

MAJURO WATER AND SEWER COMPANY, INC.

FINANCIAL STATEMENTS  
AND  
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2002 AND 2001

INDEPENDENT AUDITORS' REPORT

Board of Directors  
Majuro Water and Sewer Company, Inc.:

We have audited the accompanying balance sheets of Majuro Water and Sewer Company, Inc. (MWSC), a component unit of the Republic of the Marshall Islands, as of September 30, 2002 and 2001, and the related statements of income (loss) and deficit and cash flows for the years then ended. These financial statements are the responsibility of MWSC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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 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 audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of MWSC as of September 30, 2002 and 2001, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 8 to the financial statements, MWSC changed its method of accounting for contributions in aid in 2002 to conform with the provisions of Governmental Accounting Standards Board Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* and, retroactively, restated the 2001 financial statements for the change.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 25, 2002, on our consideration of MWSC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

*Deloitte & Touche*

November 25, 2002, except for note 9, as to which the date is February 19, 2003

MAJURO WATER AND SEWER COMPANY, INC.

Balance Sheets  
September 30, 2002 and 2001

	<u>2002</u>	2001 (As Restated note 8)
<u>ASSETS</u>		
Current assets:		
Cash	\$ 81,221	\$ 42,977
Receivables:		
Utility	1,557,060	1,488,195
Less allowance for doubtful accounts	<u>(1,395,485)</u>	<u>(1,364,289)</u>
	161,575	123,906
Other	12,297	11,990
Less allowance for doubtful accounts	<u>(4,555)</u>	<u>(1,838)</u>
	7,742	10,152
Receivable from affiliates, net (note 6)	<u>290,795</u>	<u>189,743</u>
Inventory	<u>92,451</u>	<u>122,199</u>
Prepaid expenses	<u>4,737</u>	<u>1,456</u>
Total current assets	638,521	490,433
Plant and equipment, net (note 4)	<u>47,738</u>	<u>8,446,388</u>
	<u>\$ 686,259</u>	<u>\$ 8,936,821</u>
<u>LIABILITIES AND STOCKHOLDER'S DEFICIENCY</u>		
Current liabilities:		
Loans payable (note 5)	\$ -	\$ 8,540,756
Accounts payable	53,218	87,948
Payable to affiliates (note 6)	919,505	1,223,387
Interest payable (note 5)	-	2,275,624
Other accrued liabilities	<u>47,567</u>	<u>43,945</u>
Total current liabilities	<u>1,020,290</u>	<u>12,171,660</u>
Stockholder's deficiency:		
Common stock, \$1 par value, 100,000 shares authorized, paid-in and unissued (note 1)	100,000	100,000
Deficit	<u>(434,031)</u>	<u>(3,334,839)</u>
Total stockholder's deficiency	<u>(334,031)</u>	<u>(3,234,839)</u>
Contingencies (notes 3 and 7)	<u>\$ 686,259</u>	<u>\$ 8,936,821</u>

See accompanying notes to financial statements.

MAJURO WATER AND SEWER COMPANY, INC.

Statements of Income (Loss) and Deficit  
Years Ended September 30, 2002 and 2001

