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Report No: PADHI00678

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED GRANT

IN THE AMOUNT OF SDR 9.9 MILLION

(US$13 MILLION EQUIVALENT)

TO THE

FEDERATED STATES OF MICRONESIA

FOR A

STRENGTHENING PUBLIC FINANCIAL MANAGEMENT II PROJECT

(P181237)

FEBRUARY 11, 2025

Governance Global Practice

East Asia and Pacific Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective November 30, 2024)

Currency Unit =	
SDR 0.76108 =	US$1
US$1.31391 =	SDR 1

FISCAL YEAR

October 1 - September 30

Regional Vice President:	Manuela V. Ferro
Regional Director:	Lalita M. Moorty
Country Director:	Stephen N. Ndegwa
Practice Manager:	Patricia Mc Kenzie
Task Team Leaders:	Bonnie Ann Sirois, Elena Georgieva Georgieva-Andonovska

ABBREVIATIONS AND ACRONYMS

BCR	Benefit-cost ratio	IRR	Internal rate of return
CBA	Cost Benefit Analysis	MFD	Maximizing Finance for Development
CIU	Central Implementation Unit	NDC	Nationally Determined Contribution
COA	Chart of Accounts	NPV	Net Present Value
COM	College of Micronesia	ONPA	Office of the National Public Auditor
CPIA	Country Policy and Institutional Assessment	PDO	Project Development Objective
CTEC	Career and Technical Education Center	PIANGO	Pacific Islands Association of Non-Government Organizations
DA	Designated Account	PIC	Pacific Island country
DOFA	Department of Finance and Administration	PITI-VITI	Pacific & Virgin Islands Training Initiative
E&S	Environmental and Social	PIU	Project Implementation Unit
ESCP	Environmental and Social Commitment Plan	PEFA	Public Expenditure and Financial Accountability
FM	Financial Management	PFM	Public Financial Management
FMIS	Financial Management Information System	PFTAC	Pacific Financial Technical Assistance Centre
FMR	Financial Management Regulations	PM	Project Manager
FSM	Federated States of Micronesia	POM	Project Operations Manual
FY	Financial year	PPs	Procurement Plans
GASB	Government Accounting Standards Board	PPSD	Project Procurement Strategy for Development
GDP	Gross Domestic Product	PSC	Project Steering Committee
GFS/COFOG	Government Finance Statistics /Expenditure by Function of Government	RPF	Regional Partnership Framework
GHG	Greenhouse Gas	RRA	Risk and Resilience Assessment
GoFSM	Government of FSM	SEP	Stakeholder Engagement Plan
HRD	Human Resource Development	SFO	State Finance Office
IA	Implementing Agency	SOP	Standard Operating Procedures
IBRD	International Bank for Reconstruction and Development	STEP	Systematic Tracking of Exchanges in Procurement
ICT	Information and Communication Technology	TOR	Terms of Reference
IDA	International Development Association	TWG	Treasury Working Group
IFR	Interim Financial Report	US	United States
IGFOA	Island Governments Finance Officers Association	WDI	World Development Indicators

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DATASHEET

BASIC INFORMATION

Project Beneficiary(ies)	Operation Name		
Micronesia, Federated States of	Strengthening Public Financial Management II Project		
Operation ID	Financing Instrument	Environmental and Social Risk Classification	
P181237	Investment Project Financing (IPF)	Low	

Financing & Implementation Modalities

[ ] Multiphase Programmatic Approach (MPA)	[ ] Contingent Emergency Response Component (CERC)
[ ] Series of Projects (SOP)	[✓] Fragile State(s)
[ ] Performance-Based Conditions (PBCs)	[✓] Small State(s)
[ ] Financial Intermediaries (FI)	[ ] Fragile within a non-fragile Country
[ ] Project-Based Guarantee	[ ] Conflict
[ ] Deferred Drawdown	[ ] Responding to Natural or Man-made Disaster
[ ] Alternative Procurement Arrangements (APA)	[ ] Hands-on Expanded Implementation Support (HEIS)

Expected Approval Date	Expected Closing Date
05-Mar-2025	29-Mar-2030
Bank/IFC Collaboration	
No	

Proposed Development Objective(s)

To improve fiscal management practices and increase fiscal transparency at the National Government level.

Components

Component Name	Cost (US$)
Improved fiscal management practices and controls	4,625,000.00
Expanded Core Financial Management Information Systems	4,325,000.00
Enhanced Human Resource Capacity, Communications and Change Management	2,300,000.00
Project Management	1,750,000.00

Organizations

Borrower:	The Federated States of Micronesia		
Contact	Title	Telephone No.	Email
Implementing Agency:	Department of Finance and Administration		
Contact	Title	Telephone No.	Email
Rose Nakanaga	Secretary of Finance	6919201987	rose.nakanaga@dofa.gov.fm

PROJECT FINANCING DATA (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? Yes

Is this project Private Capital Enabling (PCE)? No

SUMMARY

Total Operation Cost	**13.00**
Total Financing	**13.00**
of which IBRD/IDA	**13.00**
Financing Gap	**0.00**

DETAILS

World Bank Group Financing

International Development Association (IDA)	13.00
IDA Grant	13.00

IDA Resources (US$, Millions)

	Credit Amount	Grant Amount	SML Amount	Guarantee Amount	Total Amount
National Performance-Based Allocations (PBA)	0.00	13.00	0.00	0.00	13.00
Total	**0.00**	**13.00**	**0.00**	**0.00**	**13.00**

Expected Disbursements (US$, Millions)

WB Fiscal Year	2025	2026	2027	2028	2029	2030	2031
Annual	0.11	1.81	2.86	2.44	2.82	2.87	0.09
Cumulative	0.11	1.93	4.79	7.23	10.05	12.91	13.00

PRACTICE AREA(S)

Practice Area (Lead)

Governance

Contributing Practice Areas

CLIMATE

Climate Change and Disaster Screening

Yes, it has been screened and the results are discussed in the Operation Document

SYSTEMATIC OPERATIONS RISK- RATING TOOL (SORT)

Risk Category	Rating
1. Political and Governance	Moderate
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Moderate
7. Environment and Social	Low
8. Stakeholders	Moderate
9. Overall	Moderate

POLICY COMPLIANCE

Policy

Does the project depart from the CPF in content or in other significant respects?

[ ] Yes [✓] No

Does the project require any waivers of Bank policies?

[ ] Yes [✓] No

ENVIRONMENTAL AND SOCIAL

Environmental and Social Standards Relevance Given its Context at the Time of Appraisal

E & S Standards	Relevance
ESS 1: Assessment and Management of Environmental and Social Risks and Impacts	Relevant
ESS 10: Stakeholder Engagement and Information Disclosure	Relevant
ESS 2: Labor and Working Conditions	Relevant

ESS 3: Resource Efficiency and Pollution Prevention and Management	Not Currently Relevant
ESS 4: Community Health and Safety	Not Currently Relevant
ESS 5: Land Acquisition, Restrictions on Land Use and Involuntary Resettlement	Not Currently Relevant
ESS 6: Biodiversity Conservation and Sustainable Management of Living Natural Resources	Not Currently Relevant
ESS 7: Indigenous Peoples/Sub-Saharan African Historically Underserved Traditional Local Communities	Not Currently Relevant
ESS 8: Cultural Heritage	Not Currently Relevant
ESS 9: Financial Intermediaries	Not Currently Relevant

NOTE: For further information regarding the World Bank's due diligence assessment of the Project's potential environmental and social risks and impacts, please refer to the Project's Appraisal Environmental and Social Review Summary (ESRS).

LEGAL

Legal Covenants

Sections and Description
Section I.A.1 of Schedule 2 The Recipient shall, no later than one (1) month after the Effective Date, establish and thereafter maintain throughout the Project implementation period, the Project Steering Committee with mandate, composition and resources satisfactory to the Association.
Section I.A.3 of Schedule 2 The Recipient shall, no later than one (1) month after the Effective Date, establish and thereafter maintain throughout the Project implementation period, the Treasury Working Group, with mandate, composition and resources satisfactory to the Association.
Section I.A.4 of Schedule 2 The Recipient shall, no later than one (1) month after the Effective Date, establish and thereafter maintain throughout the Project implementation period a Project Implementation Unit within DOFA, with mandate, composition and resources satisfactory to the Association.
Section I.C.1(a) of Schedule 2 The Recipient shall prepare and furnish to the Association not later than one (1) month after the Effective Date (or such later date as the Association may agree), for the Association's no-objection, an Annual Work Plan and Budget containing all eligible Project activities and Eligible Expenditure, inclusive of Operating Costs, proposed to be included in the Project in the Recipient's following calendar year.
Section II.2 of Schedule 2 The Recipient shall carry out, jointly with the Association, not later than three (3) years after the Effective Date, or such other period as may be agreed with the Association, a mid-term review of the Project ("Mid-Term Review") to assess the status of Project implementation, as measured against the indicators acceptable to the Association, and compliance with the legal covenants included or referred to in this Agreement.

Conditions

Type	Citation	Description	Financing Source
Effectiveness	Article 4.01	The Additional Condition of Effectiveness consists of the following, namely that the Recipient has prepared and adopted the Project Operations Manual in accordance with Section I.B of Schedule 2 to this Agreement.	IBRD/IDA
Disbursement	Section III.B.1(a) of Schedule 2	No withdrawal shall be made for payments made prior to the Signature Date except that withdrawals up to an aggregate amount not to exceed SDR1.75 is available for payments made prior to this date but on or after May 31, 2024, for Eligible Expenditures under Category (1).	IBRD/IDA
Disbursement	Section III.B.1(b) of Schedule 2	No withdrawal shall be made for Eligible Expenditures under Category (2), until and unless the Association has notified the Recipient that the conditions set forth in Section 5.15 (a) of the General Conditions have been fulfilled.	IBRD/IDA
Disbursement	Section III.B.1(c) of Schedule 2	No withdrawal shall be made for Complementary Financing for the Cat DDO under Category (3), until and unless: (i) the Recipient has furnished to the Association a request to reallocate and thereafter withdraw all or part of the Unwithdrawn Credit Balance for the	IBRD/IDA

		Complementary Financing for the Cat DDO, and such notice specifies the Cat DDO Legal Agreement; and (ii) the Association has accepted said request and notified the Recipient thereof, and is satisfied, based on evidence satisfactory to it, that the conditions precedent to withdrawal of the financing provided under the Cat DDO Legal Agreement have been fulfilled.	

I. STRATEGIC CONTEXT

A. Country Context

1. The Federated States of Micronesia (FSM) is a small and geographically dispersed Pacific Island country (PIC) that gained its independence in 1986. FSM comprises four states, namely: Yap, Chuuk, Pohnpei, and Kosrae. The capital city is Palikir, situated on the island of Pohnpei. FSM has a population of about 114,164 persons in 2022 (World Development Indicators (WDI), 2023). The population is diverse, and English is the official language, though each state also has its own local languages. Prior to independence in 1986, FSM was administered by the United States (US) as part of the Trust Territory of the Pacific Islands. While it has its own government and constitution, the country also maintains a close relationship with the US through a Compact of Free Association ("Compact"). The FSM receives through the Compact yearly financial transfers, a source of revenue to the government. Between FY2017 and FY2019, for instance, the Compact contributed about 23 percent to total revenues on average.[1]

2. The FSM faces anemic economic growth and poverty reduction due to structural challenges. FSM is reported to have the highest estimated rates of poverty among the nine small remote islands (PIC9) covered in the World Bank Regional Partnership Framework (RPF) for FY17 to FY21.[2] Tax revenue (% GDP) averaged 10.6 percent between 2012 and 2020, compared to the PIC9 average of 24.5 percent in 2020 (WDI, 2023). In FY2024, of the 88.5 percent of the total revenue projected to be generated domestically, Fishing Access Fees comprise about 51.7 percent, with Tax Revenue making up 14.9 percent of total revenue (Citizen-friendly Budget, 2024). Heavy concentration on the fishing sector coupled with import dependency exposes the country to global economic shocks and price spikes, as well as climate shocks.[3]

3. Negative net migration has driven a decline in the population in the past decade, resulting in an acute shortage of skilled labor. Between 2012 and 2022, FSM's population size declined by about 10 percent, with outbound migration playing a central role[4]. Citizens of FSM are granted visa-free access to live, work and study in the US under the provisions of the Compact, enabling ease of outward migration. The resulting capacity constraint in skilled labor creates overdependency on foreign experts and culminates in limited opportunities for domestic revenue generation and economic growth.

