

COMMONWEALTH UTILITIES CORPORATION

REPORT ON THE AUDIT OF FINANCIAL
STATEMENTS IN ACCORDANCE
WITH OMB CIRCULAR A-133

YEAR ENDED SEPTEMBER 30, 2003

COMMONWEALTH UTILITIES CORPORATION

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2003 AND 2002

INDEPENDENT AUDITORS' REPORT

Board of Directors
Commonwealth Utilities Corporation:

We have audited the accompanying statements of net assets of the Commonwealth Utilities Corporation (CUC), a component unit of the Commonwealth of the Northern Mariana Islands (CNMI), as of September 30, 2003 and 2002, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of CUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

Because of inadequacies in the accounting records and internal control, we were unable to determine that inventory, due from grantor agencies, utility plant and obligations under capital lease were fairly stated as of September 30, 2003 and 2002. Furthermore, in our judgment, these balances materially affect the determination of results of operations and cash flows for the years ended September 30, 2003 and 2002. In addition, CUC management was unable to provide minutes of Board of Directors meetings subsequent to December 14, 2004. Accordingly, there was an incomplete record of management and Board of Directors' actions and decisions.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had the propriety of inventory, due from grantor agencies, utility plant and obligations under capital lease as of September 30, 2003 and 2002 been determined, and their effect on the changes in net assets and cash flows, been determinable, and had we received minutes of the Board of Directors meetings subsequent to December 14, 2004 as discussed in the third paragraph, such financial statements present fairly, in all material respects, the financial position of CUC as of September 30, 2003 and 2002, and their changes in net assets and their 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 on pages 3 through 5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Commonwealth Utilities Corporation's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Our audits were conducted for the purpose of forming an opinion on the Commonwealth Utilities Corporation's basic financial statements. The Statement of Revenues and Expenses on a Divisional Basis for the year ended September 30, 2003 (page 19) is presented for purposes of additional analysis and is not a required part of the basic financial statements. This supplementary information is the responsibility of the Commonwealth Utilities Corporation's management. The Statement of Revenues and Expenses on a Divisional Basis for the year ended September 30, 2003 has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, except as discussed in the third paragraph above, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 21, 2005, on our consideration of internal control over financial reporting and our 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 our 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 our audit.

Deloitte & Touche

March 21, 2005



Commonwealth Utilities Corporation



MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Commonwealth Utilities Corporation's (CUC) annual financial report presents the analysis of CUC's financial performance during the fiscal year ended September 30, 2003 compared to fiscal year ended September 30, 2002. Please read it in conjunction with the financial statements, which follow this section.

| | <u>2003</u> | <u>2002</u> |
|---|-----------------------|-----------------------|
| Assets | | |
| Net utility plant | \$ 104,424,658 | \$ 109,103,175 |
| Current assets | 37,883,170 | 39,570,265 |
| Restricted assets | <u>8,621,642</u> | <u>7,902,199</u> |
| | <u>\$ 150,929,470</u> | <u>\$ 156,575,639</u> |
| Net Assets and Liabilities | | |
| Net assets | \$ (12,932,748) | \$ (4,294,157) |
| Long-term debt | 6,741,090 | 7,672,884 |
| Current liabilities | <u>157,121,128</u> | <u>153,196,912</u> |
| | <u>\$ 150,929,470</u> | <u>\$ 156,575,639</u> |
| Revenues, Expenses and Changes in Net Assets | | |
| Operating revenues | \$ 71,353,881 | \$ 70,153,781 |
| Operating expenses | <u>73,124,726</u> | <u>72,312,473</u> |
| Loss from operations | <u>(1,770,845)</u> | <u>(2,158,692)</u> |
| Capital contributions | 3,230,248 | 4,697,950 |
| Interest income | 311,181 | 399,110 |
| Interest expense | (9,760,707) | (9,381,066) |
| Contribution to primary government | <u>(648,468)</u> | <u>(637,061)</u> |
| Total nonoperating revenues (expenses), net | <u>(6,867,746)</u> | <u>(4,921,067)</u> |
| Change in net assets | <u>\$ (8,638,591)</u> | <u>\$ (7,079,759)</u> |

REQUIRED FINANCIAL STATEMENTS

CUC's accounting policies conform to accounting principles generally accepted in the United States of America, as applicable to government entities, specifically proprietary funds. CUC's activities are financed and operated in a manner similar to a business enterprise.

The Statement of Net Assets includes all of CUC's assets and liabilities associated with the operation of proprietary funds. It provides information about the nature and amount of investments in resources and the obligations to the creditors. Theoretically, net assets represent the resources an entity has left to use after its debts are settled. Those resources, however, may not always be available for spending; restrictions may be attached to them. To clarify these issues, net assets is divided into three categories: capital assets, net of related debt, which cannot be sold or converted to cash; restricted assets, which must be retained in perpetuity; and unrestricted net assets, which may be used in any purpose, but are not in a form that can be spent.

The Statement of Revenues, Expenses and Changes in Net Assets account for the all the revenues and expenses and gains and losses arising from the ongoing operations of CUC. This statement measures the success of CUC in using the resources committed to its operations. The components in this report are very important and can be used to predict future income and cash flows.

