

KWAJALEIN ATOLL LOCAL GOVERNMENT

INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2001



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED UPON THE ENGAGEMENT TO AUDIT
PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Kwajalein Atoll Local Government Council
Kwajalein Atoll Local Government
Republic of the Marshall Islands:

We were engaged to audit the general purpose financial statements of the Kwajalein Atoll Local Government (KALGOV) as of and for the year ended September 30, 2001. Our report dated May 17, 2002, stated that the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the financial statements due to our inability to determine that assets, liabilities, revenues and expenditures were fairly stated.

Compliance

Auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, require that an audit be planned and performed in order to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement. We performed tests of KALGOV's compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of general purpose financial statement amounts. However, providing an opinion on compliance with those provisions was not our objective and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*, which are described in the accompanying Schedule of Findings (pages 3 through 16) as items 2001-12 and 2001-13.

Internal Control Over Financial Reporting

In planning the audit, we considered KALGOV's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect KALGOV's ability to record, process, summarize and report financial data consistent with the assertions of management in the general purpose financial statements. Reportable conditions are described in the accompanying Schedule of Findings as items 2001-1 through 2001-11.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we consider all of the reportable conditions described above to be material weaknesses.

This report is intended solely for the information and use of management and the Board of Directors and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche

May 17, 2002

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings
Year Ended September 30, 2001

Purchases/Disbursements

Finding No. 2001-1

Criteria: Payroll advances should only be made when there is an ability to repay those advances. Additionally, the functions of the Finance department should be properly segregated.

Condition: During the year ended September 30, 2001, payroll advances were made to KALGOV officials in the following amounts:

Finance Director	\$ 93,604
City Manager	59,440
Mayor	<u>23,504</u>
	\$ <u>176,548</u>

In addition, our review of subsequent disbursements indicated the following advances were made for the period October 1, 2001 through May 17, 2002:

Finance Director	\$ 36,787
City Manager	28,383
Mayor	<u>11,664</u>
	\$ <u>76,834</u>

The above advances were recorded as debits to an "other payroll deduction" account in the general ledger. The advances appear to be excessive. KALGOV represents that the advances were partially paid down through accrued vacation leave, however, KALGOV was unable to produce detail of accrued vacation leave payable or advances receivable at September 30, 2001. The balance in the "other payroll deduction" account was \$97,145 at September 30, 2001.

Our review of payroll checks issued to the Finance Director noted one check (ck. no. 15646) which included 842 sick leave hours in addition to 80 regular hours. Additionally, we noted that the majority of the Finance Director's payroll checks included approximately 100 annual leave hours in addition to 80 regular hours. The related timesheets were not approved by management.

Our review of payroll checks issued to the City Manager noted approximately 260 annual leave hours, in addition to regular hours, paid during the year.

Cause: The cause of the above condition is unknown. We do note that the Finance Director is responsible for cash disbursements and payroll processing. The payroll clerk also issues cash receipts.

Effect: The effect of the above condition is advances are made without an ability to repay.

Recommendation: We recommend that the Council investigate the above advances and determine appropriate action. Additionally we recommend strict segregation of duties be established within the Finance department.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Finding No. 2001-1, Continued

Auditee Response and Corrective Action Plan:

KALGOV's response to the above finding is as follows:

1. All sick leave hours accrued by the City Manager and the Finance Director are considered payables to the payroll system. Accrued sick leave hours will be applied to reduce the excess amount of advances made.
2. A sum of no more than \$250, and not less than \$200, will be made available from the City Manager's, the Finance Director's and the Mayor's biweekly paychecks to cover the excessive amount of advances made by each individual.
3. All purchase requisitions shall be approved by the Mayor or a member of the Executive Committee.
4. All outgoing checks must be presented to the Mayor or the City Manager for clearance.
5. No advances shall be allowed to any employee who has not accumulated a total of 160 hours or more.
6. A more strict policy on the responsibilities of the Finance Department shall be established and carried out as recommended.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Purchases/Disbursements

Finding No. 2001-2

Criteria: All disbursements should be evidenced by a check copy with supporting invoice and purchase requisition. Purchase requisitions should be certified by the Finance Director evidencing availability of funds.

