

October 20, 2011

Mayor John Kaiko
Utrök Atoll Local Government
Republic of the Marshall Islands

Dear Mayor Kaiko:

In planning and performing our audit of the financial statements of the governmental activities and each major fund of the Utrök Atoll Local Government (UALGOV) for the year ended September 30, 2009 (on which we have issued our report dated October 20, 2011), 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 UALGOV'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 UALGOV's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of UALGOV'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 UALGOV's internal control over financial reporting and other matters as of September 30, 2009 that we wish to bring to your attention.

We have also issued a separate report to UALGOV, also dated October 20, 2011, on our consideration of UALGOV'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.

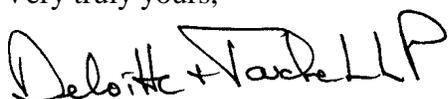
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with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

This report is intended solely for the information and use of management, the Council, others within the organization, and the Office of the Auditor-General 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 UALGOV for their cooperation and assistance during the course of this engagement.

Very truly yours,



SECTION I – CONTROL DEFICIENCIES

We identified, and have included below, control deficiencies involving UALGOV's internal control over financial reporting as of September 30, 2009 that we wish to bring to your attention:

(1) Promissory Note, Pledge Agreement & Assignment

Of fifty-six Local Distribution Authority loans tested, we noted the following items that were supported with incomplete or unsigned promissory notes, pledge agreements and/or assignments:

<u>ID #</u>	<u>Description</u>	<u>Amount</u>
QD0034	Advance on 1/10 - 1/11 Quarterly Distribution Payment	\$ 4,978
QD0045	Advance on 7/09 - 10/10 Quarterly Distribution Payment	\$ 5,027
QD0054	Advance on 4/09 - 1/11 Quarterly Distribution Payment	\$ 5,895
QD0060	Advance on 7/09 - 1/11 Quarterly Distribution Payment	\$ 6,011
QD0064	Advance on 7/09 - 10/10 Quarterly Distribution Payment	\$ 5,032
LC11113	Advance on 2009 Wotbar Alap Share Payment	\$ 1,918
LC11117	Advance on 2009 Wotbar Payment	\$ 1,894

Contracts, promissory notes and loan agreements should be completely filled out and be signed by parties. We recommend that completeness checks of loan documentation occur before approval.

(2) Non-payroll Expenditures

During the year ended September 30, 2009, payments to a service contractor in the amount of \$140,000 were made in four quarterly prepayments. However, liquidation was not evidenced by a contractor invoice or billing. We recommend that management ensure that prepayments are monitored and liquidated through vendor invoices or billings.

(3) Local Distribution Authority Payments

Of seventy-six (76) distribution payments tested, the following exceptions were noted:

- 1) Three (3) payments (check #'s 12389, 13683 and 11913) lacked indication of the recipients' signature as evidence of check receipt.
- 2) Fifteen (15) payments (check #'s 12157, 12518, 11759, 12701, 13696, 14121, 13209, 12905, 12143, 12730, 13539, 13891, 11771, 12509 and 12388) were received by financial institutions or individuals other than the designated payee. An approved assignment agreement was not available supporting these disbursements.

We recommend that management retain written authorizations on file before per capita distribution checks are released to other than the designated payee. In addition, we recommend that the designated payee, upon receipt, acknowledge disbursements received in writing.

(4) Late Charges

Of thirty-one non-payroll expenditures tested, we noted one item (check # 4150 for \$17,143) that included interest charges of \$615 for late payment. We recommend the proper monitoring and timely settlement of accounts to avoid incurrence of unnecessary fees and late charges.

(5) Time Sheets and Personnel Action Forms

Tests of timesheets for the pay period January 12-23, 2009, noted discrepancies per hours worked in the weekly payroll summary report when compared with daily timesheets. The payroll summary report was signed and approved by the previous Fiscal Officer but no documentation explaining the difference was on file. We recommend adequate documentation be filed to support such discrepancies.

In addition, no personnel action form was prepared for a new employee. We recommend that payroll related documents be prepared and be filed to provide a reliable basis for employee salaries and benefits.

(6) Supporting Invoices

Of thirty-one non-payroll expenditures tested, we noted one item (check # 4179 for \$338) that was not supported by a vendor invoice. We recommend that receipts and invoices be maintained and be filed to support all transactions.