The Statement of Cash Flows provides information about the CUC's cash flows for the period classified according to four main categories: operating activities, noncapital financing activities, capital and related financing activities and investing activities. The statement reports the net cash provided by or used by each category and explains the net increase or decrease in cash and cash equivalents.

FINANCIAL ANALYSIS OF CUC AS A WHOLE

For the year ended September 30, 2003, CUC had a loss from operations of about \$1.7 million as compared to the September 30, 2002 loss from operations of over \$2 million.

During the year ended September 30, 2003, CUC's operating revenues increased overall by over \$1.2 million (2 percent). Revenues increased for power by about \$466,000 (0.7 percent), for water, over \$174,000 (2 percent), and for sewer, about \$35,000 (2 percent). The increases in power, water and sewer revenues are due primarily to the addition of new residential and commercial customers.

During the year ended September 30, 2003, expenses increased for production fuel by about \$5.7 million (21 percent), over \$398,000 for general and administrative expenses (2 percent), for bad debts about \$1 million (58 percent), and for other production about \$30,000 (0.6 percent) while expenses for maintenance decreased for over \$6.3 million (64 percent) and for supplies over \$65,000 (11 percent) when compared to expenses for the year ended September 30, 2002.

The single largest increase in expenditures was for production fuel. This increase was brought on by the war between the U.S. and Iraq. World fuel supplies dwindled driving up the price of fuel. The average cost of fuel for the year ended September 30, 2003 was \$0.8647 per gallon as compared to \$0.701 per gallon for the year ended September 30, 2002. Another significant increase was for general and administrative expenses due to Typhoon Pongsona. CUC incurred a substantial amount of overtime for labor (CNMI-wide) and per diem, travel and freight to send personnel, equipment and materials to Rota following this natural disaster.

The most significant decrease in expenditures was for maintenance. This was due to the completion of major overhauls for power generators during fiscal years 1999 through 2002. Accordingly, during fiscal year 2003, only normal and minor maintenance was required to keep the generators in good working order and operational.

Capital contributions received from direct grants from federal government and pass-thru grants received from the CNMI government amounted to about \$3.2 million for fiscal year 2003 as compared to about \$4.6 million for fiscal year 2002. These grants are used for capital improvement projects such as upgrading of power distribution lines, design and construction of waterlines and sewage system.

ECONOMIC FACTORS AND NEXT YEAR'S PLAN OF ACTION

In order to recover rising cost of fuel, CUC plans to implement a fuel surcharge fee in fiscal year 2005. Also, CUC management is also planning to do a comprehensive rate study to adjust the rates for power, water and sewer for all three islands of Saipan, Tinian and Rota. Next fiscal year, CUC will continue its cost-cutting measures and streamlining of its operations. CUC has engaged the services of a consulting firm to look at the plans to privatize CUC's power plants.

CUC expects to finalize the Memorandum of Agreement with the Commonwealth Development Authority (CDA) to resolve the issue on CUC's long-outstanding debt with CDA amounting to over \$61.5 million and accrued interest payable of about \$77 million as of September 30, 2003.

CUC management is looking at changing its regulations to aggressively approach its accounts receivable issues, especially with the CNMI Government.

CONTACTING CUC'S FINANCIAL MANAGEMENT

This financial report is designed to provide CUC's rate payers and creditors with a general overview of CUC's finances and to demonstrate CUC's accountability for the money it receives. If you have questions about this report, or need additional information, contact CUC's Comptroller at Commonwealth Utilities Corporation, P.O. Box 501220, Saipan MP 96950, at telephone number (670) 235-7025 or e-mail ssamari@cuc.gov.mp.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Assets September 30, 2003 and 2002

ASSETS

| | <u>2003</u> | <u>2002</u> |
|---|-----------------------|-----------------------|
| Utility plant: | | |
| Electric plant | \$ 114,917,960 | \$ 113,875,907 |
| Water plant | 57,091,249 | 57,003,580 |
| Sewer plant | 22,023,014 | 21,810,302 |
| Administrative equipment | 4,407,120 | 4,247,150 |
| Construction work in progress | <u>11,336,342</u> | <u>9,210,617</u> |
| | 209,775,685 | 206,147,556 |
| Less accumulated provision for depreciation | <u>(105,351,027)</u> | <u>(97,044,381)</u> |
| Net utility plant | <u>104,424,658</u> | <u>109,103,175</u> |
| Current assets: | | |
| Cash and cash equivalents | <u>14,315,507</u> | <u>14,887,833</u> |
| Accounts receivable: | | |
| Utility | 29,080,709 | 26,658,256 |
| Other | <u>2,898,730</u> | <u>2,043,918</u> |
| | 31,979,439 | 28,702,174 |
| Less accumulated provision for uncollectible accounts | <u>(19,002,928)</u> | <u>(16,215,304)</u> |
| Net accounts receivable | <u>12,976,511</u> | <u>12,486,870</u> |
| Inventory, less allowance for obsolescence of \$1,015,128 and \$1,159,467 in 2003 and 2002, respectively | <u>9,535,762</u> | <u>10,973,209</u> |
| Due from grantor agencies | <u>1,055,390</u> | <u>1,222,353</u> |
| Total current assets | <u>37,883,170</u> | <u>39,570,265</u> |
| Restricted assets: | | |
| Cash and cash equivalents | 2,438,502 | 1,802,686 |
| Time certificates of deposit | <u>6,183,140</u> | <u>6,099,513</u> |
| Total restricted assets | <u>8,621,642</u> | <u>7,902,199</u> |
| | <u>\$ 150,929,470</u> | <u>\$ 156,575,639</u> |