Condition: Of twenty-five cash disbursements tested, seven items (check nos. 3041, 3169, 3464, 3517, 3761, 3815 and 17763) were not supported by an invoice and purchase requisitions were not signed by the Finance Director. Additionally, three items (check nos. 3041, 4022 and 17763) described for the purchase of fuel and other supplies were payable to cash with no supporting invoice.

Cause: The cause of the above condition is the lack of established internal control procedures over supporting documents. Additionally, internal controls over purchases are not followed.

Effect: The effect of the above condition is the lack of support for disbursements, improper authorization of purchases, and potential misappropriation of cash.

Recommendation: We recommend that all cash disbursements be supported by an invoice and be properly approved.

Auditee Response and Corrective Action Plan: Action has been taken to ensure that all cash disbursements are supported by invoices and are properly approved.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Revenues/Receipts

Finding No. 2001-3

Criteria: Cash receipts should be issued in a sequential manner and all supporting documents should be filed with the receipt copies. Cash receipts should be pre-numbered using one set of receipts.

Condition: We were unable to determine a random sample of cash receipts based on ranges used during the year as cash receipts were not issued and filed sequentially. KALGOV used three sets of receipts with different receipt numbers. Additionally, receipt no. 290626 did not have a supporting business license application.

Cause: The cause of the above condition is the lack of established internal control procedures.

Effect: The effect of the above condition is a weakness in the control over cash and a potential for misappropriation.

Recommendation: We recommend that KALGOV develop and maintain procedures to ensure that all cash receipts are issued and filed sequentially. Additionally, KALGOV should use only one set of cash receipts.

Auditee Response and Corrective Action Plan: Written assurance that receipts are issued and filed sequentially.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Payroll

Finding No. 2001-4

Criteria: Payment of salaries and wages should be processed accurately so that employees are paid for hours approved in the timesheet. All timesheets should be approved by the City Manager. Additionally, personnel action forms should be properly authorized.

Condition: Our tests of payroll noted check nos. 14104 and 14404 where employees were not paid 5.6 night differential hours, and 16 annual leave hours, respectively. The timesheet for check no. 12209 was not signed by the department head. Additionally, we reviewed check no. 13092 for proper authorization of pay rate and noted that the department head did not sign the personnel action form.

Cause: The cause of the above condition is the lack of adherence to internal control procedures.

Effect: The effect of the above condition is the potential misstatement of salary and wage expenditures.

Recommendation: We recommend that KALGOV adhere to established internal control procedures to eliminate inaccurate payments of salaries and wages.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

External Financial Reporting

Finding No. 2001-5

Criteria: Sufficient internal control over general ledger balances requires that control totals be periodically reconciled to subledgers and that subledgers be reviewed for reasonableness.

Condition: KALGOV did not record beginning of the year general ledger control totals for liabilities until after year end, and thus operated for the entire fiscal year with inaccurate general ledger balances. This situation would not have allowed the financial management system to determine budgetary adherence during the fiscal year.

Cause: The cause of the above condition is that policies and procedures that would require the posting of beginning of the year general ledger control totals and their subsequent reconciliation and review have not been established.

Effect: The effect of the above condition is that liability general ledger balances were misstated throughout the fiscal year.

Recommendation: We recommend that KALGOV establish policies and procedures that require the posting of beginning of the year general ledger control totals and their subsequent reconciliation and review.

Prior Year Status: Not recording beginning of the year general ledger control totals was reported as a finding in the audits of KALGOV for fiscal years 1993 through 2000.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken. Accounting software has been instituted.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

External Financial Reporting

Finding No. 2001-6

Criteria: Sufficient internal control over receivable and payable balances requires that general ledger control totals be periodically reconciled to subledgers and be reviewed for reasonableness.