4. Fragility also constrains FSM's development potential, with limited progress in systematically addressing its drivers. FSM is classified by the World Bank as a "fragile and conflicted-affected situation".[5] The 2017 Regional Risk and Resilience Assessment (RRA) for the PIC9 identified extreme geography (which tends to increase cost of public service delivery), thin institutional capacity and governance, as well as vulnerability to exogeneous shocks, including climate change, disasters, and global economic shocks as key sources of fragility. FSM is very vulnerable to natural disasters and climate change and has suffered significant adverse environmental, social, and economic losses because of hazards

[1] International Monetary Fund. (March 2024.) 2023 Article IV Consultation. IMF Country Report 24/66.
[2] "World Bank Group. 2017. Regional Partnership Framework: For Kiribati, Republic of Nauru, Republic of The Marshall Islands, Federated States of Micronesia, Republic of Palau, Independent State of Samoa, Kingdom of Tonga, Tuvalu, and Vanuatu, FY17-FY21. © World Bank, Suva, Fiji. Government of the Federated States of Micronesia. 2022. FSM Economic and Fiscal Update 2022. Report No. 100997-EAP. The RPF was extended to FY 2023 by the Board of Executive Directors on February 6, 2020.
[3] Imports of goods and services in FSM constituted about 76 percent of GDP in 2022 (WDI, 2023).
[4] International Monetary Fund. (March 2024.) 2023 Article IV Consultation. IMF Country Report 24/66.
[5] The classification distinguishes between: (i) Countries with high levels of institutional and social fragility, identified based on indicators that measure the quality of policy and institutions, and manifestations of fragility; (ii) Countries affected by violent conflict, identified based on a threshold number of conflict-related deaths relative to the population.

induced by climate change.[6] COVID-19 exacerbated these challenges by diverting the government of FSM (GoFSM)'s attention and resources away from other long-term development priorities. Throughout the COVID-19 crisis, FSM's vulnerability to external economic developments generated significant negative impacts on the economy. The international travel restrictions and closed national borders further contributed to limited human resources and made the thin administrative capacity more visible.

B. Sectoral and Institutional Context

5. In FSM, each state government has its own executive and legislative bodies and exercises considerable autonomy to manage its domestic affairs. Most public services are delivered at the state level. The FSM framework for public financial management (PFM) is guided by separate constitutions at the national and state level. The national and state governments each have their own public financial management legislative frameworks, with separate acts and regulations in force in each jurisdiction. The fiscal relationship between the National Government and the four states is reflected in revenue sharing of certain taxes and revenues in the form of grants to the four states. Due to the federal structure and large geographical distances, accomplishing policy and reform decisions at the national and state level is challenging, as consensus across the national and the state governments is required.

6. The Department of Finance and Administration (DOFA) is the key Department in the FSM responsible for policy and strategic advice, as well as financial management for the National Government. DOFA's mission is to provide financial oversight and support to whole of GoFSM to ensure fiscal responsibilities and sound financial management systems are carried out in a sustainable manner, and to ensure financial and performance accountability across GoFSM. DOFA is organized across five divisions, including: Treasury; Customs and Taxes; Investment and International Finance Budget and Economic Management.

7. The capacity constraints arising from acute skilled labor shortages and elevated levels of outbound migration adversely impact GoFSM's ability to effectively carry out public financial management. FSM suffers from a shortage of accounting, finance and procurement skills and prolonged staff vacancies persist in DOFA[7]. Limited tertiary or professional education programs are available locally to develop these skills. As a result, DOFA is largely dependent on expatriate consultants for public finance expertise and outsources the preparation of annual financial reports in accordance with principles set out by the US Government Accounting Standards Board (US GASB), which GoFSM has adopted as its national accounting framework. This challenge of attracting and retaining skilled workers has the potential for a long-term negative impact on the public financial management capacity of GoFSM. An Accounting Technician Program currently under development by the College of Micronesia (COM)-FSM's Career and Technical Education Center (CTEC) aims to mitigate this challenge and will provide the basis for the first professional qualification for accounting offered in the country.

8. Historically, assessments of PFM performance have indicated weaker performance in the FSM compared with regional, income group and global averages. A Public Expenditure and Financial Accountability (PEFA) assessment completed in 2012[8] reflects this finding. FSM's performance was assessed as significantly weaker than regional, income group and global averages, particularly in Credibility of the Budget[9], Comprehensiveness and Transparency, Policy-Based

[6] For example, in 2015, Typhoon Maysak, affected about 29,000 people and caused US$8.5 million in direct damages. United States Agency for International Development, Micronesia – Typhoon Maysak Fact Sheet #3, Fiscal Year (FY) 2015. Available at: https://www.usaid.gov/document/typhoon-maysak-fact-sheet-3-04-22-2015

[7] The vacancy rate in DOFA as of October 2024 is 14 percent.

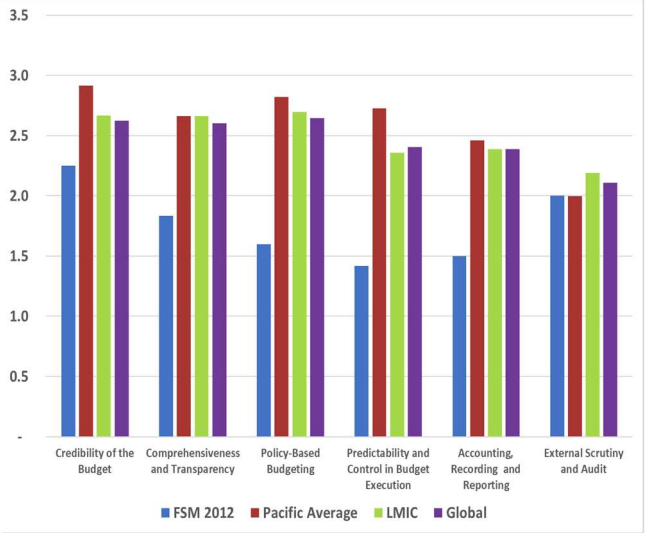
[8] The 2012 PEFA has not been published.

[9] Credibility of the budget is affected the highly variable nature of fishing revenue and the legislated requirement to present a balanced budget proposal to Congress. As a result, very conservative estimates of revenues are presented in the original budget and supplemental budgets are

Budgeting, Predictability and Control in Budget Execution, and Accounting, Recording and Reporting (see Figure 1.) Scores for Budget Classification and Comprehensiveness were assessed at C and D respectively, while the score for Public Access to Information was assessed at a C level. A 2016 PEFA self-assessment reflected some improvements in these areas, however, the results were not independently verified. It should be noted that while PEFA does provide useful insights into performance, capacity constraints in the smaller PICs limit their potential to meet "best or good practice" and there is a high correlation between population and PEFA scores (Haque, Knight, and Jayasuriya - 2015).

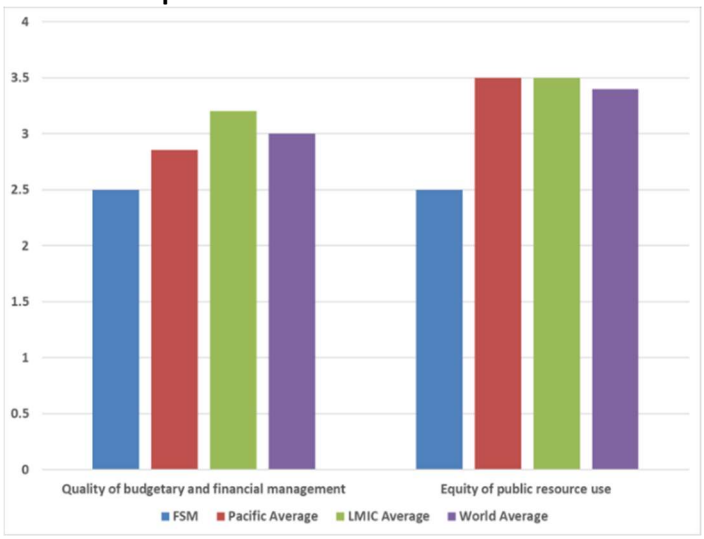
9. More recent assessments of governance indicators measured in the World Bank's Country Policy and Institutional Assessments (CPIA) continue to show mixed performance for FSM when compared with Pacific, Income Group and Global Averages. The most recent CPIA scores from 2022 highlight weaker performance for FSM compared with Pacific, Income Group and Global Averages across indicators related to *Quality of Budgetary and Financial Management* and *Equity of Public Resource Use* (see Figure 2.)

Figure 1: FSM PEFA Scores 2012 (by Pillar) Compared with Pacific, Income Group and Global Averages



Source: FSM 2012 Draft PEFA and PEFA website

Figure 2: Relevant CPIA Indicators 2022 – FSM, Pacific, Income Group and Global



Source: Country Policy and Institutional Assessment Databank

10. PFM reform in FSM is guided by the PFM Reform Roadmap 2023-2026, which sets out the vision for achieving better PFM outcomes at both National and State level and has strong political support. Priorities in the roadmap include: i) an improved budget system that is more comprehensive and open; ii) timely budget recording and reporting, including improved in year budget reporting; iii) procurement efficiency, management and supervision; iv) increased availability of information to the public; v) improved financial records and information; vi) strengthened arrangements for the control and supervision of the use of funds; viii) improved internal compliance; and ix) enhanced capacity development, focusing on ensuring DOFA can lead the reform agenda. The roadmap was developed under the previous administration but endorsed by the current administration. Quarterly updates are required to be prepared showing progress against the roadmap – the first of these was published on the DOFA website in July 2023. The strong political support for PFM reform is reinforced by external drivers creating demand for overall PFM reform and strengthening, including complying with US

passed throughout the year, resulting in significant variances between budgeted vs actual revenues and expenditures. Policy-level reforms are required to effectively address this issue.

GASB reporting requirements. While the roadmap has only been in place for one year, some progress has already been made against the stated priorities.

11. In recent years, GoFSM has taken a number of steps to strengthen institutional capacity to carry out core public finance functions. With assistance provided by the World Bank-financed *Project for Strengthening Public Financial Management (P161969, "PFM I" hereafter)* and other development partners, new Financial Management Regulations (FMRs) were enacted at FSM national level and for three out of the four states (Pohnpei, Kosrae and Yap) between 2021 and 2024. The FMRs include additional provisions on the responsibilities of key stakeholders, planning and budgeting processes, revenue collection, procurement, fixed assets and financial reporting. The Budget Division developed Standard Operating Procedures (SOP) to guide the preparation, adoption, implementation and evaluation of the budget. With support from PFM I, a new unified Chart of Accounts (COA) is being prepared across governments to align with Government Finance Statistics reporting and US GASB, the implementation of a Revenue Management System is well underway to digitize tax administration and taxpayer payments, and a new Financial Management Information System (FMIS) is being implemented across national and the four state governments to support budget execution and reporting. The development of updated procedural manuals is also underway to capture reengineered business processes aligned with these reforms and modernized information technology systems. PFM I further supported DOFA in the development of a new gender-informed competency-based framework and training programs and establishment of training partnerships. A restructuring of DOFA is underway to redefine job descriptions with core competencies. To increase availability of information to the public, DOFA has launched a website and published its first Citizens' Budget in 2024. DOFA has also developed a gender sensitive change management and communications strategy to support PFM reforms.

12. Despite recent improvements, gaps persist in fiscal management practices and controls related to budgeting, financial reporting and procurement. Budgeting weaknesses in FSM relate to comprehensiveness of budget documentation and classification of the budget, which impact overall budget quality. Additionally, the Budget Procedures Act 1981 requires modernization to address challenges in forecasting highly variable domestic revenues and "carry over" budgets. These foundational weaknesses limit the ability to advance GoFSM's budgeting process maturity to a more advanced level which would enable effective performance budgeting and linkages with policy priorities. A lack of in-house capacity to generate US GASB financial statements has necessitated annual financial reporting to be outsourced. However, outsourcing this function has become unsustainable due to cost and timeliness issues. No procurement manual is in place which details GoFSM's approach to processing procurement and there is no clear assessment criteria nor systematic approach for evaluating bids. Procurement and contract management processes are performed manually and are not carried out uniformly across Departments. Procurement is regulated through the FMR 2021, but these are not currently aligned with international public procurement standards. Additionally, while initial steps to create positions for an internal audit unit have been taken, technical assistance is required to operationalize the unit.

13. Implementation of the new FMIS is ongoing and further expansion of core financial management information systems is required. Operational acceptance of the new FMIS is expected to take place in July 2025, with broader rollout across government Departments and agencies in subsequent years. The FMIS will facilitate, *inter alia*, budget preparation and execution, accounting, financial control, and in-house preparation of financial reports. Continued rollout of the FMIS requires dedicated ongoing support and technical assistance to effectively use financial data to supervise, manage and monitor budget execution. An assessment is required to identify functional and technical requirements for further automation of public finance in priority areas such as procurement. There is no systematic use of online tendering, limited publication of large, international selections online, and limited publicly disclosed information on annual procurement spending and other reporting. Conducive to these efforts, connectivity across FSM is expected to improve in the coming years through the support of the World Bank-financed *Digital Federated States of Micronesia Project (P170718)*, which aims to strengthen the enabling environment for digital government.

14. Public budget hearings and the recent publication of the Citizens' Budget provide a degree of transparency over public finances, but public engagement remains limited throughout the budget cycle. Specifically, information on budgets, procurement and financial reports are generally not available to the public, and there is limited citizen engagement on planning, budgeting, and government programs' design. The 2022 GovTech Maturity Index placed FSM in the lowest quartile of the global distribution (D-group) in the Digital Citizen Engagement dimension, with a score of 0.41 out of 1 (the maximum attainable score).

