

February 29, 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, 2010 (on which we have issued our report dated February 29, 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, 2010 that we wish to bring to your attention.

We have also issued a separate report to the Board of Directors, also dated February 29, 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.

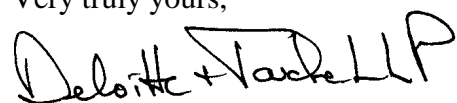
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with 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, 2010 that we wish to bring to your attention:

(1) Cash Receipts

Collections from outer island customers are not routinely monitored. We recommend that management establish policies and procedures requiring outer island collections to be accounted for and that the process is documented. This matter was discussed in our previous letters to management for the audits of fiscal years 2007 through 2009.

(2) Daily Cash Reports

Preparer and reviewer of the March 19, 2010 daily cash report did not affix their respective signatures on the report. We recommend that daily cash reports are signed to document preparer and verification by reviewer.

(3) Cash

MEC's Bank of Guam time deposit account # 0405-058018, with a \$4,959 balance as of September 30, 2010, is not recorded in the general ledger. We recommend that all valid cash accounts be recorded in the general ledger. This matter was discussed in our previous letter to management for the audit of fiscal year 2009.

(4) Returned Checks Receivable

At September 30, 2010, MEC recorded returned checks receivable (A/c # 1260) of \$57,446. We were informed that returned checks are not monitored or reconciled. Furthermore, the subsidiary ledger included four entries aggregating \$640 with no customer names. We recommend that management establish policies and procedures governing monitoring, reconciliation and collection of returned checks. This matter was discussed in our previous letter to management for the audit of fiscal year 2009.

(5) Allowance for Doubtful Accounts

MEC currently does not have policies and procedures in place with respect to assessing the adequacy of 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, identifying doubtful accounts, and monitoring accounts receivable statistics (e.g. days sales outstanding, accounts receivable turnover) for significant fluctuations. Audit adjustments were proposed to increase allowance for doubtful accounts as of September 30, 2010. This matter was discussed in our previous letters to management for the audits of fiscal years 2008 and 2009.

(6) Property, Plant and Equipment

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

- During fiscal year 2010, MEC conducted a physical count of vehicles; however, a physical count of all other fixed assets was not performed.
- Construction work-in-progress (CWIP) at September 30, 2010 includes an account (A/c # 1510) amounting to \$27,584 that does not appear to be valid. As this amount was not considered material to the financial statements, no adjustment was proposed.

(6) Property, Plant and Equipment, Continued

We recommend that management consider performing periodic physical counts and tagging of all fixed assets. Furthermore, we recommend that management require that the fixed asset register be routinely updated and reconciled. Lack of physical count of fixed assets was discussed in our previous letters to management for the audits of fiscal years 2007 through 2009. Invalid CWIP was discussed in our previous letter to management for the audit of fiscal year 2009.

(7) Property, Plant and Equipment

A fixed asset register as of September 30, 2010 for outer island residential solar projects was not provided by management. Asset cost did not change from the prior year. We recommend that management require that fixed asset cost, accumulated depreciation, and depreciation expense be supported by a reconciled fixed asset register.

Furthermore, the CWIP accounts for solar projects are not reviewed and reconciled on a regular basis to identify completed projects for transfer to fixed assets and to evaluate validity of recorded amounts. We recommend that management ensure that CWIP accounts are regularly reviewed, reconciled, and evaluated for accuracy.

(8) 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 and 2009.

(9) Gross Revenue Tax

Gross revenue tax (GRT) expense recorded for fiscal year 2010 was understated by approximately \$99,000 due to unrecorded and unreported revenues. As this amount was not considered material to the financial statements, no adjustment was proposed.

MEC has not filed an amended tax return for unreported revenues for fiscal year 2009. 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. This matter was discussed in our previous letter to management for the audit of fiscal year 2009.

(10) Import Tax Payable

At September 30, 2010, diesel import tax payable (A/c # 2120) of \$273,023 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 any taxes collected were remitted. 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 year 2009.

(11) Electric Revenue

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 significant billing errors that require adjustments. We recommend that management establish policies and procedures governing review of meter reading exception reports to facilitate accurate billing and reporting. This matter was discussed in our previous letters to management for the audits of fiscal years 2006 through 2009.

Furthermore, review and approval of monthly electric billing reports is not documented. We recommend that independent verification and approval of monthly billings reports be documented.

(12) Expenses

Of twenty expense items tested, the vendor invoice for one item (issuance slip # 6305; GLJan1013) was not provided. We recommend that management require that all expenses be supported.

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) 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. This matter was discussed in our previous letters to management for the audits of fiscal years 2008 and 2009.

We further noted that one username and password are utilized by the billing department to gain access to and edit electric customer database files. Such edits are not independently approved in writing.

(2) 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 2009.

(3) 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, resulting in collectibility concerns over significant account balances. We recommend that management enforce the 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 year 2009.

(4) 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 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. Furthermore, daily propane stock reports submitted to accounting are not independently verified to substantiate variances in actual and expected readings.
- Money bags are locked in an office safe and keys to the bags are kept by an individual who also has the combination numbers to the safe.

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 year 2009.

(5) 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 these departments' personnel that accounting does not rely on costs reflected 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. This matter was discussed in our previous letter to management for the audit of fiscal year 2009.

(6) Insurance Policies

Insurance policies in effect for fiscal year 2010 could not be located. We recommend that management require that copies of insurance policies be maintained on file.

(7) Related Party Transactions

The schedule of related party transactions provided by management included a non-affiliate receivable account and an affiliate receivable account balance that was not supported by the receivables subsidiary ledger. Affiliate balances disclosed in the notes to the 2010 financial statements were corrected; however, we recommend that management require that the schedule of related party transactions be accurate.

(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 remitted to the taxing authorities.

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.