	<u>2002</u>	2001 (As Restated note 8)
Operating revenues:		
Utility billings	\$ 1,038,191	\$ 883,056
Hook-up and deliveries	91,459	167,754
Other	<u>17,935</u>	<u>8,222</u>
Total operating revenues	<u>1,147,585</u>	<u>1,059,032</u>
Operating expenses:		
Salaries, wages and benefits	643,609	641,593
Electricity	199,332	197,600
Bad debts	105,317	31,198
Spare parts	81,697	165,689
Depreciation and amortization	38,029	429,539
Petroleum, oil and lubricants	28,566	30,082
Communications	24,331	15,300
Insurance	18,762	11,080
Office supplies	16,241	9,353
Chlorine	15,411	20,296
Uniforms	10,176	30
Contractual services	8,167	14,631
Travel	4,207	6,159
Freight and handling	2,653	7,708
Repairs and maintenance	2,484	7,596
Miscellaneous	<u>36,962</u>	<u>36,926</u>
Total operating expenses	<u>1,235,944</u>	<u>1,624,780</u>
Loss from operations	<u>(88,359)</u>	<u>(565,748)</u>
Nonoperating income (expenses):		
Gain on forgiveness of debt (notes 4 and 5)	1,726,249	-
Operating subsidy from RepMar (notes 5 and 7)	1,464,493	99,998
Income tax and MISSA penalties and interest	(201,185)	-
Interest expense (note 5)	<u>(390)</u>	<u>(587,454)</u>
Total nonoperating income (expenses), net	<u>2,989,167</u>	<u>(487,456)</u>
Net income (loss)	2,900,808	(1,053,204)
Deficit at beginning of year	<u>(3,334,839)</u>	<u>(2,281,635)</u>
Deficit at end of year	\$ <u>(434,031)</u>	\$ <u>(3,334,839)</u>

See accompanying notes to financial statements.

MAJURO WATER AND SEWER COMPANY, INC.

Statements of Cash Flows  
Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Loss from operations	\$ (88,359)	\$ (565,748)
Adjustments to reconcile loss from operations to net cash used for operating activities:		
Depreciation and amortization	38,029	429,539
Bad debts	105,317	31,198
(Increase) decrease in assets:		
Utility receivables	(68,865)	(81,322)
Other receivables	(307)	(3,020)
Receivable from affiliates	(22,456)	(66,451)
Inventory	29,748	4,931
Prepaid expenses	(3,281)	23,732
Increase (decrease) in liabilities:		
Accounts payable	(34,730)	48,266
Payable to affiliates	(505,457)	109,861
Other accrued liabilities	<u>3,622</u>	<u>17,399</u>
Net cash used for operating activities	<u>(546,739)</u>	<u>(51,615)</u>
Cash flows from noncapital financing activities:		
Operating subsidy from RepMar (note 7)	<u>600,000</u>	<u>99,998</u>
Net cash provided by noncapital financing activities	<u>600,000</u>	<u>99,998</u>
Cash flows from capital and related financing activities:		
Acquisition of capital assets	<u>(15,017)</u>	<u>(32,621)</u>
Net cash used for capital and related financing activities	<u>(15,017)</u>	<u>(32,621)</u>
Net increase in cash	38,244	15,762
Cash at beginning of year	<u>42,977</u>	<u>27,215</u>
Cash at end of year	\$ <u><u>81,221</u></u>	\$ <u><u>42,977</u></u>

Supplemental schedule of noncash capital and related financing activities:

RepMar and MWSC entered into agreements which forgave loans and interest payable and transferred related water system infrastructure to RepMar (see notes 4 and 5).

Decrease in water system infrastructure, net	\$ (8,375,638)	\$ -
Decrease in loans payable	8,540,756	-
Decrease in interest payable	2,275,624	-
Increase in gain on forgiveness of debt	(1,726,249)	-
Increase in operating subsidy from RepMar	<u>(714,493)</u>	<u>-</u>
	\$ <u><u>-</u></u>	\$ <u><u>-</u></u>

See accompanying notes to financial statements.

# MAJURO WATER AND SEWER COMPANY, INC.

Notes to Financial Statements  
September 30, 2002 and 2001

## (1) Organization

Majuro Water and Sewer Company, Inc. (MWSC) was granted a corporate charter by the Cabinet of the Republic of the Marshall Islands (RepMar) on January 26, 1989. MWSC's principal lines of business are predominantly the collection and distribution of fresh water and wastewater. The principal markets for the collection and distribution of fresh water and wastewater are government agencies, businesses and residential customers located on the atoll of Majuro.

MWSC's articles of incorporation have authorized the issuance of 100,000 shares of \$1 par value common stock, which were paid in full by the Marshall Islands Development Authority (a component unit of RepMar), although no share certificates have been issued.

