

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

AUDIT REPORT NO. 001-04

YEAR ENDED SEPTEMBER 30, 2003



OFFICE OF THE POHNPEI STATE AUDITOR

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**SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION
AUDIT REPORT
YEAR ENDED SEPTEMBER 30, 2003**

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SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT**

YEAR ENDED SEPTEMBER 30, 2003

August 30, 2004

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, 2003. 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, 2003, 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 Corporation had total assets of \$1,707,023, total liabilities of \$5,197, and total net assets of \$1,701,826 as of September 30, 2003. Net assets decreased by \$51,338 when compared with last year's balance.
- The audit cited eight (8) instances of noncompliance with laws and regulations, two (2) of these were considered material, viz:
 1. In fiscal year 2003, the Corporation used \$36,052 of the interest income earned on the \$1.5M capitalization and business development project funding for its operational and administrative expenses.
 2. The Corporation's Board of Directors and Executive Director incurred total travel expenses of \$31,990 to attend three (3) kinds of training during the year. Although the trainings were budgeted, the Corporation only received a \$70,530 funding from Pohnpei State for its fiscal year 2003 operations.
- Of the six (6) reportable conditions described in detail on pages 21 through 42 of the audit report, three (3) findings were identified to be material weaknesses. These are findings numbers 9 through 11, viz:
 1. The Corporation guaranteed three (3) loans totaling \$60,650 that were already approved by the lending bank prior to the Corporation's guarantee. These were evidenced by the promissory notes and loan agreements that were signed between the borrowers and the bank before the dates of the guarantee requests and/or guarantee approval.
 2. We noted the lack of controls on a loan guarantee approved by the former Executive Director in fiscal year 2000. The guarantee agreement was only signed in fiscal year 2003 after the Board of Directors approved the guarantee application. Three months later, the lender called on the guarantee, which led to a civil case filed by the lending bank against the Corporation and eventually ended up with the Corporation paying \$50,000 in court settlement.
 3. The Corporation prepared and approved its current year budget of \$167,428 for expenses and fixed assets. The Corporation only received a \$70,530 State funding and the annual budget did not specify the funding source where the budget deficit would come from.

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 1 (page 43). The Corporation is also required by Pohnpei State Law no. 5L-08-00, an amendment to the law that created the Office of the Pohnpei State Auditor (OPSA), to submit a monthly report to OPSA indicating its progress in clearing the deficiencies cited in the audit report, which period shall not exceed six months.

Lastly, we take this opportunity 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
Pohnpei State 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, 2003. 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, 2003, 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 June 18, 2004, 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
Pohnpei State Auditor
June 18, 2004

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year Ended September 30, 2003

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, 2003. 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 \$37,237 (or 318%).
- The increase in the Corporation's other non-current assets was primarily due to issuance of fifteen (15) loans under the Micro Loan Program, which was introduced in the same year.
- Cash and equivalents decreased by \$75,293 (or 4%).
- Net assets decreased by \$51,338 (or 3%).

Overview of the Financial Statements

The Small Business Guarantee and Finance Corporation is a component unit of the Pohnpei State Government, and follows the proprietary fund reporting; accordingly, the financial statements are presented using the economic resources measurement focus and the accrual basis of accounting. Proprietary 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, 2003 and 2002.

	<u>2003</u>	<u>2002</u>	<u>% Increase/(Decrease)</u>
Current assets	\$1,649,613	\$1,734,482	(5%)
Capital assets	8,479	10,142	(16%)
Non-current assets	48,931	11,694	318%
Total assets	<u>\$1,707,023</u>	<u>\$1,756,318</u>	<u>(3%)</u>
Long-term debt	0	0	0
Other liabilities	5,197	3,154	65%
Total liabilities	<u>5,197</u>	<u>3,154</u>	<u>65%</u>
Net assets:			
Invested in capital assets	8,479	10,142	(16%)
Restricted	1,657,740	1,692,032	(2.%)
Unrestricted	35,607	50,990	(30%)
Total net assets	<u>\$1,701,826</u>	<u>\$1,753,164</u>	<u>(3%)</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 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 and used to augment the budget shortfall.

