

MARSHALL ISLANDS DEVELOPMENT BANK

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

YEAR ENDED SEPTEMBER 30, 2005

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, 2005, and have issued our report thereon dated August 28, 2007, which report was qualified due to our inability to determine the propriety of the carryover effects of non-deferrals of insurance premiums and loan origination fees in 2004. 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 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 2005-1 through 2005-5.

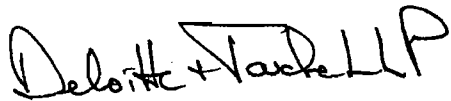
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being 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 2005-1 through 2005-3 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 28, 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.


August 28, 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, 2005. 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, 2005.

Internal Control Over Compliance

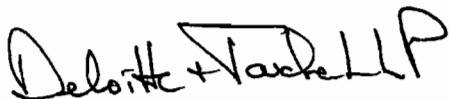
The management of MIDB is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered MIDB's internal control over compliance 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, 2005, and have issued our report thereon dated August 28, 2007, which report was qualified due to our inability to determine the propriety of the carryover effects of non-deferrals of insurance premiums and loan origination fees in 2004. 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 MIDB deferred insurance premiums and loan origination fees, 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 + Stark LLP". The signature is written in a cursive, stylized font.

August 28, 2007

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Expenditures of Federal Awards Year Ended September 30, 2005

	<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.	\$ 2,454,810	\$ -	\$ 30,107	\$ 214,759	\$ 2,270,158
<u>U.S. Department of Agriculture</u>					
<u>CFDA #10.433</u>					
Rural Housing Preservation Adjustment (see Note A below)	526,640 (240,000)	- -	230 -	16,094 -	510,776 (240,000)
Adjusted balance	<u>286,640</u>	<u>-</u>	<u>230</u>	<u>16,094</u>	<u>270,776</u>
Self-Help Housing Project	<u>-</u>	<u>44,064</u>	<u>-</u>	<u>44,064</u>	<u>-</u>
	<u>\$ 2,741,450</u>	<u>\$ 44,064</u>	<u>\$ 30,337</u>	<u>\$ 274,917</u>	<u>\$ 2,540,934</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, totaling \$1,291,877, at September 30, 2005, 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, net of the allowance for doubtful loans of \$16,009, amounted to \$55 at September 30, 2005.

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.

Note A: Funds granted by Republic of Marshall Islands as a subsidy, totaling \$240,000 were recorded under Rural Housing Preservation Grant Fund in the prior year. In 2005, this was reclassified under net assets of Republic of Marshall Islands.

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, 2005

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 carryover effects of non-deferrals of insurance premiums and loan origination fees in 2004.
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>
2005-1	Incompatible Functions	7
2005-2	Loans Receivable	8
2005-3	Loans Receivable	14
2005-4	Savings Deposit Accounts	16
2005-5	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, 2005

Section II - Financial Statement Findings

Incompatible Functions

Finding No. 2005-1

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.

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, 2005

Loans Receivable

Finding No. 2005-2

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 2005 revealed the following documentation matters:

(1) Borrower: Loan No. 39188

- 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).
- The construction contract on file (a required document) was not dated.
- No assignment of salary and proof of credit life insurance were on file.

(2) Borrower: Loan No.: 28133

- Loan action sheet, where approval of the Board/Managing Director for the loan should be affixed, was not on file. There was no other agreement on file showing approval of the loan.
- No assignment of salary was on file.

(3) Borrower: Loan No.: 39631

- Date of origination per loan system is June 1, 2005 (also the date of the loan disbursement) but date of the promissory note and loan agreement is August 24, 2004, which is also the date of loan approval. Additionally, the interest rate is 8.5%, which is above the maximum rate for housing loans as per policy and the maturity date exceeds 20 years, which is not compliant with the 15 year maximum term per existing policy. It represented a memo documenting Board approval of the revised policy exists but a copy of this memo was not available. Also, an assignment of salary was not on file and the loan is not covered by credit life insurance.
- Approval of the loan by the Managing Director was not noted on the Loan action sheet but was only in the loan application form. Further, the application form was in Marshallese (none in English format was in file)

