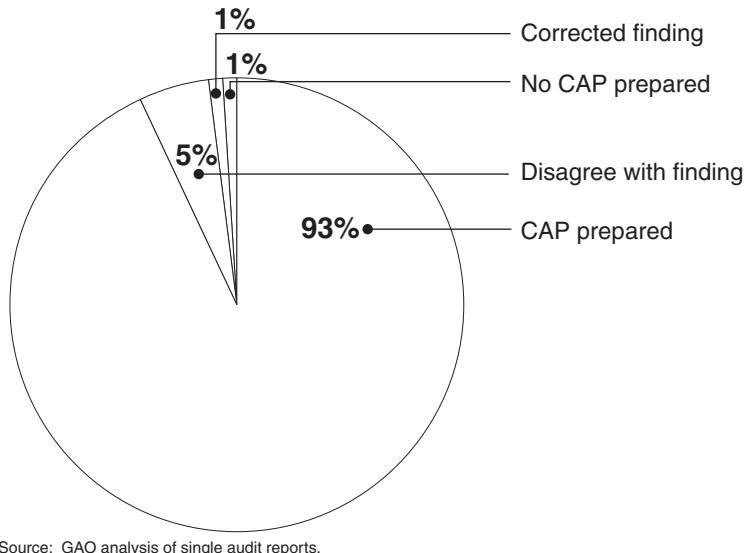
Figure 2: Auditee Findings as a Percentage of Total Findings



Source: GAO analysis of single audit reports.

Office of Management and Budget (OMB) Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, establishes policies for federal agency use in implementing the Single Audit Act, as amended, and provides an administrative foundation for consistent and uniform audit requirements for nonfederal entities that administer federal awards. In part, the circular requires the auditee to follow up and take corrective actions on audit findings identified by the single audits. It clarifies this requirement by stating that, at the completion of the single audit, the auditee shall prepare a corrective action plan (CAP) to address each audit finding included in the current year auditor's report. If the auditee does not agree with the audit findings or believes corrective action is not required, the CAP is to include an explanation of and justification for this position. Based on our review of the audit reports, the FSM, the four FSM states, and the RMI generally fulfilled their responsibility to either prepare a CAP or indicate their disagreement with the audit finding and provide reasons for their disagreement. As figure 3 shows, they prepared CAPs for 93 percent of the audit findings identified by the single audits in our review and indicated their disagreement and reasons for this disagreement for 5 percent of the findings.

Figure 3: Percentage of Corrective Action Plans Developed for Audit Findings



Source: GAO analysis of single audit reports.

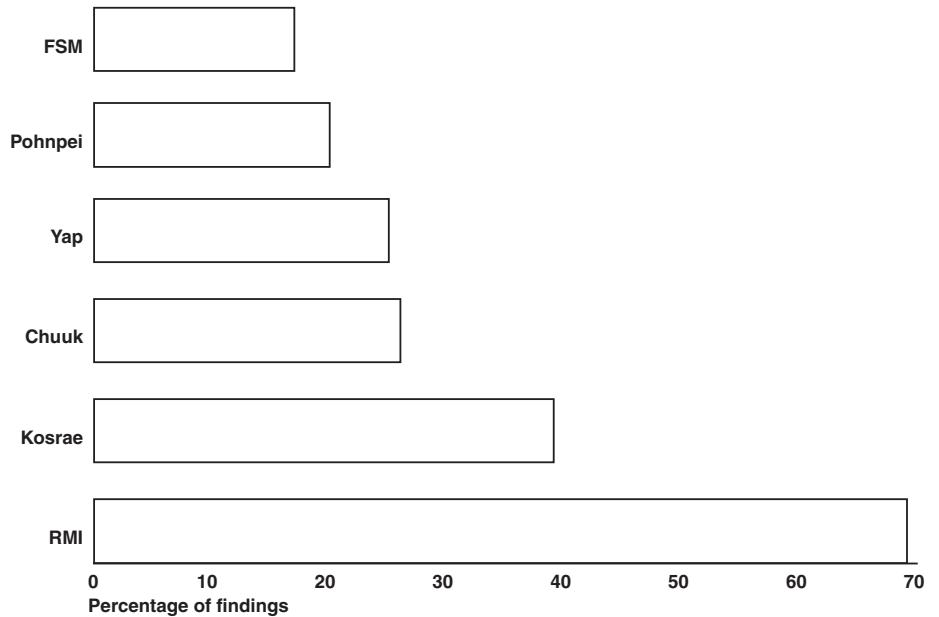
Our review of these CAPs showed that about 33 percent (138) included anticipated completion dates, and, of these plans, only 4 percent (16) indicated that the planned corrective actions would require more than 2 years to complete. Based on a review of the CAPs that did not include anticipated completion dates (287), we concluded that, with a few exceptions,⁹ the problems addressed by these plans could be corrected within a year. For example, Financial Status Reports submitted to the grantor agencies for fiscal year 2000 were not available during the single audit of the RMI. The auditors recommended that an adequate filing system, including the maintenance of Financial Status Reports, be maintained for all federal awards. The CAP called for the Ministry of Finance to ensure that an adequate filing system was in place and to review status reports periodically.

