

COMMONWEALTH UTILITIES CORPORATION

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

YEAR ENDED SEPTEMBER 30, 2005

COMMONWEALTH UTILITIES CORPORATION

**FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2005 AND 2004

INDEPENDENT AUDITORS' REPORT

Board of Directors
Commonwealth Utilities Corporation:

We have audited the accompanying statements of net deficiency of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), as of September 30, 2005 and 2004, and the related statements of revenues, expenses and changes in net deficiency, and of 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 paragraphs, 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 also 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.

In connection with our audit of the financial statements for the year ended September 30, 2005, we were unable to obtain responses from CUC's legal counsel and attorney to inquiries concerning litigation, claims and assessments that might affect such financial statements. Accordingly, we were unable to determine the impact of this matter on the accompanying financial statements.

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, 2005 and 2004. Furthermore, in our judgment, these balances materially affect the determination of results of operations and cash flows for the years ended September 30, 2005 and 2004. CUC management was unable to provide minutes of Board of Directors' meetings subsequent to December 14, 2004. Accordingly, there is an incomplete record of 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 we received responses from CUC's legal counsel and attorney concerning litigation, claims and assessments, had the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease as of September 30, 2005 and 2004 been determined, and had we received minutes of the Board of Directors' meetings subsequent to December 14, 2004, as discussed in the third and fourth paragraphs above, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2005 and 2004, and the changes in its net deficiency and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Commonwealth Utilities Corporation's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an 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, Expenses and Changes in Net Assets (Deficiency) on a Divisional Basis for the year ended September 30, 2005 (page 26) 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, Expenses and Changes in Net Assets (Deficiency) on a Divisional Basis for the year ended September 30, 2005 has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, except for the effect of the matters discussed in the third and fourth paragraphs 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 July 19, 2007, on our consideration of the Commonwealth Utilities Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The 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.

Deloitte & Touche LLC

July 19, 2007



Commonwealth Utilities Corporation



MANAGEMENT'S DISCUSSION AND ANALYSIS

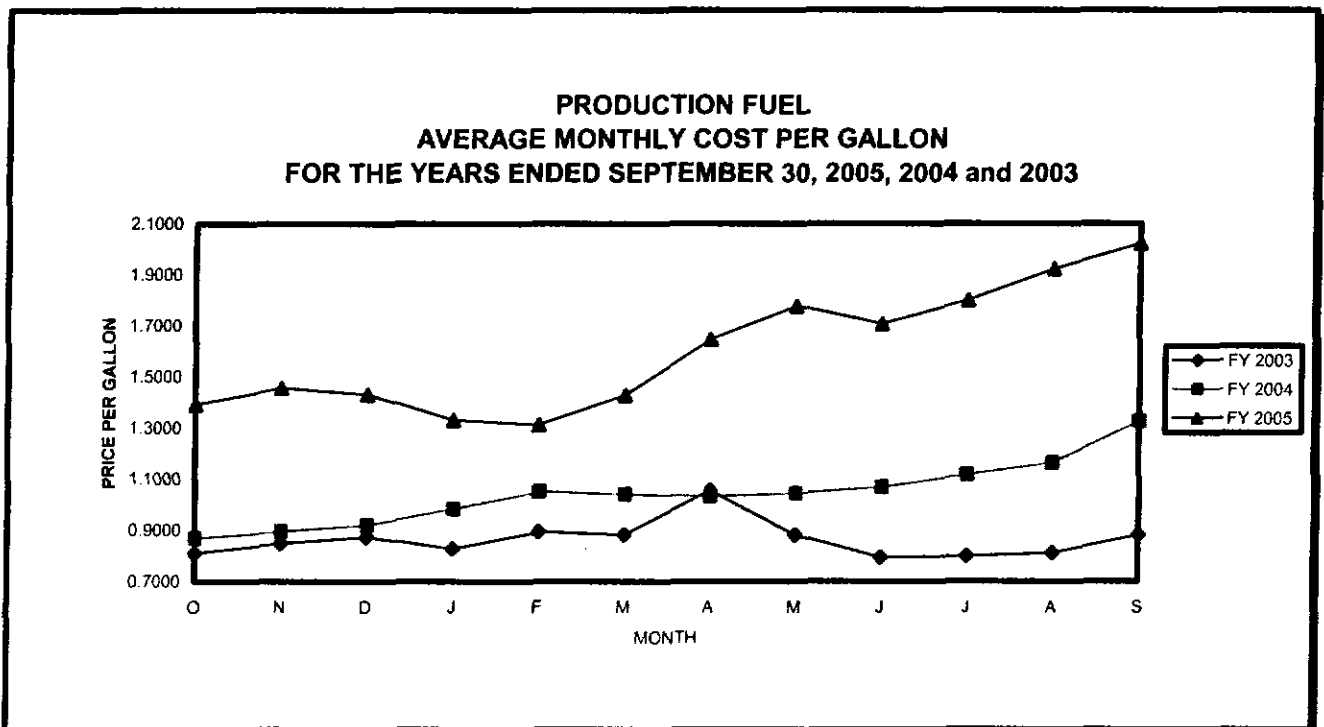
This section of the annual financial report for the Commonwealth Utilities Corporation (CUC) presents a discussion of events that had a significant impact on CUC operations and provides an analysis of its financial performance during the current fiscal year ended September 30, 2005, as compared to the previous fiscal year ended September 30, 2004. This discussion and analysis should be read in conjunction with the financial statements, which follow this section.

DISCUSSION OF EVENTS

To say the least, fiscal year 2005 was a tumultuous year for CUC due to the ever-rising cost of production fuel. This one item accounted for 75.6% of the CUC operating expenses for the power division. This cost was beyond the control of CUC. The price of fuel is driven by the worldwide economics of supply and demand. For most utility companies, changes in fuel prices, whether increases or decreases, do not present a problem. Most utilities have implemented a mechanism, commonly referred to as a fuel adjustment clause, to pass through such price changes to their customers. However, CUC did not have such a mechanism in place.

During fiscal year 2005, CUC fuel costs reached an all time high of \$59.25 million, which represents an increase of \$19.44 million (48.8%) over the fiscal year 2004 fuel costs of \$39.81 million. When compared to the fiscal year 2003 fuel costs of \$33.33 million, the increase is even more significant: \$25.92 million (77.8%) in just a 2-year period. Based on future projections, it appears that fuel prices are likely to continue on an upward trend.

The chart below shows the enormity of these increases.



During fiscal year 2004, CUC management realized that in light of the escalating fuel costs, the current electric rate schedules would not provide the revenue needed for CUC to fully meet its budgeted operating costs. Rates remained at their January 1989 levels. As a result, CUC was drawing down its cash reserves just to maintain a steady supply of production fuel. Initially, these reserves were to have been used for the refurbishment of the power generation and distribution systems. Hence, the refurbishment of these systems was being neglected. So, in March 2004, the Executive Director brought this issue to the attention of the CUC Board of Directors and recommended that CUC begin the process of implementing a fuel surcharge fee, as provided by its enabling statute, Public Law 4-47. Shortly thereafter, the Board and management began in earnest to address this issue.

By the start of fiscal year 2005, CUC was ready to move forward with the fuel surcharge. In October 2004, CUC published a notice of the proposed fuel surcharge fee and, in November, held public hearings, as required. In January 2005, CUC adopted an initial fuel surcharge of 1.5 cents per kilowatt-hour (kWh), with an effective date of February 28. However, that rate was insufficient to ensure CUC's ability to pay for fuel, so the Board increased the rate to 3.5 cents per kWh, effective April 1.

This latter rate was also insufficient, but it was the maximum rate allowable by law that could be charged during the initial year of the fuel surcharge fee. As a result, CUC exhausted all its cash reserves and then relied on the CNMI central government to provide funds in order for CUC to maintain a somewhat steady supply of production fuel and to make only emergency repairs to the power systems. Even so, CUC began to experience an increase in the number and length of both scheduled and unscheduled power outages during the remainder of fiscal year 2005.

Because the majority of CUC funds went toward the purchase of fuel, this had a negative impact on the operations of both the water and sewer divisions. Only a limited amount of funds were available for these divisions. Further, it should be noted that water rates remained at 1995 levels, when last increased in December of that year. As for the sewer rates, these had remained unchanged since CUC was established in October 1987.

Thus, in May 2005, CUC sought the services of a ratemaking firm to conduct cost-of-service studies for all three utilities - power, water, and sewer. In September, a contract was awarded, with the studies beginning in October 2005.

Further, the Governor noted that CUC's financial condition presented an urgent situation, which threatened CUC's ability to continue as a going concern. It was found that CUC would soon be unable to purchase an adequate supply of fuel and its generation capacity was reduced to the point of almost zero reserve capacity. Without electricity, CUC water and sewer pumping and treatment systems would fail. Such a failure would present an extreme, immediate, and imminent emergency.

Thus, on May 19, 2005, the Governor issued a State of Emergency Declaration, which he found necessary to ensure a continual source of power needed for the health, safety and welfare of those residing within the boundaries of the CNMI. In doing so, the Governor: (1) assumed full control of CUC, (2) suspended all regulatory statutes applicable to CUC, (3) suspended all powers, authorities and responsibilities of the CUC Board of Directors and (4) provided for the reprogramming of funds needed to address the conditions noted above. Thereafter, the Governor renewed the Declaration every month through the end of fiscal year 2005.

ANALYSIS OF FINANCIAL PERFORMANCE

Required Financial Statements

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

The Statements of Net Deficiency include all of the CUC assets and the net deficiency and liabilities associated with the operation of proprietary funds. These statements provide information about the nature and amount of investments in resources and the obligations to the creditors. Net assets represent the resources an entity has left to use after its debts are settled. However, those resources may not always be available for spending; restrictions may be attached. To clarify these issues, net assets are divided into three categories: capital assets, net of related debt, which cannot be sold or converted to cash; restricted assets; and unrestricted net assets, which may be used in any purpose.

The Statements of Revenues, Expenses and Changes in Net Deficiency account for all the revenues and expenses and the gains and losses arising from the ongoing operations of CUC. Such statements measure the success of CUC in using the resources committed to its operations. The components in this report are important in that they can be used to predict future income and cash flows.

The Statements of Cash Flows provide information about CUC's cash flows for the period, which are classified according to four main activities: (1) operating, (2) noncapital financing, (3) capital and related financing and (4) investing. The statements report the net cash provided by and or used for each activity and explains the net increase or decrease in cash and cash equivalents.

	2005	2004	2003
Assets			
Net utility plant	\$ 100,677,687	\$ 104,542,037	\$ 104,424,658
Current assets	25,826,751	24,849,221	37,883,170
Restricted assets	<u>7,591,615</u>	<u>14,853,353</u>	<u>8,621,642</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>	<u>\$ 150,929,470</u>
Net Deficiency and Liabilities			
Net deficiency	\$ (52,781,063)	\$ (30,332,640)	\$ (12,932,748)
Noncurrent liabilities	4,734,650	6,127,696	6,920,434
Current liabilities	<u>182,142,466</u>	<u>168,449,555</u>	<u>156,941,784</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>	<u>\$ 150,929,470</u>
Revenues, Expenses and Changes in Net Deficiency			
Gross operating revenues	\$ 80,018,743	\$ 71,388,171	\$ 71,353,881
Bad debts	(1,139,757)	(6,921,530)	(2,784,360)
Operating expenses	<u>(95,040,718)</u>	<u>(79,943,257)</u>	<u>(70,340,366)</u>
Loss from operations	<u>(16,161,732)</u>	<u>(15,476,616)</u>	<u>(1,770,845)</u>
Interest income	276,790	203,568	311,181
Interest expense	(10,598,165)	(10,177,630)	(9,760,707)
Settlement income and gain on sale of capital assets	823,065	-	-
Contribution to the primary government	<u>(694,759)</u>	<u>(666,695)</u>	<u>(648,468)</u>
Total non-operating revenues (expenses), net	<u>(10,193,069)</u>	<u>(10,640,757)</u>	<u>(10,097,994)</u>
Capital contributions	<u>3,906,378</u>	<u>8,717,481</u>	<u>3,230,248</u>
Change in net deficiency	(22,448,423)	(17,399,892)	(8,638,591)
Net deficiency, beginning of year	<u>(30,332,640)</u>	<u>(12,932,748)</u>	<u>(4,294,157)</u>
Net deficiency, end of year	<u>\$ (52,781,063)</u>	<u>\$ (30,332,640)</u>	<u>\$ (12,932,748)</u>

Financial Analysis of CUC as a Whole

For the year ended September 30, 2005, CUC had a loss from operations of \$16.16 million as compared to a loss of \$15.48 million for the year ended September 30, 2004. The loss for fiscal year 2005 exceeded the loss for fiscal year 2004 by \$685,000 (4.4%).

During the year ended September 30, 2005, CUC gross operating revenues increased overall by \$8.63 million (12.1%), when compared to revenues for the year ended September 30, 2004. Revenues increased for power by about \$8.25 million (13.9%) and for water by \$176,000 (1.9%). The increase in power revenues was due primarily to the implementation of the fuel surcharge fee. The increase in water revenues was due primarily to the installation of water meters to now measure and bill water charges based on actual consumption rather than the previous method that was based on an estimated flat rate assessment. On the other hand, the decrease in sewer revenues was about \$85,000 (3.7%), which was due mainly to adjustments to prior billings. The increase in other revenues (late fees) was about \$286,000 (51.4%), which was also due, in part, to the implementation of the fuel surcharge fee. Customers were experiencing difficulty paying their bills within the allowable time limit.

Regarding bad debts, each month CUC establishes an allowance for doubtful accounts (utility receivables) through a provision for bad debts that is charged to expense. Generally, the allowance is equal to 100 percent of all amounts that are past due more than 75 days, except those that are due from the CNMI government. Previously, CUC considered government receivables to be collectible, regardless of the number of days past due. Thus, no allowance had been established for these receivables. However, government receivables had increased steadily in recent years and, based on the independent external auditors' recommendation, management decided to include government receivables in its allowance for doubtful accounts for fiscal year 2004. The allowance for doubtful accounts included \$4.87 million for government receivables, which was 71% of the total bad debts of \$6.92 million for the fiscal year ended September 30, 2004.

However, during fiscal year 2005, CUC revisited its decision regarding government receivables. As mentioned earlier, CUC was now relying heavily on the CNMI central government to provide funds for the purchase of production fuel and for emergency repairs to the power systems. These funds were in addition to those received as payment of current utility charges. Further, given the current price of fuel and the absence of any prospect of being able to significantly increase electric rates in the foreseeable future, CUC anticipated that the additional payments, when applied to government receivables, would soon set-off the utility charges that were now in arrears. As such, for fiscal year 2005, bad debt expense was only about \$1.14 million, which included only non-government (residential and commercial) utility receivables.

