

GAO

Testimony

Before the Committee on Energy and
Natural Resources, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Thursday, February 8, 2007

**COMMONWEALTH OF
THE NORTHERN
MARIANA ISLANDS**

**Serious Economic, Fiscal,
and Accountability
Challenges**

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Financial Management and Assurance





Highlights of [GAO-07-436T](#), a testimony to Committee on Energy and Natural Resources, U.S. Senate

Why GAO Did This Study

The U.S. insular area of the Commonwealth of the Northern Mariana Islands (CNMI) is a self-governing commonwealth of the United States that comprises 14 islands in the North Pacific.

In a December 2006 report—*U.S. Insular Areas: Economic, Fiscal, and Financial Accountability Challenges* ([GAO-07-119](#))—regarding four insular areas including CNMI, GAO identified and reported the following: (1) economic challenges, including the effect of changing tax and trade laws on their economies; (2) fiscal condition; and (3) financial accountability, including compliance with the Single Audit Act.

The Chairman of the Senate Committee on Energy and Natural Resources, which requested the December 2006 report, asked GAO to present and discuss the results as they pertain to CNMI. Our summary and conclusions are based on our work performed for our December 2006 report on U.S. insular areas. For this testimony we also had available CNMI's fiscal year 2005 audited financial statements, which we have included in our review, along with some recent developments in fiscal year 2006.

www.gao.gov/cgi-bin/getrpt?GAO-07-436T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeanette Franzel, (202) 512-9471, franzelj@gao.gov.

COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS

Serious Economic, Fiscal, and Accountability Challenges

What GAO Found

The Commonwealth of the Northern Mariana Islands (CNMI) faces serious economic, fiscal, and financial accountability challenges. CNMI's economy depends heavily on two industries, garment manufacturing and tourism. However, recent changes in U.S. trade law have increased foreign competition for CNMI's garment industry, while other external events have negatively affected its tourism sector.

CNMI's garment industry has declined in recent years with factory closings and reduced production. The value of garment shipments to the United States dropped by more than 16 percent between 2004 and 2005 and by an estimated 25 percent in 2006.

Tourism in CNMI declined sharply in the late 1990s as a result of a series of external events, including the Asian financial crisis; cancellation of Korean Air service; and fears of international crises such as the SARS epidemic, terrorism, and the Iraq war. In 2005, Japan Airlines withdrew direct flights to the capital.

The fiscal condition of CNMI's government has steadily weakened from fiscal year 2001 through fiscal year 2005, as government spending has exceeded revenues each year since 2002. CNMI ended fiscal year 2005 with a deficit of \$84.1 million in its governmental fund balance. CNMI's liabilities also exceed its assets for its primary government. Indicators point to a severe financial crisis in fiscal year 2006. In response, the CNMI government has implemented cost-cutting and restructuring measures, including "austerity holidays," consisting of biweekly furloughs during which government workers are not paid and many government operations are closed to reduce personnel and operating costs.

CNMI's long-standing financial accountability problems include the late submission of financial audit reports, inability to achieve "clean" opinions in its financial statements by the independent financial auditors, and reports showing serious internal control weaknesses over financial reporting. Many of the auditors' findings are longstanding, going back in some cases to 1987.

Federal agencies and CNMI have sponsored and participated in conferences, training sessions, technical assistance, and other programs to improve CNMI's economy, fiscal condition, and accountability. During 2006, the CNMI government took steps to reverse its prior patterns of deficit spending. It will need to continue to work toward long-term sustainable solutions, with concentrated attention on the challenges facing the islands and feedback mechanisms for continuing improvement. Leadership on the part of the CNMI government and the Department of the Interior's Office of Insular Affairs is critical to providing long-term stability and prosperity for this U.S. insular area.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the Commonwealth of the Northern Mariana Islands' (CNMI) serious challenges in strengthening its economy, fiscal condition, and financial accountability. CNMI is a self-governing commonwealth of the United States that administers its own local government functions under its own constitution. CNMI consists of 14 islands in the North Pacific with a total land area about 2.5 times the size of Washington, D.C. In recent years, CNMI has experienced serious economic and fiscal challenges, and several indicators point to a fiscal crisis in fiscal year 2006.

Today, I will highlight our December 2006 report¹ on the recent economic trends in the CNMI economy, its weakening fiscal condition, and its financial accountability challenges, which we have updated to include information for fiscal years 2005 and 2006.

Our summary and conclusions are based on our work performed for our December 2006 report on U.S. insular areas, which included audited financial statements through fiscal year 2004. For this testimony we also had available CNMI's fiscal year 2005 audited financial statements, which we have included in our review, along with some recent developments in fiscal year 2006. We provided a draft of this statement to Department of the Interior (DOI) officials who agreed with our conclusions and provided technical comments, which we have incorporated throughout the statement as appropriate. We conducted our work in accordance with generally accepted government auditing standards.

Summary

The government of CNMI faces serious economic, fiscal, and financial accountability challenges. The government's ability to strengthen CNMI's economy has been constrained by CNMI's lack of diversification in industries. CNMI's economy is highly dependent on two industries: garment manufacturing and tourism. The garment manufacturing industry is facing the challenges of remaining internationally competitive against low-wage nations given recent changes in trade agreements. CNMI's tourism sector experienced a sharp decline in the late 1990s, and a series of external events, such as the economic trends of nearby countries and

¹GAO, *U.S. Insular Areas: Economic, Fiscal, and Financial Accountability Challenges*, GAO-07-119 (Washington, D.C.: Dec. 12, 2006). CNMI is one of the subjects of this report.

changes in airline practices, have further hampered the sector. Both the garment and tourism industries employ non-citizen workers who are paid wages lower than the U.S. minimum wage.

The fiscal condition of CNMI's government has steadily weakened from fiscal year 2001 through fiscal year 2005, the most recent year for which audited financial statements for CNMI were available. CNMI's fund balance, which generally reflects the amount of resources available for current government operations, went into a deficit balance during fiscal year 2002 and continued to decline to a deficit balance of \$84.1 million by the end of fiscal year 2005. CNMI has also shown significant declines and negative balances in its reported net assets, which is another measure of fiscal health, and which represents the balance of total assets less liabilities. In order to finance its government activities in an environment where expenditures have exceeded revenues, CNMI has increased its debt, causing its debt to asset ratio to increase significantly since fiscal year 2002. In addition, several indicators point to a severe fiscal crisis during fiscal year 2006. The CNMI government has implemented several drastic cost-cutting and restructuring measures, including "austerity holidays" consisting of biweekly furloughs, during which government workers are not paid and many government operations are closed to reduce personnel and operating costs during fiscal years 2006 and 2007. In addition, other measures were passed, including restructuring of payments to the retirement plan and reforming the rate of compensation for boards and commissions.

