

**MARSHALL ISLANDS DEVELOPMENT BANK**

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**INDEPENDENT AUDITORS' REPORTS ON  
INTERNAL CONTROL AND ON COMPLIANCE**

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**YEAR ENDED SEPTEMBER 30, 2006**

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Board of Directors  
Marshall Islands Development Bank:

We have audited the financial statements of the Marshall Islands Development Bank (MIDB) as of and for the year ended September 30, 2006, and have issued our report thereon dated August 31, 2007. We conducted our audit in accordance with 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.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered MIDB's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion 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 MIDB's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs (pages 6 through 17) as items 2006-1 through 2006-5.

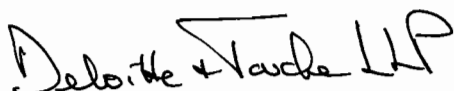
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being 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, of the reportable conditions described above, we consider items 2006-1 through 2006-3 to be material weaknesses.

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether MIDB's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of MIDB in a separate letter dated August 31, 2007.

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

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is written in a cursive, stylized font.

August 31, 2007

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL  
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM  
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

Board of Directors  
Marshall Islands Development Bank:

Compliance

We have audited the compliance of the Marshall Islands Development Bank (MIDB) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the Year Ended September 30, 2006. MIDB's major federal program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (pages 6 through 17). Compliance with the requirements of laws, regulations, contracts, and grants applicable to its one major federal program is the responsibility of MIDB's management. Our responsibility is to express an opinion on MIDB's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about MIDB's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on MIDB's compliance with those requirements.

In our opinion, MIDB complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2006.

Internal Control Over Compliance

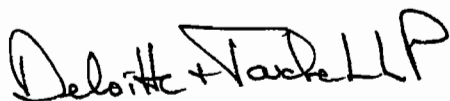
The management of MIDB is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered MIDB's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable 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 noncompliance with applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

#### Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of MIDB as of and for the year ended September 30, 2006, and have issued our report thereon dated August 31, 2007. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards (page 5) is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of MIDB. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

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

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is written in a cursive, stylized font.

August 31, 2007

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2006

	<u>Net Assets Beginning of Year</u>	<u>Federal Funds Received</u>	<u>Contributions or Earnings on Funds</u>	<u>Funds Expended</u>	<u>Net Assets End of Year</u>
<u>U.S. Department of the Interior</u> <u>CFDA #15.875</u>					
Agreement between the Government of the United States and the Government of the Marshall Islands for the Implementation of Section 211 of the Compact of Free Association.	\$ 2,270,158	\$ -	\$ 117,224	\$ -	\$ 2,387,382
<u>U.S. Department of Agriculture</u> <u>CFDA #10.433</u>					
Rural Housing Preservation	270,776	-	2	-	270,778
Self-Help Housing Project	-	116,272	250	116,522	-
	<u>\$ 2,540,934</u>	<u>\$ 116,272</u>	<u>\$ 117,476</u>	<u>\$ 116,522</u>	<u>\$ 2,658,160</u>

The above U.S. Department of the Interior funds were received in a subrecipient capacity through the Republic of the Marshall Islands. The loan portfolio established through Section 211 of the Compact of Free Association was also selected for detailed compliance testing in accordance with applicable OMB Circular A-133 requirements. The loan portfolio related to Section 211 of \$1,195,401 at September 30, 2006, is fully reserved.

The above U.S. Department of Agriculture funds were received directly from the federal grantor agency. These funds were issued to loan customers under the Housing Preservation Grant fund and to assist the operations of Self-Help Housing Program. The loan portfolio related to the Housing Preservation Grant of \$16,009 at September 30, 2006, is fully reserved.

The Schedule of Expenditures of Federal Awards is presented on the accrual basis of accounting, and is presented in accordance with the requirements of OMB Circular A-133.

See Accompanying Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards.