Further analysis of the findings revealed that successive single audits identified recurring audit findings over the 5-year period despite the time frames identified in the auditee-prepared CAPs or our estimate of the

⁹ We identified 11 CAPs that we believe could require significant amounts of time to correct. For example, 3 CAPs called for accounting system upgrades and another 2 called for accounting systems. In another 2 instances, FSM states prepared plans that required legal opinions from the FSM national government in order to resolve the problems.

amount of time corrective action should take. As figure 4 shows, many audit findings that were identified in more than one single audit report recurred in 3 or more years over the 5-year period. The percentage of each auditee's single audit findings that recurred 3 or more years over the 5-year period of our review ranged from RMI's high of 69 percent to a low of 17 percent for the FSM.

Figure 4: Percentage of 1996 through 2000 Single Audit Findings That Recurred 3 or More Years



Source: GAO analysis of single audit reports.

Compliance and Financial Statement Problems Persisted over Compact Funds

The auditors categorized the audit findings related to the Compact into three areas—federal award findings, local findings, and financial statement findings. Upon further review, we determined that 117 audit findings that the auditors categorized as federal award findings or local findings discussed problems related to compliance with Compact requirements, and the remaining 341 discussed financial statement problems. The auditors who performed these single audits qualified or disclaimed their opinion on all of the financial statements and about 60 percent of the Schedules of Expenditures of Federal Awards generally because the auditees did not provide them with all needed financial statements or documentation to

support transactions recorded in their books. Taken together, the compliance and financial statement findings and audit opinions demonstrate poor accountability over Compact funds and an inability on the part of the entities involved to provide assurances that all program funds are used as intended. They highlight the need for a stronger control environment and greater efforts to implement control activities that strengthen accountability and help ensure that Compact funds are used for program purposes.

Compliance requirements for federal assistance set forth what is to be done, who is to do it, the purpose to be achieved, the population to be served, and how much can be spent in certain areas. OMB's Single Audit Act guidance includes 15 compliance categories¹⁰ used by auditors to report on compliance-related findings. Our analysis of the compliance categories the auditors cited for the Compact-related audit findings showed that over half of the audit findings related to two categories—allowable costs/cost principles and equipment and real property management. The first category, allowable costs/cost principles, specifies the allowability of costs under federal awards. For example, expenditures for 17 types of projects or activities were allowable under the original Compact capital account, including construction or major repair of capital infrastructure, public and private sector projects, training activities, and debt service. The second category, equipment and real property management, specifies how federal award recipients should use, manage, and dispose of equipment and real property.

The following examples illustrate the types of audit findings that the auditors categorized into the 15 areas.

- Kosrae advanced \$93,000 in Compact Health and Medical Program funds to off-island health providers for medical referrals. The advances were immediately expensed without reference to the specific medical expenses actually incurred. This is an example of a compliance finding related to allowable costs/cost principles.