15. DOFA has the further objective to become a Green Climate Fund accredited entity, which would require it to meet certain criteria as set out in the Green Climate Fund's fiduciary accreditation standards. These standards encompass various aspects relating to budgeting, such as performance budgeting and establishing strong linkages between budgeting and policy priorities, accounting, public investment management, asset management, internal and external audit, procurement, transparency and accountability. However, to accomplish these goals, GoFSM must first establish strong public finance foundations to lay the groundwork for future reforms in this area.

C. Relevance to Higher Level Objectives

16. The proposed project is aligned with the FY17-21 Regional Partnership Framework (RPF) for the PIC9 (Report number 100997-EAP), which was extended to FY23 by the World Bank's Board of Executive Directors on February 6, 2020. The RPF defines focus areas relevant to this project, including Focus Area 4, a cross-cutting area focusing on strengthening the enablers of growth and opportunities, including macro-economic management, infrastructure development and addressing knowledge gaps**.**

17. Supporting Focus Area 4, the project will build capacity and strengthen public expenditure management. The proposed project will involve the development of Human Resource (HR) capacity to sustainably close knowledge gaps within PFM and improve public expenditure management via the expanded rollout of core public finance systems leveraging the use of the digital infrastructure in FSM. Additionally, by improving procurement expertise, existing delays in undertaking public investments in infrastructure and systems development can be minimized.

18. The proposed project aligns closely with the country's Public Financial Management Reform Roadmap 2023-2026. Both the project and the reform roadmap share a strong emphasis on strengthening budgeting processes and a more comprehensive budget. Transparency is a key priority for both the roadmap and the project, which aims to increase availability of fiscal information to the public, as is building a more effective and efficient procurement system. By further expanding FMIS coverage, the project contributes to the roadmap's objectives of increased control of budget execution, as well as timely in-year budget reporting. The project's focus on internal audit aligns with the ambition of the roadmap for strengthening internal compliance. In addition, both the project and the roadmap have a strong focus on enhanced capacity development.

19. The proposed project is consistent with the country's Nationally Determined Contribution (NDC). The FSM submitted its updated NDC to the United Nations Framework Convention on Climate Change in 2022[10]. The country emits a negligible quantity of greenhouse gas (GHG) emissions. However, the country is taking ambitious action to rapidly reduce emissions over the next decade. It lays out the adaptation and mitigation targets across eight core economic and policy areas: (i) energy security, (ii) short-lived climate pollutants, (iii) food security, (iv) water security, (v) ecosystems management, (vi) resilient transport systems, (vii) public health, and (viii) emergency management and response. While there are no specific targets or goals in the subsectors the project supports, this project, which focuses on increasing

[10] https://unfccc.int/sites/default/files/NDC/2022-10/Updated%20NDC%20of%20the%20MICRONESIA.pdf

government capacity to manage public finances effectively does not hinder the achievement of the country's mitigation or adaptation commitments specified in the updated NDC.

II. PROJECT DESCRIPTION

20. Project description. The project builds on the key PFM reforms achieved and investments implemented under the PFM I project to support the achievement of key strategic areas defined in GoFSM's 2023-2026 PFM Reform Roadmap (defined in paragraph 18), by addressing challenges in core institutional public finance capacity. Specifically, the project supports strengthened practices over public finance at the National level, the expansion of the core FMIS to line Departments and other agencies, and improvements in systems and processes over budget formulation and execution, procurement, treasury functions, internal controls and financial reporting. This will include building human resource capacity and strengthening technical competencies in DOFA. The project will also provide technical assistance to review existing PFM legislation and make recommendations to support reform areas envisioned in the PFM Reform Roadmap 2023-2026. The project is envisioned to establish the public finance foundations necessary to lay the groundwork for second generation reforms such as climate-informed PFM and improved revenue forecasting. The readiness for second generation reforms will be assessed during the mid-term review to determine whether they could be included in the project.

A. Project Development Objective

21. Project Development Objective (PDO) Statement: To improve fiscal management practices and increase fiscal transparency at the National Government level.

22. PDO Level Indicators Progress toward the achievement of the PDO will be assessed using the following PDO-level results indicators: (i) improved quality of the budget, measured by comprehensiveness and classification; and (ii) improved timeliness of key fiscal documents made publicly available[11].

B. Project Components

23. Project Components. The project's components are: (i) improved fiscal management practices and controls; (ii) expanded core Financial Management Information Systems; (iii) enhanced human resource capacity, communications and change management; and (iv) project management. The total project amount is US$13,000,000.

24. Component 1: Improved Fiscal Management Practices and Controls (US$4,625,000). This component will support the improvement of practices to carry out budgeting, financial reporting, internal audit and procurement within DOFA. The activities are designed to address the weaknesses noted in budget quality, financial reporting and procurement, and introduce related internal controls, which will have the greatest impact on improving fiscal management practices in these areas. The component will support the review, development or update of procedures and templates for fiscal management related to these areas and provide on-the-job learning to support their implementation. It will also provide technical assistance for a legislative review to identify revisions which may be necessary to support envisioned reforms.

25. *Sub-component 1.1: Strengthening budgeting and reporting practices (US$3,195,000).* The objective of this sub-component is to: i) improve classification and comprehensiveness of the budget; ii) establish in-house financial reporting

[11] The key fiscal documents are those from PEFA Indicator PI-9 that are fully within the control of DOFA. These are: i) annual executive budget proposal documentation; ii) in-year budget execution reports; iii) annual budget execution reports; iv) prebudget statements; and v) summaries of the budget proposal (or Citizens' budgets).

capability to produce annual consolidated financial reports, and iii) upskill and transform the existing internal compliance unit to carry out an internal audit function, thereby enhancing internal controls. To support achievement of these objectives, activities will include: i) technical assistance to review the public financial management legislative framework and preparation of draft updated legislation, as needed; ii) reviewing and updating guidelines, procedures, and templates to improve the quality of budget documentation, and preparation of annual consolidated financial statements; iii) preparation of an internal audit mandate, charter, risk-based methodology, audit plan, audit manual, programs, and reports; iv) on-the-job training to support implementation of these activities; and v) internal government consultations and awareness activities to inform and roll out changes to manuals and procedures. A review of the Budget Procedures Act 1981 and National Government FMR will be completed to identify revisions necessary to support envisioned reform areas with a view toward simplification and consider whether establishment of a revised Procurement Code and Regulations is warranted. These activities will be supported by an external consultancy, equipment and advisors who will also facilitate on-the-job learning of local staff and consultants in close coordination with the human resource development activities and formal training under Component 3. In carrying out these activities, the advisors will establish the foundations for integrating a climate perspective into PFM in future second generation reforms, including leveraging the universal chart of accounts structure developed under PFM I and raising awareness on climate budget tagging and its advantages.

26. ***Sub-component 1.2: Strengthening procurement practices (US$1,430,000).*** The objective of this sub-component is to strengthen procurement practices and transparency. To support achievement of the objective, activities will include: i) technical assistance to review the procurement framework and support preparation of draft procurement legislation and/or regulations as needed, and a procurement procedures manual for carrying out procurement in National Government; ii) advisory support and on-the-job training to strengthen procurement processes and provide guidance on applying value for money and sustainability principles, annual procurement planning and reporting; and iii) support for transitioning from a manual system to automated procurement processing through the implementation and rollout of an online tendering portal under sub-component 2.2. The procurement regulations are envisioned to set forth sustainable procurement and gender-based procurement practices, domestic preferencing, and past performance monitoring measures as a means to evaluate bids. These activities will be supported by external consultancies and advisors who will also facilitate the reforms and provide on-the-job learning of local staff and consultants in close coordination with the human resource development activities and formal training under Component 3.

27. **Component 2: Expanded Core Financial Management Information Systems (US$4,325,000).** This component will support increased efficiency and automation of public finance processes through the expanded use of the FMIS implemented under PFM I to additional government Departments and agencies. Activities will also focus on expanding automation of procurement, internal audit and other selected public finance areas, thereby improving overall operational efficiency, transparency, and timeliness in managing public resources.

28. ***Sub-component 2.1: Continued rollout of core public finance system (US$3,225,405).*** The objective of this sub-component is to support the continued use and rollout of the FMIS installed under PFM I to additional Departments and agencies. The FMIS strategy and system leverage a cloud based and local disaster recovery solution designed to recover and protect financial data, ensure the continuity of financial operations, and support the rapid resumption of services after a climate-related event. This is a crucial climate adaptation measure which mitigates risks associated with FSM's significant vulnerability to natural disasters and climate change and allows GoFSM to manage and disburse funds effectively during recovery efforts. The FMIS additionally provides for electronic document management to digitally secure data and documents, thereby securing data in the event of a climate disaster, as well as decreasing the use and waste of paper. It also includes ensuring redundancy is built into the design of the Information and Communication Technology (ICT) infrastructure and is envisioned to leverage the new telecommunications infrastructure under development in the country to further enhance disaster recovery solutions. To support achievement of the objective, activities will include: i)

FMIS training to line Departments and agencies; ii) recurrent costs for FMIS licenses, hosting and cloud services, beyond the current contract, i.e. in the last two years of the project; iii) procurement of hardware and telecommunication costs - this will include purchase of equipment such as scanners, laptops, etc. needed for the FMIS rollout to line Departments and agencies; iv) support for the continued rollout of the FMIS to line Departments and agencies, liaising with the FMIS vendor as needed, through an FMIS Advisor; and v) support to GoFSM on information technology matters related to the FMIS through an Information Technology Advisor.

29. ***Sub-component 2.2: Expand public finance systems (US$1,099,595).*** The objective of this sub-component is to support further digitization of public finance systems to include platforms supporting procurement and internal audit. An assessment will be carried out during the project to determine the nature of digitization to be implemented, the roadmap for its rollout, and develop the terms of contracts with the targeted private provider to carry out the digitization. To support achievement of the objective, activities will include: i) a needs assessment, to define the scope and functional and technical requirements of PFM processes to be digitized, beyond what is already included in the scope of the FMIS and the current contract with the vendor; ii) procurement and implementation of an online tendering portal, which would allow the government to advertise and receive tenders online; and iii) procurement and implementation of an internal audit platform. Specifications for off-the-shelf standalone systems or customizable modules will be developed based on functional and technical needs. The subcomponent will also support leveraging the use of data captured in the FMIS to support budgeting, accessibility to opportunities, and transparency initiatives identified in Components 1 and 3 to increase diversity of bidders for government programs.

30. Component 3: Enhanced Human Resource Capacity, Communications and Change Management (US$2,300,000). This component aims to build on the initiatives to strengthen human resource capacity, foster communications and carry out change management established under PFM I by continuing competency development activities, engaging in continued internal and external communications, and carrying out in citizen engagement activities. The component will support capacity building for core PFM functions and processes within DOFA, continue change management and transparency initiatives and increase citizen engagement in the budget cycle.

31. ***Sub-component 3.1: Strengthen Human Resource Capacity for Public Finance (US$1,630,000).*** The objective of this sub-component is to strengthen human resource capacity for public finance. To support achievement of the objective, activities will include: i) delivery of training programs established under PFM I and additional targeted certification programs in key areas (US GASB, Procurement, internal audit[12], Budgeting); ii) establishment of training partnerships to support the development of competencies; and iii) support establishment of an accreditation function to provide oversight of a recognized certification framework. Programs will incorporate a climate lens, to build foundational capacity in climate informed PFM. The project will support formal recognition of certifications, including within the remuneration framework of DOFA. A partnership will be established with the COM-FSM's CTEC and National Public Auditor (ONPA) to support the establishment of the Accounting Technician program currently under development. The accreditation programs will target a gender balanced delivery to provide equal opportunities to increase competencies in targeted areas. Formal training will be complemented by on-the-job learning under Component 1 to maximize learning outcomes.

32. ***Sub-component 3.2: Change Management, Communications and Citizen Engagement (US$670,000).*** The objectives of this sub-component are to: (i) support the management of change associated with reforms under the project and (ii) increase access to key fiscal documents and procurement and improve public finance awareness of citizens. To support achievement of the objective, activities will include: i) updating the Gender Informed Change Management and Communications Strategy and developing a Transparency and Citizen Engagement Strategy, with special provisions for targeting female citizens; ii) enhancements to the DOFA website to facilitate publication of fiscal documents and responses

[12] The Internal Audit certification is expected to draw on the internationally recognized framework of the Institute of Internal Auditors.

to citizen feedback; and iii) support for DOFA to conduct citizen engagement activities on PFM, including the development of media content in local languages where appropriate and public awareness campaigns to help citizens, civil society and the media to better understand public finance and the role of DOFA. The project will support the preparation and publishing of reports summarizing feedback from citizens and responses/actions taken by the project in response to the feedback. The sub-component will also support the management of change associated with the reform and improve reform awareness of internal and external stakeholders. These activities will be supported by an advisor who will support DOFA in drafting strategies and during implementation.

33. Component 4: Project Management (US$1,750,000). The objective of this component is to support overall project management and coordination. The implementing agency for the project will be DOFA. The project implementation arrangements envisage a Project Implementation Unit (PIU) to support DOFA in daily activities. The PIU will include a project manager, a procurement officer, and a financial management (FM) officer. The project will finance the required office equipment and IT facilities at DOFA to enable and facilitate implementation. Specifically, the project will fund the purchase of computers, printers, and other required equipment and office furniture related to project management. It will also finance external audit fees for the project, as needed.

