

CHUUK PUBLIC UTILITY CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2004 AND 2003

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Chuuk Public Utility Corporation:

We were engaged to audit the accompanying statements of net assets of the Chuuk Public Utility Corporation (CPUC), a component unit of the Government of the State of Chuuk, as of September 30, 2004 and 2003, and the related statements of revenues, expenses and changes in net assets 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.

CPUC was unable to provide schedules, reconciliations and subsidiary ledgers to support cash in bank, receivables, utility plant, accounts payable and accrued expense account balances at September 30, 2004 and 2003.

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 accompanying financial statements.

The Management Discussion and Analysis on pages 2-3 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplemental information is the responsibility of CPUC's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

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 considered in assessing the results of our audit.

Deloitte & Touche LLP

May 31, 2006

CHUUK PUBLIC UTILITIES CORPORATION

Management's Discussion and Analysis Year Ended September 30, 2004

The following Management Discussion and Analysis of the Chuuk Public Utility Corporation's (CPUC) activities and financial performance provides the reader with an introduction and overview to the financial statements for the fiscal year ended September 30, 2004.

GASB 34 of the U.S. Government Accounting Standards Board requires that published financial statements must contain a management discussion and analysis. This section of the CPUC's annual report presents management's discussion of CPUC's performance for years ended September 30, 2004 and 2003. It should be read in conjunction with the financial statements that follow this section.

The following table summarizes the financial position and results of operation of CPUC as of 2004 and 2003.

	2004	2003
Assets:		
Utility plant in service, net	\$ 7,689,874	\$ 8,772,313
Current assets	1,248,221	1,418,674
Total assets	\$ 8,938,095	\$ 10,190,987
Net assets and liabilities		
Invested in capital assets, net of related debt	\$ 3,544,749	\$ 4,614,450
Unrestricted	516,891	432,636
Total net assets	4,061,640	5,047,086
Long-term debt	3,461,734	3,751,847
Current liabilities	1,414,721	1,392,054
Total liabilities	4,876,455	5,143,901
Total net assets and liabilities	\$ 8,938,095	\$ 10,190,987
Revenue, expenses, and changes in net assets		
Operating revenue	\$ 1,121,024	\$ 2,041,989
Operating expenses	4,063,053	4,508,424
Operating loss	(2,942,029)	(2,466,435)
Subsidies and other income	1,982,305	1,621,422
Interest expense	(25,722)	(67,811)
Total non-operating revenue	1,956,583	1,553,611
Net loss	(985,446)	(912,824)
Net assets at beginning of year	5,047,086	5,959,910
Net assets at end of year	\$ 4,061,640	\$ 5,047,086

CHUUK PUBLIC UTILITIES CORPORATION

Management's Discussion and Analysis
Year Ended September 30, 2004

FINANCIAL HIGHLIGHTS

During fiscal year 2004, operating revenues of \$1.12 million declined by \$0.92 million (down 45%), from \$2.04 million in the prior year. This decrease reflects many causes. First of all, the automated billing system was down for several months making it incapable for the software to generate either the bills or the accrual reports from which the accounting entries were made. Secondly, there was haphazard meter readings for many of the larger commercial and government accounts because of prior non-payment experience. Finally, for the second consecutive year, CPUC was forced to implement power rationing because of generator problems and an inability to afford the fuel necessary for full-time power. Total expenses in fiscal year 2004 of \$4.1 million decreased \$0.4 million (or 9%) from the \$4.5 million expenditures recorded in fiscal year 2003 as management decreased staff and cut all expenditures except for fuel and essential personnel. The net operating loss of \$2.9 million compares to an operating loss of \$2.5 million in the prior year (up 19%).

The operating loss in fiscal year 2004 was partially off-set by the \$1.98 million in subsidies and other income. Of this amount, \$0.13 pertained to a U.S. OMIP grant. The major portion of this amount (approximately \$1.8 million), however, actually pertains to revenues realized in cash from billings that had not been recorded in the accounting system; that is, non-capital financing activities. Hence, taking into account these accounting anomalies, the net loss of \$0.98 million in fiscal year 2004 was only \$0.07 million higher (up 7.7%) than the \$0.91 million recorded in fiscal year 2003. Reflecting this net loss, net assets of \$4.06 million at September 30, 2004 had declined \$0.98 million (down 19%) from \$5.05 million recorded at September 30, 2003.