¹⁰ The 15 areas are (1) activities allowed or unallowed, (2) allowable costs/cost principles, (3) cash management, (4) Davis-Bacon Act, (5) eligibility, (6) equipment and real property management, (7) matching, level of effort, and earmarking, (8) period of availability of federal funds, (9) procurement, (10) program income, (11) real property acquisition and relocation assistance, (12) reporting, (13) subrecipient monitoring, (14) special tests and provisions, and (15) none.

-
- Kosrae incurred over \$274,000 in expenditures of Compact Capital funds that lacked proper supporting vendor's invoices. This is an example of a compliance finding related to allowable costs/cost principles.
 - Chuuk transferred about \$169,000 in Compact Capital funds to entities (subrecipients) that have not been audited or reviewed for compliance with Compact requirements. This is an example of a compliance finding related to subrecipient monitoring.

As mentioned earlier, the auditors performing the single audits also categorized findings as financial statement findings. The audit findings for this category related to the reliability of financial reporting and involved recording, processing, summarizing, and reporting financial data. Unlike the findings that related to compliance with Compact requirements, the auditors did not tie the financial statement findings to the categories contained in the Single Audit Act guidance. Our review of these findings identified 101 financial statement findings involving problems with assets or accounts that we consider susceptible to misuse. The following examples illustrate financial statement findings related to assets or accounts that we consider susceptible to misuse.

- Yap's three major bank accounts (general checking, savings, and payroll) were not reconciled to bank records at the end of fiscal year 1999. Differences between the amounts shown for these cash accounts in Yap's books and the bank records amounted to over \$150,000. The auditors identified this lack of bank reconciliations as an internal control weakness in Yap's single audit reports for the years 1995 through 1999. A record being out of balance is a risk factor auditors use to identify the possibility of fraud. This is an example of a cash problem.
- The RMI had not conducted a physical inventory or updated property records for equipment and real property. As of September 30, 2000, RMI reported that its equipment was worth about \$11 million, but the auditor could not substantiate this amount due to inadequate records. The auditor identified a lack of updated property records for the General Fixed Asset Group in single audit reports for the years 1988 through 2000. Missing documents, such as the property records for equipment in this example, are a risk factor used by auditors to identify the possibility of fraud. This is an example of an equipment problem.

The 30 single audit reports included auditor opinions or disclaimers of opinion on the financial statements and Schedules of Expenditures of

Federal Awards for the FSM, the four FSM states, and the RMI. The financial statements reflect a federal award recipient's financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the year. The Schedules of Expenditures of Federal Awards show the amount of expenditures for each federal award program during the year. If the auditors are not able to perform all of the procedures necessary to complete an audit, they consider the audit scope to be limited or restricted. Scope limitations may result from the timing of the audit work, the inability to obtain sufficient evidence, or inadequate accounting records. If the audit scope is limited, the auditors must make a professional judgment about whether to qualify or disclaim an opinion. A qualified opinion states that, except for the matter to which the qualification relates, the financial statements are fairly presented in accordance with generally accepted accounting principles. In a disclaimer of opinion, the scope limitation is serious enough that the auditor does not express an opinion.

The auditor's opinions on the financial statements and Schedules of Expenditures of Federal Awards for the 30 single audits in our review reveal overall poor financial management. The auditors performing these single audits qualified or disclaimed their opinions on all of the financial statements and about 60 percent of the Schedules of Expenditures of Federal Awards generally because they were unable to obtain sufficient evidence or adequate accounting records. For example, the auditor qualified its opinion on the FSM's financial statements for the year 2000 because of the auditor's inability to ensure the propriety of receivables from other governments and missing financial statements for a component unit. In another example, the auditor did not express an opinion on Chuuk's financial statements for the year 1999 because of inadequacies in the accounting records and internal controls, incomplete financial statements for component units, and its inability to obtain audited financial statements supporting investments.