The government of CNMI has long-standing financial accountability problems, including the inability to achieve unqualified ("clean") audit opinions on its financial statements, and numerous, long-standing material weaknesses in internal control over financial reporting and compliance with laws and regulations governing federal grant awards. CNMI received \$65.6 million in federal grants in fiscal year 2005, and its audited financial statements are used by federal agencies for overseeing and monitoring the use of federal grants. Progress has been made by CNMI concerning the timely submission of its audit reports. Specifically, for fiscal year 2004, CNMI's audited financial statements were 22 months late compared with 1 month late for its fiscal year 2005 submission. However, given CNMI's continued inability to achieve clean opinions on its financial statements and the continuing material internal control weaknesses over financial reporting, there is limited accountability over federal grants to this insular area. Furthermore, the lack of timely and reliable financial information hampers CNMI's ability to monitor programs and the reliability of financial

information, such as revenues and expenditures, in order to make informed decisions.

The DOI's Office of Insular Affairs² (OIA) has ongoing efforts to support economic development in CNMI and assist CNMI in addressing its accountability issues. To help diversify and strengthen the insular area economies (including CNMI), OIA has programs aimed at attracting American businesses to the insular areas. However, the effectiveness of these conferences and business opportunity missions is uncertain due to the lack of formal evaluation of these efforts. In addition, DOI's OIA and Inspector General (IG), along with other federal IGs, oversee CNMI's efforts to improve its financial accountability. OIA monitors the progress of completion and issuance of audit reports and provides general technical assistance funds to train insular area employees and enhance financial management systems and processes. Yet, progress has been slow and inconsistent. A focused effort is called for where direct and targeted attention is concentrated on the challenges facing CNMI to help CNMI achieve economic and fiscal stability. OIA plays a key role in this effort by helping CNMI and the other insular areas improve their business climates, identify areas of potential for private sector investment, and market insular areas to potential investors.

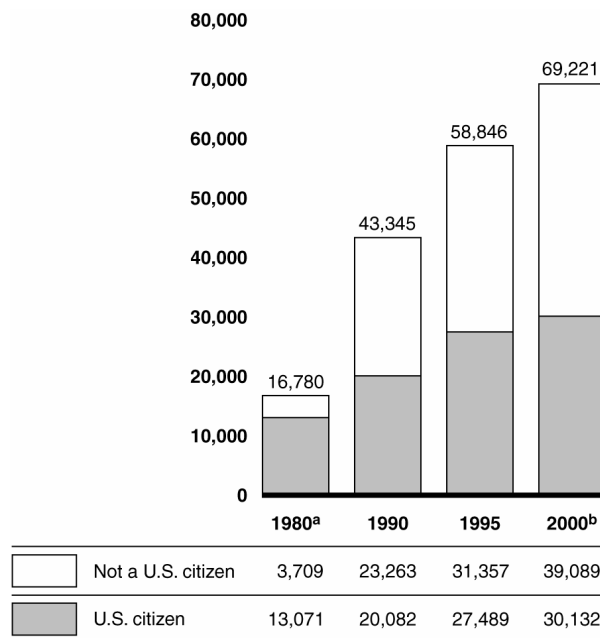
Strong leadership is needed to address CNMI's current challenges. During 2006, the CNMI government took dramatic steps to reverse prior patterns of deficit spending. The CNMI government will need to continue to work toward long-term sustainable solutions. In response to our recent report, OIA expressed its commitments to continuing its comprehensive approach and to implementing other innovative ideas to assist CNMI and the other insular areas to continue to improve financial management and accountability and to support economic development. We are encouraged by OIA's commitment to taking a leadership position in assisting CNMI and monitoring CNMI's progress in facing its current economic, fiscal, and accountability challenges.

²OIA's mission is to promote sound financial management processes, boost economic development, and increase the federal government's responsiveness to the unique needs of the insular areas.

Narrow Economic Base and Intrinsic and External Factors Limit Economic Progress in CNMI

Several factors constrain CNMI's economic potential, including the lack of diversification, scarce natural resources, small domestic markets, limited infrastructure, and shortages of skilled labor. The United States exercises sovereignty over CNMI, and, in general, federal laws apply to CNMI.³ However, federal minimum wage provisions and federal immigration laws do not apply.⁴ CNMI immigration policies and the demands for labor by the garment manufacturing industry and tourism sector have resulted in rapid population growth since 1980 such that the majority of the population are non-U.S. citizens. (See fig. 1.) According to U.S. Census Bureau data for 2000, the most recent census data available, about 56 percent of the CNMI population of 69,221 were not U.S. citizens.

Figure 1: Reported CNMI Population by Citizenship



Sources: U.S. Census Bureau; CNMI Central Statistics Division.

³CNMI is an unincorporated territory to which Congress has determined that only selected parts of the U.S. Constitution apply. Residents born in CNMI are U.S. citizens and although they have many of the rights of citizens of the 50 states, CNMI residents cannot vote in national elections and do not have voting representation in Congress.

⁴The U.S. House of Representatives and the Senate recently passed H.R. 2, "Fair Minimum Wage Act of 2007," which, if enacted, would make the federal minimum wage provisions applicable to CNMI with a phased-in implementation.

^aU.S. citizenship was not conferred to residents of CNMI until 1986. However, the CNMI Central Statistics Division has classified persons born in CNMI together with persons born in the United States or other territories as “U.S. citizens” for 1980.

^bThe 2000 decennial population census is the most recent population census information available.

According to U.S. Census Bureau data for 2000, the median household income in CNMI was \$22,898, a little more than half of the U.S. median household income of almost \$42,000 for 2000. The percentage of individuals in poverty in 2000 was 46 percent, nearly four times the continental U.S. rate of 12 percent in that same year.

CNMI’s economy depends on two industries, garment manufacturing and tourism, for its employment, production, and exports. These two industries rely heavily on a noncitizen workforce. This workforce⁵ represents more than three quarters of the labor pool that are subject to the CNMI minimum wage, which is lower than the U.S. minimum wage. The garment industry, for example, uses textiles and labor imported mostly from China. A 1999 study found that garment manufacturing and tourism accounted for about 85 percent of CNMI’s total economic activity and 96 percent of its exports.⁶ A 2005 estimate of CNMI’s gross domestic product (GDP) suggest that, in 2002, the garment industry contributed to roughly 40 percent of CNMI’s GDP and 47 percent of payroll.⁷ However, recent changes in trade laws have increased foreign competition for CNMI’s garment industry, while other external events have negatively impacted its tourism sector.