MWSC's financial statements are incorporated into the general purpose financial statements of RepMar as a component unit.

## (2) Summary of Significant Accounting Policies

The accounting policies of MWSC 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. MWSC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

### 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.

### 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 in the balance sheets. 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.

# MAJURO WATER AND SEWER COMPANY, INC.

## Notes to Financial Statements September 30, 2002 and 2001

### (2) Summary of Significant Accounting Policies, Continued

#### Cash

For purposes of the balance sheets and the statements of cash flows, cash is defined as cash on hand and cash held in demand accounts. As of September 30, 2002 and 2001, cash was \$81,221 and \$42,977, respectively, and the corresponding bank balances were \$75,990 and \$50,180, respectively, which are maintained in two financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2002 and 2001, bank deposits were fully FDIC insured.

#### Receivables

All receivables are due from government agencies, businesses and individuals located within the Republic of the Marshall Islands and are interest free and uncollateralized. The allowance for doubtful 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.

#### Inventory

Inventory is valued at the lower of cost (first-in, first-out) or market (net realizable value).

#### Plant and Equipment

Plant and equipment are stated at cost. Depreciation of plant and equipment and amortization of leasehold improvements are calculated on the straight-line method based on the estimated useful lives of the respective assets.

#### Taxes

Corporate profits are not subject to income tax in the Republic of the Marshall Islands. The Government of the Republic of the Marshall Islands imposes a gross revenue tax of 3% on revenues. Pursuant to the Income Tax Act of 1989, as amended, sales of water and sewer services by public utility companies are exempt from gross revenue tax. Accordingly, MWSC is exempt from this tax relating to gross revenue from sales of water and sewer services.

### (3) Risk Management

MWSC 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. MWSC has elected not to purchase commercial insurance for the risks of loss to which it is exposed. Instead, MWSC believes it is more economical to manage its risks internally. Claims expenses and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. No losses as a result of these risks have occurred in any of the past three years.

MAJURO WATER AND SEWER COMPANY, INC.

Notes to Financial Statements  
September 30, 2002 and 2001

(4) Plant and Equipment

Plant and equipment at September 30, 2002 and 2001, consists of the following:

	<u>Estimated Useful Lives</u>	<u>2002</u>	<u>2001</u>
Water system infrastructure (note 9)	25 years	\$ -	\$ 9,110,478
Vehicles	2 - 4 years	123,733	123,733
Office equipment	3 - 8 years	82,950	80,710
Buildings and leasehold improvements	4 years	54,317	54,317
Machinery and equipment	5 - 10 years	<u>66,772</u>	<u>53,996</u>
		327,772	9,423,234
Less accumulated depreciation and amortization		<u>(280,034)</u>	<u>(976,846)</u>
		\$ <u>47,738</u>	\$ <u>8,446,388</u>

RepMar and MWSC entered into a Water and Sewer System Franchise Agreement (see note 9) which transferred the water system infrastructure, and cancelled related loan agreements to RepMar. Management of MWSC and RepMar have elected to record this transaction during the year ended September 30, 2002. As such, \$7,826,263 of principal and \$2,024,361 of related accrued interest, less \$8,375,638 of net water system infrastructure, has been recorded as gain from forgiveness of debt, for the year ended September 30, 2002, in the accompanying financial statements.

(5) Loans Payable

Majuro Water Supply Project ADB Loan #1

On March 24, 1994, the Board of Directors of MWSC obtained a loan from RepMar in an amount equivalent to 503,000 Special Drawing Rights. The loan bore interest at a fixed rate of 6.64% per annum on the outstanding principal balance and was a subsidiary loan of a loan agreement dated November 17, 1993 between the Asian Development Bank (ADB) and RepMar. As of September 30, 2001, MWSC had drawn \$714,493 against this loan. Interest was calculated on a day-to-day basis from the date of each drawing against the loan account and was payable semi-annually on May 15 and November 15 of each year until March 24, 1997 at which time MWSC was to repay the principal amount of the loan, together with interest thereon, in twenty-four semi-annual installments of \$44,376. MWSC was in default of loan repayments under the loan agreement as of September 30, 2001 and the loan amount was classified as a current liability.

