

CHUUK PUBLIC UTILITY CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2002 AND 2001

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Chuuk Public Utility Corporation:

We have audited the accompanying balance sheets of the Chuuk Public Utility Corporation (CPUC), a component unit of the Government of the State of Chuuk, as of September 30, 2002 and 2001, and the related statements of operations and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the CPUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, 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 respective financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of CPUC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

CPUC was unable to provide supporting schedules, reconciliations and subsidiary ledgers for its cash in bank, receivables, utility plant, accounts payable and accrued expenses as of September 30, 2002.

Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements as of and for the year ended September 30, 2002.

In our opinion, the balance sheet as of September 30, 2001, and the related statements of operations and retained earnings and cash flows for the year then ended, present fairly, in all material respects, the financial position of CPUC as of September 30, 2001, and the results of its operations and its cash flows 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 May 31, 2006, on our consideration of CPUC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. 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.

Deloitte & Touche LLP

May 31, 2006

CHUUK PUBLIC UTILITY CORPORATION

Balance Sheets
September 30, 2002 and 2001

<u>Assets</u>	<u>2002</u>	<u>2001</u>
Utility plant, at cost:		
Electric plant in service	\$ 14,732,845	\$ 14,658,307
Water and sewer plant in service	10,088,112	10,061,111
Construction work-in-process	-	27,000
	<u>24,820,957</u>	<u>24,746,418</u>
Less accumulated depreciation	<u>(14,961,914)</u>	<u>(13,701,909)</u>
Total utility plant	<u>9,859,043</u>	<u>11,044,509</u>
Current assets:		
Cash	950	35,909
Accounts receivable, net	813,428	641,422
Other receivables	444,105	444,105
Inventory	<u>22,973</u>	<u>22,973</u>
Total current assets	<u>1,281,456</u>	<u>1,144,409</u>
	<u>\$ 11,140,499</u>	<u>\$ 12,188,918</u>
<u>Fund Equity and Liabilities</u>		
Fund equity:		
Retained earnings	<u>\$ 5,959,910</u>	<u>\$ 7,289,215</u>
Contingencies		
Current liabilities:		
Overdraft	59,816	-
Current portion of notes payable	279,973	211,141
Accounts payable:		
Fuel oil	274,362	316,837
Fixed assets	709,163	709,162
Operations	112,438	19,996
Accrued taxes and other liabilities	75,970	37,856
Accrued interest expense	292,551	208,718
Deferred income	50,000	50,000
Accrued annual leave	<u>132,738</u>	<u>100,656</u>
Total current liabilities	1,987,011	1,654,366
Noncurrent liabilities:		
Notes payable	<u>3,193,578</u>	<u>3,245,337</u>
Total liabilities	<u>5,180,589</u>	<u>4,899,703</u>
	<u>\$ 11,140,499</u>	<u>\$ 12,188,918</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Operations and Retained Earnings
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Operating revenues:		
Electricity sales	\$ 2,561,161	\$ 3,125,928
Other sales	<u>24,195</u>	<u>65,918</u>
Total operating revenues	<u>2,585,356</u>	<u>3,191,846</u>
Operating and maintenance expenses:		
Production fuel	1,899,296	2,246,736
Administrative and general	1,770,453	1,775,653
Depreciation	1,260,005	1,260,004
Bad debts	<u>-</u>	<u>456,150</u>
Total operating and maintenance expenses	<u>4,929,754</u>	<u>5,738,543</u>
Operating loss	<u>(2,344,398)</u>	<u>(2,546,697)</u>
Nonoperating revenues and expenses:		
Federal grants and subsidies	57,753	585,744
FSM National Government and Chuuk State grants and subsidies	1,000,000	1,000,000
Contributed assets	-	518,099
Other income	836	5,333
Interest expense	<u>(43,496)</u>	<u>(72,299)</u>
Total nonoperating revenues	<u>1,015,093</u>	<u>2,036,877</u>
Net loss	<u>(1,329,305)</u>	<u>(509,820)</u>
Retained earnings at beginning of year	<u>7,289,215</u>	<u>7,799,035</u>
Retained earnings at end of year	<u>\$ 5,959,910</u>	<u>\$ 7,289,215</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Cash Flows Years Ended September 30, 2002 and 2001

