

August 15, 2012

Mr. David Paul
General Manager
Marshalls Energy Company, Inc.
P.O. Box 1439
Majuro, Marshall Islands 96960

Dear Mr. Paul:

In planning and performing our audit of the financial statements of Marshalls Energy Company (MEC) as of and for the year ended September 30, 2011 (on which we have issued our report dated August 15, 2012), 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 MEC'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 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. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to MEC's internal control over financial reporting and other matters as of September 30, 2011 that we wish to bring to your attention.

We have also issued a separate report to the Board of Directors, also dated August 15, 2012, on our consideration of MEC's internal control over financial reporting and on 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 Appendix I.

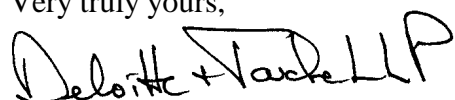
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with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

This report is intended solely for the information and use of the Board of Directors, management, others within the organization, and the Office of the Auditor-General 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 MEC for their cooperation and assistance during the course of this engagement.

Very truly yours,



SECTION I - CONTROL DEFICIENCIES

We identified, and have included below, certain control deficiencies involving MEC's internal control over financial reporting as of September 30, 2012 that we wish to bring to your attention:

(1) Receivables

- **Timely application of customer payments to individual accounts:**

In the electricity receivable subsidiary ledger, we noted account number 9999 Allotments with a credit balance of \$917,997, which mainly consists of payments by the Government of Republic of Marshall Islands (RepMar) for allocation to RepMar entities and landowners. Payments should be applied and offset against individual customer accounts.

For one of six cash power electricity receivable samples tested for subsequent collections, we noted that payment related to cash tendered by the customer before fiscal year 2011 end. The amount should have decreased receivables as at September 30, 2011.

We recommend that customer accounts be promptly adjusted and that negative balances in the 9999 allotment account be closed out at year-end.

- **Review of meter readings prior to billing finalization:**

After transition from the Napier Computer System (NCS) to the Utility Star Platinum (UTP), MEC encountered billing errors. Errors in billings occurred due to a combination of the following:

- Incorrect readings and input to hand-held machines
- Changes in meters without corresponding monitoring of cut-off readings
- An incorrect multiplier used by UTP for commercial customers

To rectify the errors, MEC reviewed usage history of all customer accounts with balances over \$10,000. For any spikes identified, billings were manually adjusted by taking an adjusted reading for the three previous months' average. Differences for incorrect readings from the average were adjusted and removed from receivables. The accounting department adjusted the electricity receivables general ledger control account but not all individual customer accounts were adjusted in the subsidiary ledger.

We performed procedures on the review performed by MEC. Based on our tests, we identified and proposed an adjustment to correct an extrapolated understatement of electricity receivables and electricity sales of \$78,000.

MEC's billing system generates meter reading exception reports that highlight excessive meter readings. It does not appear that these reports were reviewed throughout the year, resulting in significant billing errors that required adjustments. Furthermore, the review and approval of monthly electric billing reports is not documented.

MEC should enforce a stricter review of meter readings prior to finalizing billings to minimize recurrence of this matter. We recommend that management establish policies and procedures governing review of meter reading exception reports to facilitate accurate billing and reporting. We recommend that independent verification and approval of monthly billings reports be documented. This matter was discussed in our previous letters to management in the audits of fiscal years 2006 through 2010.

APPENDIX I, CONTINUED

- Collection of outer island solar electricity billings:

Solar electricity customers in the outer islands are to be billed by MEC at \$5 per month; however, bills are not sent to customers. MEC has representatives in the outer islands responsible for collections. Customers do not all pay and MEC does not enforce the 30-day disconnection policy. Also, collections from outer island customers are not routinely monitored.

We recommend that management establish and enforce policies and procedures governing outer island collections. This matter was discussed in our previous letters to management for the audits of fiscal years 2007 through 2010.

- Returned checks receivable:

At September 31, 2011, MEC recorded \$63,067 of returned checks receivable. Of this amount, \$57,446 arose in prior years. Historically, no monitoring and reconciliation of the account occurred. In fiscal year 2011, the accountants attempted to monitor and reconcile but there does not appear to be a formal policy governing the monitoring and collection of returned checks.

We recommend that management establish related policies and procedures. This matter was discussed in our previous letter to management for the audits of fiscal years 2009 and 2010.