The following table summarizes the changes in operating income between fiscal years 2003 and 2002:

	<u>2003</u>	<u>2002</u>	<u>% Increase/(Decrease)</u>
Operating revenues	\$6,956	\$7,957	(13%)
Operating expenses	153,520	153,286	0%
Operating income (loss)	<u>(146,564)</u>	<u>(145,329)</u>	<u>(1%)</u>
Non-operating revenues	98,380	104,869	(6%)
Net income (loss)	<u>(\$48,184)</u>	<u>(\$40,460)</u>	<u>(19%)</u>

Capital Assets and Debt Administration

Capital assets. As of September 30, 2003, the Corporation's investment in capital assets was \$8,479 (net of accumulated depreciation). The Corporation's capital assets include office furniture and equipments, and vehicles. There was one major capital asset purchase this year, a Suzuki jeep worth \$4,300. Capital assets activity for the year ended September 30, 2003 was as follows.

Description	Beginning Balance	Increases	Decreases	Ending Balance
Vehicles	\$3,844	\$4,300	\$0	\$8,144
Furniture and fixtures	23,830	0	0	23,830
Total cost	<u>27,674</u>	<u>4,300</u>	<u>0</u>	<u>31,974</u>
Less accumulated depreciation for:				
Vehicles	2,114	1,558		3,672
Furniture and fixtures	15,418	4,405		19,823
Total accumulated depreciation	<u>17,532</u>	<u>5,963</u>		<u>23,495</u>
Capital assets, net	<u>\$10,142</u>			<u>\$8,479</u>

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

Contacting the Corporation's Financial Management

This Management's Discussion and Analysis 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, 2003

ASSETS

Current assets:

Cash and equivalents (note 2)	29,948
Cash and equivalents-restricted (note 2)	1,612,867
Accounts receivable, net (note 3)	5,901
Commissions receivable	139
Interest receivable	758
Total current assets	<u>1,649,613</u>

Non-current assets:

Capital assets (note 5):	
Vehicles, net	4,472
Office furniture and fixtures, net	4,007
Employee loans receivable (note 4)	4,059
Notes receivable-restricted (note 6)	44,872
Total non-current assets	<u>57,410</u>

Total assets 1,707,023

LIABILITIES

Current liabilities:

Accrued expenses	1,087
Credit life insurance payable	395
Taxes payable	3,670
Employee benefits payable	45
Total liabilities	<u>5,197</u>

NET ASSETS

Invested in capital assets (note 1)	8,479
Restricted for capital stock and business development projects (note 1)	1,657,740
Unrestricted (note 1)	35,607
Total net assets	<u><u>1,701,826</u></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, 2003

OPERATING REVENUES

Loan guarantee fee (note 7)	3,375
Loan packaging fee	125
Loan processing fee	768
Interest income-MLP (note 8)	2,688
Total operating revenues	<u>6,956</u>

OPERATING EXPENSES

Salaries	81,501
Travel	35,585
Office supplies	6,044
Depreciation	5,962
Rent	5,936
Payroll tax	4,337
Utilities	2,588
Postage and telephone	2,458
Employee benefits	2,127
Repairs and maintenance	1,966
Representation and entertainment	1,608
Janitorial and cleaning	1,387
Gasoline	700
Meeting allowance	460
Legal and professional	385
Advertising	336
Bank charges	107
Miscellaneous	33
Total operating expenses	<u>153,520</u>

Operating income (loss) (146,564)

NON-OPERATING REVENUES (EXPENSES)

Transfers in (note 9)	70,560
Interest income (note 10)	27,407
CLI Commissions income	324
Other income	89
Total non-operating revenues	<u>98,380</u>

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Revenues, Expenses, and Changes in Net Assets, Continued
For the Year Ended September 30, 2003

Income (loss) before other revenues, expenses, gains, losses, and transfers	(48,184)
Adjustments that affect net income (loss)	<u>(3,154)</u>
Increase (decrease) in net assets	(51,338)
Net assets – beginning of year	<u>1,753,164</u>
Net assets - end of year	<u><u>1,701,826</u></u>

See accompanying notes to financial statements.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Cash Flow For the Year Ended September 30, 2003

CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from (payments to) customers	(25,521)
Payments to suppliers and providers of goods and services	(62,720)
Payments to employees	(82,154)
Other receipts (payments)	1,021
	<hr/>
Net cash provided (used) by operating activities	(169,374)

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Operating transfers in	70,560
Commissions income – credit life insurance	325
Other income	89
	<hr/>
Net cash provided by noncapital financing activities	70,974

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES

Purchase of capital assets	(4,300.00)
	<hr/>
Net cash provided (used) by capital and related financing activities	(4,300.00)

