

COMMONWEALTH UTILITIES CORPORATION

REPORT ON THE AUDIT OF FINANCIAL
STATEMENTS IN ACCORDANCE
WITH OMB CIRCULAR A-133

YEAR ENDED SEPTEMBER 30, 2002

COMMONWEALTH UTILITIES CORPORATION

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2002 AND 2001

INDEPENDENT AUDITORS' REPORT

Board of Directors
Commonwealth Utilities Corporation:

We have audited the accompanying statements of net assets of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), as of September 30, 2002 and 2001, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of CUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of 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 CUC's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Because of inadequacies in the accounting records and internal control, we were unable to determine that inventory, due from grantor agencies, utility plant and obligations under capital lease were fairly stated as of September 30, 2002 and 2001. In addition, we were unable to determine that accounts payable, accrued liabilities and accrued payroll were fairly stated at September 30, 2001. Furthermore, in our judgment, these balances materially affect the determination of results of operations and cash flows for the years ended September 30, 2002 and 2001. In addition, CUC management was unable to provide minutes of Board of Directors meetings subsequent to December 14, 2004. Accordingly, there was an incomplete record of management and Board of Directors' actions and decisions.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease as of September 30, 2002 and 2001 been determined, and had the propriety of accounts receivable, accounts payable, accrued liabilities and accrued payroll as of September 30, 2001 been determined, and their effect on the results of operations and cash flows, been determinable, and had we received minutes of the Board of Directors meetings subsequent to December 14, 2004 as discussed in the third paragraph, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in note 1 to the accompanying financial statements, CUC adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*.

The Management's Discussion and Analysis on pages 3 through 5 is not a required part of the basic financial statements but is supplementary information required by the GASB. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the Commonwealth Utilities Corporation's basic financial statements. The Statement of Revenues and Expenses on a Divisional Basis for the year ended September 30, 2002 (page 20) is presented for purposes of additional analysis and is not a required part of the basic financial statements. This supplementary information is the responsibility of the Commonwealth Utilities Corporation's management. The Statement of Revenues and Expenses on a Divisional Basis for the year ended September 30, 2002 has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, except as discussed in the third paragraph above, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

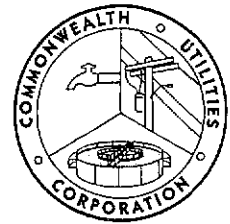
In accordance with *Government Auditing Standards*, we have also issued our report dated March 21, 2005, on our consideration of internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



March 21, 2005



Commonwealth Utilities Corporation



MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Commonwealth Utilities Corporation's (CUC) annual financial report presents the analysis of CUC's financial performance during the fiscal year ended September 30, 2002 as compared to fiscal year ended September 30, 2001. Please read it in conjunction with the financial statements, which follow this section.

	<u>2002</u>	<u>2001</u>
Assets		
Net utility plant	\$ 109,103,175	\$ 113,244,403
Current assets	39,570,265	36,002,501
Restricted assets	<u>7,902,199</u>	<u>7,188,372</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>

Net Assets and Liabilities

Net assets	\$ (4,294,157)	\$ 2,785,602
Long-term debt	7,672,884	8,761,219
Current liabilities	<u>153,196,912</u>	<u>144,888,455</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>

Revenues, Expenses and Changes in Net Assets

Operating revenues	\$ 70,153,781	\$ 68,338,849
Operating expenses	<u>72,312,473</u>	<u>75,335,977</u>
Loss from operations	<u>(2,158,692)</u>	<u>(6,997,128)</u>
Capital contributions	4,697,950	4,594,970
Interest income	399,110	794,168
Settlement income	-	5,950,000
Recovery of bad debts	-	1,747,674
Interest expense	(9,381,066)	(8,872,557)
Contribution to primary government	<u>(637,061)</u>	<u>(703,563)</u>
Total nonoperating revenues (expenses), net	<u>(4,921,067)</u>	<u>3,510,692</u>
Change in net assets	<u>\$ (7,079,759)</u>	<u>\$ (3,486,436)</u>

REQUIRED FINANCIAL STATEMENTS

CUC's accounting policies conform to accounting principles generally accepted in the United States of America, as applicable to government entities, specifically proprietary funds. CUC's activities are financed and operated in a manner similar to a business enterprise.

The Statement of Net Assets includes all of CUC's assets and liabilities associated with the operation of proprietary funds. It provides information about the nature and amount of investments in resources and the obligations to the creditors. Theoretically, net assets represent the resources an entity has left to use after its debts are settled. Those resources, however, may not always be available for spending; restrictions may be attached to them. To clarify these issues, net assets is divided into three categories: capital assets, net of related debt, which cannot be sold or converted to cash; restricted assets, which must be retained in perpetuity; and unrestricted net assets, which may be used in any purpose, but are not in a form that can be spent.

The Statement of Revenues, Expenses and Changes in Net Assets account for the all the revenues and expenses and gains and losses arising from the ongoing operations of CUC. This statement measures the success of CUC in using the resources committed to its operations. The components in this report are very important and can be used to predict future income and cash flows.

The Statement of Cash Flows provides information about the CUC's cash flows for the period classified according to four main categories: operating activities, noncapital financing activities, capital and related financing activities and investing activities. The statement reports the net cash provided by or used by each category and explains the net increase or decrease in cash and cash equivalents.

FINANCIAL ANALYSIS OF CUC AS A WHOLE

For the year ended September 30, 2002, CUC had a loss from operations of over \$2 million as compared to the September 30, 2001 loss from operations of over \$6.9 million.

During the year ended September 30, 2002, CUC operating revenues increased overall by about \$1.8 million (3 percent). Revenues increased for power, over \$1.2 million (2 percent), for water, about \$378,000 (5 percent), and for sewer, over \$8,500 (0.4 percent). The increase in power revenue is due primarily to the addition of one large tourist-related facility to the customer base. The increases in water and sewer revenues are attributable to increased customer billings. The decrease in franchise income is due to the establishment of the Commonwealth Telecommunications Commission (CTC) that replaced CUC. Since CTC now has oversight responsibility for telecommunications activities, it now collects the franchise fees associated with these activities.

During the year ended September 30, 2002, expenses decreased for production fuel by over \$5 million (15 percent) and for supplies by about \$101,000 (15 percent). Conversely, expenses increased for maintenance by about \$223,000 (2 percent) and for other production by over \$654,000 (17 percent) when compared to expenses for the year ended September 30, 2001.

Capital contributions received from direct grants from federal government and pass-thru grants received from the CNMI government amounted to about \$4.6 million for fiscal year 2002 as compared to over \$4.5 million for fiscal year 2001. These grants are used for capital improvement projects such as upgrading of power distribution lines, design and construction of waterlines and sewage system.

CUC received over \$5.9 million for the settlement of damages related to a power plant generator during the year ended September 30, 2001.

ECONOMIC FACTORS AND NEXT YEAR'S PLAN OF ACTION

In order to settle the \$61.5 million notes payable and related accrued interest payable of over \$68 million with the Commonwealth Development Authority (CDA), CUC and CDA have entered into a Memorandum of Agreement (MOA). The MOA provides for a waiver of a portion of the notes payable owed by CUC to CDA, certain specified interest payments and to convert the balance into equity ownership. CUC has been authorized to issue cumulative nonconvertible non-transferable preferred shares valued at \$45.5 million.

CUC management is looking at changing its regulations to aggressively approach its accounts receivable issues, especially with the CNMI Government.

CONTACTING CUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide CUC's rate payers and creditors with a general overview of CUC's finances and to demonstrate CUC's accountability for the money it receives. If you have questions about this report, or need additional information, contact CUC's Comptroller at Commonwealth Utilities Corporation, P.O. Box 501220, Saipan MP 96950, at telephone number (670) 235-7025 or e-mail ssamari@cuc.gov.mp.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Assets
September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
<u>ASSETS</u>		
Utility plant:		
Electric plant	\$ 113,875,907	\$ 107,377,339
Water plant	57,003,580	55,414,456
Sewer plant	21,810,302	20,132,601
Administrative equipment	4,247,150	4,326,926
Construction work in progress	<u>9,210,617</u>	<u>15,971,168</u>
	206,147,556	203,222,490
Less accumulated provision for depreciation	<u>(97,044,381)</u>	<u>(89,978,087)</u>
Net utility plant	<u>109,103,175</u>	<u>113,244,403</u>
Current assets:		
Cash and cash equivalents	<u>14,887,833</u>	<u>14,572,414</u>
Accounts receivable:		
Utility	26,658,256	24,022,809
Other	<u>2,043,918</u>	<u>2,165,789</u>
	28,702,174	26,188,598
Less accumulated provision for uncollectible accounts	<u>(16,215,304)</u>	<u>(14,742,373)</u>
Net accounts receivable	<u>12,486,870</u>	<u>11,446,225</u>
Inventory, less allowance for obsolescence inventory of \$1,159,467 in 2002 and 2001	<u>10,973,209</u>	<u>9,983,862</u>
Due from grantor agencies	<u>1,222,353</u>	<u>-</u>
Total current assets	<u>39,570,265</u>	<u>36,002,501</u>
Restricted assets:		
Cash and cash equivalents	1,802,686	7,188,372
Time certificates of deposit	<u>6,099,513</u>	<u>-</u>
Total restricted assets	<u>7,902,199</u>	<u>7,188,372</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Assets, Continued
September 30, 2002 and 2001

NET ASSETS AND LIABILITIES

	<u>2002</u>	<u>2001</u>
Net assets:		
Investment in capital assets, net of related debt	\$ 38,707,165	\$ 42,125,434
Restricted	7,902,199	7,188,372
Unrestricted	<u>(50,903,521)</u>	<u>(46,528,204)</u>
Total net assets	<u>(4,294,157)</u>	<u>2,785,602</u>
Long-term debt:		
Obligations under capital lease, less current maturities	7,426,149	8,473,332
Loan payable less current maturities	246,735	287,887
Compensated absences, less current portion	<u>337,489</u>	<u>202,666</u>
	<u>8,010,373</u>	<u>8,963,885</u>
Commitments and contingencies		
Current liabilities:		
Current maturities of long-term debt	61,609,902	61,607,527
Current obligations under capital lease	1,113,224	750,223
Accounts payable	7,274,818	9,615,752
Accrued liabilities	1,178,298	103,331
Accrued payroll	754,379	204,840
Compensated absences, current portion	702,682	676,560
Deferred revenue	-	110,165
Customer deposits	7,740,558	7,654,130
Due to primary government	3,997,847	3,420,786
Interest payable	<u>68,487,715</u>	<u>60,542,475</u>
Total current liabilities	<u>152,859,423</u>	<u>144,685,789</u>
	<u>\$ 156,575,639</u>	<u>\$ 156,435,276</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Operating revenues:		
Power	\$ 59,149,741	\$ 57,869,281
Water	7,897,698	7,519,825
Sewer	2,178,191	2,169,662
Franchise income	-	209,599
Other	<u>928,151</u>	<u>570,482</u>
Total operating revenues	<u>70,153,781</u>	<u>68,338,849</u>
Operating expenses:		
Production fuel	27,553,429	32,591,674
General and administrative	18,907,336	18,609,111
Maintenance	9,745,199	9,522,327
Depreciation	9,271,636	8,552,050
Other production	4,442,408	3,787,981
Bad debts	1,764,084	1,043,486
Supplies	586,206	687,914
Other	<u>42,175</u>	<u>541,434</u>
Total operating expenses	<u>72,312,473</u>	<u>75,335,977</u>
Loss from operations	<u>(2,158,692)</u>	<u>(6,997,128)</u>
Nonoperating revenues (expenses):		
Interest income	399,110	794,168
Settlement income	-	5,950,000
Recovery of bad debts	-	1,747,674
Interest expense	(9,381,066)	(8,872,557)
Contribution to the primary government	<u>(637,061)</u>	<u>(703,563)</u>
Total nonoperating revenues (expenses), net	<u>(9,619,017)</u>	<u>(1,084,278)</u>
Net loss before capital contributions	(11,777,709)	(8,081,406)
Capital contributions	<u>4,697,950</u>	<u>4,594,970</u>
Change in net assets	(7,079,759)	(3,486,436)
Net assets - beginning	<u>2,785,602</u>	<u>6,272,038</u>
Net assets - ending	\$ <u>(4,294,157)</u>	\$ <u>2,785,602</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Cash received from customers	\$ 67,435,481	\$ 74,817,469
Cash payments to suppliers for goods and services	(50,172,421)	(55,503,906)
Cash payments to employees for services	(13,734,382)	(13,223,110)
Net cash provided by operating activities	<u>3,528,678</u>	<u>6,090,453</u>
Cash flows from noncapital financing activities:		
Payments to primary government	<u>(60,000)</u>	<u>(59,999)</u>
Net cash used for noncapital financing activities	<u>(60,000)</u>	<u>(59,999)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(5,130,408)	(7,649,802)
Capital contributions	4,697,950	4,594,970
Principal repayment of debt	(722,959)	(119,847)
Interest paid on outstanding debt	(1,435,826)	(1,666,196)
Net disbursements for capital grants	(247,299)	644,874
Increase in restricted assets	(713,827)	(1,004,128)
Net cash used for capital and related financing activities	<u>(3,552,369)</u>	<u>(5,200,129)</u>
Cash flows from investing activities:		
Interest received on time certificates of deposit	<u>399,110</u>	<u>794,168</u>
Net cash provided by investing activities	<u>399,110</u>	<u>794,168</u>
Net increase in cash and cash equivalents	315,419	1,624,493
Cash and cash equivalents at beginning of year	<u>14,572,414</u>	<u>12,947,921</u>
Cash and cash equivalents at end of year	<u>\$ 14,887,833</u>	<u>\$ 14,572,414</u>
Reconciliation of loss from operations to net cash provided by operating activities:		
Loss from operations	\$ (2,158,692)	\$ (6,997,128)
Adjustments to reconcile loss from operations to net cash provided by operating activities:		
Depreciation	9,271,636	8,552,050
Provision for bad debts	1,764,084	1,043,486
Recovery of bad debts	-	1,747,674
Settlement income	-	5,950,000
(Increase) decrease in assets:		
Accounts receivable:		
Utility	(2,926,600)	(1,420,751)
Other	121,871	(111,126)
Inventory	(989,347)	(352,982)
Increase (decrease) in liabilities:		
Accounts payable	(2,340,934)	(1,957,326)
Accrued liabilities	150,693	(201,632)
Accrued payroll	549,539	(474,635)
Customer deposits	<u>86,428</u>	<u>359,515</u>
Net cash provided by operating activities	<u>\$ 3,528,678</u>	<u>\$ 6,137,145</u>
Supplemental disclosure of noncash capital and related financing and operating activities:		
Accrual of progress billings related to various ongoing capital projects:		
Noncash increase in due from grantor agencies	\$ 1,085,219	\$ -
Noncash increase in accrued liabilities	<u>(1,085,219)</u>	<u>-</u>
	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(1) Organization and Summary of Significant Accounting Policies

The Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), was established as a Public Corporation by CNMI Public Law 4-47, as amended by Public Law 5-47, effective October 1, 1985, and began operations on October 1, 1987. CUC was given responsibility for supervising the construction, maintenance, operations, and regulation of all utility services, including power, sewage, refuse collection, telephone, cable television, and water, provided however, that whenever feasible, CUC shall contract for private businesses to assume its duties with respect to one or more of these divisions. CUC was also designated the responsibility to establish rates, meter, bill and collect fees in a fair and rational manner from all customers of utility services in order for CUC to become financially independent of appropriations by the CNMI Legislature. CUC is governed by a nine-member Board of Directors, appointed for terms of four years by the Governor of the CNMI.

Public Law 4-47 effected transfer to CUC of identifiable assets, liabilities, operations, and unexpended capital improvement funding allocations formerly administered directly by the CNMI Department of Public Works.

The accounting policies of CUC conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. CUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

New Accounting Standards

GASB has issued Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*. These statements establish financial reporting standards for governmental entities which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements. CUC adopted GASB Statement No. 34, as amended by GASB Statement No. 37, and certain provisions of GASB Statement No. 38 in fiscal year 2002.

To conform to the requirements of GASB 34, the following changes have been made to CUC's financial statements:

- Retained earnings have been reclassified into the following net assets categories:
 - Investment in capital assets net of related debt; capital assets, net of accumulated depreciation, less outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(1) Organization and Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- Restricted:
 - Nonexpendable - Net assets subject to externally imposed stipulations that CUC maintain them permanently. For the years ended September 30, 2002 and 2001, CUC does not have nonexpendable net assets.
 - Expendable - Net assets whose use by CUC is subject to externally imposed stipulations that can be fulfilled by actions of CUC pursuant to those stipulations or that expire by the passage of time.
- Unrestricted; net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.
- The statement of cash flows has been presented using the direct method.

For fiscal year 2005, CUC will be implementing GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)* and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. As of September 30, 2002, CUC has not evaluated the financial statement impact of GASB Statement Nos. 40 and 42.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included on the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets.

The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. Revenues are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued for each cycle based on the most recent cycle billing.

Budgets

In accordance with CNMI Public Law 3-68, the Planning and Budgeting Act of 1983, CUC submits annual budgets to the CNMI Office of the Governor.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(1) Organization and Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents and Time Certificates of Deposit

For purposes of the statements of net assets and cash flows, cash and cash equivalents and restricted cash and cash equivalents are defined as cash on hand, cash in checking and savings accounts, and short-term time certificates of deposit with a maturity date within three months of the date acquired. Time certificates of deposit with original dates greater than ninety days are separately classified on the statement of net assets. At September 30, 2002 and 2001, cash and cash equivalents were \$16,690,519 and \$21,760,786, respectively, and the corresponding bank balances were \$16,803,863 and \$21,850,546, respectively. Of the bank balance amounts, \$16,803,863 and \$21,850,546 are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance as of September 30, 2002 and 2001, respectively. Bank deposits in the amount of \$200,000 and \$186,661 were FDIC insured as of September 30, 2002 and 2001, respectively. CNMI law does not require component units to collateralize their bank accounts and thus, CUC's deposits in excess of FDIC insurance are uncollateralized.

Time certificates of deposit of \$6,099,513 as of September 30, 2002 and cash and cash equivalents of \$1,742,536 and \$6,874,265 as of September 30, 2002 and 2001, respectively, represent customer deposits, which must be segregated pursuant to CUC policy, and accordingly, are classified as restricted in the accompanying financial statements. Cash and cash equivalents of \$60,150 and \$314,107 as of September 30, 2002 and 2001, respectively, represent advances from a grantor agency for the use on a specific project and, accordingly, are classified as restricted in the accompanying financial statements.

Receivables and Allowance for Doubtful Accounts

CUC provides utility services to customers within the CNMI and bills for these services on a monthly basis. The accumulated provision for uncollectible accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense.

Inventory

Inventories of fuel are valued at the lower of cost (first-in, first-out) or market (net realizable value). Inventories of supplies and materials are valued at average cost.

Utility Plant and Depreciation

Utility plant are stated at cost, where available. Cost of certain utility plant transferred from the CNMI Department of Public Works, is based on contract amounts to construct certain utility plant. Depreciation is calculated on the straight-line method based on the estimated useful lives of the respective assets. Current policy is to capitalize items in excess of \$300.

Capitalization of Interest

CUC capitalizes interest in order to recognize all costs associated with non-contributed construction projects based on CUC's weighted average borrowing rate. During the years ended September 30, 2002 and 2001, eligible interest expense was not considered significant and consequently no interest has been capitalized.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(1) Organization and Summary of Significant Accounting Policies, Continued

Retirement Plan

CUC contributes to the Northern Mariana Islands Retirement Fund (the Fund), a cost-sharing multiple employer defined benefit pension plan administered by the CNMI. The Fund provides retirement, security and other benefits to employees, and their spouses and dependents, of the CNMI Government and CNMI agencies, instrumentalities, and public corporations. CNMI Public Law 6-17, the Northern Mariana Retirement Fund Act of 1988 assigns the authority to establish and amend benefit provisions to the Fund's Board of Trustees. The Fund issues a publicly available financial report that includes financial statements and required supplementary information for the Fund. That report may be obtained by writing to the Northern Mariana Islands Retirement Fund, P.O. Box 501247, Saipan, MP, 96950-1247.

Plan members are required to contribute 6.5% and 9.0% of their annual covered salary for Class I and Class II members, respectively, and CUC is required to contribute at an actuarially determined rate. The current rate is 26.4% of annual covered payroll. The contribution requirements of plan members and CUC are established and may be amended by the Fund's Board of Trustees. CUC's contributions to the Fund for the years ended September 30, 2002, 2001 and 2000 were \$2,620,144, \$2,731,623, and \$2,687,910, respectively, equal to the required contributions for each year.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefits accrue to employees. The liability at September 30, 2002 and 2001 amounted to \$1,040,171 and \$879,226, respectively. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The sick pay benefit liability as of September 30, 2002 and 2001, was approximately \$2,287,928 and \$2,004,456, respectively.

Franchise Income

Franchise income was received from a local telecommunications company for the right to provide telecommunication services within the CNMI. In February 2001, the CNMI established the Commonwealth Telecommunications Commission (CTC), which was tasked to regulate telecommunication services in the CNMI. CTC began receiving the franchise income in February, 2001.

(2) Due From (Deferred Revenue) Grantor Agencies

CUC is a subrecipient of federal grants received by the CNMI from various U.S. federal agencies. CUC follows the accounting principle generally accepted in the United States of America of recording grants-in-aid for construction or acquisition of facilities and equipment as contributions. Excess grant disbursements over receipts are recognized as due from grantor agencies until funds are received in accordance with grant terms and conditions.

Changes in the due from (deferred revenue) grantor agencies accounts for the years ended September 30, 2002 and 2001, are as follows:

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(2) Due From (Deferred Revenue) Grantor Agencies, Continued

	<u>2002</u>	<u>2001</u>
Balance at beginning of year	\$ (110,165)	\$ 534,709
Adjustments	418,434	(124,167)
Deductions - cash receipts from grantor agencies	(3,783,866)	(5,200,536)
Additions - program outlays	<u>4,697,950</u>	<u>4,679,829</u>
Balance at end of year	\$ <u>1,222,353</u>	\$ <u>(110,165)</u>

(3) Utility Plant

Utility plant at September 30, 2002 and 2001, consists of the following:

	Estimated Useful Lives	Balance at October 1,2001	Additions	Deletions	Adjustments/ Reclassifications	Balance at September 30, 2002
Utility plant:						
Electric plant	20 years	\$ 107,377,339	\$ 1,076,044	\$ (373)	\$ 5,422,897	\$ 113,875,907
Water plant	20 years	55,414,456	4,308,952	-	(2,719,828)	57,003,580
Sewer plant	20 years	20,132,601	1,688,018	-	(10,317)	21,810,302
Administrative equipment	3 - 5 years	<u>4,326,926</u>	<u>344,626</u>	-	<u>(424,402)</u>	<u>4,247,150</u>
		187,251,322	7,417,640	(373)	2,268,350	196,936,939
Less accumulated provision for depreciation		<u>(89,978,087)</u>	<u>(9,271,636)</u>	<u>373</u>	<u>2,204,969</u>	<u>(97,044,381)</u>
		97,273,235	(1,853,996)	-	4,473,319	99,892,558
Construction work in progress		<u>15,971,168</u>	-	-	<u>(6,760,551)</u>	<u>9,210,617</u>
		\$ <u>113,244,403</u>	\$ <u>(1,853,996)</u>	\$ <u>-</u>	\$ <u>(2,287,232)</u>	\$ <u>109,103,175</u>
		Balance at October 1, 2000	Additions	Deletions	Adjustments/ Reclassifications	Balance at September 30, 2001
Utility plant:						
Electric plant	20 years	\$ 105,998,553	\$ 6,710,923	\$ -	\$ (5,332,137)	\$ 107,377,339
Water plant	20 years	50,297,630	8,563,687	-	(3,446,861)	55,414,456
Sewer plant	20 years	16,783,489	3,349,112	-	-	20,132,601
Administrative equipment	3 - 5 years	<u>4,032,335</u>	<u>406,713</u>	<u>(15,995)</u>	<u>(96,127)</u>	<u>4,326,926</u>
		177,112,007	19,030,435	(15,995)	(8,875,125)	187,251,322
Less accumulated provision for depreciation		<u>(81,452,997)</u>	<u>(8,552,050)</u>	<u>15,995</u>	<u>10,965</u>	<u>(89,978,087)</u>
		95,659,010	10,478,385	-	(8,864,160)	97,273,235
Construction work in progress		<u>18,487,641</u>	-	-	<u>(2,516,473)</u>	<u>15,971,168</u>
		\$ <u>114,146,651</u>	\$ <u>10,478,385</u>	\$ <u>-</u>	\$ <u>(11,380,633)</u>	\$ <u>113,244,403</u>