C. Project Beneficiaries

34. The primary project beneficiary is DOFA. Line Departments in the National Government and the four State governments will also benefit from the project. The project activities focus on back-office PFM processes and IT systems and build capacity for all public workers engaged in public financial management functions, irrespective of administrative unit. It is expected to indirectly benefit all citizens of FSM.

D. Results Chain

35. Theory of Change. Weaknesses in budgeting, procurement, and financial reporting practices adversely impact fiscal management and fiscal transparency. These weaknesses further hinder the adoption of second-generation reforms including the adoption of climate-aware public financial management which has been identified as a priority in GoFSM's National Development Strategy. The Theory of Change (Figure 3) illustrates the linkage between project activities and PDO-level outcomes.

Key Assumptions

- A1: Training will lead to improved skills and knowledge among financial officers.
- A2: Clear guidelines and procedures will be followed and enforced.
- A3: Access to transparent financial information will lead to greater public scrutiny and accountability.
- A4: Independent oversight will ensure adherence to fiscal management and transparency guidelines.

External Factors:

- EF1: Political will and leadership commitment to fiscal management and transparency.
- EF2: Economic conditions that may affect the implementation of new practices.
- EF3: Citizen demand and donor requirements for fiscal transparency.

Figure 3: Theory of Change for FSM PFM II[13]

Key Issues	Proposed Activities of PFM II		Outputs	Intermediate Outcomes	PDO Outcomes
Procedures and guidelines to support implementation of PFM are not comprehensive. Budget documentation and classification not comprehensive. Outsourcing preparation of financial statements has become unsustainable and reporting delayed. No internal audit function exists.	Component 1	Review, develop or update guidelines, procedures, and templates for fiscal management related to budgeting, procurement, transparency, internal audit, and financial reporting. Advisory support for implementation and on-the-job training for new policies, procedures, and guidelines operational	Updated documentation to support budgeting, internal audit, financial reporting and procurement practices. Updated budget format, annual financial reporting and annual procurement report templates. Internal audit unit established and operational	Improved capability to carry out budgeting, procurement and financial reporting. Improved internal controls. Improved ability to identify and mitigate risks and challenges in carrying out PFM. Improved timeliness and efficiency in public expenditure and procurement. Increased access to digitally enabled services for online tendering. Increased transparency over public finance information. Increased citizen engagement on public finances and the role of DOFA.	(i) Improved quality of the budget, measured by comprehensiveness and classification. (ii) Increase in timeliness of key fiscal documents made publicly available. ↓ **Improved fiscal management practices and transparency at the national level**
FMIS requires a broader roll out to other government departments, increased user competencies, the system needs to be maintained, and information must be used. Procurement is carried out manually, processes are inconsistent.	Component 2	Decentralized rollout of FMIS to track and report on budget execution. Conduct needs assessment for online tendering and internal audit platforms, define specifications, and procure platforms.	Regular and timely in-year budget execution reports Online tendering system adopted across Departments. Annual financial statements		
Shortage of key skills and domestic educational opportunities to carry out PFM. GoFSM depends on expatriate consultants for accounting, procurement and budget expertise. No professional accounting qualification, procurement accreditation or internal audit accreditation in the country	Component 3	Establish additional training partnerships to build capacity in improved fiscal management practices. Establish accreditation function. Develop and deliver training programs and certification programs for financial reporting and procurement.	Training and certification programs in procurement, budgeting and US GASB financial reporting. Accreditation function established. Additional training partnerships established. People trained and competencies built.		
Limited public finance and procurement information is publicly available Citizen awareness and engagement on public finances is weak.		Develop strategy and guidelines for increased citizen engagement on public finance. Publication of key fiscal and procurement documents. Update gender sensitive change mgmt. and comms strategy.	Published fiscal and procurement documents. Citizen engagement campaign delivered on public finances and the role of DOFA. Updated gender sensitive change mgmt. and comms strategy.		

E. Rationale for Bank Involvement and Role of Partners

36. The World Bank is well positioned to support the project given its strong track record of implementing PFM reform projects and in particular implementing PFM reforms in FSM. The World Bank has extensive experience in supporting improvements in PFM performance, as well as projects for design and implementation of government financial management information systems, including the current PFM I project. The Bank support has helped strengthen the legal, regulatory, and institutional environment for PFM, introduced two core public finance systems, and introduced digital services for citizens in FSM. The Bank's value add also includes global expertise in PFM, including management of PFM projects and programs in countries across the globe.

37. GoFSM is receiving support from several development partners to strengthen aspects of public financial management. The International Monetary Fund's Pacific Financial Technical Assistance Centre (PFTAC) is providing

[13] Some outputs contribute to multiple intermediate outcomes, and some intermediate outcomes are achieved through multiple outcomes. For example, improved capability to carry out budgeting, procurement and financial reporting is achieved through (i) updated documentation, (ii) updated budget format, annual financial reporting and annual procurement report templates; (iii) training and certification programs; and (iv) establishing accreditation function and training partnerships. For simplicity, these dependencies have not been depicted in the figure.

technical assistance and training in selected areas including banking regulations and supervision frameworks, compilation and dissemination of Government Finance Statistics (GFS) including support to the revision of the chart of accounts, macroeconomic forecasting, policy analysis and revenue administration. The Asian Development Bank is supporting a training program for economists, to be delivered through the USA Graduate school. The USA Graduate School's Pacific & Virgin Islands Training Initiative (PITI-VITI) provides support though the delivery of executive leadership development programs and virtual and in-person training on a range of public financial management topics, as well as convening bi-annual conferences for the Island Governments Finance Officers Association (IGFOA). The European Union has provided PFM support through the provision of technical assistance to the Budget Division in DOFA, as well as supporting the United Nations Development Programme Vaka Pasifika Project which works in partnership with the Pacific Islands Association of Non-Government Organizations (PIANGO) to strengthen civil society engagement in PFM, including in FSM. The New Zealand Ministry of Foreign Affairs and Tade-funded Country Flexible Finance – Capacity Support Program is a new Pacific-wide initiative focused on climate financing and is currently scoping its support to FSM. The project will be closely coordinated with these initiatives.

38. The limited level of support to FSM from regional and bilateral PFM programs, as well as the requirement to report in accordance with US GASB, highlight the need for targeted support for GoFSM. Regional PFM programs, such as PFTAC, are based in the South Pacific, and tend to recruit staff from other South Pacific countries. This presents challenges for them in supporting the Northern Pacific Countries who have more US-aligned systems of government accounting and auditing practices. Whilst there are some specific initiatives to support the countries and territories of the North Pacific, such as the USA Graduate School's PITI-VITI and IGFOA, neither of these provide "on-the-ground" technical assistance.

F. Lessons Learned and Reflected in the Project Design

39. The project design has undergone significant simplification from the previous project, adopting a streamlined approach within the National Government which builds on earlier reforms to deepen investments in systems and processes over budget formulation and execution, procurement, treasury functions, internal controls and financial reporting. A key lesson learned from PFM I is that attempting reform simultaneously across national and multiple semi-autonomous subnational governments is an ambitious and complex exercise, particularly in a fragile, developing environment. Taking into account further lessons learned from PFM I, there are no plans for procuring large, complex information technology systems that necessitate consensus across all five governments. Instead, the proposed project will facilitate the acquisition of either off the shelf standalone systems or bespoke, customizable modules to bolster reform efforts of the project specifically within the National Government. In doing so, the project recognizes the autonomy of the four State governments and the lack of authority of DOFA to direct activities of the four State Finance Departments. However, the four State governments will benefit from continued FMIS support as outlined in sub-component 2.1 and resources and training provided under sub-component 1.1 to support US GASB financial reporting, ensuring sustained support in these areas and complementing the project's development objective. The composition of the Project Steering Committee (PSC) has also been revisited to include individuals with more senior levels of authority, and a Treasury Working Group (TWG) has been established to coordinate implementation of the project, deliberate on the project technical aspects and provide recommendations for PSC decision. To bolster training, development and retention efforts, the project will introduce nationally recognized certifications in PFM related disciplines, including within the remuneration framework of DOFA, thereby enhancing the career prospects and professional reputations of certificate holders.

III. IMPLEMENTATION ARRANGEMENTS

A. Institutional and Implementation Arrangements

40. The project implementing agency, DOFA, has broad experience implementing donor-funded projects and engaging with donor partners. Institutional and implementation arrangements are depicted in Annex 1. DOFA, supported by a Project Implementation Unit (PIU), is the implementing agency for PFM I and has satisfactorily carried out project management to navigate critical legislative, technical, and procurement hurdles. DOFA will also be the implementing agency for the proposed project and will coordinate efforts with other key institutions including sectoral Departments and State governments, as applicable. However, DOFA has limited absorptive capacity to implement and coordinate the project effectively.

41. To address the implementing agency capacity gap, DOFA will continue to be supported by a PIU and the project will benefit from a significantly simplified design. The PIU will include a project manager, a procurement officer, and a FM officer to support project implementation, including coordination with relevant national and state government institutions. The PIU will oversee the day-to-day implementation, monitoring, and reporting of project activities, carrying out financial management and procurement of goods and consultancies with support from the Central Implementation Unit (CIU), and monitoring and reporting on results achieved by activities financed under the project. The CIU, established in DOFA, will provide advisory and stopgap implementation support related to procurement, financial management, communications, monitoring and evaluation. Due to low risk for environmental and social (E&S) safeguards, the CIU will also provide implementation support on E&S functions of the project. DOFA has prepared a Project Operations Manual (POM) which will set out the institutional and implementation arrangements for day-to-day project execution. The POM will be adopted as a condition of project effectiveness. The PIU of the existing project, as well as the CIU, are supporting project preparation activities. Establishment of the PIU and the appointment of key staff are expected shortly after project effectiveness. Before the PIU members are recruited, it is expected that the implementing agency, with support from the CIU and the PIU of the existing PFM I project, will directly manage project implementation to avoid delays in key activities.

42. A Project Steering Committee (PSC) will be maintained to enhance project coordination and oversee project implementation and results, and a Treasury Working Group (TWG) will be established to support coordination. The PSC will be established within one (1) month after the Effective Date. To eliminate redundancies and enhance engagement of the PSC, the Intergovernmental Working Group maintained under PFM I will be eliminated, and State Finance Directors will participate in the PSC. The TWG will comprise technical focal points to support the FMIS rollout to line ministries under sub-component 2.1 and coordination of US GASB implementation under sub-component 1.1.

B. Results Monitoring and Evaluation Arrangements

43. The PDO indicators and intermediate results indicators will be tracked using the following instruments, sources and methodologies:

i) Data and information collected through the existing and developed systems within the IA, to be prepared by the IA and compiled by the PIU.
ii) Data and information collected from project processes, to be prepared by the IA and compiled by the PIU.
iii) Independent assessments completed through the project.

44. The IA is responsible for gathering the relevant data and information. The IA, supported by its PIU, will collect and compile the necessary data and information to monitor the progress of the PDO indicators and intermediate results

indicators. The IA, supported by its PIU, will be responsible for communicating to the World Bank the updated data and information in accordance with the manner and frequency described in the Results Framework.

45. No later than three (3) years after the Effective Date (or such other date as agreed with the Bank), DOFA will carry out a mid-term review of the project, and prepare and furnish to the Bank a mid-term report documenting progress achieved in the implementation of the project during the period preceding the date of such report, taking into account the monitoring and evaluation activities performed and setting out the measures recommended to ensure the continued efficient implementation of the project and the achievement of its objectives during the period following such date. It will also review with the Bank said mid-term report, on or about one month after its submission, and thereafter take all measures required to ensure the continued efficient implementation of the project and the achievement of its objectives. At the end of the project, the Bank will prepare an Implementation Completion and Results Report to evaluate the project and draw lessons. This report will include an assessment of the project by the government.

46. Regular reporting on implementation progress will be provided to the World Bank by DOFA every six (6) months. The reports will include: 1) progress in key activities including environmental and social aspects tracked against the planned timelines, 2) descriptions of key outputs finalized over the 6-month period, 3) progress towards meeting the targets of the Results Framework, and 4) descriptions of any issues in project implementation and planned follow-up actions. A draft report will be submitted to the World Bank ahead of regular implementation support missions, and a final report which incorporates the discussions and agreements during the mission will be submitted 45 days after the end of the calendar semester.

C. Sustainability

47. The project is designed to achieve sustainable improvements in fiscal management practices and transparency notwithstanding the institutional constraints of human resource capacity limitations. Technical resources will support capacity building and implementation tools and resources to achieve targeted and sustainable reforms in budgeting, financial reporting, internal audit and procurement. A two-pronged approach to capacity building will be used that complements on-the-job training of local staff and consultants with formal education and certification programs which adopt a competency-based learning approach mapped to DOFA's core competency framework. Local consultants are expected to eventually meet the competencies necessary to fill prolonged staff vacancies. An accreditation function will be established to provide certification of training programs. GoFSM's citizens will also gain awareness and insights into public finance and the role of DOFA which are envisioned to increase citizens' demand for transparent and accountable government. This collaborative approach not only fosters innovation but also will strengthen the long-term sustainability of the project's interventions.

