

**MARSHALLS ENERGY COMPANY, INC.**  
**(A COMPONENT UNIT OF THE REPUBLIC OF**  
**THE MARSHALL ISLANDS)**

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**INDEPENDENT AUDITORS' REPORT ON**  
**INTERNAL CONTROL AND ON COMPLIANCE**

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**YEAR ENDED SEPTEMBER 30, 2011**

**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**

Board of Directors  
Marshalls Energy Company, Inc.:

We have audited the financial statements of Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2011 and have issued our report thereon dated August 15, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

Management of MEC is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered MEC'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 MEC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of MEC'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, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings and Responses (pages 3 through 6), we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

A *deficiency in internal control* 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 *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying Schedule of Findings and Responses as items 2011-1 and 2011-2 to be material weaknesses.

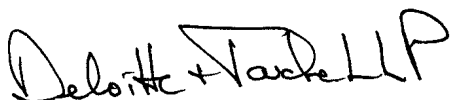
## Compliance and Other Matters

As part of obtaining reasonable assurance about whether MEC'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 audit and accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and which is described in the accompanying Schedule of Findings and Responses as item 2011-3.

We noted certain matters that we reported to management of MEC in a separate letter dated August 15, 2012.

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

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, supplemental lenders, federal awarding agencies, the cognizant audit and other federal agencies, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

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

August 15, 2012

# MARSHALLS ENERGY COMPANY, INC.

## Schedule of Findings and Responses Year Ended September 30, 2010

### Finding No. 2011-1

#### Account Reconciliations

Criteria: Subsidiary ledgers should be periodically reconciled to the general ledger control accounts in a timely fashion and be independently reviewed and approved.

Condition: Account reconciliations were not periodically performed in a timely fashion during fiscal year 2011, resulting in numerous correcting year-end audit adjustments affecting all significant accounts. Adjustments from reconciliations performed by management during audit fieldwork reduced variances to amounts not considered material to the financial statements.

Cause: The cause of the above condition is the lack of established policies and procedures requiring periodic performance of account reconciliations in a timely fashion and the lack of supervisory review.

Effect: The effect of the above condition is potential misstatement of account balances and increased risk of undetected fraud.

Recommendation: We recommend that management establish internal control policies and procedures requiring periodic performance and review of account reconciliations in a timely fashion.

Prior Year Status: Lack of periodic performance of account reconciliations and supervisory review was reported as a finding in the audits of MEC for fiscal years 2008 through 2010.

#### Auditee Response and Corrective Action Plan:

MEC agrees with this finding and recommendation. Management understands that this continues to be a repeated finding and understands the potential significant impact or risk of the finding as this relates to MEC's internal control over its financial statements. As such, MEC management is in progress with ensuring that all reconciliations have been completed to include a proper review and approval of reconciliations for fiscal year ending September 2012.

MEC management will establish internal control policies and procedures requiring periodic performance and review of account reconciliations in a timely fashion. At a high level, the reconciliation policies and procedures will include the following:

- Perform monthly reconciliations. Depending on the reconciliation account type, MEC management may identify the frequency of the reconciliations to be performed on a quarterly or an annual basis, if appropriate.
- All supporting documentation include (but not limited to) subsidiary ledger reports, bank statements, general ledger reports and other forms (i.e excel spreadsheet, journal entries, screenshots, invoices etc.) must be attached to substantiate the reconciliation completed
- All material variances will be researched and resolved by the following month.
- All variances will be aged using standard aging categories
- Variances greater than ninety days (90) aged will be reported/escalated to management
- Variances greater then ninety days aged will be reported and escalated to management
- Supervisory/manager or designee (someone other than the reconciler) review and approval will be completed (as evident by the existence of a physical signature on the face of the reconciliation.

## MARSHALLS ENERGY COMPANY, INC.

### Schedule of Findings and Responses, Continued Year Ended September 30, 2011

#### Finding No. 2011-2

##### Fuel and Supplies

**Criteria:** Adequate internal control policies and procedures should be established to require physical verification of supplies inventory and timely reconciliation with the subsidiary ledger and general ledger control accounts to facilitate accurate financial reporting. Policies and procedures should also be established concerning valuation, receipts and accurate recording, issuances, and adequate segregation of duties.

**Condition:** We noted the following exceptions during our observation of the year-end physical count:

- Inventory locations were not arranged and written count instructions were not provided to staff prior to the count;
- Pre-numbered and pre-listed count sheets were not utilized during the count;
- Inventory locations were not mapped and provided to staff and count teams were not assigned to specific locations;
- Issuances were not immediately documented on pre-numbered issue slips; and
- Job order #s are not accurately documented on issue slips.

