

PALAU NATIONAL
COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED DECEMBER 31, 2007

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
Palau National Communications Corporation:

We have audited the financial statements of the Palau National Communications Corporation (PNCC) as of and for the year ended December 31, 2007, and have issued our report thereon dated June 10, 2008. 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 PNCC's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PNCC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PNCC's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects PNCC's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of PNCC's financial statements that is more than inconsequential will not be prevented or detected by PNCC's internal control. We consider the deficiencies described in the accompanying Schedule of Findings and Responses (pages 3 and 4) to be significant deficiencies in internal control over financial reporting as items 2007-1 and 2007-2.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by PNCC's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiencies described above are material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PNCC'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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of PNCC in a separate letter dated June 10, 2008.

PNCC's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. We did not audit PNCC's responses and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the management of PNCC, the Board of Directors, the Rural Utilities Service, the cognizant audit and other federal agencies, and is not intended to be and should not be used by anyone other than these specified parties.

Deborah J. Joske LLC

June 10, 2008

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Schedule of Findings and Responses
Year Ended December 31, 2007

Accounts Receivable

Finding No. 2007-1

Criteria: The accounts receivable sub-ledger total should be reconciled to the general ledger control total on a monthly basis.

Condition: A variance of \$181,324 existed between the accounts receivable sub-ledger total and the general ledger control total at year end. This condition was corrected through a proposed audit adjustment.

Cause: The cause of the above condition is that the accounts receivable sub-ledger and general ledger totals are not reconciled on a monthly basis. Additionally, the accounts receivable listing and recurring journal entries are not reviewed by management prior to posting to the general ledger.

Effect: The effect of the above condition is an overstatement of accounts receivable.

Recommendation: We recommend that PNCC reconcile accounts receivable sub-ledger totals to general ledger control totals on a monthly basis and that resulting reconciling items be reviewed by management prior to posting to the general ledger.

Prior Year Status: Inadequate controls over accounts receivable and journal entries were reported as a finding in the audits of PNCC for fiscal years 2005 and 2006.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Mr. Leo Ben Teriong, Chief Financial Officer and Ms. Loretta Shmull, Accounting Manager

Corrective Action: PNCC does reconcile its sub-ledgers and general ledger. However, the reconciliation is not always performed on time as desired and A/R listings and journal entries are reviewed sporadically.

PNCC agrees with the finding and corrective actions will be taken to ensure reconciliation of sub-ledgers and general ledgers is carried out on monthly basis. A manual writing board will be utilized to show if and when reconciliations are completed. The CFO with assistance of Accounting Manager will ensure all A/R listings and journal entries will be reviewed and discrepancies addressed right away.

Proposed Completion Date: Corrective actions will be implemented immediately and shall be carried out throughout the fiscal year.

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Schedule of Findings and Responses, Continued
Year Ended December 31, 2007

Long Distance Revenue

Finding No. 2007-2

Criteria: Minutes billed by international carriers for long distance calls should be reconciled to long distance revenue control totals on a monthly basis.

Condition: PNCC does not reconcile minutes billed by international carriers to long distance revenue control totals on a monthly basis. Our comparison of minutes billed by international carriers, times standard long distance rates, to long distance revenues billed to customers determined an unknown variance of approximately \$478,000 for the year ended December 31, 2007. Management has determined that this variance is not billable or collectible. Additionally we determined that management does not factor the effects of internal usage of long distance minutes into the above variance nor are such internal minutes tracked.

Cause: The cause of the above condition is the lack of reconciliation of minutes billed by international carriers to long distance revenue control totals.

Effect: The effect of the above condition is the possibility that all long distance revenue may not be billed.

Recommendation: We recommend that PNCC reconcile minutes billed by international carriers to long distance revenue control totals on a monthly basis. Additionally, we recommend that PNCC determine the effects of internal usage of long distance minutes in this reconciliation.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Mr. Leo Ben Teriong, Chief Financial Officer and Ms. Loretta Shmull, Accounting Manager

Corrective Action: Prior to introduction of wireless long distance calls, PNCC did not experience much discrepancies or issues with long distance revenues as there was limited options for making international calls and that was through use of fixed line phones. However, as more options become available for customers to make long distance calls, for instance with use of cellular phones, we're beginning to see such discrepancies between carriers billed minutes and what's reported in the AvaBill system.

PNCC agrees with the finding and corrective actions will be taken to require monthly internal audits of carrier billed minutes and what's reported in the systems.

Proposed Completion Date: Immediately and ongoing throughout the fiscal year.

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Unresolved Prior Year Comments
Year Ended December 31, 2007

The status of unresolved prior year findings are disclosed within the Schedule of Findings and Responses section of this report (page 3 and 4).