

CHUUK PUBLIC UTILITY CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2006 AND 2005

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, 2006 and 2005, 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.

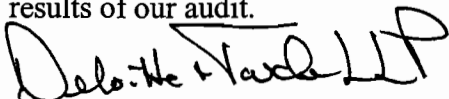
CPUC was unable to provide schedules and subsidiary ledgers to support inventory, utility plant, accounts payable and accrued expense account balances at September 30, 2006. In September 30, 2005, CPUC was unable to provide schedules, reconciliations and subsidiary ledgers to support 2005 cash in bank balances and receivables, utility plant, accounts payable and accrued expense account balances.

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 accompanying financial statements have been prepared assuming that CPUC will continue as a going concern. As discussed in Note 5 to the financial statements, CPUC's recurring losses from operations and net deficiency raise substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also described in Note 5. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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 measurement 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 January 23, 2008, 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.



January 23, 2008

CHUUK PUBLIC UTILITIES CORPORATION

Management's Discussion and Analysis Year Ended September 30, 2006

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 fiscal year ended September 30, 2006.

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, 2006, 2005 and 2004. It should be read in conjunction with the financial statements that follow this section.

The following table summarizes the financial position and results of operations of CPUC as of 2006, 2005 and 2004.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Assets:			
Utility plant in service, net	\$ 4,967,361	\$ 6,105,721	\$ 7,689,874
Current assets	<u>632,560</u>	<u>654,280</u>	<u>1,248,221</u>
Total assets	\$ <u>5,599,921</u>	\$ <u>6,760,001</u>	\$ <u>8,938,095</u>
Net assets and liabilities:			
Invested in capital assets, net of related debt	\$ 824,371	\$ 2,143,427	\$ 3,544,749
Unrestricted (deficit) net assets	<u>(1,151,640)</u>	<u>(734,473)</u>	<u>516,891</u>
Total net assets (deficiency)	<u>(327,269)</u>	<u>1,408,954</u>	<u>4,061,640</u>
Long-term debt	3,431,865	3,461,734	3,461,734
Current liabilities	<u>2,495,325</u>	<u>1,889,313</u>	<u>1,414,721</u>
Total liabilities	<u>5,927,190</u>	<u>5,351,047</u>	<u>4,876,455</u>
Total net assets and liabilities	\$ <u>5,599,921</u>	\$ <u>6,760,001</u>	\$ <u>8,938,095</u>
Revenue, expenses and changes in net assets			
Operating revenues	\$ 2,363,191	\$ 3,140,136	\$ 1,121,024
Operating expenses	<u>4,296,149</u>	<u>4,754,868</u>	<u>4,063,053</u>
Operating loss	<u>(1,932,958)</u>	<u>(1,614,732)</u>	<u>(2,942,029)</u>
Subsidies and other income	492,110	548,747	1,982,305
Interest expense	<u>(295,375)</u>	<u>(269,327)</u>	<u>(25,722)</u>
Total non-operating revenue	<u>196,735</u>	<u>279,420</u>	<u>1,956,583</u>
Net loss	<u>(1,736,223)</u>	<u>(1,335,312)</u>	<u>(985,446)</u>
Net assets at beginning of year	1,408,954	4,061,640	5,047,086
Prior period adjustments	<u>-</u>	<u>(1,317,374)</u>	<u>-</u>
Net assets (deficiency) at end of year	\$ <u>(327,269)</u>	\$ <u>1,408,954</u>	\$ <u>4,061,640</u>

CHUUK PUBLIC UTILITIES CORPORATION

Management's Discussion and Analysis
Year Ended September 30, 2006

FINANCIAL HIGHLIGHTS

During fiscal year 2006, operating revenues of \$2.36 million declined by \$0.78 million (down by 24%) from \$3.14 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. 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 2006 of \$4.30 million decreased by \$0.46 million (or 9%) from the \$4.76 million of expenditures recorded in fiscal year 2005 as management cuts all expenditures except for fuel. The operating loss of \$1.93 million compares to an operating loss of \$1.61 million in the prior year (down by 19%).

The operating loss in fiscal year 2006 was partially off-set by the \$0.49 million in subsidies and other income. Out of this amount, \$0.48 million pertained to a Chuuk State Subsidy. The net non-operating revenue for fiscal year 2006 is \$0.20 million as compared to \$0.28 million in previous year. Reflecting this net loss, net assets (deficiency) of (\$0.32 million) at September 30, 2006 had declined \$1.73 million (down by 123%) from \$1.4 million recorded at September 30, 2005.

