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April 6, 2009

CONFIDENTIAL

The Board of Directors
Yap State Public Service Corporation:

Dear Board Members:

In planning and performing our audit of the financial statements of the Yap State Public Service Corporation (YSPSC) as of and for the year ended September 30, 2008 (on which we have issued our report dated April 6, 2009), 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, we considered YSPSC's 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 YSPSC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of YSPSC's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to YSPSC's internal control over financial reporting and other matters as of September 30, 2008 that we wish to bring to your attention.

We have also issued a separate report to the management, also dated April 6, 2009, on our consideration of YSPSC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.

The definition of a deficiency is also set forth in the attached Appendix I.

A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with this report.

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

We will be pleased to discuss the attached comments with you and, if desired, to assist you in implementing any of the suggestions.

We wish to thank the staff and management of YSPSC for their cooperation and assistance during the course of this engagement.

Very truly yours,

Deloitte & Touche LLP

**APPENDIX I**

## SECTION I – CONTROL DEFICIENCIES

We identified, and have included below, control deficiencies involving YSPSC's internal control over financial reporting as of September 30, 2008 that we wish to bring to your attention:

1. Grant Revenue Recorded Based on Cash Received

   Observation: YSPSC continues to recognize revenue based on grants received, not on grant expenditures. This is a recurring audit comment.

   Recommendation: YSPSC should record income when there's qualifying expenditures in the amount of the grant revenues. If qualifying expenditures have not been incurred, the cash receipts should be recorded as deferred revenue liability.

2. Unsupported Project Charges

   Observation: One construction in progress project included materials charges which actually consisted of additional equipment usage and labor charges that were not supported by actual time charges incurred. The amount charged as materials is based on the job quotation initially submitted to the contractor.

   Recommendation: All project charges should be supported by invoices and other relevant documents (i.e., actual time charges for labor and equipment).

3. Physical Segregation of Slow Moving Inventory Items

   Observation: We noted slow-moving inventory items included in the inventory listing which have available units at September 30, 2008 but have no corresponding unit costs. We were informed that these items were included in the inventory listing for monitoring purposes only.

   Recommendation: We recommend that slow-moving inventory items be physically segregated from usable inventory and records of such items be maintained in a separate file.

4. Inventory Costs

   Observation: Six (6) of 29 inventory items tested showed unit costs per inventory listing which differ from invoice unit costs.

   Recommendation: We recommend that unit costs entered to the inventory system match unit costs reflected in the respective invoices.

5. Fixed Assets Purchases

   Observation: Purchases for one project were made based on quotes obtained from two suppliers. Prudent procurement practices entail requests from at least three suppliers.

   Recommendation: We recommend that YSPSC follow approved bidding processes.

## SECTION I – CONTROL DEFICIENCIES, CONTINUED

6. Prepayments

   Observation: We found one prepayment for materials purchased and received during the year that was not reclassified to the work-in-process account as the receiving report was not provided by the warehouse to the accounting department.

   Recommendation: We recommend that all receiving reports be timely provided to the accounting.

7. Cut-off Procedures

   Observation: We discovered seven (7) expenses which were improperly accrued or not accrued during the year due to cut-off errors.

   Recommendation: We recommend that YSPSC practice cut-off procedures such that (a) expenses incurred during the year but paid subsequent to year-end, and (b) expenses for services and goods paid but not yet received are recorded in the correct period.

8. Computer User Access of Terminated Employees

   Observation: YSPSC policy requires that computer system access of terminated employees be deleted. During our walk-through of the system, access provided to us was the access and username code of an employee no longer working for YSPSC.

   Recommendation: We recommend that only active employees be given access to the computer system and timely monitoring of active and inactive employees should be performed.

## SECTION II – OTHER MATTERS

Our observations concerning other matters related to operations and best practices involving internal control over financial reporting that we wish to bring to your attention are as follows:

1. Production Losses

   Observation: Station and line losses increased from 1,595 MWH (12%) in 2007 to 1,899 MWH (14%) in 2008. Losses may be caused by equipment problems, inefficiencies at generation plants or through transmission and distribution, or by theft of service. This may have resulted in loss of revenue and/or increase in generation costs.

   Recommendation: We recommend that YSPSC continue to investigate the cause(s) of the increase in losses and take steps to reduce losses to a more acceptable level.

## SECTION III – DEFINITION

The definition of a control deficiency that is established in AU 325, *Communicating Internal Control Related Matters Identified in an Audit*, is as follows:

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 deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met. A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

## MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, INTERNAL CONTROL OVER FINANCIAL REPORTING

The following comments concerning management's responsibility for internal control over financial reporting and the objectives and inherent limitations of internal control over financial reporting are adapted from auditing standards generally accepted in the United States of America.

### Management's Responsibility

YSPSC's management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

### Objectives of Internal Control over Financial Reporting

Internal control over financial reporting is a process affected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

### Inherent Limitations of Internal Control over Financial Reporting

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.