48. By building on the key PFM reforms achieved and investments implemented under the PFM I project, the project imbeds the earlier stage reforms in institutional processes. The achievements of the PFM I project laid the foundation for the second stage reforms of the PFM II project. Adopting a building block approach is anticipated to advance reform efforts in a structured manner, leading to significant and lasting improvements over time.

IV. PROJECT APPRAISAL SUMMARY

A. Technical, Economic and Financial Analysis

49. The major benefits of the project are expected to accrue from the efficiency gains, improved management of public finances and greater transparency in government operations and performance expected from the project activities. Significant investments in IT infrastructure to support treasury functions have been undertaken under PFM I.

Continued support is essential to operationalize and maximize the value of these investments. The project's benefits will flow from efficiencies in processing financial transactions, reduced time in the procurement of standard goods, economies of scale and more efficient prices, increased access and transparency over public finance data, and human resource capacity development in PFM. Experience suggests that the proposed intervention would lead to improved budget credibility, better preparedness for shocks, strengthened transparency and enhanced oversight in public resource management.

50. Cost-Benefit Analysis (CBA), considering the Net Present Value (NPV), Benefit-Cost Ratio (BCR), and Internal Rate of Return (IRR), shows that the project is profitable to implement. The analysis indicated an NPV of US$23,238,102 and a BCR of 2.68 and an IRR of 27.80 percent ten years after the implementation of the project.[14] The positive NPV indicates that the project is financially viable and is expected to generate value greater than the initial investment cost. The BCR of the project also implies that, for every dollar invested, the project is expected to generate about US$2.68 in benefits. The IRR of the project additionally demonstrates a potentially attractive return on investment, being greater than the assumed discount rate of 5 percent. Further sensitivity analysis considering departures from the benefit, cost, and discount rate of the baseline scenario is documented in Table 1. The sensitivity analysis is based on four (4) scenarios considering deviations from the benefit (15 percent increase in benefit in scenario 2), cost (15 percent increase in the project cost in scenario 3), and discount rate (15 percent discount rate instead of 5 percent[15]). The results consistently show robust evidence in favor of implementing the project.

Table 1: Sensitivity Analysis for CBA

Scenario		NPV	BCR	IRR
Scenario 1 (Baseline)	US$	23,238,102	2.68	27.80%
Scenario 2 (15% higher benefits)	US$	28,797,751	3.08	33.54%
Scenario 3 (15% higher costs)	US$	21,288,102	2.35	22.78%
Scenario 4 (15% discount rate)	US$	10,553,081	1.78	16.69%

51. Research also shows that transparency of public information brings benefits to the private sector through the reduction of information asymmetry and transaction costs to access information as well as uncertainty, thus facilitating investment decisions. Estimates suggest that benefits could be valued between 0.03 percent of GDP (in the United Kingdom) to 1.28 percent of GDP at the level of the European Union. Assuming a lower bound estimate of 0.03 percent, FSM's annual gains would be US$0.6 million cumulatively over the five years of the project. Related key potential benefits also include more efficient and accountable budget management alongside better program implementation, resource allocation, and service delivery. This implies that added (indirect and qualitative) benefits would be realized beyond the benefits accounted for in the CBA.

52. *Paris Alignment:* The project is aligned with the goals of the Paris agreement on mitigation and adaptation. On mitigation, activities focus on (i) public administration activities, including PFM and public institutions reform, (ii) purchase

[14] The main scenario of the CBA assumes: (i) a discount rate of 5 percent, using the International Monetary Fund's unified discount rate; (ii) the project cost of US$13 million; (iii) per annum recurrent cost of US$107,000 after the project is completed; and (iv) per annum benefit of 4 percent in cost savings (based on FY2021 National Government Expenditure of US$120 million, 2022 Economic and Fiscal Update). Recent research has also shown that, on average, lower income countries were found to have larger losses (about 30 percent of budgetary central government expenditure) compared to high income countries (23 percent).

[15] The range of discount rates employed for the sensitivity analysis captures the risk-free rate and country-specific risks. Given that FSM does not have long-term government bonds, we use the US 10-year Treasury note rate of 4.15 percent (as of July 31, 2024) as a benchmark.

and use of digital devices, such as financing the purchase of hardware (computers, laptops, and/or tablets, printers) and digital/online platforms, and (iii) training activities, which are universally aligned. Activities related to purchasing other required office furniture have a negligible impact on GHG emissions and are not likely to have an adverse effect on the country's low-GHG emissions development pathways. On adaptation, a climate and disaster risk screening was conducted for the operation and the inherent risk is considered low. While the FSM is highly vulnerable to coastal floods and cyclones and is expected to experience increasing occurrences of heat waves and droughts as well as increased intensity of tropical cyclones due to climate change, these hazards are not expected to have a material impact on the operation. The operation supports activities related to governance and public institutions and includes activities relating to provision of training and technical support for use of digital devices and basic office equipment and furniture, which are not expected to have a material risk from climate hazards. The operation is expected to finance neither construction of physical infrastructure nor activities in vulnerable sectors or areas.

53. ***Climate Change.*** FSM is significantly vulnerable to natural disasters and has been affected by coastal hazards, tidal surges, tropical storms, typhoons, droughts and extreme rainfall events, which have led to flooding disasters and damage to public infrastructure. This vulnerability directly impacts GoFSM's responsiveness during disaster recovery efforts, which include effectively managing and disbursing funds to rebuild infrastructure, providing aid to affected populations, and implementing climate adaptation measures. The FMIS disaster recovery solution and electronic document management mitigate the impact of climate-induced disasters on financial management systems, ensuring that the FMIS is robust and can withstand climate-related disruptions, thereby contributing to the overall resilience of the economic and social systems that depend on these financial resources. The project further allows for the introduction of tools and practices to improve the budgeting process and expenditure management which lay the foundations for embedding a climate focus into PFM.

54. ***Citizen Engagement.*** The project will contribute to citizen engagement by supporting DOFA to conduct citizen engagement activities on PFM, including the development of media content in local languages where appropriate and public awareness campaigns to help citizens, civil society and the media to better understand public finance and the role of DOFA. The project will also support DOFA to prepare and publish reports summarizing citizen feedback and responses/actions taken by the project in response to the feedback received. Enhancements will also be made to the DOFA website to enable responses to citizen feedback. The staff responsible for DOFA website management will collect citizen feedback and respond regularly, and the project will review this feedback quarterly. All feedback provided by beneficiaries will be used to inform project management and determine corrective action, if needed. Citizen engagement will also be strengthened through improvements in the quality, timeliness and accessibility of information on public finances. The Results Framework includes an indicator aimed at increasing citizen engagement, which will be measured through the publication of reports summarizing citizen feedback received and the responses/actions taken.

55. ***Gender.*** In FSM, there is a clear gender imbalance in the workforce, with 67.8 percent of men participating compared to 46.2 percent of women and women facing a higher unemployment rate of 13.9 percent, compared to 5.4 percent for men. Women hold 39 percent of formal sector jobs and are underrepresented in senior management, occupying only 13 percent of leadership positions. Despite women making up a significant portion of the workforce, their access to skilled employment remains limited. [16] These disparities highlight structural barriers that hinder women's economic participation and advancement in FSM, including historical limitations on women's participation in education.[17] Despite these challenges, FSM's gender-based priorities are not clearly articulated.

[16] UN Women (2022). *Federated States of Micronesia: Gender Equality Snapshot 2022.* Available at Asiapacific.unwomen.org
[17] World Bank (2018). *Gender Profile, Federated States of Micronesia*.

56. Against this backdrop, DOFA is a model of gender equality. A gender analysis of DOFA, conducted under the PFM I project, indicated a slight gender disparity in favor of women, with 51 percent of total staff being women and 49 percent men. However, at the technical level, a small gender gap persists, with men holding 51 percent of technical roles and women 49 percent. Even with near gender parity at the technical level, the underrepresentation reflects the traditional barriers faced by women and there is a risk of backsliding which could hinder women's long-term advancement and equality. Meanwhile, administrative support roles remain female-dominated, with three out of four positions held by women, which may indicate occupational segregation.

57. Building on these findings, the project seeks to provide women with equal access to technical training in PFM related disciplines by ensuring equitable participation in specialized certification programs. It specifically targets 55 percent female participation in technical certification programs in PFM-related disciplines for technical and administrative staff. By equipping women with advanced technical skills and formal credentials, the initiative aims to bridge the gender gap in technical roles, enabling women to compete for and secure higher-skilled positions. These certifications are expected to serve as a pathway for career progression in the PFM field, where structured qualifications are often required for advancement, and are expected to lead to financial reward within the salary structure of DOFA. Given that FSM currently lacks formal education opportunities in these specialized PFM disciplines, this initiative is a critical step toward building an equitable talent pipeline and reducing gender disparities in technical fields. Without access to certifications, it is expected that female participation at the technical level would decrease. To measure progress the project will monitor the *Number of individuals completing certifications in specialized technical areas and retained within GoFSM, of which 55 percent female (US GASB, AT, Procurement, Internal Audit).* To further strengthen female participation in technical PFM disciplines, the project also supports the implementation and expansion of a gender-informed competency framework.[18] More broadly, the project's citizen engagement strategy includes targeted outreach to female citizens and women's groups to strengthen awareness of PFM.

58. ***Maximizing Finance for Development.*** The project is aligned with the World Bank Maximizing Finance for Development (MFD) approach. Component 2.2 is verified MFD-e given the target activities to assess the nature of digitization, develop the roadmap for roll out and the contracts targeted at private providers for the digitization of the public finance systems. Additionally, research shows that transparency of public information brings benefits to the private sector thus facilitates investment decisions. As such, including platforms enabling procurement and internal audit supports leveraging the use of data captured in the FMIS for budgeting, increasing accessibility to government procurement opportunities, and supports transparency initiatives identified in Components 1 and 3 and is expected to result in increased diversity of bidders for government programs.

B. Fiduciary

59. **Financial Management. The FM risk is assessed as moderate.**[19] Under World Bank IPF guidelines with respect to projects financed by the World Bank, the borrower and the project implementing agencies are required to maintain satisfactory FM arrangements—including planning and budgeting, accounting, internal controls, funds flow, financial reporting, and auditing arrangements—acceptable to the World Bank, to provide reasonable assurance that the proceeds

[18] The DOFA gender-informed competency framework integrates gender considerations into the skills, knowledge and behaviors required for a specific role, thereby ensuring that the competencies promote gender equality, prevent bias, and create an inclusive work environment.
[19] The assessment was completed on October 8, 2024 in accordance with the World Bank Guidance 'Financial Management Manual for World Bank Investment Project Financing Operations' issued on September 7, 2021.

are used for the intended purposes for which they were granted. The implementing agency, with the support from CIU, has the fiduciary responsibility for the project. A FM officer will be recruited as part of the PIU and will work closely with CIU to establish a financial management system. An assessment of DOFA's prior experience in implementing the ongoing PFM I Bank-financed project observed satisfactory FM performance on interim financial reporting, preparation of annual work plan and budget, payment processing, and account recording. However, the annual audit reports have been persistently delayed. The FY23 project audit is overdue for five months. The mitigating measures proposed are the preparation and submission of project-level audits separate from the national audit that is delayed. The FSM National Government FMRs and policies will govern the project FM arrangements and the project's accounting and financial reporting will be established in the government FMIS. The PIU will adopt a POM which includes the arrangements and procedures for (a) the institutional arrangements for day-to-day execution of the project including FM arrangements; (b) project monitoring, reporting, and evaluation arrangements; and c) any other arrangements necessary to ensure proper fiduciary coordination and implementation of the project. The World Bank FM team will provide fiduciary guidance, support and training to the PIU, and will monitor the FM aspects of the project through implementation support missions.

60. Procurement. The procurement risk rating has been assessed as moderate.[20] Under the PFM II project, all activities will be carried out in accordance with the World Bank Procurement Regulations for IPF Borrowers (dated September 2023), hereafter referred to as the World Bank's Procurement Regulations. The World Bank's Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants, referred to as the World Bank's Anti-Corruption Guidelines (latest update July 2016) will also apply. DOFA has prepared a Project Procurement Strategy for Development (PPSD) and Procurement Plans (PPs) in line with paragraphs 4.1, 4.2 and 4.4 of the Procurement Regulations, the Guidance Manual "Pacific Procurement Guidance 2023" and the provisions stipulated in the Financing Agreement. Under the proposed project, the World Bank's procurement planning and tracking system, STEP, will be used to prepare, clear, and update Procurement Plans and conduct all procurement transactions for the project. Accordingly, all the procurement activities under the proposed project will be entered into, tracked, and monitored online through the system.

61. Procurement activities under PFM II include: (i) consulting services (e.g., technical assistance firms for training and governance advisory); (ii) individual consultants; (iii) goods and non-consulting services.

C. Legal Operational Policies

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Area OP 7.60	No

[20] The procurement assessment was completed in July 2024.