Decline in Garment Industry Tied to Trade Law Changes

Recent developments in international trade laws have reduced CNMI’s trade advantages, and the garment industry has declined in recent years. Historically, while garment exporters from other countries faced quotas and duties in shipping to the U.S. market, CNMI’s garment industry

⁵The 2000 U.S. Census shows that noncitizens, predominantly Chinese and Filipinos, make up over half of CNMI’s population. Almost all of these temporary foreign workers came to CNMI after 1990.

⁶Business Development Center, Northern Marianas College, *An Economic Study for the Commonwealth of the Northern Mariana Islands*, U.S. Department of the Interior, October 1999.

⁷See M. Rubin and S. Sawaya, *Final Trip Report on Benchmark Estimates of 2002 Gross Domestic Product in the Commonwealth of the Northern Mariana Islands* (Washington, D.C.: U.S. Census Bureau, 2005). Many businesses, including the garment factories, are owned and operated by foreigners.

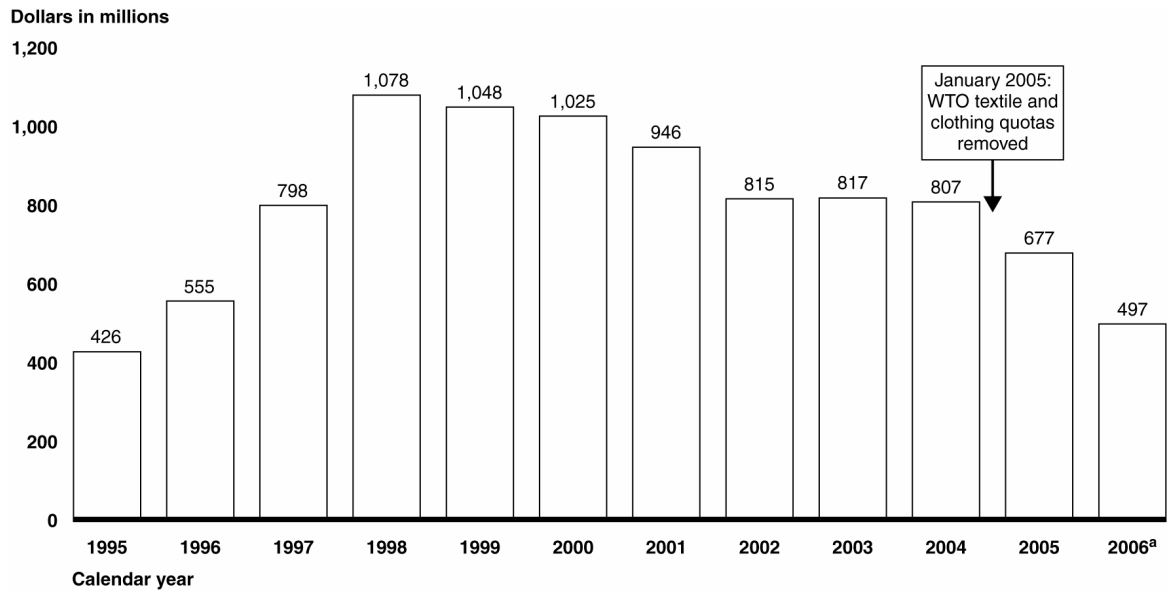
benefited from quota-free and duty-free access to U.S. markets for shipments of goods in which 50 percent of the value was added in CNMI.⁸ In recent years, however, U.S. agreements with other textile-producing countries have liberalized the textile and apparel trade. For example, in January 2005, in accordance with one of the 1994 World Trade Organization (WTO) Uruguay Round agreements, the United States eliminated quotas on textile and apparel imports from other textile-producing countries, leaving CNMI's apparel industry to operate under stiffer competition, especially from low-wage countries such as China.⁹ According to a DOI official, more than 3,800 garment jobs were lost between April 2004 and the end of July 2006, with 10 out of 27 garment factories closing.¹⁰ U.S. Department of Commerce data show that the value of CNMI shipments of garments to the United States dropped by more than 16 percent between 2004 and 2005, from about \$807 million to \$677 million, and down from a peak of \$1 billion in 1998–2000. In 2006, reported garment exports to the United States fell further, by an estimated 25 percent compared to 2005, with exports declining to an estimated \$497 million. The reported level of shipments to the United States in 2006 was comparable to levels of sales in 1995–1996, prior to the significant build-up of the industry. (See fig. 2.) In December 2006, the largest and oldest garment factory closed. Given that the garment industry is significant to CNMI's economy, these developments will likely have a negative financial effect on government revenue. For example, reported fees collected by the government on garment exports fell 37 percent from \$38.6 million in 2000 to \$24.4 million in 2005.

⁸ According to the U.S. Harmonized Tariff Schedule, certain items of which at least 50 percent of the value was added in a U.S. possession are eligible for duty-free shipment to the United States.

⁹ GAO, *U.S.-China Trade: Textile Safeguard Procedures Should Be Improved*, [GAO-05-296](#) (Washington, D.C.: Apr. 4, 2005.)

¹⁰ The burden of this job loss on the government may be mitigated to some extent by the fact that garment industry workers are almost exclusively foreigners on temporary guest visas. Also, data we obtained from the U.S. Census Bureau indicate that foreign workers send much of their earnings back to their countries of origin in the form of remittances; the remainder, which is spent on local goods and services, is relatively small, and as a result, has limited effect on local economic activity. Remittances were estimated at about \$80 million for 2002, roughly 10 percent of GDP, and at over \$100 million in 2005.

Figure 2: Reported U.S. Apparel Imports from CNMI



Sources: U.S. Dept. of Commerce, International Trade Administration, Office of Textiles & Apparel.

^aImport value for 2006 reflects 11 months of Commerce data and a GAO estimate for December imports based on changes in monthly shipments in 2005.