The accumulated effect of four straight years of net losses is steadily taking its toll on CPUC's deteriorating balance sheet, particularly in its utility plant. Mounting net losses year after year means that CPUC does not have the cash to replace aging capital assets. CPUC's balance sheet at September 30, 2004, shows net utility plant of \$7.7 million, a decrease of \$1.1 million (or 12%) from the \$8.8 million from the prior year. When one reflects that net utility plant assets stood at \$11.0 million at September 30, 2001, however, the magnitude of decline becomes more apparent, and the challenges confronting CPUC more stark.

FISCAL YEAR 2005 OUTLOOK

Throughout most of fiscal year 2004, CPUC was without a general manager or Controller. A permanent general manager was hired in February 2005 and a Controller came on board in July 2005. The central task confronting CPUC's new management team will be to adjust the electric tariff to cover operating and capital replacement costs. After this, it will be essential to get the financial management system operating correctly so CPUC management and others requiring accurate financial information can obtain a correct picture of the true state of CPUC's financial position and operating results. Finally, it will be necessary to replace some of CPUC's generating capacity with new engines. In this regard, loan negotiations with the Asian Development Bank and applications for Compact public infrastructure sector grants will need to be actively pursued.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Net Assets September 30, 2004 and 2003

<u>Assets</u>	<u>2004</u>	<u>2003</u>
Utility plant, at cost:		
Electric plant in service	\$ 15,136,112	\$ 14,922,376
Water and sewer plant in service	10,088,112	10,088,112
	<u>25,224,224</u>	<u>25,010,488</u>
Less accumulated depreciation	<u>(17,534,350)</u>	<u>(16,238,175)</u>
Total utility plant	<u>7,689,874</u>	<u>8,772,313</u>
Current assets:		
Cash	306,720	152
Accounts receivable, net	474,423	951,444
Other receivables	444,105	444,105
Inventory	22,973	22,973
Total current assets	<u>1,248,221</u>	<u>1,418,674</u>
	<u>\$ 8,938,095</u>	<u>\$ 10,190,987</u>
<u>Net Assets and Liabilities</u>		
Net assets:		
Invested in capital assets, net of related debt	\$ 3,544,749	\$ 4,614,450
Unrestricted (deficit)	<u>516,891</u>	<u>432,636</u>
Total net assets	<u>4,061,640</u>	<u>5,047,086</u>
Contingencies		
Current liabilities:		
Overdraft	-	115,330
Current portion of notes payable	618,244	340,869
Accounts payable:		
Fuel oil	73,638	150,777
Fixed assets	65,147	65,147
Operations	140,191	190,358
Accrued taxes and other liabilities	96,497	80,033
Accrued interest expense	292,551	299,602
Deferred income	50,000	50,000
Accrued annual leave	78,453	99,938
Total current liabilities	<u>1,414,721</u>	<u>1,392,054</u>
Noncurrent liabilities:		
Notes payable	<u>3,461,734</u>	<u>3,751,847</u>
Total liabilities	<u>4,876,455</u>	<u>5,143,901</u>
	<u>\$ 8,938,095</u>	<u>\$ 10,190,987</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets Years Ended September 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Operating revenues:		
Electricity sales	\$ 1,104,999	\$ 2,020,397
Other sales	<u>16,025</u>	<u>21,592</u>
Total operating revenues	<u>1,121,024</u>	<u>2,041,989</u>
Operating and maintenance expenses:		
Production fuel	2,021,928	1,964,851
Administrative and general	744,950	1,267,312
Depreciation	<u>1,296,175</u>	<u>1,276,261</u>
Total operating and maintenance expenses	<u>4,063,053</u>	<u>4,508,424</u>
Operating loss	<u>(2,942,029)</u>	<u>(2,466,435)</u>
Nonoperating revenues:		
FSM and Chuuk State grants and subsidies	125,010	1,000,000
Other income	1,857,295	621,422
Interest expense	<u>(25,722)</u>	<u>(67,811)</u>
Total nonoperating revenues	<u>1,956,583</u>	<u>1,553,611</u>
Net loss	<u>(985,446)</u>	<u>(912,824)</u>
Net assets at beginning of year	<u>5,047,086</u>	<u>5,959,910</u>
Net assets at end of year	<u>\$ 4,061,640</u>	<u>\$ 5,047,086</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Cash Flows Years Ended September 30, 2004 and 2003

