

MARSHALL ISLANDS DEVELOPMENT BANK

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

YEAR ENDED SEPTEMBER 30, 2003

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, 2003, and have issued our report thereon dated November 9, 2006, which report was qualified due to our inability to determine the propriety of the carrying values of loans and accrued interest receivable. Except as discussed in the preceding sentence, 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 record, process, summarize, 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 13) as items 2003-1 through 2003-7.

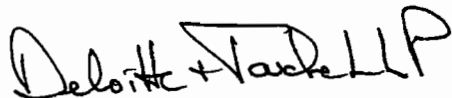
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being 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 2003-1 through 2003-4 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 that are required to be reported under *Government Auditing Standards*.

We also noted certain additional matters that we reported to management of MIDB in a separate letter dated November 9, 2006.

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.


November 9, 2006

**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, 2003. 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 13). 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, 2003.

Internal Control Over Compliance

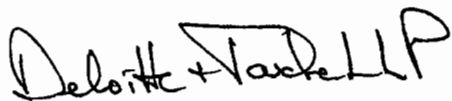
The management of MIDB is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered MIDB's internal control over compliance 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, 2003, and have issued our report thereon dated November 9, 2006, which report was qualified due to our inability to determine the propriety of the carrying value of loans and accrued interest receivable. 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, except for the effects of such adjustments, if any, as might have been determined to be necessary had the propriety of the carrying value of loans and accrued interest receivable been determined, 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, flowing style.

November 9, 2006

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2003

	<u>Grant Award</u>	<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 111 of the Compact of Free Association.	\$ 10,000,000	\$ 3,146,085	\$ -	\$ 273,302	\$ (1,132,674)	\$ 4,552,061
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.	4,994,603	2,438,368	-	77,192	-	2,515,560
<u>U.S. Department of Agriculture</u> <u>CFDA #10.433</u>						
Rural Housing Preservation	<u>200,000</u>	<u>284,704</u>	<u>-</u>	<u>41,037</u>	<u>-</u>	<u>325,741</u>
	\$ <u>15,194,603</u>	\$ <u>5,869,157</u>	\$ <u>-</u>	\$ <u>391,531</u>	\$ <u>(1,132,674)</u>	\$ <u>7,393,362</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 111 of the Compact of Free Association and the loan portfolio established through Section 211 of the Compact of Free Association were also selected for detailed compliance testing in accordance with applicable OMB Circular A-133 requirements. The loan portfolio related to Section 111, net of the allowance for doubtful loans of \$4,123,891, amounted to \$440,703 at September 30, 2003, and the loan portfolio related to Section 211, net of the allowance for doubtful loans of \$1,047,853, amounted to \$404,039 at September 30, 2003.

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. The loan portfolio related to the Housing Preservation Grant, net of the allowance for doubtful loans of \$3,881, amounted to \$18,544 at September 30, 2003.

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 Notes to Schedule of Expenditures of Federal Awards.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs Year Ended September 30, 2003

Section I - Summary of Auditor's Results

1. The Independent Auditors' Report on the financial statements expressed a qualified opinion due to our inability to determine the propriety of the carrying value of loans and accrued interest receivable.
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 the major federal award program 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 \$455,838 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>
2003-1	Loans Receivable	7
2003-2	Loans Receivable	8
2003-3	Loans Receivable	9
2003-4	Loans Receivable	10
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2003-7	Insurance Coverage	13

Section III - Federal Award Findings and Questioned Costs

No federal awards findings are reported for the year ended September 30, 2003.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued Year Ended September 30, 2003

Section II - Financial Statement Findings

Loans Receivable

Finding No. 2003-1

Criteria: Loan policies and procedures should address significant areas such as documentation and underwriting, loan review, grading, review of the allowance for loan losses, collection and recovery, review and approval of charge-offs, and foreclosure. Additionally, loan subsidiary ledgers should be maintained and reconciled with the general ledger and loan statements should be provided to borrowers on a regular basis.

Condition: MIDB's loan policies and guidelines do not address the above areas. Consequently, we noted various discrepancies including loans recorded in the wrong period, multiple holder #s for the same borrower, and loan #s that were not the same in the "Request for Loan Drawdown" form and the loan system. We also noted that loans receivable at September 30, 2003 included two loans (note #s 12377 and 14631) that had been cleared in a house purchase agreement with the borrowers. An audit adjustment was proposed to correct loans receivable and premises and equipment. Additionally, MIDB does not have policies that require nonperforming loans to be placed on nonaccrual status.

The RMI-funded loan subledger provided for audit purposes totaled \$20,815,442; however, the final reconciled subledger totaled \$20,838,975. No explanation was made available regarding the variance.

Cause: The cause of the above condition is the lack of formal policies and procedures.