(4) Notes Payable

A schedule of CUC's long-term debt as of September 30, 2002 and 2001, is as follows:

	<u>2002</u>	<u>2001</u>
Promissory note payable to the Commonwealth Development Authority (CDA), a component unit of the CNMI. Principal amount available to \$30,000,000, interest at 7% per annum, with a maturity date of February 17, 2013. Principal and interest payments are due in quarterly payments of \$658,469.	\$ 30,000,000	\$ 30,000,000

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(4) Notes Payable, Continued

	<u>2002</u>	<u>2001</u>
Promissory note payable to CDA. Principal amount available to \$16,135,650, interest at 5% per annum, with a maturity date of January 12, 2014. Principal and interest payments are due in quarterly payments of \$359,514.	16,068,750	16,068,750
Promissory note payable to CDA. Principal amount available to \$5,500,000, interest at 7% per annum, with a maturity date of January 30, 2000. Principal and interest payments are due in quarterly payments of \$276,471.	5,500,000	5,500,000
Promissory note payable to CDA. Principal amount available to \$10,000,000 and interest at 7% per annum. Principal and interest payments are due in monthly payments of \$58,509. No promissory agreement related to this note has been signed.	<u>10,000,000</u>	<u>10,000,000</u>
	<u>\$ 61,568,750</u>	<u>\$ 61,568,750</u>

At September 30, 2002 and 2001, and subsequent to that date, CUC was in default of repayment terms of all notes payable to CDA. In accordance with the associated loan agreements, in the event of default, CDA may accelerate all remaining amounts due. Thus, \$61,568,750 at September 30, 2002 and 2001, associated with the notes payable to CDA along with interest payable on these notes of \$68,487,715 and \$60,542,475 as at September 30, 2002 and 2001, respectively, has been classified as current liabilities within the accompanying financial statements.

(5) Loan Payable

On June 29, 1988, the CNMI executed a loan contract with the United States Department of Agriculture, Farmers Home Administration in the amount of \$1,033,400. The loan contract bears interest at 6.125% per annum with repayments due on January 1 beginning in 1989 and continuing through 2008. Proceeds of the loan are to be used for the acquisition and construction of improvements and replacements to the Saipan Water System, which is administered by CUC. CUC is required to deposit all water system revenue and funds it receives through the "Covenant to Establish a CNMI in Political Union With the United States of America (the Covenant)" into a water system revenue fund to provide for repayment of the loan. As of September 30, 2002 and 2001, CUC had not established the required water system revenue fund but has established separate general ledger accounts to summarize water system revenues and Covenant funds. It is CUC's intention to repay the loan from these sources and management is of the opinion that its process of accounting for water system revenues and Covenant funds is in compliance with the intent of the loan agreement.

The following summarizes this loan payable as of September 30, 2002 and 2001:

	<u>2002</u>	<u>2001</u>
Loan payable to the U.S. Department of Agriculture with repayments due on January 1, beginning in 1989 through 2008, bearing interest at 6-1/8% per annum.	\$ 287,887	\$ 326,664
Less current portion	<u>41,152</u>	<u>38,777</u>
Long-term loan payable	<u>\$ 246,735</u>	<u>\$ 287,887</u>

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(5) Loan Payable, Continued

Future repayment commitments of principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2003	\$ 41,152	\$ 17,633	\$ 58,785
2004	43,672	15,113	58,785
2005	46,347	12,438	58,785
2006	49,186	9,599	58,785
2007	52,199	6,586	58,785
2008	<u>55,331</u>	<u>3,389</u>	<u>58,720</u>
	<u>\$ 287,887</u>	<u>\$ 64,758</u>	<u>\$ 352,645</u>

(6) Primary Government Funding

Public Law 9-66, enacted October 19, 1995, requires government agencies to pay the Commonwealth Treasurer an amount not less than the greater of 1% of its total operations budget from sources other than legislative appropriations or pursuant to any other formula, which the Public Auditor and the agency may agree, to fund the Office of the Public Auditor (OPA). At September 30, 2002 and 2001, CUC had an outstanding payable to the primary government in the amount of \$3,997,847 and \$3,420,786, respectively.

(7) Capital Lease

On June 10, 1997, CUC entered into an agreement with a contractor for the construction, maintenance and operation, and transfer of ownership of a 10 Megawatt Power Plant on the island of Tinian. The agreement is for a guaranteed price of \$9,959,000 plus interest and fees of \$11,641,000 payable over ten years in equal monthly installments of \$180,000. During this period, the contractor will maintain and operate the power plant and be paid operation, production and maintenance fees of \$50,000 per month in addition to the guaranteed price. Additionally, CUC will pay a production fee of two cents (\$0.02) per plant-produced kilowatt hour for as long as the operations and maintenance portion of the contract is in effect. The power plant will be turned over to CUC at the end of the ten year period from the date of substantial completion. On December 13, 1998, CUC executed a change order to expand the 10 Megawatt Power Plant to 30 Megawatts. Such expansion is to be fulfilled within the ten-year period as stated in the original agreement. On May 10, 2001, CUC executed another change order (Expanded Agreement) to extend the term of the original agreement to be effective upon the execution of the expanded agreement until the later of March 31, 2020 or the completion of the term as mutually agreed upon. The expanded agreement provides for CUC to pay a base loan rate of \$0.03 plus applicable price adjustments per kilowatt-hour CUC uses each month effective March 1, 2009 until March 31, 2020. Additionally, the contractor will operate and maintain the existing distribution system of CUC for the duration of the expanded agreement at no cost to CUC. During the term of the expanded agreement, CUC is not allowed to purchase electric energy from any other producer other than the contractor for the island of Tinian.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(7) Capital Lease, Continued

CUC implemented accounting guidance of Emerging Issues Task Force (EITF) Issue No. 01-8, which provides guidance in determining when purchase agreements may be subject to lease accounting. CUC has determined that the agreement to purchase electricity is in fact a capital lease to acquire the plant and that the capacity payments made under the agreement are lease payments. The operation, production and maintenance payments and production fees under the agreement are reflected as energy conversion costs under other production expense.

The effects of adopting EITF No. 01-8 were to increase plant and obligations under capital lease by \$9,959,000. CUC has not obtained the actual cost of the power plant and has not obtained an appraisal to determine the fair value of the leased property, which is required by accounting principles generally accepted in the United States of America. As a result, management has not been able to assess its compliance with the EITF requirements and the impact of this matter on the accompanying financial statements is uncertain. The lease has an effective interest rate of 18%.

CUC may, without penalty, discharge the entire outstanding balance of the guaranteed price by paying a discounted amount equal to the adjusted guaranteed price as follows:

<u>Period</u>	<u>Amount</u>
End of year 4	\$ 8,821,000
End of year 5	\$ 7,750,000
End of year 6	\$ 6,540,000
End of year 7	\$ 5,200,000
End of year 8	\$ 3,900,000

CUC entered into a capital lease agreement with a contractor for a generator. The agreement is for a guaranteed price of \$485,000, payable over two years in monthly installments of \$10,000, inclusive of interest, with a final payment of \$245,000 on March 20, 2003.

The annual requirement to amortize all debt of CUC outstanding as of September 30, 2002 is as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2003	\$ 1,113,224	\$ 1,417,817	\$ 2,531,041
2004	888,122	1,271,878	2,160,000
2005	1,062,758	1,097,242	2,160,000
2006	1,271,733	888,267	2,160,000
2007	1,521,801	638,199	2,160,000
2008 - 2009	<u>2,681,735</u>	<u>378,269</u>	<u>3,060,004</u>
	\$ <u>8,539,373</u>	\$ <u>5,691,672</u>	\$ <u>14,231,045</u>

(8) Settlement Income

CUC received \$5,950,000 for the settlement of damages related to a generator during the year ended September 30, 2001.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(9) Commitments and Contingencies

Commitments

CUC has entered into a commitment to borrow \$89,000,000 from the Commonwealth Development Authority for proposed capital improvement projects. As of September 30, 2002 and 2001, CUC had entered into promissory note agreements for \$30,000,000, \$16,135,650, and \$5,500,000 against the \$89,000,000. Although CUC retains the ability to borrow, management does not believe that future borrowing will occur.

On September 23, 1996, CUC entered into an agreement with a third party for the purchase of electric power and associated services. The agreement provides for a monthly minimum purchase of 7,300,000 kilowatt-hours (KWH) at \$0.033 per KWH after January 1, 1998. Additionally, the agreement provides for periodic adjustment of the prices agreed upon but not to exceed 10% of the price then in effect. The agreement will expire on July 31, 2006 and renewable for an additional ten year period to expire on July 31, 2016. Future minimum commitments related to the purchase of electric power are as follows:

<u>Year ending September 30,</u>	<u>Minimum Payment</u>
2003	\$ 2,960,880
2004	3,101,040
2005	3,101,040
2006	<u>2,584,200</u>
	<u>\$ 11,747,160</u>

Contingencies

CUC entered into certain memorandums of understanding (MOUs) with developers who paid CUC sewer connection fees in excess of that required by CUC's regulations. To the extent that CUC has not complied with obligations imposed on it by the MOUs (i.e., depositing the contributions in a special fund, making accountings, and spending the contributions for specified capital improvement projects), developers could consider CUC to have breached the terms of the MOUs. The maximum amount that CUC could be required to expend pursuant to the MOUs is \$3,027,951. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

CUC currently does not maintain insurance coverage with respect to its inventory and utility plant. In the event of a loss, CUC will be self insured for the entire amount. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

CUC participates in a number of federally assisted grant programs funded by the United States Government. These programs are subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Cumulative questioned costs of \$251,166 have been set forth in CUC's Single Audit Report for the year ended September 30, 2002. The ultimate disposition of these questioned costs can be determined only by final action of the respective grantor agencies. Therefore, no provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(10) Subsequent Events

On November 21, 2002, a Memorandum of Agreement (MOA) was established between CDA and CUC to waive a portion of the notes payable to CDA and the conversion into equity ownership of the balance. Public Law 13-35 effectuated terms of the MOA allowing CDA to waive \$16,068,750 and waive certain specified interest payments and for other purposes. Public Law 13-36 effectuated terms of the MOA by authorizing CUC to issue shares to CDA of cumulative nonconvertible non-transferable preferred stock valued at \$45,500,000. At September 30, 2002, terms of the MOA are being negotiated between CDA and CUC and thus debt has not been waived and preferred stock has not been issued.

In January 2004, the Memorandum of Agreement (MOA), entered into on November 21, 2002 between CUC and CDA was amended to exclude a certain provision requiring CUC to obtain legislative approval for rate increases. As terms of the MOA are in the process of negotiations, no adjustments have been made to the accompanying financial statements.

On October 26, 2004, CUC published proposed amendments to the Electrical Service Regulations (ESR) for a fuel surcharge. The regulation limited the fuel surcharge to a maximum of 3.5 cents per kilowatt hour (kwh) for the first calendar year after adoption of the regulation, but allowed for full cost recovery in subsequent calendar years. The regulation includes an exception, required by statute, limiting the annual increase for low volume users. After notices and hearings, the fuel surcharge was adopted in January 2005. The final regulation was published on February 17, 2005 and became effective by operation of law on February 28, 2005. As a result of the regulation being finalized in 2005, the 3.5 per kwh cents cap on the surcharge will remain in effect until the end of calendar year 2005. For calendar year 2006, the formula included in the fuel surcharge regulation will be applied to establish a new ceiling and the fuel surcharge may be increased to that ceiling over the course of the year.

During the year ended September 30, 2003, CUC and the CNMI Government, with the concurrence of OPA, offset a portion of the liability related to CNMI OPA funding against utility receivables of the CNMI Government. The offset was performed through an exchange of checks for \$3,997,847.

