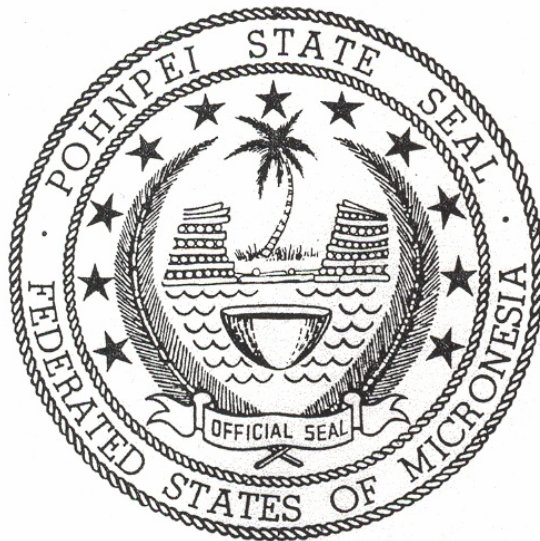


SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

AUDIT REPORT NO. 002-05

YEAR ENDED SEPTEMBER 30, 2004



**OFFICE OF THE PUBLIC AUDITOR
POHNPEI STATE GOVERNMENT**

ANNES H. LEBEN
State Public Auditor
P.O. Box 370
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**SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION
AUDIT REPORT
YEAR ENDED SEPTEMBER 30, 2004**

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December 27, 2005

The Honorable Johnny P. David, Governor, State of Pohnpei
The Honorable Nelson N. Pelep, Speaker, Pohnpei State Legislature
The Honorable Members of the Pohnpei State Legislature
The Board of Directors, Small Business Guarantee and Finance Corporation
Mr. Eddie J. Linus, Executive Director, Small Business Guarantee and Finance Corporation

EXECUTIVE SUMMARY

We respectfully submit the financial audit report of Small Business Guarantee and Finance Corporation (the Corporation) as of and for the year ended September 30, 2004. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and the Government Auditing Standards, issued by the Comptroller General of the United States. The audit was also conducted pursuant to Article 11, Section 8 (2) of the Pohnpei State Constitution and Pohnpei State Law No. 1L-10-79, and such other laws promulgated thereafter.

The objectives of our audit were: (1) the expression of an opinion concerning whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of Small Business Guarantee and Finance Corporation, in conformity with accounting principles generally accepted in the United States of America, (2) reporting on the internal control relevant to an audit of the financial statements, and (3) reporting on the Corporation's compliance with laws and regulations, which could have a material effect on the financial statements. Also, as part of our audit, we conducted a review of management controls to determine whether there is reasonable assurance that management's objectives will be achieved efficiently and effectively.

The audit report consists of the financial, and compliance and internal control sections. The financial section includes the Corporation's financial statements, and notes to the financial statements. A Management's Discussion and Analysis, prepared by the Corporation's management, is also presented before the financial statements. In the

compliance and internal control sections, we have offered our recommendations to each of the findings, we believe once implemented could improve the operations of the Corporation.

The highlights of the report are as follows:

- The financial statements present fairly, in all material respects, the financial position of the Corporation as of September 30, 2004, and the result of its operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.
- The other non-current assets of the Corporation increased by \$73,528 (or 150%) compared to last year's other non-current assets. This was primarily due to the issuance of sixteen (16) loans under the Micro Loan Program.
- The net assets decreased by \$4,084 (or 0.24%) when compared to last year's balance.
- The operating revenues increased by \$9,329 (or 134.12%) while the operating expenses decreased by \$40,233 (or 26.21%) when compared to last year's balances.

The audit cited two (2) instances of material non-compliance with laws and regulations and two (2) other instances of immaterial non-compliance with laws and regulations. The two (2) that were considered material were as follows:

- During the year, the Corporation received the government funding subsidy in the amount of \$70,530 to fund its operations. Of the total uses of funds amounting to \$163,943, the interest income used for operations was \$41,905. This interest income used was from the initial capitalization of \$1.5M which is supposed to be used for business development project funding.
- The Corporation has seven (7) notes receivable arising from guarantees paid as of the end of the fiscal year 2004. Three (3) of which were for defaulted guarantees paid during the year. The amount paid for the three (3) defaulted guarantees mentioned was \$52,553. The Corporation may have been lenient in collecting from delinquent accounts and the collectibility of these defaulted accounts has become uncertain without clearly defined remedies.

Of the three (3) reportable conditions described in detail on pages 22 through 36 of the audit report, two (2) findings were identified to be material weaknesses. These are findings no. 5 and 6 which are also described below:

- There is lack of adequate control measures that will protect the Corporation from the guarantee implementation procedures. There were three (3) defaulted guarantees paid during the year and one (1) of which was approved by the former Executive Director in fiscal year 2000 without the Board's approval. The guarantee agreement was signed in fiscal year 2003. Three (3) months after the

date of the guarantee agreement, the lender called on the guarantee which led to a civil case against the Corporation and also resulting to payment by the Corporation of \$50,000 to the lender in settlement of the defaulted loan.

- The total operations budget for the fiscal year which was approved by the Corporation's Board was \$134,855. The source of funding from the Board approved subsidy of \$45,590 has not been properly authorized. The request for authorization to use the other funding sources from the State Legislature was not prepared.