CASH FLOWS FROM INVESTING ACTIVITIES

Interest income	27,406
	<hr/>
Net cash provided by investing activities	27,406
	<hr/>
Net increase (decrease) in cash and equivalents	(75,294)
	<hr/>
Cash and equivalents at beginning of year	1,718,109
	<hr/>
Cash and equivalents at end of year	1,642,815
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SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Statement of Cash Flow, Continued
For the Year Ended September 30, 2003

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

Operating income (loss)	(146,564)
Adjustments to reconcile operating income (loss) to net cash provided by (used for) operating activities:	
Depreciation	5,962
Prior year adjustments	(3,154)
(Increase) decrease in assets:	
Accounts receivable	1,010
Advances	2,372
Employee loans receivable	692
Commissions receivable	(138)
Interest receivable	1,581
Notes receivable	(33,178)
Increase (decrease) in liabilities:	
Accrued expenses	(90)
Taxes payable	1,731
Employee benefits payable	7
Credit life insurance payable	395
	<hr/>
Net cash provided (used) by operating activities	(169,374)
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SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2003

(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 administered 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, 2003

(1) Summary of Significant Accounting Policies, Continued

the policies set out by the Board of Directors and 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, with 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, 2003

(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). The enabling legislation allows funds not expended in any given fiscal year to be carried over in subsequent fiscal years. In fiscal year 2003, PSL 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, 2003

(1) 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 the current year, 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, 2003

(2) Cash and Equivalents

At September 30, 2003, the Corporation had deposits and cash on hand as follows:

	\$	300
Investment Transaction Account (ITA)		29,648
Wife savings (restricted)		20,436
Savings (restricted)		27,681
Time of Deposit (TCD)-short term (restricted)		<u>1,564,750</u>
Total	\$	<u><u>1,642,815</u></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 rest of the receivables arose from advances for travel. A summary of the receivable follows:

<u>Description</u>	<u>Amount</u>	r Bad Debts	<u>Amount</u>
Due to former Chairman and Vice Chairman	\$ 24,259	\$	19,407
	1,049		4,852
	<u>\$ 25,308</u>	\$	<u>19,407</u>
			<u>1,049</u>
			<u>5,901</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.

(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' activity for the year ended September 30, 2003 was as follows:

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2003

(5) Capital Assets, continued:

Description	Beginning	Increases	Decreases	Ending
	Balance			Balance
Vehicles	\$3,844	\$4,300	\$0	\$8,144
Furniture and fixtures	\$23,830	\$0	\$0	\$23,830
Total cost	\$27,674	\$4,300	\$0	\$31,974
Less accumulated depreciation for:				
Vehicles				\$3,672
Furniture and fixtures				\$19,823
Total accumulated depreciation				23,495
Capital assets, net				\$8,479

(6) Notes Receivable

The account represents three (3) promissory notes arising from called off guarantees and fifteen (15) promissory notes ensuing from the direct lending program, which the Corporation launched this year.

(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 2003 for the Corporation's current operations.

(10) Interest Income

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

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Notes to Financial Statements
September 30, 2003

(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 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.

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, \$24,259 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, 2003, the Corporation has fifty-three (53) outstanding guarantees, with a total exposure of \$528,982. 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 \$54,227 to the lender (bank) representing guarantee payment of two (2) defaulted loans. In addition, the lender is calling on three (3) more guarantees totaling \$105,184.

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, 2003, and have issued our report thereon dated June 18, 2004. 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 instances of noncompliance that are required to be reported under *Government Auditing Standards*, which are described in the accompanying Schedule of Findings and Recommendations (pages 21 through 42) in finding numbers 1 to 2.

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 21 through 42) in finding numbers 3 to 8.

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 21 through 42) as finding numbers 9 to 14.

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 21 through 42) as finding numbers 9 to 11.

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

Pohnpei State Auditor

June 18, 2004

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

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:

During the year, the Corporation transferred \$45,911 from the savings account where interest income from the \$1.5M are deposited, to the Investment Transaction Account (ITA), which is the account used by the Corporation for its operations. In addition, another \$24,000 was withdrawn from a time certificate of deposit (TCD) and transferred to the ITA-Savings account. The TCD also materialized from the \$1.5M funding.

The ITA-Savings account has a bank balance of \$33,859 as of September 30, 2003. Hence, we calculated that interest income amounting to \$36,052 was used in the Corporation's operations during the year.

In the subsequent period, the Corporation closed the \$500,000 TCD, which represents the initial funding for business development projects. Out of the TCD proceeds, the Corporation deposited \$200,000 to the Direct Loan Program account and \$300,000 to the Loan Guarantee account.