# MARSHALL ISLANDS DEVELOPMENT BANK

## Schedule of Findings and Questioned Costs Year Ended September 30, 2006

### Section I - Summary of Auditor's Results

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were identified, some of which are considered to be material weaknesses.
3. No instances of noncompliance considered material to the financial statements were disclosed by the audit.
4. No reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were identified.
5. The Independent Auditors' Report on compliance with requirements applicable to the major federal award program expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. MIDB's one major program is as follows:

<u>Name of Federal Program</u>	<u>CFDA Number</u>
Compact of Free Association	15.875

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. MIDB did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

### Section II - Financial Statement Findings

<u>Reference Number</u>	<u>Findings</u>	<u>Refer Page #</u>
2006-1	Incompatible Functions	7
2006-2	Loans Receivable	8
2006-3	Loans Receivable	14
2006-4	Savings Deposit Accounts	16
2006-5	Purchase Orders	17

### Section III - Federal Award Findings and Questioned Costs

No findings are reportable.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

**Section II - Financial Statement Findings**

Incompatible Functions

Finding No. 2006-1

Criteria: A functioning system of internal control provides for adequate segregation of duties.

Condition:

- a) The Chief Financial Officer (CFO), is a check signatory and is also the only authorized employee who can post disbursement entries to the general ledger.
- b) The MIS Manager performs functions such as payroll register review and posting of loan entries in the absence of the CFO.

Cause: The cause may be a lack of consideration of the criteria.

Effect: The effect is that noncompliance with the criteria may have resulted.

Recommendation: We recommend that management revisit its organizational structure to ensure that incompatible duties are not assigned to employees.

Prior Year Status: Issue on incompatible functions was reported as a finding in the Single Audit of MIDB for fiscal year 2005.

Auditee Response and Corrective Action Plan: Due to minimal manpower and manpower capability limitations, there were certain incompatible functions that were overlooked. Management has agreed to revisit the Bank's organizational structure and its processes to identify incompatible duties and other opportunities for process improvement. All posting procedures in the accounting and loan systems are now delegated to the MIS Dept.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable

Finding No. 2006-2

Criteria: Loan files and attendant recalculations should support the validity of underlying loan balances and calculations.

Conditions:

(a) Loan Origination Procedures

Review of loans originated during fiscal year 2006 revealed the following documentation matters:

(1) Borrower: Loan No. 30084

- Loan approval by the Managing Director was not noted on the Loan action sheet but was located only on the loan application form. Further, the application form was only in Marshallese (no English format was on file).
- Promissory note in file but was not signed by the borrower and not notarized. Also, acknowledgement portion was not completed.
- No proof of credit life insurance was on file.

(2) Borrower: Loan No. 30012

- Loan folder was not located.

(3) Borrower: Loan No. 30000

- Loan maturity date exceeds 20 years, which is not compliant with the 15-year maximum term per existing policy. It was represented that a memo documenting Board approval of the revised policy exists but a copy of this memo was not available.
- Loan approval by the Managing Director was not noted on the Loan action sheet but was located only on the loan application form. Further, the application form was only in Marshallese (no English format was on file).
- No proof of credit life insurance was noted in file. It was represented that the borrower is an employee of the Bank and is therefore exempt from credit life insurance. This matter is not included in the loan policy.

(4) Borrower: Loan No. 30031

- Loan application form was not in file.
- Interest rate per promissory note is 8.5% but loan system showed 8%.
- Board paper and loan action sheet did not reflect loan approval.
- Request for loan drawdown was not approved.
- No proof of credit life insurance was on file.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable, Continued

Finding No. 2006-2, Continued

(b) Aging of Loans

During a review of individual loan payment histories, we identified accounts whose aging was erroneously calculated due to the initial payment dates posted in the loan profile. The CFO and the MIS Manager indicated that the loan officers mistakenly posted erroneous first payment dates during loan boarding. Since the Bank bases the allowance calculation on the age of the loans, accurate aging is significant to the determination of computed loan losses. While the Bank recognized the error and commenced effecting system corrections, we noted that the majority have remained uncorrected as of examination date (*35 of 79 loans reviewed contained errors*). Management is aware of this matter and the 35 affected loans are as follows:

	<u>Loan Number</u>	<u>Outstanding Loan as of 9/30/06</u>	<u>1<sup>st</sup> Payment Date Erroneously Posted</u>	<u>Date 1st Payment Should Be</u>
1	30031	\$ 79,453	8/30/06	8/18/06
2	29999	13,840	6/30/06	7/1/06
3	29969	13,272	6/30/06	6/5/06
4	30037	12,617	8/21/06	8/18/06
5	30012	27,617	6/23/06	7/6/06
6	30032	13,305	7/21/06	8/13/06
7	38505	11,967	12/23/05	1/15/06
8	39574	9,820	5/30/05	5/22/05
9	38535	11,186	2/10/06	3/15/06
10	29989	22,848	5/26/06	6/26/06
11	38742	12,236	1/13/06	2/4/06
12	38468	12,086	12/23/05	1/6/06
13	29939	11,863	3/31/06	4/3/06
14	30072	11,350	8/31/06	9/24/06
15	29976	13,609	5/26/06	6/12/06
16	30023	10,780	7/21/06	8/14/06
17	28858	10,098	11/30/05	12/11/05
18	28986	10,026	1/1/06	2/22/06
19	38539	9,805	12/23/05	1/15/06
20	29434	12,896	2/3/06	2/18/06
21	29498	12,798	2/3/06	2/27/06
22	29245	10,300	1/6/06	2/24/06
23	27876	9,934	3/30/05	3/21/05
24	39858	9,552	7/15/05	10/15/05
25	28422	12,707	10/21/05	11/20/05
26	28544	11,358	11/6/05	1/28/06
27	38688	10,768	2/28/06	3/29/06

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable, Continued

Finding No. 2006-2, Continued

	<u>Loan Number</u>	<u>Outstanding Loan as of 9/30/06</u>	<u>1<sup>st</sup> Payment Date Erroneously Posted</u>	<u>Date 1st Payment Should Be</u>
28	40112	10,631	6/10/05	7/1/05
29	38908	10,482	3/18/05	4/11/05
30	29817	10,349	12/23/05	1/9/06
31	28615	10,201	11/11/05	11/28/05
32	30019	24,373	9/21/06	8/6/06
33	25602	2,795,869	6/15/03	6/23/03
34	25601	2,581,653	5/9/04	6/9/03
35	29502	1,377	2/20/06	2/28/06

(c) Loan System Limitations

The following cases were noted as a result of loan system limitations:

- 1) The Bank adopted Statement of Financial Accounting Standards No. 91 effective 2005. In relation to this, tests of deferred loan and insurance fees were performed but we were not provided an adequate schedule documenting new loans originated during 2006, as this appears to be a limitation of the loan system. A report was generated, which excluded loans released and paid-off during the year. While alternative procedures were performed utilizing different schedules, the inability of the loan system to generate receiving reports connotes a potential system limitation that may require necessary attention and corrective action.
- 2) Total loans per the delinquency report did not agree with total loans per the loan trial balance/GL. Certain loans were missed in the loan aging during the delinquency report generation. This process appears to be another potential limitation of the loan system.

The table below summarizes loans that were not captured in the delinquency report:

<u>Loan Type</u>	<u>Particulars</u>	
RMI Consumer	Various accounts (reported to be under the non-current, 1.5% provision category):	
	Total outstanding loan amount	\$ 220,910
	Total outstanding accrued interest receivable	15,592
RMI Housing 20%	Various accounts (reported to be under the non-current, 1.5% provision category):	
	Total outstanding loan amount	\$ 17,116
RMI Business	Borrower: Pacific Marshalls Inc.	
	Outstanding loan amount	\$ 2,581,653
BPF Business	(Various accounts (Charge-off category))	
	Total outstanding loan amount	\$ 38,330
IDF	Various accounts (Charge-off category)	
	Total outstanding loan amount	\$ 5,554

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable, Continued

Finding No. 2006-2, Continued

We recommend that management continue to evaluate the above systems issues and determine the most feasible corrective action plan.

