

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, 2008

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, 2008, and have issued our report thereon dated May 7, 2009. 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 2008-1 and 2008-2.

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, of the significant deficiencies described above, we consider item 2008-2 to be a material weakness.

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 May 7, 2009.

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.

Deloitte & Touche LLC

May 7, 2009

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Schedule of Findings and Responses
Year Ended December 31, 2008

Accounts Balances

Finding No. 2008-1

Criteria: Sub-ledger balances should be reconciled to the general ledger control total on a monthly basis.

Condition: Variances of \$16,199, \$25,423 and \$39,624 existed between the accounts receivable, employee annual leave accrual and customer deposit sub-ledger totals and the general ledger control total at year end. This condition was not corrected through proposed audit adjustments as the amounts were not considered material to the financial statements.

Cause: The cause of the above condition is that the accounts receivable, employee annual leave accrual and customer deposit sub-ledgers and general ledger totals are not reconciled on a monthly basis.

Effect: The effect of the above condition is an overstatement of accounts receivable, employee annual accrued leave and customer deposits.

Recommendation: We recommend that PNCC reconcile accounts receivable, annual leave and customer deposit sub-ledger totals to general ledger control totals on a monthly basis.

Prior Year Status: Inadequate controls over accounts receivable was reported as a finding in the audits of PNCC for fiscal years 2005 through 2007.

Auditee Response and Corrective Action Plan:

Name of Contact Persons: Ms. Pkngey Otobed, Revenue Requirement and Billing Manager and Mr. Leo Ben Teriong, Chief Financial Officer

Corrective Action: The Finance and Accounting Department of PNCC will review existing procedures and practices of account reconciliations to ensure effectiveness and relevancy of such practices. If necessary, the procedures will be revised and requirements put in place to ensure strict adherence to reconciliation procedures. Monthly review and discussion on any resulting reconciliation discrepancies will be carried out among stakeholders in order to resolve the discrepancies.

Proposed Completion Date: These proposed actions will have been carried out by the end of June 2009 and regular monthly reconciliations to be performed by the end of each month.

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Schedule of Findings and Responses, Continued
Year Ended December 31, 2008

Long Distance Revenue

Finding No. 2008-2

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 a variance of approximately \$450,000 for the year ended December 31, 2008. Per further verification, it appears that the toll charges in the prepaid card were not reclassified under the long distance revenue account, thereby causing the difference.

Cause: The cause of the above condition is the lack of reconciliation of minutes billed by international carriers to long distance revenue control totals, as well as the inability of the system to calculate the toll charges in the prepaid cards.

Effect: The effect of the above condition is the possibility that financial statements do not reflect the current status of the operations.

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 continuously work on the soft switch to enable PNCC to compute toll charges in the prepaid cards.

Prior Year Status: The lack of reconciliation of minutes billed by international carriers to long distance revenue control totals was reported as a finding in the audit of PNCC for fiscal year 2007.

Auditee Response and Corrective Action Plan:

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

Corrective Action: As reported by the auditor, PNCC currently lacks systems' capability to capture Call Details Report (CDRs) which is required for reconciliation of carrier billed minutes to long distance revenue control totals. To address this short coming, PNCC has procured a Soft Switch hardware and software system to be installed by the end of June 2009. The soft switch system will enable PNCC to capture details of outbound and inbound call minutes. The captured information is what is required for PNCC to be able to carry out long distance call minutes reconciliations.

Proposed Completion Date: We anticipate to have the soft switch installed and in operation by the end of August 2009.

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Unresolved Prior Year Comments
Year Ended December 31, 2008

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