

NATIONAL DEVELOPMENT BANK OF PALAU

INDEPENDENT AUDITORS' REPORTS ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2006

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS
BASED UPON THE AUDIT PERFORMED IN ACCORDANCE
WITH GOVERNMENT AUDITING STANDARDS

Board of Directors
National Development Bank of Palau:

We have audited the financial statements of the National Development Bank of Palau (the Bank) as of and for the year ended September 30, 2006, and have issued our report thereon dated May 15, 2007. 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 the Bank'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 assurance 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 the Bank's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described in the accompanying Schedule of Findings (pages 3 through 6) as items 2006-1 and 2006-2.

A material weakness is a 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 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, we consider item 2006-1 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Bank's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 one instance of noncompliance that is required to be reported under *Government Auditing Standards*, which is described in the accompanying Schedule of Findings as item 2006-3.

This report is intended solely for the information and use of the Board of Directors, management, federal awarding agencies, pass-through entities, 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.

Deloitte & Touche LLC

May 15, 2007

NATIONAL DEVELOPMENT BANK OF PALAU

Schedule of Findings
Year Ended September 30, 2006

Investments

Finding No. 2006-1

Criteria: Investments should be recorded at fair market value.

Condition: In fiscal year 2004, the Bank paid \$1,000,000 for 10,000 shares in Palau Rock Island Air, Inc. The investment is collateralized by real property owned by other stockholders in the airline. The airline has ceased operations and it is uncertain when operations will resume. The Bank has not recorded an impairment of the investment.

Cause: The cause for the above condition is that the Bank believes airline operations will resume and that the collateral of the investment is sufficient.

Effect: The condition may result in a potential misstatement of investments.

Prior Year Status: Lack of internal controls to ensure investments are recorded at fair market value was reported as a finding in the audits of the Bank for fiscal years 2004 and 2005.

Recommendation: The Bank should strengthen internal controls to ensure investments are recorded at fair market value.

Auditee Response and Corrective Action Plan: Based on repurchase agreements with several parties for a fixed period and real property securities subjected to title searches and professional valuations, the investment should remain as stated.

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Schedule of Findings, Continued
Year Ended September 30, 2006

Foreclosed Real Estate

Finding No. 2006-2

Criteria: Foreclosed properties should be recorded at the lower of cost or fair market value.

Condition: For two foreclosed properties, the Bank has not obtained formal appraisals to determine the fair market value.

Cause: There appears to be weak internal controls ensuring foreclosed properties are recorded at the lower of cost or fair market value.

Effect: The above condition may result in a potential misstatement of foreclosed properties.

Prior Year Status: Lack of internal controls to ensure foreclosed properties are recorded at the lower of cost or fair market value was reported as a finding in the audit of the Bank for fiscal year 2005.

Recommendation: The Bank should strengthen internal controls to ensure foreclosed properties are recorded at the lower of cost or fair market value.

Auditee Response and Corrective Action Plan: The Bank has requested an appraisal on the property located in Ngchesar State, Republic of Palau. The Bank will record this property at the lower of cost or fair market value, upon receiving the appraisal report.

The second property situated in Ngerchelung State, Republic of Palau is pending final land survey for an appraisal to be requested by the Bank.

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Schedule of Findings, Continued
Year Ended September 30, 2006

Local Noncompliance

Finding No. 2006-3

Criteria: The Bank's operational procedures manual stipulates criteria used to determine applicant qualification; prequalification, loan amounts, interest rates and term requirements, equity requirements, security requirements, loan proceed disbursement requirements and Board approval. Additionally, all loan closing documents should be kept on file.

Condition:

1. For 3 (or 7%) of 42 loans tested, affidavits from first-time homeowners were obtained after the loan was entered into.

<u>Loan No.</u>	<u>Amount</u>
1922	\$ 67,453
1927	\$ 58,507
1904	\$ 35,250

2. For 1 (or 2%) of 42 loans tested, we noted no insurance documents on file for the asset taken as security.

<u>Loan No.</u>	<u>Amount</u>
1907	\$ 50,000

3. For 1 (or 3%) of 33 loans tested, we noted the commercial applicant had no insurance documents on file for a building taken as security.

<u>Loan No.</u>	<u>Amount</u>
1872	\$ 92,119

Cause: There appears to be weak internal controls ensuring established operational procedure requirements are followed.

Effect: The Bank is in noncompliance with established operational procedures.

Recommendation: The Bank should strengthen internal controls to ensure established operational procedure requirements are followed.

Prior Year Status: Lack of internal controls to ensure established operational procedure requirements are followed was reported as a finding in the audit of the Bank for fiscal year 2005.

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Schedule of Findings, Continued
Year Ended September 30, 2006

Finding No. 2006-3, Continued

Auditee Response and Corrective Action Plan:

Loan No. 1922, \$67,453: Affidavit is sworn and subscribed before both borrowers as dated December 13, 2006, notarized and is in file.

Loan No. 1927, \$58,507: Affidavit is in file, completed and dated February 21, 2007.

Loan No. 1904, \$35,250: Affidavit is in file, completed and dated February 21, 2007.

Loan No. 1907, \$50,000: Noncompliance is noted and the Bank will contact the borrower to provide an insurance policy as required under Approving Conditions/Comments.

Loan No 1872, \$92,119: An insurance policy was obtained on November 15, 2005. The insurance company declined to cover the building due to its structure as substandard using containers as the first floor and the basement storage area constructed of wood, tin roof and concrete. Only the contents are insured. An account review is being taken to address this issue.

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Unresolved Prior Year Comments
Year Ended September 30, 2006

The status of unresolved prior year findings are disclosed within the Schedule of Findings section of this report (pages 3 through 6).