The significant number of audit findings involving FSM and RMI noncompliance with Compact requirements and weaknesses in their financial management systems, along with auditor qualified opinions or disclaimers of opinion on financial statements, echo the control and accountability issues that we identified in our earlier reports on Compact assistance. Further, the pervasive and recurring nature of the compliance and financial statement problems highlights (1) the need for stronger control environments that will help ensure that Compact funds are used for program purposes and (2) the limited progress made during the 5-year

period of our review in establishing accountability in the FSM, the four FSM states, and the RMI that would provide reasonable assurance that Compact funds are used for their intended purposes.

Amended Compact Agreements Contain Improved Accountability Measures

In responding to our previous reviews of the original Compact program, Interior officials expressed concerns about the U.S. government's limited ability to enforce accountability over Compact funds due to certain provisions of the original Compact and the related FPA. According to these officials, administrators have been reluctant to commit oversight resources to the Compact when no enforcement mechanisms exist due to these provisions. The United States and the FSM signed an amended Compact in May 2003. The United States and the RMI signed an amended Compact in April 2003. These amended Compacts are awaiting legislative approval in the United States, the FSM, and the RMI. They contain strengthened reporting and monitoring measures over the original Compact that could improve accountability over Compact assistance, if diligently implemented.

According to Interior officials, the FPA in effect during the period of our review created a financial management regimen unique in federal practice. They explained that it was negotiated to give the FSM and the RMI governments clear control over Compact funding and to limit the U.S. government's authority to intervene in spending decisions and, most important, to withhold payments if the terms and conditions of funding were violated. More specifically, these officials explained that the expiring FPAs lacked basic elements of federal grant management practice similar to those in OMB Circular A-102, *Grants and Cooperative Agreements with State and Local Governments*, which requires standard procurement practices and cost principles. They elaborated that, when coupled with the full faith and credit provisions of the Compact,¹¹ this lack of standards limited the U.S. government's response to mismanagement. In summing up, they stated that while additional personnel and funding could have been committed to Compact oversight, the United States would still have had almost no ability to influence fiscal decisions made by the FSM or the RMI.

¹¹ "Except as otherwise provided, approval of the Compact by the Government of the United States shall constitute a pledge of the full faith and credit of the United States for the full payment of the sums and amounts specified in Articles I and III of this Title. The obligations of the United States under Article I and III of this Title shall be enforceable in the United States Claims Court." Compact of Free Association, section 236 (Jan. 14, 1986).

The amended Compacts could potentially cost the U.S. government about \$6.6 billion in new assistance. Of this amount, \$3.5 billion would cover payments over a 20-year period (2004-23), while \$3.1 billion represents payments for U.S. military access to the Kwajalein Atoll in the RMI for the years 2024 through 2086. The amended Compacts contain strengthened reporting and monitoring measures that could improve accountability over Compact assistance, if diligently implemented. In addition, the Department of the Interior has taken actions to increase resources dedicated to monitoring and oversight of Compact funds.

The following are amended Compact and related FPA measures that represent changes from the prior Compact and FPAs.

- In 2000, we reported that Compact funds were placed in a general government fund and commingled with other revenues and, therefore, could not be further tracked. In addition, some Compact assistance was only traced at a high level with few details readily available regarding final use. The amended Compacts and FPAs include requirements that should address these accountability concerns. Specifically, they require fiscal control and accounting procedures sufficient to permit (1) preparation of required reports and (2) tracing of funds to a level of expenditures adequate to establish that such funds have been used in compliance with applicable requirements. Further, the amended Compacts specify standards for the financial management systems used by the FSM and the RMI. For example, these systems should maintain effective controls to safeguard assets and ensure that they are used solely for authorized purposes.
- The new FPAs would establish a joint economic management committee for the FSM and the RMI that would meet at least once a year. The committee would be composed of three U.S. appointed members, including the chairman, and two members appointed, as appropriate, by either the FSM or the RMI. The committee's duties would include (1) reviewing planning documents and evaluating island government progress to foster economic advancement and budgetary self-reliance, (2) consulting with program and service providers and other bilateral and multilateral partners to coordinate or monitor the use of development assistance, (3) reviewing audits, (4) reviewing performance outcomes in relation to the previous year's grant funding level, terms, and conditions, and (5) reviewing and approving grant allocations (which would be binding) and performance objectives for the upcoming year.

