

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

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**INDEPENDENT AUDITOR'S REPORT  
AND  
FINANCIAL STATEMENTS**

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**Years Ended  
September 30, 2007 and 2006**

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Years Ended September 30, 2007 and 2006

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COMPANY

CERTIFIED PUBLIC ACCOUNTANT

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**INDEPENDENT AUDITOR'S REPORT**

The Executive Director  
Commonwealth Utilities Corporation

I 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, as of September 30, 2007 and 2006, 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. My responsibility is to express an opinion on these financial statements based on my audits.

Except as discussed in the following paragraphs, I conducted my 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 I 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, I express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. I believe that my audits provide a reasonable basis for my opinion.


CUC estimated an allowance for inventory obsolescence of \$697,125 and \$700,652 in 2007 and 2006, respectively, and was unable to provide a listing of the basis for this allowance. Obsolescence, deterioration, damage, changing prices, or other factors may cause an inventory's recorded cost to exceed its market value. In such cases, accounting principles generally accepted in the United States of America require inventory to be written down to market value and an unrealized loss to be recognized against current period income. The amount by which this departure would affect the assets, net deficiency, and expenses of the CUC is not reasonably determinable.

In my opinion, except for the effect of such adjustments, if any, as might have been determined to be necessary had the propriety of inventory valuation is assessed, as discussed in the third paragraph, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2007 and 2006, and the changes in 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 (MD&A) on pages 3 to 14 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. I have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, I did not audit this information and express no opinion on it.

My audits were conducted for the purpose of forming opinion on the CUC's basic financial statements. The Statement of Revenues, Expenses and Changes in Net Deficiency on a Divisional Basis for the year ended September 30, 2007 on page 20 is presented for purposes of additional analysis and is not a required part of the basic financial statements. This supplemental information is the responsibility of CUC's management. The supplemental information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in my opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with the *Government Auditing Standards*, I have also issued my report dated September 26, 2008 on my consideration of CUC's internal control over financial reporting and on my 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 my 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 my audits.

  
Saipan, Commonwealth of the Northern Mariana Islands  
September 26, 2008

Except for Notes 13 and 15, as to which the date is April 20, 2010

**COMMONWEALTH UTILITIES CORPORATION**  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2007

This discussion and analysis of the Commonwealth Utilities Corporation's (CUC's) financial performance provides an overview of CUC's activities for the fiscal year ended September 30, 2007 with comparisons to prior fiscal years ended September 30, 2006 and 2005. We encourage readers to consider the information presented here in conjunction with the financial statements and related notes (pages 15 through 45).

**FINANCIAL HIGHLIGHTS**

- Total assets on September 30, 2007, were \$143.7 million, an increase of \$1.0 million (0.7 percent) when compared to September 30, 2006, which had an increase of \$9.8 million (7.4 percent) when compared to September 30, 2005. This was due primarily to increase in accounts receivable-utility in 2007 and increase in capital assets in 2006.
- Total liabilities on September 30, 2007, were \$214.5 million, an increase of \$9.4 million (4.6 percent) when compared to September 30, 2006, which had an increase of \$14.2 million (7.4 percent) when compared to September 30, 2005. In both years, the increases were due primarily to accruals for interest payable.
- Total net operating revenues for fiscal year 2007 were \$96.5 million, an increase of \$8.2 million (9.2 percent) when compared to fiscal year 2006, which had an increase of \$9.4 million (12.0 percent) when compared to fiscal year 2005. In both years, the increases were due primarily to increase in power rates.
- Total operating expenses for fiscal year 2007 were \$95.6 million, a decrease of \$13.9 million (12.7 percent) when compared to fiscal year 2006, which had an increase of \$14.4 million (15.1 percent) when compared to fiscal year 2005. The decrease and increase, in 2007 and 2006, respectively, were attributable to the volatility of fuel costs.
- In fiscal year 2007, CUC recognized \$3.4 million in capital contributions compared to \$7.3 million in fiscal year 2006 and \$3.9 million in fiscal year 2005. This was a decrease of \$3.9 million (53.4 percent) when 2007 is compared to 2006 and an increase of \$3.4 million (87.2 percent) when 2006 is compared to 2005.
- CUC's net deficiency continued to increase in fiscal year 2007. In 2007, the net deficiency increased \$8.5 million (13.6 percent) when compared to 2006, which had an increase of \$4.3 million (7.5 percent) when compared to 2005.

**COMMONWEALTH UTILITIES CORPORATION**  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2007

**OVERVIEW OF THE FINANCIAL STATEMENTS**

The Financial Section of this report presents the CUC's financial statements as two components: basic financial statements, and notes to the financial statements. It also includes supplemental information.

*Basic Financial Statements*

The *Statements of Net Assets (Deficiency)* presents information on assets and liabilities, with the difference between the two reported as net assets (deficiency). Changes in net assets (deficiency) over time may provide an indicator as to whether the financial position of the CUC is improving or deteriorating.

The *Statements of Revenues, Expenses and Changes in Net Assets (Deficiency)* reports how net assets have changed during the year. It compares related operating revenues and operating expenses connected with the CUC's principal business of providing power, water and sewer services. Operating expenses include the cost of direct services to customers, administrative expenses, contracted services and depreciation on capital assets. All other revenues and expenses are reported as non-operating.

The *Statements of Cash Flows* reports inflows and outflows of cash, classified into four major categories:

- Cash flows from operating activities include transactions and events reported as components of operating income in the Statement of Revenues, Expenses and Changes in Net Assets (Deficiency).
- Cash flows from non-capital financing activities include operating grant proceeds.
- Cash flows from capital and related financing activities include the borrowing and repayment (principal and interest) of capital-related debt, the acquisition and construction of capital assets, and the proceeds of capital grants and contributions.
- Cash flows from investing activities include proceeds from sale of investments, receipt of interest and changes in the fair value of investments subject to reporting as cash equivalents. Outflows in this category include the purchase of investments.

*Notes to the Financial Statements*

Various notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements and are found immediately following the financial statements to which they refer.

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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2007

*Other Information*

This report also presents certain supplementary information concerning CUC's Statements of Revenues, Expenses and Changes In Net Deficiency on a divisional basis (see page 20).

ANALYSIS OF BASIC FINANCIAL STATEMENTS

Net Assets (Deficiency)

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Current assets	\$ 34,218,952	\$ 27,696,737	\$ 25,826,751
Capital assets, net	101,620,428	107,155,887	99,452,795
Restricted assets	<u>7,860,736</u>	<u>7,870,804</u>	<u>7,591,615</u>
Total Assets	<u>143,700,116</u>	<u>142,723,428</u>	<u>132,871,161</u>
Current liabilities	205,609,175	192,531,325	182,142,468
Noncurrent liabilities	<u>8,889,922</u>	<u>12,511,709</u>	<u>8,693,886</u>
Total Liabilities	<u>214,499,097</u>	<u>205,043,034</u>	<u>190,836,354</u>
Net Assets (Deficiency):			
Invested in capital assets, net of related debt	37,119,613	40,669,282	29,005,794
Restricted	(2,786,684)	(1,953,688)	4,345,350
Unrestricted	<u>(105,131,910)</u>	<u>(101,035,200)</u>	<u>(91,316,337)</u>
Net Deficiency	<u>\$ (70,798,981)</u>	<u>\$ (62,319,606)</u>	<u>\$ (57,965,193)</u>
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Operating revenues, net	\$ 96,488,062	\$ 88,326,321	\$ 78,878,986
Operating expenses	<u>95,572,264</u>	<u>109,436,358</u>	<u>95,040,718</u>
Gain (loss) from operations	915,798	(21,110,037)	(16,161,732)
Nonoperating revenues(expenses), net	(11,921,814)	8,412,692	(10,193,069)
Change in deferred fuel costs	<u>(887,057)</u>	<u>1,041,961</u>	<u>-</u>
Net loss before capital contributions	(11,893,073)	(11,655,384)	(26,354,801)
Capital contributions	<u>3,413,698</u>	<u>7,300,971</u>	<u>3,906,378</u>
Change in net deficiency	(8,479,375)	(4,354,413)	(22,448,423)
Restatement	-	-	(5,184,130)
Net deficiency, beginning	<u>(62,319,606)</u>	<u>(57,965,193)</u>	<u>(30,332,640)</u>
Net deficiency, ending	<u>\$ (70,798,981)</u>	<u>\$ (62,319,606)</u>	<u>\$ (57,965,193)</u>

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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2007

Highlights of events affecting assets, liabilities and net deficiency balances follow.

During fiscal 2007, total assets increased \$1.0 million. Significant changes in account balances were noted for the following:

- Accounts receivable increased by \$6.4 million, which was brought on by new power rates that were substantially higher than the previous rates.
- Inventory, primarily fuel, decreased by \$1.1 million due to working capital shortfall which made it necessary to reduce quantity of recurring fuel orders.
- Under-recovery of fuel cost shown as deferred fuel cost was \$155 thousand. This represents the difference between actual fuel costs and electric fuel charge revenues, resulting in a net under-recovery of fuel costs.
- Capital assets, net of accumulated depreciation, decreased \$5.5 million due to depreciation of plant and equipment.
- Cash and equivalents increased \$943 thousand due to the timing of payments to major suppliers and contractors.

Total liabilities increased \$9.4 million. Significant changes in account balances were noted for the following:

- Interest payable increased \$10.7 million. Interest continues to accrue on the notes payable to the Commonwealth Development Authority (CDA) totaling \$61.6 million. Although CNMI Legislature has authorized CDA to waive the principal and accrued interest, CUC and CDA have not yet finalized an agreement to carryout the provisions of the Public Laws.
- Long-term debt, less current maturities, decreased by \$1.4 million due to payments made in 2007.
- Customer deposits increased \$823 thousand. This represents the amounts collected from customers with open accounts net of deposits refunded to customers with closed accounts.

Net deficiency increased \$8.5 million primarily due to loss incurred during the year.

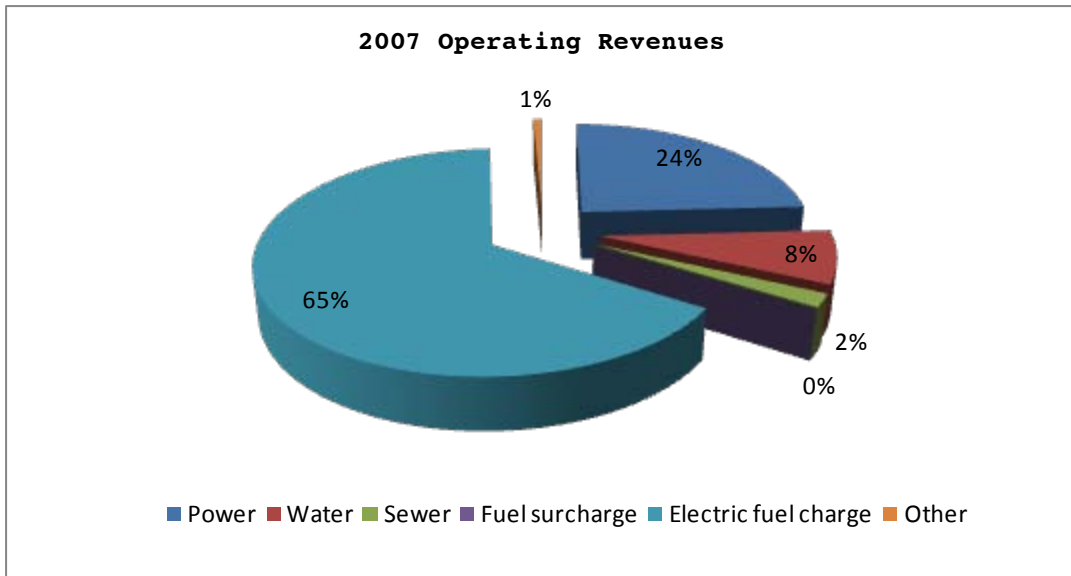


**COMMONWEALTH UTILITIES CORPORATION**  
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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2007

Operating Revenues

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Power	\$ 23,870,082	\$ 51,202,196	\$ 59,800,839
Water	7,643,878	9,246,145	9,541,082
Sewer	1,902,748	1,849,869	2,205,589
Fuel surcharge	-	11,151,559	7,629,234
Electric fuel charge	64,714,485	14,378,371	-
Other	<u>707,506</u>	<u>498,181</u>	<u>841,999</u>
Total	98,838,699	88,326,321	80,018,743
Bad debts	<u>(2,350,637)</u>	<u>-</u>	<u>(1,139,757)</u>
Operating revenues, net	<u>\$ 96,488,062</u>	<u>\$ 88,326,321</u>	<u>\$ 78,878,986</u>



In 2007, operating revenues increased more than \$8.2 million (9.2 percent) when compared to revenues for 2006, which increased \$9.4 million (12.0 percent) when compared to 2005.

All, or the majority of the increases were related to power revenues. In 2007, power revenues (including fuel surcharge and electric fuel charge) increased \$11.9 million (15.4 percent) when compared to revenues for 2006, which increased \$9.3 million (13.8 percent) when compared to 2005.

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In 2007, water, sewer, and other (late charge) revenues decreased by \$1.3 million (11.6 percent) when compared to revenues for 2006, which decreased \$1 million (7.9 percent) when compared to revenues for 2005.

The decrease in water revenues was brought on by the following: (1) continued installation of additional water meters to measure and bill water charges based on actual consumption, rather than the previous method that was based on an estimated flat rate assessment, has encouraged customers to now conserve water to lower their water charges; (2) closure of many garment manufacturing businesses, which were large consumers of water, have resulted in reduced water sales; and (3) the steady decline in the number of tourists visiting the islands have resulted in reduced water sales to hotels and businesses that service tourists.

