

July 24, 2015

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, 2010 (on which we have issued our report dated July 24, 2015), 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, 2010 that we wish to bring to your attention.

We have also issued a separate report to UALGOV, also dated July 24, 2015, 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.

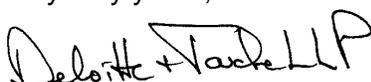
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with 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, 2010 that we wish to bring to your attention:

### 1. Unlocated Copies of Checks

Of forty-eight disbursements tested, totaling \$1,081,860, for the period from October 1, 2010 through December 31, 2010, the following items were not available for verification:

<u>Check #</u>	<u>Amount</u>
1729	\$ 9,412
9396	\$ 269
9398	\$ 1,280

We recommend that management establish internal control procedures requiring that check disbursements and underlying supporting documentation such as vendor invoices be adequately safeguarded and filed.

### 2. Local Distribution Authority (LDA) Payments

Of eighty-eight LDA distribution expenditures tested, the following exceptions were noted:

- a. Two (check #s 15134 and 15137) did not evidence recipient's signature as evidence of check receipt.
- b. Three (check #s 7635, 15388 and 16888) remitted to financial institutions or individuals other than the designated recipient were not evidenced by an approved assignment.
- c. Five (check #s 7392, 7798, 8416, 14469 and 16732) were unlocated and not available for verification.
- d. Three (check #s 7708, 15361 and 16680) were not evidenced by a completed and signed promissory note, pledge agreement and/or assignment.
- e. For all, claim forms, birth certificates and numbers of eligible beneficiaries were not on file.

We recommend that management establish internal control procedures requiring: (1) written authorization for distribution checks to be released to anyone other than the designated payee; (2) the designated payee, upon receipt, acknowledge all disbursements received in writing and sign on the promissory notes when advances are made; (3) check disbursements be adequately safeguarded and filed; (4) promissory notes and loan agreements to be completed and signed by all parties contractually binding all parties; and (5) claims forms, and birth and death certificates be maintained on file to verify the number of beneficiaries eligible for payment.

### 3. Invoice Support and Receipts Filing/Missing Invoices

Of sixty-five General Fund expenditures tested, six aggregating \$11,641 (check #s 1847, 5549, 5685, 37656 and 50068, and Land Lease-6150) were not supported by underlying vendor invoices. We recommend that check disbursements and underlying supporting documentation such as vendor invoices be adequately safeguarded and filed.

4. Purchase Returns

We noted two purchases (check #s 5591 and 5593) that were subsequently returned; however, no documentation was maintained on file to indicate that the goods were returned. We recommend that management require the return of goods to vendors be adequately documented.

5. 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 require that potential collectability issues are addressed.

6. Investment Valuation, Monitoring and Reconciliation

We noted no difference in investment account market value when compared to the UBS statement; however, we recalculated a \$18,578 difference on changes in unrealized gains/losses. Differences in interest income and miscellaneous income amounted to \$106,038 and \$68,147, respectively, were also noted. UALGOV does not perform independent checks of investment earnings 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.

7. Allowance for Doubtful Accounts

UALGOV has extended salary advances for periods 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 require that policies are in place to address delinquent accounts. We recommend that management pursue collection of these receivables and determine the adequacy of the allowance for doubtful accounts.

8. Legal Fees

Payments are made to legal counsel in advance on a quarterly basis. The contract with legal counsel indicated annual retainage of \$120,000 plus a flat rate of \$20,000 for expenses incurred. The contract requires the contractor to provide copies of billing statements to UALGOV submitted to the custodian. No invoices or billing statements were provided by the contractor to UALGOV. We recommend that management require that legal counsel comply with the contractual requirements of submitting copies of billing statements to UALGOV.

9. Investment Management Fees

During the year ended September 30, 2010, investment management fees in the aggregate amount of \$172,824 were deducted from UALGOV's investment accounts. Based on average asset values of investments, we estimated that UALGOV incurred investment management fees of \$124,268, which resulted in a difference of \$48,556. Although fees can be traced to the investment statements, a supporting calculation from the investment manager was not obtained and independent recalculations are 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.

10. Budgetary Reporting

The budget includes estimates of the proposed expenditures for all funds and the sources of the funds. The budget is employed as the management control device during the year; however, we noted that UALGOV has over expended by \$18,051. We recommend that management develop policies requiring strict compliance with the budget.

**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 involvement of management on a continuing basis and 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 require 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, 2010, an error on the bank reconciliation for BOG Loan Account # 052776 was noted, which resulted in the understatement of cash of \$30. The error occurred due to the non-timely preparation of bank reconciliations. We recommend timely preparation of bank reconciliations to identify reconciling differences.

4. Interest Rate on Loans and Advances

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 available. We recommend that appropriate approval and documentation be maintained for significant policies.

**SECTION III - DEFINITIONS**

The definition of a deficiency 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.