As is customary, we provided a draft of this report to the management of the Corporation for their review and comments. Their response and corrective action plans to the audit findings are included in this report as Exhibit I (page 37). The Corporation is also required by Pohnpei State Law No. 5L-08-00, an amendment to the law that created the Office of the Public Auditor (OPA), to submit a monthly report to OPA indicating its progress in clearing the deficiencies cited in the audit report, which period shall not exceed six months.

Once again, we want to express our sincere appreciation to the management and staff of the Corporation for the cooperation and assistance extended to us during the course of our audit.

Annes H. Leben
State Public Auditor

INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Small Business Guarantee and Finance Corporation

We have audited the accompanying financial statements of the Small Business Guarantee and Finance Corporation (the Corporation), a component unit of the State of Pohnpei, as of and for the year ended September 30, 2004. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Small Business Guarantee and Finance Corporation as of September 30, 2004, and the result of its operations and its cash flow for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 27, 2005, on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in

accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 3 to 5 is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Annes H. Leben
State Public Auditor
December 27, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year Ended September 30, 2004

This section of the Small Business Guarantee and Finance Corporation's financial audit report presents management's discussion and analysis of the Corporation's financial performance during the fiscal year ended September 30, 2004. The management's discussion and analysis is intended to serve as an introduction to the Corporation's financial statements. Please read it in conjunction with the Corporation's financial statements and accompanying notes.

Financial Highlights

- Other non-current assets of the Corporation increased by \$73,528 (or 150%).
- The increase in the Corporation's other non-current assets was primarily due to issuance of sixteen (16) loans under the Micro Loan Program, and payment of three (3) defaulted guarantee loans to lender.
- Cash and equivalents decreased by \$76,258 (or 4.64%).
- Net assets decreased by \$4,084 (or 0.24%).
- Operating Revenues increased by \$9,329 (or 134.12%)
- Operating Expenses decreased by \$40,233 (or 26.21%)

Overview of the Financial Statements

The discussion and analysis is intended to serve as an introduction to the Corporation's financial statements. This annual financial report consists of two parts: Management's Discussion and Analysis (this section) and the basic financial statements. The Corporation is subsidized in part by Pohnpei State Government, through the approval of the Legislature, and follows enterprise fund reporting; accordingly the financial statements are presented using the economic resources measurement focus and the accrual basis of accounting. Enterprise fund statements are presented in a manner similar to a private business, such as real estate development, investment banking, commercial lending and private consulting.

Financial Analysis

Net assets. The statement of net assets presents information on all of the Corporation's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Corporation is improving or deteriorating. The following table summarizes the changes in net assets between September 30, 2004 and 2003.

	<u>2004</u>	<u>2003</u>	<u>% Increase/(Decrease)</u>
Current assets	\$1,575,798	\$1,649,613	(4.47%)
Capital assets	5,086	8,479	(40.00%)
Non-current assets	122,459	48,931	150.00%
Total assets	<u>\$1,703,343</u>	<u>\$1,707,023</u>	<u>(0.22%)</u>
Long-term debt	0	0	0
Other liabilities	\$5,601	\$5,197	7.76%
Total liabilities	<u>\$5,601</u>	<u>\$5,197</u>	<u>7.76%</u>
Net assets:			
Invested in capital assets	\$5,086	8,479	(40.02%)
Restricted	1,648,558	1,657,740	(0.55%)
Unrestricted	44,098	35,607	23.85%
Total net assets	<u>\$1,697,742</u>	<u>\$1,701,826</u>	<u>(0.24%)</u>

Operating Activities. The Corporation charges 1% guarantee fees per annum on the guaranteed outstanding loan based on the diminishing balance thereof and payable one (1) prepayment period in advance. On the Micro Loan Program, which started in the middle part of the last fiscal year, the Corporation charges 15% interest per annum, and 1% penalty fees for delinquent loans, based on the diminishing balance in the event an installment is made after the fifteenth (15th) day of the due date. Before the loan is closed, the Corporation also charges 1.5% processing fee, while a 35% agent's commission is collected on every credit life insurance premium that the Corporation issues on each loan. Other source of funding is the State subsidy, as approved by the Pohnpei State Legislature. This fiscal year, about 44% of the Corporation's budget is being subsidized by the State. Interest income from the \$1,500,000 capitalization and business development projects funds accrues to the benefit of the Corporation.

The following table summarizes the changes in operating income between fiscal years 2004 and 2003:

	<u>2004</u>	<u>2003</u>	<u>% Increase/(Decrease)</u>
Operating revenues	\$16,286	\$6,956	134.12%
Operating expenses	113,287	153,520	(26.21%)
Operating income (loss)	<u>(97,002)</u>	<u>(146,564)</u>	<u>(33.82%)</u>
Non-operating revenues	92,918	98,380	(5.55%)
Net income (loss)	<u>(\$4,084)</u>	<u>(\$48,184)</u>	<u>(91.52%)</u>

Capital Assets and Debt Administration

Capital assets. As of September 30, 2004, the Corporation's investment in capital assets was \$5,086 (net of accumulated depreciation). The Corporation's capital assets include office furniture and equipments, and vehicles. There was no major capital asset purchased this year except for a brand new air-conditioning unit.

