

**CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT
OF THE STATE OF CHUUK)**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2008 AND 2007

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Chuuk Public Utility Corporation:

We were engaged to audit the accompanying statements of deficiency of the Chuuk Public Utility Corporation (CPUC), a component unit of the Government of the State of Chuuk, as of September 30, 2008 and 2007, and the related statements of revenues, expenses and changes in deficiency 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.

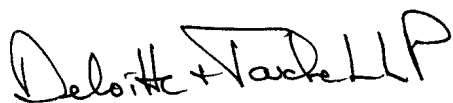
CPUC was unable to provide schedules and subsidiary ledgers to support inventory, utility plant, accounts payable and accrued expense account balances as of September 30, 2008 and 2007.

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 2-4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). This 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 June 15, 2009, 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.



June 15, 2009

CHUUK PUBLIC UTILITIES CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Management's Discussion and Analysis
Years Ended September 30, 2008 and 2007

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, 2008.

GASB 34 of the U.S. Government Accounting Standards Board requires that 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, 2008, and 2007. It should be read in conjunction with the financial statements that follow this section.

The CPUC is a component unit of the Government of the State of Chuuk. Its primary objective is to provide electrical, water, and sewer service to the public.

The following table summarizes the financial position and results of operation of CPUC as of 2008, 2007 and 2006.

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Assets:			
Utility plant in service, net	\$ 2,961,336	\$ 3,971,652	\$ 4,967,361
Current assets	<u>545,217</u>	<u>668,840</u>	<u>632,560</u>
Total Assets	\$ <u>3,506,553</u>	\$ <u>4,640,492</u>	\$ <u>5,599,921</u>
Deficiency and Liabilities:			
Invested in capital assets, net of related debt	\$ (1,500,636)	\$ (226,560)	\$ 824,372
Unrestricted deficit	<u>(2,258,321)</u>	<u>(1,636,203)</u>	<u>(1,151,641)</u>
Total deficiency	<u>(3,758,957)</u>	<u>(1,862,763)</u>	<u>(327,269)</u>
Long-term debt	3,522,834	3,318,811	2,495,325
Current liabilities	<u>3,742,676</u>	<u>3,184,444</u>	<u>3,431,865</u>
Total Liabilities	<u>7,265,510</u>	<u>6,503,255</u>	<u>5,527,190</u>
Total Deficiency and liabilities	\$ <u>3,506,553</u>	\$ <u>4,640,492</u>	\$ <u>5,599,921</u>
Revenue, Expenses, and Changes in Net Assets			
Operating revenues	2,421,386	2,151,578	\$ 2,363,191
Operating expenses	<u>4,406,868</u>	<u>3,859,142</u>	<u>4,296,149</u>
Operating loss	<u>(1,985,482)</u>	<u>(1,707,564)</u>	<u>(1,932,958)</u>
Subsidies and Other Income	414,126	407,865	492,110
Interest expense	<u>(324,838)</u>	<u>(235,795)</u>	<u>(295,375)</u>
Total non-operating revenue	<u>89,288</u>	<u>172,070</u>	<u>196,735</u>
Net Loss	(1,896,194)	(1,535,494)	(1,736,223)
Net deficiency at beginning of year	<u>(1,862,763)</u>	<u>(327,269)</u>	<u>1,408,954</u>
Net deficiency at end of year	\$ <u>(3,758,957)</u>	\$ <u>(1,862,763)</u>	\$ <u>(327,269)</u>

CHUUK PUBLIC UTILITIES CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Management's Discussion and Analysis
Years Ended September 30, 2008 and 2007

FINANCIAL HIGHLIGHTS

In fiscal year 2008, CPUC's widening operating losses, deteriorating utility plant and increasing liabilities virtually doubled the deficiency of net assets, highlighting the precarious nature of CPUC's financial position and its ability to continue to operate as a going concern.

Operating revenues of \$2.42 million in fiscal year 2008 were \$0.27 million higher (or 12.54%) than the \$2.15 million in fiscal year 2007. The increase in revenue, however, was more than offset by expenditures that increased at a higher rate. In fiscal 2008, CPUC's total operating expenses of \$4.41 million were \$0.55 million higher (or 14.2%) than \$3.86 million incurred in FY-07. Production fuel expenditures of \$2.31 million increased \$0.24 million (up 10.5%) from \$2.07 million in fiscal year 2007. Administrative and general expenditures of \$1.09 million were up \$0.32 million (or 42%) from \$0.76 million in fiscal year 2007. The operating loss of \$1.99 million was up \$0.28 million (or 16.3%) from the \$1.71 million loss in FY-2007. These year-over-year escalating losses reflect the failure to increase utility tariffs and collections at a pace sufficient to cover variable operating expenses.

