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May 29, 2014

Mr. Amon Tibon
Managing Director
Marshall Islands Development Bank

Dear Mr. Tibon:

In planning and performing our audit of the financial statements of the Marshall Islands Development Bank (MIDB) as of and for the year ended September 30, 2013 (on which we have issued our report dated May 29, 2014), 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, we considered MIDB's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of MIDB's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of MIDB's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to MIDB's internal control over financial reporting and other matters as of September 30, 2013 that we wish to bring to your attention. Although we have included management's written responses to our comments contained therein, such responses have not been subjected to the auditing procedures applied in our audit of the basic financial statements and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the responses or the effectiveness of any corrective actions described therein.

We have also issued a separate report to the Board of Directors, also dated May 29, 2014, on our consideration of MIDB's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.

The definition of a deficiency is also set forth in the attached Appendix I.

A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with this report.

This report is intended solely for the information and use of the Office of the Auditor-General, management, others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss the attached comments with you and, if desired, to assist you in implementing any of the suggestions.

We wish to thank the staff and management of MIDB for their cooperation and assistance during the course of this engagement.

Very truly yours,

Deloitte + Touche LLP

## SECTION I – CONTROL DEFICIENCIES

We identified, and have included below, deficiencies involving MIDB's internal control over financial reporting as of September 30, 2013 that we wish to bring to your attention:

### 1. Absence of Lease Agreements

Comment: Signed copies of lease agreement for the tenant/properties were not available for Thomas Davidson.

Recommendation: We recommend that signed lease agreements be timely executed and filed.

Management Response: We already obtained the copy of lease agreements for the Banking Commission. And we ensure that recommendation will be complied for future tenants.

## SECTION II – OTHER MATTERS

Our observations concerning other matters related to operations, compliance with laws and regulations, and best practices involving internal control over financial reporting that we wish to bring to your attention are as follows:

### 1. Matured Loans

Comment: We noted 2,083 loans with a total balance of $7,460,428 that matured as of September 30, 2013; some of which have actual maturity dates of 2012 and earlier. Of the total, 265 with an aggregate outstanding balance of $573,712 are aged 270 days and below, while the rest are aged above 270 days and are fully reserved.

Recommendation: Management should verify and correct loans with the noted condition. Additionally, management should designate an officer to periodically review loan data for loan information errors.

Management Response: Matured loans are provided reserves according to the Bank policy. Most of the outstanding borrowers were not able to meet the required allotments. We ensure that recommendation will be complied.

### 2. Loans with Incorrect Open Dates

Comment: The September 30, 2013 system-generated loan trial balance contains 191 loans totaling $2,552,007, which have incorrect open dates of December 31, 1999. Furthermore, 44 loans with total balances of $295,058 have maturity dates earlier than the open date. This issue appears to be caused by a system migration error in 2000. All of these loans have been delinquent for more than 270 days and are therefore fully reserved.

Recommendation: Management should verify and correct loans with the noted condition and consider possible charge-off. Additionally, management should designate an officer to periodically review loan data for information errors.

Management Response: Loan with open dates of December 31, 1999 are already provided full provision in which the Bank will have the difficulty of retrieving old documents to correct its open dates. The Bank's current operation with regards to its current notes ensures that recommendation has been complied.

**SECTION II – OTHER MATTERS, CONTINUED**

**3. Long Outstanding Checks**

Comment: The September 30, 2013 bank reconciliation for Cash in Bank (CA-BOMI) contains 32 checks aggregating $23,336 that have been outstanding for more than one year. MIDB does not have a policy to separately record stale dated checks as a liability.

Recommendation: MIDB should consider establishing a policy over the processing, reconciliation, monitoring and disposition of stale dated checks.

Management Response: The local banks accept long outstanding checks once we provide them formal letter stating as to validity of these checks which is duly signed by the Managing Director and the local banks were informed as to the check status.

**4. Written Agreement on Sample House**

Comment: MIDB was able to provide a copy of the agreement relating to the sample house receivable of $52,145 at September 30, 2013; however, we noted insufficient information on the agreement, i.e. agreed interest rate, amount of total receivable, etc. This matter was discussed in our previous letters for the audit of fiscal years 2008 to 2012.

Recommendation: We recommend that management require that all lending arrangements be supported by executed agreements detailing pertinent information.

Management Response: The Bank has a letter of agreement written in the local language in both parties understand duly notarized and recorded in the Land Registration Authority. In which, it is stated in the letter that the owners has authorize the Bank to renovate and use it for rental until such time that all expenses spent to renovate are cleared, including interest of the money used for such project. And it is also agreed upon that after 10 years if all expenses were not paid off it will be the responsibility of the owners to pay off all the remaining balances. Currently, the Bank complies with the recommendation.