During the year ended September 30, 2005, overall operating expenses increased \$15.10 million (18.9%), when compared to expenses for the year ended September 30, 2004. However, only two expense categories increased: production fuel, over \$19.44 million (48.8%) and maintenance, \$105,000 (2.1%). All other expense categories decreased by the following amounts: general and administrative, \$2.41 million (12.9%); depreciation, \$925,000 (10.2%); other production (purchased power from independent power producers), \$891,000 (14.4%); supplies, \$104,000 (15.3%); and other (miscellaneous), \$111,000 (24.8%).

By far, the single largest increase was for production fuel. This increase was brought on primarily by: (1) worldwide demand for petroleum products and (2) escalating political tensions in various parts of the world. These factors gave rise to fears of shortages of petroleum-related products; triggering significant increases in fuel prices. Thus, CUC's average cost of fuel for the year ended September 30, 2005, had risen to over \$1.60 per gallon as compared to an average of about \$1.04 per gallon for the year ended September 30, 2004.

For those expenses that decreased, this was due primarily to the implementation of austerity measures. Without such measures, CUC and the CNMI central government would have experienced a great deal of difficulty in maintaining an adequate supply of fuel needed to provide continuous utility services to its customers.

CUC received capital contributions as direct grants from the federal government and as pass-thru grants received from the CNMI government, which amounted to \$3.91 million for fiscal year 2005, as compared to the \$8.72 million that CUC received during fiscal year 2004, a decrease of \$4.81 million (55.2%). These grants were used for the design and construction of water and sewer capital improvement projects. In addition, the U.S. Department of Homeland Security, Federal Emergency Management Agency (FEMA), provided public assistance to repair and or replace power, water, and sewer systems and related equipment that were damaged during Typhoon Chaba. Please refer to note 3 in the financial statements for detail of activity in CUC's plant accounts.

ECONOMIC FACTORS AND NEXT YEAR'S PLAN OF ACTION

In an effort to fully recover its operating costs and to comply with its enabling statute, CUC has contracted for cost-of-service studies to develop new rate schedules for the three utility services provided by CUC. The rates would be developed in accordance with generally accepted rate making principles. Further, such rates and fees would be set at levels that would allow CUC to be financially independent of all appropriations by the CNMI legislature and be sufficient to recover all costs associated with the operation, maintenance, transmission, generation and delivery of each utility service; to repay any debt associated with the applicable service; and to repair and or replace related capital equipment.

In addition, CUC plans to continue its cost-cutting efforts and to streamline its operations. In this regard, CUC will place emphasis on the privatization of the power plants located on Saipan and Rota. Currently, CUC has engaged the services of a consulting firm to develop a plan of action to achieve this goal.

To improve its financial position, CUC plans to continue negotiations with the Commonwealth Development Authority (CDA) to resolve the issue of CUC's long-outstanding debt of \$61.57 million and the related accrued interest payable of \$95.03 million as of September 30, 2005. To move this issue forward, CUC will seek the support and assistance of the CNMI central government and the legislature.

Also, management will take a more proactive and aggressive approach toward the collection of its utility receivables, especially those that are due from the CNMI government. Presently, CUC has contracts with two private collection agencies to assist in the collection of long-outstanding receivables that are due from residential and commercial customers.

CONTACTING CUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide CUC creditors and ratepayers with a general overview of CUC's finances and to demonstrate its accountability for the monies received. If you have questions about this report, or need additional information, contact CUC's Chief Financial Officer at:

Commonwealth Utilities Corporation
P.O. Box 501220
Saipan, MP 96950-1220

Or, call (670) 235-7025 through 7032 or email at acguerrero@cuc.gov.mp.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Deficiency
September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
<u>ASSETS</u>		
Utility plant:		
Electric plant	\$ 118,129,929	\$ 117,816,572
Water plant	59,176,887	60,255,604
Sewer plant	23,697,843	23,615,456
Administrative equipment	<u>4,440,907</u>	<u>4,535,054</u>
	205,445,566	206,222,686
Less accumulated provision for depreciation	<u>(122,324,311)</u>	<u>(114,204,984)</u>
	83,121,255	92,017,702
Construction work in progress	<u>17,556,432</u>	<u>12,524,335</u>
Net utility plant	<u>100,677,687</u>	<u>104,542,037</u>
Current assets:		
Cash and cash equivalents	<u>3,794,728</u>	<u>1,598,359</u>
Accounts receivable:		
Utility	35,507,347	34,253,028
Other	<u>2,735,316</u>	<u>1,904,273</u>
	38,242,663	36,157,301
Less accumulated provision for uncollectible accounts	<u>(26,773,815)</u>	<u>(25,781,504)</u>
Net accounts receivable	<u>11,468,848</u>	<u>10,375,797</u>
Inventory, less allowance for obsolescence of \$701,462 and \$743,317 in 2005 and 2004, respectively	<u>9,328,099</u>	<u>11,463,810</u>
Due from grantor agencies	<u>1,235,076</u>	<u>1,411,255</u>
Total current assets	<u>25,826,751</u>	<u>24,849,221</u>
Restricted assets:		
Cash and cash equivalents	7,591,615	8,613,144
Time certificates of deposit	<u>-</u>	<u>6,240,209</u>
Total restricted assets	<u>7,591,615</u>	<u>14,853,353</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Deficiency, Continued
September 30, 2005 and 2004

NET DEFICIENCY AND LIABILITIES

	<u>2005</u>	<u>2004</u>
Net deficiency:		
Invested in capital assets, net of related debt	\$ 30,230,687	\$ 36,232,197
Restricted	4,345,350	5,630,207
Unrestricted	<u>(87,357,100)</u>	<u>(72,195,044)</u>
Total net deficiency	<u>(52,781,063)</u>	<u>(30,332,640)</u>
Commitments and contingencies		
Noncurrent liabilities:		
Obligations under capital lease, less current maturities	4,203,536	5,475,269
Long-term debt less current maturities	107,529	156,716
Compensated absences, less current portion	<u>423,585</u>	<u>495,711</u>
	<u>4,734,650</u>	<u>6,127,696</u>
Current liabilities:		
Current maturities of long-term debt	64,864,202	61,615,097
Current obligations under capital lease	1,271,733	1,062,758
Accounts payable	9,342,340	9,971,996
Accrued liabilities	133,957	155,821
Accrued payroll	553,220	415,548
Compensated absences, current portion	399,822	438,552
Customer deposits	9,219,337	8,573,435
Due to primary government	1,331,453	636,694
Interest payable	<u>95,026,402</u>	<u>85,579,654</u>
Total current liabilities	<u>182,142,466</u>	<u>168,449,555</u>
	<u>\$ 134,096,053</u>	<u>\$ 144,244,611</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Deficiency
Years Ended September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Operating revenues:		
Power	\$ 59,800,839	\$ 59,176,587
Water	9,541,082	9,365,015
Sewer	2,205,589	2,290,258
Fuel surcharge	7,629,234	-
Other	<u>841,999</u>	<u>556,311</u>
	80,018,743	71,388,171
Less bad debts	<u>(1,139,757)</u>	<u>(6,921,530)</u>
Net operating revenues	<u>78,878,986</u>	<u>64,466,641</u>
Operating expenses:		
Production fuel	59,246,625	39,812,826
General and administrative	16,270,152	18,680,894
Depreciation	8,182,733	9,107,348
Other production	5,291,414	6,182,042
Maintenance	5,132,005	5,026,514
Supplies	579,358	683,814
Other	<u>338,431</u>	<u>449,819</u>
Total operating expenses	<u>95,040,718</u>	<u>79,943,257</u>
Loss from operations	<u>(16,161,732)</u>	<u>(15,476,616)</u>
Nonoperating revenues (expenses):		
Settlement income	795,800	-
Interest income	276,790	203,568
Gain on sale of capital assets	27,265	-
Interest expense	(10,598,165)	(10,177,630)
Contribution to the primary government	<u>(694,759)</u>	<u>(666,695)</u>
Total nonoperating revenues (expenses), net	<u>(10,193,069)</u>	<u>(10,640,757)</u>
Net loss before capital contributions	(26,354,801)	(26,117,373)
Capital contributions	<u>3,906,378</u>	<u>8,717,481</u>
Change in net deficiency	(22,448,423)	(17,399,892)
Net deficiency - beginning	<u>(30,332,640)</u>	<u>(12,932,748)</u>
Net deficiency - ending	\$ <u>(52,781,063)</u>	\$ <u>(30,332,640)</u>

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Cash Flows
Years Ended September 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Cash received from customers	\$ 79,227,637	\$ 67,228,321
Cash payments to suppliers for goods and services	(69,396,022)	(55,086,809)
Cash payments to employees for services	(12,607,597)	(15,150,153)
Net cash used for operating activities	<u>(2,775,982)</u>	<u>(3,008,641)</u>
Cash flows from noncapital financing activities:		
Payments to primary government	-	(618,469)
Net cash used for noncapital financing activities	<u>-</u>	<u>(618,469)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(4,318,383)	(9,224,727)
Proceeds from sale of capital assets	27,265	-
Capital contributions received	4,449,216	8,381,616
Principal repayment of debt	(1,572,858)	(931,794)
Interest paid on outstanding debt	(1,151,417)	(1,286,990)
Net decrease (increase) in restricted time certificates of deposit	6,240,209	(57,069)
Net cash provided by (used for) capital and related financing activities	<u>3,674,032</u>	<u>(3,118,964)</u>
Cash flows from investing activities:		
Interest received on time certificates of deposit	276,790	203,568
Net cash provided by investing activities	<u>276,790</u>	<u>203,568</u>
Net change in cash and cash equivalents	1,174,840	(6,542,506)
Cash and cash equivalents at beginning of year	<u>10,211,503</u>	<u>16,754,009</u>
Cash and cash equivalents at end of year	\$ <u>11,386,343</u>	\$ <u>10,211,503</u>
Reconciliation of loss from operations to net cash used for operating activities:		
Loss from operations	\$ (16,161,732)	\$ (15,476,616)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Depreciation	8,182,733	9,107,348
Provision for bad debts	1,139,757	6,921,530
Reduction in provision for inventory obsolescence	-	(271,811)
Settlement income	795,800	-
(Increase) decrease in assets:		
Accounts receivable:		
Utility	(1,401,765)	(5,315,273)
Other	(831,043)	994,457
Inventory	2,135,711	(1,656,237)
Increase (decrease) in liabilities:		
Accounts payable	3,080,362	3,445,165
Accrued liabilities	(388,523)	(461,285)
Accrued payroll	137,672	(440,562)
Compensated absences	(110,856)	(16,323)
Customer deposits	<u>645,902</u>	<u>160,966</u>
Net cash used for operating activities	\$ <u>(2,775,982)</u>	\$ <u>(3,008,641)</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	\$ 366,659	\$ 20,000
Noncash increase in accrued liabilities	<u>(366,659)</u>	<u>(20,000)</u>
	\$ -	\$ -
Conversion of accounts payable to Mobil to note payable (note 5):		
Noncash decrease in accounts payable	\$ (3,710,018)	\$ -
Noncash decrease in long-term debt	<u>3,710,018</u>	<u>-</u>
	\$ -	\$ -

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(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.

On May 19, 2005, the Governor of the CNMI declared CUC in a State of Disaster Emergency. Through the state of emergency, the Governor invoked his constitutional authority to take all necessary measures, including but not limited to: assuming full control of CUC, suspension of regulatory statute provisions and regulations applicable to CUC including procurement, suspension of CUC's Board of Directors' powers, authority and/or responsibility during the period of the state of emergency, except as provided in writing by the Governor, and reprogramming of necessary funds to allow CUC to continue operations. The State of Disaster Emergency declaration on CUC was subsequently extended through October 2005.

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.

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 in 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.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

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

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.

Concentrations of Credit Risk

Financial instruments which potentially subject CUC to concentrations of credit risk consist principally of cash demand deposits, time certificates of deposit and accounts receivable.

At September 30, 2005 and 2004, CUC has cash deposits and time certificates of deposit in bank accounts that exceed federal depository insurance limits. CUC has not experienced any losses in such accounts.

Cash and Cash Equivalents and Time Certificates of Deposit

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by CUC or its agent in CUC's name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in CUC's name; or
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in CUC's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, CUC's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. CUC does not have a deposit policy for custodial credit risk.

For purposes of the statements of net deficiency and cash flows, 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 statements of net deficiency. At September 30, 2005 and 2004, cash and cash equivalents and time certificates of deposit were \$11,386,343 and \$16,451,712, respectively, and the corresponding bank balances were \$11,722,264 and \$16,878,706, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$135,441 and \$115,681 were FDIC insured as of September 30, 2005 and 2004, respectively. CNMI law does not require component units to collateralize their cash deposits; therefore deposit levels in excess of FDIC insurance are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

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

Cash and Cash Equivalents and Time Certificates of Deposit, Continued

Of the cash and cash equivalents of \$7,561,398 at September 30, 2005, \$7,500,000 represents customer deposits held as security pursuant to a letter of credit obtained from a financial institution to secure a \$7,500,000 credit limit for fuel purchases with a vendor. Cash and cash equivalents of \$- and \$5,630,207 as of September 30, 2005 and 2004, respectively, represent an escrow fund to be used specifically for contract payments and as security pursuant to a loan agreement with a contractor, and accordingly, are classified as restricted in the accompanying financial statements. Time certificates of deposit of \$6,240,209 and cash and cash equivalents of \$2,953,271 as of September 30, 2004 represent customer deposits, segregated pursuant to CUC policy, and accordingly, are classified as restricted in the accompanying financial statements.

Cash and cash equivalents of \$30,217 and \$29,666 as of September 30, 2005 and 2004, 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. Current policy is to provide one hundred percent of account balances greater than seventy-five days old.

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 is stated at cost, where costs are 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, 2005 and 2004, eligible interest expense was not considered significant and consequently no interest has been capitalized.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(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 multi-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, 2005, 2004 and 2003 were \$2,451,132, \$2,903,663, and \$2,648,761, respectively, equal to the required contributions for each year.

Revenue Recognition

CUC defines operating revenues as revenue generated from power, water and sewer sales and services. Operating expenses are costs incidental to the generation of operating revenues. Revenues and expenses not meeting the above definitions are classified as nonoperating revenues and expenses.

Power, water and sewer sales 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 subsequent cycle billing. Unbilled receivables at September 30, 2005 and 2004 are \$5,157,463 and \$4,206,455, respectively.