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.

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.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Interests Income, continued:

Prior Year Status:

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

Travel and training

2. Criteria:

The Corporation’s Manual of Administration states that: “The Corporation may nominate staffs to attend specialized external training courses to improve the skill level of employees in an area identified as necessary to the functioning of the Corporation. Any employee attending a training course is expected on his return to submit a report detailing: content of the course, quality of instruction, relevance of course material provided, and personal value gained”.

Condition:

The Corporation had a travel and training budget of \$35,000 for the year. The Executive Director (ED) and the Board of Directors (BOD) used this budget to attend three (3) kinds of training and incurred travel expenses of \$31,990. The details of the expenses are as follows:

<u>Item</u>	<u>Number of Delegates</u>	<u>Airfare</u>	<u>& Car Rental</u>	<u>Hotel Cost</u>	<u>Total Cost</u>
Study Tour		\$3,750	\$6,165	\$2,250	\$12,165
State Governance and Risk Management		5,972	6,166	4,250	16,388
Resource Conference (Board Chairman)		1,251	2,186	0.00	3,437
Total					<u>\$31,990</u>

- /a The Executive Director and three (3) Board of Directors also attended the first study tour in the previous year. This year, the second study tour consists of short visits to institutions extending assistance to small and medium enterprises, and project sites. The attendees to the second study tour included the Executive Director, former Board Chairman and Vice Chairman. The Corporation paid \$2,000 to the training consultant.
- /b Based on supporting documents, the two-day course was intended for a Bank’s Board of Directors, with a training fee of \$850 per delegate. The attendees to this training included the Executive Director, former Board Chairman, Vice Chairman, and two Board members. After the training, the ED and the former Chairman spent two and a half days (2^{1/2}) in Guam to pay courtesy call to the Presidents of the Small Business Development Center and

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Travel and training, continued:

Condition, continued:

and Pacific Islands Development Bank. There was no trip report prepared for the stay in Guam.

/c The former Board Chairman also attended a Finance Resource Conference last year. The Executive Director joined the former Chairman in attending this year's conference.

Cause:

The Executive Director and the Board of Directors approved the use of the budget for their own travels and trainings.

Effect:

The Corporation only has a \$70,530 Pohnpei State funding for its current year expenses and used 45% for the trainings of the Executive Director and the Board of Directors. Other employees were deprived of the opportunity to attend specialized external training courses that would improve their skill level.

Prior Year Status :

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

Recommendation:

Because of the limited funding of the Corporation, we recommend that the management and Board of Directors should select the off-island trainings that are essential to the Corporation's business and nominate staffs that would best contribute to the improvement of the Corporation's operations. In addition, we recommend that upon return from the trip, the travelers should submit a detailed trip report that outlines the exact purpose and nature of the trip and how the trip provides benefit to the Corporation.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Loan guarantees

3. Criteria:

Pursuant to Pohnpei State Law no. 3L-86-95 (the Corporation's establishing law) and the Corporation's lender guide, the Corporation shall guarantee loans that are utilized for the following purposes:

- Acquisition of fixed assets.
- Building improvement/expansion or construction of plant facilities.
- Permanent working capital.
- Credit line accommodation for temporary or seasonal working capital.

Condition:

The Corporation guaranteed a loan of \$10,150 in June 2003, \$4,150 of which was used to liquidate the existing loan. The Corporation also issued a guarantee for the old loan in the amount of \$9,958 in September 2000 and due to mature in October 2004.

Cause:

The Board of Directors approved the loan guarantee request without taking into consideration the loan purpose requirement of the loan guarantee.

Effect:

The above condition is a noncompliance to Pohnpei State law and the Corporation's policy. It also appears that even though the borrower was not consistent in paying his old loan, the Corporation guaranteed the new loan.

Prior Year Status:

The above condition was reported as a finding in the financial audits of the Corporation for fiscal years 2002, and 2001-2000.

Recommendation:

We recommend that the Board of Directors should approve the loan guarantee requests in accordance with policy.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Loan guarantees, continued:

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Loan guarantee fees

4. 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 did not pay the guarantee fee after forty-five (45) days, the guarantor has the option to terminate the guarantee.

Condition:

Guarantee fees of eighteen (18) loans were received late, eleven (11) of which were received more than forty-five (45) days late, and three (3) of which were received in the subsequent fiscal year. Total amount of guarantee fees received late is \$2,729.