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Net Assets, Continued September 30, 2003 and 2002

NET ASSETS AND LIABILITIES

| | <u>2003</u> | <u>2002</u> |
|--|-----------------------|-----------------------|
| Net assets: | | |
| Investment in capital assets, net of related debt | \$ 35,183,024 | \$ 38,707,165 |
| Restricted | 8,621,642 | 7,902,199 |
| Unrestricted | <u>(56,737,414)</u> | <u>(50,903,521)</u> |
| Total net assets | <u>(12,932,748)</u> | <u>(4,294,157)</u> |
| Long-term debt: | | |
| Obligations under capital lease, less current maturities | 6,538,027 | 7,426,149 |
| Loan payable less current maturities | 203,063 | 246,735 |
| Compensated absences, less current portion | <u>179,344</u> | <u>337,489</u> |
| | <u>6,920,434</u> | <u>8,010,373</u> |
| Commitments and contingencies | | |
| Current liabilities: | | |
| Current maturities of long-term debt | * 61,612,422 | 61,609,902 |
| Current obligations under capital lease | 888,122 | 1,113,224 |
| Accounts payable | 6,526,831 | 7,274,818 |
| Accrued liabilities | * 597,106 | 1,178,298 |
| Accrued payroll | 856,110 | 754,379 |
| Compensated absences, current portion | 771,242 | 702,682 |
| Customer deposits | 8,412,469 | 7,740,558 |
| Due to primary government | 588,468 | 3,997,847 |
| Interest payable | * <u>76,689,014</u> | <u>68,487,715</u> |
| Total current liabilities | <u>156,941,784</u> | <u>152,859,423</u> |
| | <u>\$ 150,929,470</u> | <u>\$ 156,575,639</u> |

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Revenues, Expenses and Changes in Net Assets Years Ended September 30, 2003 and 2002

| | <u>2003</u> | <u>2002</u> |
|---|------------------------|-----------------------|
| Operating revenues: | | |
| Power | \$ 59,615,273 | \$ 59,149,741 |
| Water | 8,071,618 | 7,897,698 |
| Sewer | 2,213,169 | 2,178,191 |
| Other | <u>1,453,821</u> | <u>928,151</u> |
| Total operating revenues | <u>71,353,881</u> | <u>70,153,781</u> |
| Operating expenses: | | |
| Production fuel | 33,333,642 | 27,553,429 |
| General and administrative | 19,305,216 | 18,907,336 |
| Depreciation | 8,583,344 | 9,271,636 |
| Other production | 4,471,719 | 4,442,408 |
| Maintenance | 3,477,406 | 9,745,199 |
| Bad debts | 2,784,360 | 1,764,084 |
| Supplies | 521,115 | 586,206 |
| Other | <u>647,924</u> | <u>42,175</u> |
| Total operating expenses | <u>73,124,726</u> | <u>72,312,473</u> |
| Loss from operations | <u>(1,770,845)</u> | <u>(2,158,692)</u> |
| Nonoperating revenues (expenses): | | |
| Interest income | 311,181 | 399,110 |
| Interest expense | (9,760,707) | (9,381,066) |
| Contribution to the primary government | <u>(648,468)</u> | <u>(637,061)</u> |
| Total nonoperating revenues (expenses), net | <u>(10,097,994)</u> | <u>(9,619,017)</u> |
| Net loss before capital contributions | <u>(11,868,839)</u> | <u>(11,777,709)</u> |
| Capital contributions | <u>3,230,248</u> | <u>4,697,950</u> |
| Change in net assets | <u>(8,638,591)</u> | <u>(7,079,759)</u> |
| Net assets - beginning | <u>(4,294,157)</u> | <u>2,785,602</u> |
| Net assets - ending | <u>\$ (12,932,748)</u> | <u>\$ (4,294,157)</u> |

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Statements of Cash Flows Years Ended September 30, 2003 and 2002