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, 2005 and 2004 amounted to \$823,407 and \$934,263, respectively. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The outstanding sick pay benefit available to employees as of September 30, 2005 and 2004, was approximately \$2,119,613 and \$2,250,816, respectively.

Net Assets

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, requires CUC to establish net asset categories as follows:

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

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

Net Assets, Continued

- Invested in capital assets; capital assets, net of accumulated depreciation and reduced by the outstanding balances of any notes or other borrowings that are attributable to the acquisition, construction or improvement of these assets.
- Restricted:
 - Nonexpendable - Net assets subject to externally imposed stipulations that CUC maintain them permanently.
 - 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.

New Accounting Standards

During fiscal year 2005, CUC implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)*. GASB Statement No. 40 addresses common deposit and investment risks such as credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, GASB Statement No. 40 requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates.

In November 2003, GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. GASB Statement No. 42 establishes standards for impairment of capital assets when their service utility has declined significantly and unexpectedly. The provisions of this Statement are effective for periods beginning after December 15, 2004. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this Statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

In May 2004, GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section, an amendment to NCGA Statement 1*. GASB Statement No. 44 improves the understandability and usefulness of statistical section information and adds information from the new financial reporting model for state and local governments required by GASB Statement No. 34. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

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

New Accounting Standards, Continued

In July 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after December 15, 2008. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

In December 2004, GASB issued Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefit Expenditures/Expense and Liabilities by Cost-Sharing Employers*. GASB Technical Bulletin No. 2004-2 clarifies the requirements of GASB Statement Nos. 27 and 45 for recognition of pension and other postemployment benefit expenditures/expense and liabilities by cost-sharing employers. Management does not believe the implementation of this pronouncement will have a material effect on the financial statements of CUC.

In December 2004, GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation (an amendment to GASB Statement No. 34)*, which requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe the implementation of this Statement will have a material effect on the financial statements of CUC.

In June 2005, GASB issued Statement No. 47, *Accounting for Termination Benefits*. GASB Statement No. 47 establishes guidance for state and local governmental employers on accounting and financial reporting for termination benefits. These benefits include incentives for voluntary terminations (e.g., early retirement window programs) and severance payments with respect to involuntary terminations. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of CUC.

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 disclosure 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.

Reclassification

Certain 2004 balances in the accompanying financial statements have been reclassified to conform to the 2005 presentation.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(2) Due From 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 grantor agencies accounts for the years ended September 30, 2005 and 2004, are as follows:

	<u>2005</u>	<u>2004</u>
Balance at beginning of year	\$ 1,411,255	\$ 1,055,390
Adjustment	(121,014)	(31,698)
Deductions - cash receipts from grantor agencies	(3,961,543)	(8,329,918)
Additions - program outlays	<u>3,906,378</u>	<u>8,717,481</u>
Balance at end of year	\$ <u>1,235,076</u>	\$ <u>1,411,255</u>

(3) Utility Plant

Utility plant at September 30, 2005 and 2004, consists of the following:

	Estimated Useful Lives	Balance at October 1, 2004	Additions	Deletions	Adjustments/ Reclassifications	Balance at September 30, 2005
Utility plant:						
Electric plant	20 years	\$ 117,816,572	\$ 33,116	\$ (3,838)	\$ 284,079	\$ 118,129,929
Water plant	20 years	60,255,604	50,419	(10,184)	(1,118,952)	59,176,887
Sewer plant	20 years	23,615,456	62,761	(582)	20,208	23,697,843
Administrative equipment	3 - 5 years	<u>4,535,054</u>	<u>18,443</u>	<u>(36,854)</u>	<u>(75,736)</u>	<u>4,440,907</u>
		206,222,686	164,739	(51,458)	(890,401)	205,445,566
Less accumulated provision for depreciation		<u>(114,204,984)</u>	<u>(8,182,733)</u>	<u>-</u>	<u>63,406</u>	<u>(122,324,311)</u>
		92,017,702	(8,017,994)	(51,458)	(826,995)	83,121,255
Construction work in progress		<u>12,524,335</u>	<u>3,388,730</u>	<u>-</u>	<u>1,643,367</u>	<u>17,556,432</u>
		\$ <u>104,542,037</u>	\$ <u>(4,629,264)</u>	\$ <u>(51,458)</u>	\$ <u>816,372</u>	\$ <u>100,677,687</u>
	Estimated Useful Lives	Balance at October 1, 2003	Additions	Deletions	Adjustments/ Reclassifications	Balance at September 30, 2004
Utility plant:						
Electric plant	20 years	\$ 114,917,960	\$ 802,500	\$ -	\$ 2,096,112	\$ 117,816,572
Water plant	20 years	57,091,249	381,813	-	2,782,542	60,255,604
Sewer plant	20 years	22,023,014	360,404	-	1,232,038	23,615,456
Administrative equipment	3 - 5 years	<u>4,407,120</u>	<u>158,536</u>	<u>-</u>	<u>(30,602)</u>	<u>4,535,054</u>
		198,439,343	1,703,253	-	6,080,090	206,222,686
Less accumulated provision for depreciation		<u>(105,351,027)</u>	<u>(9,107,348)</u>	<u>-</u>	<u>253,391</u>	<u>(114,204,984)</u>
		93,088,316	(7,404,095)	-	6,333,481	92,017,702
Construction work in progress		<u>11,336,342</u>	<u>8,290,851</u>	<u>-</u>	<u>(7,102,858)</u>	<u>12,524,335</u>
		\$ <u>104,424,658</u>	\$ <u>886,756</u>	\$ <u>-</u>	\$ <u>(769,377)</u>	\$ <u>104,542,037</u>

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(4) Notes Payable

A schedule of CUC's long-term debt as of September 30, 2005 and 2004, is as follows:

	<u>2005</u>	<u>2004</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
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, 2005 and 2004, 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, 2005 and 2004, associated with the notes payable to CDA along with interest payable on these notes of \$95,026,402 and \$85,579,654 as at September 30, 2005 and 2004, respectively, has been classified as current liabilities within the accompanying financial statements.

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. In January 2004, the Memorandum of Agreement (MOA), entered into on November 21, 2002 between CUC and CDA was amended to exclude a 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.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(5) Loans 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, 2005 and 2004, 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, 2005 and 2004:

	<u>2005</u>	<u>2004</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.	\$ 156,716	\$ 203,063
Less current portion	<u>49,187</u>	<u>46,347</u>
Long-term loan payable	\$ <u>107,529</u>	\$ <u>156,716</u>

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>
2006	\$ 49,187	\$ 9,599	\$ 58,786
2007	52,198	6,586	58,784
2008	<u>55,331</u>	<u>3,389</u>	<u>58,720</u>
	\$ <u>156,716</u>	\$ <u>19,574</u>	\$ <u>176,290</u>

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(5) Loans Payable, Continued

Changes in long-term liabilities for the years ended September 30, 2005 and 2004, are as follows:

	<u>Balance October 1, 2004</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance September 30, 2005</u>	<u>Due Within One Year</u>
Notes and loans payable	\$ 61,771,813	\$ 3,710,018	\$ 510,100	\$ 64,971,731	\$ 64,864,202
Other liabilities:					
Obligations under capital lease	6,538,027	-	1,062,758	5,475,269	1,271,733
Compensated absences	<u>934,263</u>	<u>666,359</u>	<u>777,215</u>	<u>823,407</u>	<u>399,822</u>
	<u>\$ 69,244,103</u>	<u>\$ 4,376,377</u>	<u>\$ 2,350,073</u>	<u>\$ 71,270,407</u>	<u>\$ 66,535,757</u>
	<u>Balance October 1, 2003</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance September 30, 2004</u>	<u>Due Within One Year</u>
Notes and loans payable	\$ 61,815,485	\$ -	\$ 43,672	\$ 61,771,813	\$ 61,615,097
Other liabilities:					
Obligations under capital lease	7,426,149	-	888,122	6,538,027	1,062,758
Compensated absences	<u>950,586</u>	<u>810,215</u>	<u>826,538</u>	<u>934,263</u>	<u>438,552</u>
	<u>\$ 70,192,220</u>	<u>\$ 810,215</u>	<u>\$ 1,758,332</u>	<u>\$ 69,244,103</u>	<u>\$ 63,116,407</u>

On June 3, 2005, CUC executed a debt rescheduling agreement with Mobil Oil Micronesia Islands, Inc. (Mobil) for the repayment of an outstanding payable balance of \$3,710,018 as of June 2005 related to fuel purchases under a fuel supply agreement between CUC and Mobil. Under the agreement, the principal balance of \$3,710,018 plus interest thereon, determined at a fluctuating rate equal to 3% points above the prime interest rate on the principal amount of the balance remaining from time to time unpaid, is payable in consecutive monthly installments of \$168,497 each beginning on July 15, 2005 until December 15, 2005 and thereafter in consecutive monthly installments of \$505,490 each beginning on January 15, 2006 until June 15, 2006. At September 30, 2005, CUC had an outstanding loan payable to Mobil in the amount of \$3,246,265 that has been classified in current maturities of long-term debt within the accompanying financial statements.

(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, 2005 and 2004, CUC had an outstanding payable to the primary government in the amount of \$1,331,453 and \$636,694, respectively.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(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. 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. On May 6, 2003, CUC and the contractor executed another change order to create a specific limited exception for the allowance of certain liens to be placed on the power plant as designed and built in accordance with the terms and conditions of the original agreement and previous change orders.

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%.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(7) Capital Lease, Continued

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	\$25,000,000
End of year 5	\$21,000,000
End of year 6	\$17,250,000
End of year 7	\$14,000,000
End of year 8	\$11,000,000

The annual requirement to amortize the capital lease obligations of CUC outstanding as of September 30, 2005 is as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 1,271,733	\$ 888,267	\$ 2,160,000
2007	1,521,801	638,199	2,160,000
2008	1,821,040	338,960	2,160,000
2009	<u>860,695</u>	<u>39,305</u>	<u>900,000</u>
	<u>\$ 5,475,269</u>	<u>\$ 1,904,731</u>	<u>\$ 7,380,000</u>

(8) Fuel Surcharge Fee

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. Fuel surcharge revenue for the year ended September 30, 2005 amounted to \$7,629,234.

(9) Settlement Income

During the year ended September 30, 2005, CUC assessed \$500,000 to a customer as a settlement of all claims that CUC may have against the customer relating to waste discharged by the customer's business operations into CUC's sewer system in prior years. At September 30, 2005, CUC also received \$295,800 from an insurance company as performance bond for the default by a contractor to execute the terms of a construction agreement previously entered into with CUC.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(10) 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, 2005 and 2004, 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 expires on July 31, 2006 and is renewable for an additional ten year period to expire on July 31, 2016. Future minimum commitment related to the purchase of electric power for the year ending September 30, 2006 amounts to \$2,584,200.

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 is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. 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. CUC currently reports all of its risk management activities as they are incurred. 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 \$1,245,922 have been set forth in CUC's Single Audit Report for the year ended September 30, 2005. 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.

(11) Subsequent Events

On January 27, 2006, the CNMI Governor issued Executive Order No. 2006-1 which provided for the transfer of CUC to the Department of Public Works (DPW) of the CNMI for purposes of administration and coordination as a major component of DPW equivalent to a division which will have its own chief executive officer who will have the rank of a Division Director. The Board of Directors of CUC was abolished and its functions transferred to DPW.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2005 and 2004

(11) Subsequent Events, Continued

Subsequently, on May 5, 2006, the CNMI Governor issued Executive Order No. 2006-4 which provided for the reorganization of CUC. Under Executive Order No. 2006-4, the functions and duties of CUC are reorganized as a public corporation of the CNMI that has as its head an executive director. The role of the CUC Board of Directors is advisory. With respect to utility services that are generated or delivered in whole or in part by private businesses, the CUC Board of Directors will act as a public utility commission with respect to those services only until such time as the legislature establishes a public utility commission and the commission notifies the board that it is ready to assume its duties and responsibilities with respect to utility services.

On June 6, 2006, the Governor of the CNMI approved Public Law (P.L.) No. 15-12 which authorized CDA to waive the sum of \$45,500,000 of the principal amount owed by CUC, such amount being the aggregate sum of all outstanding sewer and water project loans given to CUC and referenced in the amended MOA executed in January 2004, by CUC and CDA. Pursuant to the same amended MOA, CDA is authorized to waive any and all accrued interest owed by CUC on all outstanding loans in accordance with the terms and conditions of the amended MOA. Section 2 of the P.L. provides that in the event that the power generation system for the CNMI is privatized and controlled by an independent power producer, fifty percent of the principal amount of \$45,500,000 shall be paid by the independent power producer to CDA. On January 23, 2007, the Governor of the CNMI approved P.L. 15-44 to amend section 2 of P.L. 15-12. P.L. 15-44 removes the fifty per cent (\$22,750,000) payment requirement by the independent power producer and instead requires such amount to be rebated to residential power consumers in the event that the power generation system is privatized and controlled by an independent power producer. The rebate shall be subject to review and approval of the Public Utilities Commission upon privatization. As of September 30, 2005, no adjustments have been made to the accompanying financial statements as CUC and CDA have yet to finalize an agreement on the execution of the provisions of P.L. 15-2 and 15-44.

In July 2006, the CUC Electric Service Regulations, Part 24 Rate Schedules was amended to implement an adjustment of the utility rate structure. The amendment of the CUC Electric Service Regulations is in accordance with the recommendations and findings set forth in a comprehensive electric, sewer and wastewater rate study prepared for CUC by a consultant. The fuel surcharge fee, made effective on February 27, 2005, as Part 24.5.8 of the CUC Electric Service Regulations, was rescinded as of the effective date of the amendments to Part 24 of the CUC Electric Service Regulations. The new utility rate is effective beginning with August 2006 utility consumption and was formally adopted on October 24, 2006.