-
- Grant conditions normally applicable to U.S. state and local governments would apply to each grant. General terms and conditions for the grants would include conformance to plans, strategies, budgets, project specifications, architectural and engineering specifications, and performance standards. Specific postaward requirements address financial administration by establishing, for example, (1) improved financial reporting, accounting records, internal controls, and budget controls, (2) appropriate use of real property and equipment, and (3) competitive and well-documented procurement.
 - The United States could withhold payments if either the FSM or the RMI fails to comply with grant terms and conditions. The amount withheld would be proportional to the breach of the term or condition. In addition, funds could be withheld if the FSM or RMI governments do not cooperate in U.S. investigations of whether Compact funds have been used for purposes other than those set forth in the amended Compacts.
 - The new FPAs include numerous reporting requirements for the two countries. For example, each country must prepare strategic planning documents that are updated regularly, annual budgets that propose sector expenditures and performance measures, annual reports to the U.S. President regarding the use of assistance, quarterly and annual financial reports, and quarterly grant performance reports.

The successful implementation of the new accountability provisions will require a sustained commitment by the three governments to fulfilling their new roles and responsibilities. Appropriate resources from the United States, the FSM, and the RMI represent one form of this commitment. While the amended Compacts do not address staffing issues, officials from Interior's Office of Insular Affairs have informed us that they intend to post six staff in a new Honolulu office: a health grant specialist, an education grant specialist, an accountant, an economist, an auditor, and an office assistant. Interior can also contract with the Army Corps of Engineers for engineering assistance, when necessary. These Honolulu-based staff may spend about half of their time in the FSM and the RMI. Further, an Interior official noted that his office has brought one new staff member on board in Washington, D.C. and intends to post one person to work in the RMI (one staff member already works in the FSM). We have not conducted an assessment of Interior's staffing plan and rationale and cannot comment on the adequacy of the plan or whether it represents sufficient resources in the right locations.

Conclusions

The 30 single audit reports demonstrate a lack of or poor accountability over U.S. Compact assistance that has totaled an estimated \$2.1 billion since 1987. The large number and recurring nature of the findings involving noncompliance with Compact requirements or financial management weaknesses, along with the preponderance of auditor's qualified opinions or disclaimers of opinion on FSM and RMI financial statements, clearly indicate the need for improved FSM and RMI management of U.S. assistance and greater U.S. oversight and monitoring of the use of this assistance. Changes are needed especially considering the fact that the amended Compacts with these nations could potentially cost the U.S. government about \$3.5 billion in new assistance over the next 20 years.

Under the original Compact, the Department of the Interior was responsible for supervising, coordinating, and monitoring the program assistance provided. Interior officials expressed frustration with the lack of tools available to them to administer or track this assistance in a manner that could reasonably ensure that such assistance was having its intended effect. The amended Compacts strengthen reporting and monitoring measures that could improve accountability over assistance, if diligently implemented. These measures include strengthened fiscal control and accounting procedures requirements, expanded annual reporting and consultation requirements, and the ability to withhold funds for noncompliance with grant terms and conditions. The successful implementation of the new accountability provisions will require appropriate resources and sustained commitment from the United States, the FSM, and the RMI. The joint economic committees called for in the Compact with each nation and Interior's planned increase in staff associated with Compact oversight and monitoring functions should play key roles in improving accountability over Compact funds.