(d) Posting of Data in the Loan System

- (1) Borrower: Loan No. 3000  
Loan Amount: \$63,000

The loan was current as of September 30, 2006 and as of our examination date despite an absence of payments received since loan boarding. Investigation showed that this is due to erroneous posting of '240' in the loan system under the 'No. of payment extensions' tab. Based on erroneous input, the system calculated a grace period of 240 payments.

- (2) Borrower: Loan No.13264  
Loan Amount: \$42,169

The payment history showed no movements in the balance since 2004. However, the loan delinquency report shows the account is current as of September 30, 2006. Further investigation indicated an erroneous loan system posting of the number of required payments. Instead of 180, 18 was posted in the loan profile, thus making the system recognize and calculate the age based on the erroneous input.

This matter was subsequently corrected and it was discovered that the loan was actually 2,248 days past due as of September 30, 2006. While correction has occurred, we emphasize the need to revisit data input in the loan profiles to ensure that issues of this type, if any, are timely identified and corrected.

(e) Discrepancies in the Original Loan Amount

Borrower: Loan no. 214823

The loan trial balance indicates the original amount of the loan is \$311,257, while the promissory note showed \$3,144,454. Further investigation revealed this resulted from an error in the code used when the second drawdown was posted. It appears that only the first drawdown was captured. Although this error did not have an apparent effect on the principal balance and in the computation of interest, the error is visible in loan reports generated (i.e, delinquency report) and may mislead readers.

While this matter has been subsequently corrected, we believe that this may be an indication that other accounts with the same error may exist. We therefore recommend that management initiate measures to review the loan trial balances against original loans underwritten.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable, Continued

Finding No. 2006-2, Continued

(f) Results of Loan Confirmation Procedures

The following resulted from the loan confirmation procedures:

<u>Loan Number</u>	<u>Particulars</u>	
28976	Discrepancy is noted as follows:	
	Balance per MIDB	\$ 12,093.71
	Balance per confirmation reply	<u>10,450.00</u>
	Difference	\$ <u>1,643.71</u>
12007	As the confirmation reply was not received, an alternative procedure was utilized by checking details of the loans per trial balances against the loan system. We noted a difference on the amount of outstanding balance as follows:	
	Per loan trial balance	\$ 56,670.20
	Per loan system	<u>57,046.90</u>
	Difference	\$ <u>376.70</u>
13043	No confirmation replies were received and the letters were returned due to incorrect addresses. We suggest that the loan department revisit customer files to ensure accurate, updated and adequate records exist.	
12114	As the confirmation was not received, an alternative procedure was performed by agreeing the loan per the trial balance against the loan system. A difference exists in the name of the borrower per each system.	
	We suggest that that Loan department revisit customer files to ensure that accurate, updated and adequate records are maintained.	

(g) Loan Department's Collection Procedures

One loan (loan no. 28860) was categorized as doubtful, but should have been classified as current if collection efforts were performed as represented by the Loan department. It appears there is a need to improve collection procedures utilized by the Loan department to increase recovery of delinquent loans.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable, Continued

Finding No. 2006-2, Continued

Cause: The cause of the above conditions appears to be noncompliance with the criteria.

Effect: The effect of the above is noncompliance with the criteria and potential errors in the loan portfolio balances and in the financial statements.

Recommendation: While we commend management for the current corrective action to improve the quality of its loan accounting and collection procedures, we recommend that the above conditions be addressed and be resolved and that formal corrective action plans be established to resolve the above matters.

Prior Year Status: Inadequate loan documentation was reported as a finding in the Single Audit of MIDB for fiscal year 2005.