CPUC's overall changes in its balance sheet components from September 30, 2008 to 2007 include a decrease in utility plant and current assets, an increase in long-term debt and current liabilities, and an increase in its unrestricted deficit. In short, all balance sheet components are worsening at accelerating rates.

Utility plant declined to \$2.96 million (or 25% percent) in fiscal year 2008 from \$3.97 million in the prior year. There were no significant additions to the utility plant in fiscal year 2008 so the trend reflects the continued depreciation of old assets and the failure to replace aging assets with new capital stock.

Current assets declined to \$0.54 million (or 18.5%) in fiscal year 2008 from \$.67 million in fiscal year 2007.

In fiscal year 2008, long-term debt increased to \$3.5 million (up 6%) from \$3.3 million in 2007. CPUC is several years in arrears on all its debt covenants and the current portion of these liabilities is increasing accordingly. Current liabilities in fiscal year 2008 increased to \$3.7 million (up 17.5%) from \$3.18 million in fiscal year 2007. The following comparative schedule of CPUC's current liabilities points out the chief components and negative trends of CPUC's current debt positions:

CURRENT LIABILITIES at 9-30-XX:			
<i>Amounts in '000's</i>	2008	2007	% Change
Bank Overdraft	\$ 111	\$ 55	102%
Current portion of notes payable	939	879	7%
Accrued interest expense	1,053	728	45%
Accrued taxes for SST and FSM withholding	1,278	887	44%
Advances from Chuuk Housing Authority	220	110	100%
Vendor payables and other	<u>142</u>	<u>525</u>	(73 %)
	\$ <u>3,743</u>	\$ <u>3,184</u>	18%

CHUUK PUBLIC UTILITIES CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Management's Discussion and Analysis
Years Ended September 30, 2008 and 2007

CPUC's total liabilities at September 30, 2008 (\$7.26 million) are now three (3) times its annual revenue collections.

The total deficiency of capital assets and unrestricted deficit in net assets stood at \$ 3.76 million at September 30, 2008, an increase of \$1.9 million (or 101%) from \$1.86 million in the prior year. By any measure, this is a matter of grave concern to the viability of future operations of CPUC. Assets are the foundation on which future revenues are generated and the continued impairment of CPUC's assets in addition to the magnitude of its liabilities calls into question the going-concern status of CPUC without substantial outside recapitalization.

Capital Assets and Debt

For additional information concerning capital assets, please refer to note 2 to the financial statements.

For additional information concerning debt, please refer to note 7 to the financial statements.

Management's Discussion and Analysis for the years ended September 30, 2007 and 2006, is set forth in the report on the audit of CPUC's financial statements, which is dated June 30, 2008, and that Discussion and Analysis explains the major factors impacting the 2007 and 2006 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmpublicauditor.fm

FISCAL YEAR 2009 OUTLOOK

On November 3, 2008 the Chuuk Governor declared a State of Emergency concerning CPUC and convened a task force to oversee key CPUC operations. The emergency declaration was the result of increasing power outages and CPUC's inability to generate enough revenues to purchase fuel on a sustainable basis. Although progress was made in providing a more reliable supply of electric power, the major reforms required to permanently address CPUC's recurring operational and financial problems have yet to be made. The future is uncertain.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Statements of Deficiency
Years Ended September 30, 2008 and 2007