In July 2006, CUC decided not to renew the agreement, which expires on July 31, 2006, with a contractor for the purchase of electric power and associated services. However, the contractor is defending its rights to the extension of the agreement. Under the agreement, the contract is renewable for an additional ten year period to expire on July 31, 2016. CUC may have to pay the contractor approximately \$8,000,000 if the contract is terminated. The arrangements between CUC and the contractor on this matter are currently under negotiation. At September 30, 2005, no provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statement of Revenues, Expenses and Changes in Net Assets (Deficiency) on a Divisional Basis
Year Ended September 30, 2005

	Power	Water	Sewer	Administrative and General	Internal Revenues and Expenses (1)	Total
Operating revenues:						
Governmental:						
CNMI Government	\$ 6,747,943	\$ 2,537,335	\$ 1,044,492	\$ -	\$ -	\$ 10,329,770
CNMI agencies	3,808,080	1,908,369	433,130	-	(2,281,614)	3,867,965
Total governmental	10,556,023	4,445,704	1,477,622	-	(2,281,614)	14,197,735
Commercial	38,320,760	2,318,384	569,063	-	-	41,208,207
Residential	20,675,707	2,958,324	130,391	-	-	23,764,422
Other	159,197	(181,330)	28,513	841,999	-	848,379
	69,711,687	9,541,082	2,205,589	841,999	(2,281,614)	80,018,743
Less bad debts	-	-	-	(1,139,757)	-	(1,139,757)
Net operating revenues	69,711,687	9,541,082	2,205,589	(297,758)	(2,281,614)	78,878,986
Operating expenses:						
Production fuel	59,246,625	-	-	-	-	59,246,625
General and administrative	5,605,530	2,277,563	1,117,291	7,269,768	-	16,270,152
Depreciation	4,810,365	2,199,916	972,851	199,601	-	8,182,733
Other production	4,573,661	2,300,929	601,508	96,930	(2,281,614)	5,291,414
Maintenance	4,008,660	588,874	386,578	147,893	-	5,132,005
Supplies	155,624	238,204	45,247	140,283	-	579,358
Other	-	-	-	338,431	-	338,431
Total operating expenses	78,400,465	7,605,486	3,123,475	8,192,906	(2,281,614)	95,040,718
Earnings (loss) from operations	(8,688,778)	1,935,596	(917,886)	(8,490,664)	-	(16,161,732)
Nonoperating revenues (expenses):						
Settlement income	-	-	-	795,800	-	795,800
Interest income	-	-	-	276,790	-	276,790
Gain on sale of capital assets	-	-	-	27,265	-	27,265
Interest expense	(9,781,660)	(816,505)	-	-	-	(10,598,165)
Contribution to the primary government	-	-	-	(694,759)	-	(694,759)
Total nonoperating revenues (expenses), net	(9,781,660)	(816,505)	-	405,096	-	(10,193,069)
Net income (loss) before capital contributions	(18,470,438)	1,119,091	(917,886)	(8,085,568)	-	(26,354,801)
Capital contributions	479,560	645,947	2,742,783	38,088	-	3,906,378
Change in net assets (deficiency)	\$ (17,990,878)	\$ 1,765,038	\$ 1,824,897	\$ (8,047,480)	\$ -	\$ (22,448,423)

(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, 2005

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS 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, 2005, and have issued our report thereon dated July 19, 2007, which report was qualified due to our inability to obtain responses from CUC's legal counsel and attorney concerning litigation, claims and assessments; 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 discussed 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 an opinion 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 initiate, record, process, 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 9 through 44) as items 2005-1 through 2005-26.

A material weakness is a reportable 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 caused by error or fraud 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 items 2005-7, 2005-12, 2005-13, 2005-14, 2005-15, 2005-18, 2005-19, 2005-20, 2005-22 and 2005-25 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 grant agreements, 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Questioned Costs as items 2005-22 and 2005-26.

We noted certain matters that we reported to management of CUC in a separate letter dated July 19, 2007.

This report is intended solely for the information and use of the management and the Board of Directors of CUC, 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 LLC

July 19, 2007

**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 each of its major federal programs for the year ended September 30, 2005. CUC's major federal programs are identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (pages 9 through 44). Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs 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 of CUC's compliance with those requirements.

As described in item 2005-27 in the accompanying Schedule of Findings and Questioned Costs, CUC did not comply with requirements regarding procurement and suspension and debarment that are applicable to its major federal program. Compliance with such requirements is necessary, in our opinion, for CUC to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, CUC complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2005.

Internal Control Over Compliance

The management of CUC is responsible for establishing and maintaining effective internal control over compliance with the 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 the internal control over compliance in accordance with OMB Circular A-133.

We noted one matter involving the internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect CUC's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the accompanying Schedule of Findings and Questioned Costs as item 2005-27.

A material weakness is a reportable 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 the applicable requirements of laws, regulations, contracts, and grants caused by error or fraud 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. Our consideration of the internal control over compliance 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, we consider the reportable condition described above to be a material weakness.

Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of CUC as of and for the year ended September 30, 2005, and have issued our report thereon dated July 19, 2007, which was qualified due to our inability to obtain responses from CUC's legal counsel and attorney concerning litigation, claims and assessments; 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 basic 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 basic 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 basic financial statements and, in our opinion, except for the effects of such adjustments, if any, as described in the aforementioned report, is fairly stated, in all material respects, when considered in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the management and the Board of Directors of CUC, 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.

DeBodt & Busch LLC

July 19, 2007

COMMONWEALTH UTILITIES CORPORATION

Schedule of Programs Selected for Audit in
 Accordance with OMB Circular A-133
 Year Ended September 30, 2005

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 - 2003 Capital Development Projects	\$ <u>2,603,819</u>
		Total program expenditures	\$ 3,906,378
		Less local match	<u>(1,108,464)</u>
		Total federal program expenditures	\$ <u>2,797,914</u>
		% of total federal program expenditures tested	<u>93%</u>

COMMONWEALTH UTILITIES CORPORATION

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2005

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, 2004	Adjustments FY05	Cash Receipt FY05	Expen- ditures FY05	Receivable (Deferred) Revenue) from Grantor at September 30, 2005
<u>U.S. Environmental Protection Agency</u>							
Direct Program:							
Beach Road Sewer System	66.418/-/-	\$ -	\$ -	\$ -	\$ 157,196	\$ 157,196	\$ -
Kanat Tabla IMG Tank	66.418/-/-	-	-	10,997	31,499	-	(20,502)
Airport Sand Filtration Rehabilitation	66.418/-/-	-	-	13,732	29,667	-	(15,935)
Achugao/Tanapag Filtration System	66.418/-/-	21,000	(4,168)	-	-	-	(4,168)
Subtotal CFDA #66.418		21,000	(4,168)	24,729	218,362	157,196	(40,605)
<u>U.S. Department of the Interior</u>							
Buddy System Grant	OMIP 2001-1	15,000	-	2,517	-	-	2,517
Buddy System Grant (2002-2 Bar Coding)	OMIP 2001-1	42,300	-	-	1,190	1,190	-
Buddy System Grant (2004-1 Hydraulic Model)	OMIP 2001-1	-	3,547	-	3,547	-	-
Passed through the Government of the CNMI:							
<u>Federal Portion</u>							
Power Plant I Renovation	15.875/-/-	2,673,000	-	-	-	479,560	479,560
Sinapalo III Waterline	15.875/-/-	-	-	54,833	-	136,813	191,646
Beach Road Sewer System	15.875/-/-	-	-	-	1,395,308	1,457,745	62,437
San Vicente Waterline	15.875/-/-	-	-	-	27,200	27,200	-
Carolina Agriculture Homestead Waterline	15.875/-/-	805,000	73,694	(59,118)	50,959	36,383	-
China Town Sewer System	15.875/-/-	860,000	36,838	(36,838)	-	-	-
Kagman Sewer System	15.875/-/-	5,000,000	-	-	30,524	30,524	-
Koblerville Sewer System	15.875/-/-	-	61,893	(51,893)	268,017	268,017	10,000
Carolina/Marpo Heights II Waterline	15.875/-/-	-	-	-	166,387	166,387	-
Subtotal Federal Portion		9,395,300	175,972	(90,499)	1,943,132	2,603,819	746,160
<u>Local Matching Portion</u>							
Tun Doi Waterline	15.875/-/-	-	52,617	-	52,000	(617)	-
Carolina Agriculture Homestead Waterline	15.875/-/-	805,000	73,694	(59,118)	50,958	36,382	-
China Town Sewer System	15.875/-/-	860,000	8,027	(8,027)	-	-	-
Kagman Sewer System	15.875/-/-	5,000,000	-	-	30,524	30,524	-
Carolina/Marpo Heights II Waterline	15.875/-/-	-	-	-	166,386	166,386	-
Beach Road Sewer System	15.875/-/-	-	-	-	508,019	530,762	22,743
San Vicente Waterline	15.875/-/-	-	-	-	27,200	27,200	-
Sinapalo III Waterline	15.875/-/-	-	-	-	-	49,811	49,811
Koblerville Sewer System	15.875/-/-	-	61,893	(51,893)	268,016	268,016	10,000
Subtotal Local Matching Portion		6,665,000	196,231	(119,038)	1,103,103	1,108,464	82,554
Subtotal CFDA #15.875		16,060,300	372,203	(209,537)	3,046,235	3,712,283	828,714
<u>U.S. Department of Homeland Security</u>							
Passed through the Government of the CNMI:							
Public Assistance Grants	97.036/-/-	-	1,043,220	63,794	691,837	31,790	446,967
Homeland Security - ODP Critical Infrastructure		-	-	-	-	-	-
Water Augmentation Program	97.036/-/-	-	-	-	5,109	5,109	-
Subtotal CFDA #97.036		-	1,043,220	63,794	696,946	36,899	446,967
		\$16,081,300	\$1,411,255	\$ (121,014)	\$3,961,543	\$ 3,906,378	\$ 1,235,076

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, 2005

(1) Scope of Audit

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 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 that 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.

Any federal funds expended in excess of federal funds received are recorded as a receivable from the grantor agency and any federal funds received in excess of federal funds expended are recorded as a payable to the grantor agency.

B. Indirect Cost Allocation

For fiscal year 2005, CUC had no indirect cost agreement with grantor agencies.

C. Matching Requirements

In allocating project expenditures between the federal share and the local share, a percentage is used based upon local matching requirements, unless funds are specifically identified to a certain phase of the project.

COMMONWEALTH UTILITIES CORPORATION

Notes to Schedule of Expenditures of Federal Awards
Year Ended September 30, 2005

(3) Adjustments

During the year ended September 30, 2005, CUC reconciled the amount due from grantor agencies resulting in a net adjustment of \$121,014.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs
Year Ended September 30, 2005

Section I - Summary of Auditor's Results

1. The Independent Auditors' Report on the basic financial statements expressed a qualified opinion due to our inability to obtain responses from CUC's legal counsel and attorney concerning litigation, claims and assessments; 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.
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 basic financial statements were disclosed by the audit.
4. One reportable condition in internal control over compliance with requirements applicable to major federal award programs was identified, which is considered to be a material weakness.
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: OTIA Capital Development Projects	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 Statement Findings

<u>Reference Number</u>	<u>Findings</u>	<u>Refer Page #</u>
2005-1 - 2	Revenue/Receipts	11 - 12
2005-3 - 4	Purchases/Disbursements	13 - 14
2005-5 - 6	Payroll	15 - 17
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COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Section II - Financial Statement Findings, Continued

<u>Reference Number</u>	<u>Findings</u>	<u>Refer Page #</u>
2005-22	Debt	38
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Section III - Federal Award Findings and Questioned Costs

<u>Reference Number</u>	<u>Findings</u>	<u>Questioned Costs</u>	<u>Refer Page #</u>
2005-27	Procurement and Suspension and Debarment	\$ 66,907	43 - 44

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Section II - Financial Statement Findings

Revenue/Receipts

Finding No. 2005-1

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

Condition: Investigation of long outstanding accounts revealed a listing of twenty-one accounts amounting to \$1,042,034 prepared by the credit and collections division of accounts that were not to be disconnected. Although these accounts are substantially 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 years 1996 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Revenue/Receipts

Finding No. 2005-2

Criteria: Pursuant to CUC's Electric Service Regulations Part 24.5.8.1, fuel surcharge fee provides that any difference between the actual fuel costs and fuel surcharge fee (FSF) revenues shall be accumulated in a deferred account and shall be subject to an annual reconciliation. Any over- or under-recovery of fuel costs will be included in the next annual FSF.

Condition: During the fiscal year ended September 30, 2005, CUC did not perform an analysis or determination of the difference between the actual fuel costs and fuel surcharge fee revenues. As a result, CUC did not maintain a deferred account.

Cause: The cause of the above condition is the lack of policies and procedures in determining and analyzing actual fuel costs against fuel surcharge fee revenues.

Effect: The effect of the above condition is noncompliance with Part 24.5.8.1 of CUC's Electric Service Regulations.

Recommendation: We recommend that CUC establish policies and procedures to analyze actual fuel costs against fuel surcharge fee revenues and ensure that necessary FSF revenue deferrals are properly recorded and are in accordance with CUC's Electric Service Regulations.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Purchases/Disbursements

Finding No. 2005-3

Criteria: Capital expenditures should be recorded in the period incurred and in a timely manner.

Condition: Of \$3,185,929 in construction in progress expenditures tested, we noted the following:

- 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>
270 OS	3	\$ 65,252
280 OS	3813	\$ 34,921
282 OS	1, 2, 3	\$412,520
285 OS	1, 2, 3	\$210,030

- The current year expenditures for one contract (contract # 280-05, payment applications 4-9) amounting to \$66,368 was not recorded.

Cause: The cause of the above condition is the lack of reconciliation of capital expenditures with the CNMI Government Capital Improvement Projects Coordinator and lack of procedures in place to ensure that payment requests made to the CNMI Government are forwarded on a timely basis to CUC accounting for recording.

Effect: The effect of the above condition is the misstatement of current and prior year capital expenditures and liabilities.

Recommendation: We recommend that CUC ensure reconciliations of capital expenditures are performed with the CNMI Government Capital Improvement account and ensure that all payment requests made from the Grants Department are reviewed and forwarded to the Accounting Department in a timely manner to ensure capital expenditures are properly recorded.

Prior Year Status: Lack of reconciliation of capital expenditures with the CNMI Government Capital Improvement Projects Coordinator and lack of procedures in place to ensure that payment requests made to the CNMI Government are forwarded on a timely basis to CUC accounting for recording was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Purchases/Disbursements

Finding No. 2005-4

Criteria: Disbursements should be properly supported with receiving reports or certification of completion as evidence of receipt of goods or performance of services. Further, such supporting documents should be maintained and filed accordingly.

Condition: The receiving report or certification of completion of services performed for the following disbursements were not made available:

<u>Check #</u>	<u>Invoice/Contract #</u>	<u>Amount</u>
71008	147946	\$ 16,167
71247	37687	61,961
71019	994623	<u>8,113</u>
		\$ <u>86,241</u>

Cause: The cause of the above condition is failure to ensure completeness of relevant supporting documents prior to processing payment, a lack of strict compliance with established policies and procedures and a lack of proper and systematic filing of relevant supporting documents.

Effect: The effect of the above condition is the potential for unauthorized/invalid expenditures and possible duplicate payments to vendors.