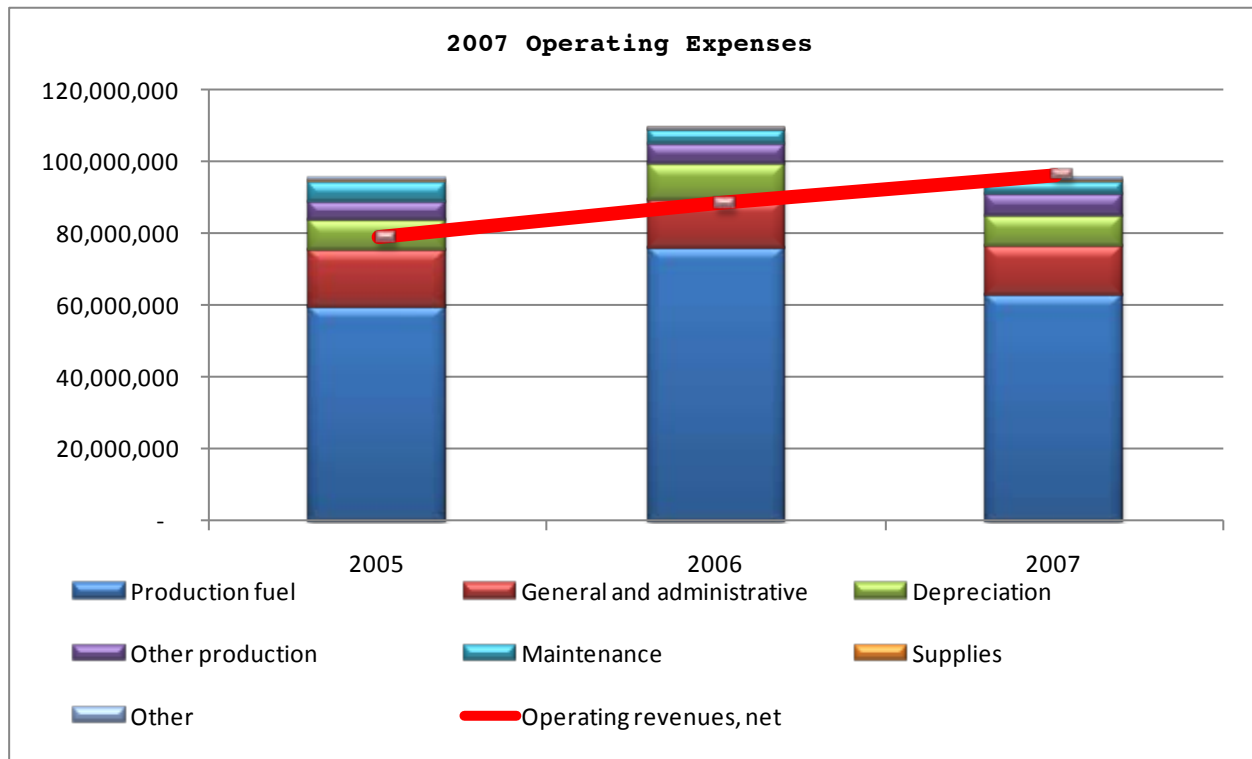
Because water consumption is used as a basis to assess and bill sewer charges, sewer revenues have declined for the same reasons mentioned for water.

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Operating Expenses

	2007	2006	2005
Production fuel	\$ 62,710,355	\$ 76,027,452	\$ 59,246,625
General and administrative	13,661,565	13,425,821	16,270,152
Depreciation	8,538,161	9,919,927	8,182,733
Other production	5,877,589	5,392,323	5,291,414
Maintenance	3,488,146	3,812,540	5,132,005
Supplies	581,603	350,495	579,358
Other	714,845	507,800	338,431
	<u>\$ 95,572,264</u>	<u>\$ 109,436,358</u>	<u>\$ 95,040,718</u>



This graph shows the total relationship of the total operating expenses (stacked bar graph) in relation to the total operating revenues (line graph).

In 2007, total operating expenses decreased by about \$13.9 million (12.7 percent) when compared to expenses for 2006, which increased by about \$14.4 million (15.1 percent) when compared to expenses for 2005.

In 2007, production fuel was \$62.7 million, a decrease of \$13.3 million (17.5 percent) when compared to 2006, which increased by \$16.8 million (28.4 percent) when compared to 2005. Production fuel is the single largest expense of CUC, accounting for 65.6 percent of total expenses for 2007, 69.4 percent for 2006 and 62.3 percent for 2005.

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In 2007, maintenance expense decreased by \$324 thousand (8.5 percent) when compared to 2006, which also decreased by \$1.3 million (25.7 percent) when compared to 2005.

In 2007, general and administrative expense, which is primarily personnel costs and related benefits, increased by \$236 thousand (1.8 percent) when compared to 2006, which decreased by \$2.8 million (17.5 percent) when compared to 2005.

In 2007, other production expense increased by \$485 thousand (9.0 percent) when compared to 2006, which also increased by \$101 thousand (1.9 percent) when compared to 2005. The increases were brought on by decreases in maintenance expense that resulted in equipment failures for some of the larger power generating equipment. In an effort to provide electric service to all CUC customers, CUC purchased additional production from its independent power producer.

In 2007, supplies and other expenses increased by \$438 thousand (51.0 percent) when compared to 2006, which decreased by \$59 thousand (6.5 percent) when compared to 2005.

Capital Assets

At September 30, 2007, CUC had \$101.6 million invested in capital assets, net of depreciation where applicable, including electric plant, water plant, sewer plant, administrative equipment and construction in progress. This represents a net decrease of \$5.5 million (5.1 percent) over last year.

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Utility plant in service			
Electric plant	\$ 127,312,900	\$ 128,809,068	\$ 118,129,929
Water plant	62,194,538	62,205,859	59,176,887
Sewer plant	36,933,143	29,634,620	23,697,843
Administrative equipment	<u>4,609,407</u>	<u>4,588,582</u>	<u>4,440,907</u>
	231,049,988	225,238,129	205,445,566
Accumulated depreciation	<u>(137,772,135)</u>	<u>(130,696,101)</u>	<u>(120,844,555)</u>
Depreciable assets, net	93,277,853	94,542,028	84,601,011
Construction work-in-progress	<u>8,342,575</u>	<u>12,613,859</u>	<u>14,851,784</u>
Capital assets, net	<u>\$ 101,620,428</u>	<u>\$ 107,155,887</u>	<u>\$ 99,452,795</u>

Please refer to Note 6 to the financial statements for additional information regarding capital asset activity.

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MANAGEMENT'S DISCUSSION & ANALYSIS  
September 30, 2007

Capital Projects

CUC incurred capital expenditures and recognized related revenue in the form of capital contributions of \$3.4 million in fiscal year 2007, which is a decrease of \$3.9 million (53.2 percent) when compared to fiscal year 2006.

The capital contributions, by source, are as follows:

	2007		2006		2005	
	Amount	%	Amount	%	Amount	%
Federal	\$ 3,178,551	93.1	\$ 4,121,841	56.5	\$ 2,767,319	70.8
Local	235,147	6.9	3,179,130	43.5	1,139,059	29.2
Total	<u>\$ 3,413,698</u>	<u>100.0</u>	<u>\$ 7,300,971</u>	<u>100.0</u>	<u>\$ 3,906,378</u>	<u>100.0</u>

Following is a summary of the CUC's major capital expenditures for 2007:

Federal Assistance

The U.S. Department of the Interior provided \$0.5 million, for the following:

- Power Plant Rehabilitation \$0.2 million
- Meter Maintenance Program \$0.3 million

The U.S. Environmental Protection Agency provided \$2.2 million for the upgrade of sewer and water systems and related equipment.

Additional information about capital activities appears in Note 6 - Capital Assets of the Notes to the Financial Statements.

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Debt

Long-term debts as of September 30, 2007, 2006 and 2005 are as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Commonwealth Development Authority	\$ 61,568,750	\$ 61,568,750	\$ 61,568,750
Commonwealth Ports Authority	8,215,026	8,215,026	3,385,131
Mobil Oil Mariana Islands, Inc.	293,494	574,105	3,820,372
United States Department of Agriculture	<u>-</u>	<u>107,530</u>	<u>156,716</u>
Total	70,077,270	70,465,411	68,930,969
Current maturities	<u>(62,963,346)</u>	<u>(61,901,559)</u>	<u>(64,864,204)</u>
Long-term debt, net of current portion	<u>\$ 7,113,924</u>	<u>\$ 8,563,852</u>	<u>\$ 4,066,765</u>

Additional information about debt activities appears in Note 8 - Long-term Debt of the Notes to the Financial Statements.

ECONOMIC FACTORS AND FUTURE PLANS

In the March 1994 Metzler and Associates (Metzler) Management Audit Report on CUC, Metzler report states, there is a significant shortfall between revenue and expenses. This shortfall has existed throughout CUC's existence and is the primary reason contributing to CUC's current financial situation. If the existing rate structure is not revised, it is likely that CUC's net income deficit will continue to increase for the foreseeable future."

As earlier stated in this analysis, CUC's net asset deficiency is \$70.8 million as of September 30, 2007. An increase of \$8.5 million from the previous fiscal year.

CUC continues to struggle with full cost recovery. Insufficient funding has been the crux of the operational demise of CUC's utility systems.

In the summer of 2008, over a decade of maintenance neglect deadlined 6 of CUC's generators at Saipan Power Plant 1 (PP1) and caused extensive power outages in Saipan. Extensive power outages also diminished water and wastewater services nearly to a point of endangering public health and safety. Procurement and installation of temporary power services on September 12, 2008, brought an end to power outages and allowed for CUC to embark on a rehabilitation plan of PP1 generators. It is expected that when the initial term of temporary power service expires on September 11, 2009, CUC will have sufficient power generation assets rehabilitated at PP1 to meet Saipan's power demand needs.

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MANAGEMENT'S DISCUSSION & ANALYSIS  
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ECONOMIC FACTORS AND FUTURE PLANS, CONTINUED

On March 11, 2009, two stipulated orders were filed in U.S. District Court addressing CUC water and wastewater operations plus fuel and oil management and disposal. CUC's noncompliance, going back several years, with Clean Water and Safe Drinking Water Acts (Acts) were cited as necessitating the need for the stipulated orders and ensure operational compliance with the respective Acts.

In the short term, effecting full cost recovery will be critical to completing PPl rehabilitation and compliance with the Clean Water and Safe Drinking Water Acts. For the long term, full cost recovery will allow CUC to access long term financing markets as it needs to make utility systems capital improvements or expansion. Current capital funding is sourced from federal or local government grants or appropriations which are outside of CUC control. Recurring availability of capital funding from the federal and local government is not assured and limited.

In September 2008, CUC, in a collaborative effort with the Commonwealth Public Utilities Commission (CPUC) consultants, Georgetown Consulting Group (GCG), commenced a process to effect a new rate structure for all of its utility systems (Power, Water, and Wastewater) with an ultimate goal of achieving full cost recovery. In December of 2008, an interim rate adjustment for Power was effected by replacing the Electric Fuel Charge (EFC) with the Levelized Energy Adjustment Clause (LEAC). The LEAC has several levels of cost recovery to not only allow for recovery of electric fuel costs but also other costs such as PPl rehabilitation expenses. In April of 2009, interim adjustment to Water and Wastewater rates was effected to close the gap between actual revenues and expenses necessary to maintain Water and Wastewater systems plus compliance with the stipulated orders above-mentioned.

On May 7, 2009, a major step towards improving CUC's financial condition was taken with the signing of the CDA - CUC Memorandum of Agreement which will allow for the discharge of over \$170 million of principal, accumulated interest, and late charges of CUC debt to CDA in exchange for the issuance of \$45 million of preferred stock with a dividend rate of 2%. Payment of dividends to CDA is deferred until 1 Oct 2012.

CUC is at a critical juncture of its corporate existence where reversing a deteriorating financial condition is the paramount issue or else face the reality of not being a going concern and render it financially incapable of operating and maintaining its utility systems and at the cost of endangering public health and safety. Achieving full cost recovery in the near term is a must.

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ECONOMIC FACTORS AND FUTURE PLANS, CONTINUED

Achieving full cost recovery is not entirely within CUC's direct control. The Metzler Management Audit separates its recommendations in achieving full cost recovery in two broad categories, those within CUC's direct control and those outside CUC's direct control. The latter (recommendations which are outside CUC's control) can be further subdivided into two categories:

Recommendations which are dependent on or affect the laws and regulations under which CUC can operate

Recommendations which relate to CUC's various external funding sources

CUC will need to review current legislation and regulations in effect and determine (plus request relief from) those that are obstacles to the efficient and effective maintenance of CUC utility systems, hinder delivery of services, or an unnecessary financial burden to all CUC customers.