(2) Allowance for Doubtful Accounts

MEC does not currently have policies and procedures in place with respect to assessing the adequacy of the allowance for doubtful accounts. Audit adjustments were proposed to increase the allowance for doubtful accounts as of September 30, 2011.

We recommend that management establish policies and procedures governing the allowance for doubtful accounts including, but not limited to, reviewing aged accounts receivable reports on a monthly basis, identifying doubtful accounts, and monitoring accounts receivable statistics (e.g. days of sales outstanding, accounts receivable turnover) for significant fluctuations. This matter was discussed in our previous letters to management for the audits of fiscal years 2008 through 2010.

(3) Inventory

- Calculation of average fuel inventory cost:

MEC calculates average costs manually. We tested average costs and noted differences in the recalculated averages. Differences range from -1 to 13% of recalculated averages. The dollar equivalent of the difference approximates a \$332,000 understatement of the cost of fuel. For audit purposes, we proposed correction of the ending balance of fuel inventory, which corresponded with the recorded cost of fuel.

We recommend that management establish a more systematic calculation methodology.

- Update distribution and power plant inventory list:

We noted the following during our audit of distribution and power plant inventory:

- Items with zero costs
- Items with incorrect costs
- Quantities of items in the final inventory list differed from quantities per sample counts
- Items were counted but were not in the final inventory list
- Items with part numbers that differed with count sheets and the final inventory list

APPENDIX I, CONTINUED

The final September 30, 2011 inventory list was not updated for the inventory count results.

We recommend timely and periodic monitoring and reconciliation of the inventory list against the results of physical counts and inventory movements.

- Recording fixed gallons for fuel in pipes as inventory:

Fuel in the tank pipelines approximates 9,000 to 12,000 gallons. At a cost per gallon of \$3.1694, which is the latest price per invoice, 12,000 gallons in the pipelines approximates \$38,000. Inventory appears to be understated by this amount. We proposed an adjustment to correct the misstatement.

We recommend that management consider record existing inventory.

- Inventory cut-off procedures:

Lubricant inventories of \$49,259 were received on September 29, 2011 but were not recorded. We proposed a related adjustment to correct this misstatement.

We recommend that management monitor year end cut-off for inventory.

(4) Property, Plant and Equipment

- Periodic inventories of plant and equipment:

During fiscal year 2011, MEC conducted a physical count of vehicles; however, a physical count of all other fixed assets was not performed.

We recommend that management consider performing periodic physical counts and tagging all fixed assets. Furthermore, we recommend that management routinely update and reconcile the fixed asset register. Lack of a physical count of fixed assets was discussed in our previous letters to management for the audits of fiscal years 2007 through 2010.

- Review composition of costs of additions to property:

The annual \$12,588 maintenance cost for Utility Star Platinum was capitalized as part of software costs. We extrapolated the amount and proposed a related audit adjustment to correct this misstatement.

We recommend that management review the composition of capitalized property.

- Monitoring construction work-in-progress :

Construction work-in-progress (CWIP) at September 30, 2011 included a receivable of \$68,198 from RepMar that appears unrecoverable. We proposed a related adjustment to correct this misstatement. Invalid CWIP was discussed in our previous letter to management in the audits of fiscal years 2009 and 2010.

Monitoring the outer island fixed asset register:

A fixed asset register as of September 30, 2011 for outer island residential solar projects was not provided. Asset costs did not change from the prior year. Furthermore, the CWIP accounts for solar projects are not regularly reviewed and reconciled to identify completed projects or to identify invalid items.

We recommend that management support fixed asset costs, accumulated depreciation, and depreciation expense by a reconciled fixed asset register. We further recommend that management regularly review, reconcile, and evaluate the register for accuracy.

- Evaluation of long-lived assets:

GASB Statement No. 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries, states that if an event or circumstance indicates that a capital asset may be impaired, but the test of impairment determines that impairment has not occurred, the estimates used in depreciation calculations - remaining estimated useful life and salvage value - should be reevaluated and changed, if necessary. Although our evaluation of MEC's long-lived assets did not indicate that long-lived assets are impaired, we recommend that MEC consider the implication of GASB 42. This matter was discussed in our previous letters to management for the audits of fiscal years 2008 through 2010.

(5) Gross Revenue Tax (GRT)

- Clarification of potentially unreported revenue and exemption of certain sales from GRT:

GRT expense for fiscal year 2011 was understated by approximately \$137,000 due to unrecorded and unreported revenues. An adjustment was proposed to correct this misstatement. GRT was also understated in fiscal years 2009 and 2010. MEC has not filed an amended tax return for unreported revenues for fiscal years 2009 and 2010.