Recommendation: We recommend that CUC ensure all expenditures are properly supported by receiving reports or certification for completion of services. Additionally, CUC should ensure that established policies and procedures regarding the processing of payments are strictly adhered to.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Payroll

Finding No. 2005-5

Criteria: Personnel independent of the payroll process should perform the input of employee pay rates.

Condition: During our testing of payroll expenses, we noted that the payroll department inputs the approved pay rate into the system.

Cause: The cause of the above condition is the lack of proper segregation of duties of payroll processing.

Effect: The effect of the above condition is the potential for payroll personnel to alter pay rates.

Recommendation: We recommend that management review the payroll process to ensure all input of pay rates be performed by the Human Resources Department.

Prior Year Status: Lack of established policies and procedures over proper segregation of duties of payroll processing was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Payroll

Finding No. 2005-6

Criteria: Payroll timesheet/timecard reports, overtime and leave authorizations should be signed by the employee and approved by the respective division manager. Non-emergency overtime is required to be pre-approved by a supervisor seventy-two hours in advance. Additionally, all allotments should be approved by the employee and be maintained in the employee personnel file.

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

- Although timesheets were properly approved, the timecard reports did not evidence the employee's signature for the following:

<u>Pay Period</u> <u>Ended</u>	<u>Employee No.</u>
12/25/04	4141
04/16/05	402
06/25/05	806
04/02/05	59
05/28/05	10109
04/30/05	4276

- The overtime requests and authorization for the following employees were approved after the job was completed:

<u>Pay Period</u> <u>Ended</u>	<u>Employee No.</u>
10/30/04	788
01/08/05	3511
04/16/05	402
07/23/05	10020
12/25/04	4141
03/19/05	10100
05/28/05	10109

- Four 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. Further, we noted instances where deductions do not agree to supporting allotment forms.

<u>Pay Period</u> <u>Ended</u>	<u>Employee No.</u>
12/11/04	230
06/11/05	13
07.09.05	2444
07.23.05	10020

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Finding No. 2005-6, Continued

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 of overtime and unauthorized deductions from employee pay.

Recommendation: We recommend that CUC ensure that all payroll timesheet/timecard reports, overtime and leave authorizations are signed by the employee and approved by the respective division managers. We also recommend that CUC ensure all payroll deductions are properly supported by employee authorizations maintained in employee personnel files.

Prior Year Status: Lack of adherence to established policies and procedures relating to the review and authorization of payroll related documents was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

External Financial Reporting

Finding No. 2005-7

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. At September 30, 2005, CUC's Schedule of Expenditures of Federal Awards (SEFA) contains adjustments amounting to \$121,014 with no support.

Cause: The cause of the above condition is that management has not implemented an adequate system of reconciling receivable or payable balances and monitoring related transactions.

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 SEFA.

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 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Receivables

Finding No. 2005-8

Criteria: Accounts receivable should be based on valid billings and collected in a timely manner.

Condition: At September 30, 2005, CUC has recorded \$16,632,680 in receivables from the CNMI government. The CNMI government reported a payable to CUC of \$15,593,119 at September 30, 2005, resulting in a variance of \$1,039,561. A reconciliation of this variance was not provided. The CNMI government has determined that most of these receivables are based on estimates related to water and sewer billings from previous years. As such, the CNMI is disputing these receivables. At September 30, 2005, CUC recorded an allowance for doubtful accounts of \$16,279,944 related to these receivables.

In addition, at September 30, 2005, the CNMI government reported total utilities expense of \$12,926,624. Revenues earned from the government per CUC at September 30, 2005 amounted to approximately \$10,329,770, resulting in a variance of \$2,596,854. A reconciliation of this variance was not provided.

Cause: The cause of the above condition is lack of reconciliation and review of individual government accounts and timely collection of outstanding balances.

Effect: The effect of the above condition is that receivables and revenue from the CNMI government may be misstated.

Recommendation: We recommend CUC review the government utility accounts in detail with the CNMI to determine proper classification of the accounts and ensure proper billing.

Prior Year Status: Lack of reconciliation and review of individual government accounts and timely collection of outstanding balances was reported as a finding in the audits of CUC for fiscal years 2003 and 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Receivables

Finding No. 2005-9

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

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

- Account # 29619-4, amounting to \$289,943, 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 has not been disconnected.
- Account # 18802-9, amounting to \$33,849, 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. The account indicated no activity during the year.
- Account #21868-5, amounting to \$119,756, was backbilled due to an unregistered meter. The customer is not making payments on the backbilling and has not been disconnected.
- Thirty-two accounts amounting to \$3,155,295 at September 30, 2005 made payments only sufficient to cover current billings. They did not make payments on past due balances and have not been disconnected.
- One account (# 53112-9) amounting to \$78,198 at September 30, 2005 made no payments during the year; however, they were assessed late charges.
- One account (# 8267-7) amounting to \$42,843 at September 30, 2005 made no payments during the year; however, was assessed current and late charges. The power and water services have been disconnected.
- Fifteen accounts (#s 12504-7, 29460-3, 27421-7, 26138-8, 36169-1, 10509-8, 15542-4, 7587-9, 26354-1, 27613-9, 8055-6, 35751-7, 29506-3, 40700-7 and 13263-9) amounting to \$674,089 at September 30, 2005 indicated no activity during the year. All of the accounts have been disconnected.
- An adjustment made for one account (customer #42499-4) pertains to prior year billings (i.e. November 2000 to May 2004) that were identified and adjusted only in the prior fiscal year which resulted in a negative receivable balance. At September 30, 2005, the receivable balance of this customer amounts to (\$1,400).
- Billings for water usage for one account (customer #32529-0) were based on estimates but adjustments to actual water usage were made. Further, estimates made varied significantly throughout the year.
- One account (customer #1905-9) made no payments during the year, however, was assessed current and late charges. Although the power service has been disconnected since 2003, the water and sewer services for this account remain active.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Finding No. 2005-9, Continued

Condition, Continued:

- Account # 39601-0, amounting to \$1,018,639, was erroneously billed electric charges amounting to \$959,604 in March 2005. CUC made an adjustment to reverse the erroneous billing only in the next fiscal year. Because of the delay in correcting the erroneous billing, the account was also billed for late charges automatically computed by the system. This was corrected through an audit adjustment.
- Account #s 11190-6, 40537-3, 18802-9, and 47612-7, amounting to \$40,141, \$39,089, \$33,849, and \$31,148, respectively, at September 30, 2005, were adjusted in the subsequent fiscal year to correct previous billing errors or reverse prior year overcharges. This was corrected with an audit adjustment.
- Account # 838-3, amounting to \$27,019, was sent a closing billing in March 2005 due to nonpayment, but subsequent readings and charges were still made. It appears that the account has not been disconnected despite the nonpayment.
- Account # 49628-1, amounting to \$44,862, was billed two accumulated one-time charges during the year due to irregular readings made.
- Accounts #s 55385-9, 56282-7, and 38794-4, amounting to \$40,322, \$39,922, and \$14,507, respectively, at September 30, 2005, were billed based on erroneous meter readings resulting in over billings of \$38,898, \$39,922, and \$14,507, respectively. These balances were adjusted through audit adjustments.
- Account #s 4330-7, 4329-9, 29619-4, 4333-1, 18141-2, 4863-7, 31696-8, 53024-6, and 13001-3, amounting to \$601,696, \$385,449, \$289,993, \$230,003, \$158,549, \$127,364, \$98,267, \$36,233, and \$29,484, respectively, appear to have not been aged properly. Regular payments were made only for current charges, sometimes not even adequate to cover current charges. Since prior year's ending receivable balances have not been paid, the total amounts should have been aged as more than seventy-five days due. However, as of September 30, 2005, the total balance aged as more than seventy-five days due was less than the prior year's ending receivable balance.

The accounts noted above are substantially allowed for.

Further, during our testing of the other receivables balance amounting to \$805,136 at September 30, 2005, 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 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 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, lack of 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.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Finding No. 2005-9, Continued

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 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Receivables

Finding No. 2005-10

Criteria: CUC's policy for accounts receivable allowance assessment provides for a one hundred percent (100%) provision for account balances greater than seventy-five days old.

Condition: Of fifty-eight accounts receivable (totaling \$5,825,559) tested, we noted balances less than seventy-five days old representing billings due to erroneous meter usage and disputed balances amounting to \$94,117. Based on our review of subsequent collections, we noted that some of these billing errors were written-off in the subsequent fiscal year but were not adequately provided for.

Cause: The cause of the above condition is the lack of specific review of accounts receivable that are less than seventy-five days old which, at September 30, 2005, amounted to \$9,095,178.

Effect: The effect of the above condition is the possible overstatement of net receivables and understatement of bad debt.

Recommendation: We recommend CUC evaluate its current accounts receivable allowance assessment policy to consider specific review of individual accounts in the determination of the allowance for doubtful accounts. CUC should also consider establishing an allowance for accounts aged less than seventy-five days based on historical experience.

Prior Year Status: Lack of specific review of accounts receivable was reported as a finding in the audits of CUC for fiscal years 2003 and 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Receivables

Finding No. 2005-11

Criteria: All advances should be periodically reviewed to ensure recovery or proper recording of expense.

Condition: Detailed summaries of other receivables and travel advances outstanding amounting to \$805,136 and \$8,279, respectively, as of September 30, 2005 were found to contain many individual items outstanding in excess of one year. At September 30, 2005, CUC recorded an allowance for doubtful accounts of \$668,436 related to these accounts.

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

Effect: The effect of the above condition is an overstatement of CUC's assets and an understatement of expenses at September 30, 2005. 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, 2005 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 2004.

COMMONWEALTH UTILITIES CORPORATION
Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Inventory

Finding No. 2005-12

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 sixty-two inventory items physically counted, seventeen instances were noted where the count varied from the final inventory listing.
- Of sixty-two inventory items traced from CUC's count sheet to the final inventory listing, we noted four instances where the final quantity varied from the counts.
- The count sheets for four warehouses (ref. Warehouse E-Saipan Generation, R-Rota Power Distribution, S-Rota Water and U-Rota Generation) were not made available.

Cause: The cause of the above conditions 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 be inventory on hand. Therefore, inventory issuances by warehouse may result in negative inventory per books.
- Inventory issuances are not always 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.

Effect: The effect of the above condition is a possible misstatement of inventory balances resulting in an opinion qualification on the account balance and related expenses.

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 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Inventory

Finding No. 2005-13

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 valuation 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 is the lack of established policies and procedures over inventory reconciliations.

Effect: The effect of the above condition is a possible misstatement of inventory balances resulting in an opinion qualification on the account balance and related expenses.

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

Prior Year Status: Lack of established policies and procedures over inventory reconciliations was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Inventory

Finding No. 2005-14

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 balances resulting in an opinion qualification on the account balance and related expenses.

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.

Prior Year Status: Lack of established policies and procedures for the review and monitoring of obsolete and non-moving inventories was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Inventory

Finding No. 2005-15

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, 2005 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 of 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 resulting in an opinion qualification on the account balance and related expenses.

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.

Prior Year Status: Untimely posting of inventory purchases, receipts and issuances, the lack of coordination between warehouse and accounts payable personnel for input of purchases and issuances and monitoring and review of inventory adjustments was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Collection of Notes Receivable

Finding No. 2005-16

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 eight 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 the 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. Based on review of subsequent collections, no payments were made. We were unable to locate documentation to indicate that alternate collection procedures were pursued.
- The promissory note for one customer (# 56599) has not been provided for review.

In tests of \$1,023,230 of \$1,223,245 total notes receivable recorded at September 30, 2005, we noted the following:

- Nine customer accounts (#s 8267, 53017, 26567, 9086, 11848, 50277, 35769, 45277 and 8263) amounting to \$148,610 did not indicate any payments made subsequent to year end.

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.

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

Recommendation: We recommend that 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 audits of CUC for fiscal years 2001 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Prepayments

Finding No. 2005-17

Criteria: Recorded prepayments should represent valid assets of an entity. Additionally, a good internal control provides for timely identification and reversal of prepayments upon receipt of goods and/or services.

Condition: Prepayments per the general ledger amounting to \$480,334 at September 30, 2005 include the following items, which were paid and received during fiscal year 2005:

<u>Vendor Number</u>	<u>Document Ref. Number</u>	<u>Check Number</u>	<u>Amount</u>
1928	05-6393	5089/5097/5101	\$ 22,400
1928	P05-5414	5027	7,261
183	05-5712	5044	16,034
183	CUCPG04-C011	4128/5018	7,480
			<u>\$ 53,175</u>

Additionally, two items (ref. PO #s 05-5991 and 05-6383) amounting to \$46,824 were paid subsequent to September 30, 2005 but have been recorded as prepayments at September 30, 2005. The above conditions were corrected through a proposed audit adjustment.

Relevant supporting invoices and check payments for one prepayment amounting to \$2,988 (vendor # 183) were not made available.

Cause: The cause of the above condition is the lack of establish policies and procedures on strict monitoring of prepayments.

Effect: The effect of the above condition is the misstatement of prepayments and expenses.

Recommendation: We recommend that CUC establish policies and procedures on monitoring of prepayments.

COMMONWEALTH UTILITIES CORPORATION
 Schedule of Findings and Questioned Costs, Continued
 Year Ended September 30, 2005

Utility Plant

Finding No. 2005-18

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 determining utility rates 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. During our detailed testing of fixed assets, we noted the following:

- There is a lack of timely review and certification of projects for completion. 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.
- 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 repair and maintenance expense in the related fiscal years was overstated and understated, respectively.
- 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.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued Year Ended September 30, 2005

Finding No. 2005-18, Continued

Condition, Continued:

- 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 projects, are not consistently capitalized. This condition resulted in numerous variances between project costs recorded by CUC and project costs determined through attest procedures.
- A periodic inventory of CUC's fixed assets 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.
- 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 and inoperable, CUC should suspend depreciation and record a disposal of fixed assets.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Finding No. 2005-18, Continued

Condition, Continued:

- The supporting documents for the following work orders evidencing material issuances, labor charges to appropriate work orders and certification of work completion have not been provided. Thus, we were unable to verify that the following work orders were valid and closed in a timely manner.