D. Environmental and Social

62. The project will finance activities to enhance PFM in FSM, including to expand the core FMIS, enhance human resource capacity and capabilities, and support project management. The project is not expected to support any physical activities, or feasibility studies/technical design for future investment projects. All the activities of the project are technical assistance type of activities. Through Component 1, the project will provide technical assistance to review and update legislative frameworks, guidelines, and procedures to address existing weaknesses and integrate environmental and social considerations into public financial management, and strengthen institutional capacity to carry out budgeting, procurement, treasury and internal audit functions. Component 2 will support the continuation of implementation of the FMIS to optimize its use across government. Component 3 aims to build on the human resource capacity, strengthened communications and change management established under PFM I by continuing competency development activities, fostering continued internal and external communications, and conducting citizen engagement activities. Component 4 will support the overall project management (i.e. office equipment and furniture) of the PIU. These technical assistance activities are expected to have minor or negligible environmental and social impacts. Furthermore, it is expected to further enhance the environmental and social sustainability of country's PFM through integration of E&S considerations into budgeting and procurement. The environmental and social considerations will be integrated into the Terms of Reference (TORs) for all project tasks. The project will also adhere to existing labor contract management under the Bank procurement's guidelines and process. An Environmental and Social Commitment Plan (ESCP) and Stakeholder Engagement Plan (SEP) have been developed to ensure the implementation of these commitments and were disclosed by the Borrower on November 21, 2024. The ESCP was disclosed by the Bank on December 12, 2024 and the SEP on November 5, 2024. The project grievance redress mechanism (GRM) is outlined in the SEP. Project stakeholders are mainly Government Agencies and implementing partners and it is unlikely that the project will cause impacts on the community, though information will be disclosed via the FSM Government website. Overall, the project is considered to have low environmental and social risks, and does not require further environmental and social assessment.

63. The project grievance redress mechanism (GRM) is outlined in the stakeholder engagement plan (SEP). Project stakeholders are mainly Government Agencies and implementing partners and it is unlikely that the project will cause impacts on the community, though information will be disclosed via the FSM Government website. This will include information on the project GRM. GRM will be managed by the E&S specialists in the FSM Central Implementation Unit (CIU), who are responsible for logging grievances and reporting on progress. Grievances can be lodged via the DOFA web portal, phone, email or in person. Once the complaint is received CIU E&S officer will report this to the PIU PM and will work with the relevant agencies and the complainant to resolve the issue.

V. GRIEVANCE REDRESS SERVICES

64. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit

http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VI. KEY RISKS

65. The overall risk for the proposed project is assessed as moderate. The only risks considered substantial are those associated with institutional capacity for implementation and sustainability. All the other types of risk are assessed as low to moderate, not critically constraining the project from achieving its development objectives.

66. Risks associated with institutional capacity for implementation and sustainability are considered substantial. The IA's human resource constraint poses some challenges to project implementation and the high levels of outbound migration affecting FSM create risks of sustaining the project's long-term results and outcomes beyond its lifecycle. To mitigate this risk, the project includes measures to develop public finance capacity and imbed reforms in institutional processes to contribute to sustainable implementation beyond project life. These include (i) increased automation of public finance; (ii) development of clear procedures and guidelines; (iii) a strong focus on training programs and capacity building; and (iv) measures to attract and retain staff, including nationally and internationally recognized certifications and support for recognizing these within the renumeration framework of GoFSM. Lessons learned from the implementation PFM I have been considered when revising the implementation arrangements for PFM II. The inclusion of the Directors of State Finance Offices (SFO) in the PSC is expected to increase the level of engagement. The proposed project will continue to include a project manager, a procurement officer, a FM officer and technical experts, and will support State level participation related to sub-components 2.1 and 3.1. The project also provides technical assistance to develop public finance capacity which will contribute to sustainable implementation beyond project life. Close coordination between the implementing agency and the World Bank team will allow for hands-on implementation support, especially on technical and fiduciary aspects. There are risks that key staff trained under PFM II leave DOFA after they are upskilled – this will be addressed by ensuring the project trains enough staff to mitigate risks of turnover, and work with DOFA to develop retention strategies for staff that have been trained under the project.

VII. RESULTS FRAMEWORK AND MONITORING

PDO Indicators by PDO Outcomes

Baseline	Period 1	Period 2	Period 3	Period 4	Closing Period
Improved quality of the budget					
PDO-1 Budget classification and documentation is consistent with criteria for a B score for PI-4 and PI-5 of the PEFA Framework (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
Economic/functional classification used for budget formulation is not consistent with GFS/COFOG standards, and ii) budget documentation contains three elements (one basic and two additional) as set out in the criteria for PEFA Indicator PI-4.	n/a	Budget Documentation contains one additional element from the criteria for PI-5.	Budget Documentation contains two additional elements from the criteria for PI-5.	Budget formulation is based on administrative, economic and functional/sub functional classification comparable with GFS/COFOG standards (at least 'Group' level of the GFS standard—3 digits)	Budget prepared consistent with criteria for a B score for PI-4 and PI-5 of the PEFA Framework.
Improved timeliness of key fiscal documents made publicly available by DOFA					
PDO-2 Number of key fiscal documents made publicly available by DOFA within the timeline specified in PEFA Indicator PI-9.1 (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
Three documents* used as criteria for PEFA Indicator PI-9.1 are made publicly available within the specified timeframes (one basic and two additional). Note: *The key fiscal documents are those from	n/a	One additional document used as criteria for PI-9.1 made publicly available within the specified timeframes	One additional document used as criteria for PI-9.1 made publicly available within the specified timeframes.	Two additional documents used as criteria for PI-9.1 made publicly available within the specified timeframes.	Four additional fiscal documents used as criteria for PI-9.1 made publicly available within the specified timeframes.

PEFA Indicator PI-9 that are fully within the control of DoFA. These are: i) annual executive budget proposal documentation; ii) in-year budget execution reports; iii) annual budget execution reports; iv) prebudget statements; and v) summaries of the budget proposal (or citizens' budgets).					

Intermediate Indicators by Components

Baseline	Period 1	Period 2	Period 3	Period 4	Closing Period
Improved fiscal management practices and controls					
IR-1 Improved capacity of DoFA to prepare US GASB consolidated financial statements (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
Preparation of Annual Financial Statements outsourced, new unified COA captures US GASB reporting requirements	n/a	US GASB f/s prepared in-huse for National Government without disclosures	US GASB f/s prepared in-house for National Government with disclosures	US GASB Consolidated f/s prepared in-house without disclosures	US GASB consolidated financial statements prepared in-house with disclosures
IR-2 Improved Procurement Transparency (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
Two elements used as a criteria for PEFA Dimension 24.3 are publicly available (Legal and regulatory framework	n/a	n/a	One additional element used as criteria for PI-24.3 made publicly available by DoFA.	One additional element used as criteria for PI-24.3 made publicly available by DoFA.	Procurement information made publicly available consistent with criteria for a B score for PI-24.3 of the PEFA Framework (at least four

for procurement and bidding opportunities).					elements made publicly available in a timely manner).
IR-3 Internal Audit Unit Operational (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
Internal compliance Unit operational.	n/a	Internal Audit unit established and Annual Work Plan approved.	Two pilot audits completed following risk-based methodology and audit reports issued.	Annual cycle of internal audits completed following risk-based methodology and audit reports issued.	Y4 target plus follow-up of previously issued audit findings.
Expanded Core Financial Management Information Systems					
IR-4 FMIS rolled out to sectoral Departments (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
FMIS rolled out in DOFA and State Finance Offices	n/a	25% of national line departments and targeted embassies and agencies using FMIS * (* Department, embassies and agencies will be determined as using FMIS when at least 80% of expenditure transactions are entered into the FMIS at the department or agency level.)	50% of national line departments and targeted embassies and agencies using FMIS *	75% of national line departments and targeted embassies and agencies using FMIS *	At least 90% of national line Departments and targeted embassies and agencies using FMIS
IR-5 Number of active users submitting tenders through the online tendering system (Number)					
Dec/2024					Mar/2030
0					1,000
Enhanced Human Resource Capacity, Communications and Change Management					
IR-6 Number of individuals completing certifications in specialized technical areas and retained within GoFSM (US GASB, AT, Procurement, Internal Audit) (Number of people)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
0	10	20	30	40	50
➢of which, 55% female (Percentage)					
Dec/2024					Mar/2030
0					55%

IR-7 Increased engagement with citizens on public finances and the role of DoFA (Text)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
No reporting by DOFA summarizing feedback received from citizens (e.g., the main trends, key issues, main types of queries, etc.) and actions being taken based on the feedback received.	Conduct at least one citizen engagement activity and publish report summarizing feedback and responses/actions taken.	Conduct at least one additional citizen engagement activity and publish report summarizing feedback and responses/actions taken.	Conduct at least one additional citizen engagement activity and publish report summarizing feedback and responses/actions taken.	Conduct at least one additional citizen engagement activity and publish report summarizing feedback and responses/actions taken.	Five annual reports published summarizing the citizen feedback received and the responses/actions taken.
IR-8 Training partnerships for qualification courses in specialized areas. (Procurement, AT, IA, US GASB) (Number)					
Dec/2024	Mar/2026	Mar/2027	Mar/2028	Mar/2029	Mar/2030
0	n/a	1	2	3	4
Project Management					

Monitoring & Evaluation Plan: PDO Indicators by PDO Outcomes

PDO Outcome 1: Improved quality of the budget	
PDO-1 Budget classification and documentation is consistent with criteria for a B score for PI-4 and PI-5 of the PEFA Framework.	
Description	This indicator captures improvement in budget quality measured by classification and comprehensiveness of the budget in accordance with the PEFA framework. Annual targets include the incremental addition of elements to the budget documentation, consistent with the criteria for PEFA PI-4 and PI-5[21].
Frequency	Annual
Data source	Assessment of budget documentation against criteria for PI-4 and PI-5.
Methodology for Data Collection	DOFA will collect the budget documentation. The assessment will be conducted by an expert based on budget documentation submitted to Congress.
Responsibility for Data Collection	DOFA and Project Implementation Unit
PDO Outcome 2: Improved timeliness of key fiscal documents made publicly available by DOFA	
PDO-2 Number of key fiscal documents made publicly available by DOFA within the timeline specified in PEFA Indicator PI-9.1	
Description	This indicator will measure the number of key fiscal documents made publicly available by DOFA within the timelines specified in the criteria for PEFA PI-9.1, which is a proxy for transparency. The three documents currently made publicly available are the enacted budget, other external audit reports, and the citizen's budget. Only the citizen budget is entirely within the control of DOFA. Annual targets include the incremental increase in publication of fiscal documents as specified in the criteria for PEFA PI-9.1
Frequency	Annual
Data source	Fiscal documents published on the DOFA website.
Methodology for Data Collection	DOFA will publish reports on the DOFA website.
Responsibility for Data Collection	DOFA and Project Implementation Unit

Monitoring & Evaluation Plan: Intermediate Results Indicators by Components

Component 1: Enhanced PFM framework, processes and controls	
IR-1 Improved capacity of DOFA to prepare US GASB consolidated financial statements	
Description	This intermediate indicator measures progress toward preparation of US GASB consolidated financial statements with disclosures by DOFA. Annual targets include in house preparation of financial statements with incremental improvements.
Frequency	Annual
Data source	Financial statements prepared by DOFA. Audited financial statements from the Office of the National Public Auditor Website, if available.
Methodology for Data Collection	DOFA will collect the financial statements.
Responsibility for Data Collection	DOFA and Project Implementation Unit

[21] The PEFA Framework is used only as a guiding post and a formal PEFA assessment is not required to gauge progress.