External Events Affect Tourism

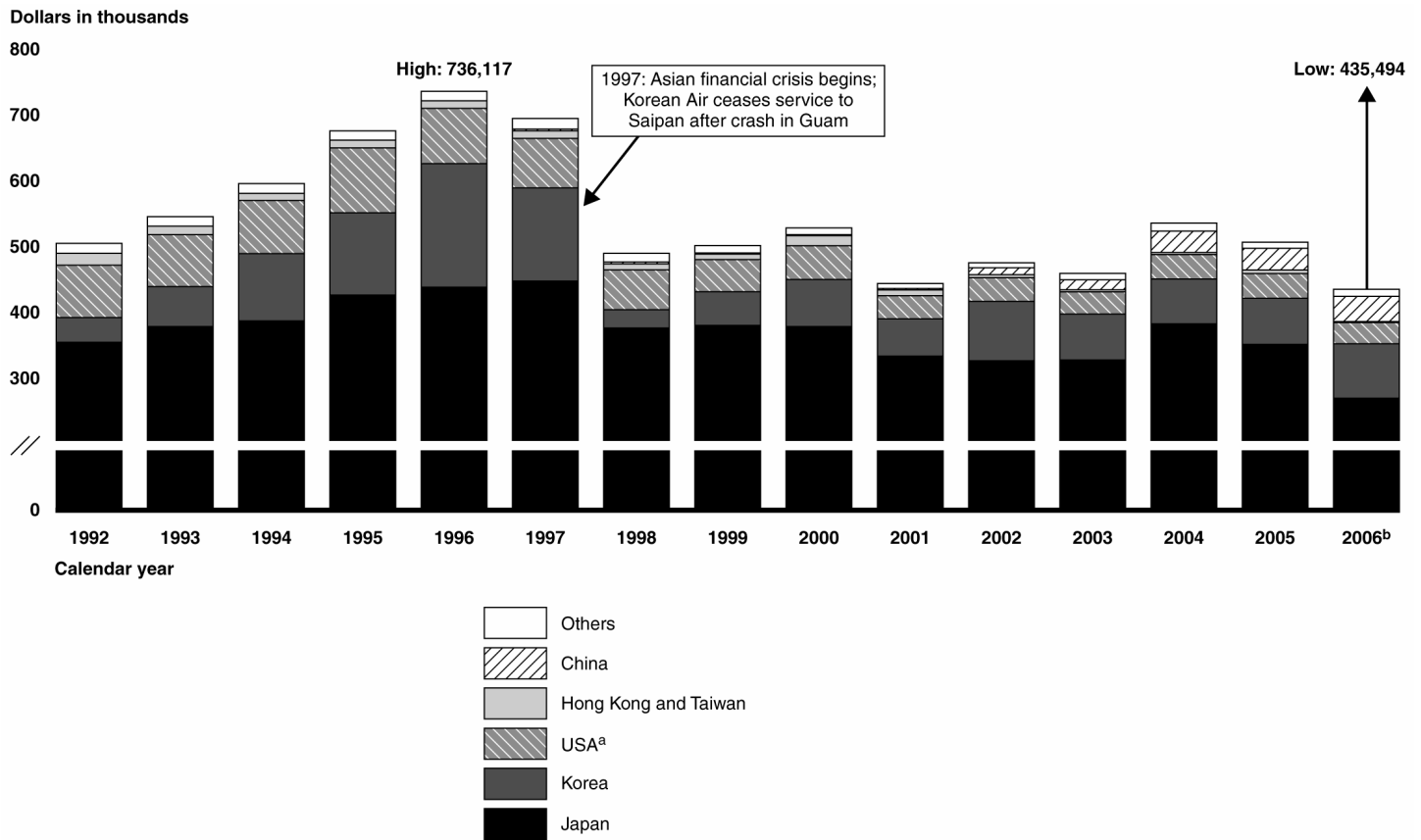
CNMI's tourism sector experienced a sharp decline in the late 1990s, and a series of external events have further hampered the sector. Tourism became a significant sector of economic activity in CNMI by the mid-1980s and continued to grow into the 1990s. Due to its proximity to Asia, Asian economic trends and other events have a direct effect on CNMI's economy. For example, tourism in CNMI experienced a sharp decline in the late 1990s with the Asian financial crisis and due to the cancellation of Korean Air service to CNMI following an airplane crash on Guam in August 1997. (See fig. 3.) Visitors from Korea, the second largest source of tourists, decreased by 85 percent from 1996 to 1998. After a modest recovery in 2000, tourism faltered again with the September 11, 2001, terrorist attacks on the United States. In 2003, according to CNMI officials, tourism slowed—with a double-digit decline in arrivals for several months—in reaction to the SARS epidemic and to the war in Iraq.

Tourism in CNMI is also subject to changes in airline practices. For example, Japan Airlines (JAL) withdrew its direct flights between Tokyo and Saipan in October 2005, raising concerns because roughly 30 percent

of all tourists and 40 percent of Japanese tourists arrive in CNMI on JAL flights, according to CNMI and DOI officials. The Marianas Visitors Authority's June 2006 data show that the downward trend in Japanese arrivals is not being offset by the growth in arrivals from other markets such as China and South Korea, with the total number of foreign visitors dropping from 43,115 in June 2005 to 38,510 a year later.¹¹ At the same time, CNMI has experienced increased Chinese tourists in recent years, which offer the potential to reenergize the industry.

¹¹China Southern Airlines' August 2006 decision to suspend its flights from Guangzhou City in China to Saipan in September because of low load factor, high fuel costs, and low yield in fares is likely to slow the growth of Chinese visitors and hinder CNMI's efforts to attract more tourists from China.

Figure 3: Reported CNMI Visitor Arrivals by Nation



Source: Marianas Visitors Authority.

^aUSA includes visitors from Guam.

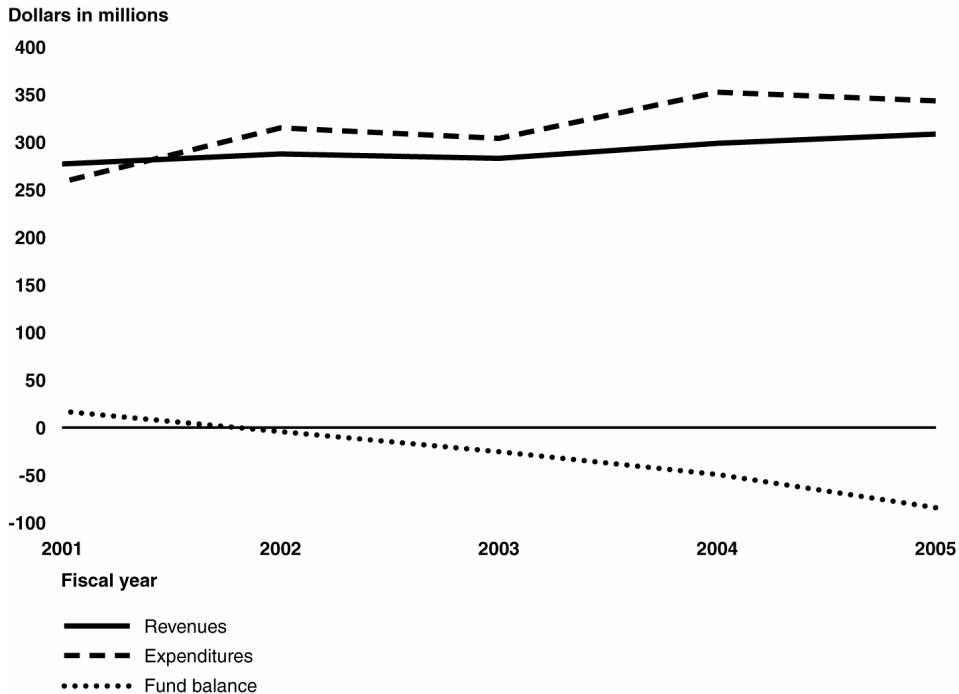
^bEffective October 2006, arrivals from Hong Kong are included with China.