COMMONWEALTH UTILITIES CORPORATION

Statement of Revenues, Expenses and Changes in Net Assets on a Divisional Basis
Year Ended September 30, 2002

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses (1)	Total
Operating revenues:						
Governmental:						
CNMI Government	\$ 6,152,925	\$ 2,131,211	\$ 907,320	\$ -	\$ -	\$ 9,191,456
CNMI agencies	4,101,469	904,320	443,177	-	(2,504,783)	2,944,183
Total governmental	10,254,394	3,035,531	1,350,497	-	(2,504,783)	12,135,639
Commercial	33,994,923	2,058,569	714,470	-	-	36,767,962
Residential	16,822,013	2,802,551	113,131	-	-	19,737,695
Grants and contributions	583,194	1,047	93	-	-	584,334
Other	-	-	-	928,151	-	928,151
Total operating revenues	61,654,524	7,897,698	2,178,191	928,151	(2,504,783)	70,153,781
Operating expenses:						
Production fuel	27,553,429	-	-	-	-	27,553,429
General and administrative	7,011,402	3,051,832	1,468,435	7,375,667	-	18,907,336
Maintenance	8,273,432	794,112	402,756	274,899	-	9,745,199
Depreciation	5,235,918	2,964,318	845,145	226,255	-	9,271,636
Other production	4,369,362	2,577,829	-	-	(2,504,783)	4,442,408
Bad debts	-	-	-	1,764,084	-	1,764,084
Supplies	201,708	155,545	46,418	182,535	-	586,206
Other	-	-	-	42,175	-	42,175
Total operating expenses	52,645,251	9,543,636	2,762,754	9,865,615	(2,504,783)	72,312,473
Earnings (loss) from operations	9,009,273	(1,645,938)	(584,563)	(8,937,464)	-	(2,158,692)
Nonoperating revenues (expenses):						
Interest income	-	-	-	399,110	-	399,110
Interest expense	(8,556,990)	(824,076)	-	-	-	(9,381,066)
Contribution to the primary government	-	-	-	(637,061)	-	(637,061)
Total nonoperating revenues (expenses), net	(8,556,990)	(824,076)	-	(237,951)	-	(9,619,017)
Net earnings (loss) before capital contributions	452,283	(2,470,014)	(584,563)	(9,175,415)	-	(11,777,709)
Capital contributions	4,697,950	-	-	-	-	4,697,950
Change in net assets	\$ 5,150,233	\$ (2,470,014)	\$ (584,563)	\$ (9,175,415)	\$ -	\$ (7,079,759)

(1) The Water and Sewer Divisions recognize an expense for power supplied by the Power Division to operate their facilities. The Power division recognizes internal revenue for the corresponding amount.

See accompanying independent auditors' report.

COMMONWEALTH UTILITIES CORPORATION

INDEPENDENT AUDITORS' REPORTS ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2002

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS
BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS

Board of Directors
Commonwealth Utilities Corporation:

We have audited the financial statements of the Commonwealth Utilities Corporation (CUC), as of and for the year ended September 30, 2002, and have issued our report thereon dated March 21, 2005, which was qualified due to our inability to determine the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease, and management's inability to provide minutes of Board of Directors meetings subsequent to December 14, 2004. Except as described in the preceding sentence, 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

In planning and performing our audit, we considered CUC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect CUC's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs (pages 8 through 34) as Findings 2002-1 through 2002-21.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Findings 2002-6, 2002-9, 2002-10, 2002-13, 2002-14, 2002-15, 2002-17 and 2002-21 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CUC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 that is required to be reported under *Government Auditing Standards* and which is described in the accompanying Schedule of Findings and Questioned Costs as item 2002-22.

This report is intended for the information of the management of CUC, the Board of Directors, the cognizant audit and other federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche

March 21, 2005

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND
INTERNAL CONTROL OVER COMPLIANCE APPLICABLE
TO EACH MAJOR FEDERAL AWARD PROGRAM AND ON
THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Board of Directors
Commonwealth Utilities Corporation:

Compliance

We have audited the compliance of the Commonwealth Utilities Corporation (CUC) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended September 30, 2002. CUC's major federal program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (pages 8 through 34). Compliance with the requirements of laws, regulations, contracts and grants applicable to its major federal program is the responsibility of CUC's management. Our responsibility is to express an opinion on CUC's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about CUC's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on CUC's compliance with those requirements.

In our opinion, CUC complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2002.

Internal Control Over Compliance

The management of CUC is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered CUC's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of CUC as of and for the year ended September 30, 2002, and have issued our report thereon dated March 21, 2005, which was qualified due to our inability to determine the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease, and management's inability to provide minutes of Board of Directors meetings subsequent to December 14, 2004. Our audit was performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards (page 6) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the financial statements. This schedule is the responsibility of the management of CUC. Such information has been subjected to the auditing procedures applied in our audit of the financial statements and, in our opinion, except as described in the aforementioned report, is fairly stated, in all material respects, when considered in relation to the financial statements taken as a whole.

This report is intended for the information of the management of CUC, the Board of Directors, the cognizant audit and other federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche

March 21, 2005

COMMONWEALTH UTILITIES CORPORATION

Schedule of Programs Selected for Audit in
 Accordance with OMB Circular A-133
 Year Ended September 30, 2002

The following list specifies grants selected for detailed compliance testing in accordance with applicable A-133 requirements.

<u>Original Grantor</u>	<u>CFDA #</u>	<u>Description</u>	<u>Amount of Expenditures</u>
U.S. Department of the Interior	15.875	OTIA Fiscal Year 1993, 1994, 1995 and 1996 - 2002 Capital Development Projects	\$ <u>4,315,817</u>
		Total program expenditures tested (1)	\$ <u>4,315,817</u>
		Total federal program expenditures	\$ <u>4,697,950</u>
		% of total federal program expenditures tested	<u>92%</u>

COMMONWEALTH UTILITIES CORPORATION

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2002

Federal Grantor/ Pass Through Grantor/ Program Title	Federal CFDA Number/ Grantor ID No./ Pass Through Grantor's Number	Program or Award Amount	Receivable (Deferred) Revenue) from Grantor at October 1, 2001	Adjustments FY02	Cash Receipt FY02	Expen- ditures FY02	Receivable (Deferred) Revenue) from Grantor at September 30, 2002
U.S. Environmental Protection Agency							
Direct Program:							
Beach Road Sewer System	66.418/-/-	\$ 2,886,120	\$ 242,433	\$ (66,261)	\$ 176,172	\$ -	\$ -
Lower Navy Hill Sewerline	66.418/-/-	-	116,101	86,841	218,712	15,770	-
Agingan Sewage Treatment Plant Ocean Outfall	66.418/-/-	435,000	(303,635)	-	-	282,012	(21,623)
Achugao/Tanapag Filtration System	66.418/-/-	-	-	-	55,220	55,220	-
Lower Gualo Rai	66.418/-/-	-	2,700	(2,700)	-	-	-
Subtotal CFDA #66.418		3,321,120	57,599	17,880	450,104	353,002	(21,623)
U.S. Department of the Interior							
Partnership Agreement to Strengthen CUC	OMIP 99-2	149,000	(8,799)	38,805	25,124	23,093	27,975
Buddy System Grant		-	-	-	7,899	15,000	7,101
Passed through the Government of the CNMI:							
Federal Portion							
Water and Power Projects	15.875/-/-	-	(164,322)	164,322	-	-	-
Upgrade Feeder 4	15.875/-/-	1,152,000	-	-	218,121	244,757	26,636
San Antonio Power Upgrade	15.875/-/-	73,300	-	-	3,391	3,391	-
Obyan Power Expansion	15.875/-/-	73,300	-	-	1,140	1,140	-
Carolina Heights Power Project	15.875/-/-	293,200	-	-	18,854	18,854	-
Carolina Agriculture Homestead Waterline	15.875/-/-	455,000	-	-	27,169	27,169	-
Tatachog/Songsong Waterline	15.875/-/-	513,100	(16,515)	16,515	-	-	-
Kagman 1.0MG Water Tank	15.875/-/-	1,000,000	-	-	39,341	39,341	-
As Matus Homestead Sewer System	15.875/-/-	1,000,000	-	-	21,763	21,763	-
Precinct II Distribution Upgrade	15.875/-/-	1,200,000	-	-	5,612	16,638	11,026
Design & Construction San Jose Waterline Replacement	15.875/-/-	1,158,509	(69,029)	69,029	17,252	151,219	133,967
Sinapalu-Chugai Waterline	15.875/-/-	479,008	(2,184)	2,184	-	-	-
Precinct I Waterline Improvement	15.875/-/-	316,259	(15,628)	15,628	54,083	54,083	-
Upgrade of Beach Road Sewer System	15.875/-/-	-	-	-	77,408	141,796	64,388
New Marpo Water Well	15.875/-/-	607,862	331	(331)	861	861	-
Rota Power Distribution Project	15.875/-/-	475,000	-	-	354,246	354,246	-
South Saipan Power Transmission Substation	15.875/-/-	4,005,112	-	-	57,915	57,915	-
Papago Power Project	15.875/-/-	500,000	-	-	35,518	42,858	7,340
Papago Waterline Improvement	15.875/-/-	-	-	-	21,452	21,452	-
Marpo Carolina Heights Power Upgrade	15.875/-/-	600,000	-	-	-	426,033	426,033
China Town Sewer System	15.875/-/-	860,000	-	-	341,501	343,413	1,912
Kagman Sewer System	15.875/-/-	-	-	-	240,165	240,165	-
Beach Road Sewer System	15.875/-/-	4,105,338	-	-	40,320	40,320	-
Dan Dan San Vicente Power Project	15.875/-/-	-	-	-	1,583	1,583	-
Chalan Pale Arnold Sewerline	15.875/-/-	640,883	-	-	186,315	186,315	-
Subtotal Federal Portion		19,656,871	(276,146)	306,152	1,797,033	2,473,405	706,378
Local Matching Portion							
Upgrade Feeder 4	15.875/-/-	768,250	-	-	145,413	163,171	17,758
San Antonio Power Upgrade	15.875/-/-	26,700	-	-	1,662	1,662	-
Obyan Power Expansion	15.875/-/-	26,700	-	-	415	415	-
Carolina Heights Power Project	15.875/-/-	106,800	-	-	6,864	6,864	-
Carolina Agriculture Homestead Waterline	15.875/-/-	455,000	-	-	27,169	27,169	-
Tatachog/Songsong Waterline	15.875/-/-	186,900	(4,416)	4,416	-	-	-
Kagman 1.0MG Water Tank	15.875/-/-	1,000,000	-	-	39,341	39,341	-
As Matus Homestead Sewer System	15.875/-/-	1,000,000	-	-	21,763	21,763	-
Precinct III Distribution Upgrade	15.875/-/-	800,000	-	-	2,981	10,332	7,351
Design & Construction San Jose Waterline Replacement	15.875/-/-	422,515	(25,704)	25,704	6,280	55,079	48,799
Precinct I Waterline Improvement	15.875/-/-	115,200	(5,693)	5,693	19,700	19,700	-
Upgrade of Beach Road Sewer System	15.875/-/-	-	-	-	28,183	51,627	23,444
New Marpo Water Well	15.875/-/-	405,247	-	-	574	574	-
Rota Power Distribution Project	15.875/-/-	475,000	-	-	354,246	354,246	-
South Saipan Power Transmission Substation	15.875/-/-	1,458,888	-	-	21,085	21,085	-
Papago Power Project	15.875/-/-	500,000	-	-	35,519	42,858	7,339
Papago Waterline Improvement	15.875/-/-	-	-	-	21,452	21,452	-
Marpo Carolina Heights Power Upgrade	15.875/-/-	400,000	-	-	-	284,022	284,022
China Town Sewer System	15.875/-/-	860,000	-	-	341,501	343,414	1,913
Kagman Sewer System	15.875/-/-	-	-	-	240,165	240,165	-
Beach Road Sewer System	15.875/-/-	1,494,662	-	-	14,680	14,680	-
Dan Dan San Vicente Power Project	15.875/-/-	-	-	-	577	577	-
Gualo Rai Sewer System	15.875/-/-	-	-	-	29,089	29,089	-
Chalan Pale Arnold Sewerline	15.875/-/-	233,446	-	-	93,127	93,127	-
Subtotal Local Matching Portion		10,735,308	(35,813)	35,813	1,451,786	1,842,412	390,626
Subtotal CFDA #15.875		30,392,179	(311,959)	341,965	3,248,819	4,315,817	1,097,004
U.S. Federal Emergency Management Agency							
Passed through the Government of the CNMI:							
Public Assistance Office	83.544/-/-	-	-	58,589	58,589	-	-
Water Augmentation Program	83.544/-/-	1,279,500	144,195	-	26,354	29,131	146,972
Subtotal CFDA #83.544		1,279,500	144,195	58,589	84,943	29,131	146,972
		\$ 34,992,799	\$ (110,165)	\$ 418,434	\$ 3,783,866	\$ 4,697,950	\$ 1,222,353

See accompanying notes to schedule of expenditures of federal awards.