REQUESTS FOR INFORMATION

This financial report is designed to provide our citizens, taxpayers, customers and creditors with a general overview of the CUC's finances and to demonstrate accountability for the funds it manages. Please direct any questions about this report or requests for additional information about CUC's finances to:

Commonwealth Utilities Corporation  
Attn: Chief Financial Officer  
PO Box 501220  
Saipan, MP 96950

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**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Net Deficiency  
September 30, 2007 and 2006

	<u>2007</u>	<u>2006</u> <u>Restated</u>
<u>ASSETS</u>		
Current assets		
Current unrestricted assets		
Cash and cash equivalents	\$ 2,464,456	\$ 1,521,874
Accounts receivable - utility, net	18,494,714	12,088,470
Due from grantor agencies	1,637,407	936,654
Inventory, net	9,509,298	10,575,003
Deferred fuel costs	154,904	1,041,961
Other assets, net	<u>1,958,173</u>	<u>1,532,775</u>
Total current unrestricted assets	<u>34,218,952</u>	<u>27,696,737</u>
Current restricted assets		
Cash and cash equivalents	<u>7,860,736</u>	<u>7,870,804</u>
Total current restricted assets	<u>7,860,736</u>	<u>7,870,804</u>
Total current assets	<u>42,079,688</u>	<u>35,567,541</u>
Noncurrent assets		
Capital assets		
Utility plant in service		
Electric plant	127,312,900	128,809,068
Water plant	62,194,538	62,205,859
Sewer plant	36,933,143	29,634,620
Administrative equipment	<u>4,609,407</u>	<u>4,588,582</u>
Accumulated depreciation	231,049,988	225,238,129
	<u>(137,772,135)</u>	<u>(130,696,101)</u>
Net utility plant and administrative equipment	93,277,853	94,542,028
Construction in progress	<u>8,342,575</u>	<u>12,613,859</u>
Total capital assets	<u>101,620,428</u>	<u>107,155,887</u>
<b>TOTAL ASSETS</b>	<u>\$ 143,700,116</u>	<u>\$ 142,723,428</u>

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Net Deficiency  
September 30, 2007 and 2006

	<u>2007</u>	<u>2006</u> <u>Restated</u>
<u>LIABILITIES AND NET DEFICIENCY</u>		
Current liabilities		
Accounts payable	\$ 10,891,825	\$ 11,414,329
Current obligations under capital lease	1,821,040	1,521,801
Accrued liabilities	36,185	56,055
Accrued payroll	299,016	301,463
Compensated absences, current portion	359,277	348,897
Due to primary government	2,720,971	2,026,212
Customer deposits including accrued interest	10,647,420	9,824,492
Current maturities of long-term debt	62,963,346	61,901,559
Interest payable	<u>115,870,095</u>	<u>105,136,517</u>
Total current liabilities	<u>205,609,175</u>	<u>192,531,325</u>
Noncurrent liabilities		
Long-term debt net of current maturities	7,113,924	8,563,852
Retirement contributions payable	116,612	107,945
Obligations under capital lease, net of current maturities	1,111,025	3,288,523
Advances from CNMI Government	166,860	180,911
Compensated absences, less current portion	<u>381,501</u>	<u>370,478</u>
Total noncurrent liabilities	<u>8,889,922</u>	<u>12,511,709</u>
<b>TOTAL LIABILITIES</b>	<u>214,499,097</u>	<u>205,043,034</u>
Commitments and contingencies		
Net deficiency		
Invested in capital assets, net of related debt	37,119,613	40,669,282
Restricted	(2,786,684)	(1,953,688)
Unrestricted	<u>(105,131,910)</u>	<u>(101,035,200)</u>
<b>NET DEFICIENCY</b>	<u>(70,798,981)</u>	<u>(62,319,606)</u>
<b>TOTAL LIABILITIES AND NET DEFICIENCY</b>	<u>\$ 143,700,116</u>	<u>\$ 142,723,428</u>

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Revenues, Expenses and Changes in Net Deficiency  
For the Years Ended September 30, 2007 and 2006

	2007	2006 Restated
Operating revenues		
Power	\$ 23,870,082	\$ 51,202,196
Water	7,643,878	9,246,145
Sewer	1,902,748	1,849,869
Electric fuel charge	64,714,485	14,378,371
Fuel surcharge	-	11,151,559
Other	707,506	498,181
 Total	 98,838,699	 88,326,321
Bad debts	(2,350,637)	-
 Net operating revenues	 96,488,062	 88,326,321
 Operating expenses		
Production fuel	62,710,355	76,027,452
General and administrative	13,661,565	13,425,821
Depreciation	8,538,161	9,919,927
Other production	5,877,589	5,392,323
Maintenance	3,488,146	3,812,540
Supplies	581,603	350,495
Other	714,845	507,800
 Total operating expenses	 95,572,264	 109,436,358
 Earnings (loss) from operations	 915,798	 (21,110,037)
 Non-operating revenues (expenses)		
Recovery of bad debts	-	15,273,467
Interest income	320,813	255,751
Miscellaneous income	57,461	67,104
Settlement expense	(36,724)	(51,963)
Impairment of electric plant	(522,247)	-
Contribution to the CNMI government	(694,759)	(694,759)
Interest expense	(11,046,358)	(6,436,908)
 Total non-operating revenues (expenses), net	 (11,921,814)	 8,412,692
 Change in under (over) recovery of fuel costs	 (887,057)	 1,041,961
 Net loss before capital contributions	 (11,893,073)	 (11,655,384)
 Capital contributions	 3,413,698	 7,300,971
 Change in net deficiency	 (8,479,375)	 (4,354,413)
 Net deficiency, beginning	 (62,319,606)	 (57,965,193)
 Net deficiency, ending	 \$ (70,798,981)	 \$ (62,319,606)

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Cash Flows  
For the Years Ended September 30, 2007 and 2006

	2007	2006 Restated
Cash flows from operating activities:		
Cash received from customers	\$ 93,312,844	\$ 86,615,439
Cash payments to suppliers for goods and services	(81,693,299)	(79,994,106)
Cash payments to employees for services	<u>(7,883,220)</u>	<u>(8,953,998)</u>
Net cash provided by (used for) operating activities	<u>3,736,325</u>	<u>(2,332,665)</u>
Cash flows from noncapital financing activities:		
Advances from (payment to) primary government, net	<u>(14,051)</u>	<u>180,911</u>
Net cash provided by (used for) noncapital financing activities	<u>(14,051)</u>	<u>180,911</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(3,155,392)	(1,752,064)
Capital contributions received	2,343,388	7,599,393
Principal repayment of debt	(1,985,789)	(4,567,186)
Interest paid on outstanding debt	(312,780)	(1,195,152)
Net increase in restricted time certificates of deposit	<u>-</u>	<u>(279,189)</u>
Net cash used for capital and related financing activities	<u>(3,110,573)</u>	<u>(194,198)</u>
Cash flows from investing activities:		
Interest received on time certificates of deposit	<u>320,813</u>	<u>352,287</u>
Net cash provided by investing activities	<u>320,813</u>	<u>352,287</u>
Net change in cash and cash equivalents	932,514	(1,993,665)
Cash and cash equivalents at beginning of year	<u>9,392,678</u>	<u>11,386,343</u>
Cash and cash equivalents at end of year	<u>\$ 10,325,192</u>	<u>\$ 9,392,678</u>
Cash and cash equivalents	\$ 2,464,456	\$ 1,521,874
Restricted cash and cash equivalents	<u>7,860,736</u>	<u>7,870,804</u>
	<u>\$ 10,325,192</u>	<u>\$ 9,392,678</u>

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Statements of Cash Flows  
For the Years Ended September 30, 2007 and 2006

	2007	2006 Restated
Reconciliation of earnings (loss) from operations to net cash provided by (used for) operating activities:		
Earnings (loss) from operations	\$ 915,798	\$ (21,110,037)
Adjustments to reconcile earnings (loss) from operations to net cash provided by (used for) operating activities:		
Depreciation	8,538,161	9,919,927
Provision for bad debts	2,350,637	-
Recovery of bad debts	-	(15,273,467)
Miscellaneous income	57,461	(67,104)
Settlement expense	(36,724)	54,963
Change in under (over) recovery of fuel costs	(887,057)	-
Restatement	-	5,184,130
(Increase) decrease in assets		
Accounts receivable - utility	(8,756,881)	12,816,596
Inventory	1,065,705	(1,246,904)
Deferred fuel costs	887,057	-
Other assets	(425,398)	304,474
Increase (decrease) in liabilities		
Accounts payable	(522,504)	2,165,600
Accrued liabilities	(19,870)	(77,902)
Accrued payroll	(2,447)	(251,757)
Compensated absences	21,403	(104,032)
Customer deposits including accrued interest	822,928	508,619
Retirement contributions payable	8,667	14,334
Long-term debt	(280,611)	4,829,895
Net cash provided by (used for) operating activities	\$ 3,736,325	\$ (2,332,665)
Supplemental disclosure of noncash capital and related financing and operating activities:		
Conversion of accounts payable to notes payable		
Noncash decrease in accounts payable	\$ -	\$ (4,829,895)
Noncash increase long-term debt	-	4,829,895
	\$ -	\$ -
Federal grants passed through the CNMI Government:		
Noncash increase in capital assets	\$ 369,557	\$ 4,784,800
Noncash increase in capital contributions	(369,557)	(4,784,800)
	\$ -	\$ -

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Supplementary Information  
Statements of Revenues, Expenses and Changes in Net Deficiency on a Divisional Basis  
For the Year Ended September 30, 2007

	<u>Power</u>	<u>Water</u>	<u>Sewer</u>	<u>Administrative and General</u>	<u>Internal Revenues and Expenses</u>	<u>Total</u>
<b>Operating revenues:</b>						
Governmental						
CNMI Government	\$ 10,997,499	\$ 3,406,700	\$ 1,904,256	\$ -	\$ -	\$ 16,308,455
CNMI Agencies	<u>7,819,712</u>	<u>1,527,797</u>	<u>334,004</u>	<u>-</u>	<u>(5,337,589)</u>	<u>4,343,924</u>
Total governmental	18,817,211	4,934,497	2,238,260	-	(5,337,589)	20,652,379
Commercial						
Residential	50,460,654	2,199,079	473,233	-	-	53,132,966
Other	24,644,291	3,619,753	146,381	-	-	28,410,425
	<u>-</u>	<u>(3,109,451)</u>	<u>(955,126)</u>	<u>707,506</u>	<u>-</u>	<u>(3,357,071)</u>
Total operating revenues	93,922,156	7,643,878	1,902,748	707,506	(5,337,589)	98,838,699
Bad debts	<u>-</u>	<u>-</u>	<u>-</u>	<u>(2,350,637)</u>	<u>-</u>	<u>(2,350,637)</u>
Net operating revenues	<u>93,922,156</u>	<u>7,643,878</u>	<u>1,902,748</u>	<u>(1,643,131)</u>	<u>(5,337,589)</u>	<u>96,488,062</u>
<b>Operating expenses:</b>						
Production fuel	62,710,355	-	-	-	-	62,710,355
General and administrative	4,740,846	2,075,392	855,514	5,989,813	-	13,661,565
Depreciation	4,613,479	2,315,060	1,511,998	97,624	-	8,538,161
Other production	4,663,115	4,769,879	1,522,089	260,095	(5,337,589)	5,877,589
Maintenance	2,872,380	343,720	204,319	67,727	-	3,488,146
Supplies	76,142	405,116	3,397	96,948	-	581,603
Other	<u>-</u>	<u>-</u>	<u>-</u>	<u>714,845</u>	<u>-</u>	<u>714,845</u>
Total operating expenses	<u>79,676,317</u>	<u>9,909,167</u>	<u>4,097,317</u>	<u>7,227,052</u>	<u>(5,337,589)</u>	<u>95,572,264</u>
Earnings (loss) from operations	<u>14,245,839</u>	<u>(2,265,289)</u>	<u>(2,194,569)</u>	<u>(8,870,183)</u>	<u>-</u>	<u>915,798</u>
<b>Non-operating revenues (expenses):</b>						
Interest income	-	-	-	320,813	-	320,813
Miscellaneous income	-	-	-	57,461	-	57,461
Settlement expense	-	-	-	(36,724)	-	(36,724)
Impairment of electric plant	-	-	-	(522,247)	-	(522,247)
Contribution to the CNMI government	-	-	-	(694,759)	-	(694,759)
Interest expense	<u>-</u>	<u>-</u>	<u>-</u>	<u>(11,046,358)</u>	<u>-</u>	<u>(11,046,358)</u>
Total non-operating revenues	<u>-</u>	<u>-</u>	<u>-</u>	<u>(11,921,814)</u>	<u>-</u>	<u>(11,921,814)</u>
Cost to be recovered in future period	<u>(887,057)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(887,057)</u>
Net income (loss) before capital contribution	13,358,782	(2,265,289)	(2,194,569)	(20,791,997)	-	(11,893,073)
Capital contributions	<u>327,984</u>	<u>761,613</u>	<u>1,557,701</u>	<u>766,400</u>	<u>-</u>	<u>3,413,698</u>
Change in net deficiency	<u>\$ 13,686,766</u>	<u>\$ (1,503,676)</u>	<u>\$ (636,868)</u>	<u>\$ (20,025,597)</u>	<u>\$ -</u>	<u>\$ (8,479,375)</u>

See accompanying notes to financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(1) Organization

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.

(2) Summary of Significant Accounting Policies

*Measurement Focus, Basis of Accounting and Basis of Presentation*

CUC maintains an enterprise fund to account for its operations. An enterprise fund is a proprietary fund, which is accounted for on the flow of economic resources measurements focus and uses the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. Enterprise funds are used to account for operations that are financed and operated in a manner similar to a private business enterprise, where the intent of management is to finance the costs of providing services to the public primarily through user charges.

The accompanying financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP). The accompanying financial statements have been prepared in accordance with the reporting model defined by Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis - for State and Local Governments: Omnibus* - an Amendment of GASB Statements No. 21 and No. 34, and GASB Statement No. 38, *"Certain Financial Statement Note Disclosures*.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Accounting Standards*

GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, requires that governments' proprietary activities apply all GASB pronouncements as well as pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements, Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins. Governments are given the option whether or not to apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. CUC has elected not to implement FASB Statements and Interpretations issued after November 30, 1989.