Long-term debt. The Corporation does not have any long-term liabilities at this time.

Contacting the Corporation's Financial Management

This financial report is designed to provide our citizens, taxpayers, customers, creditors, and all those with interest, with a general overview of the Corporation's finances and to demonstrate the Corporation's accountability for the appropriations it receives. Questions concerning any of the information provided in this discussion and analysis or requests for additional financial information should be addressed to the Executive Director, Small Business Guarantee and Finance Corporation, P.O. Box 1751 Kolonia Pohnpei, FSM 96941, or call (691) 320-2968 or (691) 320-3264.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Net Assets As of September 30, 2004

ASSETS

Current assets:

Cash and equivalents (note 2)	\$40,459
Cash and equivalents-restricted (note 2)	1,526,099
Accounts receivable, net (note 3)	5,908
Travel advances	(3)
Commissions receivable	72
Employee loans receivable (note 4)	1,982
Interest receivable	1,281
Total current assets	<u>\$1,575,798</u>

Non-current assets:

Capital assets (note 5):

Vehicles, net	\$2,844
Office furniture and fixtures, net	\$2,242
Employee loans receivable (note 4)	
Notes receivable-restricted (note 6)	\$122,459
Total non-current assets	<u>\$127,545</u>

Total assets \$1,703,343

LIABILITIES

Current liabilities:

Accrued expenses	\$1,711
Credit life insurance payable	205
Taxes payable	3,615
Deductions Payable	70
Total liabilities	<u>\$5,601</u>

NET ASSETS

Invested in capital assets (note 1)	\$5,086
Restricted for capital stock and business development projects (note 1)	1,648,558
Unrestricted (note 1)	44,098
Total net assets	<u>\$1,697,742</u>

See accompanying notes to financial statements

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Revenues, Expenses, and Changes in Net Assets For the Year Ended September 30, 2004

OPERATING REVENUES

Loan guarantee fee (note 7)	\$7,897
Loan packaging fee	50
Loan processing fee	749
Interest income-MLP (note 8)	7,590
Total operating revenues	<u>\$16,286</u>

OPERATING EXPENSES

Salaries	\$78,822
Travel	519
Office supplies	5,898
Depreciation	4,428
Rent	5,936
Payroll tax	4,503
Utilities	2,874
Postage and telephone	2,162
Employee benefits	2,211
Repairs and maintenance	892
Representation and entertainment	2,176
Janitorial and cleaning	1,188
Gasoline	588
Meeting allowance	640
Advertising	75
Bank charges	263
Miscellaneous	113
Total operating expenses	<u>\$113,288</u>

Operating income (loss) (\$97,002)

NON-OPERATING REVENUES (EXPENSES)

Transfers in (note 9)	\$70,530
Interest income (note 10)	20,325
CLI Commissions income	408
Other income	1,655
Total non-operating revenues	<u>\$92,918</u>

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Revenues, Expenses, and Changes in Net Assets, Continued
For the Year Ended September 30, 2004

Income (loss) before other revenues, expenses, gains, losses, and transfers	(\$4,084)
Adjustments that affect net income (loss)	<u>0</u>
Increase (decrease) in net assets	(\$4,084)
Net assets – beginning of year	<u>\$1,701,826</u>
Net assets - end of year	<u><u>\$1,697,742</u></u>

See accompanying notes to financial statements.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Cash Flow
For the Year Ended September 30, 2004

CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from (payments to) customers	(61,425)
Payments to suppliers and providers of goods and services	(21,684)
Payments to employees	(83,494)
Other receipts (payments)	<u>(1,539)</u>
Net cash provided (used) by operating activities	<u>(168,142)</u>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Operating transfers in	70,530
Commissions income – credit life insurance	408
Other income	<u>1,655</u>
Net cash provided by noncapital financing activities	<u>72,593</u>

**CASH FLOWS FROM CAPITAL AND RELATED FINANCING
ACTIVITIES**

Purchase of capital assets	<u>(1,034)</u>
Net cash provided (used) by capital and related financing activities	<u>(1,034)</u>

CASH FLOWS FROM INVESTING ACTIVITIES

Interest income	<u>20,325</u>
Net cash provided by investing activities	<u>20,325</u>

Net increase (decrease) in cash and equivalents	(76,258)
Cash and equivalents at beginning of year	<u>1,642,815</u>
Cash and equivalents at end of year	<u><u>1,566,557</u></u>

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Cash Flow, Continued
For the Year Ended September 30, 2004

**Reconciliation of operating income (loss) to net cash
provided (used) by operating activities:**

Operating income (loss) (97,002)

Adjustments to reconcile operating income
(loss) to net cash provided by (used for)
operating activities:

Depreciation 4,428

(Increase) decrease in assets:

Accounts receivable (7)

Advances 3

Employee loans receivable 2,077

Commissions receivable 67

Interest receivable (523)

Notes receivable (77,587)

Increase (decrease) in liabilities:

Accrued expenses 624

Taxes payable (56)

Employee benefits payable (45)

Credit life insurance payable (190)

Deductions Payable 70

Net cash provided (used) by operating
activities (168,142)

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies

A. Reporting Entity

The Corporation was established by Pohnpei State Law No. 3L-86-95 on February 14, 1995. However, it officially started its operation on October 1, 1999 when the accounting system was transferred from the Department of Treasury and Administration to the Corporation. The Corporation's mission is to provide, promote, develop and widen in both scope and service, reach various alternative modes of financing for small enterprises, including, but not limited to, direct and indirect project lending, venture capital, financial leasing, secondary mortgage and/or rediscounting of loan papers to small businesses.