(b) Aging of Loans

During the review of individual loan payment histories of selected loans, 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.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

(b) Aging of Loans, Continued

While the Bank recognizes the error and that it commenced effecting the system corrections, we noted that the majority have remained uncorrected as of examination date (26 of 44 loans reviewed contained errors). Management is aware of this matter and the 26 affected loans are as follows:

	<u>Loan Number</u>	<u>Outstanding Loan as of 9/30/05</u>	<u>1st Payment Date Erroneously Posted</u>	<u>Date 1st Payment Should Be</u>
1	39867	\$ 10,605	07/22/05	08/13/05
2	39858	14,487	07/15/05	10/15/05
3	39970	14,261	08/19/05	08/12/05
4	39474	13,097	04/29/05	05/28/05
5	39246	12,465	04/29/05	05/15/05
6	39272	13,069	04/29/05	05/14/05
7	40112	14,414	06/10/05	07/01/05
8	39014	12,002	03/18/05	04/17/05
9	39452	11,075	04/29/05	05/28/05
10	27876	14,571	03/30/05	03/21/05
11	28752	13,723	03/30/05	03/21/05
12	38908	13,599	03/18/05	04/11/05
13	27446	12,835	01/30/05	03/07/05
14	27577	15,269	01/30/05	01/09/05
15	26211	10,943	08/30/04	10/05/04
16	27308	10,687	12/30/04	12/18/04
17	39832	10,471	07/22/05	08/08/05
18	39902	11,974	07/08/05	08/08/05
19	25601	2,716,901	05/09/04	06/09/04
20	25602	3,923,946	06/15/03	06/23/03
21	20019	25,961	06/30/01	06/07/01
22	39564	12,815	05/13/05	06/09/05
23	39014	12,002	03/18/05	04/17/05
24	39921	11,546	10/13/16	10/25/06
25	39452	11,075	04/29/05	05/28/05
26	39796	9,792	07/15/05	07/24/05

(c) Loan System Limitations

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

Loan No: 27577

Origination date: December 9, 2004

Maturity date: December 30, 2006

Payment history indicated that despite limited payments made since inception through May 2007, the loan was only 108 days past due per the loan system. A loan system limitation appears to be that once a non-accruing loan reaches the original maturity date, the day count reverts to zero. Therefore, the system age is inaccurately calculated as it includes January 1, 2007 onwards.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

(c) 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 of approximately \$500,000. While alternative procedures were performed utilizing different schedules, the inability of the loan system to generate receiving reports connotes a potential significant system limitation that may require necessary attention and corrective action.

- 2) Total loans per the delinquency report did not agree with the 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 -	\$1,010,542.30
	Accrued interest receivable -	118,733.93
RMI 20% Housing	Various accounts (reported to be under the non-current, 1.5% provision category):	
	Total outstanding loan amount -	\$ 14,470.00
RMI Business	Various accounts (reported to be under the non-current, 1.5% provision category):	
	Total outstanding loan amount -	\$ 10,478.04
RMI Housing	Various accounts (reported to be under the non-current, 1.5% provision category):	
	Total outstanding loan amount -	\$ 71,804.33
BPF Business	Loan No: 11008 (Charge-off category)	
	Total outstanding loan amount:	\$17,042.25
	Accrued interest receivable:	424.41
BPF Housing	Various accounts (Charge-off category)	
	Total outstanding loan amount:	\$68,666.62
	Accrued interest receivable:	439.10

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

(c) Loan System Limitations, 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

The payment history for loan no. 13264, showed no movements in the balance since 2004. However, the loan delinquency report shows the account is current as of September 30, 2005. 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 discussed that the loan was actually 1,888 days past due as of September 30, 2005. 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) Missing Loan Accounts and Erroneously Posted Loan Transactions

- 1) Loan no.: 26904
Origination date: November 1, 2004
Loan balance as of 9/30/05: \$13,456

This loan was 182 days past due as of September 30, 2005 per the loan delinquency report. However, the reason for the loan default was non-updated records. It appears that when the records were not updated and the Bank was using Excel to monitor collections, the loan was missed; thus ceasing loan collection and monitoring. When the loan system was finally updated in the latter part of 2006, this loan appeared in the system, and the borrower was informed and continued payment. However, due to the reasonably long period of time that the loan was missing in the system, the loan became delinquent.