*Recent Pronouncements*

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers. This statement is not effective until June 30, 2008. CUC has not determined its effect on the financial statements.

GASB Statement No. 48 - In September 2006, the GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. This Statement addresses accounting and financial reporting standards for transactions where governments exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments. This statement establishes criteria and reporting standards regarding the exchange as either a sale or collateralized borrowing, resulting in a liability. This statement is not effective until June 30, 2008. CUC has not determined its effect on the financial statements.

GASB Statement No. 49 - In November 2006, the GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This Statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. This Statement is not effective until June 30, 2009. CUC has not determined its effect on the financial statements.



**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Recent Pronouncements, Continued*

GASB Statement No. 50 – In May 2007, the GASB issued Statement No. 50, *Pension Disclosures – an amendment of GASB Statements No. 25 and No. 27*. This statement more closely aligns the financial reporting requirements for pensions with those for OPEB and, in doing so, enhances information disclosed in notes to financial statements or presented as RSI by pension plans and by employers that provide pension benefits. This Statement is not effective until June 30, 2008. CUC has not determined its effect on the financial statements.

GASB Statement No. 51 – In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. This Statement establishes accounting and financial reporting standards for many different types of assets that may be considered intangible assets, including easements, water rights, timber rights, patents, trademarks, and computer software. This Statement is not effective until June 30, 2010. CUC has not determined its effect on the financial statements.

*Budgets*

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

*Cash and Cash Equivalents*

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.

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.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Cash and Cash Equivalents, Continue*

GASB Statement No. 40 amended GASB Statement No. 3 to 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 in the depositor government's name 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.

At September 30, 2007 and 2006, cash and cash equivalents were \$10,325,192 and \$9,392,678, respectively, and the corresponding bank balances were \$10,469,378 and \$9,487,848, respectively. Of the bank balance amounts, \$10,323,489 and \$9,398,295, respectively were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. Bank deposits in the amount of \$200,000 in each year were FDIC insured as of September 30, 2007 and 2006 and \$145,889 in 2007 and \$89,553 in 2006 was maintained in non-FDIC insured financial institution. 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.

*Restricted Cash and Cash Equivalents*

The restricted cash and cash equivalents of \$7,860,736 and \$7,870,804 at September 30, 2007 and 2006, respectively pertains to customer deposits, of which, \$7,500,000 in 2007 and 2006 is 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.

*Accounts Receivable and Allowance for Uncollectable Accounts*

Accounts receivable are classified as current assets and are reported net of an allowance for uncollectible amounts.

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 collectability 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 (100%) of account balances greater than seventy-five (75) days old.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Inventory*

Fuel and lubes inventory are valued at the lower of cost (first-in, first-out) or market (net realizable value). Material and supplies inventory are valued at average cost.

Inventory as of September 30, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Fuel and lubes	\$ 2,664,465	\$ 3,226,983
Materials and supplies	<u>7,541,958</u>	<u>8,048,672</u>
	10,206,423	11,275,655
Allowance for obsolescence	<u>(697,125)</u>	<u>(700,652)</u>
Inventory, net	<u>\$ 9,509,298</u>	<u>\$10,575,003</u>

*Fuel Oil Costs*

Fuel oil costs increase or decrease billings to customers based on price changes in fuel oil purchased by CUC. Under or over recovery of fuel oil cost is recorded as deferred fuel cost asset or liability, respectively, in the accompanying Statement of Net Deficiency, and is recovered or deducted in future billings to customers based on the amendments to Part 24 of the Electric Service Regulations of the CUC adopted on July 20, 2006. Electric fuel rates are computed monthly. Any difference between the actual fuel costs and the electric fuel rate shall be accumulated in a deferred account and subject to annual reconciliation. No interest will be charged or paid on any under or over recovery balance in the deferred account. Under-recovery as of September 30, 2007 and 2006 are \$154,904 and \$1,041,961, respectively.

*Capital Assets and Depreciation*

Capital assets consist of utility plant, administrative equipment and construction-in-progress. Capital assets are stated at original cost, where costs are available, less accumulated depreciation. Depreciation is provided on the straight-line method based on the estimated useful lives of the respective assets, which range from 3 to 20 years. The costs of additions and replacements are capitalized. Repairs and maintenance are charged to expense as incurred. Retirements, sales and disposals are recorded by removing the cost and accumulated depreciation from the asset and accumulated depreciation accounts with any resulting gain or loss reflected in non-operating revenues (expenses) in the Statements of Revenues, Expenses and Changes in Net Deficiency. Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the fair value is less than the carrying amount of the asset, a loss is recognized for the difference.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Capital Assets and Depreciation, Continued*

Current policy is to capitalize items in excess of \$1,000. The costs of acquisition and construction of equipment and facilities are recorded as construction-in-progress until such assets are completed and placed in service, at which time the CUC commences recording depreciation expense.

*Compensated Absences*

Compensated absences are accrued and reported as a liability in the period earned. Annual leave to be paid out within the next fiscal year is accrued and is included in current liabilities. The liability at September 30, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Total compensated absences, beginning of year	\$ 719,375	\$ 823,407
Vacation earned	601,333	647,358
Vacation used	<u>(579,930)</u>	<u>(751,390)</u>
Total compensated absences, end of year	740,778	719,375
Current portion	<u>(359,277)</u>	<u>(348,897)</u>
Compensated absences – noncurrent	<u>\$ 381,501</u>	<u>\$ 370,478</u>

No liability is recorded for non-vesting accumulating rights to receive sick pay benefits. An employee cannot carry over to the following calendar year accumulated annual leave in excess of three hundred sixty (360) hours. However, any annual leave accumulated in excess of 360 hours as of the end of the calendar year can be converted to sick leave on the last day of such calendar year.

*Net Assets (Deficiency)*

Net assets represent the residual interest in CUC's assets after liabilities while net deficiency represents the excess liability over assets. Net assets (deficiency) consist of three sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable; and unrestricted. Net assets invested in capital assets, net of debt include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation.

**COMMONWEALTH UTILITIES CORPORATION**  
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(2) Summary of Significant Accounting Policies, Continued

*Retirement Plan – Defined Benefit Plan*

CUC contributes to the Northern Mariana Islands Retirement Fund (NMIRF), a defined benefit, cost-sharing multi-employer pension plan established and administered by the CNMI. NMIRF provides retirement, security and other benefits to employees of the CNMI government and CNMI agencies, instrumentalities and public corporations, and to their spouses and dependents. Benefits are based on the average annual salary over the term of credited service. Generally, benefits vest after three years of credited service. For early retirement, 10 years of vesting service is required and members must be at least 52 years of age. Members, who retire at or after age 60, or with 25 years of vesting service, are entitled to retirement benefits. CNMI Public Law 6-17, "the Northern Mariana Islands Retirement Fund Act of 1988", is the authority under which benefit provisions are established.

As a result of the Fund's actuarial valuation report (as of October 1, 2006), it has been determined that for the year ended September 30, 2007, the funding requirement for employer is 36.7727% of covered payroll, and funding requirements for employees are 6.5% and 9.0% of covered payroll for Class I and Class II members, respectively.

Required contributions and the percentage actually contributed for the current year and for the preceding three years are as follows:

<u>Fiscal Year</u>	<u>Required Contribution</u>	<u>Percentage of Covered Payroll</u>	<u>Actual Contribution</u>	<u>Percentage of Required Contributions Contributed</u>
2007	\$2,895,766	36.7727%	\$2,895,766	100%
2006	\$3,136,714	36.7727%	\$3,136,714	100%
2005	\$2,451,132	24.0000%	\$2,451,132	100%
2004	\$2,903,663	24.0000%	\$2,903,663	100%

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Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Retirement Plan – Defined Contribution Plan*

The Defined Contribution Plan (DC Plan) is a multi-employer pension plan of the CNMI Government and shall be the single retirement program for all new employees whose employment commences on or after January 1, 2007.

Existing Class I members of the Defined Benefit Plan with less than 10 years of service credit may, upon written election, voluntarily and irrevocably elect membership in the DC Plan. This option shall expire 12 months after enactment of legislation.

Summarized as follows are the changes in the Defined Contribution Plans from inception to September 30, 2007.

Employee contributions	\$73,777
Employer contributions	1,511
Transfers and rollovers	46,496
Withdrawals	-
Earnings	20,855
Unrealized gain (loss)	2,161
Expenses	<u>-</u>
 Market value, end of year	 <u>\$74,800</u>

	<u>No. of Participants</u>	<u>Account Balance</u>
Active member	14	\$74,800
Terminated member with balance	<u>-</u>	<u>-</u>
 Total	 <u>14</u>	 <u>\$74,800</u>

*Medical and Life Insurance Benefits*

In addition to providing pension benefits, the CNMI Government also ensures that employees are provided medical and life insurance benefits. The CNMI Government created the Group Health and Life Insurance Trust Fund (GHLITF), held in trust and administered by the Northern Mariana Islands Retirement Fund (NMIRF). CUC contributes to the Group Health and Life Insurance program. This is open to active employees who work at least 20 hours per week and retired CNMI government employees who retire as a result of length of service, disability or age, as well as their dependents. Further, these eligible persons must have elected to enroll during the period permitted in the Emergency Regulations adopted on September 6, 1996. Life insurance coverage is provided by a private carrier through the GHLITF. Contributions from employees and employers are based on rates as determined by NMIRF Board of Trustees. Employee deductions are made through payroll or pension benefit withholdings.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

*Revenue and Expense 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 non-operating 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 included in current year's earnings at September 30, 2007 and 2006 are \$7,798,857 and \$6,009,305, respectively.

*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 2006 balances in the accompanying financial statements have been reclassified to conform to the 2007 presentation.

**COMMONWEALTH UTILITIES CORPORATION**  
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September 30, 2007 and 2006

(3) Accounts Receivable – Utility

Account receivable – utility as of September 30, 2007 and 2006 summarized by location and customer classification are as follows:

By Location

	<u>2007</u>	<u>2006</u>
Saipan		
Commercial	\$ 8,317,289	\$ 6,381,943
Residential	9,644,367	6,709,702
Government	<u>2,360,842</u>	<u>610,856</u>
	<u>\$ 20,322,498</u>	<u>\$ 13,702,501</u>
Tinian		
Commercial	\$ 1,470,738	\$ 1,366,177
Residential	834,844	375,398
Government	<u>3,818,442</u>	<u>3,240,638</u>
	<u>\$ 6,124,024</u>	<u>\$ 4,982,213</u>
Rota		
Commercial	\$ 474,164	\$ 427,381
Residential	851,703	623,925
Government	<u>3,466,636</u>	<u>2,855,126</u>
	<u>\$ 4,792,503</u>	<u>\$ 3,906,432</u>
	<u>\$ 31,239,025</u>	<u>\$ 22,591,146</u>

By Customer Classification

	<u>2007</u>	<u>2006</u>
Commercial	\$ 10,262,191	\$ 8,175,501
Residential	11,330,914	7,709,025
Government	<u>9,645,920</u>	<u>6,706,620</u>
	31,239,025	22,591,146
Allowance for uncollectible accounts	<u>(12,744,311)</u>	<u>(10,502,676)</u>
Accounts receivable – utility, net	<u>\$ 18,494,714</u>	<u>\$ 12,088,470</u>



**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2007 and 2006

(3) Accounts Receivable – Utility, Continued

Changes in allowance for uncollectible accounts for utility and other assets for the years ended September 30, 2007 and 2006 are as follows:

	2007	2006
Total allowance, beginning of year	\$ 11,400,743	\$ 26,773,815
Provision for uncollectible accounts	2,350,637	-
Recovery	-	(15,273,467)
Accounts written-off	(454,464)	(99,605)
Total allowance, end of year	\$ 13,296,916	\$ 11,400,743
Accounts receivable - utility	\$ 12,744,311	\$ 10,502,676
Others assets	552,605	898,067
Total allowance, end of year	\$ 13,296,916	\$ 11,400,743

(4) Other Assets

Other assets as of September 30, 2007 and 2006 consist of the following.

	2007	2006
Prepayments	\$ 1,109,622	\$ 307,232
Notes receivable	673,141	923,342
Temporary facility	144,579	76,903
Others	583,436	1,123,365
	2,510,778	2,430,842
Allowance for uncollectible accounts	(552,605)	(898,067)
Other assets, net	\$ 1,958,173	\$ 1,532,775

(5) Due from Grantor Agencies

CUC is a sub-recipient of federal grants received by the CNMI central government 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.



**COMMONWEALTH UTILITIES CORPORATION**  
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(6) Capital Assets, Continued

Included in utility plant in service adjustments/transfers for fiscal year ended September 30, 2007 and 2006 are completed projects transferred from construction work-in-progress to utility plant in service of \$7,266,210 and \$12,094,413, respectively.

Depreciation expense for the years ended September 30, 2007 and 2006 is \$8,538,161 and \$9,919,927, respectively.