<u>Assets</u>	<u>2008</u>	<u>2007</u>
Utility plant, at cost:		
Electric plant in service	\$ 15,708,109	\$ 15,709,995
Water and sewer plant in service	<u>10,088,111</u>	<u>10,088,111</u>
	25,796,220	25,798,106
Less accumulated depreciation	<u>(22,834,884)</u>	<u>(21,826,454)</u>
Total utility plant	<u>2,961,336</u>	<u>3,971,652</u>
Current assets:		
Cash	4,854	1,314
Accounts receivable, net	325,125	275,250
Other receivables	19,377	8,377
Inventory	195,861	195,861
Prepayments	<u>-</u>	<u>188,038</u>
Total current assets	<u>545,217</u>	<u>668,840</u>
	<u>\$ 3,506,553</u>	<u>\$ 4,640,492</u>
<u>Deficiency and Liabilities</u>		
Net deficiency:		
Invested in capital assets, net of related debt	\$ (1,500,636)	\$ (226,560)
Unrestricted deficit	<u>(2,258,321)</u>	<u>(1,636,203)</u>
Total deficiency	<u>(3,758,957)</u>	<u>(1,862,763)</u>
Commitment and contingencies		
Current liabilities:		
Overdraft	111,346	54,555
Current portion of notes payable	939,138	879,401
Accounts payable:		
Fuel oil	-	162,402
Operations	-	70,380
Accrued taxes and other liabilities	1,277,583	887,206
Accrued interest expense	1,052,701	727,864
Advances from Chuuk State Housing Authority	220,000	110,000
Deferred income	67,693	230,695
Accrued annual leave	<u>74,215</u>	<u>61,941</u>
Total current liabilities	3,742,676	3,184,444
Noncurrent liabilities:		
Notes payable	<u>3,522,834</u>	<u>3,318,811</u>
Total liabilities	<u>7,265,510</u>	<u>6,503,255</u>
	<u>\$ 3,506,553</u>	<u>\$ 4,640,492</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Statements of Revenues, Expenses and Changes in Deficiency
Years Ended September 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Operating revenues:		
Electricity sales	\$ 2,399,490	\$ 2,131,785
Other sales	<u>21,896</u>	<u>19,793</u>
Total operating revenues	<u>2,421,386</u>	<u>2,151,578</u>
Operating and maintenance expenses:		
Production fuel	2,305,709	2,068,993
Administrative and general	1,088,916	764,586
Depreciation	<u>1,012,243</u>	<u>1,025,563</u>
Total operating and maintenance expenses	<u>4,406,868</u>	<u>3,859,142</u>
Operating loss	<u>(1,985,482)</u>	<u>(1,707,564)</u>
Nonoperating (expense) revenues:		
FSM National Government and Chuuk State grants, and other subsidies	384,473	398,640
Other income	29,653	9,225
Interest expense	<u>(324,838)</u>	<u>(235,795)</u>
Total nonoperating revenues	<u>89,288</u>	<u>172,070</u>
Change in net deficiency	<u>(1,896,194)</u>	<u>(1,535,494)</u>
Net deficiency at beginning of year	<u>(1,862,763)</u>	<u>(327,269)</u>
Net deficiency at end of year	<u>\$ (3,758,957)</u>	<u>\$ (1,862,763)</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Statements of Cash Flows
Years Ended September 30, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Cash received from customers	\$ 2,361,897	\$ 2,115,298
Cash payments to suppliers and employees	<u>(3,089,720)</u>	<u>(2,568,405)</u>
Net cash used in operating activities	<u>(727,823)</u>	<u>(453,107)</u>
Cash flows from noncapital financing activities:		
Operating grants and other income	414,126	407,865
Increase in overdraft	<u>56,791</u>	<u>19,873</u>
Net cash provided by noncapital financing activities	<u>470,917</u>	<u>427,738</u>
Cash flows from capital and related financing activities:		
Acquisition of utility plant	(3,314)	(29,854)
Proceeds from notes payable	<u>263,760</u>	<u>55,223</u>
Net cash provided by capital and related financing activities	<u>260,446</u>	<u>25,369</u>
Net change in cash	3,540	-
Cash at beginning of year	<u>1,314</u>	<u>1,314</u>
Cash at end of year	<u>\$ 4,854</u>	<u>\$ 1,314</u>
<u>Reconciliation of operating loss to net cash used in operating activities:</u>		
Operating loss	\$ (1,985,482)	\$ (1,707,564)
Adjustments to reconcile operating loss to net cash used for operating activities:		
Depreciation	1,012,243	1,025,563
Other expense (income)	143,534	(353,783)
Decrease (increase) in assets:		
Accounts receivable	(192,022)	324,564
Other receivables	(11,000)	(7,061)
Prepayments	188,038	-
Increase (decrease) in liabilities:		
Accounts payable	(232,782)	18,955
Accrued liabilities	239,648	136,219
Advances from Chuuk State Housing Authority	<u>110,000</u>	<u>110,000</u>
Net cash used in operating activities	<u>\$ (727,823)</u>	<u>\$ (453,107)</u>

See accompanying notes to financial statements.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(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 \$1,462,484 and \$2,055,448, respectively, as of September 30, 2008 and 2007. 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.

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, 2008 was \$55,964.

Revenues

Sales of electricity are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2008 and 2007, unbilled revenues are accrued based on the most recent billing cycles. Unbilled receivables at September 30, 2008 and 2007 are \$19,207 and \$78,582, 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.

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.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

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.

- 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.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

Accounting Standards, Continued

- 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, 2008 and 2007.