COMMONWEALTH UTILITIES CORPORATION

Notes to Schedule of Expenditures of Federal Awards Year Ended September 30, 2002

(1) Scope of Review

The Commonwealth Utilities Corporation (CUC) was established as a Public Corporation by the Commonwealth of the Northern Mariana Islands (CNMI) Public Law 4-47, effective October 1, 1985. CUC was given responsibility for supervising the construction, maintenance operations, and regulation of all utility services, including power, sewage, refuse collections, telephone, cable television, and water, provided however, that, whenever feasible, CUC shall contract for private businesses to assume its duties with respect to one or more of its divisions. CUC was also designated with the responsibility to establish rates, meter, bill and collect fees in a fair and rational manner from all customers of utility services in order for CUC to become financially independent of appropriations by the Commonwealth Legislature. All projects of CUC are funded either directly by U.S. federal agencies through the CNMI or indirectly as loans from the Commonwealth Development Authority (CDA), the U.S. Environmental Protection Agency and the U.S. Department of Agriculture are included in the scope of the OMB Circular A-133 audit (the "Single Audit"). The U.S. Department of the Interior has been designated as CUC's cognizant agency for the Single Audit.

A. Programs Subject to Single Audit

All of the programs presented in the Schedule of Expenditures of Federal Awards are subject to the Single Audit. U.S. Federal Covenant funds received as loans from CDA and funds received from the U.S. Department of Agriculture as loans are also subject to the Single Audit.

(2) Summary of Significant Accounting Policies

A. Basis of Accounting

For purposes of this report, certain accounting procedures were followed, which help illustrate the authorizations and expenditures of the individual programs. The Schedule of Expenditures of Federal Awards is prepared on the accrual basis of accounting. All authorizations represent the total allotment or grant awards received. All expenses and capital outlays are reported as expenditures.

B. Indirect Cost Allocation

For fiscal year 2002, CUC had no indirect cost agreement with grantor agencies.

(3) Adjustments

During the year ended September 30, 2002, CUC reconciled the amount due from grantor agencies resulting in a net adjustment of \$418,434.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs
Year Ended September 30, 2002

Section I - Summary of Auditor's Results

1. The Independent Auditors' Report on the financial statements expressed a qualified opinion.
2. Reportable conditions in internal control over financial reporting were identified, some of which are considered to be material weaknesses.
3. Instances of noncompliance considered material to the financial statements were disclosed by the audit.
4. No reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed a qualified opinion.
6. The audit disclosed findings required to be reported by OMB Circular A-133.
7. CUC's major program is as follows:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
U.S. Department of the Interior	15.875

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. CUC did not qualify as a low-risk audit as that term is defined in OMB Circular A-133.

Section II - Financial Statements Findings

<u>Reference Number</u>	<u>Findings</u>	<u>Refer Page #</u>
2002-1	Revenue/Receipts	9
2002-2 - 3	Purchases/Disbursements	10 - 11
2002-4 - 5	Payroll	12 - 13
2002-6	External Financial Reporting	14
2002-7 - 8	Receivables	15 - 17
2002-9 - 13	Inventory	18 - 22
2002-14 - 15	Utility Plant	23 - 26
2002-16	Payables	27
2002-17	Capital Lease	28
2002-18	Automated Data Processing	29
2002-19	Recovery of Labor Costs	30
2002-20	Collection of Notes Receivable	31
2002-21	Board Minutes	33

Section III - Federal Award Findings and Questioned Costs

<u>Reference Number</u>	<u>Findings</u>	<u>Questioned Costs</u>	<u>Refer Page #</u>
2002-22	Allowable Cost/Cost Principles	\$ 251,166	34

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Section II - Financial Statement Findings

Revenue/Receipts

Finding No. 2002-1

Criteria: All recorded revenues and receivables should reflect collectible balances.

Condition: Investigation of long outstanding and undisconnected accounts revealed a listing of twenty-two accounts amounting to \$658,739 prepared by the credit and collections division of accounts that were not to be disconnected. Although these accounts are fully provided for, the explanation given for the lack of disconnection of these accounts was that these customers had CUC wells, poles, pumps, etc., on their property, and were therefore not billed for utility usage.

Cause: The cause of the above condition is the lack of formal agreements with landowners.

Effect: The effect of the above condition is the potential uncollectibility of accounts receivable and understatement of rental expense. Additionally, there could be inequalities in the consideration paid for certain parcels depending on the value of utilities used.

Recommendation: We recommend that CUC execute formal agreements with all landowners for the use of land.

Prior Year Status: Lack of formal agreements with landowners for the use of land was reported as a finding in the audits of CUC for fiscal year 1996 through 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Purchases/Disbursements

Finding No. 2002-2

Criteria: Proper internal control requires the receipt of purchases at a central location with goods subsequently dispatched to the requesting division.

Condition: Purchased goods can be received by the requesting, purchasing and/or warehouse divisions.

Cause: The cause of the above condition is the lack of established policies and procedures regarding the receipt of purchases.

Effect: The effect of the above condition is the possibility of purchases not being properly recorded in the subsidiary ledger and/or general ledger. As a result, misstatements are likely to occur in inventory, payables and expenses.

Recommendation: We recommend that CUC's management establish policies and procedures to centralize receiving of all purchases and properly monitor assets, liabilities and expenses.

COMMONWEALTH UTILITIES CORPORATION
 Schedule of Findings and Questioned Costs, Continued
 Year Ended September 30, 2002

Purchases/Disbursements

Finding No. 2002-3

Criteria: Expenditures should be recorded in the period incurred.

Condition: Of \$4,315,817 in construction in progress expenditures tested, we noted that expenditures incurred in prior fiscal years were recorded in the current year for the following:

<u>Contract</u>	<u>Invoice #/ Payment Request #</u>	<u>Amount</u>
99 OS	2 and 3	\$ 21,241
59 OS	20	\$ 82,245
133 OS	8 and 9	\$ 15,140
85 OS	1	\$ 43,260
91 OS	1 thru 3	\$ 126,000
144 OS	1	\$ 187,000
66 OS	1/185, 191, 195	\$ 17,344

In addition, although the progress billings were made available for contract #91-OS, we were unable to verify if certification was made by the Executive Director and Project Manager.

Cause: The cause of the above condition is the lack of reconciliation of expenses with the CNMI Government Capital Improvement Projects Coordinator.

Effect: The effect of the above condition is the overstatement of current year expenditures.

Recommendation: We recommend that CUC ensure expenditures are recognized in the proper period and that disbursements are properly certified and supported.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Payroll

Finding No. 2002-4

Criteria: Changes to employee timesheets should be authorized and personnel independent of the payroll process should perform the input of employee pay rates.

Condition: We noted the following:

- Division timekeepers are allowed to make changes on the timesheet edit reports; and
- The payroll department inputs the approved pay rate into the system.

Cause: The cause of the above condition is the lack of established policies and procedures over timesheet changes and proper segregation of duties of payroll processing.

Effect: The effect of the above condition is the potential for division timekeepers to alter hours in the system subsequent to finalizing the timesheet edit report, and the potential for payroll personnel to alter pay rates.

Recommendation: We recommend that management review the payroll process to ensure all changes to the timesheet edit report are authorized. In addition, we recommend all input of pay rates be performed by the Human Resources Department.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Payroll

Finding No. 2002-5

Criteria: Payroll timesheet/timecard reports, overtime and leave authorizations should be signed by the employee and approved by the respective division manager. Additionally, all allotments should be approved by the employee and be maintained in the employee personnel file.

Condition: Of twenty-seven payroll disbursements tested, the following exceptions were noted:

- For pay period no. 18, one employee (# 10023) was authorized eight and a half hours of annual leave; however, he was paid for nine hours.
- Although timesheets were properly approved, the timecard reports did not present evidence of the employee's signature and approval from the division managers for the following employees:

<u>Pay Period No.</u>	<u>Employee No.</u>	<u>Pay Period No.</u>	<u>Employee No.</u>
07	806	16	5249
08	7761	02	10024
10	5200	20	00180
22	4729	05	10014
16	296	18	10023
18	3631	02	10045
16	4506	08	1490
06	3600	11	0201

- The overtime request for one employee (# 296, pay period no. 16) was not signed by the authorizing official.
- Twenty-six items indicated employee withholding authorizations do not correspond to deductions from gross pay and amounts recorded in the payroll register. In some cases, authorization allowing vendor deductions could not be located and/or no authorization could be found discontinuing vendor deduction from gross pay. We also observed that different withholding forms are used when initiating or discontinuing allotments.

Cause: The cause of the above condition is the lack of adherence to established policies and procedures relating to the review and authorization of payroll related documents.

Effect: The effect of the above condition is the possible unauthorized payment and deduction from employee pay.

Recommendation: We recommend that CUC ensure that all payroll timecard reports and timesheets are properly reviewed and approved by division managers. We also recommend that CUC ensure all payroll deductions are properly supported by employee authorizations maintained in employee personnel files.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

External Financial Reporting

Finding No. 2002-6

Criteria: Without an adequate system to record receivable or payable balances from or to the grantor agency, an entity cannot accurately report on the use of funding.

Condition: CUC is not reconciling receivable or payable balances from or to the grantor agency on a timely basis. CUC's Schedule of Expenditures of Federal Awards (SFA) contains numerous adjustments with no support. Additionally, CUC is not reconciling expenditures of its Schedule of Expenditures of Federal Awards to capital contributions.

Cause: The cause of the above condition is that management has not introduced an adequate system of reconciling receivable or payable balances or capital contributions accounts.

Effect: The effect of the above condition is that amounts due from or to the grantor agency and capital contributions accounts are misstated throughout the year.

Recommendation: We recommend that CUC implement a system whereby a receivable/payable account records all cash received from the grantor agency and records all related expenditures. The account should be reconciled on a monthly basis to the SFA. Additionally, we recommend that expenditures of the Schedule of Expenditures of Federal Awards be reconciled to capital contributions accounts on a timely basis.

Prior Year Status: The non-reconciliation of receivable or payable balances from or to grantor agencies and capital contributions accounts was reported as a finding in the audits of CUC for fiscal years 1990 through 2001.

Auditor Response: CUC is reconciling its SFA to its general ledger due from grantor agencies account through adjustments made directly to the SFA and not through the general ledger.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Receivables

Finding No. 2002-7

Criteria: Disputed receivable balances should be resolved in a timely manner.

Condition: Of sixty-three receivable accounts tested, we noted the following:

- Account # 29619-4, amounting to \$205,641, was backbilled for water and sewer charges incurred from 1997 through 1999 for \$138,063. The customer is not making payments on the backbilling and had not been disconnected.
- Account # 15058-1, amounting to \$100,083, was closed in 1993 and written off in 1995 but charges were made to the account in 1996 and 1997 totaling \$100,083. This account was a master account of an apartment building for which individual accounts were established. The account appears to be a duplication of individual accounts charged.
- Account # 21110-2 for \$94,302 has made no payment since 1994. The customer has not been disconnected due to an easement claim.
- Account # 18802-9, amounting to \$482,292, was making payments on current meter billings, however, was not making payments on the amounts past due. The account has not been disconnected.
- Account # 35751-7, amounting to \$138,658, was not making appropriate payments on a promissory note related to raw sewage brought to CUC's waste water treatment plants.
- Account # 12176-4 for \$82,232 was backbilled in 1997 for lack of multiplier use in meter readings. The customer is not making payments on the backbilling.
- Account # 21868-5 for \$84,520 was backbilled due to an unregistered meter. The customer is not making payments on the backbilling.
- Twenty accounts amounting to \$1,503,594 at September 30, 2002 made payments only sufficient to cover current billings. They did not make payments on past due balances and were not disconnected.
- Two accounts (#s 38005-5 and 29506-3) amounting to \$64,612 at September 30, 2002 made no payments during the year; however, they were assessed late charges.
- Two accounts (#s 8267-7 and 5939-4) amounting to \$28,794 at September 30, 2002 made no payments during the year; however, they were assessed current and late charges. They were not disconnected.
- Fourteen accounts (#s 36169-1, 10509-8, 15542-4, 2339-0, 11024-7, 4997-3, 7587-9, 26354-1, 17780-8, 27613-9, 26834-2, 26313-7, 8055-6 and 13263-9) amounting to \$405,190 at September 30, 2002 indicated no activity during the year.