| | 2003 | 2002 |
|---|----------------------|----------------------|
| Cash flows from operating activities: | | |
| Cash received from customers | \$ 68,751,792 | \$ 67,435,481 |
| Cash payments to suppliers for goods and services | (46,963,714) | (50,172,421) |
| Cash payments to employees for services | (15,183,795) | (13,734,382) |
| Net cash provided by operating activities | <u>6,604,283</u> | <u>3,528,678</u> |
| Cash flows from noncapital financing activities: | | |
| Payments to primary government | (4,057,847) | (60,000) |
| Net cash used for noncapital financing activities | <u>(4,057,847)</u> | <u>(60,000)</u> |
| Cash flows from capital and related financing activities: | | |
| Acquisition and construction of capital assets | (3,904,827) | (5,130,408) |
| Capital contributions | 3,230,248 | 4,697,950 |
| Principal repayment of debt | (1,154,376) | (722,959) |
| Interest paid on outstanding debt | (1,559,408) | (1,435,826) |
| Net receipts (disbursements) for capital grants | 677,863 | (247,299) |
| Increase in restricted assets | (719,443) | (713,827) |
| Net cash used for capital and related financing activities | <u>(3,429,943)</u> | <u>(3,552,369)</u> |
| Cash flows from investing activities: | | |
| Interest received on time certificates of deposit | 311,181 | 399,110 |
| Net cash provided by investing activities | <u>311,181</u> | <u>399,110</u> |
| Net (decrease) increase in cash and cash equivalents | (572,326) | 315,419 |
| Cash and cash equivalents at beginning of year | <u>14,887,833</u> | <u>14,572,414</u> |
| Cash and cash equivalents at end of year | \$ <u>14,315,507</u> | \$ <u>14,887,833</u> |
| Reconciliation of loss from operations to net cash provided by operating activities: | | |
| Loss from operations | \$ (1,770,845) | \$ (2,158,692) |
| Adjustments to reconcile loss from operations to net cash provided by operating activities: | | |
| Depreciation | 8,583,344 | 9,271,636 |
| Provision for bad debts | 2,784,360 | 1,764,084 |
| Provision for inventory obsolescence | (144,339) | - |
| (Increase) decrease in assets: | | |
| Accounts receivable: | | |
| Utility | (2,419,189) | (2,926,600) |
| Other | (854,812) | 121,871 |
| Inventory | 1,581,786 | (989,347) |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (747,987) | (2,340,934) |
| Accrued liabilities | (1,181,677) | 150,693 |
| Accrued payroll | 101,731 | 549,539 |
| Customer deposits | <u>671,911</u> | <u>86,428</u> |
| Net cash provided by operating activities | \$ <u>6,604,283</u> | \$ <u>3,528,678</u> |
| Supplemental disclosure of noncash capital and related financing and operating activities: | | |
| Accrual of progress billings related to various ongoing capital projects: | | |
| Noncash increase in due from grantor agencies | \$ 510,900 | \$ 1,085,219 |
| Noncash increase in accrued liabilities | <u>(510,900)</u> | <u>(1,085,219)</u> |
| | \$ - | \$ - |

See accompanying notes to financial statements.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2003 and 2002

(1) Organization and Summary of Significant Accounting Policies

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. CUC is governed by a nine-member Board of Directors, appointed for terms of four years by the Governor of the CNMI.

Public Law 4-47 effected transfer to CUC of identifiable assets, liabilities, operations, and unexpended capital improvement funding allocations formerly administered directly by the CNMI Department of Public Works.

The accounting policies of CUC conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. CUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

New Accounting Standards

For fiscal year 2005 CUC will be implementing GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)* and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. As of September 30, 2003, CUC has not evaluated the financial statement impact of GASB Statement Nos. 40 and 42.

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 disclosures 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.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2003 and 2002

(1) Organization and Summary of Significant Accounting Policies, Continued

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included on the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets.

The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. Revenues 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 most recent cycle billing.

Budgets

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

Cash and Cash Equivalents and Time Certificates of Deposit

For purposes of the statements of net assets and cash flows, cash and cash equivalents and restricted 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 statement of net assets. At September 30, 2003 and 2002, cash and cash equivalents were \$16,754,009 and \$16,690,519, respectively, and the corresponding bank balances were \$16,737,818 and \$16,803,863, respectively. Of the bank balance amounts, \$16,737,818 and \$16,803,863 are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance as of September 30, 2003 and 2002, respectively. Bank deposits in the amount of \$154,189 and \$200,000 were FDIC insured as of September 30, 2003 and 2002, respectively. CNMI law does not require component units to collateralize their bank accounts and thus, CUC's deposits in excess of FDIC insurance are uncollateralized.

Time certificates of deposit of \$6,183,140 and \$6,099,513 and cash and cash equivalents of \$2,409,088 and \$1,742,536 as of September 30, 2003 and 2002, respectively, represent customer deposits, which must be segregated pursuant to CUC policy, and accordingly, are classified as restricted in the accompanying financial statements. Cash and cash equivalents of \$29,414 and \$60,150 as of September 30, 2003 and 2002, respectively, represent advances from a grantor agency for the use on a specific project and, accordingly, are classified as restricted in the accompanying financial statements.

Receivables and Allowance for Doubtful Accounts

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 collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2003 and 2002

(1) Organization and Summary of Significant Accounting Policies, Continued

Inventory

Inventories of fuel are valued at the lower of cost (first-in, first-out) or market (net realizable value). Inventories of supplies and materials are valued at average cost.

Utility Plant and Depreciation

Utility plant are stated at cost, where available. Cost of certain utility plant transferred from the CNMI Department of Public Works, is based on contract amounts to construct certain utility plant. Depreciation is calculated on the straight-line method based on the estimated useful lives of the respective assets. Current policy is to capitalize items in excess of \$300.

Capitalization of Interest

CUC capitalizes interest in order to recognize all costs associated with non-contributed construction projects based on CUC's weighted average borrowing rate. During the years ended September 30, 2003 and 2002, eligible interest expense was not considered significant and consequently no interest has been capitalized.