Recommendations for Executive Action

To help promote compliance with Compact requirements and sound financial management, the Secretary of the Interior should delegate responsibility to the Office of Insular Affairs and hold appropriate officials in that office accountable for

- ensuring the adequacy of staff dedicated to Compact oversight and monitoring,
- monitoring FSM and RMI progress in addressing Compact-related single audit report findings,

-
- reporting on the FSM and RMI actions to correct Compact-related compliance and financial management findings identified in single audit reports to the Secretary of the Interior or other appropriate high-level Interior official,
 - initiating appropriate actions when the FSM or the RMI do not undertake adequate actions to address Compact-related single audit findings in a timely manner, and
 - investigating single audit findings that indicate possible violations of grant conditions or misuse of funds and taking appropriate actions when such problems are verified.
-

Government and Agency Comments and Our Evaluation

In commenting on this report, the Office of Insular Affairs of the Department of the Interior, FSM, and RMI agreed with our findings or conclusions and recommendations. They also cited the amended Compacts as mechanisms that should result in improved financial management over Compact assistance. The FSM and RMI also provided technical comments and information on current actions to address financial management issues. We considered all comments and made changes to the report, as appropriate.

The FSM comments noted that it found the report constructive and useful as it continues to prepare for the implementation of the amended Compact and its related agreements. The comments (reprinted in app. I) recognized that, although FSM has worked hard to develop a consistent approach to satisfy the Compact and FPA requirements, significant work remains to be done to improve and strengthen accountability in all aspects throughout the nation. Further, FSM agreed that it must continue to improve internal financial control through upgrading the current financial management system, providing for capacity building, and retaining its most productive and experienced employees. Finally, it noted that the amended Compact and related fiscal procedures agreement include requirements that will address all of the accountability concerns expressed in the report.

RMI's comments (reprinted in app. II) stated that it concurred with the report's findings and noted that the report will be useful since it gives a summary of the financial and management situation of the RMI between 1996 and 2000. RMI noted that its problems stem partly from the fact that it has not had a global system for following up on audits that would apply throughout all ministries of the government as well as other entities that

receive Compact grant assistance. RMI stated that it has made progress recently by upgrading its information system and strengthening its internal control procedures and noted that it will add personnel to the budget, procurement, and supply areas.

In its comments (reprinted in app. III), the Office of Insular Affairs of the Department of the Interior agreed with the conclusions and recommendations in the report. The Office also noted that it looks forward to discharging its responsibilities under the amended Compacts and that it is confident that it will now have the tools needed to properly protect the American taxpayer's investment in the freely associated states.

As agreed with your offices, unless you publicly announce its contents earlier, we will not distribute this report until 30 days after its date. At that time, we will send copies to the Secretary of the Interior, the President of the Federated States of Micronesia, the President of the Republic of the Marshall Islands, and appropriate congressional committees. Copies will also be made available to others on request. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

For future contacts regarding this report, please call McCoy Williams at (202) 512-6906 or Susan S. Westin at (202) 512-4128. Staff contacts and other key contributors to this report are listed in appendix IV.



McCoy Williams
Director
Financial Management and Assurance



Susan S. Westin
Managing Director
International Affairs and Trade

Comments from the Federated States of Micronesia



The President
Palikir, Pohnpei
Federated States of Micronesia

September 30, 2003

Mr. McCoy Williams
Director
Financial Management and Assurance
U.S. General Accounting Office, Room 5089
441 G Street, NW
Washington, D.C. 20548-0001

Dear Mr. Williams:

We appreciate the opportunity given to the Federated States of Micronesia (FSM) to review and comment on the draft report entitled "Compact of Free Association: Single Audits Demonstrate Accountability Problems Over Compact Funds (GAO-04-7). At the outset, we find the report most informative and would like to offer the following comments and observations:

1. The Federated States of Micronesia (FSM) welcomes the United States General Accounting Office report on the audits of the Compact of Free Association funds. We find the report constructive and useful as we continue to prepare for the implementation of Amended Compact and its related agreements.
2. The FSM is concerned that the document combines reporting jointly on the Federated States of Micronesia and the Republic of the Marshall Islands. We would like to again, recommend that future GAO reports at least include information separately for each jurisdiction (FSM/RMI) to ease the review process and reference purposes.
3. The FSM recognizes that although we have worked hard to develop a consistent approach to satisfy the application and accounting requirements of the Compact Fiscal Procedures Agreement, significant work remains to be done to improve and strengthen accountability in all aspects throughout the nation. We agree that we must continue to improve internal financial control through upgrading the current financial management system, provision for capacity building and retaining our most productive and experienced employees.
4. The FSM has made significant progress in the resolution of findings identified in prior years' single audit reports. As of September 30, 2001, the total outstanding questioned cost FSM-wide amounted to \$75,533.00 a decrease of approximately \$83,160.00 from the \$158,693.00 recorded at the end of FY-2000. The FSM National Government continues to coordinate resolution of single audit findings for the five governments and the external auditors.

Appendix I
**Comments from the Federated States of
Micronesia**



Mr. McCoy Williams
September 30, 2003
Page 2

5. Compact funds are received, appropriated and expended in accordance with the financial legal framework of each of the five FSM Governments and provisions of the Compact and its related agreements. Compact funds designated as current accounts are drawn to each government on a quarterly basis. Capital funds are transferred to each government based on valid obligations. Public funds are disbursed based on legally binding obligations of the government.
6. The legal framework necessary to control public fund expenditures and accountability is in place at all government levels in the FSM. If properly implemented and followed, the system allows restricted access to fraud, abuse and misuse of public funds. We agree for implementation of stronger accountability measures to ensure Compact funds are expended accordingly. The Amended Compact and the related Fiscal Procedures Agreement include requirements that will address all of the accountability concerns expressly identified in the report.

Again, thank you for allowing us the opportunity to review and comment on the report.

Sincerely,

A handwritten signature in black ink, appearing to read "Joseph J. Urusemal".

Joseph J. Urusemal
President

Comments from the Republic of the Marshall Islands



EMBASSY OF THE REPUBLIC OF THE MARSHALL ISLANDS

2433 Massachusetts Avenue, N.W.,
Washington, D.C. 20008
Tel. # (202) 234-5414
Fax # (202) 232-3236

October 2, 2003

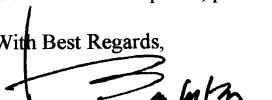
Mr. McCoy Williams
Director, Financial Management and Assurance
U.S. General Accounting Office, Room 5089
441 G Street, NW
Washington, D.C. 20548-0001

Dear Mr. Williams:

First, thank you for the opportunity to comment on the drafts of your reports. On behalf of the Government of the Republic of the Marshall Islands (RMI), I am pleased to forward to you comments on your most recent draft report entitled *Compact of Free Association: Single Audits Demonstrate Accountability Problems Over Compact Funds*.

I hope you will take time to consider the reactions of the RMI Government in the final version of your report. If you have any questions about the content of the RMI Government's response, please feel free to contact me at anytime.

With Best Regards,


Banny deBrum
Ambassador to the United States

Appendix II
Comments from the Republic of the Marshall Islands

RMI RESPONSE TO DRAFT GAO REPORT ENTITLED “COMPACT OF FREE ASSOCIATION: SINGLE AUDITS DEMONSTRATE ACCOUNTABILITY PROBLEMS OVER COMPACT FUNDS”

The RMI government has reviewed the draft GAO report on the findings of possible misuse of federal grants allocated to the RMI under the Compact of Free Association. Funding from the U.S. government is authorized and implemented under Section 211 of the Compact of Free Association, approved under U.S. Public Law 99-239.

The RMI is committed to being accountable to its constituency in the spirit of good governance. It is the desire of the RMI government to serve as a model democratic nation, with accountability and transparency as its underlying principles.

The RMI concurs with the findings of the GAO in respect to problems resulting from a lack of follow-up on audit findings for government operations over the period 1996-2000. This problem stems partly from the fact that the RMI has not had a “global” system for following up on audits that would apply throughout all ministries of the government as well as other entities that receive Compact grant assistance. As a result, certain ministries, instrumentalities of the government, and other entities receiving Compact assistance have made substantial efforts to respond to and correct problems revealed by audits, while others have done little or nothing in the past.