	2002	2001
Cash flows from operating activities:		
Cash received from customers	\$ 2,413,350	\$ 2,673,608
Cash payments to suppliers and employees	<u>(3,465,752)</u>	<u>(3,717,630)</u>
Net cash used for operating activities	<u>(1,052,402)</u>	<u>(1,044,022)</u>
Cash flows from noncapital financing activities:		
Operating grants received	1,058,589	1,720,618
Increase in overdraft	<u>59,816</u>	<u>-</u>
Net cash provided by noncapital financing activities	<u>1,118,405</u>	<u>1,720,618</u>
Cash flows from capital and related financing activities:		
Acquisition of utility plant	(74,539)	(2,298,243)
Proceeds from notes payable	22,323	1,631,430
Repayment of notes payable	(5,250)	-
FSM contribution	-	73,994
Interest paid	<u>(43,496)</u>	<u>(72,299)</u>
Net cash used for capital and related financing activities	<u>(100,962)</u>	<u>(665,118)</u>
Net (decrease) increase in cash	(34,959)	11,478
Cash at beginning of year	<u>35,909</u>	<u>24,431</u>
Cash at end of year	<u>\$ 950</u>	<u>\$ 35,909</u>
<u>Reconciliation of operating loss to net cash</u>		
<u>used for operating activities:</u>		
Operating loss	\$ (2,344,398)	\$ (2,546,697)
Adjustments to reconcile operating loss to net cash		
used for operating activities:		
Depreciation	1,260,005	1,260,004
Allowance for bad debts	-	456,150
Decrease (increase) in assets:		
Accounts receivable	(172,006)	(518,238)
Inventory	-	26,042
Increase (decrease) in liabilities:		
Accounts payable	49,968	171,554
Accrued liabilities	<u>154,029</u>	<u>107,163</u>
Net cash used for operating activities	<u>\$ (1,052,402)</u>	<u>\$ (1,044,022)</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(1) Summary of Significant Accounting Policies

General

The Chuuk Public Utility Corporation (CPUC) is a component unit of the Government of the State of Chuuk. CPUC was created by Chuuk State Law 192-12. Its primary objective is to provide electrical, water and sewer services to the public. CPUC has adopted the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC).

The financial statements of CPUC have been prepared in conformity with generally accepted accounting principles (GAAP) as applied to government units. Government 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 Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The CPUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

Utility Plant

Utility plant is stated at cost with the exception of certain utility plant assets transferred to CPUC at the carrying value of the Department of Public Works as of September 30, 2001. The net book value of electric plant assets and water and sewer plant assets so transferred to CPUC was \$5,153,275 and \$5,746,406, respectively, as of September 30, 2002 and 2001.

Depreciation

Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

Capitalization of Interest

CPUC charges to construction in progress interest incurred during the period of construction. Interest capitalized is computed based on the interest expense incurred on the loans proceeds restricted to construction. Interest capitalization ceases when constructed facilities are placed in service.

Annual and Sick Leave

Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, CPUC accrues these benefits in the period earned. It is the policy of CPUC to record the cost of sick leave when leave is actually taken and a liability is actually incurred. CPUC was unable to determine the accumulated sick leave at September 30, 2002. The accumulated estimated amount of sick leave at September 30, 2001 was \$102,136.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(1) Summary of Significant Accounting Policies, Continued

Revenues

Sales of electricity are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2002 and 2001, unbilled revenues are accrued based on the most recent billing cycles.

Allowance for Doubtful Accounts

CPUC establishes an allowance for doubtful accounts receivable based on the credit risk of specific customers, historical trends and other information.

Federal Grants and Subsidies

CPUC receives various federal grants as a subrecipient from Chuuk State in addition to Chuuk State Legislature appropriated subsidies and matching funds for federal programs as required.

Cash

For purposes of the balance sheets and statements of cash flows, cash includes cash on hand and cash in banks. Of the cash, up to \$100,000 is covered by FDIC. CPUC does not require collateralization of its deposits. Therefore, the amounts which exceed FDIC insurable limitations are characterized as uncollateralized.

Inventories

Inventories of materials and merchandise are determined by physical count and are valued at the lower of cost or market.

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 liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Risk Management

Chuuk Public Utility Corporation carries workmen's compensation liability insurance for all employees of the Corporation. Chuuk Public Utility Corporation is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice during the last three years.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(2) Utility Plant

Utility plant consists of the following at September 30, 2002 and 2001:

	<u>Estimated Useful Life</u>	<u>2002</u>	<u>2001</u>
General plant in service	3 - 7 years	\$ 308,880	\$ 299,916
Electric plant in service	3 - 20 years	14,423,966	14,358,391
Water and sewer plant in service	3 - 20 years	<u>10,088,111</u>	<u>10,061,111</u>
Total utility plant in service		24,820,957	24,719,418
Less accumulated depreciation		<u>(14,961,914)</u>	<u>(13,701,909)</u>
		9,859,043	11,017,509
Construction work-in-process		<u>-</u>	<u>27,000</u>
		<u>\$ 9,859,043</u>	<u>\$ 11,044,509</u>

(3) Accounts Receivable

Bills are issued to customers near mid-month approximately one month subsequent to providing the service. Therefore, approximately forty-five days of service is accrued at September 30, 2002 and 2001, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2002 and 2001, are summarized as follows:

	<u>2002</u>	<u>2001</u>
Residential	\$ 341,369	\$ 540,413
Commercial	1,100,907	448,059
Government	170,090	234,326
Unbilled	<u>185,476</u>	<u>403,038</u>
	1,797,842	1,625,836
Less allowance for doubtful receivables	<u>(984,414)</u>	<u>(984,414)</u>
	<u>\$ 813,428</u>	<u>\$ 641,422</u>

All of CPUC's accounts receivable are with customers and government agencies based in Chuuk.