Effect: The effect of the above condition is the possible misstatement of loans receivable, accrued interest receivable and interest income resulting in a qualification of the opinion on the financial statements.

Recommendation: We recommend that MIDB adopt loan policies and procedures regarding documentation and underwriting, loan review, grading, review of the allowance for loan losses, collection and recovery, review and approval of charge-offs, and foreclosure. Such policies and procedures should be reviewed and approved on a regular basis. We also recommend that management ensure that loan subsidiary ledgers are maintained and reconciled with the general ledger and that loan statements are provided to borrowers on a regular basis.

Prior Year Status: Lack of formal loan policies and procedures was reported as a finding in the Single Audit of MIDB for fiscal year 2002.

Auditee Response and Corrective Action Plan: MIDB Management has agreed to review the whole loan process from loan evaluation, loan documentation, loan granting to loan collection. The process review will give Management a clear understanding of the loan processes in order to come up and update loan policies and procedures. The current written policies and procedures on loans was made effective August 17, 1994.

MIDB maintains and reconciles subsidiary ledgers with the general ledgers. Discrepancies between the general ledger and the subsidiary ledgers have been identified. The Bank is currently exhausting all efforts to update the Loan System and the Accounting System, once updated loan statements will be sent regularly to borrowers.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2003

Loans Receivable

Finding No. 2003-2

Criteria: Management should routinely review certain critical loan information such as delinquency reports and restructured loans to effectively manage the loan portfolio.

Condition: Management does not routinely review critical information in the loan portfolio.

Cause: The cause of the above condition is the lack of formal policies and procedures to ensure that critical loan information is routinely reviewed by management.

Effect: The effect of the above condition is the possible misstatement of loans receivable resulting in a qualification of the opinion on the financial statements.

Recommendation: We recommend that MIDB adopt policies and procedures to ensure that critical information is provided to and routinely reviewed by management.

Prior Year Status: Lack of management review of critical loan portfolio information was reported as a finding in the Single Audit of MIDB for fiscal year 2002.

Auditee Response and Corrective Action Plan: Management is exhausting all efforts to update the Loan System so that accurate loan balances and delinquency reports can be obtained from the system that will be used in conducting routine review and evaluation of all delinquent and restructured loans.

The Loan System Reports are currently being reviewed by the Finance Department to assess what reports are useful to Management, delinquency reports are being revised to show the correct delinquent loan accounts which will help Management effectively and efficiently appraise certain critical loan portfolio and thereafter effectively make sound loan collection decisions.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2003

Loans Receivable

Finding No. 2003-3

Criteria: The allowance for loan and interest receivable losses should be periodically reviewed and maintained at a level adequate to absorb estimated losses.

Condition: The adequacy of the allowance for loans and interest receivable was not assessed on a periodic basis during the year ended September 30, 2003. The allowance was adjusted in preparation for the audit; however, audit procedures performed determined that the allowance was inadequate to absorb estimated losses.

Additionally, the loan file for #11003 could not be located and the maturity date in the loan system for loan #10676 is January 1, 3100.

Cause: The cause of the above condition is that loans and interest receivable are not periodically reviewed for collectibility and the assessment of loan losses is not being performed on a timely basis.

Effect: The effect of the above condition is that loans and interest receivable were overstated.

Recommendation: We recommend that MIDB adopt policies and procedures on determining the adequacy of the allowance for loan and interest receivable losses and that all loans receivable be reviewed on a monthly basis to determine collectibility. This assessment should include management judgments incorporating micro- and macro-economic factors; past, current, and anticipated events based on facts in evidence at the balance sheet date; and realistic courses of action it expects to take.

Prior Year Status: Lack of periodic review and adjustment of the allowance for loan receivable losses was reported as a finding in the Single Audits of MIDB for fiscal years 1994 through 2002.

Auditee Response and Corrective Action Plan: MIDB's Management in coordination with the Loans Department and Finance Department will come up with a policy on grading loans in order to identify and measure allowance for loan losses both for performing and non-performing loans. The following will show how much should be provided for probable losses on loans based on number of days outstanding:

a.	Current	0-30 days	1.5%
b.	Non-current	31-90 days	5%
c.	Sub-standard	91-180 days	30%
d.	Doubtful	181-270 days	50%
e.	Charged-off	270days and above	100%

MIDB Management has agreed to periodically review and evaluate loan and interest receivable to come up with a sound estimate of probable losses.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued Year Ended September 30, 2003

Loans Receivable

Finding No. 2003-4

Criteria: Foreclosed properties should be transferred out of loans receivable and be properly classified.

Condition: A property that was foreclosed during the year ended September 30, 2003 was not transferred to foreclosed properties until the books were prepared for audit. Furthermore, title to and ownership of the property had been transferred to MIDB, therefore, the property should have been recorded in premises and equipment rather than foreclosed properties.