In addition, there has been little or no sanction under either domestic or the original Compact provisions for not correcting audit deficiencies after such deficiencies have been reported. This problem is now being affirmatively addressed in the RMI’s Appropriation act for FY 2004, which will provide that entities that have been determined by the Auditor General to be “unauditable” will not be permitted to receive funding until such problems are remedied. Although only a first step, this measure is independent of anything required in the Compact, as Amended, or the new Fiscal Procedures Agreement.

While the Compact, as Amended, provides for closer monitoring of the use of Compact grant funds than has been done in the past, the RMI believes that domestic revenues must also be brought under stricter accountability requirements so we do not end up with two different systems and accountability standards for Compact funding and other revenues of the RMI Government.

In the Compact, as Amended, both the RMI and the U.S. have agreed to detailed financial and management procedures and consultations that will assist the RMI in being more accountable to its people. These mechanisms can be found in the Fiscal Procedures Agreement (FPA), and they include the Medium Term Budget and Investment Framework (MTBIF) and the Joint Economic Management and Financial Accountability Committee (JEMFAC) that will review audit findings in the future.

The GAO report states that the RMI does not comply with the quarterly reports requirement of its federal programs. The RMI would point out that this is an overly broad

Appendix II
Comments from the Republic of the Marshall Islands

statement and that it has been able to make timely reports for most, but not all federal programs in accordance with those programs requirements.

The GAO notes that one improvement that will improve the accountability situation in the RMI is the Ministry of Finance (MOF) implementing a new filing system to keep better track of the government's documents. This is just one new mechanism that MOF has put into place, and there are other new measures that the GAO fails to mention.

Much progress has been made recently, specifically the upgrading of the information system and strengthening of the internal control procedures, which will address most of the on-going audit findings. Furthermore, additional personnel (budget, procurement and supply) will soon be added to better monitor and ensure internal and external compliance.

The RMI is also exploring other avenues to improve its accountability capacity. The RMI is committed to upgrade its fiscal operation and work closely with its DOI partners. From time to time, the RMI seeks the assistance of DOI, particularly the Technical Assistance Division, to resolve remaining audit findings. Thus the task ahead should be mutually beneficial for the RMI and the U.S. governments in combined efforts to achieve greater transparency and accountability.

The RMI appreciates the fact that the GAO conducted this study. This study will be useful to the RMI as it gives it a summary of the financial and management situation of the RMI between 1996 and 2000.

Comments from the Department of the Interior



United States Department of the Interior

OFFICE OF INSULAR AFFAIRS
1849 C Street, NW
Washington, D.C. 20240

Deputy Assistant Secretary

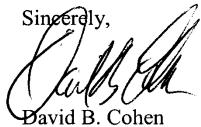
Mr. McCoy Williams
Director, Financial Management and Assurance
United States General Accounting Office
Washington, DC 20548

Dear Mr. Williams:

I have reviewed the draft report entitled "Compact Of Free Association: Single Audits Demonstrate Accountability Problems over Compact Funds", dated October 2003. I agree with the conclusions and recommendations of the report.

The report found that the proposed amendments to the Compacts of Free Association and the related fiscal procedures agreements should, if implemented properly, address the need to properly administer and oversee federal assistance. The Department of the Interior's extensive preparations to implement the amended Compact are already well underway, even though the amendments have yet to be approved as of this writing. We look forward to discharging our responsibilities under the amended Compacts, and are confident that we will finally have the tools that we need to properly protect the American taxpayer's investment in the freely associated states.

Thank you for the opportunity to comment on the above report.

Sincerely,

David B. Cohen

GAO Contacts and Staff Acknowledgments

GAO Contacts

Tom Broderick, (202) 512-8705 or broderickt@gao.gov
Emil Friberg, Jr., (202) 512-8990 or friberge@gao.gov

Acknowledgments

In addition to the contacts named above, Perry Datwyler and Leslie Holen made key contributions to this report.

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