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 2008, CPUC implemented the following pronouncements:

- GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which establishes uniform financial reporting for other postemployment benefit plans by state and local governments.
- GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*, which establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing, and includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components.
- GASB Statement No. 50, *Pension Disclosures an amendment of GASB Statements No. 25 and 27*, which more closely aligns the financial reporting requirements for pensions with those for other post-employment benefits.

The implementation of these pronouncements did not have a material effect on the accompanying 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 post-employment 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. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CPUC.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CPUC.

In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CPUC.

In November 2007, GASB issued Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. GASB Statement No. 52 improves the quality of financial reporting by requiring endowments to report their land and other real estate investments at fair value, creating consistency in reporting among similar entities that exist to invest resources for the purpose of generating income. The provisions of this statement are effective for periods beginning after June 15, 2008. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CPUC.

In June 2008, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements. The provisions of this statement are effective for periods beginning after June 15, 2009. 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
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in CPUC's name and non-collateralized deposits.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

Cash, Continued

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, 2008 and 2007, cash was \$4,854 and \$1,314 and the corresponding bank balances were \$3,618 and \$6,913, respectively, which are maintained in financial institutions subject to the Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2008 and 2007, bank deposits in the amount of \$3,618 and \$6,913, 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, 2008 and 2007, is as follows:

	<u>2007</u>	<u>Additions</u>	<u>Disposals/ Adjustments</u>	<u>2008</u>
General plant in service	\$ 323,200	\$ 3,314	\$ (5,200)	\$ 321,314
Electric plant in service	15,386,795	-	-	15,386,795
Water and sewer plant in service	<u>10,088,111</u>	<u>-</u>	<u>(5,200)</u>	<u>10,088,111</u>
	<u>25,798,106</u>	<u>3,314</u>	<u>-</u>	<u>25,796,220</u>
Less accumulated depreciation	<u>(21,826,454)</u>	<u>(1,012,243)</u>	<u>3,813</u>	<u>(22,834,884)</u>
	<u>\$ 3,971,652</u>	<u>\$ (1,008,929)</u>	<u>\$ (1,387)</u>	<u>\$ 2,961,336</u>
	<u>2006</u>	<u>Additions</u>	<u>Disposals/ Adjustments</u>	<u>2007</u>
General plant in service	\$ 302,840	\$ 20,360	\$ -	\$ 323,200
Electric plant in service	15,376,680	9,494	621	15,386,795
Water and sewer plant in service	<u>10,088,111</u>	<u>-</u>	<u>-</u>	<u>10,088,111</u>
	<u>25,767,631</u>	<u>29,854</u>	<u>621</u>	<u>25,798,106</u>
Less accumulated depreciation	<u>(20,800,270)</u>	<u>(1,025,563)</u>	<u>(621)</u>	<u>(21,826,454)</u>
	<u>\$ 4,967,361</u>	<u>\$ (995,709)</u>	<u>\$ -</u>	<u>\$ 3,971,652</u>

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(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, 2008 and 2007, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2008 and 2007, are summarized as follows:

	<u>2008</u>	<u>2007</u>
Residential	\$ 617,614	\$ 532,287
Commercial	681,998	479,115
Government	390,201	427,014
Unbilled	<u>19,207</u>	<u>78,582</u>
	1,709,020	1,516,998
Less allowance for doubtful receivables	<u>(1,383,895)</u>	<u>(1,241,748)</u>
	<u>\$ 325,125</u>	<u>\$ 275,250</u>

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

(4) Grants and Subsidies

FSM National Government, Chuuk State, and other subsidies are comprised of the following for the years ended September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
FSM National Government fuel subsidy	\$ 150,000	\$ 232,053
Chuuk State fuel subsidy	192,146	125,600
OMIP Grants	42,327	-
Other subsidy	<u>-</u>	<u>40,987</u>
	<u>\$ 384,473</u>	<u>\$ 398,640</u>

The 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.

(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, 2008, current liabilities exceeded current assets by \$3,197,459, and total liabilities exceed total assets by \$3,758,957. 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
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(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, 2008, 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, 2008 and 2007.

(7) Notes Payable

	<u>2008</u>	<u>2007</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 security interest in fixed assets, accounts receivable and inventories.	\$ 81,921	\$ 81,921
Amount drawn on a note payable with an available total of \$737,743, facilitated by Federated States of Micronesia Development Bank (FSMDB), interest at 9%, due in monthly installments of \$4,000. The loan is collateralized by major machinery, equipment and assignment of income.	737,743	737,743

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(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>3,642,308</u>	<u>3,378,548</u>
Less current maturities	<u>4,461,972</u> <u>939,138</u>	<u>4,198,212</u> <u>879,401</u>
Long-term portion of notes payable	\$ <u>3,552,834</u>	\$ <u>3,318,811</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. In June 2007, the loan payment was refinanced and was set at \$4,000 per month.