Stock reports from tank farm, power plant and distribution personnel are not independently verified. Furthermore, approval of adjustments to inventory quantity and cost in the system is not documented.

Cost of inventory does not include freight and other incidental charges as such are directly expensed when incurred.

Of 57 inventory supplies test counted, the following errors were noted:

- 20 items have quantities in final inventory list different from counted quantities
- Five items have no cost in the final inventory list
- Five items were counted but not in the final inventory list

Of 8 inventory supplies selected for valuation testing, the following errors were noted:

- Cost of one item was not traced to a purchase document

**Cause:** The cause of the above condition is the lack of internal control policies and procedures governing physical verification of supplies inventory, timely reconciliation to subsidiary ledgers and general ledger control accounts, valuation, receipts and accurate recording, issuances, and adequate segregation of duties.

**Effect:** The effect of the above condition is potential material misstatement of supplies inventory resulting in inaccurate financial reporting.

**MARSHALLS ENERGY COMPANY, INC.**

Schedule of Findings and Responses, Continued  
Year Ended September 30, 2011

Finding No. 2011-2, Continued

Fuel and Supplies, Continued

**Recommendation:** We recommend that management establish internal control policies and procedures governing physical verification of supplies inventory, timely reconciliation to subsidiary ledgers and general ledger control accounts, valuation, receipts and accurate recording, issuances, and adequate segregation of duties.

Auditee Response and Corrective Action Plan:

MEC agrees with this finding and recommendation. Management understands that this continues to be a repeated finding and understands the potential significant impact or risk of the finding as this relates to MEC's internal control over its financial statements.

MEC management has taken necessary steps to resolve the issues and ensure that proper internal control policies and procedures regarding fuel and supplies are established and communicated.

It is the role of the Procurement Manager (for supplies) and the Fuel and Propane Analyst (for fuel and propane) to ensure that all receiving reports and issuances are pre-numbered, completed and reconciled to invoices prior to submission to the Accounts Payable Department for payment. Invoices submitted for payment will not be processed if there are any discrepancies. There will be close coordination and communication between procurement department, operations, and accounts department to ensure timely and accurate recording of invoices.

Furthermore, MEC will develop a template for costing out inventory items to ensure that freight and other incidental charges are included as cost of inventory.

**MARSHALLS ENERGY COMPANY, INC.**

Schedule of Findings and Responses, Continued  
Year Ended September 30, 2011

Finding No. 2011-3

Coverage Ratios

Criteria: Section 5.4 of the RUS loan contract requires MEC to establish rates to provide revenue sufficient to meet average coverage ratio requirements as follows:

Times Interest Earned Ratio (TIER)	=	1.50
Operating Times Interest Earned Ratio (OTIER)	=	1.10
Debt Service Coverage (DSC)	=	1.25
Operating Debt Service Coverage (ODSC)	=	1.10

Condition: During the year ended September 30, 2011, MEC achieved the following average coverage ratios:

TIER	=	0.9
OTIER	=	(1.2)
DSC	=	0.7
ODSC	=	(0.1)

Cause: The cause of the above condition is that utility rates are not sufficient to provide adequate revenues to comply with the prescribed ratio requirements.

Effect: The effect of the above condition is noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

Recommendation: We recommend that management review MEC's rates to comply with average coverage ratio requirements.

Prior Year Status: Noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract was reported as a finding in the audits of MEC for fiscal years 2000 through 2010.

Auditee Response and Corrective Action Plan:

MEC is in agreement with this finding. As wholly owned government entity, MEC is not able to fully obtain and achieve full cost recovery. However, with the approval by the RMI Cabinet, the tariff pricing template has been revised to allow MEC management the flexibility to increase (and decrease) the electricity tariff based on the variable fuel cost component in line with each shipment received.

Until MEC is allowed to achieve full cost recovery, this finding will continue to be an audit finding. It is essential that RepMar continues to provide financial support to the MEC operations. MEC's Comprehensive Recovery Plan (CRP) is an aggressive plan to revive and sustain the MEC's core and financial operations. The CRP includes goals and objectives towards reducing generation costs through initiatives such as alternative power generation solutions, system efficiencies and energy conservations. The CRP milestones reached and impact to the average coverage ratio requirement required by section 5.4 of the RUS loan will be evident in subsequent audit years.

**MARSHALLS ENERGY COMPANY, INC.**

Unresolved Prior Year Findings  
Year Ended September 30, 2011

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Responses section of this report (pages 3 through 6).