Pursuant to Pohnpei State Law no. 5L-14-00 (Executive Reorganization Act of 2000), the Corporation shall be attached to the Pohnpei State Government's Office of Economic Affairs, and shall be under the policy, program, and administrative supervision of the Small Enterprise Development (SED) Council. It shall exercise all the general powers conferred by law upon corporations as are incidental or conducive to the attainment of the Business Development Act of 1994, including the power to promulgate articles of incorporation, bylaws, rules and regulations, guiding programs and policies. Its main function is to guarantee loans to qualified small enterprises, local and/or regional associations' small enterprises and industries, private voluntary organizations and/or cooperatives. It may guarantee loans up to 85% and may also provide second guarantees on the credit and/or investment guarantees made by credit guarantee associations and other institutions in support of small enterprises.

The powers of the Corporation shall be vested upon a seven-member Board of Directors. The Administrator of the Office of Economic Affairs shall serve as Chairman, with the other six members appointed by the Governor upon recommendation of the SED Council with the advice and consent of the Legislature. Three members shall come from the private sector and the other three members are from the public sector. At present, the Board consists of only six (6) members, including its Chairman.

The Corporation is managed by an Executive Director, appointed by the Board of Directors and who reports directly to the Board. He is charged with the responsibility of ensuring smooth operation of the Corporation in line with

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

the policies established by the Board of Directors and he is also in charge of the implementation of the guarantee program.

B. Financial Statements

The financial statements of Small Business Guarantee and Finance Corporation have been prepared in conformity with accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting," requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989.

The Corporation has implemented the general provisions of GASB Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments" in the current year, pursuant to paragraph 142 of the Statement. The financial statements in this report include the Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Net Assets; and Statement of Cash Flows.

C. Fund Structure, Measurement Focus, and Basis of Accounting

The accounts of the Corporation are organized as a proprietary fund-component unit of Pohnpei State Government. Proprietary funds are used by governmental units to account for operations that are financed and operated in a manner similar to private business enterprises. The purpose of a proprietary fund is to provide periodic determination of revenues, expenses and net income as well as the maintenance of capital.

Proprietary funds are accounted for on a flow of economic resources measurement focus, whereby all assets and liabilities associated with the operations of the funds are included in the statement of net assets. Net asset is segregated into three (3) components: invested in capital assets, restricted, and

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

unrestricted. The operating statement for proprietary funds is the statement of revenues, expenses, and changes in fund net assets. Revenues are reported by major sources and distinguished between operating and nonoperating revenues.

Basis of accounting refers to when revenues and expenses are recorded in the accounts and reported in the financial statements. The Corporation utilizes the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when cash is received or payment is made.

D. Budget

The Corporation operates on an annual budget appropriated by the Pohnpei State Legislature (PSL). In fiscal year 2004, Pohnpei State Law No. 5L-113-03 appropriated \$70,530 for the Corporation's current year operation.

E. Cash and Equivalents

For the purpose of the statement of net assets and statement of cash flow, cash and equivalents are defined as cash on hand and cash in banks, including time certificates of deposit that mature within one year. Of these amounts, \$200,000 is insured through the FDIC, with the remaining balance exceeding insurable limits. The Corporation does not require collateralization of its deposits by its banks. Therefore, the amounts, which exceed the FDIC insurable limits, are characterized as uncollateralized.

F. Capital Assets

Assets with value of \$1,000 or more are capitalized and recorded at cost less accumulated depreciation. Depreciation is based on the straight-line method over the estimated useful lives of the respective assets.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

Summary of Significant Accounting Policies, Continued

G. Revenues

Annual operating subsidies to the Corporation, which finance either capital or current operations, are reported as nonoperating revenues based on GASB Statement No. 33.

H. Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefit accrues to employees. In accordance with the provisions of FASB Statement No. 43-Accounting for Compensated Absences, no liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The related sick pay expense is recorded when the benefit is actually taken.

I. Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual reports could differ from those estimates.

J. Contributed Capital

The \$1,500,000 Pohnpei State funding for capital stock and business development projects has been recorded in the Corporation's financial records as "contributed capital" and reflected in the prior years' financial statements under "fund equity". Due to the implementation of GASB Statement no. 34 in FY 2003, fund equity is no longer shown in the financial statements. The difference between assets and liabilities is now displayed as "net assets", which is further segregated into three (3) components: "invested in capital assets", "restricted", and "unrestricted". The restricted component of net assets includes cash and notes receivable restricted for capital stock and business development projects. The unrestricted component of net assets includes all other assets and liabilities that are not restricted for use by the Corporation.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

(2) Cash and Equivalents

At September 30, 2004, the Corporation had deposits and cash on hand as follows:

Petty cash	\$	300
Cash in bank-Investment Transaction Account (ITA)		40,159
Cash in bank-swift savings Direct Loan Program (restricted)		46,652
Cash in bank-savings (restricted)		279,447
Time Certificate of Deposit (TCD)-short term (restricted)		<u>1,200,000</u>
Total	\$	<u>1,566,558</u>

The restricted cash represents current balances of cash in banks arising from the capitalization funding (\$1,000,000) and business development projects funding (\$500,000) received by the Corporation in fiscal year 2000.