(4) Grants and Subsidies

Chuuk State and Federal grants and subsidies are comprised of the following for the years ended September 30, 2002 and 2001:

	<u>2002</u>	<u>2001</u>
Chuuk State fuel subsidy	\$ 1,000,000	\$ 1,000,000
Trust Territory of the Pacific Islands (TTPI)	-	330,418
U.S. Department of the Interior:		
Operations and maintenance improvement program (OMIP) – various grants	57,753	244,732
Buddy system	<u>-</u>	<u>10,594</u>
	<u>\$ 1,057,753</u>	<u>\$ 1,585,744</u>

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(4) Grants and Subsidies, Continued

The Chuuk State fuel subsidy derives from grants under Section 214(b) of the Compact of Free Association. There are no specific compliance terms associated with these funds other than that they be utilized in the process of power generation or to facilitate alternative energy.

(5) Contingencies

CPUC is party to various legal proceedings, the ultimate impact of which is not currently predictable. Therefore, no liability has been recorded in the accompanying financial statements due to management's inability to predict the ultimate outcome of these proceedings.

CPUC is a component unit of the State of Chuuk. The ability of CPUC to pay liabilities in the ordinary course of business is dependent on subsidies from the State and from providing power and water services at fair utility rates.

(6) Contributed Assets

During the fiscal year ended September 30, 1999, the State of Chuuk contributed various electric plant and water and sewer plant assets to the Corporation. The Corporation has recorded these assets as retained earnings in the accompanying financial statements.

The contributions from the FSM National Government result from compliance with Section 7.01 of the Financing Agreement between the National Government of the FSM (FSM), State of Chuuk and CPUC wherein the FSM is obligated to finance 10% (ceiling of \$186,900) of the actual costs of the civil and mechanical works of the FSM Water Supply and Sanitation Project. The remaining 90% is financed through a loan from the Asian Development Bank which is passed through the FSM National Government to Chuuk State and then to CPUC.

Net contributions for the years ended September 30, 2002 and 2001 are as follows:

	<u>2002</u>	<u>2001</u>
Water and sewer plant assets	\$ -	444,105
FSM National Government	-	<u>73,994</u>
	<u>\$ -</u>	<u>\$ 518,099</u>

(7) Notes Payable

	<u>2002</u>	<u>2001</u>
Notes payable to a commercial bank, ninety-day terms, interest at prime plus 2.00% on a \$150,000 line of credit. The loan is collateralized by a Bank of the FSM deposit and security interest in fixed assets, accounts receivable and inventories.	\$ 127,650	\$ 130,000
Amount drawn on a note payable with an available total of \$549,743, facilitated by the Federated States of Micronesia Development Bank (FSMDB), interest at 9%, due in monthly installments of \$11,412. The loan is collateralized by major machinery, equipment and assignment of income.	528,183	508,760

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(7) Notes Payable, Continued

Amount drawn on a note payable with an available total of \$2,795,540 to the State of Chuuk, facilitated by an Asian Development Bank loan to the FSM, interest at 6.82%, due in semi-annual principal installments commencing August 1, 2007. The loan is ultimately collateralized by a Chuuk State pledge of Compact of Free Association revenues to the FSM National Government. The State of Chuuk has not imposed collateralization on the Corporation.

	<u>2,817,718</u>	<u>2,817,718</u>
	3,473,551	3,456,478
Less current maturities	<u>279,973</u>	<u>211,141</u>
Long-term portion of notes payable	\$ <u>3,193,578</u>	\$ <u>3,245,337</u>

The note to the commercial bank is due currently.

The loan from the FSMDB requires that CPUC maintain hazard insurance. Hazard insurance has not been obtained and the ultimate impact of this matter is currently unknown.