IR-2 Improved Procurement Transparency (Text)	
Description	This intermediate indicator measures the publication of procurement information by DOFA in accordance with the criteria specified in the criteria for PEFA PI-24.3 (at least four elements made publicly available in a timely manner).
Frequency	Annual
Data source	Documentary evidence and published reports.
Methodology for Data Collection	Review of documents and published information
Responsibility for Data Collection	DOFA and Project Implementation Unit
IR-3 Internal Audit Unit Operational (Text)	
Description	This intermediate indicator measures the establishment of an effective internal audit function within DOFA. This will be met when an annual cycle of internal audits is completed following risk-based methodology and there is follow-up on previously issued audit findings. Annual targets include establishing the internal audit unit and incremental numbers of audits completed following risk-based methodology.
Frequency	Annual
Data source	Annual work plan and Internal Audit reports
Methodology for Data Collection	DOFA will annually monitor documentation as per the intermediate targets.
Responsibility for Data Collection	DOFA and Project Implementation Unit
Component 2: Expand Core Financial Management Information Systems	
IR-4 FMIS rolled out to sectoral Departments (Text)	
Description	This intermediate indicator measures the percentage of national line Departments and targeted embassies and agencies that are using the FMIS. Annual targets include incremental increases in the utilization of the FMIS.
Frequency	Annual
Data source	Number of user licenses, ICT unit data on active users and vendor reports
Methodology for Data Collection	Annual monitoring of numbers of departments, embassies and agencies using the FMIS as per the intermediate targets.
Responsibility for Data Collection	DOFA and Project Implementation Unit
IR-5 Number of active users submitting tenders through the online tendering system	
Description	This intermediate indicator is intended to measure the number of people using digitally enabled services for online tendering. It will be measured by the number of vendor registrations in the system.
Frequency	Once at end of project
Data source	Documentary evidence, online tendering portal data and reports

Methodology for Data Collection	Track number of vendor registrations over time based on system data and reports.
Responsibility for Data Collection	DOFA and Project Implementation Unit
Component 3: Enhance Human Resource Capacity, Communications and Change Management	
IR-6 Number of individuals completing certifications in specialized technical areas and retained within GoFSM, of which 50% female (US GASB, AT, Procurement, IA) (Text)	
Description	This intermediate indicator measures the number of individuals that complete certifications in specialized technical areas such as US GASB, AT, Procurement, IA, that are retained by GoFSM over time, disaggregated by gender, targeting 50% female representation.
Frequency	Annually
Data source	Project progress reports
Methodology for Data Collection	Human Resource Development Consultant and Project Implementation Unit will prepare the project progress report
Responsibility for Data Collection	HRD Consultant and Project Implementation Unit
IR-7 Increased engagement with citizens on public finances and the role of DOFA (Text)	
Description	This intermediate indicator assesses engagement with citizens on public finances and the role of DOFA as measured by the publication of reports summarizing citizen feedback received and the responses/actions taken.
Frequency	Annually
Data source	Project progress reports. Baseline, mid-project and end of project survey on citizen awareness of public finances and the role of DOFA.
Methodology for Data Collection	Project Implementation Unit will prepare the project progress report and reports summarizing citizen feedback and actions taken.
Responsibility for Data Collection	Project Implementation Unit
IR-8 Training partnerships for qualification courses in specialized areas. (Procurement, AT, IA, US GASB) (Number)	
Description	This intermediate indicator measures the number of training partnerships in place for qualification courses in specialized areas (Procurement, AT, IA, US GASB).
Frequency	Annual
Data source	Partnership documents and project progress report
Methodology for Data Collection	HRD Consultant and Project Implementation Unit will prepare the project progress reports
Responsibility for Data Collection	HRD Consultant and Project Implementation Unit

ANNEX 1: Implementation Arrangements and Support Plan

COUNTRY: Federated States of Micronesia
Strengthening Public Financial Management II

Project Steering Committee (PSC)

1. The PSC will take on overall responsibility for PFM II project implementation. The PSC is similar to the PSC established under PFM I however its participants are different. The PSC will be chaired by the Secretary of Finance and will also include the Directors, or their representatives, of each of the State Finance Offices (SFO), as well as Assistant Secretaries of the four Departments within DOFA, each of which will be voting members, and the ONPA as an observer. Additional observers may be added at the discretion of the PSC. The Assistant Secretary, Treasury, will act as Deputy Chair and carry out the Secretariat function, supported by the PIU. Lessons learned from the implementation PFM I have been considered when revising the implementation arrangements for PFM II. The inclusion of the Directors of SFOs in the PSC (rather than delegation to focal points paid by the project) is expected to increase the level of engagement. The PSC is tasked with overall accountability for project implementation and results. This includes making key decisions on the strategic direction of the project and its components as reflected in the annual work plan and budget, signing off on all the project's reporting obligations to the World Bank, and monitoring the performance of the project consultants and the quality of project outputs. Details on PSC membership, frequency of regular meetings, mechanisms for quorum and delegation, recording of minutes, specific tasks, decision-making mechanisms, and reporting flows will be elaborated in formal terms of reference and summarized in the POM. The PSC will be established within one (1) month after the Effective Date of the project.

Treasury Working Group (TWG)

2. A TWG will be established to support coordination of the FMIS rollout to line ministries under sub-component 2.1 and coordination of US GASB implementation under sub-component 3.1. The TWG will be chaired by the Assistant Secretary, Treasury, and comprise relevant technical specialists within DOFA, the PIU, sectoral Departments and State Finance Offices to coordinate implementation of these areas, deliberate on the project technical aspects and provide recommendations for PSC decision. Details on TWG membership, frequency of regular meetings, mechanisms for quorum and delegation, recording of minutes, specific tasks, decision-making mechanisms, and reporting flows will be elaborated in formal terms of reference and summarized in the POM. The TWG may form subcommittees to focus on specific technical topics. The TWG will be established within one (1) month after the Effective Date of the project.

Project Implementation Unit (PIU)

3. A PIU will be recruited under the project to take on the day-to-day implementation of project tasks. Due to the human resource capacity constraints in the implementing agency, the project will hire a team of consultants to take on the day-to-day implementation and management of the project. This includes monitoring project timelines, interfacing with World Bank systems and the CIU for procurement and FM , preparing reports on implementation progress and financial management, monitoring progress towards the Results Framework, and providing routine updates to the PSC. The PIU will consist of, at a minimum, a Project Manager and a procurement officer, and a FM officer. The structure of the PIU will be reevaluated during the Mid Term Review.

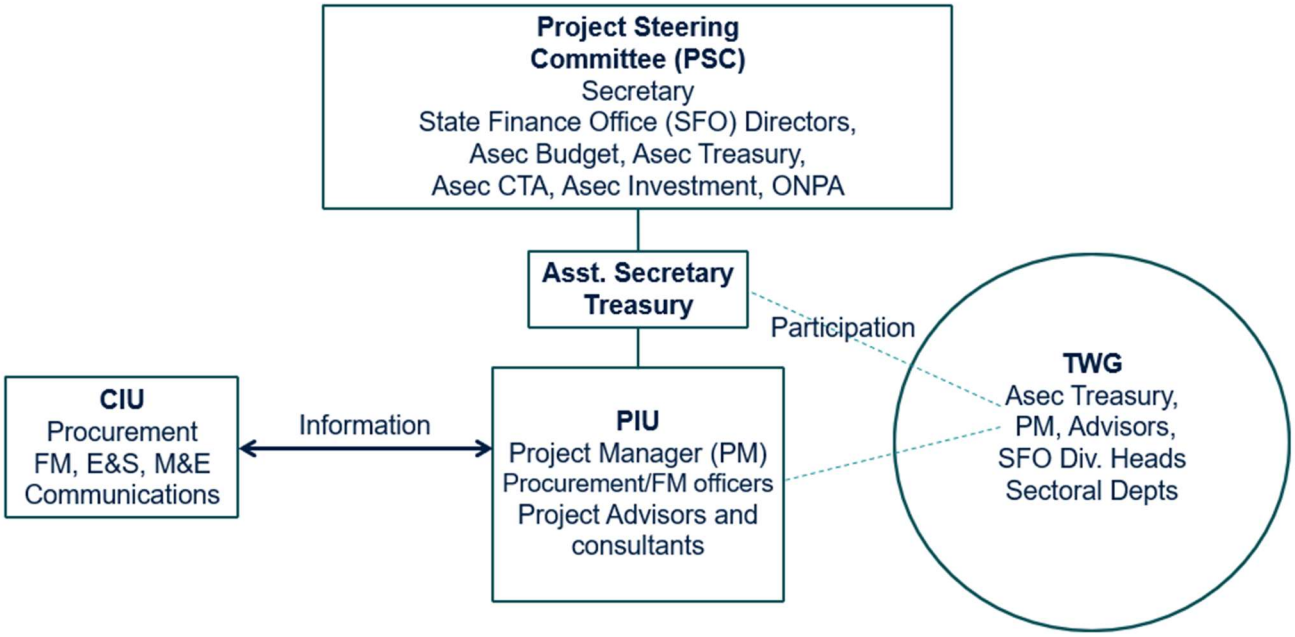
4. Establishment of the PIU and the appointment of key staff are expected within one (1) month after project effectiveness as detailed in the project's legal covenants. Before the PIU members are recruited, it is expected that the

implementing agency, with support from the CIU and the PIU of the existing PFM I project, will directly manage project implementation to avoid delays in key activities. The PIU will comprise:

a. One Project Manager tasked with day-to-day running of the project, project reporting, monitoring the results framework and compliance with safeguards requirements.

b. A procurement officer, and a FM officer, tasked with supporting the Project Manager on financial management and procurement responsibilities of the PIU.

Figure A1.1. Project Implementation Arrangements



5. The Project Manager (PM) will be the primary consultant responsible for the smooth implementation of the project. Key tasks assigned to the PM include ensuring that project activities run on time and within budget, overseeing the implementation of procurement activities using World Bank systems, preparing routine progress reports and annual workplans and budgets at the project level, monitoring the progress towards the results framework, and maintaining compliance with safeguards requirements. In addition, the PM will oversee the overall work of the PIU.

6. The Central Implementation Unit (CIU) will provide centralized support services to the project. The existing CIU was established to provide cross-cutting functions to all World Bank-financed projects and will support the procurement, financial management, communications, monitoring and evaluation, environmental and social safeguards, and disbursement functions for the project. The finance team is led by a senior finance specialist and includes a senior finance officer and four finance officers. There is a dedicated finance officer for each project to carry out the day-to-day financial management and disbursement tasks and ensure FM compliance. The CIU has an in-house capacity for safeguards and will be involved with the preparation and implementation of safeguards instruments. CIU support is in transition and centralized support could be carried out by the CIU or a successor arrangement. FM responsibility will remain a shared responsibility between the PIU and the CIU, or the CIU successor arrangements.

Implementation support plan

7. The approach to implementation support has been developed based on the nature of the activities of the project and the risk profile. The World Bank task team comprises staff from different global practices and a broad mix of skills and will draw on consultants with specific expertise as needed. Skills will cover procurement, financial management, social and environmental safeguards, statistical expertise, governance in the public sector and auditing expertise. Project performance and results evaluation will be based on the results monitoring framework. Implementing agencies will produce annual progress reports. The task team will review these reports and, during missions, verify those outputs/outcomes of the reports. The implementation support plan will be reviewed on at least an annual basis and updated as needed based on project progress or at the request of the implementing agencies.

Table A1.1 Implementation Support Plan

Timeline	Activities	Skills
0 – 12 months	• Support establishment of the PIU and project initiation activities. • Review annual workplan and budget. • Review TORs for consultants hired. • Participate in meetings with DOFA as requested. • Confirm baselines for results indicators and review progress reports. • Review PPSD and 18-month procurement plan. • Provide implementation support as needed.	• Task team leaders • PFM Specialists • FM specialists • Procurement specialists • E&S specialists
12 – 24 months	• Review audited financial reports. • Review annual workplan and budget. • Review progress reports. • Review STEP activity. • Confirm progress against results framework. • Complete technical review of outputs as needed. • Provide implementation support as needed.	• Task team leaders • PFM Specialists • FM specialists • Procurement specialists • E&S specialists
24 – 36 months	• Conduct mid-term evaluation. • Review audited financial reports. • Review annual workplan and budget. • Review progress reports. • Confirm progress against results framework. • Review procurement plan. • Complete technical review of outputs as needed. • Provide implementation support as needed.	• Task team leaders • PFM Specialists • FM specialists • Procurement specialists • E&S specialists
36 – 48 months	• Review audited financial reports. • Review annual workplan and budget.	• Task team leaders • PFM Specialists

Timeline	Activities	Skills
	• Review progress reports. • Confirm progress against results framework • Review procurement plan. • Complete technical review of outputs as needed. • Provide implementation support as needed.	• FM specialists • Procurement specialists • E&S specialists
48 – 60 months	• Review audited financial reports. • Review annual workplan and budget. • Review progress reports. • Confirm progress against results framework. • Review ongoing contracts and close out as necessary. • Complete technical review of outputs as needed. • Provide implementation support as needed. • Conclude project activities and prepare for end of project evaluation.	• Task team leaders • PFM Specialists • FM specialists • Procurement specialists • E&S specialists

Financial Management Arrangements

8. FM implementation arrangements. An FM officer in PIU in coordination with CIU will support the project's day-to-day FM activities including ensuring FM arrangements, controls, and procedures are in compliance. The project will be implemented over five years and the distribution and coordination of the project's FM arrangements in PIU and CIU will be aligned accordingly with the implementation arrangements.

9. Budgeting. The PIU Project Manager will lead the project budget preparation and monitoring. The first budget will be submitted no later than one (1) month after the Effective Date, and then no later than August 1 for each subsequent year during the project implementation period. The project budget will be endorsed by the Secretary before submitting to the World Bank for clearance. DOFA also has experience in preparing project budgets through the implementation of the PFM I. The PIU will prepare an overall planned project budget of US$13 million of project funds and split this into annual budgets. Annual budgets can be revised as needed to reflect project implementation. The budget should be consistent with the annual work plan and the PIU will coordinate with the CIU for project budget guidance and review.