CNMI's Reported Fiscal Condition Continues to Weaken

The fiscal condition of CNMI's government has steadily weakened from fiscal year 2001 through fiscal year 2005, the most recent year for which audited financial statements for CNMI were available. In addition, several indicators point to a severe financial crisis in fiscal year 2006. As shown in figure 4, CNMI's reported governmental fund balance declined from a positive \$3.5 million at the beginning of fiscal year 2001 to a deficit of \$84.1 million by the end of fiscal year 2005, as CNMI's expenditures for its governmental activities consistently exceeded revenues in each year since fiscal year 2002. Most of CNMI's governmental activities, which include basic services such as public safety, health care, general administration,

streets and parks, and security and safety, are reported in its governmental activities, or government funds. The fund balance (or deficit) for these activities reflects the amount of funds available at the end of the year for spending. A significant contributing factor to the gap between expenditures and revenues is that actual expenditures have exceeded budgeted expenditures each fiscal year during the period 2001 through 2005.¹²

Figure 4: Reported Revenues, Expenditures, and Fund Balance for CNMI's Government Activities



Source: GAO analysis of single audit reports covering fiscal years 2001, 2002, 2003, 2004, and 2005.

Another measure of fiscal health is the measure of net assets for governmental activities, which represents total assets minus total liabilities. As shown in table 1, CNMI has experienced a negative trend in its balance of net assets for governmental activities, going from a reported positive \$40.6 million balance at the end of fiscal year 2001 to a negative

¹² The over-expenditure of budget amounts has been recorded as a finding in CNMI's single audits since fiscal year 2000.

\$38 million balance at the end of fiscal year 2005.¹³ The primary difference between the fund balance measure and net assets is that the net assets include capital assets and long-term liabilities, whereas the fund balance figure focuses on assets available for current period expenditures and liabilities that are due and payable in the current period.

Table 1: CNMI's Fiscal Condition

	Fiscal Years Ending September 30,				
	2001	2002	2003	2004	2005
Data					
Population	71,868	74,003	76,129	78,252	80,362
Own source revenues	227,709,651	215,650,986	225,412,808	235,754,891	244,183,778
Federal contributions	49,348,134	71,964,627	57,560,034	63,006,595	64,346,950
Total Revenues	\$277,057,785	\$287,615,613	\$282,972,842	\$298,761,486	308,530,728
Total Expenditures	258,177,431	314,985,333	303,986,379	352,488,419	343,370,293
Revenues less Expenditures [Surplus/(Deficit)]	18,880,354	(27,369,720)	(21,013,537)	(53,726,933)	(34,839,565)
Total net other financing ^a	6,511,003	3,510,667	0	39,493,350	7,625
Governmental funds beginning year balance ^c	3,540,878	19,609,305 ^b	(4,249,748)	(35,011,807) ^b	(49,245,390)
Governmental funds end of year balance	17,219,852	(4,249,748)	(25,263,285)	(49,245,390)	(84,077,330)
Net Assets, end of year ^d	40,575,181	30,760,955 ^e	15,596,170	(18,656,437)	(38,131,589)
Change in net assets	—	(9,814,226)	(15,164,785)	(34,252,607)	(19,475,152)
Calculations					
Federal contributions as a percent of revenues	17.8	25.0	20.3	21.1	20.9
Government revenue per capita	\$3,855	\$3,887	\$3,717	\$3,818	\$3,839
Government expenditures per capita	3,592	4,256	3,993	4,505	4,273
Government revenue as percent of GDP ^f	—	.30	—	—	—
Government expenditures as percent of GDP ^f	—	.33	—	—	—

Source: GAO analysis of single audit reports covering fiscal years 2001, 2002, 2003, 2004, and 2005. The estimate of GDP, in the amount of \$946,854,877, came from *Final Trip Report on Benchmark Estimates of 2002 Gross Domestic Product in the Commonwealth of the Northern Mariana Islands*, U.S. Census Bureau, Feb. 11, 2005.

¹³The net asset amount at September 30, 2005, when compared to the fund balance amount as of the same date, includes an additional positive balance of \$46 million resulting from capital and deferred assets of approximately \$180.8 million less long-term liabilities of \$134.8 million.

Notes: Financial data in table 1 reflects CNMI's financial statements for its governmental activities, which include most of CNMI's basic services. This financial data does not include CNMI's component units, which are legally separate but related to CNMI. This financial data also does not include CNMI's fiduciary funds, because those funds cannot be used to finance CNMI operations.

CNMI's audited financial statements received qualified opinions from its external auditors and therefore, these amounts are subject to the limitations cited by the auditors in their opinions and to the material internal control weaknesses identified.

^aOther financing includes transfers in and out of other funds.

^bThe end-of-year fund balance for the prior fiscal year may not agree with the beginning of year fund balance for the succeeding fiscal year due to amounts being restated in subsequent financial statements. We could not readily identify explanations for these restatements because comparative information was not always available or disclosures were not made in subsequent financial statements.

^cGovernmental funds finance most of the basic services provided by the government.

^dNet assets are capital assets and other assets, such as cash and receivables, less liabilities.

^eThe amount reported is the restated amount from the 2003 Single Audit Report, corrected because of excluded and misstated amounts.