Cause:

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

Effect:

The above condition resulted to the Corporation guaranteeing the loans free of charge during the period when the guarantee fees were not yet received. Also, a decrease in revenue collection for the year has resulted from the above condition.

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.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Direct loans

5. Criteria:

The policy on direct loans states that the Corporation shall be responsible for accepting and processing loan applications that are financially sound and economically viable.

Condition:

A \$5,000 loan was approved although the financial projections of the business showed a net loss for the first three (3) years of operations. The borrower is presently employed in another FSM State.

Cause:

Management submitted the loan application for Board's approval despite a letter from the Loan Officer indicating some deficiencies of the loan package. The Board of Directors also approved the loan application.

Effect:

Other qualified borrowers could have availed of the loan. The loan is three (3) months in arrears per March 16 to April 15, 2004 status report.

Recommendation:

We recommend that management should only recommend to the Board loan applications that are financially viable to ensure repayment of the loans.

Auditee Response:

Please refer to Exhibit 1.

Auditor's Reply to Auditee Response dated August 24, 2004:

The financial projections showing net losses for the first three years of operations were taken from the borrower's loan file.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Mortgage of Securities/Collateral for Direct Lending Program

6. Criteria:

The Corporation's policy on direct loans requires that mortgage documents must be registered with State Courts and/or Land Commission or Registrar by the borrower and submitted to the Corporation. Furthermore, the mortgage must be annotated on the land certificate of title (if applicable) and on the vehicle registration certificate.

Condition:

The Corporation uses a chattel mortgage form to document the assets collateralized with them for the direct loans. We noted that said mortgages, although signed by the borrowers and the Corporation, were not registered with the appropriate court or registrar. We also noted that the Corporation did not require the borrowers to submit their vehicle registration certificates for annotation of the mortgage.

Cause:

The Corporation did not comply with its own policy.

Effect:

The assets collateralized for the loan may be sold or transferred without the prior consent of the Corporation. Hence, the risk of collecting the unsecured loans will be higher.

Recommendation:

We recommend that the Executive Director direct the Loans Division to ensure that all mortgage documents must be registered with the appropriate courts or registrars; and the mortgage be annotated in the applicable certificates prior to disbursing the loans.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Accepted security

7. 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.

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.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Delinquent accounts

8. 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 three (3) notes receivable arising from guarantees paid as of September 30, 2003. However, all three (3) borrowers had stopped paying their loans to the Corporation. The Corporation had also sold the two (2) vehicles that have been held as security for the loans. Aside from letters sent to the borrowers, no other action has been carried out by the Corporation to collect the accounts. The outstanding principal amount of the three (3) notes is \$11,317.

In addition, the lender/bank is calling on three (3) more guarantees totaling \$105,184 in June 2003. Two (2) more guarantees totaling \$54,227 have been paid in the subsequent period. Only one of the borrowers is paying his loan.

Cause:

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

Effect:

The collectibility of the above accounts becomes uncertain without other stern remedies. 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.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Delinquent accounts, continued:

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, 2003

Loan guarantee approval

9. Criteria:

The Board of Directors should use sound judgment in approving loan guarantee requests aside from ensuring that the eligibility requirements of the guarantee are met.

Condition:

In our review of loan guarantees approved during the year, we noted that the Corporation guaranteed three (3) loans totaling \$60,650 that were already approved by the lending bank prior to the Corporation's guarantee. These were evidenced by the promissory notes and loan agreements that were signed between the borrowers and the bank before the dates of the guarantee requests and/or guarantee approval.

Cause:

The Board of Directors did not properly review the loan guarantee requests prior to approval.

Effect:

The above condition raises doubt on the necessity of the Corporation's guarantee.

Recommendation:

We recommend that the Board of Directors should properly review the guarantee requests to determine whether the guarantee is actually needed or not.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Controls on loan guarantee

10. Criteria:

The Corporation should establish control measures that will protect its interest in the guarantee scheme.

Condition:

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.

<u>Date</u>	<u>Transaction</u>
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.
10/14/00	The Corporation's Executive Director wrote the Lender to inform of

2	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.
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.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Controls on loan guarantee, continued:

Condition, continued:

<u>Date</u>	<u>Transaction</u>
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.

Cause:

A lack of 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 \$50,000 in the subsequent period to settle the civil case filed concerning the defaulted loan.