	2004	2003
Cash flows from operating activities:		
Cash received from customers	\$ 1,598,045	\$ 1,903,973
Cash from other income	1,857,295	365,292
Cash payments to suppliers and employees	(2,899,205)	(3,950,581)
Net cash provided by (used for) operating activities	556,135	(1,681,316)
Cash flows from noncapital financing activities:		
Operating grants received	125,010	1,256,130
(Decrease) increase in overdraft	(115,330)	55,514
Net cash provided by noncapital financing activities	9,680	1,311,644
Cash flows from capital and related financing activities:		
Acquisition of utility plant	(213,736)	(189,531)
Proceeds from notes payable	-	619,165
Repayment of notes payable	(12,738)	-
Interest paid	(32,773)	(60,760)
Net cash (used for) provided by capital and related financing activities	(259,247)	368,874
Net increase (decrease) in cash	306,568	(798)
Cash at beginning of year	152	950
Cash at end of year	\$ 306,720	\$ 152
<u>Reconciliation of operating loss to net cash provided by (used for) operating activities:</u>		
Operating loss	\$ (2,942,029)	\$ (2,466,435)
Other income	1,857,295	365,292
Adjustments to reconcile operating loss to net cash provided by (used for) operating activities:		
Depreciation	1,296,175	1,276,261
Decrease (increase) in assets:		
Accounts receivable	477,021	(138,016)
Decrease in liabilities:		
Accounts payable	(127,306)	(689,681)
Accrued liabilities	(5,021)	(28,737)
Net cash provided by (used for) operating activities	\$ 556,135	\$ (1,681,316)

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(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 \$3,834,146 and \$4,427,110, respectively, as of September 30, 2004 and 2003.

Depreciation

Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which range from 3 to 20 years.

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 estimated sick leave at September 30, 2004 and 2003.

Revenues

Sales of electricity are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2004 and 2003, 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.

Subsidy

CPUC receives appropriated subsidy from Chuuk State Legislature.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

Cash

For purposes of the statements of net assets and cash flows, cash is defined as cash on hand and cash held in demand accounts. As of September 30, 2004 and 2003, cash was \$306,720 and \$152, respectively, and the corresponding bank balances were \$63,631 and \$71,136, respectively, which are maintained in financial institutions subject to the Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2004 and 2003, bank deposits in the amount of \$63,631 and \$71,136, respectively, were FDIC insured. CPUC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are 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

CPUC carries workmen's compensation liability insurance for all employees of the Corporation. CPUC 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.

Accounting Standards

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. CPUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

CPUC has adopted GASB Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB 34) as amended by GASB Statement Nos. 37 and 38. GASB 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following net asset categories:

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

Accounting Standards, Continued

- Invested in capital assets, net of related debt:

Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require CPUC to maintain them permanently.
 - Expendable – Net assets whose use by CPUC is subject to externally imposed stipulations that can be fulfilled by actions of CPUC pursuant to those stipulations or that expire through the passage of time.

- Unrestricted:

Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

CPUC has no nonexpendable restricted net assets at September 30, 2004 and 2003.

New Accounting Standards

For fiscal year 2005, CPUC implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)*. The impact of GASB Statement No. 40 was not significant to the financial statements.