Notes payable mature as follows:

<u>Year ending</u> <u>September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2003	\$ 279,973	\$ 226,489	\$ 506,462
2004	112,250	216,863	329,113
2005	122,779	206,333	329,112
2006	140,831	194,997	335,828
2007	29,869	192,168	222,037
Thereafter	<u>2,787,849</u>	<u>2,727,722</u>	<u>5,515,571</u>
	\$ <u>3,473,551</u>	\$ <u>3,764,572</u>	\$ <u>7,238,123</u>

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

The Board of Directors
Chuuk Public Utility Corporation:

We were engaged to audit the financial statements of Chuuk Public Utility Corporation (CPUC) as of and for the year ended September 30, 2002. Our report dated May 31, 2006, stated that the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the financial statements due to our inability to determine that assets, liabilities, revenues and other support, and expenses were fairly stated and the omission of inventory and fixed assets from the financial statements.

Internal Control Over Financial Reporting

In planning our engagement to audit, we considered CPUC'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 a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. 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 CPUC's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in the accompanying Schedule of Findings (page 11) as item 2002-01.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we consider the reportable condition described above to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CPUC'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 engagement to audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*, which are described in the accompanying Schedule of Findings as item 2002-01.

This report is intended solely for the information and use of the Board of Directors and management of CPUC, 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. However, this report is also a matter to public record.

Deloitte + Touche LLP

May 31, 2006

CHUUK PUBLIC UTILITY CORPORATION

Schedule of Findings
Year Ended September 30, 2002

Finding 2002-01 - Reconciliation

Criteria: CPUC should maintain an adequate system of accounting and should be able to reconcile its general ledger with subsidiary ledgers. Additionally, bank reconciliations should be prepared monthly. Fixed asset ledgers should be constructed that detail CPUC's fixed assets and support depreciation calculations. Source documents (checks, invoices, cash receipts, etc.) should be on file to substantiate accounting transactions. Source documents are required to be on file through the audit and then for an additional three years.

Condition: CPUC did not maintain an adequate system of accounting during the year. Bank reconciliations were not prepared monthly and subsidiary ledgers were not reconciled with general ledger balances. In some cases, subsidiary ledgers were not maintained, such as for payables and fixed assets. Therefore, CPUC was not able to prepare financial statements that are supported by its books and records. Additionally, source documents were placed in a storage facility that was exposed to the elements and virtually no checks, invoices or cash receipts were available to support entries into the financial statements.

Cause: The cause of this condition is primarily due to inadequate accounting assistance, inadequate use and understanding of the CPUC accounting software, the absence of monthly closing procedures and the lack of adequate filing and document maintenance systems.

Effect: The effect of this condition is an inability to substantiate financial statement balances, financial statement transactions and compliance with laws and regulations.

Recommendation: CPUC must acquire adequate accounting assistance, must prepare monthly financial statements that are supported by its books and records, must ensure an adequate filing and retention system exists and must be able to demonstrate compliance with laws and regulations.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Management acknowledges that it has failed to provide an acceptable level of fiscal responsibility over CPUC operations during the last several years. As pointed out in the finding, and as reflected in the auditor's disclaimers of opinions on CPUC's financial statements, accountability and transparency have been significantly impaired.

The board and management of CPUC are committed to changing this state of affairs, but heretofore have had only limited success. A controller that came on board in July of 2005 left in May 2006. During this time, bank reconciliations were performed on a monthly basis and a fixed asset register was established that ties to the general ledger. Many reconciliation tasks, however, were not performed. The failure to maintain adequate accounts receivable and accounts payable subledgers required writing off \$3-4 million in bad debts and old balances as of September 30, 2005. Moreover, during the same period there was a steady depletion of cash flows to where only diesel fuel and essential personnel could be maintained and routine maintenance of the utility plant suffered accordingly. Necessary purchases of computer hardware to support the billing and accounting departments and software maintenance were also neglected during this period. Some of the cash flow problems have been alleviated by the completion of more cash power installations and by the new electric tariffs that became effective in October 2005 but funding accounting priorities continues to be a struggle.

CHUUK PUBLIC UTILITY CORPORATION

Schedule of Findings, Continued
Year Ended September 30, 2002

Finding 2002-01 – Reconciliation, Continued

Auditee Response and Corrective Action Plan, Continued:

CPUC management will undertake the following corrective actions to improve its accountability:

- Hiring a new controller by August 2006.
- Determining whether to upgrade or scrap the existing accounting software and purchase a more user-friendly package, no later than September 2006
- Development of accounting policies and procedures to ensure the monthly preparation of financial statements supported by the FMIS; monthly reconciliations of key control accounts with the subsidiary ledger balances; the printing and retention of monthly reports from the UtilStar billing system to adequately support and track accounts receivable balances; implementation of internal controls over cash and bank deposits to adequately protect cash assets; proper compliance with laws and regulations.
- Implementation of a new filing system to support access to accounting and billing information and a retention policy to ensure records are kept for suitable periods of time.

Management is committed to having these procedures in effect for all of fiscal year 2007 and will retroactively reconcile the 2006 accounts as time permits to prepare for the fiscal year 2006 audit.