<u>Work Order #</u>	<u>Fixed Asset #</u>	<u>Amount</u>
201550	9641501	\$ 4,800
300802	Various	\$ 7,543
200346	Various	\$ 69,891
201550	9651901	\$ 11,543
301749	9680181	\$ 10,751

- There were no overhead costs charged to two work orders (#s 201550 and 300802).
- The current year depreciation per the accumulated depreciation lapsing schedule is \$185,965 more than the recorded depreciation expense per the general ledger. Additionally, tests of reasonableness of recorded depreciation expense noted an understatement in recorded depreciation by \$457,525. Further, the accumulated depreciation balance per the general ledger is \$1,474,625 more than the amount per the fixed asset register.
- Current year movements in the accumulated depreciation account include transfers from work orders of \$13,758, disposals of \$330,312 and adjustments of \$565,929. Detailed schedules for these transactions were not made available.
- The fixed asset balance per the general ledger was not reconciled to the subsidiary ledger resulting in a variance of \$1,939,698.
- A detailed schedule of current year construction-in-progress (CIP) has not been provided.
- Current year movement in the fixed assets account includes transfers from work orders of \$1,185,779, transfer from CWIP of \$ 5,804,902, additions of \$ 164,739 and adjustments of \$7,881,081. Detailed schedules for these transactions were not made available.

Cause: The causes of the above conditions are as follows:

- No inventory of fixed assets has been performed.
- Lack of coordination between CUC's departments responsible for project oversight and the accounting department relative to procedures for closing completed projects.
- Lack of timely review and certification of projects for completion.
- The fixed asset capitalization policy is not being consistently applied.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Finding No. 2005-18, Continued

Cause, Continued:

- Lack of supporting documents.
- Lack of details and a reconciliation of the construction in progress accounts.
- Assets are not individually evaluated as to their useful life prior to being capitalized.
- Lack of periodic review of work orders.
- Lack of reconciliation between the general ledger and subledger.

Effect: The effect of the above conditions is a possible misstatement of fixed asset balances resulting in an opinion qualification on the account balance and related depreciation expense. 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 2004.

COMMONWEALTH UTILITIES CORPORATION
Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Utility Plant

Finding No. 2005-19

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 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Obligations under Capital Lease

Finding No. 2005-20

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 possible misstatement of obligations under capital lease resulting in an opinion qualification on the account balance.

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 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Accrued Expenses

Finding No. 2005-21

Criteria: Accrued annual leave and other accruals should be reviewed and reconciled regularly.

Condition: Accrued annual leave per the general ledger varies with the subsidiary ledger by \$90,045. This condition was corrected through a proposed audit adjustment. Additionally, other accrued expenses include payables for compensatory time credits which have been outstanding for more than one year.

Cause: The cause of the above condition is lack of policies and procedures to properly review and reconcile accrued annual leave.

Effect: The effect of the above condition is the misstatement of accrued expenses and related expense accounts.

Recommendation: We recommend that CUC establish policies and procedures to properly review and reconcile annual leave. We also recommend CUC review the validity of accruals on a regular basis.

COMMONWEALTH UTILITIES CORPORATION
Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Debt

Finding No. 2005-22

Criteria: Section 7.2 of a loan agreement with a contractor requires CUC to establish and maintain an escrow account of not less than \$360,000 as part of their security agreement.

Condition: At September 30, 2005, CUC closed the escrow fund account established in a prior year.

Cause: The cause of the above condition is lack of sufficient funds and a tight cash flow position.

Effect: The effect of the above condition is noncompliance with the loan agreement.

Recommendation: We recommend that CUC re-establish the escrow account to ensure compliance with debt requirements.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Automated Data Processing

Finding No. 2005-23

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 a lack of required policies and procedures regarding ADP.

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 the 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. CUC should also 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 audits of CUC for fiscal years 2001 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Recovery of Labor Costs

Finding No. 2005-24

Criteria: Generally, direct costs incurred internally, including labor costs, related to 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 CUC review the above condition and consider requesting reimbursement of direct labor costs 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 audits of CUC for fiscal years 2001 through 2004.

COMMONWEALTH UTILITIES CORPORATION
Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Board Minutes

Finding No. 2005-25

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

Condition: The minutes of board of directors' meetings subsequent to December 14, 2004 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 an incomplete record of board of directors' actions and decisions resulting in an opinion qualification.

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

Prior Year Status: Lack of timely transcription of the minutes of board of directors' meetings was reported as a finding in the audits of CUC for fiscal years 2002 through 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Local Noncompliance

Finding No. 2005-26

Criteria: In certain instances, the award of contracts for recurring and continuing service requirements are often delayed due to circumstances beyond the control of contracting offices. An effective procurement regulation should explicitly provide for policies governing extension of performance for recurring and continuing service requirements.

Condition: Our review of compliance with procurement regulations noted three contracts (ref. Contracts CUC-PG-04-C002, CUC-ALL-04-C005 and CUC-AD-03-C024), which were renewed for another year. The contracts included a provision for contract renewal that was exercised by CUC. CUC's procurement regulations, however, do not explicitly provide for policies governing extension of contracts for recurring and continuing service requirements.

Cause: The cause of the above condition is lack of established policies governing extension of contracts for recurring and continuing service requirements.

Effect: The effect of the above condition is the potential to award contracts without providing for an open and free competition.

Recommendation: We recommend CUC review existing procurement regulations and formulate policies governing extension of contracts for recurring and continuing service requirements.

Prior Year Status: Lack of established policies governing extension of contracts for recurring and continuing service requirements was reported as a finding in the audit of CUC for fiscal year 2004.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Section III - Federal Award Findings and Questioned Costs

Procurement and Suspension and Debarment

Finding No. 2005-27

Program	Reason for Questioned Costs	Questioned Costs
U.S. Department of the Interior / DOI and Capital Improvement Projects / CFDA # 15.875 / Federal Award # Fiscal Year 1996 - 2002 Appropriations Act / Federal Award Period Available Until Expended	<p><u>Criteria:</u> Section 12.76(a) of 43 CFR 12, Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments, requires that a State will use the same policies and procedures used for procurements from non-Federal funds. They also shall ensure that every purchase order or other contract includes any clauses required by Federal statutes and executive orders and their implementing regulations.</p> <p>Furthermore, in accordance with Section 5-103 of the CNMI Procurement Regulations, contractors shall not be allowed to continue working beyond the expiration term of an original contract in the absence of an approved new contract or change order. Change orders shall be processed using the procedures for processing new contracts in Section 2-104. Further, Section 5-103 (2) of the CNMI Procurement Regulations states that before adding significant new work to existing contracts, the agency shall thoroughly assess whether or not it would be more prudent to seek competition. Change orders on construction and A&E contracts which exceed 25 percent of the cumulative contract price shall automatically be procured through competitive procedures pursuant to Section 3-101, except when the procurement of the additional work is authorized without using full and open competition under Section 3-104.</p>	

Condition: Of \$2,097,640 in expenditures tested, we noted the following:

- Expenditures were incurred beyond the contract expiration for the following:

<u>Contract</u>	<u>Invoice/ Payment Request #</u>	<u>Total Amount</u>	<u>Federal Share</u>
250 OS	13	\$ 72,767	\$ 36,383
144 OS	10	<u>61,047</u>	<u>30,524</u>
Total		<u>\$ 133,814</u>	<u>\$ 66,907</u>

The related change orders for the above contracts were approved subsequent to the expiration date of the original contracts.

We noted that the delay in processing the change order to extend the contract period for one contract (Ref. 144 OS) was due to the suspension of funds by the grantor agency on February 21, 2003. However, documentation verifying that grantor agency had lifted the suspension during the year has not been provided.

\$ 66,907

- One contract (ref. # 278-OS) for construction management services was procured through competitive sealed proposals. During our review, it was noted that only the highest ranked contractor was approached to submit a cost proposal for negotiation. It was also noted that the second and third ranked contractors were within competitive range and should have been approached to submit a cost proposal for proper consideration of all evaluation factors. The actual expenditures incurred to date, however, are still within the original contract amount; therefore, no questioned costs result at this time.

COMMONWEALTH UTILITIES CORPORATION

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2005

Finding No. 2005-27, Continued

Program	Reason for Questioned Costs	Questioned Costs
U.S. Department of the Interior / DOI and Capital Improvement Projects / CFDA # 15.875 / Federal Award # Fiscal Year 1996 - 2002 Appropriations Act / Federal Award Period Available Until Expended	<p><u>Condition, Continued:</u></p> <ul style="list-style-type: none"> • Two change orders related to one contract (ref. #280-OS, change orders #s 1 & 2 amounting to \$23,935 and \$54,955, respectively) were procured through small purchase instead of competitive procedures as required by CNMI Procurement Regulations. The change orders exceeded the 25 percent cumulative requirement. We did not note the justification for the small purchase procurement and evidence that the change orders were procured in accordance with CNMI Procurement Regulations. The actual expenditures incurred to date, however, are still within the original contract amount; therefore, no questioned costs result at this time. • Two change orders related to one contract (ref. #282-OS, change orders #s 1 & 2 amounting to \$556,020 and \$516,588, respectively) were procured through small purchase instead of competitive procedures as required by CNMI Procurement Regulations. The change orders exceeded the 25 percent cumulative requirement. We did not note the justification for the small purchase procurement and evidence that the change orders were procured in accordance with CNMI Procurement Regulations. The actual expenditures incurred to date, however, are still within the original contract amount; therefore, no questioned costs result at this time. <p><u>Cause:</u> The cause of the above condition is the lack of established policies and procedures to ensure timely processing of change orders and the use of CUC procurement of contracts in accordance with CUC's procurement regulations.</p> <p><u>Effect:</u> The effect of the above condition is noncompliance with Section 5-103 of the CNMI Procurement Regulations, noncompliance with federal procurement requirements and questioned costs of \$66,907.</p> <p><u>Recommendation:</u> We recommend that CUC ensure compliance with established procurement regulations for pass through grants.</p> <p><u>Prior Year Status:</u> Lack of established policies and procedures to ensure timely processing of change orders and the use of CUC procurement of contracts in accordance with CUC's procurement regulations was reported as a finding in the audit of CUC for fiscal year 2004.</p>	<p style="text-align: right;">Total Questioned Costs \$ <u>66,907</u></p>

COMMONWEALTH UTILITIES CORPORATION

Unresolved Prior Year Findings and Questioned Costs
Year Ended September 30, 2005

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, 2005:

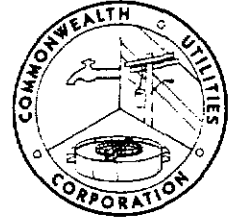
Questioned costs as previously reported	\$ 1,179,015
Questioned costs of fiscal year 2005 Single Audit	<u>66,907</u>
Unresolved questioned costs at September 30, 2005	\$ <u>1,245,922</u>

Unresolved Findings

The status of unresolved prior year findings is discussed in the Schedule of Findings and Questioned Costs section of this report (pages 9 through 44).



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, 2005

Financial Statement Findings

Revenue/Receipts Finding No. 2005-1

CUC partially agrees with the finding.

CUC has continuously investigated easement claims. The Internal Auditor was tasked to conduct a review of these claims. Her report dated February 21, 2006 detailed the following actions taken by CUC to resolve the easement issues:

1. Seven accounts were granted administrative hearings. It was determined that the easement claims were not valid. A final order to close these cases was being prepared by the administrative hearing officer. Subject customers were asked to pay their current charges.
2. Six accounts had meetings with CUC's outside Legal Counsel. Legal advice was that the nature of property was an agricultural homestead. A proposal for settlement was submitted to the customers. The customers requested for administrative hearings. Administrative hearings were conducted. The customers agreed to settle their cases and committed to sign promissory notes (PNs). To date, these customers have not shown up to CUC to sign PNs.
3. Five accounts were disconnected and closed.

The Easement Specialist is also working closely with the new Legal Counsel in reviewing these easement disputes. Per a memorandum dated February 1, 2007, the Easement Specialist forwarded two accounts to the Legal Counsel for review.

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, the Easement Specialist ensures that CUC projects do not encroach on 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.

CUC has established procedures for easement claims. All easement claims are forwarded to the Easement Specialist for preliminary investigation. As soon as he completes his investigation and validates the claim, the Legal Counsel would initiate contact with the customer to settle the problem. A customer who is not willing to settle can request for an administrative hearing. The Legal Counsel would advise the customer to pay their current bill until such time that their case is heard and concluded.

Financial Statement Findings, Continued

Revenue/Receipts, Continued

Finding No. 2005-2

CUC partially agrees with the finding.

The former Assistant Comptroller prepared an analysis of the difference between the actual costs and fuel surcharge fee revenues for the period April 2005 to December 2005. His files were turned over to the Acting Chief Financial Officer (ACFO) and are available for review. There was no request from the auditor for a copy of these analyses.

As of September 30, 2005, the total unrecovered fuel costs amounted to about \$13.7 million. Management is still seeking legal advice whether CUC is capable of recovering such amount before recording it in the books.

CUC is in the process of setting up accounts to monitor the over and under recoveries. The Executive Director assigned staff to research and prepare policies and procedures in order to accurately determine the difference between actual fuel costs against fuel surcharge fee revenues.

Auditor Response: CUC's Electric Service Regulations Part 24.5.8.1 specifically states that any difference between the actual fuel costs and fuel surcharge fee shall be accumulated in a deferred account and subject to an annual reconciliation. CUC did not have such an account at September 30, 2005. This information was requested from the previous Chief Accountant and the Acting Comptroller at the time.

Purchases/Disbursements

Finding No. 2005-3

CUC partially agrees with the finding.

One of CUC's corrective action plans in fiscal year (FY) 2004 to ensure that expenditures were recorded in a timely manner was to perform reconciliation of expenses with the CNMI Government Capital Improvement Projects Coordinator (CNMI-CIP). For FY 2005, CUC obtained a copy of the CNMI-CIP project detail reports and compared dates, numbers of payment requests and amounts to CUC's records. To reconcile with the CNMI-CIP, CUC prepared catch-up entries to the general ledger for those payment requests recorded by the CNMI-CIP but not recorded by CUC. Some of the entries pertained to expenditures incurred in prior fiscal years, which may be the expenditures cited by the auditors that were recorded up in FY 2005.

The expenditures for four contracts cited were for FY 2004 when no reconciliation of expenses was performed.

CUC prepared policies and procedures to ensure proper coordination of transaction processing and recording of payment requests among the different divisions involved such as the initiating division, grants management section and the accounting section. Also included in the procedures are the steps to be undertaken to reconcile records with the CNMI-CIP.

Financial Statement Findings, Continued

Purchases/Disbursements, Continued

Finding No. 2005-4

CUC disagrees with the finding.

The receiving reports and certifications of completion of services for the three instances cited are on file. The Accounts Payable (A/P) staff explained that the documents have always been in the vendors' files. According to her, the auditor did not ask or request for the documents.

The A/P staff ensures that all disbursements are properly supported with receiving reports or certifications of completion of services. The A/P staff prepares the A/P voucher and attaches all supporting documents for review by the A/P supervisor and approval by the ACFO.