(7) Customer Deposits

Pursuant to 4 CMC § 8143, as amended by Public Law 15-80, the CUC shall collect one month security deposits per customer account. Such deposits shall be placed in an interest earning trust fund and shall not be used for any other purpose. As of September 30, 2007 and 2006, customer deposits including accrued interest amounts to \$10,647,420 and \$9,824,492, respectively. CUC placed in a restricted cash only \$7,860,736 in 2007 and \$7,870,804 in 2006, thus CUC has deficit of \$2,786,684 and \$1,953,688 as of September 30, 2007 and 2006, respectively, in its restricted funds. Interest earned on restricted cash of \$320,813 in 2007 and \$255,751 in 2006 is recorded as current earnings by CUC.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2007 and 2006

(8) Long-term Debt

Long-term debt at September 30, 2007 and 2006 is as follows:

	2007	2006
Commonwealth Development Authority	\$61,568,750	\$61,568,750
Commonwealth Ports Authority	8,215,026	8,215,026
Mobil Oil Mariana Islands, Inc	293,494	574,105
United States Department of Agriculture	-	107,530
	70,077,270	70,465,411
Current maturities	<u>(62,963,346)</u>	<u>(61,901,559)</u>
Long-term debt, net of current portion	<u>\$ 7,113,924</u>	<u>\$ 8,563,852</u>

Changes in long-term debt for fiscal year ending September 30, 2007 and 2006 are as follows:

	Balance at October 1, 2006	Additions	Repayments	Balance at September 30, 2007
Commonwealth Development Authority	\$61,568,750	\$ -	\$ -	\$ 61,568,750
Commonwealth Ports Authority	8,215,026	-	-	8,215,026
Mobil Oil Mariana Islands, Inc	574,105	-	(280,611)	293,494
United States Department of Agriculture	107,530	-	(107,530)	-
Total	<u>\$70,465,411</u>	<u>\$ -</u>	<u>\$ (388,141)</u>	<u>\$ 70,077,270</u>
	Balance at October 1, 2005	Additions	Repayments	Balance at September 30, 2006
Commonwealth Development Authority	\$61,568,750	\$ -	\$ -	\$ 61,568,750
Commonwealth Ports Authority	3,385,131	4,829,895	-	8,215,026
Mobil Oil Mariana Islands, Inc	3,820,372	-	(3,246,267)	574,105
United States Department of Agriculture	156,716	-	(49,186)	107,530
Total	<u>\$68,930,969</u>	<u>\$4,829,895</u>	<u>\$ (3,295,453)</u>	<u>\$ 70,465,411</u>

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2007 and 2006

(8) Long-term Debt, Continued

*Commonwealth Development Authority (CDA)*

A summary of CUC's loans payable to CDA as of September 30, 2007 and 2006 is as follows:

	2007	2006
Loan payable to CDA, a component unit of the CNMI, principal of \$30,000,000, interest at 7% per annum, with maturity date of February 17, 2013. Principal and interest payments are due in quarterly payments of \$658,469.	\$30,000,000	\$30,000,000
Loan payable to CDA, principal of \$16,135,650, interest at 5% per annum with maturity date of January 12, 2014. Principal and interest payments are due in quarterly payments of \$359,514.	16,068,750	16,068,750
Loan payable to CDA, principal of \$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
Loan payable to CDA, principal of \$10,000,000 with 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 since the loan was obtained through Public Law 9-23.	<u>10,000,000</u>	<u>10,000,000</u>
	<u>\$61,568,750</u>	<u>\$61,568,750</u>

At September 30, 2007 and 2006, CUC was in default of repayment terms of all loans 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, 2007 and 2006, associated with the loans payable to CDA including interest payable on these notes of \$115,870,095 and \$105,136,517 as at September 30, 2007 and 2006, respectively, are classified as current liabilities in the accompanying financial statements.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2007 and 2006

(8) Long-term Debt, Continued

*Commonwealth Development Authority (CDA), Continued*

On June 6, 2006, the Governor of the CNMI approved Public Law 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 Public Law 15-12 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.

Section 2 of the Public Law 15-12 was amended by Public Law 15-44, approved by the Governor of the CNMI on January 23, 2007. The amended section 2 provides that in the event that CUC's power division or any section thereof is privatized, fifty percent or \$22,750,000 of the principal amount of \$45,500,000 shall be rebated to the residential power consumers and the remaining fifty percent shall be waived. The said rebate shall be subject to review and approval by the Public Utilities Commission upon privatization.

On October 2, 2008, Public Law 16-17 or the Commonwealth Utilities Corporation Act of 2008, authorized CUC to issue shares of cumulative, non convertible, non-transferable preferred stock valued at \$45,000,000 to CDA. CUC and CDA may provide by written agreement, subject to the terms and conditions of their Memorandum of Agreement, such terms and conditions being incorporated herein by reference, for the following:

- (1) Guaranteed annual dividends fixed and payable as agreed;
- (2) Buy-back provisions;
- (3) Default provisions;
- (4) Preferred shareholder rights; and
- (5) Consistent with Commonwealth law, such other rights and remedies are typically found in shareholder and stock purchase agreements.

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
September 30, 2007 and 2006

(8) Long-term Debt, Continued

*Commonwealth Ports Authority (CPA)*

A summary of CUC's loans payable CPA at September 30, 2007 and 2006 is as follows:

	<u>2007</u>	<u>2006</u>
Loan payable to CPA, a component unit of the CNMI, principal of \$3,385,131, interest at 6.25% per annum, with a maturity date of October 31, 2017. Principal and interest payments are due in monthly payments of \$38,008 beginning October 31, 2007.	\$ 3,385,131	\$ 3,385,131
Loan payable to CPA, principal of \$4,829,895, interest at 6.25% per annum with a maturity date of October 31, 2012. Principal and interest payments are due in monthly payments of \$93,938 beginning October 31, 2007.	<u>4,829,895</u>	<u>4,829,895</u>
Current portion	<u>8,215,026</u> <u>(1,101,102)</u>	<u>8,215,026</u> <u>-</u>
Long-term debt, net of current portion	<u>\$ 7,113,924</u>	<u>\$ 8,215,026</u>

Future repayment commitments of principal and interest are as follows:

<u>Year ending</u> <u>September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2008	\$1,101,102	\$ 482,252	\$ 1,583,354
2009	1,171,927	411,427	1,583,354
2010	1,247,307	336,047	1,583,354
2011	1,327,536	255,818	1,583,354
2012	1,412,926	169,941	1,582,867
2013-2017	<u>1,954,228</u>	<u>326,073</u>	<u>2,280,301</u>
	<u>\$8,215,026</u>	<u>\$1,981,558</u>	<u>\$10,196,584</u>

**COMMONWEALTH UTILITIES CORPORATION**  
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Notes to Financial Statements  
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(8) Long-term Debt, Continued

*United States Department of Agriculture*

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, 2006, 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, 2007 and 2006:

	2007	2006
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.	\$ -	\$ 107,530
Current maturities	-	(52,198)
Long-term loan payable	\$ -	\$ 55,332

*Mobil Oil Mariana Islands*

The following summarizes the loan payable to Mobil Oil Mariana Islands as of September 30, 2007 and 2006:

	2007	2006
Loan payable to the Mobil Oil Mariana Islands with repayments due on January 1, beginning in 2007 through June 2008, bearing interest at 6.00% per annum.	\$ 293,494	\$ 574,105
Current maturities	(293,494)	(280,611)
Long-term loan payable	\$ -	\$ 293,494



**COMMONWEALTH UTILITIES CORPORATION**  
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(9) 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 ten (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.

In 2000 CUC implemented accounting guidance of Emerging Issues Task Force (EITF) Issue No. 01-8, *"Determining Whether an Arrangement Contains a Lease"*, 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 adoption of EITF No. 01-8 increased electric plant by and obligations under capital lease by \$15,434,147. The capital lease obligation has a stated interest rate of 18%. However, to reflect the time value of money, the liability and the corresponding capital asset recorded in the financial statements reflect future payments discounted at an imputed interest rate of 7.10%, which was CUC's long-term borrowing rate at March 1999.

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Notes to Financial Statements  
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(9) 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 at September 30, 2007 is as follows:

<u>Year ending September 30,</u>	<u>Lease Payments</u>	<u>Interest</u>	<u>Face Value of Obligation</u>	<u>Unamortized Premium</u>	<u>Total</u>
2008	\$ 2,160,000	\$ (337,499)	\$ 1,822,501	\$ 196,241	\$ 2,018,742
2009	<u>900,000</u>	<u>(39,124)</u>	<u>860,876</u>	<u>23,367</u>	<u>884,243</u>
	<u>\$ 3,060,000</u>	<u>\$ (376,623)</u>	<u>\$ 2,683,377</u>	<u>\$ 219,608</u>	<u>\$ 2,902,985</u>

(10) Due to Primary Government

Public Law 9-66, enacted on 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 CNMI Office of the Public Auditor (OPA) and the agency may agree, to fund the OPA. At September 30, 2007 and 2006, CUC had an outstanding payable to the CNMI Government in the amount of \$2,720,971 and \$2,026,212, respectively.

(11) 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 remained in effect until the end of calendar year 2005.

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(11) Fuel Surcharge Fee, Continued

On July 2006, the CUC Electric Service Regulations, Part 24 Rate Schedules were 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, which includes an electric fuel charge, is effective beginning August 2006 utility consumption and was formally adopted on October 24, 2006.

Fuel surcharge revenue for the year ended September 30, 2006 amounted to \$11,151,559 while electric fuel charges were \$64,714,485 for the year ended September 30, 2007 and \$14,378,371 from July to September 2006.

(12) Risk Management

The CNMI government is a self-insured entity. The government has limited its general liability to individuals to \$100,000 or \$200,000 per occurrence. For this reason the government does not maintain any insurance on its buildings, or employees. At some future date, CUC may insure some of its assets, as an autonomous agency as it is not required to follow the CNMI's government of self-insurance.

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, however, requires performance bonds on all its constructions projects.

(13) 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, 2007 and 2006, 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.

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(13) Commitments and Contingencies, Continued

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 original agreement expired on July 31, 2006 and was subsequently renewed for an additional ten year period to expire on July 31, 2016.

*Contingencies*

CUC is subject to various claims and legal proceedings covering a wide range of matters that arise in the ordinary course of its operations, including customer disputes.

CUC is a defendant in a class action lawsuit, Superior Court Civil Case No. 09-410, wherein CUC is alleged to have overcharged its customers from July 22, 2006 to October 24, 2006. The damages sought include a refund of approximately \$4.2 million, in addition to related punitive damages and attorney fees. CUC have not accrued any liability for this class action lawsuit in the accompanying financial statements.

CUC is also involved in several disputes with contractors. CUC has worked out a settlement agreement with a contractor, subject to the approval of the Commonwealth Public Utilities Commission. The financial terms of the settlement are subject to a confidentiality agreement; however, the settlement will not have a material effect on the CUC's financial condition or results of operations. CUC has proposed a settlement with another contractor. The Contractor continues to claim for the stand by costs incurred. If CUC does not prevail, potential loss could be approximately \$657,000. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

CUC entered into certain memoranda of understanding (MOUs) with certain 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), CUC could be considered in breach of 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.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(13) Commitments and Contingencies, Continued

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, 2007. 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.

The Environmental Protection Agency (EPA) sought to force CUC and the CNMI to comply with various regulations and requirements. To date there have been two stipulated orders.

Stipulated Order One is intended to ensure that CUC's wastewater and drinking water systems achieve compliance with the Clean Water Act (CWA) and Safe Drinking Water Act (SDWA). The major components of Stipulated Order One are:

1. The reformation of CUC's management, finances and operations;
2. The development of a wastewater and drinking water Master Plan; and
3. The construction of wastewater infrastructure.

CUC is also required to take steps to comply with National Pollution Discharge Elimination System permits and compliance orders, comply with drinking water standards, and to eliminate spills from the wastewater system.

Stipulated Order Two is intended to ensure that CUC's power plant facilities achieve compliance with the CWA. These requirements include requiring CUC to eliminate oil spills, implement appropriate spill prevention measures, implement effective inspection procedures for its oil storage facilities, provide containment for oil storage facilities and prepare appropriate operating plans.

Subsequent to September 30, 2008, fines and penalties related to these stipulated orders have accrued to approximately \$4 million, of which, \$29,000 was paid by CUC to the United States Department of Justice on January 13, 2010.

On February 25, 2010, a further stipulation was signed between the CUC and EPA and so ordered by the court. As further penalties and fines are contingent on CUC's performance, and as EPA has not, at this time, chosen to attempt to collect on the majority of the penalties and fines, CUC believes it is difficult to evaluate future liabilities.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(14) Going-Concern Issues Arising from Default of Certain Loan Agreement

CUC is involved in environmental remediation and ongoing compliance as discussed in Note 13. At September 30, 2007, and 2006, CUC has not estimated total remediation and ongoing monitoring costs to be made in the future.

(15) Restatement

CUC restated the 2006 balances for the following:

As discussed in Note 9, CUC implemented accounting guidance of Emerging Issues Task Force (EITF) Issue No. 01-8, *"Determining Whether an Arrangement Contains a Lease"*, which provides guidance in determining when purchase agreements may be subject to lease accounting.

In April 2010, CUC's management was able to obtain the fair value of the asset acquired through a capital lease agreement and have restated 2006 balances to reflect the adjusted cost of the capital asset acquired to \$15,434,147, which is the net present value of the minimum lease payments discounted at an imputed interest rate of 7.10%, CUC's long-term borrowing rate at March 1999.

CUC also corrected the recording of interest income earned on restricted cash pertaining to customers' deposits. Pursuant to Public Law 16-2, a residential security deposit refunds shall be paid within 30 days after disconnection of such utilities and with earned interest.