Auditee Response and Corrective Action Plan: Management is reviewing the Loan Processes to come up with procedural enhancements to ensure adequate, efficient and effective loan guidelines and processes. Audit finding no. 2005-2 has been addressed, corrections have been made on noted audit samples, and a review of other loans is in process. A rigid supervision and monitoring process on loans will be in place to avoid erroneous encoding of loan data, missing loan entries or any discrepancies between loan files and the loan system.

Management has agreed to get the service of Bank of Marshall Islands IT Department to work on the system limitations that were identified during the audit. Additional reporting requirements and report generation enhancements were identified to expedite loan analysis and reporting. Management and the Board of Directors are studying the possibility of purchasing another loan system that can cater all MIDB loan processing, loan maintenance, and loan reporting requirements. A system that can easily be customized in accordance with the Bank's needs.

## MARSHALL ISLANDS DEVELOPMENT BANK

### Schedule of Findings and Questioned Costs, Continued Year Ended September 30, 2006

#### Loans Receivable

#### Finding No. 2006-3

Criteria: The Bank should maintain an adequate system that establishes periodic estimates of loan losses and attendant accrued interest and that also assesses when loans should be charged off.

#### Conditions:

#### (a) Loan Loss Provisioning

In prior years, the Bank had no policy on loan allowance provisioning and this matter was cited in prior audits. In response, the Bank established a policy based on loan aging, as follows:

<u>Loan Category</u>	<u>Age of Loan</u>	<u>Rate Provision</u>
a. Current	0 days	0%
b. Non-current	1-30 days	1.5%
c. Non-current	31-90 days	5%
d. Sub-standard	91-180 days	30%
e. Doubtful	181-270 days	50%
f. Charged-off	270 days and above	100%

Accrued interest receivable aged 0-90 days is not provided an allowance, while a 100% provision is provided for balances aged in excess of 91 days.

The above policy was implemented in 2005 but is still in informal implementation, pending formal approval from the Board.

We recommend that the above practice be supported, reviewed and acted upon by the Board. Additionally, we suggest consideration occur of a general provision for all current loans (i.e., 1%) and that consideration occur of instituting a minimum and maximum allocation range for each loan classification.

#### (b) Development of a Write-Off Policy

The Bank implemented a loan loss provisioning policy in 2005 and a classification is the 'charge-off' category for loans aged 270 days and above. As of September 30, 2006, total loans under this category amounted to \$13.9MM, which approximates 53% of total outstanding loans. The Bank recognizes that these loans have been long outstanding and has provided a 100% reserve.

We suggest that management develop a write-off policy and consider the disposition of these long outstanding loans.

#### (c) Accrual of Interest for Non-accruing Loans

The Bank does not have a policy to suspend interest accruals on non-accrual loans (aged 90 days and above). It has been the Bank's practice to recognize interest income on all loans, regardless of performance. As a result, for some loans, accrued interest is almost as much as the principal balance.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Loans Receivable, Continued

Finding No. 2006-3, Continued

(c) Accrual of Interest for Non-accruing Loans, Continued

When this issue was brought to management's attention in the prior year, the Bank responded by deferring accrued interest on delinquent loans and recording these amounts as a liability. This practice may overstate Bank liabilities.

We reiterate the need to formulate a policy to place nonperforming, delinquent loans on non-accrual status and discontinue the accrual of interest for financial statement purposes.

Cause: The cause of the above conditions is lack of sufficient policy that ensures compliance with the criteria.

Effect: The effect of the above conditions is non-compliance with the criteria.

Recommendation: The above policies, subject to Board amendments, should be implemented and the policies should be subject to periodic review to ensure their continuing adequacy.

Prior Year Status: The issue on loan loss provisioning, lack of policies on write-off of loans and suspension of interest accrual for non-accruing loans, were reported as a finding in the Single Audits of MIDB for fiscal years 2002 through 2005.

Auditee Response and Corrective Action Plan: Management has agreed to implement the new loan allowance provisioning shown below. After giving consideration to audit recommendation, a minimum to maximum allocation range has been set for each loan classification. The new loan allowance provisioning policy will be presented in the next Board of Director's meeting for approval.

