COMMONWEALTH DEVELOPMENT AUTHORITY
(A COMPONENT UNIT OF THE COMMONWEALTH
OF THE NORTHERN MARIANA ISLANDS)

INDEPENDENT AUDITORS' REPORTS ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2009

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors
Commonwealth Development Authority:

We have audited the financial statements of the Commonwealth Development Authority (CDA), as of and for the year ended September 30, 2009, and have issued our report thereon dated October 18, 2010. 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.

For purposes of this report, our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grants, and other matters did not include the Northern Marianas Housing Corporation (NMHC) which was audited by us. We have issued separate reports on our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grants, and other matters for NMHC that was audited by us. The findings included in those reports are not included herein.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered CDA's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CDA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of CDA's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying Schedule Findings and Responses (pages 3 through 7) to be significant deficiencies in internal control over financial reporting as items 2009-1 and 2009-2.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe the significant deficiencies described above are material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CDA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and which is described in the accompanying Schedule of Findings and Responses as item 2009-3.

We noted certain matters that we reported to management of CDA in a separate letter dated October 18, 2010.

CDA's responses to the findings identified in our audit are described in the accompanying Schedule Findings and Responses. We did not audit CDA's responses and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, the Board of Directors, 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 these specified parties.

Deloitte & Touche LLC

October 18, 2010

DCD Loans Receivable

Finding No. 2009-1

Criteria: An effective system of internal control includes procedures to ensure that loan payments are received on a timely basis. Further, all receivables should be assessed and monitored for collectability. Balances deemed not collectible should be adequately allowed for. Additionally, calculation of allowance for loan losses and other related receivables should be regularly reviewed for accuracy, completeness and reasonableness. Further, for restructured loans, the allowance should be determined in the same manner as prior to the restructuring until a sufficient time has passed to demonstrate that the borrower can meet the revised debt service requirements.

Condition: Our tests of DCD's loans receivable noted the following:

1. An analysis of DCD's past due loans was performed to determine the propriety of the allowance for doubtful loans as of September 30, 2009. This analysis revealed that loans which are six months or more in arrears amounted to $28,279,955 or 77.1% of the total loans receivable outstanding of $36,681,854 as of September 30, 2009. The related accrued interest on loans that are six months or more in arrears amounted to $17,102,152 or 99.6% of the total accrued interest receivable outstanding of $17,166,710 as of September 30, 2009.

2. For two restructured loans (#s CD 70347 and CD 70332) classified as less than six months in arrears in the receivables aging report as of September 30, 2009, an analysis of the loan ledger subsequent to September 30, 2009 indicated that borrowers did not meet revised debt service requirements. An audit adjustment was proposed to record an additional allowance of $1,444,387.

3. For two restructured loans (#s RE 70325 and CD 70349), allowances were calculated in the same manner for loans that are over 12 months past due. However, an analysis of the loan ledger prior and subsequent to restructuring indicated that loans should be classified as less than six months.

Cause: The cause of the above condition is the increase in past due loans and lack of adequate review of the reasonableness of the calculation of the allowance for loan losses and other related receivables.

Effect: The effect of the above condition is an increased possibility of loan losses due to non-payment by borrowers and potential misstatement of loans receivable and related accounts.

Recommendation: We recommend that CDA continue to follow-up on past due loans, continue to evaluate these loans and develop corrective action plans. Future results may be compared against action plans and other actions taken by management as deemed necessary. Legal action should be considered for loans considered unlikely to be serviceable by the borrower. We further recommend that CDA review the aging of restructured loans and revisit the allowance calculation for these loans. In addition, we recommend that CDA perform periodic review of the calculation of the allowance for loan losses and other related receivables for accuracy, completeness and reasonableness.

Prior Year Status: Past due loans was reported as a finding in the Single Audits of CDA for fiscal years 1994 through 2008.

Finding No. 2009-1, Continued

Auditee Response and Corrective Action Plan:

Name of Contact Person: Stuart Smith, Comptroller

Corrective Action: Ensuring collection of loans is a complex problem exacerbated by difficult financial times in the CNMI. Inadequate levels of staffing in the Loan Department also reduce the ability to monitor and work with clients closely. If loans are monitored more closely perhaps there would be fewer delinquent loans and the valuation of the loans would have less negative impact.

CDA has continued to make improvements in fiscal year 2010 to make sure loans are valued in a manner consistent with the guidelines set forth by CDA in conjunction with the auditors. Restructured loans that have insufficient time (one year) to establish payment histories based on the restructured status are valued in the same manner as their status dictated prior to restructuring. Miscellaneous charges are fully allowed for.

In the third quarter of fiscal year 2010, CDA adopted a commercial-bank-like policy of accruing interest in the general ledger only up to 120 days for delinquent loans. While this method gives CDA a financial picture that is similar to accrual of all interest regardless of length of delinquency but with a correspondingly high allowance for bad debts, it is better in that it treats each loan on its own merits versus portfolio totals only.