The following is a summary of the restatements for fiscal year ending September 30, 2006:

Fiscal year 2006 ending net deficit, as previously stated	\$ (65,384,914)
Changes in prior years' income and expenses:	
Increase in depreciation	( 1,706,515)
Decrease in interest expense	4,868,359
Decrease in interest income	<u>(96,536)</u>
	<u>\$ (62,319,606)</u>

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Financial Statements  
September 30, 2007 and 2006

(16) Subsequent Events

On September 3, 2009, the Commonwealth Public Utilities Commission issued Decision and Order Docket No. 09-1, wherein the Preferred Stock Agreement between CUC and CDA dated May 7, 2009 was approved by the Commonwealth Public Utilities Commission pursuant to 4 CMC § 8409[d] and the contract review protocol established by Commission order dated December 19, 2008. Under the Agreement, over \$177 million dollars of CUC debt would be transformed into \$45 million of preferred stock, with provision made for CUC to repurchase up to \$16.2 million dollars of this stock through internal capital investments.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

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**REPORTS ON THE AUDITS OF FINANCIAL  
STATEMENTS IN ACCORDANCE WITH  
OMB CIRCULAR A-133**

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**Year Ended  
September 30, 2007**



J. Scott Magliari  
& COMPANY

CERTIFIED PUBLIC ACCOUNTANT

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**INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND  
ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS  
PERFORMED IN ACCORDANCE WITH GOVERNMENTAL AUDITING STANDARDS**

To the Executive Director  
Commonwealth Utilities Corporation

I have audited the financial statements of the Commonwealth Utilities Corporation (CUC), as of and for the year ended September 30, 2007, and have issued my report thereon dated September 26, 2008, except for Notes 13 and 15, as to which the date is April 20, 2010, which report was qualified due to my inability to determine the propriety of inventory. Except as discussed in the preceding sentence, I conducted my 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 of America.

Internal Control Over Financial Reporting

In planning and performing my audit, I considered CUC's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of CUC's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of CUC's internal control over financial reporting.

My 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, I identified certain deficiencies in internal control over financial reporting that I 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. I consider the following deficiencies, Findings 2007-1 through 2007-18, described in the accompanying Schedule of Findings and Questioned Costs to be significant deficiencies in internal control over financial reporting.

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.


My 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 describe above, I believe that findings 2007-1 through 2007-4, 2007-6 through 2007-18 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, I 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 my audit, and accordingly, I do not express such an opinion. The results of my 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 Findings 2007-1, 2007-3, 2007-5 through 2007-7, 2007-9, 2007-17 and 2007-19 and 2007-20.

CUC's responses to the findings identified in my audit described in the accompanying Schedule of Findings and Questioned Costs are in a separate letter prepared by CUC's management. I did not audit CUC's response and, accordingly, I express no opinion on it.

This report is intended solely for the information and use of the management of CUC, the CNMI Office of the Public Auditor, 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. However, this report is also a matter of public record.

  
Saipan, Commonwealth of the Northern Mariana Islands  
September 26, 2008

J. Scott Magliari  
& COMPANY

CERTIFIED PUBLIC ACCOUNTANT

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**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE**  
**WITH REQUIREMENTS APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM**  
**AND ON INTERNAL CONTROL OVER COMPLIANCE WITH OMB CIRCULAR A-133**  
**AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

To the Executive Director  
Commonwealth Utilities Corporation

Compliance

I have audited the compliance of 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, 2007. CUC's major federal programs are identified in the Summary of Auditor's Results section of the accompanying Schedule of Findings and Questioned Costs. 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. My responsibility is to express an opinion on CUC's compliance based on my audit.

I conducted my 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 of America; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that I 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 I considered necessary in the circumstances. I believe that my audit provides a reasonable basis for my opinion. My audit does not provide a legal determination of CUC's compliance with those requirements.

As described in Findings 2007-19 and 2007-20 in the accompanying Schedule of Findings and Questioned Costs, CUC did not comply with requirements regarding reporting that are applicable to its Construction Grants for Wastewater Treatment (CFDA 66.418). Compliance with such requirements is necessary, in my opinion, for CUC to comply with the requirements applicable to that program.

In my 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, 2007.

### 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 my audit, I considered CUC's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine my auditing procedures for the purpose of expressing an opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, I do not express an opinion on the effectiveness of CUC's internal control over compliance.

My consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, I identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies.

A *control deficiency* in an entity's internal control over compliance 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 noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. I consider the deficiencies in internal control over compliance described in the accompanying Schedule of Findings and Questioned Costs as Findings 2007-19, 2007-20 to be significant deficiencies.


A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over compliance described in the accompanying Schedule of Findings and Questioned Costs, I consider Findings 2007-19 and 2007-20 to be material weaknesses.

### Schedule of Expenditures of Federal Awards

I have audited the basic financial statements of CUC as of and for the year ended September 30, 2007, and have issued my report thereon dated September 26, 2009. My 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 on page 51 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 the audit of the basic financial statements and, in my opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

CUC's responses to the findings identified in my audit described in the accompanying Schedule of Findings and Questioned Costs are in a separate letter prepared by CUC's management. I did not audit CUC's response and, accordingly, I express no opinion on it.

This report is intended solely for the information and use of the management of CUC, the CNMI Office of the Public Auditor, 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. However, this report is also a matter of public record.

  
Saipan, Commonwealth of the Northern Mariana Islands  
September 26, 2008

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Schedule of Expenditures of Federal Awards  
For the Year Ended September 30, 2007

Federal Grantor/Pass-Through Grantor Program Title	Federal CFDA Number Pass Through Grantor's Number	Program or Award Amount	Receivable (Deferred Revenue) from Grantor at October 1, 2006	Cash Receipts FY 2007	Adjustments	Expenditures FY 2007	Receivable (Deferred Revenue) from Grantor at September 30, 2007
<u>U.S. Environmental Protection Agency</u>							
Direct Programs:							
Beach Road Sewer System	66.418	\$ -	\$ (5,238)	\$ 30,800	\$ -	\$ 28,804	\$ (7,234)
Kanat Tabla IMG Tank	66.418	-	-	216,962	-	426,065	209,103
Airport Sand Filtration Rehabilitation	66.418	-	(10,991)	-	-	6,409	(4,582)
Agingan Sewage Treatment Plant Ocean Outfall	66.418	3,114,157	165,124	950,447	-	1,751,332	966,009
Achugao/Tanapag Filtration System	66.418	21,000	(4,168)	-	-	-	(4,168)
		3,135,157	144,727	1,198,209	-	2,212,610	1,159,128
<u>U.S. Department of the Interior</u>							
<u>Direct Grant</u>							
Meter Maintenance Program	OMIP-CUC-2007-1	160,494	-	160,494	-	147,429	(13,065)
Information Technology Upgrade	OMIP-CUC-2007-2	94,964	-	94,964	-	-	(94,964)
Technical Consultant	OMIP-CUC-2007-3	185,000	-	185,000	-	185,000	-
Passed through the Government of the CNMI:							
Federal Portion:							
Renovation and Rehabilitation of Power Plant	15.875	2,673,000	137,745	46,420	-	65,187	156,512
Saipan Power Plant Improvement	15.875	-	-	-	-	142,212	142,212
Kanat Tabla IMG Tank (Water Task Force)	15.875	-	5,108	5,108	-	-	-
Beach Road Sewer System	15.875	-	5,392	-	(5,392)	-	-
		3,113,458	148,245	491,986	(5,392)	539,828	190,695
Local Matching Portion:							
Beach Road Sewer System	15.875	-	1,964	-	(1,964)	-	-
Sinapalu III Waterline	15.875	-	-	-	-	-	-
Koblerville Sewer System	15.875	-	-	-	-	-	-
Relocation of T-1 Lift Station	15.875	-	15,750	-	(15,750)	-	-
		-	17,714	-	(17,714)	-	-
		3,113,458	165,959	491,986	(23,106)	539,828	190,695
<u>U.S. Department of Homeland Security</u>							
Passed through the Government of the CNMI							
Public Assistance Grants	97.036	-	625,968	318,029	(20,355)	-	287,584
<b>Total</b>		\$ 6,248,615	\$ 936,654	\$ 2,008,224	\$ (43,461)	\$ 2,752,438	\$ 1,637,407

See accompanying notes to schedule of expenditures of federal awards.

**COMMONWEALTH UTILITIES CORPORATION**  
 (A Component Unit of the CNMI Government)

Schedule of Programs Selected for Audit  
 In Accordance with OMB Circular A-133

Year Ended September 30, 2007

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

<u>Original Grantor</u>	<u>CFDA No</u>	<u>Description</u>	<u>Amount of Expenditures</u>
U.S. Department of the Interior	15.875	Capital Development Projects	\$ 539,828
U.S. Environmental Protection Agency	66.418	Construction Grants for Wastewater Treatment Works	<u>2,212,610</u>
		Total federal program expenditures	<u>\$ 2,752,438</u>
		% of total federal program expenditures tested	<u>100%</u>

Dollar threshold used to distinguish between

Type A and Type B programs: \$ 300,000

Auditee qualified as low-risk auditee yes X no

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Notes to Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2007

(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 2007, 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**  
(A Component Unit of the CNMI Government)

Notes to Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2007

(3) Adjustments

During the year ended September 30, 2007, CUC reconciled the amount due from grantor agencies resulting in a net adjustment of \$43,461 to reduce receivables due from grantors.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2007

**SECTION I – SUMMARY OF AUDITOR’S RESULTS**

Financial Statements

Type of auditor’s report issued: Qualified

Internal control over financial reporting:

- Material weakness(es) identified?   X   yes        no
  
- Significant deficiency(ies) identified that are not considered to be material weaknesses?   X   yes        none reported

Noncompliance material to financial statements noted?   X   yes        no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified?   X   yes        no
  
- Significant deficiency(ies) identified that are not considered to be material weaknesses?   X   yes        none reported

Type of auditor’s report issued on compliance for major federal programs: Qualified

CFDA 66.418 – Reporting

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?   X   yes        no

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2007

**SECTION II – FINANCIAL STATEMENT FINDINGS**

**Budget**

Finding No. 2007-1

**Criteria:**

Pursuant to 1 CMC §7206, CUC must submit annual budgets to the CNMI Office of the Governor.

**Condition:**

CUC was not able to provide copies of its adopted budget for the fiscal year ending September 30, 2007.

Although CUC has a policy to prepare annual budget, this policy does not include regular review and comparison of actual results to budget.

Furthermore, CUC does not fully utilize its accounting systems budget capabilities.

**Cause:**

There is a lack of management monitoring and oversight on the significance of proper budgeting process.

**Effect:**

CUC is not in compliance with 1 CMC §7206.

Management is unable to review and investigate significant variations, take timely remedial steps to get back on track, if necessary, or investigate whether accounting errors or fraud might be the cause of otherwise unexplained variations between budget and actual results.

**Recommendation:**

Budgets should be incorporated into CUC's financial reporting system to allow it to measure actual performance versus budgeted performance. A more frequent review of operating results and budget variations will enable management to more actively run CUC by recognizing unusual trends that may indicate fraud, unwise use of resources, operational inefficiencies, poor decision making, missed opportunities, and other threats that derail operation.

CUC should consider fully utilizing its AS400 accounting software to monitor its budget.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2007

**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Timely Financial and Management Reporting**

Finding No. 2007-2

**Criteria:**

Pursuant to 4 CMC 8141, the Executive Director shall manage the Corporation in a business-like manner so as to provide the most efficient delivery of its services at the most reasonable cost to its customers.

**Condition:**

Monthly financial statements are not prepared timely. The September 30, 2007 trial balance was only provided to the auditor on May 6, 2008.

**Cause:**

There is lack of established internal controls and monitoring procedures to ensure that the financial statements are prepared in a timely manner. Additionally, CUC experienced personnel turnover in key finance positions.

**Effect:**

CUC is not able to complete its Single Audit reporting requirements within nine months from close of the fiscal year in accordance with OMB Circular A-133.

Without a complete set of financial statements and management analysis, management decisions could be made based on incomplete or inaccurate information. Furthermore, it would be difficult for management to identify irregularities or possible fraud without these reports.

**Recommendation:**

Part of a sound internal control environment is regular and timely reporting. CUC should establish deadlines for regular financial and management reports. At present, the primary current information produced by CUC's closing process is a balance sheet and an income statement. Although these statements are very important, other management reports, such as performance measures, are also important for effective management of CUC. Performance measures are indices developed by function or position that management can use to properly understand the results of operations and gauge the improvement in performance over time. Performance measures are developed by reviewing the time, quality, and quantity of a function. For example, performance measures in the power generation function would include the analysis of fuel efficiency, line loss, etc. By comparing monthly fuel efficiency, management may note of significant fluctuations and identify what went wrong or what was done differently during the month when these occurred and be able to use this information to improve fuel efficiency in the future. This will also help explain fluctuation in fuel expenses. CUC should consider developing performance measures for each major function and periodically report the key measures to provide positive feedback to employees and management tools for supervisors and managers.

**COMMONWEALTH UTILITIES CORPORATION**  
(A Component Unit of the CNMI Government)

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2007

**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Procurement**

Finding No. 2007-3

**Criteria:**

Pursuant to CUC procurement operating procedures and CNMI Procurement Regulations, all purchases over \$50,000 must be supported by contracts. Furthermore, §70-30.3-220 of the Northern Mariana Islands Administrative Code (NMIAC), states that purchase orders may be utilized for small purchases below \$10,000. Procurement requirements shall not be artificially divided so as to constitute a small purchase.

**Condition:**

Several payments made during fiscal year ending September 30, 2007 to service provider #1769 totaling \$455,443 were not supported by a contract. No reference to a contract or purchase order noted on the payment documents.

**Cause:**

According to Procurement Department, the contract may have been routed for approval to the former CUC Executive Director. However, a copy of the approved contract was not returned to the Procurement Department.

**Effect:**

Payments made to this contractor were not in accordance with CUC's procurement policies and may not be allowable costs. Furthermore, overpayments may have been made and not detected.

**Recommendation:**

The management of CUC should investigate the propriety of the payments made to the above-mentioned vendor, determine whether a valid executed contract exist, and ascertain whether the expenditures were allowable costs incurred pertinent to a valid contract and were paid within the contract period.

