

October 19, 2010

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 the Marshalls Energy Company (MEC) as of and for the year ended September 30, 2009 (on which we have issued our report dated October 19, 2010), 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, 2009 that we wish to bring to your attention.

We have also issued a separate report to the Board of Directors, also dated October 19, 2010, 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.

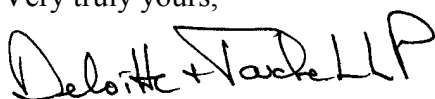
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with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

We identified, and have included below, deficiencies involving MEC's internal control over financial reporting as of September 30, 2009 that we wish to bring to your attention:

(1) Cash Receipts

Collections from outer islands customers are not routinely monitored. We recommend that management establish policies and procedures to document that collections from outer islands are accounted for. This matter was discussed in our previous letter to management for the audit of fiscal year 2008.

(2) Cash

We noted the following exceptions in our test of cash accounts:

- Evidence is on file that Bank of Marshall Islands received an MEC payroll account check (# 27142) on October 3, 2008 for MEC employee allotments; however, this check is included as an outstanding check in the September 2009 payroll account reconciliation.
- As of September 30, 2009, stale checks aggregated \$20,504 and this includes checks dating back to 2004.
- MEC's Bank of Guam time deposit account # 0405-058018, with a \$4,940 balance as of September 4, 2009, is not recorded in the general ledger.

We recommend that bank reconciling items be investigated and resolved in a timely fashion and that all valid cash accounts be recorded in the general ledger.

(3) Meter Reading Exception Reports

MEC's billing system generates meter reading exception reports that highlight excessively high or low meter readings. Such reports are not reviewed throughout the year, resulting in billing errors that require adjustments. We recommend that management establish policies and procedures governing the review of meter reading exception reports to facilitate accurate billing and reporting. This matter was discussed in our previous letter to management for the audit of fiscal year 2008.

(4) Returned Checks Receivable

At September 30, 2009, MEC recorded returned checks receivable (A/c #1260) of \$58,494. We were informed that returned checks are not monitored or reconciled. Further, the subsidiary ledger included two September 30, 2009 entries aggregating \$911 with no customer names. We recommend that management establish policies and procedures governing monitoring, reconciliation and collection of returned checks.

(5) Other Receivables

At September 30, 2009, other receivables included a customer A/c # 12191 'Miscellaneous' of \$13,865, which includes \$13,101 that is over a year old. We were informed that this customer account is utilized for non-recurring customers. Further, this account is not monitored or reconciled. We recommend that management establish policies and procedures governing monitoring, reconciliation and collection of these non-recurring balances.

(6) Allowance for Doubtful Accounts

MEC currently does not have policies and procedures in place with respect to estimating and recording an allowance for doubtful accounts. We recommend that management establish policies and procedures governing allowance for doubtful accounts, including, but not limited to, reviewing aged accounts receivable reports on a monthly basis, discussing specific accounts with the credit and collections department to identify doubtful accounts, and monitoring accounts receivable statistics (e.g., days sales outstanding, accounts receivable turnover) for significant fluctuations. An audit adjustment was proposed to increase the allowance for doubtful accounts as of September 30, 2009. This matter was discussed in our letter to management in the 2008 audit.

(7) Supplies Inventory

We noted the following exceptions in our test of supplies inventory:

- Count sheets for distribution inventory were not available.
- Of nine items tested for valuation, the cost of two items (part #s C0004BA and P163) did not include freight and other incidental charges. Further, we were informed that another item (part # ME0001D) had been purchased in fiscal year 2008; however, we were unable to trace the item to the 2008 inventory valuation report. Additionally, two power plant inventory items (part #s P163 and P192) were not included in the count sheets.

We recommend that management ensure that accurate counts sheets are retained and support recorded inventory and that inventory costs are accurate.

(8) Property, Plant and Equipment

We noted the following exceptions in our test of property, plant and equipment:

- During fiscal year 2009, MEC conducted a physical count of its vehicles. However, physical counts of all other fixed assets have not been performed.
- One addition (air conditioner costing \$1,089) on January 20, 2009 was incorrectly recorded in the general ledger and was not included in the fixed asset register. As the addition was not considered material to the financial statements, no audit adjustment was proposed.
- Construction-work-in-progress at September 30, 2009 included two accounts (#s 1500.999 and 1510) aggregating \$43,898 that do not appear to be valid. As these amounts were not considered material to the financial statements, no adjustments were proposed.