(2) Utility Plant

Utility plant movement for the years ended September 30, 2004 and 2003:

	<u>2003</u>	<u>Additions</u>	<u>Deductions</u>	<u>2004</u>
General plant in service	\$ 310,360	\$ -	\$ -	\$ 310,360
Electric plant in service	14,612,016	213,736	-	14,825,752
Water and sewer plant in service	<u>10,088,112</u>	<u>-</u>	<u>-</u>	<u>10,088,112</u>
	25,010,488	213,736	-	25,224,224
Less accumulated depreciation	<u>(16,238,175)</u>	<u>(1,296,175)</u>	<u>-</u>	<u>(17,534,350)</u>
	\$ <u>8,772,313</u>	\$ <u>(1,082,439)</u>	\$ <u>-</u>	\$ <u>7,689,874</u>

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(2) Utility Plant

	<u>2002</u>	<u>Additions</u>	<u>Deductions</u>	<u>2003</u>
General plant in service	\$ 308,880	\$ 1,480	\$ -	\$ 310,360
Electric plant in service	14,423,966	188,051	-	14,612,017
Water and sewer plant in service	<u>10,088,111</u>	<u>-</u>	<u>-</u>	<u>10,088,111</u>
	24,820,957	189,531	-	25,010,488
Less accumulated depreciation	<u>(14,961,914)</u>	<u>(1,276,261)</u>	<u>-</u>	<u>(16,238,175)</u>
	<u>\$ 9,859,043</u>	<u>\$ (1,086,730)</u>	<u>\$ -</u>	<u>\$ 8,772,313</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, 2004 and 2003, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2004 and 2003, are summarized as follows:

	<u>2004</u>	<u>2003</u>
Residential	\$ 321,341	\$ 363,496
Commercial	435,446	545,173
Government	133,027	805,127
Unbilled	<u>569,023</u>	<u>222,062</u>
	1,458,837	1,935,858
Less allowance for doubtful receivables	<u>(984,414)</u>	<u>(984,414)</u>
	<u>\$ 474,423</u>	<u>\$ 951,444</u>

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

(4) Subsidy

Chuuk State and Federal grants and subsidies are comprised of the following for the years ended September 30, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
Chuuk State fuel subsidy	\$ <u>125,010</u>	\$ <u>1,000,000</u>
	<u>\$ 125,010</u>	<u>\$ 1,000,000</u>

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.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(5) Contingencies, Continued

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 contributed capital 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.

There were no net contributions for the years ended September 30, 2004 and 2003.

(7) Notes Payable

	<u>2004</u>	<u>2003</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 a security interest in fixed assets, accounts receivable and inventories.	\$ 81,921	\$ 94,659
Amount drawn on a note payable with an available total of \$549,743, facilitated by 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 an assignment of income.	536,323	536,323
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>3,461,734</u>	<u>3,461,734</u>
	4,079,978	4,092,716
Less current maturities	<u>618,244</u>	<u>340,869</u>
Long-term portion of notes payable	\$ <u>3,461,734</u>	\$ <u>3,751,847</u>

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2004 and 2003

(7) Notes Payable, Continued

The note to the commercial bank is due currently. Management has not paid off the line but has submitted a proposal to term the loan out over three years. Since this proposal has yet to be accepted by the bank, the entire loan balance is reflected as current.

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 September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2005	\$ 618,244	\$ 206,333	\$ 824,577
2006	-	194,997	194,997
2007	29,869	192,168	222,037
2008	59,737	189,113	248,850
2009	59,737	185,039	244,776
2010-2014	298,685	864,082	1,162,767
2015-2019	547,640	745,251	1,292,891
2020-2024	796,595	227,441	1,024,036
2025-2029	796,595	227,441	1,024,036
2030-2031	<u>872,876</u>	<u>17,715</u>	<u>890,591</u>
	<u>\$ 4,079,978</u>	<u>\$ 3,049,580</u>	<u>\$ 7,129,558</u>

(8) Other Income

Other income in 2004 and 2003 includes an entry of \$1,857,295 and \$365,292, respectively, to balance the accompanying financial statements at September 30, 2004 and 2003. The composition of these balances and the period or periods to which they relate is unknown.

**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, 2004. 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 15) as item 2004-01.

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 2004-01.

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, 2004

Finding 2004-01 - 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, 2004

Finding 2004-01 – 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.