

MARSHALLS ENERGY COMPANY, INC.

INDEPENDENT AUDITORS' REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2001



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL
CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors
Marshalls Energy Company, Inc.:

We have audited the financial statements of the Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2001, and have issued our report thereon dated November 28, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether MEC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards*, which is described in the accompanying Schedule of Findings (pages 3 through 5) as item 2001-3.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered MEC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect MEC's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings as items 2001-1 and 2001-2.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we consider the reportable condition described above in item 2001-2 to be a material weakness. We also noted other matters involving the internal control over financial reporting, which we have reported to management of MEC in a separate letter dated November 28, 2001.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche

November 28, 2001

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings
Year Ended September 30, 2001

Material and Supplies

Finding No. 2001-1

Criteria: Internal controls should be established to ensure accuracy and completeness of transactions recorded.

Condition: Prenumbered inventory issuance slips were not issued in numeric sequence.

Cause: The cause of the above condition is the lack of adherence to policies and procedures requiring that inventory issuance slips be issued in numeric sequence.

Effect: The effect of the above condition is the possibility of misstatement of materials and supplies balances.

Recommendation: We recommend that management ensure that inventory personnel adhere to established policies and procedures requiring inventory issuance slips be issued in numeric sequence.

Auditee Response and Corrective Action Plan: Steps will be taken to ensure that the appropriate staff adhere to established policies and procedures pertaining to inventory issuance slips.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings, Continued
Year Ended September 30, 2001

Material and Supplies

Finding No. 2001-2

Criteria: Final inventory summaries should reflect the correct quantity of items counted during the year end physical count.

Condition: Of fifty-two inventory items tested, the following were noted:

- Three items (part #s C0012, CA004C and TX0027A) from the Distribution inventory and one item (part # DZ413) from the Power Plant inventory were not counted during the year end physical count.
- The final inventory summary for the Distribution inventory included receipts and issuances subsequent to year end.
- Two units of one item (part # C0013) from the Distribution inventory were issued without an inventory issuance slip.
- Two items (part #s NE0024 and NE0095A) from the Distribution inventory and two items (part #s TX0004B and TX0001) from the Power Plant inventory were incorrectly recorded in the final inventory summaries.

As a result of these errors, a recount was performed for the Distribution inventory. As a result of the recount, it was determined through alternative auditing procedures that the Distribution inventory balance was overstated in the amount of \$350,065 at September 30, 2001. Accordingly, an audit adjustment was proposed to reduce the inventory balance.

In addition, no written inventory instructions were issued relating to the year end physical count.

Cause: The cause of the above condition is the resignation of the Distribution inventory administrator in July 2001 and his replacement being appointed six weeks prior to year end.

Effect: The effect of the above condition is the misstatement of the materials and supplies balances.

Recommendation: We recommend that management ensure that physical counts are accurately performed for all materials and supplies items and the final summaries reflect the number of items counted during the year end physical count.

Auditee Response and Corrective Action Plan: Management will ensure that the new Distribution inventory administrator is trained in all procedures pertaining to the Distribution inventory.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings, Continued
Year Ended September 30, 2001

Coverage Ratios

Finding No. 2001-3

Criteria: Section 5.4 of the RUS loan contract requires MEC to establish rates to provide revenue sufficient to meet average coverage ratio requirements as follows:

Times Interest Earned Ratio (TIER)	=	1.50
Debt Service Coverage (DSC)	=	1.25
Operating Times Interest Earned Ratio (OTIER)	=	1.10
Operating Debt Service Coverage (ODSC)	=	1.10

Condition: During the year ended September 30, 2001, MEC achieved the following average coverage ratios:

TIER	=	(1.12)
DSC	=	0.16
OTIER	=	(3.70)
ODSC	=	(1.56)

Cause: The cause of the above condition is that utility rates are not sufficient to provide adequate revenues to comply with the prescribed rates.

Effect: The effect of the above condition is noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

Recommendation: We recommend that management review MEC's rates in order to comply with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

Prior Year Status: Noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract was reported as a finding in the audit of MEC for fiscal year 2000.

Auditee Response and Corrective Action Plan: Management has reviewed the rates as is indicated by our request and approval of a rate increase in May 2001. Management continues to monitor and evaluate our operations in order to comply with the RUS loan ratios.

MARSHALLS ENERGY COMPANY, INC.

Unresolved Prior Year Comments
Year Ended September 30, 2001

The status of unresolved prior year findings is disclosed within the Schedule of Findings section of this report (pages 3 through 5).