Retirement Plan

CUC contributes to the Northern Mariana Islands Retirement Fund (the Fund), a cost-sharing multiple employer defined benefit pension plan administered by the CNMI. The Fund provides retirement, security and other benefits to employees, and their spouses and dependents, of the CNMI Government and CNMI agencies, instrumentalities, and public corporations. CNMI Public Law 6-17, the Northern Mariana Retirement Fund Act of 1988 assigns the authority to establish and amend benefit provisions to the Fund's Board of Trustees. The Fund issues a publicly available financial report that includes financial statements and required supplementary information for the Fund. That report may be obtained by writing to the Northern Mariana Islands Retirement Fund, P.O. Box 501247, Saipan, MP, 96950-1247.

Plan members are required to contribute 6.5% and 9.0% of their annual covered salary for Class I and Class II members, respectively, and CUC is required to contribute at an actuarially determined rate. The current rate is 26.4% of annual covered payroll. The contribution requirements of plan members and CUC are established and may be amended by the Fund's Board of Trustees. CUC's contributions to the Fund for the years ended September 30, 2003, 2002 and 2001 were \$2,648,761, \$2,620,144, and \$2,731,623, respectively, equal to the required contributions for each year.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefits accrue to employees. The liability at September 30, 2003 and 2002 amounted to \$950,586 and \$1,040,171, respectively. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits. The sick pay benefit liability as of September 30, 2003 and 2002, was approximately \$2,300,943 and \$2,287,928, respectively.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2003 and 2002

(2) Due From Grantor Agencies

CUC is a subrecipient of federal grants received by the CNMI 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.

Changes in the due from (deferred revenue) grantor agencies accounts for the years ended September 30, 2003 and 2002, are as follows:

| | 2003 | 2002 |
|--|---------------------|---------------------|
| Balance at beginning of year | \$ 1,222,353 | \$ (110,165) |
| Adjustment | 30,895 | 418,434 |
| Deductions - cash receipts from grantor agencies | (3,428,106) | (3,783,866) |
| Additions - program outlays | <u>3,230,248</u> | <u>4,697,950</u> |
| Balance at end of year | \$ <u>1,055,390</u> | \$ <u>1,222,353</u> |

(3) Utility Plant

Utility plant at September 30, 2003 and 2002, consists of the following:

| | Estimated Useful Lives | Balance at October 1, 2002 | Additions | Deletions | Adjustments/ Reclassifications | Balance at September 30, 2003 |
|--|---------------------------|----------------------------------|-----------------------|------------|-----------------------------------|-------------------------------------|
| Utility plant: | | | | | | |
| Electric plant | 20 years | \$ 113,875,907 | \$ 141,712 | \$ - | \$ 900,341 | \$ 114,917,960 |
| Water plant | 20 years | 57,003,580 | 84,948 | - | 2,721 | 57,091,249 |
| Sewer plant | 20 years | 21,810,302 | 167,681 | - | 45,031 | 22,023,014 |
| Administrative equipment | 3 - 5 years | <u>4,247,150</u> | <u>155,704</u> | - | <u>4,266</u> | <u>4,407,120</u> |
| | | 196,936,939 | 550,045 | - | 952,359 | 198,439,343 |
| Less accumulated provision for depreciation | | <u>(97,044,381)</u> | <u>(8,583,344)</u> | - | <u>276,698</u> | <u>(105,351,027)</u> |
| | | 99,892,558 | (8,033,299) | - | 1,229,057 | 93,088,316 |
| Construction work in progress | | <u>9,210,617</u> | <u>3,402,870</u> | - | <u>(1,277,145)</u> | <u>11,336,342</u> |
| | | \$ <u>109,103,175</u> | \$ <u>(4,630,429)</u> | \$ - | \$ <u>(48,088)</u> | \$ <u>104,424,658</u> |
| | Estimated Useful Lives | Balance at October 1, 2001 | Additions | Deletions | Adjustments/ Reclassifications | Balance at September 30, 2002 |
| Utility plant: | | | | | | |
| Electric plant | 20 years | \$ 107,377,339 | \$ 1,076,044 | \$ (373) | \$ 5,422,897 | \$ 113,875,907 |
| Water plant | 20 years | 55,414,456 | 4,308,952 | - | (2,719,828) | 57,003,580 |
| Sewer plant | 20 years | 20,132,601 | 1,688,018 | - | (10,317) | 21,810,302 |
| Administrative equipment | 3 - 5 years | <u>4,326,926</u> | <u>344,626</u> | - | <u>(424,402)</u> | <u>4,247,150</u> |
| | | 187,251,322 | 7,417,640 | (373) | 2,268,350 | 196,936,939 |
| Less accumulated provision for depreciation | | <u>(89,978,087)</u> | <u>(9,271,636)</u> | <u>373</u> | <u>2,204,969</u> | <u>(97,044,381)</u> |
| | | 97,273,235 | (1,853,996) | - | 4,473,319 | 99,892,558 |
| Construction work in progress | | <u>15,971,168</u> | - | - | <u>(6,760,551)</u> | <u>9,210,617</u> |
| | | \$ <u>113,244,403</u> | \$ <u>(1,853,996)</u> | \$ - | \$ <u>(2,287,232)</u> | \$ <u>109,103,175</u> |