We recommend that management consider performing physical counts of all fixed assets. Further, we recommend that management ensure that the fixed asset register is routinely updated and reconciled. Lack of physical count of all fixed assets was discussed in our previous letters to management for the audits of fiscal years 2007 and 2008.

(9) 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 letter to management for the audit of fiscal year 2008.

(10) Fuel Sales

Sales to customers should be based on approved and published rates, with exceptions being approved by appropriate management. Of fifty-nine fuel sales items tested, management approval of rates for the following sales was not documented:

<u>Invoice #</u>	
A-055	30949
A-087	31290
A-931	31308
1044	31729
29738	31829
30278	32217
30501	32300
30539	32369

Payment for only 100 gallons of fuel was collected for a sale of 200 gallons (invoice # 31412); reason for the discrepancy was not documented.

We recommend that management implement policies and procedures governing adequate documentation of exceptions to published rates. This matter was discussed in our previous letters to management for the audits of fiscal years 2007 and 2008.

(11) Employee Benefits Expense

One item tested (check # 24561) was not supported by a vendor invoice. We recommend that management ensure that expenses are adequately supported.

(12) Gross Revenue Tax

We noted the following exceptions in our test of gross revenue tax (GRT):

- Quarterly GRT returns are due in the month following each quarter end; however, MEC filed and paid its GRT after deadlines as follows:

<u>Quarter End</u>	<u>Due Date</u>	<u>Date Filed</u>	<u>Date Paid</u>
9/30/2008	10/31/2008	10/31/2008	11/03/2008
12/31/2008	1/31/2009	2/17/2009	2/19/2009
3/31/2009	4/30/2009	4/30/2009	5/08/2009
6/30/2009	7/31/2009	9/07/2009	9/07/2009
9/30/2009	10/31/2009	10/30/2009	1/04/2010

MEC incurred penalty and interest charges as a result of late filing and payment.

- GRT expense recorded and paid for fiscal year 2009 was understated due to unrecorded and under-reported revenues. Further, GRT for quarter ended 9/30/2009 was not accrued. Audit adjustments were proposed to correct revenues and GRT expense and payable.

We recommend that management ensure that quarterly GRT returns are filed and paid when due. We further recommend that reported revenue is reconciled with accounting records and that tax returns are reviewed for accuracy and approved prior to filing and payment.

(13) Import Tax Payable

At September 30, 2009, diesel import tax payable (A/c # 2120) of \$273,023 represented import taxes collected from MEC's fuel co-purchaser (non-affiliate party) for remittance to tax authorities. Of the amount, \$230,753 originated from fiscal years prior to 2009. We were informed that this account is not monitored or reconciled; therefore, we were unable to ascertain whether the third party had been invoiced for and had paid all import taxes due. Further, we were unable to ascertain whether taxes collected were remitted.

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

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) Employee Evaluations

Employee evaluations are performed through verbal discussions with management. We recommend that MEC consider formalizing its employee evaluation process. This matter was discussed in our previous letter to management for the audit of fiscal year 2008.

(2) Information System

Passwords are not authenticated or strictly enforced in accordance with minimum standards of password length, strength, and lock out attempts. Further, there is no offsite storage for back-ups and restoration test of back-ups is not routinely performed. We recommend that management enforce password authentication and consider offsite storage and routine tests of back-ups. This matter was discussed in our previous letter to management for the audit of fiscal year 2008.

(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 previous letters to management for the audits of fiscal years 2003 through 2008.

(4) Disconnection Policy

MEC's policy requires disconnection of customer accounts more than 30 days delinquent; however, our test of delinquent accounts indicated that this policy is not strictly enforced. We recommend that management enforce the disconnection policy and ensure that authorized exceptions are documented on file.

(5) Segregation of Duties

Inadequate segregation of duties was noted in the following functions:

- Billing adjustments forms are initiated and posted to customer accounts by the same individual with no independent review and approval.
- Adjustments to LPG/propane inventory by the individual who is also responsible for its custody are not independently reviewed and approved.

We recommend that management establish adequate controls to mitigate risks associated with the above incompatible functions.

(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. Thus, these reports may not portray accurate power generation costs and stock value. We were informed by the above department personnel that accounting personnel do not rely on costs included in the reports but instead use the reports mainly to obtain quantities consumed and on hand. This was corroborated by accounting personnel who confirmed that they obtain costs from applicable vendor invoices when recording power generation costs and stock value. We recommend that the statistical and stock reports reflect actual prices to provide more meaningful and useful information.

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.