The accounts noted above are one hundred percent (100%) allowed for.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Finding No. 2002-7, Continued

Further, during our testing of other receivables balance amounting to \$773,663 at September 30, 2002, we noted an amount receivable from the Commonwealth Ports Authority (CPA) of \$325,054. Based on our review of supporting documents, we noted that CPA actually paid CUC approximately \$73,856 (check #s 18935, 24548 and 24556, dated 02/27/96, 02/27/96 and 03/21/96, respectively) of this amount. CUC is currently unable to determine where the payment was ultimately applied. The remaining balance of \$251,198 appears to relate to relocation of power poles and installation of services at CPA facilities. We have been advised by CPA that such costs should have been assessed against the independent contractors requesting for such services from CUC.

Cause: The cause of the above condition is the lack of timely review and resolution of old and/or disputed receivable balances, disconnection of customers who have not paid on time, inaccurate reading of meters, incorrect meters installed, incorrect meter multiplier used and incorrect utility schedule used to bill customers.

Effect: The effect of the above condition is the increased potential for bad debts, resulting in losses to CUC and the misstatement of revenues and receivables.

Recommendation: We recommend that CUC implement policies and procedures to ensure the timely review and resolution of disputed receivable balances. We also recommend CUC review and strengthen its existing controls over meter reading policies and procedures to ensure accurate and timely readings.

Prior Year Status: Lack of timely review and reconciliation of receivable accounts was reported as a finding in the audits of CUC for fiscal years 2000 and 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Receivables

Finding No. 2002-8

Criteria: All advances should be periodically reviewed to determine if the actual expense has been incurred.

Condition: Detailed summaries of other receivables and travel advances outstanding amounting to \$773,663 and \$24,020, respectively, as of September 30, 2002 were found to contain many individual items outstanding for in excess of one year. At September 30, 2002, CUC recorded an allowance for doubtful accounts of \$528,066 related to these accounts.

Cause: The cause of the above condition is the lack of periodic review of the accounts.

Effect: The effect of the above condition is an overstatement of CUC's assets and an understatement of expenses at September 30, 2002. Additionally, the lack of timely follow-up on travel advances reduces the chance of recovery.

Recommendation: We recommend that long outstanding balances included in the accounts as of September 30, 2002 be reviewed and expensed as necessary. We also recommend that these accounts be reviewed on a monthly basis.

Prior Year Status: The lack of timely follow-up of advances and prepayments was reported as a finding in the audits of CUC for fiscal years 1993 through 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Inventory

Finding No. 2002-9

Criteria: Final inventory summaries should reflect the number of items counted during inventory procedures.

Condition: During tests of inventory, the following exceptions were noted:

- Of thirty-three inventory items tested, sixteen instances were noted where the number of items counted varied from the final inventory listing.
- Of twenty items tested from the final inventory valuation report (Physical Inventory Worksheet Post), the count sheets for two items (part #s 4209-05-95 and 2000-25-55) were not made available.
- Tests of inventory quantities and costs from the subledger (Inventory Value Report) to the final inventory listing determined one item (part # 5120-90-03) which still had a quantity and value on the subsidiary ledger; however, the actual count indicated zero quantity on hand. We also noted that the specific part number represents a disabled part number, which is no longer in use.

Cause: The cause of the above condition may be due to the following:

- CUC's computer system records inventory when Accounts Payable personnel post vendor invoices into the system. Receiving reports prepared and posted by CUC's warehouse are matched by the system with the corresponding vendor invoices posted. Consequently, if corresponding invoices have not been posted by Accounts Payable or cannot be identified, inventory per books is not adjusted for warehouse receipts. As a result, inventory per books may be zero even though there may physically be inventory on hand. Therefore, inventory issuances by warehouse may result in negative inventory per books.
- Inventory issuances not properly recorded including items being removed from the warehouse without proper documentation, thus resulting in balances in the system when items are not physically available in the warehouse.
- Lack of retaining and maintaining count sheets.

Effect: The effect of the above condition is a possible misstatement of inventory balances as of September 30, 2002.

Recommendation: We recommend that final inventory listings reflect quantities of items counted. We also recommend that the subsidiary ledger be reconciled to the final inventory listing.

Prior Year Status: Inaccuracies in inventory items counted as of balance sheet date versus the final inventory listing was reported as a finding in the audits of CUC for fiscal years 1994 through 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Inventory

Finding No. 2002-10

Criteria: A reconciliation of inventory balances between the general ledger and subledger should be performed regularly and differences, if any, should be investigated.

Condition: While the inventory balance per the general ledger was adjusted to agree to the inventory value report (subsidiary ledger) and the actual count, no reconciliation was performed to account for and investigate the differences between the general ledger and subsidiary ledger.

Cause: The cause of the above condition may be due to the following:

- the lack of established policies and procedures over inventory reconciliation; and
- warehouse personnel posted the physical count adjustments on various dates. The adjustments were duplicated by accounting in their reconciliation of the physical count to the general ledger. This error occurred because only the physical count adjustments are provided to accounting. In addition, the reconciliation was not properly reviewed prior to recording.

Effect: The effect of the above condition is a possible misstatement of inventory balances as of September 30, 2002.

Recommendation: We recommend that CUC establish and implement policies and procedures for timely reconciliation and investigation of significant variances between inventory balances per general ledger and subsidiary ledger. CUC may consider specifically designating an employee to regularly perform the reconciliation.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Inventory

Finding No. 2002-11

Criteria: Facilities should represent valid assets of CUC.

Condition: Monthly postings are made from inventory to a temporary facilities account, amounting to \$156,886 as of September 30, 2002, for items used in community activities. No entries are made when those facilities are removed or dismantled, and transferred back to inventory.

Cause: The cause of the above condition is the lack of accounting for temporary facilities.

Effect: The effect of the above condition is an overstatement of temporary facilities and an understatement of inventory.

Recommendation: We recommend that temporary facilities be accounted for when dismantled or removed.

Prior Year Status: Lack of accounting for temporary facilities was reported as a finding in the audit of CUC for fiscal year 2001.

COMMONWEALTH UTILITIES CORPORATION
Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Inventory

Finding No. 2002-12

Criteria: Inventories should be reviewed regularly for possible obsolescence.

Condition: Inventory items were not reviewed for possible obsolescence. Moreover, an inventory-aging analysis is not prepared to identify slow moving inventory items.

Cause: The cause of the above condition is the lack of established policies and procedures for the review and monitoring of obsolete and non-moving inventories.

Effect: The effect of the above condition is a possible misstatement of inventory as of September 30, 2002.

Recommendation: We recommend that CUC establish formal policies and procedures for obsolescence review and tracking of inventory movements. We also recommend that CUC establish and maintain an aging analysis to assist in determining potential obsolescence of inventory.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Inventory

Finding No. 2002-13

Criteria: When the moving average unit cost method of inventory costing is utilized, unit cost is updated for new purchases and issuances are valued based on the most recent average unit cost.

Condition: Certain inventory items have negative unit costs as of September 30, 2002 and, accordingly, related issuances have negative values. In addition, costs of inventory adjustments were not based on the most recent average unit costs.

Cause: The cause of the above condition may be due to the following:

- untimely posting of inventory purchases, receipts and issuances;
- lack of coordination between warehouse and accounts payable personnel for input or purchases and issuances; and
- lack of monitoring and review of inventory adjustments.

Effect: The effect of the above condition is a possible misstatement of inventory balances and corresponding expense accounts (i.e., maintenance expense) as of September 30, 2002.

Recommendation: We recommend that CUC (a) take steps to establish policies and procedures to ensure timely posting of inventory purchases, receipts and issuances; (b) establish a formal review process and monitoring procedures for inventory adjustments; (c) ensure coordination between responsible personnel; and (d) ensure that these policies and procedures are strictly adhered to.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Utility Plant

Finding No. 2002-14

Criteria: Adequate presentation and control of fixed assets is essential in preparing accurate financial statements. Additionally, unless all fixed assets are recorded, depreciation used in rate settings could be misstated.

Condition: CUC has not taken a physical inventory of fixed assets. Additionally, CUC has no registration system in place to ensure safekeeping of fixed assets. Numerous audit adjustments were proposed to record unrecorded plant. Additionally, we noted the following:

- There is a lack of timely review and certification of projects for completion. Additionally, the lack of coordination between the departments responsible for project oversight and the accounting department relative to the transfer and capitalization of completed projects contributed to this condition.
- Completed projects are not closed and transferred to fixed assets in a timely manner and often remain in Construction Work in Progress for several years. These assets, although already in use, are not being depreciated resulting in material misstatements of depreciation expense. This condition contributed to large variances between the net book values of assets tested and net book value derived through calculation of accumulated depreciation based on estimated useful lives. Adjustments have been proposed to CUC to correct these variances.
- We were unable to complete tests of the following Power and Water assets due to a lack of adequate documentation supporting original capitalized costs:

<u>Account Number</u>	<u>General Ledger Description</u>	<u>Cost Per Books</u>	<u>Useful Life</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value</u>
Power Division:					
023-1002	Saipan Permanent Power Plant 4T	\$ 2,866,819	15	\$ 2,376,852	\$ 489,967
023-1020	Emergency Power	2,753,768	20	1,870,083	883,685
022-1020	Fuel Storage Tanks	615,897	20	368,290	247,607
033-2001	Tinian Power Plant	<u>501,752</u>	20	<u>344,921</u>	<u>156,831</u>
Total Power Assets		\$ <u>6,738,236</u>		\$ <u>4,960,146</u>	\$ <u>1,778,090</u>
Water Division:					
327-3001	Water Transmission Line-Rota	\$ 1,014,266	25	\$ 419,228	\$ 595,038
206-1003	Sadog Tasi Water	<u>883,189</u>	25	<u>435,705</u>	<u>447,484</u>
Total Water Assets		\$ <u>1,897,455</u>		\$ <u>854,933</u>	\$ <u>1,042,522</u>

- Open work orders are not periodically reviewed to ensure timely closing and capitalization or write-off of the related costs recorded in construction in progress. Our tests revealed that work orders dating back to FY1992 remained open and as a result, construction in progress and depreciation or repairs and maintenance expenses in the related fiscal years was overstated and understated, respectively.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Finding No. 2002-14, Continued

- Despite efforts by the accounting division to close out old work orders for FY2000 and prior, which resulted in approximately \$4.2 million in old work orders being closed, approximately \$1.2 million in work orders relating to fiscal year 2000 and prior remain in construction in progress. Further, work orders opened from October 1, 2000 through September 30, 2001 have yet to be analyzed to determine if such represent valid construction in progress.
- During physical presence and asset condition tests, we were unable to verify the existence of a Waste Oil Incinerator, valued at approximately \$510,000, at the Tinian Telesource Power Plant. The contract documents and the original project plan required a Waste Oil Incinerator to be built as part of the Power Plant. CUC personnel are currently determining whether a change order or subsequent agreement reached with Telesource eliminated the requirement to construct this asset.
- Portions of construction contracts, such as design and survey costs associated with the project, are not consistently capitalized. This condition resulted in numerous variances between projects costs recorded by CUC and project costs determined through attest procedures.
- A periodic inventory of CUC's fixed assets is not currently performed or has not been performed in recent years. There is no periodic verification concerning the existence and condition of fixed assets. As a result, assets that are retired and are no longer in use continue to be carried in CUC's fixed assets register.
- CUC's AS400 upgrades, which occur approximately every two years, are being depreciated over five years. This condition results in assets being depreciated for periods longer than their expected useful life.
- Currently, no process exists to ensure that retired or broken fixed assets are removed from the fixed asset listing. We noted several assets that have been retired, broken and in some instances destroyed, that were still carried in CUC's fixed asset register.
- During our review of the Rota Wastewater Project and the Rota Wastewater Outfall, we determined that both projects were completed in fiscal year 1989, but were never commissioned and remain unused to date.
- One Yanmar engine at the old Tinian Power Plant, which is no longer operational, has only seventy-eight hours of use. This engine has not been in use since the new Telesource Power Plant came on line in 1999. Discussions with CUC personnel in Tinian indicate that this engine is basically new. Additionally, we noted that numerous parts ordered for an overhaul of one of the other engines, valued in excess of \$100,000, are still in boxes in the parts warehouse.
- We noted various small dollar items (as low as \$30) being capitalized. CUC's fixed asset policy requires capitalization of assets with a value of \$300 or more, with the exception of small tools, which are to be depreciated over two years. We noted that this policy is not consistently followed.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Finding No. 2002-14, Continued

- One of the three Caterpillar “containerized” engines at the old Isley Power Plant has not been in operation. We learned from discussions with CUC personnel that these engines currently only serve as a back up power source for the water pumps and related equipment located in and around the Isley area. Further, we learned that two of the engines are in need of repair; however, no funds have been allocated. If the engines are in fact idle, CUC should suspend depreciation and record a disposal of fixed assets.