(3) Accounts Receivable

The receivable from the former employee consists of travel and payroll advances, and employee loans and advances. The receivables from the former Board Chairman and Vice-Chairman arose from advances for travel and the receivables from present employees are for miscellaneous expenses. A summary of the receivable follows:

<u>Description</u>	<u>Gross Amount</u>	<u>Allowance for Bad Debts</u>	<u>Net Amount</u>
Former employee	\$ 24,258	\$ 19,407	\$ 4,851
Former Board Chairman and Vice Chairman	1,046		1,046
Present employees	<u>11</u>		<u>11</u>
Total	\$ <u>25,315</u>	\$ <u>19,407</u>	\$ <u>5,908</u>

(4) Employee Loans Receivable

The Corporation has a staff loan program that serve as an incentive to its employees. The program allows maximum loan of \$5,000 per employee.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

(5) Capital Assets

The Corporation's capital assets are recorded at cost except for donated assets, which are recorded using fair market value. Capital assets' activities for the year ended September 30, 2004 were as follows:

<u>Description</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Vehicles	\$8,144	\$0	\$0	\$8,144
Furniture and fixtures	\$23,830	\$1,034	\$1,250	\$23,614
Total cost	\$31,974	\$1,034	\$1,250	\$31,758
Less accumulated depreciation for:				
Vehicles				\$5,300
Furniture and fixtures				\$21,372
Total accumulated depreciation				\$26,672
Capital assets, net				\$5,086

(6) Notes Receivable

The account represents seven (7) promissory notes arising from called off guarantees and twenty seven (27) promissory notes ensuing from the direct lending program, which was established by the corporation during the FY 2003. There were sixteen (16) new loans processed under the direct lending program during the FY 2004.

(7) Loan Guarantee Fee

The amount represents one percent (1%) fee collected on newly approved guarantee applications, and existing guarantees issued in previous years.

(8) Interest Income-MLP

The amount represents interests earned on direct loans under the Micro Loan Program (MLP) and interests earned on loans arising from defaulted guarantees. Interest rate of 15% is assessed on the direct loans while 9% interest is assessed on defaulted guarantee loans.

(9) Operating Transfers-In

The Pohnpei State Legislature appropriated \$70,530 in fiscal year 2004 for the Corporation's current operations.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2004

(10) Interest Income

This represents interest earned on all bank accounts maintained by the Corporation and includes interest earned on employee loans.

(11) Contingencies

Risk Management

The Corporation does not purchase commercial insurance covering its potential risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

Claims

The Corporation has court cases which pose as potential liability. These cases arose from the guarantee agreements. In one instance, there is an action for recovery of sum of money. The amount of the loan was \$435,000 and the guarantee percentage was 57% of the loan amount. At the time of the final demand for payment, the total outstanding obligation of the borrower to the lender bank was \$357,289. Based on the guaranteed percentage, there is a potential liability of \$204,795.

Another case involves a loan amount of \$128,500. At the time of the final demand for payment, the outstanding balance was \$118,365. The guarantee rate was 85%, hence, there is a potential liability of \$100,610.

The answers to the claims have been filed and discovery will begin soon on these cases.

There is another case which has been reported during prior year's audit. The Corporation has also been charged for breach of contract arising from labor-related issues. The case is still pending in the Pohnpei Supreme Court. The Corporation's legal counsel estimates the likely amount of award to be no more than \$7,536 if claimant succeeds. However, no liability as a result of the ultimate resolution of this matter has been recorded in the accompanying financial statements.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements September 30, 2004

A litigation instituted by the Corporation is also pending in the Pohnpei Supreme Court. This litigation is concerning action filed against its former employee concerning certain monies that she received or obtained when she was connected with the Corporation. Of the total amount of claim of \$73,988.21, \$24,258 has been recorded as "accounts receivable" in the accompanying financial statements. This receivable represents the total of the payroll and travel advances, and employee loans and advances, which were received by the former employee.

Guarantees

Pursuant to the Corporation's enabling act [PSL no. 3L-86-95, Section 15 (3)], the Corporation shall become liable under its guarantees upon proof that the loan has become past due under such terms and guidelines adopted by its Board and printed on the contract of guarantee. As of September 30, 2004, the Corporation has thirty eight (38) outstanding guarantees, with a total exposure of \$428,857. No provision for any liability that may result from this matter has been recorded in the accompanying financial statements.

(12) Subsequent Events

In the subsequent period, the Corporation paid the total amount of \$11,693 to the lender (bank) representing guaranty payments for four (4) defaulted guarantees.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE

AND

ON INTERNAL CONTROL OVER FINANCIAL REPORTING

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND
ON INTERNAL CONTROL OVER FINANCIAL REPORTING
BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

The Board of Directors
Small Business Guarantee and Finance Corporation

We have audited the financial statements of the Small Business Guarantee and Finance Corporation (the Corporation), as of and for the year ended September 30, 2004 and have issued our report thereon dated December 27, 2005. 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.