Auditor Response: The receiving reports and certification of completion of services were not available on file or per request as of our test date of July 17, 2006.

Payroll

Finding No. 2005-5

CUC agrees with this finding.

CUC management recognizes the need to transfer the function of inputting approved pay rates from the Payroll Section (Payroll) to the Human Resources (HR) office. The Deputy Director for Administration was tasked to find a good HR module for CUC operations. He is still in the process of evaluating the proposals to ensure that the HR module will be able to address CUC's requirements and at the same time facilitate proper segregation of functions in payroll processing. Target completion date to install the CUC HR module is September 2007.

At present, only the Payroll Manager has access to inputting the approved pay rates in the system. The other payroll personnel are restricted. From time to time, the ACFO or her designated staff performs spot checks to review pay rates entered by the Payroll Manager against the approved personnel action.

Finding No. 2005-6

CUC partially agrees with the finding.

The ACFO issued a memorandum to all division managers reiterating strict adherence to established policies and procedures relating to payroll-related documents. Also, the ACFO met with the staff of Payroll and discussed the FY 2005 findings and recommendations.

The Payroll Manager had a meeting with all timekeepers regarding timecards submitted to Payroll. Payroll will no longer accept timecards without the signature of the employee. In the past, Payroll would accept explanations such as, the employee is out on the field or the employee is on leave, as reasons for the employee not signing his or her timecard. Citing the finding, the Payroll Manager will return all unsigned timecards to the division timekeeper.

After-the-fact overtime requests and authorizations are unavoidable for emergencies and trouble calls. Employees and/or crews respond to trouble calls after regular working hours. On the following day, the employee/crew submits the trouble call log to the timekeeper. The timekeeper is responsible for preparing the overtime authorization form (OT form) and attaches the trouble call log to the OT form. The OT form is then routed to the ACFO and the Executive Director for approval.

Financial Statement Findings, Continued

Payroll, Continued Finding No. 2005-6, Continued

Payroll organized the personnel files and ensured that employee withholding authorizations and allotment forms were updated and on file. Also, Payroll was reminded that they should not accept phone-in requests or instructions for payroll deductions. All employees are required to fill out a payroll allotment form and submit the form to Payroll prior to payroll processing.

External Financial Reporting Finding No. 2005-7

CUC partially agrees with the finding.

CUC implemented a system whereby a due from/to account records all cash received from the grantor agency as well as the related expenditures. The procedure was established to address a finding and was part of the corrective action plan for FY 1999. However, due to personnel turnover in the accounting section, the monthly reconciliation of this account was not performed. For FY 2005, a reconciliation of due from/to grantor agencies and capital contributions accounts was only performed at year end.

Also, CUC compared records with the project details report provided by the CNMI-CIP. Each variance noted was investigated. CUC entered all payment requests recorded by the CNMI-CIP but not recorded by CUC to the general ledger.

The ACFO will oversee the training of an accounting staff to handle the due from/to grantor agencies and the related expenditures recorded in the capital contributions accounts.

Receivables Finding No. 2005-8

CUC agrees with the finding.

CUC met with the CNMI Department of Finance (CNMI-DOF) staff-in-charge for utility payables and expenses. The ACFO was assigned to take the lead in reconciling accounts with the CNMI-DOF. Both representatives will sit down to determine the accuracy and the completeness of their records. The CNMI-DOF's listing of utility payables will be compared against CUC's listing of government utility receivable accounts. The comparison will be detailed. The account status (active/closed/disputed) and outstanding balances as of the agreed cut-off date of each individual account from the two (2) listings will be reviewed. Any variance noted will be investigated. Adjustments will be made to bring both records to balance.

As discussed in the most recent meeting with the CNMI-DOF, it was agreed that they will reconcile balances as of September 30, 2006.

Given the reconciled balances, CUC and the CNMI-DOF will prepare a reconciliation on a monthly basis.

Financial Statement Findings, Continued

Receivables, Continued

Finding No. 2005-9

CUC partially agrees with the finding.

Pursuant to Part 19 of the Electric Service Regulations of CUC regarding disputes, in the event of a disagreement of a bill, the customer shall pay the undisputed portion of a challenged billing and any unchallenged additional billings received before the agreement is reached is completed. Account numbers 29619-4, 18802-9, 21868-5 and the thirty-two accounts cited amounting to \$3,155,295 are all disputed accounts. These accounts were backbilled by CUC. Customers disagreed on the amount of the backbilling. The accounts cited are paying current charges. They have not been disconnected pending settlement of their dispute and legal advice.

Dispute of account number 18802-9 was settled in March 2007 and is now current.

Account number 53112-9 refers to a promissory note of a contractor for a government capital improvement project. The contractor owes CUC for the cost of labor and materials incurred for the relocation of poles. This account will be closed, late charges assessed will be reversed and an adjustment to reclassify the receivable will be recorded in FY 2006.

Disconnected/closed account numbers 35751-7, 12504-7, 27421-7, 36169-1, 15542-4, 29506-3 and 40700-7 were already referred to a collection agency. The Executive Director instructed the ACFO to get a report from the collection agency. Should the collection agency see no chance of collecting these long-outstanding accounts, the ACFO will recommend write-off of these receivables.

The ACFO will recommend write-off for account numbers 29460-3, 26138-8, 7587-9, 26354-1, 8055-6, 10509-8, 27613-9 and 13263-9.

Account numbers 8267-7 and 1905-9 will be adjusted in the system. Late charges will be reversed for these closed accounts.

Account number 838-3 was disconnected, closed and transferred/name-changed to another account. Adjustment to transfer balance from this account to the new account will be performed.

Account number 49628-1 is disputing a backbill for water charges. Pending final report from the water investigation team, the account has not been disconnected and is paying current charges.

Account numbers 42499-4, 39601-0, 11190-6, 40537-3, 18802-9, 47612-7, 55385-9, 56282-7 and 38794-4 have adjustments pertaining to prior years' billings. Due to limitations of the automated utility billing module, adjustments for prior years' cannot be posted on its actual year of occurrence. Adjustments are recorded in the current year. Audit adjustments were proposed to correct this error. CUC recorded the adjustments. The ACFO will review all adjustments that affect prior years. She will ensure that adjustments are recorded on their proper period.

Account numbers 4330-7, 4329-9, 29619-4, 4333-1, 18141-2, 4863-7, 31696-8, 53024-6 and 13001-3 are all disputed accounts. Payments are being made only for current charges. It would seem that these accounts have not been aged properly. However, CUC's utility billing system is designed to apply payments received, either for current or past due, always to the over-75 days first. The ACFO will monitor these disputed accounts paying current charges. At year end, when a specific review of accounts is performed, the ACFO will correct the aging report to reflect a more accurate application of payments for the disputed accounts.

Financial Statement Findings, Continued

Receivables, Continued
Finding No. 2005-9, Continued

The ACFO discussed the long-outstanding receivable from the Commonwealth Ports Authority (CPA) with the auditors. CPA advised the auditors that these receivables should have been billed to the contractors. The ACFO recommended write-off of the receivable from CPA noting that there is inadequate documentation to support the claim. This has been outstanding in 1996 and has been 100% allowed for. With the approval of the Executive Director, this receivable will be cleared in CUC books in FY 2007.

Finding No. 2005-10

CUC partially agrees with the finding.

As one of its corrective action plans in FY 2004, CUC reassessed its procedures for determining the allowance for doubtful accounts. To improve financial reporting, CUC implemented procedures to conduct year-end reviews of all accounts not in over-75 days. The Accounts Receivable Section (A/R) individually reviewed each account to determine whether any part of the balance is due to erroneous meter usage (meter reading errors or meter malfunctions) and/or disputed balances. CUC then made a preliminary assessment of the amount that it believed may be uncollectible, including any late charges, which were included in the allowance for doubtful accounts. To prove that these procedures were performed, an analysis was prepared by A/R is available for review. A journal voucher was prepared to provide an additional allowance for doubtful accounts based on this analysis.

This was the first time that this specific review of accounts was performed. The auditors cited some accounts that were not adequately allowed for. The ACFO will revisit the procedures performed to completely capture and assess all accounts in the determination of allowance for doubtful accounts.

Finding No. 2005-11

CUC agrees with the finding.

The ACFO reviewed the status of long-outstanding other receivables and travel advances. Her review revealed that there has been no movement for the past years. Also, these long-outstanding accounts have been substantially allowed for.

A recommendation to write-off these accounts was forwarded to the Executive Director for his approval. Upon his concurrence, a journal voucher will be prepared to clear the general ledger of these accounts.

The ACFO will see to it that there will be monthly review of receivables to ensure timely follow-up of advances.

Inventory
Finding No. 2005-12

CUC agrees with the finding.

The resignation of the Inventory Accountant created a big impact in the accounting functions to ensure reconciliation of final inventory summaries and count sheets. The Warehouse Manager and the ACFO worked together to review the discrepancies noted. One of the accounting staff was temporarily assigned to perform the functions vacated by the former Inventory Accountant.

Financial Statement Findings, Continued

Inventory, Continued

Finding No. 2005-12, Continued

The ACFO and the Warehouse Manager will conduct a refresher training with the personnel involved in the inventory module. A proper coordination among the users of the inventory modules from warehouse operations, accounting, procurement and supply divisions' office staff is the key to accurate inventory records.

The count sheets for Warehouses E, R, S and U are now available for review.

Finding No. 2005-13

CUC agrees with the finding.

The ACFO assigned one of the accounting staff to perform the function of reconciling the inventory balances per the general ledger (GL) and the subsidiary ledger (SL). The former Inventory Accountant used to analyze both records on a monthly basis. Unfortunately, he was not able to complete FY 2005's reconciliation of inventory balances per the GL and the SL.

Reconciliation of inventory balances per the GL and the SL as of September 30, 2005 is in progress. The ACFO will oversee that procedures are properly performed.

Also, the ACFO will initiate action to update the CUC general operating procedures on inventory functions. Preparation of written policies and procedures to ensure timely reconciliation of inventory balances per the GL and the SL is in process.

Finding No. 2005-14

CUC agrees with the finding.

CUC has tasked the Warehouse Manager to segregate all obsolete inventory items. A listing was prepared by warehouse staff and reviewed by the Warehouse Manager. All division managers were required to verify the listing.

To address this audit finding on inventory obsolescence matters, the Warehouse Manager drafted updated CUC's general operating procedures to establish written policies and procedures for the review/assessment and removal of slow-moving, obsolete and/or dead-stock inventories. The draft was forwarded to the ACFO for comments and review. This will be routed to the Executive Director for approval and adoption.

Financial Statement Findings, Continued

Inventory, Continued

Finding No. 2005-15

CUC agrees with the finding.

A team from warehouse operations and accounting was formed to review the negative costs and quantities cited in the finding. The Warehouse Manager was asked to look into the causes of these unusual figures in the inventory records. After his meticulous investigation and review, the Warehouse Manager believes that he needs to reorganize the work groups related to inventory costing. Due to personnel turnover, the Warehouse Manager explains that a staff training on the proper coordination of all modules involved in inventory costing is very much needed. The training will highlight discussions about the flow of transactions that affects the inventory unit cost. Employees responsible in Accounts Payable, Procurement and Supply and the Warehouse need to know how to process inventory transactions in a timely manner. The training will emphasize the effects of timely and accurate encoding of data from the preparation of purchase, receiving and issuing to the encoding of vendor's invoices in coming up with an accurate inventory unit cost. Personnel involved will be instructed on how to use the system-generated daily exception report for negative unit costs and negative quantities. The Warehouse Manager and the ACFO will work hand-in-hand to strictly monitor the flow of information processed in the financial modules involved with inventory costing.

Also, CUC is in the final stage of the installation of the bar-coding system. The new warehouse system is expected to maximize efficiencies such as paperless transactions, immediate postings, as well as improved procedures to ensure accuracy and completeness of inventory transactions.

Collection of Notes Receivable

Finding No. 2005-16

CUC agrees with the finding.

CUC management has reorganized the Credit and Collection Section (C & C). The objective of the reorganization was to improve the transaction processing of the section. The new C & C leadership will review long-outstanding promissory notes and will see to it that demand letters are issued to customers with delinquent accounts.

The PN of customer number 8267 cited in the finding was reviewed by the ACFO. Adjustment to this account will be made.

The nine customers with PNs that did not indicate any payment were already referred to the collection agency. CUC has engaged the services of a collection agency to pursue more aggressive efforts to collect overdue accounts.

The PN for customer number 56599 has been located and is now available for review.

Prepayments

Finding No. 2005-17

CUC partially agrees with the finding.

This finding was corrected through a proposed audit adjustment.

Financial Statement Findings, Continued

Prepayments, Continued

Finding No. 2005-17, Continued

CUC disagrees that there is lack of established policies and procedures for prepayments. CUC General Operating Procedure on General Ledger Functions No. AC-001 established policies and procedures to strictly monitor prepayments. The General Ledger Accountant is responsible for coordinating with A/P to analyze and liquidate prepayments. However, the policies and procedures need to be reviewed, revised and updated to meet the current operations and accounting system.

The ACFO has included prepayments in the plan to revisit the general operating procedures in accounting. She will see to it that the staff-in-charge to monitor prepayments will strictly adhere to the policies and procedures.

Utility Plant

Finding No. 2005-18

CUC agrees that it has not conducted a 100 percent physical inventory of its fixed assets. However, in 2002, CUC engaged Deloitte & Touche LLC (D&T) to perform agreed-upon procedures related to the fixed assets and accounting records. One such procedure was to conduct a physical inventory of all major fixed assets, of which D&T verified the existence of more than 80 percent of the total assets.

Conversely, CUC disagrees that it lacks a registration system for fixed assets. The CUC automated data processing system has a fixed asset module for recording and entering all pertinent data needed to readily identify and account for its assets. The module has three maintenance screens for this purpose, as follows:

Asset Information Screen: for assigning a number to each asset, description, location, classification number, depreciation rate, general ledger code, tag number, serial number, model, manufacturer, vendor name, license number with expiration date (for vehicles), and, if property assigned, employee name.

Asset History Screen: for recording asset cost and or acquisitions and retirements.

Net Book Value Screen: for summarizing the asset cost, accumulative depreciation and net book value.

CUC disagrees that many of the itemized conditions contained in this finding existed at the time of this audit. D&T assisted CUC in reconciling, adjusting, and recording the proposed adjustments to its fixed asset records and/or initiated corrective action to address and remove from the report the following conditions:

- Implemented procedures to ensure timely review, certification, transfer and capitalization of completed projects. The accounting section now coordinates with division engineers to promptly transfer construction work in progress to fixed assets.
- Recorded the D&T adjustments to correct depreciation for completed projects that were not timely closed and transferred to fixed assets.