Recommendation:

We recommend that the Corporation should establish control measures to protect its interest in the guarantee scheme. 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.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Controls on loan guarantee, continued:

Recommendation, continued:

- Issuance of 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.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Approved budget

11. Criteria:

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

Condition:

The Board of Directors initially approved a budget of \$157,428 for fiscal year 2003. A budget amendment of \$10,000 was later approved, revising the total budget to \$167,428. The budget is shown below.

<u>Category</u>	<u>budget</u>	<u>lment</u>	<u>ded budget</u>	<u>Total</u> <u>get</u>
benefits	\$91,592	\$626	\$92,218	%
ning	25,000	10,000	35,000	%
rices	12,800	(2,126)	10,674	;
	5,000	0	5,000	;
ods	23,036	1,500	24,536	%
Total	\$157,428	\$10,000	\$167,428	%

However, Pohnpei State Legislature only appropriated \$70,530 for its operation fund in fiscal year 2003. The Corporation's budget did not also specify where the funding source would come from.

Cause:

Management and Board prepared and approved the annual budget without considering the funding sources.

Effect:

The above condition resulted to a budget deficit of \$96,898. In addition, the Corporation used the interest income earned from its capitalization and business development project funds to augment the budget deficit.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Approved budget, continued:

Recommendation:

We recommend that the management and Board should always prepare the budget within the financial capability of the Corporation. Furthermore, we recommend that management and Board should also identify the funding sources that would finance the budgeted expenses.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Direct loan approval

12. Criteria:

Board's approval of direct loans should be properly documented.

Condition:

The Board of Directors did not document its approval of the direct loans in the space provided in the individual loan evaluation report submitted by management. The minutes of Board meetings that would also document the loan approval were also not signed by the Board of Directors. In addition, two (2) loans were approved and were not evidenced by the minutes of Board meetings.

Cause:

The management and Board were not aware of the importance of the loan approval documents.

Effect:

The Board's approval of the loan could be questioned.

Recommendation:

We recommend that the management and Board of Directors ensure that loan approval is documented and kept in individual loan files.

Auditee Response:

Please refer to Exhibit 1.

Auditor's Reply to Auditee Response dated August 24, 2004:

The minutes of June 5, 2003 Board regular meeting was not furnished to the auditors.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Direct lending procedures

13. 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, it started its direct lending program. We noted some discrepancies between the established procedures and the actual procedures performed during the year, viz:

<u>Manual/Transaction</u>	<u>Manual and Board minutes</u>	<u>Actual</u>
Interest rate	% above prime rate	15%
Interest computation	None	Balance before payment multiplied by rate multiplied by number of days divided by 360.
Interest recording	None	Upon payment.
Charge-late payment	\$25	Outstanding principal balance
Charge-payment less than the required monthly amortization	None	Outstanding principal balance
Amortization schedule	None	Amortization program in Excel (Microsoft XP Professional).
Mortgage documents	Filed with appropriate courts or registrars. Mortgage to be annotated on certificates (land title or vehicle registration).	Filed and no annotation on certificates.

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.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

**Schedule of Findings and Recommendations
Fiscal Year Ended September 30, 2003**

Direct lending procedures, continued:

Cause:

The manual did not contain complete procedures regarding direct loans. Per minutes of Board meeting of November 13, 2002, the Board of Directors approved the manual to facilitate the implementation of the direct lending program.

Effect:

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

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. Also, management should ensure that the Board of Directors approves any amendment to the existing policy.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

Schedule of Findings and Recommendations Fiscal Year Ended September 30, 2003

Minutes of Board meetings

14. Criteria:

The minutes of Board meetings are vital records that would document the actions of the Board of Directors. Hence, the minutes of meetings should be properly written and signed by the designated Board officials.

Condition:

The Executive Director signed all the minutes of Board meetings as preparing officer. No other signature appears on the minutes of meetings.

Cause:

The Secretary of the Board or designee did not ensure the completeness of the minutes of Board meetings.

Effect:

The authenticity and completeness of the minutes of meetings could be questioned.

Prior Year Status :

The above condition was reported as a finding in the financial audits of the Corporation for fiscal years 2002, and 2001-2000.

Recommendation:

We recommend that the Board of Directors should ensure that the Secretary of the Board or designee sign the minutes of meetings as preparing officer. We also recommend that the Chairman of the Board or the Presiding Officer sign the minutes of Board meetings that were formally adopted by the Board of Directors.

Auditee Response:

Please refer to Exhibit 1.

SMALL BUSINESS GUARANTEE AND FINANCE CORPORATION

AUDITEE RESPONSE (EXHIBIT 1)

YEAR ENDED SEPTEMBER 30, 2003