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June 20, 2014

Mr. Marcelino Actouka
General Manager
Pohnpei Utilities Corporation

Dear Mr. Actouka:

In planning and performing our audit of the financial statements of the Pohnpei Utilities Corporation (PUC) as of and for the year ended September 30, 2013 (on which we have issued our report dated June 20, 2014), in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered PUC's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of PUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the PUC'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 was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses or significant deficiencies. However, in connection with our audit, we identified, and included in the attached Attachment I, deficiencies related to PUC's internal control over financial reporting and other matters as of September 30, 2013 that we wish to bring to your attention.

We have also issued a separate report to the Board of Directors, also dated June 20, 2014, on our consideration of PUC'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 definition of a deficiency is also set forth in the attached Attachment I.

A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Attachment II and should be read in conjunction with this report.

This report is intended solely for the information and use of the Board of Directors, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss the attached comments with you and, if desired, to assist you in implementing any of the suggestions.

We wish to thank the staff and management of PUC for their cooperation and assistance during the course of this engagement.

Very truly yours,

SECTION I – DEFICIENCIES

We identified the following deficiencies involving PUC's internal control over financial reporting for the year ended September 30, 2013 that we wish to bring to your attention at this time:

1. Control over Inventories

Condition: Prior to 2012, PUC did not properly account for materials inventory. Inventory purchases and uses were directly recorded in the repair and maintenance or construction-in-progress accounts. At the end of each year, inventory accounts were adjusted based on results of physical counts. The differences therefore could not be investigated due to lack of controls over inventory receipts and issuances. During the year ended September 30, 2012, PUC implemented a system requiring all inventory movements to be recorded through inventory accounts. However, full compliance has not been achieved as inventory uses and adjustments during the year ended September 30, 2013 were not fully supported by issuance slips.

Prior Year Status: This condition is reiterative of conditions identified in our prior year audit of PUC.

Recommendation: PUC should continue to enforce and train its users on the procedures implemented over inventory receipts and issuances. Also, in addition to the year-end physical count, PUC may consider performing cycle counts to spot check items during the year. This will assist in timely identification of variances and discrepancies.

2. Allowance for Doubtful Accounts

Condition: PUC does not perform a comprehensive analysis of the allowance for doubtful accounts. During the audit, we proposed audit adjustments to increase the allowance for water accounts and to decrease the allowance for electric accounts of approximately \$291,000 and \$57,000 respectively. At September 30, 2013, the adjusted allowance for uncollectible water accounts approximated \$2,881,000, which represents 87% of total outstanding water accounts receivable.

Prior Year Status: This condition is reiterative of conditions identified in our prior year audit of PUC.

Recommendation: PUC should perform periodic reviews of the collectability of its receivables to determine an appropriate allowance. PUC should consider implementing a disconnect policy for past due water accounts and analyze water accounts for potential write-offs.

SECTION II – OTHER MATTERS

Our observations concerning other matters related to operations and best practices involving internal control over financial reporting that we wish to bring to your attention are as follows:

1. Production and Line Losses

Condition: For the year ended September 30, 2013, production and line losses of 4.3 million kWh and 1.8 million kWh, (or 13% and 5% of total production), respectively, indicated an improvement from the prior year (17% and 7%). The losses appear to be above industry standards. Losses may be caused by equipment problems, inefficiencies at generation plants or in transmission and distribution, or by theft of service.

Prior Year Status: This condition is reiterative of conditions identified in our prior year audit of PUC.

Recommendation: PUC should continue its effort to reduce production and line losses.

ATTACHMENT I, CONTINUED

2. Long Outstanding Receivables from Employees

Condition: At September 30, 2013, \$89,737 of a total of \$95,589 of accounts receivable – others are deemed uncollectible. These receivables are mainly from employees, former employees or former board members which have been outstanding for several years.

Prior Year Status: This condition is reiterative of conditions identified in our prior year audit of PUC.

Recommendation: Though fully provided with an allowance, management should strengthen its collection efforts to ensure that advances to employees are timely collected.

SECTION III – DEFINITIONS

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The definition of a deficiency is as follows:

A *deficiency* in internal control over financial reporting 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 and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, INTERNAL CONTROL OVER FINANCIAL REPORTING

The following comments concerning management's responsibility for internal control over financial reporting and the objectives and inherent limitations of internal control over financial reporting are adapted from auditing standards generally accepted in the United States of America.

Management's Responsibility

PUC's management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

Objectives of Internal Control over Financial Reporting

Internal control over financial reporting is a process affected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

Inherent Limitations of Internal Control over Financial Reporting

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.