Financial Statement Findings, Continued

Utility Plant, Continued

Finding No. 2005-18, Continued

- Cleared and/or closed open work orders dating back to FY 1992 to properly capitalize costs, adjust depreciation, write-off costs related to repairs and maintenance, and correctly state construction work in progress. Now, Support Services provides documentation for open work orders to the accounting section each month for closing.
- Analyzed and closed all work orders for FY 2001 and prior. Capitalized costs, adjusted depreciation, wrote off expenses for repairs and maintenance and adjusted construction work in progress, as applicable.
- Capitalized design and survey costs for both past and present projects.
- Recorded D&T adjustment to reclassify AS400 upgrades from asset to expense and reverse related depreciation.
- Removed all items that were either retired or damaged beyond repair from the fixed asset listing.
- Prepared policies and procedures to provide the means for the disposal of CUC's assets. Documents were forwarded to the Executive Director for his review and approval.
- Reversed depreciation for idle assets such as the two Rota wastewater projects.
- Adjusted current and past depreciation for the Yanmar engine in Tinian.
- Changed policy to expense small dollar items of \$1,000 or less. CUC continues to enter these items on the fixed asset listing, but at zero cost. Items are added to the listing to assign responsibility and maintain accountability. Asset cost and other pertinent data for these items are entered as general comments only.
- Adjusted depreciation and recorded entries for the disposal of the three "containerized" Caterpillar engines in Saipan that are no longer operational.

Only two conditions reported in the agreed-upon procedures remain.

- There is a lack of adequate documentation to support the original capitalized costs for the four Power assets and the two Water assets mentioned in the report. These assets were apparently acquired at various times between 1990 and 1993. Therefore, the possibility of locating documentation at this time is minimal at best. Further, CUC is of the opinion that the capitalized costs are fairly stated. A review of prior audit reports for the periods during and subsequent to the capitalization of these assets did not disclose any related audit findings for the six assets in question. In addition, if the actual costs for these assets are determined later, CUC doubts that any adjustment to the recorded costs and accumulated depreciation would have a material affect on the amounts as reported in the financial statements.
- The waste oil incinerator that could not be located during the physical inventory is now under review. To date, CUC found that neither a change order was processed nor an agreement reached that eliminated the incinerator from the contract. CUC referred this matter to its legal counsel for further review and recommendation. This is an ongoing matter that CUC expects to resolve during the current fiscal year.

Financial Statement Findings, Continued

Utility Plant, Continued
Finding No. 2005-18, Continued

Regarding the conditions noted during the audit, CUC disagrees with the following:

- There are no additions/movements in the GL.
- Overhead costs were applied to work order no. 0300802, but not to work order no. 0201550. Regarding No. 0201550, it accounted for costs related to the repair of various fixed assets that were damaged by a typhoon. Of these costs, the Federal Emergency Management Agency (FEMA) reimbursed CUC for 75 percent of all eligible direct costs. Note that overhead costs normally charged to a CUC work order (25 percent of labor and materials) are not an allowable cost that is reimbursable by FEMA.
- General and subsidiary ledger balances for fixed assets were reconciled. Initial reconciliation was prepared in CUC format, which was in a usable format but was apparently unacceptable to the auditor. A second reconciliation was then prepared in D&T format and provided to the auditors. Detailed schedules of transfers from work orders, transfers from CWIP, additions and adjustments are now available for review.

However, CUC does agree that further action is required to resolve the following conditions, as reported:

- Not all supporting documents were located, which were requested by the auditors. This occurred because the respective CUC divisions did not provide these documents to the Fixed Asset Accountant. Accordingly, the Comptroller shall draft a directive to all divisions, signed by the Executive Director, that all work order files must contain sufficient documentary evidence to support all recorded costs. A list of required documents will be identified for each type of project and included with the directive.
- A detailed schedule of current year construction-in-progress (CIP) was not provided to the auditors for their review. The CIP general and subsidiary ledger balances have not been reconciled. Currently, CUC is in the process of reconciling the two ledgers and, when completed, will be provided to the auditors.
- CUC is still in the process of reconciling accumulated depreciation per the general ledger against the amounts in the fixed asset register.

Auditor Response: We acknowledge that CUC has a fixed asset module; however, the proper and effective use of the module would not have resulted in the many discrepancies and issues noted during our audit. Due to the lack of supporting documentation, non-reconciliation of accounts, lack of physical inventory and significant miscellaneous adjustments among others, we are unable to determine that discrepancies have been resolved.

Finding No. 2005-19

CUC agrees with the finding.

CUC has issued a Request for Proposal (RFP) to solicit proposals from insurance companies throughout the region for insurance coverage for its fixed assets. Unfortunately, CUC has not been able to find any insurance company that is willing to offer insurance coverage.

Financial Statement Findings, Continued

Utility Plant, Continued
Finding No. 2005-19, Continued

CUC will continue to seek for insurance companies to address this finding.

Capital Lease
Finding No. 2005-20

CUC disagrees with the finding.

CUC believes that the guaranteed price of \$9,959,000 constitutes the fair value of the leased property. Any payment by CUC in excess of this amount constitutes financing costs. However, this amount may be subject to adjustment pending the resolution of the waste oil incinerator that could not be located, which is valued at \$510,000 (see Finding No. 2005-19). CUC expects the matter regarding the incinerator to be resolved during the current fiscal year. At that time, CUC will make whatever adjustments are necessary to the utility plant and obligations under capital lease.

Further, CUC does not agree that it needs to obtain an appraisal of the plant. The acquisition of the power plant underwent the scrutiny of the competitive procurement process in accordance with CUC Procurement Regulations. CUC issued an RFP and, after discussions with the responsible offerors, awarded the project to the contractor that offered the most favorable price and terms that were available to CUC. Hence, the fair value was established at \$9,959,000.

Auditor Response: CUC had agreed to this finding as reported in fiscal years 2000 through 2003. CUC has determined that the payments made under the agreement are lease payments. To comply with FASB 13 and EITF No. 01-8, a determination of the actual cost of the plant and/or appraisal would be necessary. The amount stipulated in the contract does not necessarily indicate the actual cost or fair value of the asset.

Accrued Expenses
Finding No. 2005-21

CUC agrees with the finding.

The ACFO has assigned the Payroll Manager and the General Ledger Accountant to ensure proper review and reconciliation of accrued leave balances per the payroll report and the GL.

Also, the accounting section is in the process of preparing policies and procedures to review the validity of accruals on a regular basis. This will be part of the ACFO's plan to revisit the general operating procedures of the CUC accounting section.

In regards to the long-outstanding payables for compensatory time (CT) credits, the ACFO forwarded her recommendation to reverse accruals made for this account. CT credits refer to CUC employees who have resigned.

Debt
Finding No. 2005-22

CUC agrees with the finding.

CUC is presently negotiating with the contractor regarding the escrow account. Pending agreement with the contractor, CUC will re-establish the \$360,000 escrow account to comply with the debt requirements.

Financial Statement Findings, Continued

Automated Data Processing

Finding No. 2005-23

CUC agrees with the finding.

CUC's Electronic Data Processing (EDP) department has prepared a draft of its Disaster Recovery Plan and written Automated Data Processing (ADP) policies and procedures. These documents are subject to review by the Deputy Director for Administration and approval by the Executive Director.

Currently, the daily back-up files are stored in a fire-proof vault at the EDP room. The AS/400 month end and year end 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. 2005-24

CUC disagrees with the finding.

Capital improvements projects (CIP) cited by the auditors are all contracted labor and materials project. There are no direct CUC labor costs incurred. Should there be expenses pertaining to the CIP projects, CUC will process request for reimbursement. There are also times that administrative expenses and travel expenses are directly processed at the CNMI Government Department of Finance.

Auditor's Response: Although the various capital improvement projects are contracted, CUC would have incurred labor costs related to monitoring the progress and status of the projects.

Board Minutes

Finding No. 2005-25

CUC partially agrees with the finding.

The Board of Directors have not been able to meet in recent months due to the declaration of the State of Emergency since May 2005. The minutes have not been ratified by the individual Board members.

For some meetings, the minutes are still awaiting transcription. Tapes and board assistant's notes are available for review.

Local Noncompliance

Finding No. 2005-26

CUC disagrees, in part, with the finding.

CUC agrees that it has experienced delays in awarding contracts for recurring and continuing service requirements. However, CUC disagrees that the delays are necessarily beyond the control of the contracting offices and that procurement regulations should provide explicit policies governing the extension of these types of contracts. CUC management is of the opinion that the delays were caused by the contracting office's lack of established controls to monitor the expiration date for these type of contracts. Accordingly, CUC will direct the contracting offices to institute procedures to monitor the completion dates for all contracts for recurring and continuing service requirements.

Financial Statement Findings, Continued

Local Noncompliance, Continued
Finding No. 2005-26, Continued

In this regard, the contracting office shall identify all such contracts. A suspense date shall be established that is six months prior to the expiration date of the contract. On that date, the contracting office shall send a written notice of the expiration date to the appropriate division, with a copy to the Comptroller. The division shall respond, either positive or negative, as to whether CUC has a continuing need for those services. If positive, the division shall forward with the response, those documents needed to initiate a procurement action for the additional services. If the division fails to respond within ten working days, the contracting office shall send a second notice, with a copy to the Comptroller. The division shall respond within five working days of the second notice. If there is still no response, the contracting office shall immediately notify the Comptroller, who will elevate the matter to the Executive Director. The contracting office shall be required to maintain a complete file of all such documents related to monitoring the expiration dates for all contracts with recurring and continuing service requirements.

Regarding the three contracts cited, CUC believes that it was in the best interest of CUC to extend the contracts based on their renewal clauses. These services are required twenty-four hours per day, seven days per week. CUC did not have the option to let the contracts expire, which would have caused lapses in the services. CUC required the services of the mechanics to maintain a somewhat constant supply of electricity to its consumers. In addition, CUC required the services of the guards to comply with certain regulatory requirements imposed by the U.S. Coast Guard and the Homeland Security Act.

The abovementioned procedures should eliminate the condition noted. Nonetheless, CUC will consider revisiting the use of the renewal clause to determine if this issue should be addressed in the CUC procurement regulations.

Auditor Response: The condition states that CUC's procurement regulations do not explicitly provide for policies governing the extension of contracts for recurring and continuing service requirements. Therefore, contracts with options to renew are done so without regard to any established procurement process or procedure.

Federal Award Findings and Questioned Costs

Procurement and Suspension and Debarment
Finding No. 2005-27

CUC partially agrees with the findings.

As long as the contractor is within the budgeted project cost and there is no revision in scope of work, CUC usually allows the contractor to continue work while the change order is being processed. The contractor is required to submit a letter addressed to the Executive Director to request for time extension to complete the work. CUC project engineers evaluate the reasons for time extension and recommend approval. Upon approval by the Executive Director, CUC grants the extension and revises the completion date by processing a change order. Contractors' requests for time extension and letters of approval from the Executive Director are on file and available for review.

Federal Award Findings and Questioned Costs, Continued

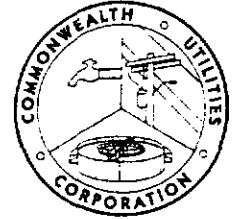
Procurement and Suspension and Debarment, Continued
Finding No. 2005-27, Continued

Although there was no document supporting the lifting of suspension of funds from the U.S. Department of the Interior (DOI) (Ref. 144-OS), DOI approved drawdowns again on May 14, 2003 (after suspension of funds on February 21, 2003).

To address this finding, the Executive Director has tasked the Grants Manager to prepare policies and procedures to ensure timely processing of change orders. The Grants Manager will meet with all division managers to discuss this finding and remind them to strictly adhere to CUC procurement regulations.



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, 2004:

Financial Statement Findings

- Finding No. 2004-1 - Not corrected. See corrective action plan to Finding No. 2005-1.
- Finding No. 2004-2 - Corrective action was taken.
- Finding No. 2004-3 - Not corrected. See corrective action plan to Finding No. 2005-3.
- Finding No. 2004-4 - Not corrected. See corrective action plan to Finding No. 2005-3.
- Finding No. 2004-5 - Not corrected. See corrective action plan to Finding No. 2005-5.
- Finding No. 2004-6 - Not corrected. See corrective action plan to Finding No. 2005-6.
- Finding No. 2004-7 - Corrective action was taken.
- Finding No. 2004-8 - Not corrected. See corrective action plan to Finding No. 2005-7.
- Finding No. 2004-9 - Not corrected. See corrective action plan to Finding No. 2005-8.
- Finding No. 2004-10 - Not corrected. See corrective action plan to Finding No. 2005-9.
- Finding No. 2004-11 - Not corrected. See corrective action plan to Finding No. 2005-10.
- Finding No. 2004-12 - Not corrected. See corrective action plan to Finding No. 2005-11.
- Finding No. 2004-13 - Not corrected. See corrective action plan to Finding No. 2005-12.
- Finding No. 2004-14 - Not corrected. See corrective action plan to Finding No. 2005-13.
- Finding No. 2004-15 - Not corrected. See corrective action plan to Finding No. 2005-14.
- Finding No. 2004-16 - Not corrected. See corrective action plan to Finding No. 2005-15.
- Finding No. 2004-17 - Not corrected. See corrective action plan to Finding No. 2005-16.

Financial Statement Findings, Continued

- Finding No. 2004-18 - Corrective action was taken.
- Finding No. 2004-19 - Not corrected. See corrective action plan to Finding No. 2005-18.
- Finding No. 2004-20 - Not corrected. See corrective action plan to Finding No. 2005-19.
- Finding No. 2004-21 - Corrective action was taken.
- Finding No. 2004-22 - Not corrected. See corrective action plan to Finding No. 2005-20.
- Finding No. 2004-23 - Not corrected. See corrective action plan to Finding No. 2005-23.
- Finding No. 2004-24 - Not corrected. See corrective action plan to Finding No. 2005-24.
- Finding No. 2004-25 - Not corrected. See corrective action plan to Finding No. 2005-25.
- Finding No. 2004-26 - Corrective action was taken.
- Finding No. 2004-27 - Not corrected. See corrective action plan to Finding No. 2005-26.

Federal Award Findings and Questioned Costs

- Finding No. 2004-28 - Not corrected. See corrective action plan to Finding No. 2005-27.
- Finding No. 2004-29 - Corrective action was taken.
- Finding No. 2004-30 - Corrective action was taken.
- Finding No. 2004-31 - Corrective action was taken.
- Finding No. 2004-32 - Corrective action was taken.
- Finding No. 2004-33 - Corrective action was taken.