The accumulated effect of net losses for the previous years 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 assets. CPUC's balance sheet at September 30, 2006, shows net utility plant of \$4.96 million, a decrease of \$1.14 million (or 18%) from the \$ 6.1 million from the prior year.

Fixed asset additions during fiscal year 2006 were quite minor. Please see Note 2 to the financial statements for additional information on fixed assets. There were no changes in long-term debt during fiscal year 2006. Please refer to Note 7 to the financial statements for additional information on debt.

FISCAL YEAR 2007 OUTLOOK

The controller left in May, 2006 leaving CPUC without a controller for the remaining months before September 30, 2006. A new controller came on board in January 2007. The central task confronting the 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 Asian Development Bank and other financial institutions will need to be actively pursued.

Management's Discussion and Analysis for the years ended September 30, 2005 and 2004, is set forth in the report on the audit of CPUC's financial statements, which is dated July 5, 2006, and that Discussion and Analysis explains the major factors impacting the 2005 and 2004 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmpublicauditor.fm

CHUUK PUBLIC UTILITY CORPORATION

Statements of Net Assets
September 30, 2006 and 2005 -

<u>Assets</u>	<u>2006</u>	<u>2005</u>
Utility plant, at cost:		
Electric plant in service	\$ 15,679,519	\$ 15,663,420
Water and sewer plant in service	<u>10,088,112</u>	<u>10,088,112</u>
	25,767,631	25,751,532
Less accumulated depreciation	<u>(20,800,270)</u>	<u>(19,645,811)</u>
Total utility plant	<u>4,967,361</u>	<u>6,105,721</u>
Current assets:		
Cash	1,314	1,314
Accounts receivable, net	246,031	275,867
Other receivables	1,316	-
Inventory	195,861	195,861
Prepayments	<u>188,038</u>	<u>181,238</u>
Total current assets	<u>632,560</u>	<u>654,280</u>
	<u>\$ 5,599,921</u>	<u>\$ 6,760,001</u>
<u>Net Assets (Deficiency) and Liabilities</u>		
Net assets:		
Invested in capital assets, net of related debt	\$ 824,372	\$ 2,143,427
Unrestricted (deficit)	<u>(1,151,641)</u>	<u>(734,473)</u>
Total net assets (deficiency)	<u>(327,269)</u>	<u>1,408,954</u>
Contingencies		
Current liabilities:		
Overdraft	34,682	124,513
Current portion of notes payable	711,124	681,255
Accounts payable:		
Fuel oil	155,831	199,519
Operations	57,996	50,838
Accrued taxes and other liabilities	678,354	263,042
Accrued interest expense	564,702	269,327
Deferred income	230,695	230,695
Accrued annual leave	<u>61,941</u>	<u>70,124</u>
Total current liabilities	2,495,325	1,889,313
Noncurrent liabilities:		
Notes payable	<u>3,431,865</u>	<u>3,461,734</u>
Total liabilities	<u>5,927,190</u>	<u>5,351,047</u>
	<u>\$ 5,599,921</u>	<u>\$ 6,760,001</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Changes in Net Assets (Deficiency) Years Ended September 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating revenues:		
Electricity sales	\$ 2,356,011	\$ 3,126,580
Other sales	<u>7,180</u>	<u>13,556</u>
Total operating revenues	<u>2,363,191</u>	<u>3,140,136</u>
Operating and maintenance expenses:		
Production fuel	1,999,642	2,159,962
Administrative and general	1,142,048	1,293,824
Depreciation	<u>1,154,459</u>	<u>1,301,082</u>
Total operating and maintenance expenses	<u>4,296,149</u>	<u>4,754,868</u>
Operating loss	<u>(1,932,958)</u>	<u>(1,614,732)</u>
Nonoperating revenues:		
Chuuk State grants and other subsidies	480,000	463,001
Other income	12,110	85,746
Interest expense	<u>(295,375)</u>	<u>(269,327)</u>
Total nonoperating revenues	<u>196,735</u>	<u>279,420</u>
Net loss	(1,736,223)	(1,335,312)
Net assets at beginning of year	1,408,954	4,061,640
Prior period adjustments	<u>-</u>	<u>(1,317,374)</u>
Net assets (deficiency) at end of year	<u>\$ (327,269)</u>	<u>\$ 1,408,954</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Statements of Cash Flows Years Ended September 30, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Cash received from customers	\$ 2,391,711	\$ 2,560,725
Cash payments to suppliers and employees	<u>(2,777,891)</u>	<u>(2,989,149)</u>
Net cash used for operating activities	<u>(386,180)</u>	<u>(428,424)</u>
Cash flows from noncapital financing activities:		
Operating grants and other income	492,110	548,747
(Decrease) increase in overdraft	<u>(89,831)</u>	<u>124,513</u>
Net cash provided by noncapital financing activities	<u>402,279</u>	<u>673,260</u>
Cash flows from capital and related financing activities:		
Acquisition of utility plant	(16,099)	(613,253)
Proceeds from notes payable	<u>-</u>	<u>63,011</u>
Net cash used for capital and related financing activities	<u>(16,099)</u>	<u>(550,242)</u>
Net change in cash	-	(305,406)
Cash at beginning of year	<u>1,314</u>	<u>306,720</u>
Cash at end of year	<u>\$ 1,314</u>	<u>\$ 1,314</u>
<u>Reconciliation of operating loss to net cash used for</u>		
<u>operating activities:</u>		
Operating loss	\$ (1,932,958)	\$ (1,614,732)
Adjustments to reconcile operating loss to net cash		
used for operating activities:		
Bad debts	-	808,949
Depreciation	1,154,459	1,301,082
Decrease (increase) in assets:		
Accounts receivable	29,836	(412,560)
Other receivables	(1,316)	(444,105)
Inventory	-	(172,888)
Prepayments	(6,800)	(181,238)
Increase (decrease) in liabilities:		
Accounts payable	(36,530)	(28,619)
Accrued liabilities	<u>407,129</u>	<u>315,687</u>
Net cash used for operating activities	<u>\$ (386,180)</u>	<u>\$ (428,424)</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(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.