Compliance

As part of obtaining reasonable assurance about whether the Corporation'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 material instance of noncompliance that are required to be reported under *Government Auditing Standards*, which are described in the accompanying Schedule of Findings and Recommendations (pages 22 through 36) in finding numbers 1 & 4.

We also noted certain immaterial instances of noncompliance that we are reporting to the management of Small Business Guarantee and Finance Corporation, which are described in the accompanying Schedule of Findings and Recommendations (pages 22 through 36) in finding numbers 2 & 3.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Corporation'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 Corporation's ability to record, process, summarize 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 Recommendations (pages 22 through 36) as finding numbers 5 to 7.

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. We noted matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. These are described in the accompanying Schedule of Findings and Recommendations (pages 22 through 36) as finding numbers 5 & 6.

This report is intended solely for the information and use of the Board of Directors and management of Small Business Guarantee and Finance Corporation, federal awarding agencies, pass-through entities, and the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than those specified parties.

Annes H. Leben
State Public Auditor
December 27, 2005

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Interests Income

1. Criteria:

The Pohnpei State Attorney General opined that the Corporation is precluded from using or applying certain amount out of the interest income earned on its capital stock and business development project funds (\$1,500,000) to defray its operational/administrative expenses. The opinion was made pursuant to the provisions of Pohnpei State Law no. 3L-86-95 or the Corporation's establishing law.

Condition:

The Corporation transferred the \$500,000 TCD, which represents the initial funding for business development projects to the Direct Loan Program Account in the amount of \$200,000 and \$300,000 to the Loan Guarantee Account. However, during the year the amount deposited to the Direct Loan Program Account of \$200,000 was deposited back to TCD while the \$300,000 deposited to the Loan Guarantee Account decreased by \$50,000 which was used as payment for a defaulted loan guarantee.

The Corporation uses the Investment Transaction Account (ITA), for its operations. During the year, the Corporation received the government funding subsidy in the amount of \$70,530 to fund its operations. Other deposits made to this account amounted to \$103,924 while the total disbursements amounted to \$163,943.

The ITA-Savings account has a bank balance of \$41,757 as of September 30, 2004 while the Corporation's book balance was \$40,159. Of the total uses of funds amounting to \$163,943, the interest income used for operations during the year was \$41,905.

Cause:

The Board of Directors approved the fund transfers and the TCD closure. Also, the Pohnpei State Legislature only appropriated \$70,530 for the Corporation's operation.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Interests Income, continued:

Effect:

The above condition is a possible noncompliance to the intent and purpose of the \$1.5M capitalization and project funds. There is also a possibility that the money appropriated for business development projects might be used for other purposes.

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal years 2003 and 2002.

Recommendation:

We recommend that management should cease from using interests income earned from the \$1 million currently invested in time certificate of deposits, for its operational and administrative expenses. Otherwise, we recommend that in order for the Corporation to comply with the intent and purpose of the \$1 million capitalization fund, management should request Pohnpei State Legislature to authorize the use of a portion of the interest earned on the \$1 million, in the event that the Legislature does not appropriate any funds for its operations.

Furthermore, we recommend that management should ensure that the \$500,000 funding for business development projects be strictly used as intended.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Loan guarantee fees

2. Criteria:

The Corporation's policy on loan guarantee and the guarantee agreement requires the lender to pay 1% guarantee fee to the guarantor on the anniversary date of the loan. The policy and the guarantee agreement also state that if the lender does not pay the guarantee fee after forty-five (45) days, the guarantor has the option to terminate the guarantee.

Condition:

Out of the forty four (44) guarantee agreements, ten (10) guarantee fees were received late and fifteen (15) guarantee fees were not paid at all during the year.

Cause:

The Corporation did not properly enforce the collection of the guarantee fees from the lender.

Effect:

The above condition resulted to the Corporation's guaranteeing of the loans free of charge during the period when the guarantee fees were not yet received. Guarantee fees income could have been received in a timely manner.

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal year 2003.

Recommendation:

We recommend that the Executive Director direct the Finance Division to strictly enforce the guarantee fee payment from the lender. For existing guarantees that have not paid the guarantee fee after the forty-five (45) days allowance, the Division should recommend to management the termination of the guarantee agreement.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2004**

Loan guarantee fees, continued:

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Accepted security

3. Criteria:

The Corporation's policy on direct loans states that: "SBGFC shall accept or require other securities by assignment. Securities may include but not limited to assignment of the following: crops, livestock, inventories, property and life insurance, shares of stocks and bonds, savings deposits, income from business and/or employment".

Condition:

The Corporation accepted these securities as collateral for the direct loans: crops, inventories, and livestock. The collateralization was only documented in the chattel mortgage signed by the borrowers and the Corporation. The chattel mortgage did not mention the assignment of the income from the sale of these items to the Corporation.

Cause:

The Corporation did not comply with its own policy.

Effect:

The mortgage on the assets mentioned above becomes worthless without the assignment.

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal year 2003.