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2003 and 2002

(4) Notes Payable

A schedule of CUC's long-term debt as of September 30, 2003 and 2002, is as follows:

| | <u>2003</u> | <u>2002</u> |
|---|----------------------|----------------------|
| Promissory note payable to the Commonwealth Development Authority (CDA), a component unit of the CNMI. Principal amount available to \$30,000,000, interest at 7% per annum, with a maturity date of February 17, 2013. Principal and interest payments are due in quarterly payments of \$658,469. | \$ 30,000,000 | \$ 30,000,000 |
| Promissory note payable to CDA. Principal amount available to \$16,135,650, interest at 5% per annum, with a maturity date of January 12, 2014. Principal and interest payments are due in quarterly payments of \$359,514. | 16,068,750 | 16,068,750 |
| Promissory note payable to CDA. Principal amount available to \$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 |
| Promissory note payable to CDA. Principal amount available to \$10,000,000 and 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. | <u>10,000,000</u> | <u>10,000,000</u> |
| | <u>\$ 61,568,750</u> | <u>\$ 61,568,750</u> |

At September 30, 2003 and 2002, and subsequent to that date, CUC was in default of repayment terms of all notes 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, 2003 and 2002, associated with the notes payable to CDA along with interest payable on these notes of \$76,689,014 and \$68,487,715 as at September 30, 2003 and 2002, respectively, has been classified as current liabilities within the accompanying financial statements.

On November 21, 2002, a Memorandum of Agreement (MOA) was established between CDA and CUC to waive a portion of the notes payable to CDA and the conversion into equity ownership of the balance. Public Law 13-35 effectuated terms of the MOA allowing CDA to waive \$16,068,750 and waive certain specified interest payments and for other purposes. Public Law 13-36 effectuated terms of the MOA by authorizing CUC to issue shares to CDA of cumulative nonconvertible non-transferable preferred stock valued at \$45,500,000. At September 30, 2003, terms of the MOA are being negotiated between CDA and CUC and thus debt has not been waived and preferred stock has not been issued.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2003 and 2002

(5) Loan Payable

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, 2003 and 2002, 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, 2003 and 2002:

| | <u>2003</u> | <u>2002</u> |
|--|-------------------|-------------------|
| 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. | \$ 246,735 | \$ 287,887 |
| Less current portion | <u>43,672</u> | <u>41,152</u> |
| Long-term loan payable | \$ <u>203,063</u> | \$ <u>246,735</u> |

Future repayment commitments of principal and interest are as follows:

| <u>Year ending September 30,</u> | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|--------------------------------------|-------------------|------------------|-------------------|
| 2004 | \$ 43,672 | \$ 15,113 | \$ 58,785 |
| 2005 | 46,347 | 12,438 | 58,785 |
| 2006 | 49,186 | 9,599 | 58,785 |
| 2007 | 52,199 | 6,586 | 58,785 |
| 2008 | <u>55,331</u> | <u>3,389</u> | <u>58,720</u> |
| | \$ <u>246,735</u> | \$ <u>47,125</u> | \$ <u>293,860</u> |

(6) Primary Government Funding

Public Law 9-66, enacted 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 Public Auditor and the agency may agree, to fund the Office of the Public Auditor (OPA). During the year ended September 30, 2003, CUC and the CNMI Government, with the concurrence of OPA, offset a portion of the liability related to CNMI OPA funding against utility receivables of the CNMI Government. The offset was performed through an exchange of checks for \$3,997,847. At September 30, 2003 and 2002, CUC had an outstanding payable to the primary government in the amount of \$588,468 and \$3,997,847, respectively.

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2003 and 2002

(7) 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 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 upon. 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.

CUC implemented accounting guidance of Emerging Issues Task Force (EITF) Issue No. 01-8, 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 effects of adopting EITF No. 01-8 were to increase plant and obligations under capital lease by \$9,959,000. CUC has not obtained the actual cost of the power plant and has not obtained an appraisal to determine the fair value of the leased property, which is required by accounting principles generally accepted in the United States of America. As a result, management has not been able to assess its compliance with the EITF requirements and the impact of this matter on the accompanying financial statements is uncertain. The lease has an effective interest rate of 18%.

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 | \$ 8,821,000 |
| End of year 5 | \$ 7,750,000 |
| End of year 6 | \$ 6,540,000 |
| End of year 7 | \$ 5,200,000 |
| End of year 8 | \$ 3,900,000 |

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements September 30, 2003 and 2002

(7) Capital Lease, Continued

The annual requirement to amortize all debt of CUC outstanding as of September 30, 2003 is as follows:

| <u>Year ending September 30,</u> | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|--------------------------------------|---------------------|---------------------|----------------------|
| 2004 | \$ 888,122 | \$ 1,271,878 | \$ 2,160,000 |
| 2005 | 1,062,758 | 1,097,242 | 2,160,000 |
| 2006 | 1,271,733 | 888,267 | 2,160,000 |
| 2007 | 1,521,801 | 638,199 | 2,160,000 |
| 2008 | 1,821,040 | 338,960 | 2,160,000 |
| 2009 | <u>860,695</u> | <u>39,309</u> | <u>900,004</u> |
| | <u>\$ 7,426,149</u> | <u>\$ 4,273,855</u> | <u>\$ 11,700,004</u> |

(8) 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, 2003 and 2002, 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.