CUC should establish monitoring procedures to ensure that all signed copies of contracts are maintained on file in accordance with the procurement document retention policy (§70-30.3-285) of the NMIAC.

Furthermore, payments should only be made for purchases or vendor invoices with reference to an approved purchase order, contract or other justification as allowed by the procurement policies of CUC and the NMIAC.

**Prior Year Status:**

Prior year finding 2006-3 also included several purchases not properly supported by approved contracts.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Payroll**

Finding No. 2007-4

**Criteria:**

Employees should be paid in accordance with an approved employment contract or personnel action form (PAF) and any changes in rates should be accompanied by approved personnel action form.

**Condition:**

A non-statistical sample of 65 payroll payments was selected for test of controls over payroll disbursements and noted the following:

- a. For 4 or 6% of 65 employees selected for testing, the actual payroll rate used does not agree with the latest approved PAF on file.

<u>Employee Number</u>	<u>Payment Date</u>	<u>Findings</u>
9978	4/13/07	Employee rate per PAF is \$15.856 per hour whereas actual payroll is \$11.375 per hour.
756	10/27/06	Employee rate per PAF is \$10.137 per hour whereas the actual payroll is \$11.154 per hour. No updated PAF was on-file. Last PAF on file was for fiscal year 2004.
2506	10/27/06	Employee rate per PAF is \$10.146 per hour whereas the actual payroll is \$10.013 per hour.
10107	3/16/07	Employee rate PAF is \$29.907 per hour whereas the actual payroll is \$40.385 per hour. Employee appears to have been overpaid for this PPE. No updated PAF on file. Last PAF was for fiscal year 2006.

- b. The employee files for 6 or 9% of the 65 employees selected for testing were not made available for audit.

**Cause:**

There is poor implementation of internal control policies and procedures and lack of monitoring controls. An edit check of changes in payroll rates is not regularly generated from the payroll system and the payroll department does not compare these changes to supporting documentation from Human Resources Department.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Payroll, Continued**

Finding No. 2007-4, Continued

**Effect:**

Some employees could have been improperly paid as a result of these differences. Furthermore, fraud could be perpetrated and not be detected in a timely manner.

**Recommendation:**

The variances listed above should be investigated by Human Resources and Payroll personnel and properly corrected. To ensure that all changes made to the personnel file in the payroll system are authorized, the Human Resources Department should only make changes based on approved contract or PAF. A copy of such contract should be provided timely to the Payroll Department for independent verification. To ensure completeness of documents submitted by the Human Resources Department to the Payroll Department, the Information Technology Department should generate a monthly edit list of all the changes made in the payroll system. All such changes should be verified against duly authorized documentation provided by the Human Resources Department.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Cash and Cash Equivalents**

Finding No. 2007-5

**Criteria:**

Pursuant to 4 CMC §8155, all funds received by CUC must be deposited into insured or fully collateralized accounts.

**Condition:**

For the year ended September 30, 2007, CUC had cash deposits totaling \$145,889 in a non-insured financial institution.

**Cause:**

CUC maintains an account with this non-insured financial institution since this financial institution also acts as one of the collecting agent of CUC.

**Effect:**

CUC is in violation of 4 CMC §8155. Furthermore, the amount of cash in this institution has high custodial risk.

**Recommendation:**

CUC should obtain collateralization from the financial institution to comply with the requirements of 4 CMC §8155.



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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Customer Deposits – Minimum Deposit**

Finding No. 2007-6

**Criteria:**

Based on a Memorandum issued by the Executive Director on September 29, 2005 to all Division Managers by the Executive Director regarding "Assessing Electric Security Deposits":

- a. New customers who apply for service at a location where no prior service was provided, the electric security deposit will be \$200 for residential and \$365 for commercial. This was amended by Public Law 15-80, which reduced the initial deposit to one month consumption instead of the fixed amounts of \$200 and \$365 for residential and commercial customers, respectively.
- b. Customers whose security deposits are to be calculated based on actual or estimated usage stated in kilowatt-hours, depending on the applicable circumstances (i.e. certified load calculations provided by the electrical engineer, the 2 highest monthly usage during the past 12-month period, or average monthly usage for the last 6 months for the prior customer), the number of kilowatt-hours shall be multiplied by the applicable electric rate plus the current fuel surcharge fee.

Additional criteria for computation of required deposits from Part 6.4 of the Electric Service Regulations states that "after one year of established use and annually thereafter, CUC may also recalculate security deposit".

**Condition:**

The minimum required deposits was recalculated for 40 customers and noted that 25 or 62.5% and 17 or 42.5% of 40 customers selected for testing had security deposits that are insufficient to the highest usage for the past 12-month period and average monthly usage for the past 6 months, respectively.

**Cause:**

CUC lacks sufficient manpower to conduct the required review of the deposit accounts pursuant to Memorandum for assessing electric security deposits and Part 6.4 of the Electric Service Regulations.

**Effect:**

In case certain cases where customers default on payment of its utility bills, CUC does not have enough security deposits from these customers to recover its receivable due from customers for nonpayment. This may result to potentially high uncollectible accounts.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Customer Deposits – Minimum Deposit, Continued**

Finding No. 2007-6, Continued

**Recommendation:**

CUC should ensure that the monitoring controls are properly implemented, to ensure that customers deposit are adequate to cover at least on month consumption, is properly implemented. CUC could utilize its Information Technology Department to facilitate the computation of required minimum deposits and comparison against actual deposit. The variance report should then be reviewed by the Controller or designated personnel for appropriate action such as pursuing deposit increase as stated in CUC's regulations.

**Prior Year Status:**

The same condition was cited as Finding 2006-16 in prior year audit.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Customer Deposits – Liability**

Finding No. 2007-7

**Criteria:**

Pursuant to Public Law 15-80, deposits shall be placed in an interest-earning trust fund to be established by the CUC Executive Director. Such funds shall not be used for any other purpose. All residential security deposit refunds shall be paid within 30 days after disconnection of such utilities and with earned interest.

**Condition:**

The following were noted during the audit of customer deposits:

- a. Though annual interest owed on deposits received from customers is calculated annually, CUC did not recognize the liability for such interest in its financial statements nor did it allocate the interest earned to individual customer deposits.
- b. Of the customer deposits received, \$7,500,000 placed in various time certificates of deposit are 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.
- c. A portion of the customer deposits received is co-mingled in CUC's general fund and may have already been expended for purposes not allowed by the law.

Restricted cash	\$ 7,860,736	\$ 7,870,804
Total customer deposits (including accumulated accrued interest)	<u>(10,647,420)</u>	<u>(9,824,492)</u>
Restricted net asset deficiency	<u>\$(2,786,684)</u>	<u>\$(1,953,688)</u>

- d. Upon disconnection of customer accounts, customer deposits are refunded or applied to outstanding balance without regard to accrued interest earned.

**Cause:**

CUC has not established and implemented procedures to allocate interest earned to individual customer deposits. Additionally, the above condition may be due to confusion caused by several amendments made to the statutes affecting CUC regulations.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Customer Deposits – Liability, Continued**

Finding No. 2007-7, Continued

**Effect:**

The liabilities and restricted net asset deficiency in financial statements of CUC is understated by the amount of the compounded interest earned on customer deposits.

**Recommendation:**

CUC should comply with statutes pertaining to customer deposits.

The liability for interest on customer deposits should be recognized by reclassifying all interest earned from customer deposits placed in time certificates of deposit to liability to customers instead of its current recognition as other income of CUC. Furthermore, interest earned on customer deposits not placed in restricted interest bearing accounts should be accrued and the corresponding expense should be recognized by CUC as a result of non-compliance with the statute.

CUC should ensure that all customer deposits are placed in restricted interest earning fund and that interest on such fund shall be rolled-over to that fund instead of the current practice of transferring interest to the general fund.

**Prior Year Status:**

This condition was cited as Finding 2006-15 in prior year audit.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Revenue/Receipts**

Finding No. 2007-8

**Criteria:**

All recorded revenues and receivables should reflect collectible balances.

**Condition:**

There were twenty-one (21) long outstanding disputed accounts totaling \$1,498,258 that were not disconnected. Management asserts that these delinquent customers represent landowners which CUC placed water wells, utility poles, pumps, etc., on their property. In-lieu of CUC making rental payments for use of the property, customers are not paying for utility usage; however, no formal contractual agreement exists between these customers and CUC. Correspondingly, no cost analysis study has been performed to determine the fair value of the property rental versus the property owner's utility consumption.

**Cause:**

CUC lacks a formal policy for its use of private property in-lieu of payment to CUC for utility usage. A formal policy was only drafted in fiscal year 2007.

**Effect:**

The above delinquent accounts may be uncollectible. Additionally, there could be inequalities in the amount paid for certain parcels of land depending on the value of utilities used.

**Recommendation:**

CUC should consider conducting cost analysis to determine the fair value of the property rental versus the property owner's utility consumption for which CUC has placed its water wells, utility poles, pumps and related equipment.

CUC should execute formal agreements with all landowners for the use of land and ensure compliance with established policies and procedures. Furthermore, depending on the agreed monthly rate to recognize as rental expense, it may be necessary for CUC to make prior period adjustments to record rent expense and reduce the related outstanding receivable.

**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 2006. During 2007, CUC adopted a policy requiring all agreements to be prepared prior to using private properties. CUC also established procedures for easement claims.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Accounts Receivable/Disconnection**

Finding No. 2007-9

**Criteria:**

Pursuant to CUC Electric Service Regulation, Part 17, CUC may disconnect past due accounts 14 calendar days after of second disconnection notice, which is sent 45 days after the first disconnection notice. The customer may seek remedy against disconnection by filing a formal dispute or execute a promissory note subject to CUC approval.

**Condition:**

The active accounts with overdue amounts from the aging of receivables were summarized. The listing of active accounts with overdue amounts was compared with the listing of accounts with dispute and accounts with promissory notes. There were 108 customer accounts whose aggregate overdue balance was \$458,059, and none of which had disputes or promissory notes and were not disconnected.

**Cause:**

There is a lack of monitoring to ensure that all accounts 90-days past due are disconnected pursuant to Part 17 of CUC's Electric Service Regulation.

**Effect:**

The collectibility of the above-mentioned past due customer accounts are doubtful may represent bad debts. Furthermore fraud could be committed on these accounts and not be detected in a timely manner.

**Recommendation:**

The above-mentioned past due customer accounts should be investigated pursuant to Part 17 of CUC's Electric Service Regulation and evaluated for collectability. CUC should adhere to its established policies and procedures for termination/disconnection of service. Furthermore, internal control monitoring should be performed to ensure that all accounts 90-days past due are timely disconnected, unless supported by promissory notes or formal customer dispute.

**Prior Year Status:**

A similar condition was cited as Finding 2006-5 in prior year audit.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Inventory**

Finding No. 2007-10

**Criteria:**

Perpetual inventory records should, at all times, reflect the total inventory quantity on-hand.

**Condition:**

The inventory valuation report as of September 30, 2007 included several inventory items with negative quantities on-hand. Although the ending inventory was adjusted to the actual physical count, the adjustment may be overstated by these items with credit balances (See Finding No. 2007-11).

**Cause:**

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 personnel are matched by the system with the corresponding vendor invoices posted. Consequently, if corresponding invoices have not been posted by the Accounting Department or cannot be identified, inventory per subsidiary ledger is not adjusted for warehouse receipts. As a result, the inventory subsidiary ledger account may be zero even though there may be actual inventory on-hand. Since the computer system allows for issuance even when there is insufficient inventory quantities on-hand per the subsidiary ledger, inventory issuances by warehouse personnel may result in negative inventory quantities per book.

**Effect:**

There is a potential for material misstatement of inventory balances and thus resulting in an opinion qualification on the account balance and related expenses. There is also the potential for theft and misappropriation of assets due to a lack of internal control and inventory variances may simply be written without adequate investigation and resolution.

Furthermore, inaccurate inventory valuation report is not useful to management in making inventory purchase decisions.

**Recommendation:**

CUC should ensure that all inventory transactions are properly posted and in a timely manner. A properly functioning perpetual inventory system will help generate more accurate interim financial statements and minimize the likelihood of making large physical inventory adjustments.

**Prior Year Status:**

A similar condition was cited as Finding 2006-6 in the prior year audit.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Inventory Reconciliation**

Finding No. 2007-11

**Criteria:**

A reconciliation of inventory balances between the general ledger and subsidiary ledgers should be performed regularly and discrepancies, if any, should be investigated in a timely manner.

**Condition:**

For fiscal year ending September 30, 2007, CUC adjusted \$186,292 as additional administrative expenses for the net overstatement of the general ledger inventory control account against the adjusted inventory valuation report. The variance was not investigated.

**Cause:**

CUC has not implemented a plan of corrective action for the above condition as this control deficiency has existed since fiscal year 2002. There is a lack of responsible personnel assigned to perform the established inventory controls and there are no monitoring procedures in place to ensure that established policies and procedures are adhered. Internal controls are ineffective for safeguarding CUC's inventories to prevent and detect discrepancies and potential waste, fraud and abuse.

**Effect:**

There is a potential for material misstatement of inventory balances and thus resulting in an opinion qualification on the account balance and related expenses. There is also the potential for theft and misappropriation of assets due to a lack of internal control and inventory variances may simply be written without adequate investigation and resolution.

**Recommendation:**

The adjustment should only be made by a responsible person after a thorough investigation and a reasonable explanation for the discrepancies have been obtained. Thus, before making the adjustment, someone with no access to the inventory should investigate the discrepancies between the inventory valuation report (subsidiary ledger) and physical count and attempt to determine whether such variances are due to clerical or counting errors, improper purchase and issuance cutoff during the physical count, theft, intentional misstatement of the records or count, etc. Steps should then be taken to address the causes so that they do not recur.