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 \$2,648,411 and \$3,241,375, respectively, as of September 30, 2006 and 2005. Current policy is to capitalize items over \$200.

Depreciation

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

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 loan 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 an expense is actually incurred. The accumulated estimated amount of sick leave at September 30, 2006 was \$55,580.

Revenues

Sales of electricity are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2006 and 2005, unbilled revenues are accrued based on the most recent billing cycles. Unbilled receivables at September 30, 2006 and 2005 are \$140,725 and \$78,213, respectively.

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.

Grants and Subsidies

CPUC periodically receives appropriated subsidies from the Chuuk State Legislature.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(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.

Inventories

Inventories of materials and fuel are determined by physical count and are valued at the lower of cost (first in, first out method), or market value.

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.

Accounting Standards

The financial statements of CPUC have been prepared in conformity with generally accepted accounting principles (GAAP) as applied to government units. 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:

- 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.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

Accounting Standards, Continued

- 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 by 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, 2006 and 2005.

Operating and Non-Operating Revenue and Expenses

Operating revenues and expenses generally result directly from the operation and maintenance of CPUC. Non-operating revenues and expenses result from capital and financing activities, costs and related recoveries from natural disasters, surcharge and certain other non-recurring income and costs.

New Accounting Standards

During fiscal year 2006, CPUC implemented the following pronouncements:

- GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which establishes standards for impairment of capital assets when service utility has declined significantly and unexpectedly.
- GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section*, an amendment to NCGA Statement 1. GASB Statement No. 44 improves the understandability and usefulness of statistical section information and adds information from the new financial reporting model for state and local governments required by GASB Statement No. 34.
- GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation (an amendment to GASB Statement No. 34)*, which requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets.
- GASB Statement No. 47, *Accounting for Termination of Benefits*, which establishes guidance for state and local governmental employers on accounting and financial reporting for termination of benefits.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- GASB Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefits Expenditures/Expense and Liabilities by Cost-Sharing Employers*, which clarifies the requirements of GASB Statement Nos. 27 and 45 for recognition of pension and other postemployment benefit expenditures/expense and liabilities by cost-sharing employers.

The implementation of these pronouncements did not have a material impact on the accompanying financial statements.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this Statement are effective for periods beginning after December 15, 2007. CPUC does not believe that the implementation of this Statement will have a material effect on its financial statements.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after December 15, 2008. CPUC does not believe the implementation of this Statement will have a material effect on its financial statements.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*. GASB Statement No. 48 establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. The Statement also includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. The provisions of this Statement are effective for periods beginning after December 15, 2006. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CPUC.