**5. Policy on Accounts Receivable Allowance for Credit Losses**

Comment: MIDB does not have a formal policy for establishing an allowance for losses for accounting receivable.

Recommendation: Management should consider formulating a policy relative to establishing an allowance for accounts receivable.

Management Response: The Bank does not have formal policy on accounts receivable because most of the receivable pertain to rentals, in which the management believes that it can be, recover on a yearly basis. The Management will ensure that recommendation will be complied.

**6. Negative Balances in Deposit Accounts**

Comment: As of September 30, 2013, there were 197 savings deposit accounts with negative balances totaling $42,802. Savings deposits generally pertain to over payments of loans resulting from outdated records and withdrawals being made through customer refunds. Therefore, it appears that MIDB may have refunded customers in excess of deposit balances. Additionally, the accounting department appears to have calculated interest expense on these negative balances that is not recorded in the books.

Recommendation: Management should revisit the cited accounts and consider adding these amounts to existing loans. Otherwise, management should decide whether these balances should be charged-off.

**SECTION II – OTHER MATTERS, CONTINUED**

**6. Negative Balances in Deposit Accounts, Continued**

Management Response: The management has consulted an IT expert to add another system solely for the savings deposit accounts to ensure proper refunds were given and to update the ledgers on a timely basis.

**7. Inadequate Monitoring of Rental Receivables**

Comment: The Property Manager monitors rent collections and calculates rent receivables and related rent income at year-end. Hence, the accrued rent receivable and the corresponding accrued income at month-ends are understated.

Recommendation: Rental activities are a major revenue generating source. Therefore, management should assign a responsible officer to monitor related activities and related recordkeeping.

Management Response: The management does it's reporting on a quarterly basis rather than monthly in which rent receivables will be book on this manner. The management ensures that recommendation shall be complied.

**8. Valuation of Collateral**

Comment: MIDB is accepting collateral for loans but the collateral is not appraised. Furthermore, MIDB does not have internal appraisal or valuation of collateral.

Recommendation: MIDB should have an internal appraisal of collateral.

Management Response: The management ensures that recommendation shall be complied.

**9. Valuation and Identification of Refinanced Loans**

Comment: MIDB tags refinanced loans based on the loan purpose; however, thirteen (13) loans were not tagged based on the definition of a refinanced loan in MIDB's policy. Per Bank policy, MIDB has two types of refinanced loans:

1. Restructured: loans from the same borrower that are reconstructed and are assigned different note numbers.

2. Paid-off: loans of the borrower and/or other delinquent loan accounts he/she guaranteed that are paid off fully or partially. A new note is also assigned.

MIDB policy requires that an allowance equivalent to 100% of outstanding refinanced loans be provided (for both principal and interest) unless the borrower pays within the scheduled amortization dates for a one year period.

Due to noted exceptions, there is a risk that MIDB did not capture all refinanced loans and did not provide an applicable allowance in accordance with policy.

Recommendation: We recommend that active monitoring of refinanced loans occur to verify that such have been adequately reserved until compliance with the one year policy period has been met.

Management Response: The Bank doesn't need an internal appraiser because only few loans requires appraisal but instead it will just outsource expert once there is a need.

## SECTION II – OTHER MATTERS, CONTINUED

### 10. Interest Income on Delinquent Loans

Comment: MIDB recognized interest income on delinquent loans that were provided with a 100% allowance. Per Bank policy, interest accrues based on the unpaid principal balance. The accrual of interest on loans is discontinued when principal or interest payments are delinquent over 90 days or when, in the opinion of management, there is an indication that the borrower may unable to meet payments as they become due. Moreover, per generally accepted accounting principles (GAAP), upon such discontinuance, all unpaid accrued interest should be reversed and thereafter interest is recognized only to the extent cash payments are received after all principal is recovered.

Recommendation: We recommend that management consider formulating a policy relative to recognition of interest income on delinquent loans.

Management Response: The Bank will seek advice as to banking practice with regards this matter in order to have uniform practice with the other banks in the island and will ensure that recommendation will be complied.

## SECTION III – DEFINITIONS

The definition of a deficiency in internal control over financial reporting that is established in AU 325, *Communicating Internal Control Related Matters Identified in an Audit*, is as follows:

A *deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

## MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, INTERNAL CONTROL OVER FINANCIAL REPORTING

The following comments concerning management's responsibility for internal control over financial reporting and the objectives and inherent limitations of internal control over financial reporting are adapted from auditing standards generally accepted in the United States of America.

### Management's Responsibility

MIDB's management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

### Objectives of Internal Control over Financial Reporting

Internal control over financial reporting is a process effected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

### Inherent Limitations of Internal Control over Financial Reporting

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.