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 agreement will expire on July 31, 2006 and renewable for an additional ten year period to expire on July 31, 2016. Future minimum commitments related to the purchase of electric power are as follows:

| <u>Year ending September 30,</u> | <u>Minimum Payment</u> |
|--------------------------------------|------------------------|
| 2004 | \$ 3,101,040 |
| 2005 | 3,101,040 |
| 2006 | <u>2,584,200</u> |
| | <u>\$ 8,786,280</u> |

COMMONWEALTH UTILITIES CORPORATION

Notes to Financial Statements
September 30, 2003 and 2002

(8) Commitments and Contingencies, Continued

Contingencies

CUC entered into certain memorandums of understanding (MOUs) with 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), developers could consider CUC to have breached 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.

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. No provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

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 \$251,166 have been set forth in CUC's Single Audit Report for the year ended September 30, 2003. 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.

(9) Subsequent Events

In January 2004, the Memorandum of Agreement (MOA), entered into on November 21, 2002 between CUC and CDA was amended to exclude a certain provision requiring CUC to obtain legislative approval for rate increases. As terms of the MOA are in the process of negotiations, no adjustments have been made to the accompanying financial statements.

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 will remain in effect until the end of calendar year 2005. For calendar year 2006, the formula included in the fuel surcharge regulation will be applied to establish a new ceiling and the fuel surcharge may be increased to that ceiling over the course of the year.

COMMONWEALTH UTILITIES CORPORATION

Statement of Revenues, Expenses and Changes in Net Assets on a Divisional Basis Year Ended September 30, 2003

| | Power | Water | Sewer | Administrative and General | Internal Revenues and Expenses (1) | Total |
|---|--------------|--------------|------------|----------------------------------|---|----------------|
| Operating revenues: | | | | | | |
| Governmental: | | | | | | |
| CNMI Government | \$ 5,923,800 | \$ 2,358,484 | \$ 962,336 | \$ - | \$ - | \$ 9,244,620 |
| CNMI agencies | 4,166,734 | 1,315,470 | 422,578 | - | (2,540,415) | 3,364,367 |
| Total governmental | 10,090,534 | 3,673,954 | 1,384,914 | - | (2,540,415) | 12,608,987 |
| Commercial | 34,332,067 | 1,414,302 | 701,672 | - | - | 36,448,041 |
| Residential | 17,342,623 | 2,982,466 | 126,501 | - | - | 20,451,590 |
| Grants and contributions | 390,464 | 896 | 82 | - | - | 391,442 |
| Other | - | - | - | 1,453,821 | - | 1,453,821 |
| Total operating revenues | 62,155,688 | 8,071,618 | 2,213,169 | 1,453,821 | (2,540,415) | 71,353,881 |
| Operating expenses: | | | | | | |
| Production fuel | 33,333,642 | - | - | - | - | 33,333,642 |
| General and administrative | 7,743,723 | 2,662,766 | 1,372,216 | 7,526,511 | - | 19,305,216 |
| Depreciation | 6,732,902 | 1,194,185 | 405,349 | 250,908 | - | 8,583,344 |
| Other production | 4,368,399 | 2,643,735 | - | - | (2,540,415) | 4,471,719 |
| Maintenance | 2,083,777 | 730,706 | 403,671 | 259,252 | - | 3,477,406 |
| Bad debts | - | - | - | 2,784,360 | - | 2,784,360 |
| Supplies | 161,857 | 171,753 | 36,094 | 151,411 | - | 521,115 |
| Other | - | - | - | 647,924 | - | 647,924 |
| Total operating expenses | 54,424,300 | 7,403,145 | 2,217,330 | 11,620,366 | (2,540,415) | 73,124,726 |
| Earnings (loss) from operations | 7,731,388 | 668,473 | (4,161) | (10,166,545) | - | (1,770,845) |
| Nonoperating revenues (expenses): | | | | | | |
| Interest income | - | - | - | 311,181 | - | 311,181 |
| Interest expense | (8,957,269) | (803,438) | - | - | - | (9,760,707) |
| Contribution to the primary government | - | - | - | (648,468) | - | (648,468) |
| Total nonoperating revenues (expenses), net | (8,957,269) | (803,438) | - | (337,287) | - | (10,097,994) |
| Net loss before capital contributions | (1,225,881) | (134,965) | (4,161) | (10,503,832) | - | (11,868,839) |
| Capital contributions | 3,230,248 | - | - | - | - | 3,230,248 |
| Change in net assets | \$ 2,004,367 | \$ (134,965) | \$ (4,161) | \$ (10,503,832) | \$ - | \$ (8,638,591) |

(1) The Water and Sewer Divisions recognize an expense for power supplied by the Power Division to operate their facilities. The Power division recognizes internal revenue for the corresponding amount.

See accompanying independent auditors' report.

statements; instead, they give their professional opinion that the presentation is fair.

When two or more alternative practices are permitted by GAAP and either is fair (which is, of course, an ambiguous criterion), management, not the auditors, decides which one is to be used. In the opinion letter, the auditors do not state that management has necessarily made the best choice among alternative principles but only that the choice made by management was an acceptable one.