Cash

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by CPUC or its agent in CPUC's name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in CPUC's name; or

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

Cash, Continued

Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the CPUC's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, CPUC's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. CPUC does not have a deposit policy for custodial credit risk.

As of September 30, 2006 and 2005, cash was \$1,314 and the corresponding bank balances were \$21,953 and \$6,962, respectively, which are maintained in financial institutions subject to the Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006 and 2005, bank deposits in the amount of \$21,953 and \$6,962, respectively, were FDIC insured. CPUC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Therefore, these deposits are exposed to custodial credit risk.

(2) Utility Plant

Utility plant movement for the years ended September 30, 2006 and 2005, is as follows:

	<u>2005</u>	<u>Additions</u>	<u>Disposals/ Adjustments</u>	<u>2006</u>
General plant in service	\$ 292,640	\$ 10,200	\$ -	\$ 302,840
Electric plant in service	15,370,780	5,899	-	15,376,679
Water and sewer plant in service	<u>10,088,112</u>	<u>-</u>	<u>-</u>	<u>10,088,112</u>
	<u>25,751,532</u>	<u>16,099</u>	<u>-</u>	<u>25,767,631</u>
Less accumulated depreciation	(19,645,811)	(1,154,459)	-	(20,800,270)
	<u>\$ 6,105,721</u>	<u>\$ (1,138,360)</u>	<u>\$ -</u>	<u>\$ 4,967,361</u>
	<u>2004</u>	<u>Additions</u>	<u>Disposals/ Adjustments</u>	<u>2005</u>
General plant in service	\$ 310,360	\$ -	\$ (17,720)	\$ 292,640
Electric plant in service	14,825,752	613,253	(68,225)	15,370,780
Water and sewer plant in service	<u>10,088,112</u>	<u>-</u>	<u>-</u>	<u>10,088,112</u>
	<u>25,224,224</u>	<u>613,253</u>	<u>(85,945)</u>	<u>25,751,532</u>
Less accumulated depreciation	(17,534,350)	(1,301,082)	(810,379)	(19,645,811)
	<u>\$ 7,689,874</u>	<u>\$ (687,829)</u>	<u>\$ (896,324)</u>	<u>\$ 6,105,721</u>

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(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, 2006 and 2005, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2006 and 2005, are summarized as follows:

	<u>2006</u>	<u>2005</u>
Residential	\$ 622,803	\$ 594,971
Commercial	459,600	478,545
Government	618,433	719,668
Unbilled	<u>140,725</u>	<u>78,213</u>
	1,841,561	1,871,397
Less allowance for doubtful receivables	<u>(1,595,530)</u>	<u>(1,595,530)</u>
	\$ <u>246,031</u>	\$ <u>275,867</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, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Hazard Mitigation Grant Program	\$ -	\$ 463,001
Chuuk State fuel subsidy	440,000	-
Other subsidy	<u>40,000</u>	<u>-</u>
	\$ <u>480,000</u>	\$ <u>463,001</u>

The 2006 Chuuk State fuel subsidy derives from the Declaration of a State of Emergency and Administrative Directive 06-2006. There are no specific compliance terms associated with these funds other than that they be utilized in the process of power generation or for purchases to generate power. The hazard mitigation grant program is received in a subrecipient capacity through the State of Chuuk.

(5) Contingencies

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplates the continuation of CPUC as a going concern. However, CPUC has sustained substantial operating losses in recent years. In addition, CPUC has used a substantial amount of working capital in its operations. Further, at September 30, 2006, current liabilities exceeded current assets by \$1,862,765, and total liabilities exceed total assets by \$327,269. Management acknowledges that it is currently dependent on the State of Chuuk to pay for actual services rendered in order to maintain CPUC as a going concern. Should the State of Chuuk choose to discontinue payment for services rendered, CPUC management may have to consider alternative measures including, among other possibilities, the State of Chuuk maintaining CPUC as a going concern.

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(5) Contingencies, Continued

In view of these matters, realization of a major portion of the assets in the accompanying statement of net assets at September 30, 2006, is dependent upon continued operations of CPUC, which in turn is dependent upon CPUC's ability to meet its future debt service requirements, and the success of future operations. Management believes that actions presently being taken to revise CPUC's operating requirements, which include exerting more effort in collecting, provide the opportunity for CPUC to continue as a going concern.

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 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 are no net contributions for the years ended September 30, 2006 and 2005.