Condition: Accounts receivable have not been reconciled to actual amounts due, and accounts payable and accrued liabilities have not been reconciled to actual obligations due. Additionally, no subsidiary ledgers were maintained to support general ledger balances.

Cause: The cause of the above condition is that policies and procedures do not exist that require periodic reconciliation of receivable and payable balances.

Effect: The effect of the above condition is that receivable and payable balances are misstated throughout the fiscal year.

Recommendation: We recommend that KALGOV establish policies and procedures that require periodic reconciliation of receivable and payable accounts.

Prior Year Status: The lack of reconciliation of receivable and payable balances was reported as a finding in the audits of KALGOV for fiscal years 1987 through 2000.

Auditee Response and Corrective Action Plan: Written assurance that action has been implemented.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Cash

Finding No. 2001-7

Criteria: An appropriate number of bank accounts should be maintained for operations.

Condition: KALGOV currently maintains five checking accounts for operations, which appears excessive for KALGOV's requirements.

Cause: The cause of the above condition is the lack of management review of operational requirements to determine an appropriate number of bank accounts.

Effect: The effect of the above condition is additional complexity in maintenance and reconciliation of the checking accounts.

Recommendation: We recommend that management review operational requirements and determine an appropriate number of bank accounts.

Prior Year Status: Lack of management review of operational requirements to determine an appropriate number of bank accounts was reported as a finding in the audits of KALGOV for fiscal years 1999 and 2000.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Cash

Finding No. 2001-8

Criteria: Checks should be safeguarded at all times and new orders for checks should follow the last check number used. Pre-numbered checks should be used instead of counter checks.

Condition: Unused payroll and general account checks leftover from processing are not marked void or otherwise distinguished as unusable and are left unsecured. Additionally, checks were not issued sequentially. We also noted that numerous counter checks were used during the year.

Cause: The cause of the above condition is the lack of policies and procedures requiring the safeguarding of checks and ensuring that checks are used in sequential order.

Effect: The effect of the above condition is the susceptibility to misappropriation and the lack of safeguarding of assets.

Recommendation: We recommend that the leftover checks be marked void and kept secured. Additionally, checks should be issued in sequential order.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Fixed Assets

Finding No. 2001-9

Criteria: Accounting principles generally accepted in the United States of America require that government entities maintain accountability for and control of their general fixed assets.

Condition: KALGOV does not account for its general fixed assets.

Cause: The cause of the above condition is that KALGOV has not established policies and procedures to ensure proper control of and accountability for fixed assets.

Effect: The effect of the above condition is the general purpose financial statements do not include a general fixed assets account group. The fixed assets account group is a necessary element of the financial statements of a government entity.

Recommendation: We recommend formal policies and procedures be implemented to establish accountability for and control of fixed assets. This can be accomplished by establishing a general fixed assets account group.

Maintaining a formal record of fixed assets will aid in budgeting, as fixed asset replacements will be easier to forecast. Having formal records of fixed assets also assists in ensuring assets are not misappropriated and assists in determining which assets have been lost or damaged.

Prior Year Status: Not accounting for general fixed assets was reported as a finding in the audits of KALGOV for fiscal years 1993 through 2000.

Auditee Response and Corrective Action Plan: Written confirmation that action has been taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Payables and Accrued Liabilities

Finding 2001-10

Criteria: Expenditures should be recorded when the related liability is incurred.

Condition: KALGOV's general ledger liability balances were not supported by detailed subledgers. KALGOV's accounts payable - other account recorded a debit balance of \$34,506 at September 30, 2001. KALGOV did not record a liability for accrued annual leave as of September 30, 2001. Additionally, KALGOV did not withhold income and social security taxes for annual leave paid during the fiscal year. The amount of unrecorded liabilities and expenditures could not be determined.

Cause: The cause of the above condition is the lack of prescribed policies and procedures requiring the creation and reconciliation of subledgers, the recording of annual leave payable and the withholding of income and social security taxes for annual leave paid.

Effect: The effect of the above condition is the misstatement of liabilities and expenditures and potential interest and penalty charges for taxes not withheld.