(7) Investment Management Fees

During the year ended September 30, 2009, investment management fees in the aggregate amount of \$173,246 were deducted from UALGOV's investment accounts. Based on average asset values of investments, we estimated that UALGOV incurred investment management fees of \$122,365, which resulted in a difference of \$50,881. Although fees can be traced to the investment statements, a supporting calculation from the investment manager was not obtained and independent recalculation is not performed by UALGOV. We recommend management perform independent checks and obtain supporting computations from the investment manager, as necessary, to verify the accuracy of fees paid.

(8) Investment Valuation, Monitoring and Reconciliation

Based on confirmation received from the investment managers, a \$16,954 difference in investment account 2510000630 was noted. Further, recalculated difference in changes in unrealized gains/losses amounted to \$54,172. UALGOV does not perform independent checks on realized and unrealized gains/losses reported by the investment manager. We recommend that sufficient understanding be obtained to reconcile investment transactions. Investment movements should be appropriately classified and reconciled to allow reliable information for investment analysis purposes.

(9) Allowance for Doubtful Accounts

UALGOV has extended salary advances for periods up through fiscal year 2011. Delinquent advances identified from previous employees and non-employees amounted to \$11,500 and \$16,845, respectively, which remain uncollected resulting in a proposed audit adjustment to recognize an allowance for uncollectible receivables. UALGOV should assess future collectability issues and ensure that policies are in place to address delinquent accounts. We recommend that management pursue collection of their receivables and determine the adequacy of the allowance for doubtful accounts.

(10) Loans and Advances

Based on Resolution # 08-09, the Council approved the disbursement of advances of up to one year of retirement payments, pension benefits, or salaries to members of the Utrök community who are quarterly recipients. On a case-by-case basis, two years of unencumbered pension, retirement and salary payments are considered for recipients whom quarterly payments have been pledged. However, we noted that loans extended beyond one year are not covered by future quarterly payments since separate loans were already obtained for the identified collateral from future distributions. We recommend that the loan policy implementation and approval be revisited and be complied with to ensure that potential collectability issues are addressed.

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 at this time are as follows:

(1) Segregation of Duties

One of the main objectives of internal control is to safeguard assets. An effective means to achieving this objective is to segregate accounting duties such that an individual who has access to assets (e.g., cash receipts, signed checks, equipment, etc.) does not also have access to the accounting records supporting those assets. Proper segregation of duties can provide reasonable assurance that an individual would be prevented from removing an asset from the organization and concealing that activity by altering the related accounting records. UALGOV's current level of staffing limits the number of personnel available for accounting duties.

Accordingly, an appropriate segregation of duties is not practical which results in a weakness in internal controls specifically in the roles of the Fiscal Officer who has access to assets, has approving authority for disbursements, and also has full access to accounting records. To mitigate this weakness, a critical element in UALGOV's internal control system is the close involvement of management in the day-to-day operations and close review of accounting activities and financial reports.

We encourage close involvement of management on a continuing basis and their thorough review of accounting activities and financial reports as a means to maintain effective internal controls until a more structured control environment becomes cost effective.

(2) Accounting and Internal Control Policies and Procedures

UALGOV does not currently have a formal accounting policies and procedures manual. A comprehensive accounting policies and procedures manual should be readily accessible to accounting personnel to ensure that accounting policies are followed and are consistently applied. This manual would also benefit the entity when there is turnover of key personnel. Thoroughly documented policies and procedures can reduce the learning period for new employees and provide management with increased assurance that accounting policies and procedures are understood and consistently followed.

The objectives of an accounting policies and procedures handbook are to document the accounting systems and processes, thus minimizing disruption caused by growth or turnover, and to assist new employees in their job performance. We recommend that management consider adopting an accounting manual to govern the financial reporting process and other significant business cycles within the entity such as expenditures, revenue and payroll cycles.

(3) Bank reconciliation

During the year ended September 30, 2009, no bank reconciliation for BOG Grant Account 0205-264676 was prepared, which resulted in unrecorded interest income of \$107. We recommend timely preparation of bank reconciliations to identify reconciling differences.

(4) Interest Rate on Loans and Advances

Based on tests of loan documents, we noted that loans and advances are charged 9% interest; however, the approved Council resolution indicated that interest shall be charged at 12% or higher. Evidence of the approval of the 9% interest rate was not made available. We recommend that appropriate approval and documentation be maintained for significant policies.

SECTION III – DEFINITIONS

The definition of a deficiency 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

UALGOV'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 affected 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.