(7) Notes Payable

	<u>2006</u>	<u>2005</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.	\$ 81,921	\$ 81,921
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 assignment of income.	599,334	599,334
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>
	4,142,989	4,142,989

CHUUK PUBLIC UTILITY CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(7) Notes Payable, Continued

	<u>2006</u>	<u>2005</u>
Less current maturities	711,124	681,255
Long-term portion of notes payable	\$ <u>3,431,865</u>	\$ <u>3,461,734</u>

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>
2007	\$ 711,124	\$ 300,066	\$ 1,011,190
2008	59,737	189,113	248,850
2009	59,737	185,039	244,776
2010	59,737	180,965	240,702
2011	59,737	176,891	236,628
2012-2016	298,685	823,340	1,122,025
2017-2021	746,804	660,366	1,407,170
2022-2025	796,595	390,425	1,187,020
2027-2031	<u>1,350,833</u>	<u>121,583</u>	<u>1,472,416</u>
	\$ <u>4,142,989</u>	\$ <u>3,027,788</u>	\$ <u>7,170,777</u>

(8) Related Party Transactions

Accounts receivable from the State of Chuuk amounted to \$618,433 and \$743,708 as of September 30, 2006 and 2005, respectively. Revenue received from the State of Chuuk for the years ended September 30, 2006 and 2005 amounted to \$727,352 and \$1,138,015, respectively.

(9) Prior Period Adjustments

To correct various balance sheet assets as of September 30, 2005, management recorded unidentified offsets as prior period adjustments. The details of these adjustments is not known and accordingly, it was not possible to restate 2004 and prior fiscal years for these matters.

**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, 2006. Our report dated January 23, 2008, 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 because CPUC was unable to provide schedules and subsidiary ledgers to support inventory, utility plant, accounts payable and accrued expense account balances.

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 17) as item 2006-01.

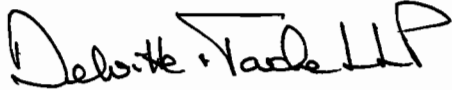
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and 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 an instance of noncompliance that is required to be reported under *Government Auditing Standards*, which is described in the accompanying Schedule of Findings as item 2006-01.

We noted other matters involving the internal control over financial reporting that we have reported to management of CPUC in a separate letter dated January 23, 2008.

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.

A handwritten signature in black ink that reads "Deloitte + Tardes LLP". The signature is written in a cursive, stylized font.

January 23, 2008

CHUUK PUBLIC UTILITY CORPORATION

Schedule of Findings
Year Ended September 30, 2006

Finding 2006-01 - 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.

Prior Year Status: The above condition is reiterative of conditions identified in the prior year audit of the Chuuk Public Utilities Corporation.

Recommendation: CPUC must acquire adequate accounting assistance, must prepare monthly financial statements that are supported by its books and records, must maintain an adequate filing and retention system 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 recognizes the need to improve its accounting, filing and retention system.

During the fiscal year 2006, a controller was hired in July 2005 but left the company in May 2006. Because of the resignation of the controller, the recording of transactions in the system was not updated and also reconciliation of accounts was not performed. A new controller came on board last January 2007. No formal turn-over of files and documents were made. As found out, the system was only updated up to February 2006 due to the system's crash. Thus, there was a need to encode entries from that March to September 30, 2006 to be able to bring the transactions up to date for the audit.

Due to financial constraints, necessary purchases of computer hardware and software maintenance were not given priority. The storage of documents also imposes a problem because of lack of filing cabinets and storing materials to safe keep the documents from elements and not enough to retain the files for a period of three years which is required in the audit.

Lack of training in the MAS 90 system presents a set back on some of the modules in MAS 90 because they were not instructed on how to use such.

CHUUK PUBLIC UTILITY CORPORATION

Schedule of Findings
Year Ended September 30, 2006

Finding 2006-01 – Reconciliation, Continued

CPUC Management will carry out the following corrective measures to improve its accountability:

- Determining to upgrade the existing accounting software.
- Training for the MAS 90 for the controller and accounting staff
- Development of accounting policies and procedures to ensure the monthly preparation of financial statements supported by FMIS; monthly reconciliations of key control accounts with the subsidiary ledger balances; the printing and retention of monthly reports from the Utilstar billing systems 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 dedicated to apply these measures in effect for all of fiscal year 2007 and will retroactively reconcile the 2006 accounts as time permits to prepare for the fiscal year 2007 audit.