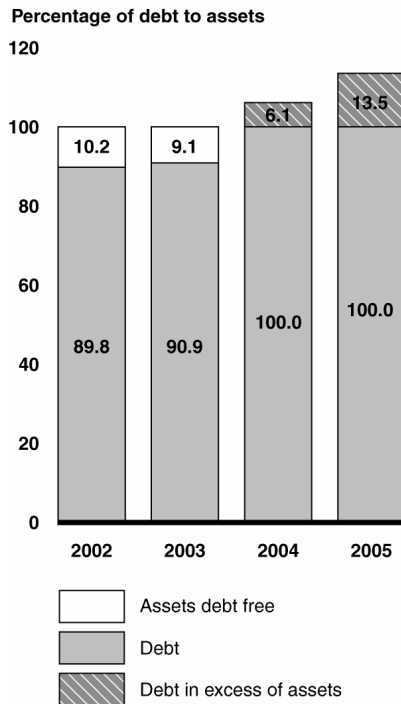
^fGDP estimates are not available for 2001, 2003, 2004, and 2005.

In order to finance its government activities in an environment where expenditures have exceeded revenues, CNMI has increased its debt and has not made the required contributions to its retirement fund. CNMI's reported balance of notes and bonds payable has increased from \$83 million in fiscal year 2002 to \$113 million in fiscal year 2005, representing an increase of 36 percent. CNMI's balance owed to its pension fund has increased from \$72 million in 2002 to \$120 million in 2005, representing an increase of 67 percent. CNMI has also been incurring penalties on the unpaid liabilities to the pension fund. The total amount of assessed penalties was \$24 million as of September 30, 2005.

As shown in figure 5, CNMI's reported debt to assets ratio¹⁴ has increased significantly, from 89.8 percent in fiscal year 2002 to 113.5 percent in 2005. In other words, at the end of fiscal year 2005, CNMI owed \$1.14 for every \$1.00 in assets that it held.

¹⁴The debt to asset ratio measures the extent to which CNMI had funded its assets with debt. The lower the debt percentage, the more equity CNMI has in its assets.

Figure 5: CNMI Debt to Assets



Source: Single audit reports, statements of net assets for fiscal years 2002, 2003, 2004, and 2005.

Although CNMI's audited fiscal year 2006 financial statements are not yet available, indicators point to a severe fiscal crisis during fiscal year 2006. In a May 5, 2006 letter to the CNMI Legislative leaders, Governor Benigno R. Fitial stated that "the Commonwealth is facing an unsustainable economic emergency. . . . I regret to say that the nature and extent of these financial problems are such that there is no simple or painless solution." CNMI has implemented several significant cost-cutting and restructuring measures during fiscal year 2006. For instance, in August 2006, CNMI enacted its Public Law No. 15-24 to implement "austerity holidays" consisting of bi-weekly furloughs, during which government employees are not paid and many government operations are closed. This measure was taken to help alleviate the financial crisis by saving millions of dollars in both personnel and operational costs. The measure declared unpaid holidays once per pay period for the remainder of fiscal years 2006 and 2007, reducing the government's normal pay period to 72 hours every 2 weeks. In June of 2006, CNMI enacted Public Law No. 15-15 to authorize the CNMI government to suspend the government's employer contributions to the retirement fund for the remainder of fiscal years 2006

and 2007. In addition, CNMI has passed laws to restructure loans among its component units, reform the rate of compensation for members of boards and commissions, increase the governor's authority to reprogram funds, extend the date for full funding of the retirement fund's defined benefit plan,¹⁵ and create a defined contribution retirement plan for government employees hired on or after January 1, 2007. These measures are immediate and dramatic, and are indicative of severe financial problems that will likely call for long-term solutions.

CNMI's Financial Accountability Remains Weak

CNMI has had long-standing financial accountability problems, including the late issuance of its single audit reports, the inability to achieve unqualified ("clean") audit opinions on its financial statements, and numerous material weaknesses in internal controls over financial operations and compliance with laws and regulations governing federal grant awards.

CNMI's Compliance with Single Audit Requirements

CNMI received a reported \$65.6 million in federal grants in fiscal year 2005 from a number of federal agencies. The five largest federal grantors in 2005 for CNMI included the Departments of Agriculture, Health and Human Services, Interior, Homeland Security, and Labor. As a nonfederal entity expending more than \$500,000 a year in federal awards, CNMI is required to submit a single audit report each year to comply with the Single Audit Act, as amended.¹⁶ Single audits are audits of the recipient organization—the government in the case of CNMI—that focus on the recipient's financial statements, internal controls,¹⁷ and compliance with laws and regulations governing federal grants.¹⁸ One of the objectives of

¹⁵Based on the actuarial report, dated October 1, 2004, the unfunded pension liability was estimated at \$552,042,142.

¹⁶31 U.S.C. Chp. 75.

¹⁷Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved—effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Internal control also serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud.

¹⁸Office of Management and Budget (OMB) Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, establishes policies for federal agencies to use in implementing the Single Audit Act and provides an administrative foundation for consistent and uniform audit requirements for nonfederal entities administering federal awards.

the act is to promote sound financial management, including effective internal controls, with respect to federal expenditures of the recipient organization. Single audits also provide key information about the federal grantee's financial management and reporting and are an important control used by federal agencies for overseeing and monitoring the use of federal grants.

For fiscal years 1997 through 2005, CNMI did not submit its single audit reports by the due date, which is generally no later than 9 months after the fiscal year end.¹⁹ CNMI's late submission of single audit reports means that the federal agencies overseeing federal grants to CNMI did not have current audited information about CNMI's use of federal grant funds. As shown in table 2, CNMI's single audit submissions were significantly late for fiscal years 1997 through 2004. However, CNMI has made significant progress in 2005 by submitting its fiscal year 2005 single audit report less than 1 month late.

Table 2: Reported Single Audit Act Report Submissions for Fiscal Years 1997 through 2005

Fiscal year end	Date single audit report due	Date single audit report received	Number of months late ^a
09/30/1997	10/31/1998	12/28/1999	14
09/30/1998	10/31/1999	12/28/1999	2
09/30/1999	06/30/2000	10/19/2000	4
09/30/2000	06/30/2001	10/17/2002	16
09/30/2001	06/30/2002	06/06/2003	11
09/30/2002	06/30/2003	08/09/2004	13
09/30/2003	06/30/2004	07/06/2005	12
09/30/2004	06/30/2005 ^b	04/17/2006	22
09/30/2005	06/30/2006	07/19/2006	1

Source: Auditors' reports, Federal Audit Clearinghouse, and GAO analysis.

^aCalculated based on the submission form date without regard to extensions granted to CNMI. The form date is the date the Federal Audit Clearinghouse receives the required single audit form certifying that the audit has been performed and summarizing its findings.

^bCNMI received an extension until February 28, 2006 for submission of the fiscal year 2004 single audit report.