Notes payable mature as follows:

<u>Year ending</u> <u>September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2009	\$ 939,138	\$ 185,039	\$ 1,124,177
2010	59,737	180,965	240,702
2011	59,737	176,891	236,628
2012	59,737	172,816	232,553
2013	59,737	168,742	228,479
2014-2018	448,058	777,506	1,225,564
2019-2023	796,595	553,409	1,350,004
2024-2028	796,595	281,769	1,078,364
2029-2031	<u>1,242,638</u>	<u>41,472</u>	<u>1,284,110</u>
	<u>\$ 4,461,972</u>	<u>\$ 2,538,609</u>	<u>\$ 7,000,581</u>

(8) Related Party Transactions

Accounts receivable from the State of Chuuk amounted to \$390,201 and \$427,014 as of September 30, 2008 and 2007, respectively. Revenue received from the State of Chuuk for the years ended September 30, 2008 and 2007 amounted to \$782,559 and \$417,560, respectively.

Advances from Chuuk State Housing Authority amounted to \$220,000 and \$110,000 as of September 30, 2008 and 2007, respectively. The underlying agreement indicates that all parties will utilize their best efforts to obtain funding from external sources to repay the advances. There has been no subsequent payment made to Chuuk State Housing Authority.

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Notes to Financial Statements
September 30, 2008 and 2007

(9) Commitment

CPUC leases office space expiring in 2011. Future minimum lease payments are as follows:

<u>Year ending</u> <u>September 30,</u>	
2009	\$ 38,400
2010	38,400
2011	38,400

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

The Board of Directors
Chuuk Public Utility Corporation:

We were engaged to audit the financial statements of Chuuk Public Utility Corporation (CPUC) a component unit of the Government of the State of Chuuk, as of and for the year ended September 30, 2008. Our report dated June 15, 2009, 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 and performing our audit, we considered CPUC's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CPUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of CPUC's internal control over financial reporting.

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

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiency described in the accompanying Schedule of Findings and Responses (page 19) to be a significant deficiency in internal control over financial reporting, which is described as item 2008-01.

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

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

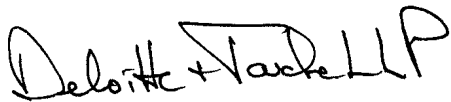
Compliance and Other Matters

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 and Responses as item 2008-01.

We noted other matters involving the internal control over financial reporting that we have reported to management of CPUC in a separate letter dated June 15, 2009.

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

This report is intended for the information and use of the Board of Directors and management of CPUC, the Office of the Public Auditor of FSM, 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 of public record.

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

June 15, 2009

CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)

Schedule of Findings and Responses
Year Ended September 30, 2008

Finding 2008-01 - 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. The financial controller left CPUC in May 2008 and until July 2009 no one was hired to fill the position. As a result, routine accounting tasks have not been performed and internal accounting controls neglected. The Governor convened a task force in November 2008 and other Chuuk State administration staff were assigned to fulfill essential accounting functions, but were only able to carry out the bare minimum of accounting tasks necessary to keep CPUC afloat. Outside technical assistance had to be obtained to meet the FY-08 audit deadline and the recurring audit opinion disclaimer in FY-08 evidences once again the dire situation with respect to CPUC accounting records and the disregard of corrective actions by the CPUC Board and management.

The Secretary of Finance has received approval to recruit a certified public accountant for CPUC under a new grant that will be under his control; it is felt that the reporting structure of any finance professional needs to be changed to ensure that attention will be paid to CPUC financial controls. Additionally, the Governor has reconvened his emergency CPUC task force and mobilized administrative staff to work in the CPUC finance department until the Controller has been hired. It is planned that the Controller will be on board by September, 2009 before the beginning of the FY-10 fiscal year.

**CHUUK PUBLIC UTILITY CORPORATION
(A COMPONENT UNIT OF THE GOVERNMENT OF THE STATE OF CHUUK)**

Schedule of Findings and Responses, Continued
Year Ended September 30, 2008

Finding 2008-01 – Reconciliation, Continued

Auditee Response and Corrective Action Plan, Continued:

One of the first job duties of the new Controller will be to develop a plan to ensure that complete accountability over all CPUC transactions; monthly bank reconciliations, and an adequate filing system that will enable CPUC to demonstrate compliance with laws and regulations. Bringing a finance professional on-board has been made one of many preconditions for a new ADB Omnibus loan that could assist CPUC in recapitalizing its organization. It is considered the most urgent immediate priority of management.