Additionally, interest income was recognized during the year on a loan that was foreclosed in fiscal year 2002. MIDB is renting out the foreclosed property; however, rental income generated and repair costs incurred were not properly recorded. Audit adjustments were proposed to properly record interest and rental income and repair costs.

Cause: The cause of the above condition is the untimely recording of foreclosed properties.

Effect: The effect of the above condition is the misstatement of loans receivable, premises and equipment, interest and rental income, and repair costs as of and for the year ended September 30, 2003.

Recommendation: We recommend that MIDB ensure that foreclosed properties are properly and timely recorded.

Prior Year Status: Incorrect and untimely recording of foreclosed properties was reported as a finding in the Single Audits of MIDB for fiscal years 2001 and 2002.

Auditee Response and Corrective Action Plan: Management has discussed the subject matter with the Finance Department. Corrections have been made transferring foreclosed accounts to premises and equipment.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued Year Ended September 30, 2003

External Financial Reporting

Finding No. 2003-5

Criteria: An entity's chart of accounts should be structured so that financial statements can present useable information.

Condition: MIDB currently segregates its loan portfolio between funds received from Compact of Free Association funding and the Republic of the Marshall Islands (RepMar). More useable information could be derived if MIDB's chart of accounts classified loans by industry type (i.e., agriculture, fisheries, tourism, forestry, small industries, handicraft, construction and services).

Cause: The cause of the above condition is the current configuration of MIDB's chart of accounts.

Effect: The effect of the above condition is that information on the types of industries for which MIDB is promoting economic development is not presented either in the financial statements or footnotes of MIDB.

Recommendation: We recommend that MIDB begin classifying loans receivable by industry type.

Prior Year Status: Lack of a structure determining industry type loans within the chart of accounts was reported as a finding in the Single Audits of MIDB for fiscal years 1994 through 2002.

Auditee Response and Corrective Action Plan: The Accounting System (MIP) is currently structured to classify Loans Receivable by Fund. MIDB has contacted its MIP Business Partner to find a way to set up MIP System and enable it to classify loan receivables by Industry. Classifying loan receivables by Industry would only be a sub classification under classification by Fund, this is because MIDB is a Government Entity and its initial capital was funded by the US Government and the RMI Government. MIDB uses the Fund Accounting System, since funds are importantly accounted as to usage, therefore, chart of accounts should be classified by Fund.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2003

External Financial Reporting

Finding No. 2003-6

Criteria: Adequate accounting controls necessitate that journal entries and adjustments be approved and recorded in the general ledger by separate individuals to ensure accuracy and authorization.

Condition: Journal entries and adjustments during the year ended September 30, 2003 were initiated and recorded by the same accounting personnel with no independent review.

Cause: The cause of the above condition is the lack of policies and procedures to ensure adequate segregation of duties pertaining to journal entries and adjustments.

Effect: The effect of the above condition is the possible misstatement of the financial statements.

Recommendation: We recommend that MIDB adopt policies and procedures to ensure adequate segregation of duties pertaining to journal entries and adjustments.

Prior Year Status: Lack of appropriate segregation of duties pertaining to journal entries and adjustments was reported as a finding in the Single Audit of MIDB for fiscal year 2002.

Auditee Response and Corrective Action Plan: Management has discussed the subject matter with the Finance Department to ensure segregation of duties on recording and approval of journal entries.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2003

Insurance Coverage

Finding No. 2003-7

Criteria: Operations should be insured by adequate general liability insurance in the event of accidents. Additionally, premises and equipment should be insured against losses.

Condition: As of and during the year ended September 30, 2003, MIDB did not maintain general liability insurance and fire, lightning and typhoon insurance for its office building and properties.

Cause: The cause of the above condition is the lack of policies requiring such insurance coverage.

Effect: The effect of the above condition is the possibility of substantial losses.

Recommendation: We recommend that MIDB consider obtaining general liability insurance and fire, lightning and typhoon insurance for its office building and properties.

Auditee Response and Corrective Action Plan: Management has agreed to adopt a general insurance and fire insurance for its office building and properties. The insurance cost will be part of the budget of FY2007.

MARSHALL ISLANDS DEVELOPMENT BANK

Unresolved Prior Year Findings and Questioned Costs
Year Ended September 30, 2003

Questioned Costs

There are no unresolved questioned costs or matters of noncompliance from prior year Single Audits of MIDB.

Findings

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Questioned Costs section of this report (pages 6 through 13).

United States Department of the Interior, Office of the Inspector General, Marshall Islands Development Bank, Republic of the Marshall Islands - Report dated August, 1999

Questionable loans:	\$12,410,148
Questionable loans converted to equity:	\$ 2,933,321