Recommendation:

We recommend that the Executive Director direct the Loans Division to ensure that the borrower signs an assignment of income on certain assets accepted as collateral for loans, e.g. crops, inventories, livestock.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2004**

Accepted security, continued:

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Delinquent accounts

4. Criteria:

Pohnpei State Law no. 3L-86-95 (the Corporation's establishing law) states that: "In the event of default, the loan and all the availments on the line shall automatically become due and demandable. There is default when a borrower fails to pay three (3) consecutive monthly, one (1) quarterly, or one (1) semi-annual amortization". The Corporation's lending manual also states that the Executive Director, with the approval of the Board, may contract collection to collection agencies or legal means.

Condition:

The Corporation has seven (7) notes receivable arising from guarantees paid as of September 30, 2004. Three (3) notes receivable were for defaulted guarantees paid by the Corporation during the year. For the prior year's notes receivable three (3) borrowers had stopped paying their loans to the Corporation while regarding the current year defaulted guarantees paid off, two (2) borrowers have inconsistencies in making payments. Aside from letters sent to the borrowers, no other action has been carried out by the Corporation to collect the accounts. The amount of the defaulted guarantees paid during the year was \$52,553.

In subsequent period, the Corporation paid for four (4) defaulted guarantees to the lender/bank. The amount paid totaled to \$11,693. Of the four (4) defaulted guarantees paid off in subsequent period, one (1) borrower is paying through allotment while another one (1) borrower who is suppose to pay also through allotment had stopped making payments. Another borrower will begin to pay through allotment and there is another one (1) account that should to be paid through the remittance of the FSMDB. As of this report date, FSMDB has not remitted any collection to the Corporation on the defaulted guarantee mentioned.

Cause:

The Corporation may have been lenient in collecting from delinquent accounts.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Delinquent accounts, continued:

Effect:

The collectibility of the above accounts becomes uncertain without clearly defined remedies. As of end of the fiscal year 2004, the total outstanding guarantee exposure was \$428,857. Comparing this amount with the initial capitalization of \$500,000 for the implementation of Business Development Projects, management should be concerned about the viability of this program. The true essence of the Business Development Program may be wasted if the working capital for the program is exhausted without any return on its investment.

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal year 2003.

Recommendation:

We recommend that the management should employ other collection procedures for delinquent accounts. Aside from the regular collection letters, the Corporation may work out other possible payment agreements with the borrower and document the agreements in writing. If collection efforts are futile, management should immediately refer the accounts to the State Attorney or legal counsel for appropriate legal actions.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Controls on loan guarantee

5. Criteria:

The Corporation should establish adequate control measures that will protect its interest in the guarantee implementation procedures.

Condition:

There were three (3) defaulted guarantees paid by the Corporation during the year. The first one is described below:

The former Executive Director approved a guarantee request in the amount of \$48,875 in fiscal year 2000 without the Board's approval. The guarantee agreement was signed on December 19, 2002, two years (2) after the guarantee approval. Three months after the date of the guarantee agreement, the lender called on the guarantee, which eventually led to a civil case filed against the Corporation. The complete sequence of events is shown in the table below.

Date	Transaction
09/21/00	Bank (Lender) approved the loan of Borrower amounting to \$57,500.
09/26/00	Lender officially requested for Small Business Guarantee and Finance Corporation's (the Corporation) guarantee.
10/03/00	The former Executive Director wrote a letter to the Lender informing that the Corporation approved the guarantee application pending an Environmental Impact Assessment (EIA) on the project. Said letter also stated that the guarantee would be issued upon receipt of advice that the Borrower has met all security requirements and upon receipt of initial guarantee fee of \$488.75.
10/06/00	Lender and Borrower signed the Promissory note and Loan agreement.
10/12/00	Lender allegedly submitted the EIA assessment to the Corporation.
08/15/02	Lender wrote to the present Executive Director requesting for approval of the guarantee for the Borrower's loan.
09/25/02	Lender provided financial information on referenced loan thru a letter to the Corporation. The information indicated the outstanding principal loan balance of \$57,389.18 and also mentioned of principal amount paid to date of \$21,465.34, which later on was found to be incorrect.
10/14/02	The Corporation's Executive Director wrote the Lender to inform of Board's approval of the guarantee application.
11/28/02	Lender paid initial guarantee fee of \$487.81. Fee was based on the outstanding principal amount of \$57,389.16 as of November 28, 2002.
12/19/02	The Corporation's Executive Director signed the guarantee agreement, which guaranteed 85% of the loan amounting to \$57,500 as per promissory note dated October 6, 2000.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Controls on loan guarantee, continued:

Date	Transaction
01/29/03	Lender sent first default notice to Borrower. Notice indicated that Borrower is already 510 days in arrears.
02/13/03	Lender sent second default notice to Borrower. Notice indicated that Borrower is now 540 days in arrears.
03/18/03	Lender called on the guarantee and requested the Corporation's payment of 85% of total amount due of \$66,716.60 as of March 18, 2003. Outstanding principal balance as of date of letter is \$57,876.99.
05/13/03	Lender followed up on the guarantee payment.
05/30/03	The Corporation's Executive Director requested for clarification on the outstanding loan balance.
07/10/03	In a Board meeting, the Corporation's Board of Directors disapproved the payment of the guarantee.
07/30/03	The Corporation's Executive Director sent a letter to Lender transmitting Board's opinion for not paying the guarantee. The Corporation also reimbursed the Lender of the initial guarantee fee, which was initially paid.
11/05/03	Lender filed a civil case against Small Business Guarantee and Finance Corporation.
12/22/03	Lender paid second guarantee fee of \$491.95.
01/16/04	The Corporation returned the second guarantee fee to the Lender.
02/18/04	The Corporation paid \$50,000 to the Lender in settlement of subject defaulted loan.
02/18/04	Lender transmits two checks to the Corporation representing guarantee fees for two years.