Taxable reported revenue excludes sales to Kwajalein Atoll Joint Utilities Resources (KAJUR). MEC does not consider sales of fuel to KAJUR as subject to GRT. MEC's position is that since KAJUR uses fuel to generate electricity and sales of electricity are not subject to GRT, no GRT should be charged on the sale of fuel to KAJUR. We believe that MEC's practice may be contestable because Section 122 of Income Tax law indicates "sales of electric...by public utility companies" as being exempt from GRT.

Except for the exclusion of sales to KAJUR, these matters were discussed in our previous letter to management for the audit of fiscal year 2009 and 2010.

We recommend that management require that revenue reported on GRT returns be reconciled to underlying accounting records and that returns be reviewed and approved prior to filing and payment. We further recommend that management file amended returns for unreported revenues. We also recommend that MEC obtain a formal position from the Republic of Marshall Islands Attorney General as to whether the entity's sale of fuel to KAJUR is exempt from GRT.

- Timely GRT filing:

During fiscal year 2011, MEC filed GRT returns after due dates and taxes were paid late as a result of cash flow issues. MEC incurred interest and penalties for late payments. This matter was discussed in our previous letter to management for the audit of fiscal year 2009 and 2010. We recommend that GRT returns be filed before deadlines.

(6) Liabilities

- Import tax payable:

At September 30, 2011, diesel import tax payable (A/c # 2120) of \$249,787 represented import taxes collected in previous years from a third party for remittance to tax authorities. We were informed that this account has not been reconciled; therefore, we were unable to ascertain whether the third party had been invoiced for and had paid all import taxes due. Furthermore, we were unable to ascertain whether taxes collected were remitted.

APPENDIX I, CONTINUED

We recommend that management investigate this account, including whether applicable taxes were billed, collected and remitted. This matter was discussed in our previous letter to management for the audit of fiscal years 2009 and 2010.

- Recorded liabilities:

At September 30, 2011, account number 2001 in the amount of \$76,197 represented withholding taxes collected in previous years. We were informed that this account has not been reconciled; therefore, we were unable to ascertain whether MEC remitted these withholding taxes.

At September 30, 2011, the composition of account number 2000 in the amount of \$110,476 cannot be determined. We were informed that this account has not been reconciled; therefore, we were unable to ascertain its validity.

We recommend that management investigate these accounts, including whether applicable taxes were billed, collected and remitted.

(7) Electric Revenue

- Timely adjustment of billing system for new tariffs:

Of 75 electricity billings tested, two were charged with a superseded tariff. Further investigation indicated that an update of the tariff in the system occurred a few days after it became effective.

We recommend timely update of tariffs and reviews of billings before finalization.

- Documentation trails:

Of 75 electricity billings tested, 24 dated between June and September 2011 were not traced to billings because MEC did not retain copies. All 75 billings tested could not be verified against underlying meter readings because raw data is not saved after billing uploading and processing. Further, there is no apparent monitoring of new meter connections, new accounts, disconnections and changes in status (e.g. active, inactive, active but nonbillable) apart from what is in the system. Two samples could not be resolved as to whether they were deactivated and when, and for one, whether it was moved to a different meter number. Connection documents cannot be provided for two items. One item was not billed for the month of May 2011 without adequate explanation.

We recommend that management maintain an audit trail of readings, billings and meter account changes outside of the UTP system to facilitate review and correction. We further recommend that meter accounts be periodically reviewed.

- Monitoring of free cash power issuances:

We scrutinized the list of cash power transactions for the months of June to September 2011 as extracted from the Suprima system. We noted that the total per month does not equal total monthly sales because transactions were issued without charge. Free issuances were not all accounted for.

We recommend that management monitor and reconcile cash power provided without charge.

(8) Fuel Revenue

- Documentation of negotiated prices:

Of 75 sample fuel sales, 31 were granted negotiated prices lower than published prices. The lower rates were not always supported by documented approvals. We could not locate a written policy documenting the basis of the lower rates, the authorized approver and the form of approval. The lower rates translated to an approximate amount of \$806,000.

A sale appears to have occurred at a negotiated price on December 30, 2010 at a price lower than the recalculated computed average cost.

We recommend that a policy be drafted and implemented relative to this matter. Also, MEC should evaluate the benefit of granting these discounts against lost revenues.