Cause: The cause of the above condition is that no inventory of fixed assets has been taken.

Effect: The effect of the above condition is that fixed assets and depreciation expense could be misstated. Additionally, a serious weakness in control exists over the safeguarding of fixed assets.

Recommendation: We recommend that CUC perform a physical inventory of all fixed assets on hand, agree the count with its records and make necessary adjustments. Additionally, we recommend that CUC implement a system of tagging fixed assets and perform periodic counts to ensure existence.

Prior Year Status: The lack of control over fixed assets was reported as a finding in the audits of CUC for fiscal years 1988 through 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Utility Plant

Finding No. 2002-15

Criteria: Insurance coverage protects an organization from potential material losses.

Condition: CUC has not obtained insurance for its fixed assets.

Cause: The cause of the above condition is the lack of an adequate policy to ensure insurance coverage.

Effect: The effect of the above condition is the possibility of material losses.

Recommendation: We recommend that CUC implement a policy with respect to required insurance coverage levels.

Prior Year Status: The lack of insurance coverage was reported as a finding in the audits of CUC for fiscal years 1989 through 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Payables

Finding No. 2002-16

Criteria: An effective system of internal control includes policies and procedures to ensure that liabilities are recorded in the appropriate fiscal year.

Condition: During tests of subsequent disbursements, we noted unrecorded liabilities amounting to \$393,494 at September 30, 2002. Audit adjustments were proposed to properly reflect liabilities at year end.

Cause: The cause of the above condition is the lack of appropriate cut-off.

Effect: The effect of the above condition is the misstatement of accounts payable, expenses and construction work-in progress at September 30, 2002.

Recommendation: We recommend implementation of appropriate policies and procedures to ensure recording of all liabilities in the appropriate fiscal year.

Prior Year Status: The lack of appropriate cut-off was reported as a finding in the audits of CUC for fiscal years 1998 through 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Capital Lease

Finding No. 2002-17

Criteria: Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, requires that the lessee record a capital lease as an asset and an obligation at an amount equal to the present value of minimum lease payments during the lease term. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and liability shall be fair value.

Emerging Issues Task Force (EITF) Issue No. 01-8 states that in certain circumstances energy-related contracts may represent lease transactions, and the evaluation of whether an arrangement contains a lease within the scope of FASB No. 13 should be based on the substance of the arrangement and whether the use of specific property, plant and equipment is necessary in the fulfillment of the arrangement.

Condition: CUC entered into an agreement with a contractor for the construction, maintenance and operation, and transfer of ownership of a 10 Megawatt Power Plant on the island of Tinian. The agreement is for a guaranteed price of \$9,959,000 plus interest and fees of \$11,641,000 payable over ten years. During this period, the contractor will maintain and operate the power plant and be paid operation, production and maintenance fees in addition to the guaranteed price. The power plant will be turned over to CUC at the end of the ten year period.

CUC has determined that this agreement is in fact a capital lease and that the payments made under the agreement are lease payments. As such, CUC recorded \$9,959,000 as plant and obligations under capital lease.

CUC has been unable to determine whether the guaranteed price of \$9,959,000, in fact, constitutes the fair value of the leased property.

Cause: The cause of the above condition is that CUC has not determined the actual cost of the power plant or obtained an appraisal.

Effect: The effect of the above condition is the inability to determine whether the recording of the plant and obligation under capital lease is in accordance with FASB No. 13 and EITF No. 01-8.

Recommendation: We recommend that CUC determine the actual cost of the plant, or obtain an appraisal of the plant for purposes of compliance with the EITF.

Prior Year Status: The inability to determine whether the recording of the plant and obligation under capital lease are in accordance with FASB No. 13 and EITF No. 01-8 was reported as a finding in the audits of CUC for fiscal years 2000 and 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Automated Data Processing

Finding No. 2002-18

Criteria: A formal Disaster Recovery Plan, written Automated Data Processing (ADP) policies and procedures and offsite storage for daily back-up files are recommended for all large organizations.

Condition: CUC currently has no formal Disaster Recovery Plan or written ADP policies and procedures. In addition, CUC does not have an offsite storage for daily back-up files.

Cause: The cause of the above condition is the lack of requirements of a formal Disaster Recovery Plan or written ADP policies and procedures.

Effect: The effect of the above condition is the potential inability of CUC's ADP department to recover from a disaster and resume operations in a reasonable time frame, which in turn, could result in loss of critical data, revenue and also lead to customer service and public relations concerns.

Recommendation: We recommend that CUC review the need to document in writing its ADP policies and procedures and to develop and adopt a formal Disaster Recovery Plan for its ADP department and to maintain an offsite storage for daily back-up files.

Prior Year Status: Lack of a formal Disaster Recovery Plan and written ADP policies and procedures was reported as a finding in the audit of CUC for fiscal year 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Recovery of Labor Costs

Finding No. 2002-19

Criteria: Generally, direct costs incurred internally, including labor costs, related to a federally funded projects are reimbursable or may be used for matching purposes.

Condition: Currently, CUC does not request reimbursement of direct labor costs incurred on various federally funded construction projects.

Cause: The cause of the above condition is that CUC has not pursued this matter with the grantor agencies.

Effect: The effect of the above condition is the potential loss of federal revenue and inefficient use of internal funds.

Recommendation: We recommend that the CUC review the above condition and pursue such if it is deemed to be in the best interest of CUC.

Prior Year Status: Lack of request of reimbursement of direct labor costs incurred on various federally funded construction projects was reported as a finding in the audit of CUC for fiscal year 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Collection of Notes Receivable

Finding No. 2002-20

Criteria: Promissory notes should be periodically reviewed to ensure that the customer is performing according to terms, and alternate collection options pursued if the amount is in arrears.

Condition: Of three promissory notes tested, we noted the following exceptions:

- The application of payments made by one customer (# 8267) did not correspond to the actual terms of the promissory note. The promissory note provides for periodic payments inclusive of principal and 12% annual interest. However, review of the customer's account history indicated payments being applied only to principal. Moreover, documentation authorizing the current treatment was not made available. In addition, the said promissory note lacks signature of authorized CUC personnel. In January 2002, interest was calculated based on the outstanding balance of the promissory note. As a result, negative amounts were applied to the principal amount thus increasing the promissory note balance.
- We noted two accounts (#s 8267 and 2246) with little or no subsequent activity. Additionally, we were unable to locate documentation to indicate that alternate collection procedures were pursued on these accounts.

Additionally, of \$710,453 notes receivable recorded at September 30, 2002, we reviewed subsequent receipts of accounts with balances greater than \$5,000 totaling \$429,406. Based on tests, we noted the following:

- Seven customer accounts (#s 8267, 5374, 8263, 9086, 45277, 11245 and 46734) amounting to \$94,129 did not indicate any payments made subsequent to year end.
- One customer account (# 2757) made regular payments through April 2004; however, the account was subsequently closed in May 2004 and was transferred back to accounts receivable.
- One customer account (# 36987) made regular payments through November 2003 and none thereafter.
- One customer account (# 14459) made regular payments through October 2003 and none thereafter.

An extrapolation of total items tested amounting to \$429,406 resulted in an indication of the need to provide an additional allowance of \$199,000 to adequately provide for doubtful notes receivable. The amount, however, was not material to warrant an audit adjustment.

Cause: The cause of the above condition is the lack of follow-up on delinquent notes receivable. In addition, there is a lack of timely review as to the application of payments received on promissory notes.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Finding No. 2002-20, Continued

Effect: The effect of the above condition is the potential overstatement of notes receivable and loss of recovery on the accounts.

Recommendation: We recommend that the CUC review the above condition and consider establishing procedures requiring periodic review of notes receivable and procedures for pursuit of delinquent accounts.

Prior Year Status: Lack of follow-up on delinquent notes receivable was reported as a finding in the audit of CUC for fiscal year 2001.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Board Minutes

Finding No. 2002-21

Criteria: All board and executive meetings should be appropriately and promptly documented and maintained.

Condition: Subsequent to December 14, 2004, the related minutes of Board of Directors meetings were not made available.

Cause: The cause of the above condition is the lack of timely transcription of the minutes of the meetings.

Effect: The effect of the above condition is incomplete and inaccurate record of management and board of directors' actions and decisions.

Recommendation: We recommend that CUC ensure that all board of directors and executive meetings are appropriately and promptly documented.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2002

Section III - Federal Award Findings and Questioned Costs

Allowable Costs/Cost Principles

Finding No. 2002-22

Program	Reason for Questioned Costs	Questioned Costs
U.S. Department of Environmental Protection Agency / Agingan Sewage Treatment Plant Ocean Outfall / CFDA #66.418	<p><u>Criteria:</u> Changes to original estimates of projects should be reported to the grantor agency and other anticipated project expenditures should be adjusted accordingly.</p> <p><u>Condition:</u> In fiscal year 2001, CUC received an advance of \$435,000 from a federal agency to provide one hundred percent (100%) funding of the design costs related to the Agingan Sewage Treatment Plant construction project. The design cost was based on the original estimate of the total project cost provided to the grantor. A significantly lower revised estimate was subsequently submitted to the grantor although CUC made no change in the design costs. Based on the actual cost of the construction project, the grantor has determined that CUC was overpaid by approximately \$272,789. At September 30, 2002, total cumulative design costs of the project amounted to \$413,377, of which \$282,012 was incurred during fiscal year 2002.</p> <p><u>Cause:</u> The cause of the above condition is the lack of communication with the grantor during the construction period. Further, the design costs were not revised to reflect subsequent changes to the original project estimate.</p> <p><u>Effect:</u> The effect of the above condition CUC will have to reimburse the grantor for the overpayment and questioned costs.</p> <p><u>Recommendation:</u> We recommend that management ensure frequent communication with the grantor agency during the various phases. We also recommend that subsequent adjustments to estimates be reflected in actual contractual agreements.</p> <p><u>Auditor Response:</u> CUC was advanced funds in excess of actual costs and should work with EPA in determining proper disposition of such excess funds.</p>	251,166
Total Questioned Costs		\$ <u>251,166</u>

COMMONWEALTH UTILITIES CORPORATION

Unresolved Prior Year Findings and Questioned Costs
Year Ended September 30, 2002

Questioned Costs

The prior year Single Audit report on compliance with laws and regulations noted the following questioned costs and comments that were unresolved at September 30, 2002:

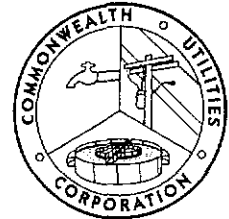
Questioned costs as previously reported	\$ -
Questioned costs of fiscal year 2002 Single Audit	<u>251,166</u>
Unresolved questioned costs at September 30, 2002	\$ <u>251,166</u>

Unresolved Findings

The status of unresolved prior year findings is discussed in the Schedule of Findings and Questioned Costs section of this report (pages 8 through 34).