Principles. The second phrase means that each of the accounting principles used in preparing the statements is "generally accepted." For many transactions, there are several generally accepted alternative treatments, and the auditors' opinion merely states that management has selected one of these. If the Financial Accounting Standards Board (or its predecessor bodies) has issued a pronouncement on a certain point, this constitutes a generally accepted accounting principle. Rule 203 of the AICPA Code of Professional Ethics states that no departures from such pronouncements can be regarded as a generally accepted accounting principle "unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading." Such circumstances are exceedingly rare. If they do exist, the report must describe the departure, give the reasons for making it, and show its approximate effect on the reported results. Thus, for all practical purposes, generally accepted accounting principles are what the FASB says they are.

Qualified Opinions. An auditors' report containing only the three paragraphs described above is informally called a **clean opinion**. Other reports are said to be **qualified opinions**. Qualification may occur for any of three reasons: (1) a lack of consistency, (2) existence of a major uncertainty, or (3) doubt as to the entity's ability to continue as a going concern.

Consistency. If a company has changed an accounting method from the method used in the preceding year, the auditors' report must point this out in a paragraph following the opinion paragraph. Consistency here does not mean, for example, that the method used to measure plant and equipment is consistent with that used to measure inventory; nor does it mean that the company's practices are consistent with industry practices or even that the several corporations within a consolidated enterprise have used the same methods. Rather, consistency refers solely to use of the same methods in successive years' financial statements. The details of any inconsistency are spelled out in a note to the financial statements, which is cited in this additional report paragraph. (See Illustration 14-1 for an example.)²

² Prior to 1988, consistency exceptions were pointed out in the opinion paragraph with a phrase beginning "except for the change in accounting for _____" that followed the words "in conformity with generally accepted accounting principles applied on a consistent basis."

Uncertainty. Sometimes a major uncertainty (such as a pending lawsuit) may ultimately have a material effect on the company's financial position. Auditors are required to call attention to such uncertainties in an additional report paragraph following the opinion paragraph, without making a prediction of the eventual outcome. The nature of the uncertainty is described in a statement note that is cited in this extra report paragraph. (An example is given in Illustration 14-1.)

Going-Concern Doubt. A significant 1988 change in auditing standards was the new requirement that the auditors in every audit evaluate whether there is a substantial doubt about the company's ability to continue as a going concern over the next year. If the auditors conclude that there is substantial doubt, then this must be disclosed in a report paragraph following the opinion paragraph.³ Again, a statement note cited in this additional report paragraph explains in some detail why the going-concern doubt exists. (See Illustration 14-1 for an example.)

In rare cases, the auditors' opinion may be a **disclaimer**; that is, they report that they are unable to express an opinion. This may happen because limitations were placed on the scope of the audit by management. If the auditors conclude that the financial statements do not "present fairly" the situation, they write an **adverse opinion**. This may occur if the company has departed from GAAP or clearly is no longer a going concern. Adverse opinions and disclaimers are extremely serious matters. Usually, they result in a suspension of trading in the company's equity securities.

Notes to Financial Statements

We have discussed three required financial statements: the balance sheet, the income statement, and the statement of cash flows. A fourth type of required information is also important: The notes that accompany and are deemed to be an integral part of the financial statements themselves. The requirements for these **notes to financial statements** are becoming increasingly elaborate and detailed.

One of these notes, usually the first, summarizes the accounting policies the company has followed in preparing the statements. Among other topics, this note usually describes the basis of consolidation (if the statements are consolidated statements), depreciation methods, policies with respect to the amortization of intangible assets, inventory methods, and policies regarding the recognition of revenues.

Other notes give details on long-term debt (including the maturity date and interest rate of each bond issue), a description of stock option plans and other management incentive plans, a description of pension plans,

³ AICPA, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," Statement on Auditing Standards No. 59 (1988). Formerly, major uncertainties, including doubt as to ability to continue as a going concern, were reported by inserting a phrase beginning "subject to [ultimate resolution of the uncertainty]" in the opinion paragraph, and such opinions were hence called **subject-to opinions**.

ILLUSTRATION 14-1
AUDITORS' REPORT**Standard Report:**

We have audited the accompanying balance sheet of X Company as of December 31, 19x1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepting auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19x1, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Illustrative required paragraph to report an inconsistency:

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19x1.

Illustrative required paragraph to report an uncertainty:

As discussed in Note Y to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

Illustrative required paragraph to report going-concern doubt:

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note Z to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about the entity's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note Z. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

spectacular frauds receive much publicity, they occur infrequently relative to the number of companies audited every year.

Opinion. The third paragraph is known as the **opinion paragraph**. The key phrases in this paragraph are *present fairly and in conformity with generally accepted accounting principles*.

Fairness. The word *fairly* should be contrasted with the word *accurately*. The auditors do not say that the reported net income is the only, or even the most accurate, number that could have been reported. Rather, they say that of the many alternative principles that could have been used, those actually selected by management do give a fair picture in the circumstances relevant to the particular company. This contrast between fairness and accuracy is further emphasized by the fact that the auditors' report is called an opinion. Auditors do not certify the accuracy of the