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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Inventory Reconciliation, Continued**

Finding No. 2007-11, Continued

**Recommendation, Continued:**

To ensure that the purchase and issuance cutoffs are proper, someone should control purchase and sales invoices issued/received shortly before and after the physical count. This person should determine that the subsidiary ledger as of the physical inventory date include purchase invoices for all goods received before, but not after, the physical count and should exclude issuances for all goods used/transferred before, but not after, the count.

Monthly inventory reconciliations should be prepared in a timely manner to identify reconciling items between the general ledger and subsidiary ledgers in order to test the accuracy of both systems and, therefore, provide more accurate financial information.

CUC should also consider performing periodic cycle counts of the fast moving inventory items and compare the results with the perpetual records. This will enable CUC to identify inventory shortages and errors on a timely basis.

**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 2006.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Inventory Valuation**

Finding No. 2007-12

**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, 2007 and, accordingly, related issuances have negative values. Consequently, operating expenses may be understated. Furthermore, costs of inventory adjustments were not based on the most recent average unit costs.

**Cause:**

CUC has not implemented a plan of corrective action for the above condition as this control deficiency has existed since fiscal year 2002.

The cause of the above condition is attributable to the following:

- Untimely posting of inventory purchases, receipts and issuances;
- Lack of coordination between accounts payable and warehouse 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 resulting in an opinion qualification on the account balance and related expenses.

**Recommendation:**

CUC should establish policies and procedures to ensure timely posting of inventory purchases, receipts and issuances; establish a formal review process and monitoring procedures for inventory adjustments; ensure coordination between responsible personnel; and ensure that these policies and procedures are strictly adhered. Even with CUC's planned implementation of a bar-coding, coordination between Warehouse and Accounts Payable accountant would still be necessary. Although the bar-coding system may facilitate the warehouse receiving and issuance functions, if the accounts payable section does not timely record the purchases, issuances will still result in credit balances in the inventory valuation report.

**Prior Year Status:**

Similar findings were cited in the audit of CUC for fiscal years 2002 through 2006.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Inventory Obsolescence**

Finding No. 2007-13

**Criteria:**

Inventories should be reviewed regularly for possible obsolescence and generally accepted accounting principles in the United States of America requires inventory to be recorded at lower of cost or net realizable values.

**Condition:**

Inventory review to determine or identify old, obsolete or overstock was not performed until after fiscal year end.

**Cause:**

The cause of the above condition is the lack of established policies and procedures for reviewing and monitoring of obsolete and non-moving inventories. CUC has not implemented a plan of corrective action for the above condition as this control deficiency has existed since fiscal year 2002.

**Effect:**

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

**Recommendation:**

A periodic inventory turnover analysis or formal obsolescence evaluation throughout the year should be performed to identify slow moving and obsolete items. The timely disposal of these items will eliminate the additional carrying costs associated with inventory.

Carrying costs of slow-moving and obsolete items should be compared with their net realizable value. Should the carrying value exceed net realizable values, CUC should adjust the valuation to reflect the lower of cost or net realizable value.

**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 2006.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Review Inventory Requirements**

Finding No. 2007-14

**Criteria:**

Inventory should be kept at a reasonable level to support operations.

**Condition:**

An analysis of materials and supplies inventory (excluding fuels and lubes) is as follows:

Average inventory	<u>\$ 7,795,315</u>
Issuances:	
Repairs and maintenance	\$ 3,488,146
Supplies	<u>581,603</u>
	<u>\$ 4,069,749</u>
Average inventory turnover	<u>2 years</u>

Based on the above analysis, CUC has inventory value equivalent to 2 years consumption. However, this does not indicate that materials may be readily available. Individual inventory levels are not regularly reviewed and the majority of the inventory on-hand is slow-moving.

**Cause:**

There is a lack of monitoring of inventory levels.

**Effect:**

The effect of the above condition is that CUC sometimes faces unanticipated and undesirable stock-out situations, while levels of other inventory items are too high. Furthermore, the limited financial resources of CUC are tied in to this non-moving inventory instead of being available to finance current operations.

**Recommendation:**

CUC should evaluate its inventory levels, consider disposing of certain obsolete and slow-moving items.

**Prior Year Status:**

Similar condition was cited as Findings 2006-10 in prior year audit.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Utility Plant**

Finding No. 2007-15

**Criteria:**

Adequate presentation and control of fixed assets is essential in preparing accurate financial statements. Unless all fixed assets are recorded, depreciation used in determining utility rates could be misstated.

**Condition:**

CUC has not conducted physical count of capital assets in over 5 years and has no basis to determine if the carrying value of its capital assets is accurate. In accordance with generally accepted accounting principles in the United States of America, long-lived assets should be evaluated for impairment. Since a physical count has not been conducted, the asset listing may still include assets that have been retired, broken, destroyed or stolen.

**Cause:**

There is a lack of management oversight on the significance accounting for and conducting physical count of capital assets and monitoring controls to ensure that asset listing is updated not only for additions but also for deletions. CUC has not implemented a plan of corrective action for the above condition as this control deficiency has existed since fiscal year 1988.

**Effect:**

The effect of the above condition is a possible misstatement of capital assets. Additionally, a control deficiency exists over the safeguarding of capital assets. Capital assets may be misappropriated and not be detected in a timely manner.

**Recommendation:**

CUC should perform a physical inventory of all fixed assets on-hand, agree the count with its records and make necessary adjustments. CUC should also consider evaluating capital assets for impairments and recoverability of carrying values. An asset should be tested for recoverability if events or changes in circumstances, such as the following among others, indicate that its carrying amount may not be fully recoverable:

- a. Significant adverse change in the asset's use or in its physical condition;
- b. Significant adverse changes in legal factors or business climate, including an adverse action or assessment by a regulator; and
- c. Costs to acquire or construct an asset that significantly exceed original expectations.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Utility Plant, Continued**

**Finding No. 2007-15, Continued**

**Recommendation, Continued**

When long-lived assets are tested for recoverability, a review of depreciation or amortization estimates may be required. Any revision to the remaining useful life should then be considered in developing estimates of future cash flows used to test the asset's recoverability.

**Prior Year Status:**

The lack of control over capital assets was reported as a finding in the audits of CUC for fiscal years 1988 through 2006.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Insurance Coverage**

Finding No. 2007-16

**Criteria:**

Insurance coverage should be maintained to protect an organization and mitigate risks from potential perils and material loss.

**Condition:**

CUC is uninsured for its capital assets and has not had any coverage since 1988.

**Cause:**

The CNMI Government is a self-insured entity. The government has limited its general liability to individuals to \$100,000 by statute. For this reason, the CNMI Government does not maintain any insurance on its buildings or its employees. CUC management tried to solicit quotation to insure its assets; however, no domestic liability insurance company is willing to insure CUC. CUC has not implemented a plan of corrective action for the above condition as this control deficiency has existed since fiscal year 1989.

**Effect:**

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

**Recommendation:**

CUC should evaluate and quantify the risk of loss associated with its capital assets and implement a policy with respect to required insurance coverage levels. Should CUC remain self-insured, it should establish a self-insurance fund at levels sufficient to cover potential losses.

**Prior Year Status:**

The lack of insurance coverage was reported as a finding in the audits of CUC for fiscal years 1989 through 2006.

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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Debt**

Finding No. 2007-17

**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 its security agreement.

**Condition:**

As of September 30, 2007, CUC did not have an escrow fund account pursuant to the loan agreement.

**Cause:**

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

**Effect:**

CUC is not in compliance with Section 7.2 of its loan agreement with a contractor.

**Recommendation:**

CUC should re-establish the escrow account to ensure compliance with debt requirements.

**Prior Year Status:**

The lack of escrow fund account was noted as finding for fiscal years 2005 through 2006.



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**SECTION II – FINANCIAL STATEMENT FINDINGS, CONTINUED**

**Accruals**

Finding No. 2007-18

**Criteria:**

CUC maintains an enterprise fund to account for its operations. An enterprise fund is a proprietary fund, which is accounted for on the flow of economic resources measurements, and focuses on, and uses the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

**Condition:**

As of September 30, 2007, CUC failed to accrue certain revenues and expenses as follows:

- a. Liabilities of \$390,288 for fiscal year ending September 30, 2007 were not posted to accounts payable. Of that amount, \$344,604 pertains to fuel purchases.
- b. Accrued electric fuel charges are computed monthly for the purpose of computing the electric fuel charge rate. These monthly accruals are subsequently reversed the following month. Year-end accrual should include all unbilled consumption. Forty (40) customer accounts were recalculated noting that the September 30, 2007 accrual only pertained to unbilled September consumption, as the unbilled prior month consumption was not included in the accrual. Based on a recalculation of the total unbilled electric fuel charges, the accrued revenue was understated by \$1,251,165.

**Cause:**

There is lack of analysis performed on significant general ledger balances to note significant fluctuation, among others, which may be indicative of unrecorded transactions, errors or fraud.

**Effect:**

The financial statements prepared by CUC were misstated at September 30, 2007 and required significant year-end audit adjustments. Interim financial statements prepared by the Accounting Department and which management relies on for monitor cash flow and decision-making are misstated.

**Recommendation:**

Account analysis should be included as part of CUC year-end closing procedures.

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**SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS**

Reporting – Construction Grants for Wastewater Treatment Works

Finding No. 2007-19

<u>CFDA No.</u>	<u>Findings/Noncompliance</u>	<u>Questioned Costs</u>
66.418	<p><u>Criteria:</u> Pursuant to the U.S. Environmental Protection Agency Administrative Conditions, CUC shall complete and submit an EPA Form 5700-52A, "MBE/WBE Utilization Under Federal Grants, Cooperative Agreements and Interagency Agreements" to the EPA Project officer by October 30 of each year.</p> <p><u>Condition:</u> CUC was late in filing the report. The EPA Forms 5700-52A for fiscal years 2004 to 2007 were filed February 19, 2008.</p> <p><u>Effect:</u> CUC is in non-compliance with Federal reporting requirements.</p> <p><u>Cause:</u> There is a lack of federal grants monitoring of compliance with applicable federal award requirements.</p> <p><u>Recommendation:</u> CUC should establish and implement internal controls and monitoring procedures to ensure that federal award reporting requirements are strictly adhered.</p>	\$ -

**COMMONWEALTH UTILITIES CORPORATION**  
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**SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS, CONTINUED**

Reporting – Construction Grants for Wastewater Treatment Works, Continued

Finding No. 2007-20

<u>CFDA No.</u>	<u>Findings/Noncompliance</u>	<u>Questioned Costs</u>
66.418	<p><u>Criteria:</u> Pursuant to the U.S. Environmental Protection Agency Administrative Conditions, CUC shall provide timely reporting of cash disbursements and balances through semi-annual submission of a Federal Cash Transactions Report (SF 272/SF272A). The reports must be submitted to the Las Vegas Finance Center within 15 working days following the end of the semi-annual periods ending June 30<sup>th</sup> and December 31<sup>st</sup> of each year.</p> <p><u>Condition:</u> CUC was late in reporting the semi-annual cash disbursements and balances to the federal grantor agency. The SF 272/SF272A report for the period July 1, 2005 to December 31, 2007 was filed only on January 19, 2008.</p> <p><u>Effect:</u> CUC is in non-compliance with federal award reporting requirements and certain expenditures reported on these forms may be un-allowed by the grantor due to non-compliance with grant requirements and regulations.</p> <p><u>Cause:</u> There is a lack of monitoring of compliance with grant requirements.</p> <p><u>Recommendation:</u> CUC should establish and implement internal controls and monitoring procedures to ensure that federal award reporting requirements are strictly adhered.</p>	\$ -

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**SECTION IV – PRIOR YEAR FINDINGS AND QUESTIONED COSTS**

**Unresolved Findings**

Except for those discussed in the Schedule of Findings and Questioned Costs section of this report (pages 55 through 80), the status of unresolved prior year findings follows:

**2006 Audit Findings**

**Finding No. 2006-2**

**Condition:**

In fiscal year ending September 30, 2006, CUC made a net adjustment of \$2,581,732 to record as prior year expenditures, several long outstanding open work orders and the difference between construction-in-progress subsidiary ledgers and general ledger balances.

**Status:**

Unresolved.

**Finding No. 2006-4**

**Condition:**

During my testing of payroll expenses, I noted that the Payroll Department inputs the approved pay rate into the system.

**Status:**

Unresolved.

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Year Ended September 30, 2007

**SECTION IV – PRIOR YEAR FINDINGS AND QUESTIONED COSTS, CONTINUED**

Unresolved Findings, Continued

**2006 Audit Findings, Continued**

**Finding No. 2006-13**

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 determined that this agreement is, in fact, a capital lease and 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, constitutes the fair value of the leased property.

Status:

Resolved.

**Finding No. 2006-14**

Condition:

I noted that there were 7 employees with advanced annual leave over 40 hours amounting to \$4,157.19 as of September 30, 2006.

Status:

Unresolved.

Questioned Costs

The prior year Single Audit report on compliance with the laws and regulations noted the following costs and comments that were unresolved at September 30, 2006:

Questioned cost as previously reported	\$1,245,922
Questioned costs of fiscal year 2007 Single Audit	<u>          -</u>
Unresolved questioned costs at September 30, 2007	<u>\$1,245,922</u>

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**SECTION V – SCHEDULE OF FINDINGS AND AUDITEE RESPONSES**

CUC will provide a separate letter in response to my findings as discussed in the Schedule of Findings and Questioned Costs section of this report (pages 55 through 80).