¹⁹Under the Single Audit Act, the single audit reporting package is generally required to be submitted to the Federal Audit Clearinghouse either 30 days after the receipt of the auditor's report or 9 months after the end of the period under audit.

CNMI Unable to Achieve “Clean” Audit Opinions Due to Persistent, Significant Weaknesses

Auditors are required by OMB Circular No. A-133 to provide opinions (or disclaimers of opinion, as appropriate) as to whether the (1) financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) and (2) auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major federal program.

The CNMI government has been unable to achieve unqualified (“clean”)²⁰ audit opinions on its financial statements, receiving qualified opinions on the financial statements issued for fiscal years 1997 through 2005. Auditors render a qualified opinion when they identify one or more specific matters that affect the fair presentation of the financial statements. The effect of the auditors’ qualified opinion can be significant enough to reduce the usefulness and reliability of CNMI’s financial statements.

CNMI has made some progress in addressing the matters that resulted in the qualified opinions on its financial statements for fiscal years 2001 through 2003. However, some of the issues continued to exist in 2004 and 2005. The auditors identified the following issues in fiscal year 2005 that resulted in the most recent qualified audit opinion: (1) inadequacies in the accounting records regarding taxes receivable, advances, accounts payable, tax rebates payable, other liabilities and accruals, and the reserve for continuing appropriations, (2) inadequacies in accounting records and internal controls regarding the capital assets of the Northern Marianas College, and (3) the lack of audited financial statements for the Commonwealth Utilities Corporation, which represents a significant component unit of CNMI.

Auditors for CNMI also rendered qualified opinions on CNMI’s compliance with the requirements for major federal award programs from 1997 through 2005. In fiscal year 2005, the auditors cited noncompliance in the areas of allowable costs, cash management, eligibility, property management, procurement, and other requirements.

²⁰ Auditors express an unqualified (“clean”) opinion on financial statements when they have determined, based on sufficient review work, that the financial statements are presented fairly in all material respects, in accordance with generally accepted accounting principles.

Weaknesses over Financial Reporting and Compliance with Requirements for Major Federal Programs

CNMI has long-standing and significant internal control weaknesses over financial reporting and compliance with requirements for federal grants. Table 3 shows the number of material weaknesses and reportable conditions for CNMI for fiscal years 2001 through 2005. The large number and the significance of reported internal control weaknesses raise serious questions about the integrity and reliability of CNMI's financial statements and its compliance with requirements of major federal programs. Furthermore, the lack of reliable financial information hampers CNMI's ability to monitor programs and financial information such as revenues and expenses and to make timely, informed decisions.

Table 3: Reported Weaknesses Identified in the Auditors' Reports for Fiscal Years 2001 through 2005

Fiscal year	Internal control over financial reporting in accordance with government auditing standards (report on financial statements)			Compliance with requirements applicable to each major program and internal control over compliance with OMB Circular No. A-133 (report on federal awards)		
	Material weaknesses	Reportable conditions	Total	Material weaknesses	Reportable conditions	Total
2001	10	0	10	4	13	17
2002	9	1	10	2	14	16
2003	10	2	12	1	15	16
2004	8	5	13	2	31	33
2005	9	4	13	2	36	38

Source: CNMI single audit reports for fiscal years 2001 through 2005.

CNMI's 13 internal control reportable conditions²¹ for fiscal year 2005, 9 of which were material weaknesses,²² indicate a lack of sound internal control over financial reporting needed to provide adequate assurance that transactions are properly recorded, assets are properly safeguarded, and controls are adequate to prevent or detect fraud, waste, abuse, and mismanagement. For example, one of the material internal control

²¹Reportable conditions over financial reporting are matters that come to an auditor's attention related to significant deficiencies in the design or operation of internal controls that could adversely affect the entity's ability to produce financial statements that fairly represent the entity's financial condition.

²²Material weaknesses in financial reporting are reportable conditions in which the design or operation of internal controls does not reduce to a relatively low level the risk that misstatements caused by error or fraud—material in relation to the financial statements being audited—may occur and not be detected in a timely period by employees in the normal course of performing their duties.

weaknesses that the auditors reported for CNMI's government for fiscal year 2005 was the lack of audited fiscal year 2005 financial statements of the Commonwealth Utilities Corporation (Corporation), a significant component unit of CNMI.²³ Because the Corporation's financial statements were unaudited, the auditors could not determine the propriety of account balances presented in the financial statements that would affect CNMI's basic financial statements. CNMI's auditors also reported other significant material internal control weaknesses that have continued from previous years, such as improper tracking and lack of support for advances to vendors, travel advances to employees, liabilities recorded in the General Fund, and tax rebates payable. Due to the lack of detailed subsidiary ledgers and other supporting evidence, the auditors could not determine the propriety of these account balances. According to the auditors, the effect of these weaknesses is a possible misstatement of expenditures and related advances and liabilities, which also resulted in a qualification of the opinion on the fiscal year 2005 CNMI financial statements. Consequently, CNMI's financial statements may not be reliable.

As shown in table 3, auditors also reported 38 reportable conditions²⁴ in CNMI's compliance with requirements for major federal programs and the internal controls intended to ensure compliance with these requirements. Two of these reportable conditions were considered material weaknesses.²⁵

One of the two material internal control weaknesses affecting compliance with federal programs reported for CNMI's government for fiscal year 2005 included the failure to record expenditures for the Medical Assistance Program when they were incurred. Specifically, the auditors identified

²³A component unit is an organization that is not part of the primary government activities but for which the nature and significance of their relationship with a primary government are such that excluding the organization would cause the reporting entity's statements to be misleading or incomplete.

²⁴In the context of compliance, reportable conditions are matters that come to an auditor's attention related to significant deficiencies in the design or operation of internal controls over compliance that could adversely affect the entity's ability to operate a major federal program within the applicable requirements of laws, regulations, contracts, and grants.

²⁵Material weaknesses in this context are reportable conditions in which internal controls do not reduce to a relatively low level the risk of noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material to the major federal program being audited and undetected in a timely way by employees in the normal course of performing their duties.

expenditures in fiscal year 2005 for billings from service providers for services rendered in previous years. The effect of this weakness is that expenditures reported to the grantor agency, the U.S. Department of Health and Human Services, are based on the paid date and not, as required, the service date. In addition, actual expenditures incurred during the year are not properly recorded and, therefore, current year expenditures and unrecorded liabilities are understated. The other material weakness affecting compliance related to the lack of adherence to established policies and procedures for managing and tracking property and equipment purchased with federal grant funds. As a result, CNMI's government was not in compliance with federal property standards and its own property management policies and procedures. The other 36 reportable conditions concerned compliance with requirements regarding allowable costs; cash management; eligibility; equipment and property management; matching, level of effort, and earmarking; procurement and suspensions and debarment; reporting; subrecipient monitoring; and special tests and provisions that are applicable to CNMI's major federal programs.