Management has taken various actions to work with clients; restructuring with set-aside or write-off of accrued interest and foreclosures when no other viable solutions are available. Most of the restructured loans are maintaining a current payment status. The Loan Department has had the services of an additional staff member since May 2010. His efforts in collections and working with clients have yielded positive results. Management is also continuing to explore different ways to assist clients in making their loans more manageable. These steps will likely involve concessions on the part of CDA regarding accrued interest, but management feels it is critical to recover loan principal and give borrowers every chance possible to avoid bankruptcy, foreclosure and other expensive or painful options.

Proposed Completion Date: Improving the delinquency rate of the loan portfolio is an ongoing process that will never be “completed” but progress has been noted since the second half of fiscal year 2010.

DCD Loans Receivable

Finding No. 2009-2

Criteria: Loan reclassifications should be timely recorded in the general ledger.

Condition: Tests of loans receivable noted the following:

1. A summary judgment was ordered prior to the current fiscal year for one loan (ref. CD 70340); however, a reclassification as a judgment loan was only recorded during fiscal year 2009. The related loan, interest and miscellaneous charges receivable amounted to $841,875, $154,532 and $3,025, respectively, as of September 30, 2009;

2. A summary judgment was ordered prior to the current fiscal year for one loan (ref. CD 70346); however, a reclassification as a judgment loan was only recorded during fiscal year 2009. The related interest and miscellaneous charges receivable amounted to $934 and $3,520, respectively, as of September 30, 2009. In addition, CDA acquired related foreclosed property in July 2008 for $32,541 but only recorded the property in fiscal year 2009; and

3. Write-offs of three loans receivable (ref. JV 2121) were recorded in the general ledger ten months subsequent to Board approval.

Cause: The cause of the above condition is the lack of monitoring procedures to ensure that loan reclassifications are recorded in the general ledger.

Effect: The effect of the above condition is incorrect classification of receivables and a potential misstatement of interest income.

Recommendation: We recommend that CDA ensure that adjustments resulting from loan reclassifications are timely recorded.

Prior Year Status: The lack of monitoring procedures to ensure that all loan reclassification adjustments are recorded in the general ledger was reported as a finding in the Single Audits of CDA for fiscal years 2007 and 2008.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Stuart Smith, Comptroller

Corrective Action: The legal machinations involved with judgments against borrowers are not a black-and-white process. While a summary judgment may be obtained against a borrower as a last resort to recovering a loan, CDA has a high rate of experience with the summary judgment NOT being the final judgment. Often, the judgment includes a period where actions by either party may render the judgment void. This is one reason the Loan Department may not ask the Accounting Department to immediately reclassify a judgment loan. The other reason for delays in the past is simply due to understaffing in both the Loan and Accounting Departments for much of the past two years.

Finding No. 2009-2, Continued

Auditee Response and Corrective Action Plan, Continued:

Corrective Action, Continued:

In fiscal year 2010, CDA is doing a better job of reviewing all loans to judge appropriateness of the valuation and classification. There continues to be gray areas for loans subject to summary judgment but staffs are doing their best to weigh the circumstances when making reclassification decisions.

Proposed Completion Date: Beginning in late fiscal year 2009, the Loan and Accounting Departments have been more diligent in booking judgment loans in a timely manner. Beginning in fiscal year 2010, CDA will record loans as judgment loans as soon as there is a court order and if there are any subsequent modifications to the judgment, they will be recorded as they occur.

Local Noncompliance

Finding No. 2009-3

Criteria: Pursuant to the "Trust Fund Use and Management Agreement" dated May 31, 1994, the remaining trust funds and accumulated earnings earned by CDA from bond issues shall be made available for appropriation by the Commonwealth Legislature for capital improvement projects (CIP) and economic development activities consistent with Part II, 3(a) of the Special Representative Agreement.

Condition: As of September 30, 2009, DBD's investments in time certificates of deposit of $7,684,205 were restricted for CIP activities and capital development purposes. These funds represent the proceeds of Covenant funding and liquidated revenue bonds derived from pledged Covenant funding. Of the total funds, CDA is unable to identify amounts previously appropriated and amounts available for future CIP appropriation. CDA is in the process of reconciling DBD funds to determine availability.

Cause: The cause of the above condition is the lack of established policies and procedures to monitor appropriated and available funds.

Effect: The effect of the above condition is the potential for misappropriation of DBD funds.

Recommendation: We recommend CDA reconcile DBD funds and identify amounts appropriated and available. Further, we recommend CDA monitor actual CIP drawdowns against appropriations on a per project basis.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Stuart Smith, Comptroller

Corrective Action: This has been a problem since fiscal year 2001 when the responsibility for CIP tracking and bond fund reconciliations was transferred from the assistant to the Executive Director to the Accounting Department. The Accounting Department was without a Comptroller for eight years and did not have the adequate manpower, skills, guidance or supervision to maintain the task.

Proposed Completion Date: In fiscal year 2010, the task of catching up the tracking was assigned to various staff members in CDA in addition to their regular duties. Catching up eight years of activity and follow actions by the Legislature is not a process that can occur in a short period of time. The staff is making progress on the task and the Executive Director has asked that it be made a priority.

Unresolved Findings

The status of unresolved findings is discussed in the Schedule Findings and Responses section of this report (pages 3 through 7).