

PUBLIC UTILITIES CORPORATION
(A COMPONENT UNIT OF THE REPUBLIC OF PALAU)

INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 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
Public Utilities Corporation:

We have audited the financial statements of the Public Utilities Corporation (PUC), as of and for the year ended September 30, 2007, and have issued our report thereon dated July 15, 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 PUC'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 PUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PUC'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 the entity'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 the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying Schedule of Findings and Responses (pages 3 through 7) 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 the entity'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 none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PUC'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 Responses as items 2007-3 and 2007-4.

We noted certain matters that we reported to management of PUC in a separate letter dated July 15, 2008.

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

This report is intended solely for the information and use of the management, the Board of Directors, and others within PUC, and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte + Touche LLP

July 15, 2008

PUBLIC UTILITIES CORPORATION

Schedule of Findings and Responses
Year Ended September 30, 2007

Payroll

Finding 2007-1

Criteria: PUC's personnel manual requires that all overtime must be approved in advance by an employee's immediate supervisor. Further, scheduling annual leave must be arranged with the employee's immediate supervisor prior to incurrence.

Condition: Of thirteen payroll disbursements tested, we noted the following:

- Overtime authorization forms were approved after the overtime hours were rendered for the following:

<u>#</u>	<u>Dept. No.</u>	<u>Employee No.</u>	<u>Pay Period Ending</u>
1	43	6061951	05/12/2007
2	53	6405835	01/20/2007
3	43	6043078	11/11/2006
4	13	6416470	03/03/2007

- Annual leave request for one employee (employee no. 6038513) was approved after the leave period was taken. Further, annual leave hours were applied against time missed by an employee (employee no. 6408614) due to tardiness and were approved after the period stated in the request.

Cause: The cause of the above condition is the untimely approval of overtime and leave requests.

Effect: The effect of the above condition is a control breakdown over payroll authorization.

Recommendation: We recommend that PUC adhere to its policy on overtime and leave as stated in the personnel manual.

Prior Year Status: Untimely approval of overtime requests was reported as a finding in the audits of PUC for fiscal years 2006 and 2005.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Ms. Kalista Isaol, Payroll Accountant

Corrective Action: In response to this finding last year, the Board met to review PUC's current policy on preapproving overtime. The Board concluded their review by ratifying this policy on November 30, 2006. The Board's decision was communicated to all departments on December 1, 2006. Unfortunately, past practice is hard to break. It took several months for managers and supervisors to finally get used to planning and preapproving overtime hours. This policy is already implemented. The payroll accountant is responsible for ensuring compliance with this rule.

Proposed Completion Date: September 30, 2008

PUBLIC UTILITIES CORPORATION

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Inventory

Finding 2007-2

Criteria: Adequate inventory controls should be implemented to assure accountability of inventory received, issued and in stock during the year.

Conditions: Our examination of inventory indicated the following:

- Of twenty-seven inventory items tested, four quantities as of September 30, 2007 increased from the prior year without additional purchases made during the year. We were informed that these are inventory returns but the related inventory return form or equivalent documentation was not provided for our examination.

#	Item Code	No. of Inventory items Returned
1	5218-165 001	13
2	8001-203-003	3
3	8001-203-001	1
4	7036-75KVA	4

- Completed work tickets for two inventory issuances (Ref. No. 403-0648 and 403-0649) charged to operations amounting to \$23,884 and \$18,095, respectively, were not made available for examination. Further, the inventory issuance form for one inventory issuance (Ref. No. 403-0648) was not signed.
- Obsolete and unusable items for one inventory item (8019-511-002) amounting to \$76,641 were included in the final inventory report. An adjustment to writedown the inventory was made subsequently.

Cause: The cause of the above conditions is weak controls over inventory.

Effect: The effect of the above conditions is possibility of unauthorized inventory issuances and misstatement of inventory.

Recommendation: We recommend that PUC strengthen controls over inventory.