Recommendation: We recommend that expenditures be recorded when related liabilities are incurred, that subledgers be created and reconciled, that annual leave payable be recorded and that income and social security taxes be appropriately withheld.

Prior Year Status: Lack of prescribed policies and procedures requiring annual leave to be recorded and to withhold income and social security taxes for annual leave paid was reported as a finding in the audits of KALGOV for fiscal years 1999 and 2000.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Payables and Accrued Liabilities

Finding 2001-11

Criteria: Contractual obligations should be adhered to.

Condition: On August 8, 1999, KALGOV entered an agreement with the Government of the Republic of the Marshall Islands (RepMar) whereby RepMar agreed to forgive KALGOV's income withholding tax payable amounting to \$287,754, contingent upon RepMar's receipt of \$99,492 from KALGOV. KALGOV has not made the required payment due to management's position that approximately \$100,000 is receivable from RepMar. Although KALGOV represented that \$99,492 was withdrawn from education grants owed to KALGOV by RepMar, management was unable to provide support for this withdrawal or the unrecorded receivable and, therefore, KALGOV's income tax payable could not be determined. Our follow-up with the RepMar Chief of the Division of Revenue and Taxation indicated that the \$99,492 had not been paid.

Cause: The cause of the above condition is unknown.

Effect: The effect of the above condition is the possible misstatement of receivables, revenues, and withholding tax payable and potential interest and penalty charges for unpaid taxes.

Recommendation: We recommend that management investigate the status of this agreement and record an adjustment, if any, based on the results of the investigation.

Prior Year Status: Possible misstatement of receivables, revenues, and withholding tax payable and potential interest and penalty charges for unpaid taxes was reported as a finding in the audits of KALGOV for fiscal years 1999 and 2000.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Local Noncompliance

Finding No. 2001-12

Criteria: Section 5 of the Republic of the Marshall Islands (RepMar) Income Tax Act of 1989, as amended, states that the employer shall, once every four weeks or thirteen times per year, pay taxes withheld under Section 4 of the Act.

Condition: KALGOV did not remit income tax withholdings from employee wages to RepMar during the year ended September 30, 2001.

Cause: The cause of the above condition is unknown.

Effect: The effect of the above condition is noncompliance with the Income Tax Act of 1989, as amended.

Recommendation: We recommend that management comply with the Income Tax Act of 1989, as amended.

Prior Year Status: Noncompliance with the Income Tax Act of 1989, as amended, was reported as a finding in the audits of KALGOV for fiscal years 1998 through 2000.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Schedule of Findings, Continued
Year Ended September 30, 2001

Local Noncompliance

Finding No. 2001-13

Criteria: Sections 131 and 215 of the RepMar Social Security Act of 1990 and the Social Security Health Fund Act of 1991, respectively, state that no later than the tenth day after the end of each quarter, every employer shall submit to the Social Security Administrator a report of the wages and salaries paid by the employer, and the contributions due from employer, under Sections 129 and 130, and 213 and 214, respectively, and pay into the Fund the contributions due.

Condition: KALGOV did not remit to the Marshall Islands Social Security Administration employer and employee contributions during the year ended September 30, 2001.

Cause: The cause of the above condition is unknown.

Effect: The effect of the above condition is noncompliance with the Social Security Act of 1990 and the Social Security Health Fund Act of 1991.

Recommendation: We recommend that management comply with the Social Security Act of 1990 and the Social Security Health Fund Act of 1991.

Prior Year Status: Noncompliance with the Social Security Act of 1990 and the Social Security Health Fund Act of 1991 was reported as a finding in the audits of KALGOV for fiscal years 1998 through 2000.

Auditee Response and Corrective Action Plan: Recommendation noted and action taken.

KWAJALEIN ATOLL LOCAL GOVERNMENT

Unresolved Prior Year Findings
Year Ended September 30, 2001

The status of unresolved prior year findings is disclosed within the Schedule of Findings section of this report (pages 3 through 16).