<u>Loan Category</u>	<u>Age of Loan</u>	<u>Rate of Provision</u>
a. Current	0 days	1%
b. Non-current	1-30 days	1.5%
c. Non-current	31-90 days	5%
d. Sub-standard	91-180 days	20-30%
e. Doubtful	181-270 days	40-60%
f. Charged-off	270 days	100%

As of to date, the Bank has a limited authority to write-off any loan under the loan category of Charged-Off. MIDB is awaiting the revision of RMI law transferring all federally funded loans from Compact Fund to RMI Fund.

Management has agreed to suspend interest accruals on loans aging 91 days and above. Non-performing loans will accrue interest in the loan system for monitoring purposes but will be discontinued in the accounting system for financial statement purposes.

# MARSHALL ISLANDS DEVELOPMENT BANK

## Schedule of Findings and Questioned Costs, Continued Year Ended September 30, 2006

### Savings Deposit Accounts

#### Finding No. 2006-4

Criteria: Savings accounts should be maintained in a manner that reflects management's assertions in the financial statements.

#### Conditions:

##### (a) Absence of Formal Policy on Savings Deposit-Taking Activity

Historically, "savings deposits pledged" pertain to customer deposits received as security for loans. As per the Bank's representation, these are security deposits that are voluntary and arbitrary (*i.e. no set amount*). Through the years, excess allotments from government agencies (for employees of government with outstanding loans) were also lodged here, where they are refunded at the request of the "depositors". As per current practice, the interest rate applied on these balances is 4%. The Bank does not have a formal policy/guidelines on the processing of these deposits. Also, as noted in prior audits, the Board has not formally approved the 4% rate set for such deposits.

##### (b) Composition of Savings Deposits Pledged Account

Movement in the "savings deposits pledged" account could not be attributed to new accounts opened during the year. This account is also used as a clearing/suspense account for the following:

- Loan collections not yet credited to corresponding loan accounts
- Other rental and miscellaneous income from managed properties

The Bank was able to identify approximately \$171,381 of these suspense items, which accounted for about 13.6% of the total savings deposits pledged balance as of September 30, 2006.

Cause: The cause of the above conditions appears to be lack of procedures to ensure compliance with the criteria.

Effect: The effect of the above condition is potential noncompliance with the criteria.

Recommendation: We recommend that other suspense items improperly lodged in this account be reclassified. Additionally, the Bank may wish to consider establishing a separate suspense account to temporarily record unidentified loan collections to specific loan accounts, as well as other suspense income items. Timely adjustment of these suspense items should occur.

We recommend that a guideline/policy be formally approved by the Board.

Prior Year Status: Lack of a formal policy on savings deposit-taking activity and inadequate monitoring of the savings deposits pledged account, were reported as a finding in the Single Audits of MIDB for fiscal years 2002 through 2005.

Auditee Response and Corrective Action Plan: All suspense accounts under the Savings Account have been reclassified to proper GL accounts. A new General Ledger account was established to recognize all unposted loan collections instead of lodging it under Savings Account.

A formal policy on Savings Account will be presented in the next Board of Director's meeting for the approval of both the 4% interest rate and its guidelines.

**MARSHALL ISLANDS DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Purchase Orders

Finding No. 2006-5

Criteria: The Bank requires that an approved purchase order be executed prior to acquisition of equipment.

Condition: Purchases are not always supported by approved purchase orders.

Cause: The cause of the condition appears to be noncompliance with the criteria.

Effect: The effect of the condition appears to be noncompliance with the criteria.

Recommendation: The Bank should ensure that acquisitions are supported by purchase orders duly approved by authorized signatories.

Prior Year Status: The need to require purchase orders was reported as a finding in the Single Audit of MIDB for fiscal year 2005.

Auditee Response and Corrective Action Plan: All major bank acquisitions are approved by the Board of Directors. Management has discussed the subject matter with the Finance Department to ensure that all acquisitions are supported by purchase orders and approved by authorized signatories.