There were two (2) other defaulted guarantees paid during the year and both of the borrowers are delinquent in paying their monthly amortization.

Cause:

The lack of adequate control measures relating to loan guarantees was the cause of the above condition.

Effect:

The above condition resulted to the payment by the Corporation of \$52,553 during the year, where \$50,000 was used as the amicable settlement in the civil case filed concerning one of the defaulted loans.

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal year 2003.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Controls on loan guarantee, continued:

Recommendation:

We recommend that the Corporation should establish adequate control measures to protect its interest in the guarantee implementation procedures. These controls should include but not limited to the following:

Make sure that all necessary conditions are met prior to the issuance of the guarantee agreement. Complete documentation is necessary.

Issue the guarantee agreement within a reasonable time from the date of guarantee approval and prior to the signing by the borrower and lender of all loan documents. Also request the lender to sign the guarantee agreement.

Enforce payment by the lender of the initial guarantee fee on the loan anniversary date and prior to the initial loan draw down. Payment of annual guarantee fee should be made within forty-five (45) days from the loan anniversary date.

Request lender to submit copies of quarterly loan status reports within twenty (20) calendar days after the end of each reporting period.

Request lender to promptly notify the guarantor (the Corporation) in writing of the default in loan payment.

Verify, review and evaluate the viability of the loan package before approving the guarantee agreement.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Approved budget

6. Criteria:

Prudent management dictates that an annual budget should be prepared within the financial capability of the Corporation.

Condition:

Pohnpei State Legislature only appropriated \$70,530 for its operation fund in fiscal year 2004. The Corporation's budget for the year far exceeded the amount appropriated by the State Legislature. The total budget approved by the Corporation's Board was \$134,855 broken down as follows:

Personnel & Benefits	\$98,711
Travel & Training	6,088
Contractual Services	5,020
Fixed Assets	2,500
Consumable Goods	<u>22,536</u>
Total	<u>\$134,855</u>

Except for the budget approved by the State Legislature of \$70,530, the source of funding from the Board approved subsidy of \$45,590 has not been properly authorized.

Cause:

Management and the Corporation's Board prepared and approved the annual budget without considering the funding sources. The request for authorization to use the other funding source from the State Legislature was not prepared.

Effect:

Although, the Corporation only expended \$41,905 from other sources on the Board's approved subsidy of \$45,590, the Corporation does not have the proper authority to use the other funding source which we found to be from the interest income earned from its capitalization and business development project funds. During the subsequent period, the Corporation requested authorization from the State Legislature to use the other funding source to augment their operations budget for FY 2005.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2004**

Approved budget, continued:

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal year 2003.

Recommendation:

We recommend that management and the Corporation's Board should always be able to identify the funding sources for their budgeted expenses and must have proper authority to use the funds before the disbursements are made.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Direct lending procedures

7. Criteria:

The Corporation's direct lending manual and other procedural manuals are established to serve as guide to its employees in performing their work.

Condition:

The Board of Directors approved the Corporation's lending manual in November 2002. Immediately after its approval, the Corporation started its direct lending program. We noted some discrepancies between the established procedures and the actual procedures being implemented by the Corporation. The table below shows the discrepancies.

<u>Item/Transaction</u>	<u>Per manual and Board minutes</u>	<u>Actual</u>
Interest rate	2% above prime rate	15%
Interest computation	None	Outstanding balance before payment multiplied by rate multiplied by number of days divided by 360.
Interest recording	None	Upon payment.
Penalty charge-late payment	\$25	1% of outstanding principal balance
Penalty charge-payment less than the required monthly amortization	None	1% of outstanding principal balance
Loan amortization schedule	None	Loan amortization program in Excel (Microsoft XP Professional).
Mortgage documents	Registered with appropriate courts or registrars. Mortgage to be annotated on certificates (land title or vehicle registration).	Not registered and no annotation on certificates.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2004

Direct lending procedures, continued:

In addition, the Corporation did not amend the lending manual to remove the 25% restriction on the loan used to acquire fixed assets per Pohnpei State Law no. 4L-91-98, an amendment to the Corporation's establishing law.

Cause:

The manual did not contain complete procedures regarding direct loans. The Board of Directors approved the manual during the last fiscal year in order to facilitate the implementation of the direct lending program.

Effect:

The above condition raises doubt on the legitimacy of some of the loan procedures.

Prior Year Status:

The above condition was reported as a finding in the financial audit of the Corporation for fiscal year 2003.

Recommendation:

We recommend that management should carefully review the direct lending procedures and determine the need for some revisions and/or additions. These however, should not conflict with the law. Hence, the Corporation is advised to request the assistance of the Office of the Attorney General for legal matter consultation regarding the existing policy. Any amendments to the existing policy must be approved by the Corporation's Board of Directors.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

AUDITEE RESPONSE (EXHIBIT 1)

YEAR ENDED SEPTEMBER 30, 2004