Commonwealth Utilities Corporation



Corrective Action Plans to Questioned Costs and Findings included in the Independent Auditors' Reports on Internal Control and Compliance for the Year Ended September 30, 2002

Financial Statements Findings

Revenues/Receipts Finding No. 2002-1

CUC agrees with the finding. CUC has forwarded all easement disputes on file to outside counsel for immediate resolution. All but two disputes (involving eight accounts) forwarded to counsel have either been resolved or is pending resolution. The unresolved dispute account holders are requesting administrative hearing to resolve their dispute. CUC has hired an administrative hearing officer and will adhere to the customers' rights to an administrative hearing.

To prevent the occurrence of future easement claims, CUC requires all new connections to be accompanied with dedication of easement by the applicant or owners of the land. For its own in house projects, CUC has hired an easement specialist to ensure that CUC projects do not encroach private property. For those projects requiring the use of private property CUC shall formally seek an agreement with the affected parties prior to using such properties.

Purchases/Disbursements Finding No. 2002-2

CUC partially agrees with the finding. CUC's policies and procedures (No. PC-010) state that receiving function will be handled by the warehouse for which the goods are assigned. However, there were instances, especially during emergency situations that the requesting division received the purchased goods. The Comptroller met with all the division managers and reiterated the CUC policy on centralized receipts at the warehouse. All items received, both stock and non-stock must be entered in the inventory system for automatic interface to payment processing.

Finding No. 2002-3

CUC partially agrees with the finding. CUC prepared a thorough review of all expenditures from federal grants recorded in the books. To get accurate and complete information, CUC got hold of the CIP 702 report prepared by CNMI Government. In order to reconcile CUC books with CNMI report, adjustments were entered.

CUC has tasked the Grants Section to locate the payment requests not made available for audit. This is an isolated case. Payment requests are properly filed in the project folders.

Financial Statements Findings, Continued

Payroll Finding No. 2002-4

CUC partially agrees with the finding. Upon review of the procedures, CUC agrees with the finding that the division timekeepers can make changes on the timesheet edit reports subsequent to payroll verification. To address the finding, the Payroll Manager disallows access to timesheet edit after submission of the time sheet edit and time cards to Payroll. She restricts them thru the Timekeeper User Security Controls. For next payroll processing, she restores their access necessary for time data entries.

CUC is in the process of purchasing a human resources module to ensure proper segregation of duties in payroll processing. As soon as the new system is installed, the Human Resources Office will be responsible in inputting the approved pay rates in the system. At present, the Payroll Section inputs the approved pay rate in the system. Only the Payroll Manager has access in inputting the pay rates in the system. The other payroll personnel are restricted.

Finding No. 2002-5

CUC agrees with the finding. All timekeepers were reminded to ensure that all time cards are signed by the employee and approved by the manager prior to submission to Payroll Section. The Comptroller instructed the Payroll Section to review in detail all the allotment forms kept in the employee's personnel file to make sure that payroll deductions are properly supported by employee authorizations.

External Financial Reporting Finding No. 2002-6

CUC disagrees with the finding. CUC reconciled receivable and payable balances from or to grantor agency for fiscal year ended September 30, 2002. CUC provided the auditors copies of these reconciliation schedules including supports to adjustments. CUC implemented a system whereby the Grants Section and project manager/engineers coordinate with the Accounting Section all cash received and payment requests in order to properly monitor the receivable/payable account.

CUC prepares on a monthly basis the Schedule of Expenditures of Federal Awards and reconciles the expenditures to capital contributions accounts.

Receivables Finding No. 2002-7

CUC disagrees with the finding that reconciliation is necessary. However, CUC agrees that disputed balances should be resolved timely.

Of the seven accounts mentioned, CUC made adjusting entries for four accounts namely #'s 15058-1, 18802-9 and 12176-4 in FY 2004. The account balances now reflect the correct amount due.

However, CUC has not yet adjusted the remaining accounts. Account # 21110-2 has an easement claim. For comments regarding easement claims, see CUC response to Finding No. 2002-1.

Financial Statements Findings, Continued

Receivables, Continued Finding No. 2002-7, Continued

The other accounts have billing disputes. CUC currently requires monthly reviews of accounts with disputes. A monthly status report of unresolved disputes is provided to the Executive Director and Comptroller to ensure timely resolution. The Comptroller has been tasked to monitor and ensure that disputes are resolved in a timely manner and that accounts requiring collection action is initiated.

Further, the Comptroller is planning to reorganize Accounting and give one manager overall responsibility for three sections: Accounts Receivable, Billing, and Credit and Collections. The manager will be tasked to ensure that all billing disputes are resolved and billing errors are corrected promptly, that all uncollectible accounts are written-off as bad debts, and that amounts due are paid or acceptable payment arrangements are made. In addition, the manager will forward all other unpaid accounts to the CUC Legal Counsel to pursue collection.

CUC is in the process of reviewing the documents related to the receivable from CPA. The Chief Accountant is tasked to discuss the matter with CPA to resolve this receivable balance.

Finding No. 2002-8

On a monthly basis, CUC will review the status of employee travel and other advances and will initiate collection action on advances that are not timely liquidated or travel that has outstanding balance. To ensure that expenses are timely recorded, CUC will enforce its payroll deduction policies for travel authorizations that are not liquidated. In addition, accounting will require the Human Resources section to obtain clearance from the accounting section prior to the processing of their resignation action and immediately inform accounting of personnel who are resigning so as to allow accounting to require immediate payroll deduction for all outstanding balances.

Inventory Finding No. 2002-9

CUC agrees with the finding. CUC has recently hired a fixed asset / inventory accountant to implement procedures to ensure that physical counts match the final inventory listing and the withdrawal of inventory is properly recorded. In addition to the procedures to be implemented, semi-annually and annually CUC will reconcile counts against the final inventory listing to ensure proper recording of the physical counts.

Finding No. 2002-10

CUC agrees with the finding. CUC has recently hired a fixed asset / inventory accountant to reconcile and investigate significant variances between inventory balances per general ledger and subsidiary ledger.

Finding No. 2002-11

CUC agrees with the finding. CUC has recently hired a fixed asset / inventory accountant to implement procedures to ensure that temporary facilities are accounted for when dismantled or removed. She will be closely working with the Support Services and Warehouse sections to come up with procedures to account for installation and removal of temporary facilities.

Financial Statements Findings, Continued

Inventory, Continued
Finding No. 2002-12

CUC agrees with the finding. CUC has recently hired a fixed asset / inventory accountant to work closely with the Warehouse Manager to establish procedures for obsolescence review and tracking of slow-moving and non-moving inventory.

Finding No. 2002-13

CUC agrees with the finding. CUC has recently hired a fixed asset / inventory accountant to work closely with the Accounts Payable and the Warehouse staff to ensure timely posting of inventory purchases, receipts and issuances. Also, training on the coordination among the users of the financial modules affecting inventory unit cost was conducted to discuss in detail the proper flow of transactions that will ensure accuracy in inventory unit cost.

Utility Plant
Finding No. 2002-14

CUC agrees with the findings. CUC has been properly capitalizing labor and material charges to its internal construction projects but has been unable to timely close completed projects. CUC has hired a fixed asset/work order accountant to address its timeliness issue.

CUC has engaged Deloitte & Touche to perform agreed-upon procedures for CUC relating to fixed asset records. Deloitte assisted us in reconciling and adjusting the fixed assets. CUC recorded adjustments proposed by Deloitte.

There is an on-going discussion between CUC and the contractor to resolve the issue on the undelivered waste oil incinerator.

Finding No. 2002-15

CUC agrees with the finding. CUC will solicit insurance coverage for its fixed assets. The recommendation has been forwarded to the Procurement manager to prepare to incorporate into its procurement requirements. This change of policy will be presented to the board for adoption.

Payables
Finding No. 2002-16

CUC partially agrees with the finding. The policies and procedures to record payables in the appropriate fiscal year are in place. CUC recorded accrued liabilities. The finding relates to a result of reconciliation of accounts between CUC and a vendor. Liability was not accrued since fiscal year 2002 general ledger was already closed.

Capital Lease
Finding No. 2002-17

CUC agrees with the finding and will endeavor to determine the fair market value of the Tinian Power Plant.

Financial Statements Findings, Continued

Automated Data Processing Finding No. 2002-18

CUC agrees with the finding. CUC's Electronic Data Processing (EDP) Department is working on the Disaster Recovery Plan and written Automated Data Processing (ADP) policies and procedures. CUC expects to complete them by the end of FY 2005.

Currently, the daily back-up files are stored in a fire-proof vault at the EDP room. The AS/400 month end and yearend back-up tapes are kept at a local bank on Saipan (off-site storage). In case of disaster, critical software can be reloaded from these back-up tapes.

Recovery of Labor Costs Finding No. 2002-19

CUC agrees with the finding. CUC has tasked the Grants Section to review costs incurred by CUC on various federally funded construction projects. Requests for reimbursements from grantor agencies will be prepared to recover all CUC-funded expenditures particularly labor costs.

Collection of Notes Receivable Finding No. 2002-20

CUC agrees with the finding. The Comptroller has tasked the Credit and Collection Section to review long-outstanding promissory notes. Demand letters are issued to customers with delinquent accounts. CUC has engaged the services of a collection agency to pursue more aggressive efforts to collect overdue accounts.

Board Minutes Finding No. 2002-21

CUC agrees with the finding. Changes in the format of the board minutes caused the delay in documentation. The Board of Directors has advised the staff responsible in preparing the board minutes to ensure prompt transcription. To date, all pending board minutes up to December 2004 were forwarded to the auditors for review.

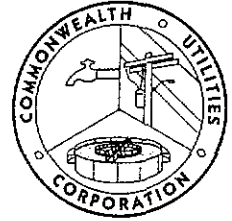
Federal Award Findings and Questioned Costs

Allowable Costs/Cost Principles Finding No. 2002-22

CUC disagrees with the finding. There was no lack of communication between CUC and EPA. Also, the construction for the Agingan Sewage Treatment Plant Ocean Outfall has not started yet. Bids for the construction were lower than the estimated completion cost and after communicating this to EPA, there was a reduction of \$272,789 in the budget for the A/E design. This amount has already been recognized by CUC. CUC has been communicating with EPA all matters regarding this project. Per EPA's most recent advice dated April 15, 2005, they explained that CUC need not reimburse EPA now for the overpayment. A final balancing change order will be prepared at the end of the project. All change orders and other adjustments will be computed to arrive at the final grant costs.



Commonwealth Utilities Corporation



Summary of Schedule of Prior Audit Findings

Status of audit findings included in the schedule of findings and questioned costs for the year ended September 30, 2001:

Financial Statement Findings

- Finding No. 2001-1 - Not corrected. See corrective action plan to Finding 2002-1.
- Finding No. 2001-2 - Corrective action was taken.
- Finding No. 2001-3 - Corrective action was taken.
- Finding No. 2001-4 - Not corrected. See corrective action plan to Finding 2002-6.
- Finding No. 2001-5 - Corrective action was taken.
- Finding No. 2001-6 - Not corrected. See corrective action plan to Finding 2002-7.
- Finding No. 2001-7 - Not corrected. See corrective action plan to Finding 2002-8.
- Finding No. 2001-8 - Not corrected. See corrective action plan to Finding 2002-9.
- Finding No. 2001-9 - Not corrected. See corrective action plan to Finding 2002-11.
- Finding No. 2001-10 - Not corrected. See corrective action plan to Finding 2002-14.
- Finding No. 2001-11 - Not corrected. See corrective action plan to Finding 2002-15.
- Finding No. 2001-12 - Not corrected. See corrective action plan to Finding 2002-16.
- Finding No. 2001-13 - Corrective action was taken.
- Finding No. 2001-14 - Corrective action was taken.
- Finding No. 2001-15 - Not corrected. See corrective action plan to Finding 2002-17.
- Finding No. 2001-16 - Not corrected. See corrective action plan to Finding 2002-18.
- Finding No. 2001-17 - Not corrected. See corrective action plan to Finding 2002-19.
- Finding No. 2001-18 - Not corrected. See corrective action plan to Finding 2002-20.