- Fuel releases:

Bulk delivery receipt (BDR) no. 2464 was issued on September 30, 2011, was signed by the customer and tank farm personnel on September 30, 2011 but was signed by security personnel on October 3, 2011. Security personnel are expected to approve the receipt before the release of fuel. Based on the documented signatures, approval occurred after the release of fuel.

Also, the last BDR for fiscal year 2011 was issued out of sequence. Per inquiry, this condition was a random error by tank farm personnel.

We recommend that MEC enforce existing approval policies.

(9) Expenses

- Monitoring fuel purchases and related file maintenance:

Initial tests of the cost of fuel resulted in an understatement of the cost of sales. The reason was due to unaccounted for purchases. Fuel purchases are not completely monitored. The remaining unexplained variance at September 30, 2011 is 12,518 gallons.

We recommend that MEC determine that all purchases are recorded and monitored.

SECTION II - OTHER MATTERS

Our observations concerning other matters related to operations, compliance with laws and regulations, and best practices involving internal control over financial reporting that we wish to bring to your attention at this time are as follows:

(1) Periodic Preparation of Financial Reports

For fiscal year 2011, there was no timely periodic closing, recording and review of accounting transactions. Based on scrutiny of fiscal year 2011 journal entries, we noted most entries were dated between August and October 2011. It appears that internal financial reports were not prepared and made available monthly. If any, the reports needed further reconciliation which the entity was able to finalize only at fiscal end. We suggest improvement in the preparation of monthly financial reports.

(2) Information Technology

MEC has not adopted formal policies and procedures governing information technology and data security. Consequently, passwords are not authenticated or strictly enforced in accordance with minimum standards of password length, strength, and lock-out attempts. Backups are not regularly performed and there is no offsite storage for back-ups. Further, back-up restoration is not routinely tested. We recommend that management adopt formal policies and procedures governing information technology and data security. We further noted that one username and password is utilized by the billing department to gain access to and edit electric customer database files. Such edits are not independently approved in writing. This matter was discussed in our previous letters to management for the audits of fiscal years 2008 through 2010.

We further noted that user accounts for NCS are still active and are used nineteen months after implementation of Sage MIP for the accounting system and nine months after implementation of UTP.

We recommend that user accounts be periodically reviewed and that passwords be routinely subject to change every ninety days. Additionally, appropriate back up routines should be documented and followed.

(3) Depreciation Rates

MEC is required to apply RUS-approved depreciation rates on all fixed assets. The list of approved depreciation rates could not be located. We recommend that this list be located and copies provided to accounting staff responsible for recording and depreciating fixed assets. This matter was discussed in our letters to management for the audits of fiscal years 2003 through 2010.

(4) Disconnection Policy

MEC's policy requires disconnection of customer accounts more than 30 days delinquent; however, the policy is not strictly enforced, resulting in collectability concerns over significant account balances. We recommend that management enforce its disconnection policy and require that authorized exceptions be documented on file. This matter was discussed in our previous letter to management for the audit of fiscal years 2009 and 2010.

(5) Segregation of Duties

Inadequate segregation of duties was noted in the following functions:

- Billing adjustment forms are initiated and posted to customer accounts by the same individual without independent review and approval.
- Adjustments to LPG/propane inventory by an individual who is also responsible for custody are not independently reviewed and approved. Furthermore, daily propane stock reports submitted to accounting are not independently verified to substantiate variances in actual and expected readings.

We recommend that management establish adequate controls to mitigate risks associated with the above incompatible functions. This matter was discussed in our previous letter to management for the audit of fiscal years 2009 and 2010.

(6) Statistical and Stock Reports

Monthly statistical and stock reports prepared and submitted to the main office by power generation and tank farm departments do not reflect current fuel and lubricant prices. We recommend that accounting personnel update the statistical and stock reports to reflect actual prices to provide more meaningful and useful information. This matter was discussed in our previous letter to management for the audit of fiscal years 2009 and 2010.

(7) Insurance Policies

Insurance policies in effect from October 2010 through June 2011 could not be located. Automobile insurance policies in effect from October through December 2010 could not be located.

(8) Retirement Savings Plan

Taxes are currently not being withheld on MEC's matching of employee contributions to the retirement plan. We recommend that management require that applicable taxes be withheld on employer matching of retirement plan contributions and be remitted to taxing authorities. This matter was discussed in our previous letter to management for the audit of fiscal year 2010.

SECTION III - DEFINITIONS

The definition of a deficiency that is established in AU 325, *Communicating Internal Control Related Matters Identified in an Audit*, is as follows:

A *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 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

MEC’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.