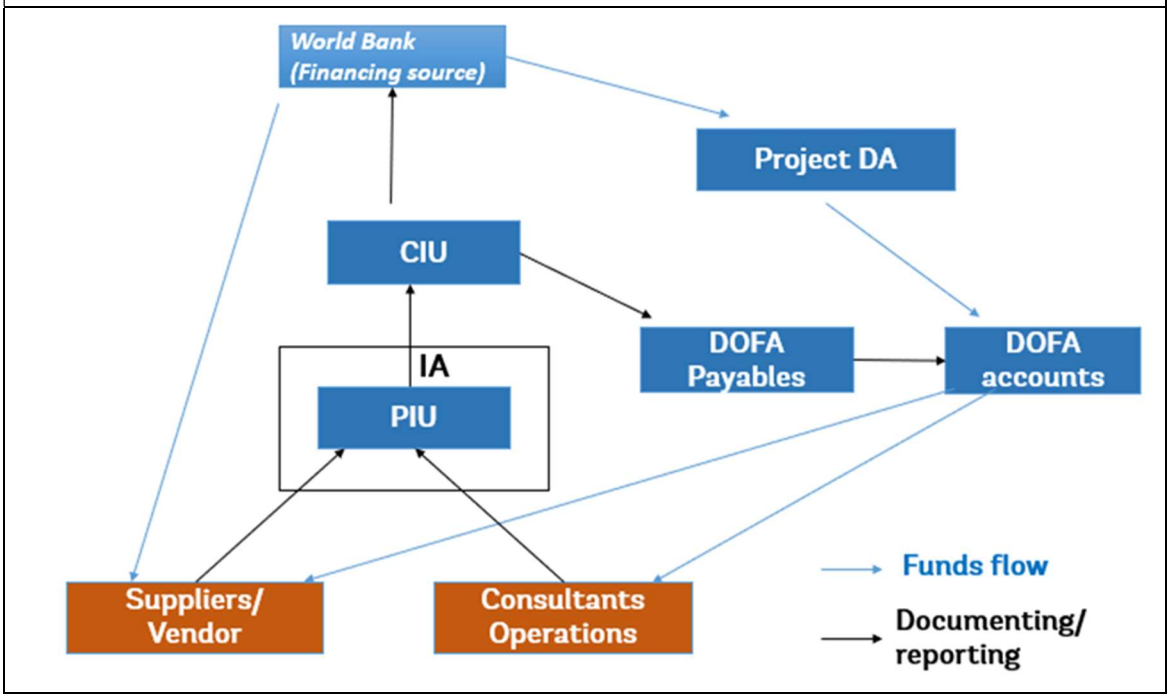
10. Accounting and maintenance of accounting records. The FMIS of the Government will be used to account for the project-eligible expenditure and has a chart of accounts, and transactions or line items can be further classified by cost center. This system can maintain accounting records that meet the World Bank's reporting requirements for this project. A new chart of accounts will be developed for the project with a separate cost center with all related payments centralized in the DOFA. The project will follow the GoFSM financial year, which is from October 1 to September 30.

11. Internal control. The GoFSM and CIU use the Financial Management Regulations and Procedural Manuals, which outline internal controls and procedures. However, compliance within agencies has been moderate. This risk should be mitigated by ensuring that the PIU project team is aware of the regulations, policies, and procedural requirements and ensuring that compliance with the manual is included in the terms of reference of the positions that will be hired by the PIU. PIU will have mechanisms in place to verify the quality of deliverables before submission to CIU for processing

payments with all supporting documents. The POM will include a section on budgeting, disbursement, and FM arrangements that will reference relevant government legislation, procedures, and manual. More detailed FM arrangements specific to the project including controls on project assets and contracts will be outlined in the POM. The government's internal audit function is not yet established. The project supports the establishment and strengthening of the internal audit function of GoFSM which will also be applied for the project. The POM will be developed and adopted as a condition of effectiveness. The government FM policies and procedures will be followed by CIU.

12. Funds flow. Funds will flow from the World Bank to a segregated Designated Account (DA) of the Government of FSM as detailed in Figure A1.2. Expenditures will be tracked through the Government accounting system and paid from the treasury account. Before completing a replenishment withdrawal application, the equivalent funds expended from the treasury account will be transferred from the DA into the treasury account, and the DA will be replenished by that amount, at least every quarter. For larger project payments, the direct payment disbursement method could be used by DOFA. Under this mechanism, the withdrawal application enables funds to flow directly from the World Bank to the supplier. The CIU will be responsible for ensuring that the project follows World Bank FM policies and procedures requirements, including documentation and reporting.

Figure A1.2: Funds Flow



13. Periodic financial reporting. Financial reporting will be fully integrated into the government's accounting system. Reports will initially be generated from the *Free Balance* accounting system. The financial reports will include an analysis of actual expenditure for the current period, (sources and uses) year to date, and the cumulative to date, plus outstanding commitments, compared against the total project budget, disaggregated by components and/or sub-activities. The project, through CIU, will be required to prepare semester unaudited interim financial reports (IFRs) in a format agreed with the World Bank. The IFRs will need to be submitted no later than 45 days after the end of the reporting period, March 31 and September 30. CIU will also prepare periodic financial reports and submit them to PIU for periodic monitoring of the annual budget and reporting to the implementing agency.

14. **External audit**. An annual audit of the project's financial statements will be required to be conducted in a manner acceptable to the World Bank and aligned with the World Bank auditing requirements. The financial statements will be prepared in accordance with acceptable accounting standards and will be audited by an independent auditor under acceptable auditing standards. The audited financial statements and copies of management letters will be submitted to the Bank within nine months after the end of each reporting period. The audited financial statements will be published on the government's websites and by the World Bank.

15. **Disbursement methods and supporting documentation arrangements.** IDA financing of the Project will be at 100 percent, inclusive of taxes. The disbursement methods to be used under this project will be advance, direct payment, and reimbursement. For larger project payments, the direct payment method can be used by the project, and the withdrawal application enables funds to flow directly from the World Bank to the supplier. Adequate documentation will need to be maintained to ensure easy reconciliation of payments made from the treasury account to payments authorized by the project. The POM will further detail the disbursement aspects of the project. The CIU will maintain a 'Statement of Expenditure' to document eligible project expenditures of the project in Client Connection. There is no counterpart funding anticipated under the project.

16. **Retroactive financing.** Retroactive financing not exceeding SDR 1,751,000 (equivalent to US$2,300,000) is available for payments made before the date of the Financing Agreement but on or after May 31, 2024[22] for eligible expenditures under this project. Payments will be made only for project expenditures against contracts procured in accordance with applicable World Bank Procurement Procedures.

Procurement Management and Mitigation Measures:

17. **In order to mitigate the above identified risks and strengthen the procurement capacity of the project, the following measures have been established and agreed to be implemented:** (a) the existing Procurement Specialist in the CIU at DOFA is providing support, advising and guiding the implementing agency as they proceed to carry out implementation functions under the World Bank-financed projects; (b) the Project Manager TORs will include procurement related functions, among others and responsible for the preparation of procurement plans, TOR drafting and oversight of procurement processes ; (c) DOFA will be supported by several international governance reform experts housed within DOFA to provide advisory and training services throughout the project and work closely with the Department of Justice and DOFA on procurement reform and ensuring local legal requirements are adhered to during reform activities; (d) the STEP system will be used to prepare, clear and update Procurement Plans and conduct all procurement transactions for the project (accordingly, all the procurement activities under the project will be entered into, tracked and monitored online through the system); and (e) a POM with a detail Procurement Module will be prepared to guide the project in carrying out procurement. In addition, the World Bank will carry out procurement post reviews annually with an initial sampling rate of 20 percent, which will be adjusted periodically during project implementation based on the performance of the project.

18. **Procurement strategy.** Based on the project requirements, operational context, economic aspects, technical solutions and market analysis, a draft Project Procurement Strategy Document (PPSD) and 18-month procurement plan is developed for the project. The PPSD will finalize the appropriate procurement approaches under the project. The PPSD includes detailed assessments of the markets for goods, works, and services required for project implementation, procurement approaches, and procurement risks analysis along with corresponding proposed risk mitigation measures. The Procurement Plan for the first 18 months of project implementation has been prepared by the PIU based on the PPSD

[22] Date is based on the expected signing date of May 31, 2025, following Board Approval.

conclusions. The procurement plan will be updated at least annually or as required during project implementation to reflect any substantial changes in procurement approaches and methods to meet the actual implementation needs, market fluctuations, and improvements in institutional capacity.

Table A1.2: Procurement Risks and Mitigation Measures

Key Risks	Mitigation Measures	By Whom
Delays, non- compliance with procedures, and poor-quality deliverables due to weak and lean capacities, and high-level decision-making.	Assign procurement responsibility to DOFA for procurement internationally, to be defined in the Financing Agreement, and detailed in the POM; ii. Establish the process flow in each IA for procurement decision-making; iii. Appoint a Procurement Evaluation Committee comprising representatives from DOFA (composition to be detailed in the POM); iv. Assign Project Manager, Technical experts (firm) and/or national procurement officers to liaise with DOFA on procurement activities, and provide technical inputs as required; v. Establish contract management systems within IA, with technical advisory support as required	IA (primary) and CIU
2. Reduced competition and low market interest due to small- size packages and remoteness of participating countries i. Invite bids under regional packages, where appropriate.	i. Invite bids under regional packages, where appropriate. II. Tailor evaluation criteria toward local content to improve bidder participation. III. Pre-Bid engagement to promote the opportunity.	IA and CIU
3. Potential for procurement delays due to inadequate oversight. Price escalation to improper cost estimation.	i. Online Tendering system to publish contract awards. ii. Ensure awards are published via UNDB. iii. Verify cost estimates with WB technical experts' quality assurance to ensure Value for Money is achieved.	IA and CIU

19. Implementation Support for Procurement. The Bank's task team will provide procurement support through prior and post reviews, and guidance during implementation support missions. Hands-on Expanded Implementation Support (HEIS) has been rendered throughout the project preparation period; governance advisor will also help define arrangements under the project and undertake a systematic diagnostic of the current DOFA governance arrangements. The CIU Procurement specialist is responsible for assisting the Project Manager develop bidding documents and carry out project procurement activities and may sit on evaluation panels as needed. Technical documents for procurement are the responsibility of the Project Manager with support from the procurement officer and/or other technical experts, including the Bank. The designated procurement specialist will visit DOFA at least bi-annually, and other IAs, as necessary during implementation.

20. Procurement of Works. N/A

21. Procurement of Goods. Goods to be procured include ICT systems such an E-GP software system and internal Audit platform including hardware and software, and office equipment. Goods will be procured based on the method thresholds agreed for the Pacific. All goods procured at the national level will be carried out under RFQ procedures.

22. Procurement of Non-Consulting services. Citizen engagement activities, website design and change campaign to be procured through a communications vendor providing campaign, advertisement services.

23. Selection of Consultants. Consultants will be hired for specialized technical services, project management, fiduciary, safeguards, and monitoring and evaluation services. DOFA and the Treasury, Finance and Procurement/supply divisions will be responsible for processing the selection of consultants to be hired internationally. International experts to be procured include: audit advisor, procurement reform and spend analysis consultancy firm, legislative reform consultant, US GASB advisor, change management advisor. DOFA will be represented in the selection evaluation committees and in negotiations, and members of DOFA/PSC will form part of evaluation panels to ensure government decisions are aligned with external consultancy decision making

24. Prior-Review Thresholds. The procurement method and prior review thresholds for different types of procurement applicable to Bank operations in fragile and small states in the Pacific shall be applicable, as per Table A1.3 below.

Works and Goods and Non-Consultant Services

Prior Review Threshold: Procurement Clearances are subject to Prior Review by the Bank as stated in Annex II of the Procurement Regulations:

Table A1.3: Procurement Method and Prior Review Thresholds for Goods and Non-Consulting Services

Category	Procurement Method Thresholds		Prior Review Thresholds	
	Applicable thresholds (US$)	Remarks	Applicable thresholds (US$)	Remarks
Works				
RFP/RFB (International market approach)	≥ 10.0 million	None	≥ 3.0 million	
Request for Quotations	< 2.0 million	None		
Direct Selection	None	No threshold; meet requirements of Procurement regulations 7.13-7.15		
Goods and Non-Consulting Services				
RFP/RFB (International market approach)	≥ 2.0 million	None	≥ 1,000,000	
Request for Quotation	< 2.0 million	None		
Direct Selection	None	No threshold; meet requirements of Procurement regulations 7.13-7.15		

Selection of Consultants

Prior Review Threshold: Procurement Clearances to Prior Review by Bank as stated in Annex II of the Procurement Regulations:

Table A1.4: Procurement Method and Prior Review Thresholds

Category	Procurement Method Thresholds		Prior Review Thresholds	
	Applicable thresholds (US$)	Remarks	Applicable thresholds (US$)	Remarks
QCBS, QBS, FBS, LCS[9] (Using the most appropriate market approach)		Methods for consulting services are specified in paragraph 7.3 to 7.12, Section VII of the Procurement Regulations.	≥ 1,000,000	
CQS[10] (Open or limited competition through national or international market approach, specified in the PP and agreed with the Bank.			≥ 1,000,000	
Direct Selection of firms	None	No threshold; meet requirements of regulations 7.13-7.15	Same as for competitive selection	
Individual Consultants		Essential individual assignments will be defined in the Procurement Plan agreed with the Bank and in line with regulations 7.34-7.39 using the most appropriate market approach	≥ 0.4 million and for the positions as specified in the PP agreed with the Bank	Risk-based approach