

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

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE
WITH ASPECTS OF CONTRACTUAL AGREEMENTS AND
REGULATORY REQUIREMENTS

YEAR ENDED SEPTEMBER 30, 2013

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH ASPECTS OF CONTRACTUAL AGREEMENTS AND REGULATORY REQUIREMENTS

Board of Directors
Marshalls Energy Company, Inc.:

We have audited, 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, the financial statements of the Marshalls Energy Company, Inc. (MEC), which comprise the statement of net position as of September 30, 2013, and the related statements of revenue and expenses, and changes in net position, and of cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated May 26, 2014. In accordance with *Government Auditing Standards*, we have also issued our report dated May 26, 2014, 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. No reports other than the reports referred to above and our schedule of findings and response related to our audit have been furnished to management.

In connection with our audit, we noted that MEC failed to comply with the terms, covenants, provisions, or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service Borrowers*, §1773.33 and clarified in the Rural Utilities Service (RUS) policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below:

RUS Grant Agreement

Criteria: The RUS Grant Agreement requires the following:

1. Section 10.4 of the grant award requires a matching contribution of 21% of the total project cost or \$631,000 of preferred match, whichever is less. The grant funds will be advanced on a pro rata basis with the expenditure of matching contributions over the life of the project or until the matching contribution is reached.
2. Section 10.6 requires that MEC shall report on the expenditure of Grant Funds and any non-Federal project funds in semi-annual financial reports and progress reports during the term of the grant. MEC shall attach Form SF 425 "Federal Financial Report" for these reports. Quarterly reports shall be due 30 days from the end of each quarter ending March 31, June 30, September 30, and December 31, of each year.
3. Adequate internal control policy should be adopted and established to facilitate compliance on Federal laws and regulations.

RUS Grant Agreement, Continued

Condition:

1. No information was available to support that MEC made a matching contribution as of September 30, 2013 except for the quarter ending June 30, 2013, which reflected of \$37,826. Based on actual disbursements as of September 30, 2013, MEC should have matched \$347,540, which results in questioned costs of \$309,714.
2. A SF 425 at September 30, 2013 was not available during the audit. In addition, no semi-annual financial or progress reports appear to have been submitted during the year.
3. WT # 105400 and 168260 were without formal invoices. Instead, a quotation previously received from the vendor supported the disbursement.
4. No procedure is in place to monitor receipt of delivered orders. Receiving reports are not filed.
5. MEC does not appear to have minimized the time elapsed between the transfer of funds from the grantor and payment to vendors as required by 31 CFR Part 205.10 of the US Department of Treasury. Payments to vendors range from 10 to 196 days after grant cash was received. Furthermore, \$404,006 of drawn cash is unexpended as of September 30, 2013.
6. MEC's fixed asset register does not provide sufficient information relative to monitoring management of Federal-funded fixed assets as required by 2 CFR Section 215.34. Furthermore, MEC does not have a formal accounting policy governing physical verification of fixed assets.

RUS Loan Agreement

Criteria: The RUS Loan Agreement requires the following:

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
Operating Debt Service Coverage (ODSC)	=	1.10

Condition: During the year ended September 30, 2013, MEC achieved the following average coverage ratios:

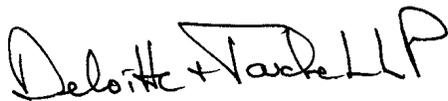
TIER	=	0.8
OTIER	=	(0.8)
ODSC	=	0.5

Our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding MEC's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with our audit, we noted no matters regarding MEC's accounting and records to indicate that MEC did not:

- Maintain adequate and effective accounting procedures
- Utilize adequate and fair methods for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts

- Reconcile continuing property records to the controlling general ledger plant accounts
- Clear construction accounts and accrue depreciation on completed construction
- Record and properly price the retirement of plant
- Seek approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap
- Maintain adequate control over materials and supplies
- Prepare accurate and timely Financial and Operating Reports
- Obtain written RUS approval to enter into any contract for the management, operation, or maintenance of the borrower's system if the contract covers all or substantially all of the electric system
- Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles
- Record depreciation in accordance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures)
- Comply with the requirements for the detailed schedule of deferred debits and deferred credits
- Comply with the requirements for the detailed schedule of investments.

The purpose of this report is solely to describe the scope of our testing of compliance, and the result of that testing, and not to provide an opinion on the compliance. Accordingly, this communication is not suitable for any other purpose.

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

May 26, 2014