- 2) Loan no.: 20017
Origination date: October 5, 2000
Loan balance as of 9/30/05: \$35,313

Per the loan delinquency report, the loan was 94 days past due as of September 30, 2005. Investigation revealed that the account is actually current and that there was a transposition error made in the input of one drawdown amount dated November 10, 2000 (posted as \$21,800 instead of \$2,180), that resulted in the erroneous amortization.

While the above issue was subsequently resolved, we recommend that the Bank continue to check the possibility that other cases of a similar nature may exist and remain unidentified and uncorrected. In the Bank's ongoing process of updating its records, we suggest that a more intensive set of procedures be instituted to search possible errors that could possible misstate loan-related balances.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

(f) Discrepancies in the Original Loan Amount

Borrower: Loan no. 214823

The loan trial balance indicates the original amount of the loan is \$311,257.31, while the promissory note showed \$3,144,454.05. 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 in the running principal balance and in the computation of interest, the error is visible in the 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.

(g) Results of Loan Confirmation Procedures

The following resulted from the loan confirmation procedures:

Loan

Number Particulars

15754 Discrepancy is noted as follows:

Balance per Bank	\$ 11,014
Balance per confirmation reply	7,535

Difference	\$ 3,479
	=====

39239 Loan Balance: \$ 11,123.37
Interest rate: 14.00%

Per confirmation reply, the borrower represents that the loan balance is not correct, and indicated that the loan and statements are incorrect.

12007 As the confirmation reply was not received, an alternative procedure was performed by agreeing details of the loan per the trial balance against the loan system. The following discrepancy was noted:

Amount per loan trial balance	\$ 56,670
Amount per loan system	<u>57,047</u>
	\$ <u>377</u>

While the difference may be minimal, we suggest that a procedure be performed to cross check all loans between the two systems.

MARSHALL ISLANDS DEVELOPMENT BANK

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

(g) Results of Loan Confirmation Procedures, Continued

13043 No confirmation replies were received and the letters were
39926 returned due to incorrect addresses. We suggest that the loan
department revisit customer files to ensure accurate, updated
and adequate records exist.

39964 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.

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, we recommend that the above conditions be addressed and be resolved and that formal corrective action plans be established to resolve the above matters.

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. Cited findings have 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, 2005

Loans Receivable

Finding No. 2005-3

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 in the 'charge-off' category for loans aged 270 days and above. As of September 30, 2005, total loans under this category amounted to \$13.2MM, which approximates 43% 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, 2005

(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: Lack of a formal policy on write-off of loans was reported as a finding in the Single Audits of MIDB for fiscal years 2002 to 2004.

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	31-90days	5%
d. Sub-standard	91-180days	20-30%
e. Doubtful	181-270days	40-60%
f. Charged-off	270days	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, 2005

Savings Deposit Accounts

Finding No. 2005-4

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 \$127,093 of these suspense items, which accounted for about 13% of the total savings deposits pledged balance as of September 30, 2005.

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: Inadequate monitoring of savings deposits pledged was reported as a finding in the Single Audits of MIDB for fiscal years 2001 and 2004 and was reported to management in our letter dated November 9, 2006 and October 13, 2006.

Auditee Response and Corrective Action Plan: All suspense accounts under the Savings Account have been reclassified to proper General ledger (GL) accounts. A new GL 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, 2005

Purchase Orders

Finding No. 2005-5

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

Condition: Office equipment amounting to \$177,983, purchased in December 2004, was not supported by a duly approved purchase order.

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.

Auditee Response and Corrective Action Plan: All major bank acquisitions are approved by the Board of Directors. The purchase order for the acquisition of the office equipment amounting to \$177,983 may have been omitted since it was supported already by the minutes of the BOD. 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.

MARSHALL ISLANDS DEVELOPMENT BANK

**Unresolved Prior Year Findings and Questioned Costs
Year Ended September 30, 2005**

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 17).

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