In CNMI's corrective action plan for fiscal year 2005, CNMI officials agreed with almost all of the auditors' findings. According to its fiscal year 2005 corrective action plan, CNMI is working to get a current audit of its component unit, the Commonwealth Utilities Corporation. Other planned actions include properly reconciling advances to vendors; reviewing travel advance balances and making adjustments as needed, including making payroll deductions if expense vouchers are not filed timely; implementing procurement receiving procedures for prepaid items; making necessary corrections to its automated tax system to enable auditors to better review tax returns; determining the correct balances for construction projects; implementing controls over verifying eligibility for Medicaid and restricting access to the related data; and ensuring proper completion of inventories. The plan provides that most of the findings will be addressed by the end of fiscal year 2007. It is important to note however, that many of the auditors' findings, particularly those categorized as material weaknesses, are longstanding findings going back in some cases to 1987.

Efforts to Assist CNMI in Its Economic and Accountability Challenges

OIA has ongoing efforts to support economic development in CNMI and assist CNMI in addressing its accountability issues. OIA has in the last 3 years sponsored conferences in the United States and business-opportunity missions in the insular areas to attract American businesses to the insular areas. The main goal of these efforts is to facilitate interaction and the exchange of information between U.S. firms and government and business officials from the insular areas to spur new investment in a variety of industries. Innovative projects such as setting up a production and mass mailing facility in CNMI aimed at the Japanese market are reported to be underway.

OIA's efforts in helping to create links between the business communities in the United States and CNMI are key to helping meet some of the economic challenges. In our recent report,²⁶ we concluded that the insular areas would benefit from formal periodic OIA evaluation of its conferences and business-opportunity missions, including assessments of the cost and benefit of its activities and the extent to which these efforts are creating partnerships with businesses in other nations. In our December 2006 report, we recommended that OIA conduct such formal periodic evaluations to assess the effect of these activities on creating private sector jobs and increasing insular area income. OIA agreed with our recommendation.

DOI's OIA and IG, other federal inspectors general, and local auditing authorities assist or oversee CNMI's efforts to improve its financial accountability.²⁷ OIA monitors the progress of completion and issuance of the single audit reports as well as providing general technical assistance funds to provide training for insular area employees and funds to enhance financial management systems and processes. DOI's IG has audit oversight responsibilities for federal funds in the insular area.

To promote sound financial management processes in the insular area government, OIA has increased its focus on bringing the CNMI government into compliance with the Single Audit Act. For example, OIA

²⁶GAO-07-119.

²⁷Although the insular areas receive grants from many federal agencies, one of the grant-making agencies is designated as the cognizant agency for purposes of the Single Audit Act. The cognizant agencies have specific responsibilities under OMB Circular No. A-133. The cognizant agency is usually the agency that provides the predominant amount of funding. The cognizant agency for CNMI is DOI.

created an incentive for CNMI to comply with the act by stating that an insular area cannot receive capital funding unless its government is in compliance with the act or has presented a plan, approved by OIA, that is designed to bring the government into compliance by a certain date. In addition, OIA provides general technical assistance funds for training and other direct assistance, such as grants, to help the insular area governments comply with the act and to improve their financial management systems and environments. The Graduate School of the U.S. Department of Agriculture (USDA) has been working with OIA for over a decade through its Pacific Islands and Virgin Islands Training Initiatives (PITI and VITI) to provide training and technical assistance.

OIA staff members make site visits to CNMI as part of its oversight activities. In our December 2006 report, we recommended that OIA develop a standardized framework for its site visits to improve the effectiveness of its monitoring. We also recommended that OIA develop and implement procedures for formal evaluation of progress made by the insular areas to resolve accountability findings and set a time frame for achieving clean audit opinions. OIA agreed with our recommendations and noted that it had already made some progress during fiscal year 2006. Establishing a routine procedure of documenting the results of site visits in a standard framework would help ensure that (1) all staff members making site visits are consistent in their focus on overall accountability objectives and (2) OIA staff has a mechanism for recording and following up on the unique situations facing CNMI.

Conclusions

CNMI faces daunting economic, fiscal, and financial accountability challenges. CNMI's economic and fiscal conditions are affected by its economy's general dependence on two key industries. In addition, although progress has been made in improving financial accountability, CNMI continues to have serious internal control and accountability problems that increase its risk of fraud, waste, abuse, and mismanagement.

Efforts to meet formidable fiscal challenges in CNMI are exacerbated by delayed and incomplete financial reporting that does not provide officials with the timely and complete information they need for effective decision making. Timely and reliable financial information is especially important as CNMI continues to take actions to deal with its fiscal crisis.

OIA has ongoing efforts to assist CNMI in addressing its accountability issues and to support economic development in CNMI. OIA officials

monitor CNMI's progress in submitting single audit reports, and OIA provides funding to improve financial management. Yet, progress has been slow and inconsistent. The benefit to CNMI of past and current assistance is unclear. Federal agencies and CNMI have sponsored and participated in conferences, training sessions, and other programs to improve accountability, but knowing what has and has not been effective and drawing the right lessons from this experience is hampered by a lack of formal evaluation and data collection.

Strong leadership is needed for CNMI to weather its current crisis and establish a sustainable and prosperous path for the future. During 2006, the CNMI government took dramatic steps to reverse prior patterns of deficit spending. The CNMI government will need to continue to work toward long-term sustainable solutions. A focused effort is called for in which direct and targeted attention is concentrated on the challenges facing CNMI, with feedback mechanisms for continuing improvement to help CNMI achieve economic, fiscal, and financial stability. OIA plays a key role in this effort. In its comments on our December 2006 report, OIA pointed out that it provides "a crucial leadership role and can provide important technical assistance" to help CNMI and the other insular areas improve their business climates, identify areas of potential for private sector investment, and market insular areas to potential investors. It also noted that improving accountability for federal financial assistance for CNMI and other insular areas is a major priority. OIA has stated its commitment to continuing its comprehensive approach and to implementing other innovative ideas to assist CNMI and the other insular areas in continuing to improve financial management and accountability. Leadership on the part of the CNMI government and OIA is critical to addressing the challenges CNMI faces and to providing long-term stability and prosperity for this insular area.

Mr. Chairman and Members of the Committee, this concludes my statement. I would be pleased to answer any questions that you and other Members of the Committee may have at this time.

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