Prior Year Status: Weak controls over inventory issuances were brought to management's attention in our previous management letter dated June 12, 2007.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Mr. Lorenzo Mamis, Power Generation Manager, and
Mr. James Mengeolt, Power Distribution Manager

PUBLIC UTILITIES CORPORATION

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Inventory, Continued

Finding 2007-2, Continued

Corrective Action: The generation plants were without full-time inventory clerks to control and log inventory issuances and returns. Plant mechanics and operators, when pressured by emergencies and urgent tasks, do occasionally take and return materials without logging these in the log sheets. New full-time inventory clerks were hired in April 2008 for both the Aimeliik and the Malakal power plants. These clerks are charged with ensuring all issuances and returns are fully documented and accounted for. They are also charged with identifying obsolete inventory parts and isolating them from employable inventory.

The power distribution manager has addressed the matter of missing work tickets with his staff and shall ensure henceforth that all work tickets are accounted for and all issuance forms are properly documented and signed.

Proposed Completion Date: September 30, 2008

PUBLIC UTILITIES CORPORATION

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Local Compliance

Finding 2007-3

Criteria: The Palau National Code (PNC) Chapter 37 Section 302 states that all entities of the national government and the state governments shall pay for all electrical and water utility services consumed, and shall not be given preferential treatment in the handling of their accounts by the agency of the national government responsible for the collection of such utility charges.

Conditions: As of September 30, 2007, utility receivables from the national government amounted to \$1,299,564 of which \$343,755 or 26% is over ninety days. Further, seventeen government accounts with a total balance of \$239,108 have not been paying since 2006 and prior. None of the government accounts were disconnected.

Cause: The cause of the above condition is that management is reluctant to disconnect government accounts as it may disrupt public services.

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

Recommendation: We recommend that PUC comply with the provisions of the PNC.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Ms. Jacqueline Alexander, Chief Financial Officer

Corrective Action: Management is aware of the delinquent status of the national government accounts and has been in constant communication with the national government in an effort to resolve this matter. Some of these accounts provide critical services to the people of Palau such as the hospital, airport and water systems. Untimely disconnection may result in serious life-threatening situations.

Management believes the national government is cognizant of the serious vitiating impact their delinquency has on PUC's operations and does not intend to run their accounts indefinitely. Discussions may be escalated to a formal contractual agreement but management believes the matter will be resolved soon.

As part of our aggressive effort to receivable reduction, PUC implemented the prepaid billing system beginning July 2007. Accounts that have overdue accounts will be subjected to conversion to prepaid unless satisfactory arrangements are proposed. The objective is to reduce receivables by 15% by September 2009. The Business Office Manager is responsible for monitoring receivables and the achievement of this goal.

Proposed Completion Date: September 30, 2009

PUBLIC UTILITIES CORPORATION

Schedule of Findings and Responses, Continued
Year Ended September 30, 2007

Local Compliance

Finding 2007-4

Criteria: All investment decisions should be governed by PUC's Investment Policy (Policy). Some of the policies set forth in the Policy are the following:

- No investment manager shall have more than 40% of the investment fund's assets under its direction.
- All fixed income securities held in the portfolio shall have a Moody's or S&P's credit quality rating of no less than "BBB". U.S. Treasury and Agency securities, while nonrated, qualify for inclusion in the portfolio.

Condition: The following were noted in our examination of compliance with the Policy:

- One investment manager has more than 40% of the investment fund's assets under its direction; and
- Fixed income securities of \$71,621 have a rating lower than BBB.

Cause: The cause of the above condition is the lack or inadequate documentation of investment activities and decisions.

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

Recommendation: We recommend that PUC monitor its investment activities and investment decisions are documented.

Prior Year Status: Inadequate documentation on Investment Committee meetings was reported as a finding in the audits of PUC for fiscal years 2006 and 2005.

Auditee Response and Corrective Action Plan:

Name of Contact Person: Jacqueline Alexander, Chief Financial Officer

Corrective Action: PPUC concurs with the conflict in the investment policy and has advised our investment consultant (Smith Barney) to correct the parameters in the policy. We have further advised our consultant to monitor all money managers and to correct promptly any deviations from our policy.

Proposed Completion Date: September 30, 2008

PUBLIC UTILITIES CORPORATION

Unresolved Prior Year Findings
Year Ended September 30, 2007

The status of unresolved prior year findings are disclosed within the Schedule of Findings and Responses section of this report (pages 3 through 7).