RepMar Cabinet Minute 248(2000) forgave the loan principal through a transfer to MWSC. Management of MWSC and RepMar have elected to record this transfer during the year ended September 30, 2002. As such, \$714,493 has been recorded as an operating subsidy from RepMar, and \$251,263 of related accrued interest has been recorded as gain from forgiveness of debt, for the year ended September 30, 2002 in the accompanying financial statements.

MWSC incurred \$47,442 of interest expense related to this loan during the year ended September 30, 2001.

MAJURO WATER AND SEWER COMPANY, INC.

Notes to Financial Statements  
September 30, 2002 and 2001

(5) Loans Payable, Continued

Majuro Water Supply Project ADB Loan #2

On September 18, 1996, the Board of Directors of MWSC obtained another loan from RepMar in an amount equivalent to 6,062,000 Special Drawing Rights. The loan bore interest at a fixed rate of 6.9% per annum on the outstanding principal balance and was a subsidiary loan of a loan agreement dated February 19, 1996 between the ADB and RepMar. As of September 30, 2001, MWSC had drawn \$7,826,263 against this loan. Interest was calculated on a day-to-day basis from the date of each drawing against the loan account and was payable semi-annually on March 1 and September 1 of each year until March 1, 2001 at which time MWSC was to repay the principal amount of the loan, together with interest thereon, in fifty semi-annual installments of \$330,571. MWSC was in default of loan repayments under the loan agreement as of September 30, 2001 and the loan amount was classified as a current liability.

RepMar and MWSC entered into a Water and Sewer System Franchise Agreement (see note 9) which cancelled the loan agreement and transferred the related water system infrastructure to RepMar. Management of MWSC and RepMar have elected to record this transaction during the year ended September 30, 2002. As such, \$7,826,263 of principal and \$2,024,361 of related accrued interest, less \$8,375,638 of net water system infrastructure, have been recorded as gain from forgiveness of debt, for the year ended September 30, 2002, in the accompanying financial statements.

MWSC incurred \$540,012 of interest expense related to this loan during the year ended September 30, 2001.

(6) Related Party Transactions

MWSC is wholly-owned by the Marshall Islands Development Authority (MIDA), a component unit of RepMar, and is therefore affiliated with all RepMar-owned and affiliated entities.

MWSC's utility service is provided to RepMar and all RepMar-owned and affiliated entities. Services are extended to these entities at the same terms and conditions provided to third parties.

MWSC utilizes services from certain affiliated entities at substantially more favorable terms and conditions than those incurred from third parties.

A summary of related party transactions for the years ended September 30, 2002 and 2001, and related receivable (less allowance for doubtful accounts) and payable balances as of September 30, 2002 and 2001, is as follows:

	2002			
	<u>Revenues</u>	<u>Expenses</u>	<u>Receivables</u>	<u>Payables</u>
RepMar	\$ 101,624	\$ 40,260	\$ 374,897	\$ 234,632
Marshall's Energy Company, Inc.	4,066	201,249	3,449	173,548
Marshall Islands National Telecommunications Authority	10,362	13,191	995	1,716
Marshall Islands Social Security Administration	6,615	216,973	413	492,950
Majuro Resort, Inc.	40,673	4,487	6,534	-
Other	35,561	9,894	11,304	16,659
	<u>\$ 198,901</u>	<u>\$ 486,054</u>	397,592	<u>\$ 919,505</u>
Less allowance for doubtful accounts			(106,797)	
			<u>\$ 290,795</u>	

MAJURO WATER AND SEWER COMPANY, INC.

Notes to Financial Statements  
September 30, 2002 and 2001

(6) Related Party Transactions, Continued

	2001			
	<u>Revenues</u>	<u>Expenses</u>	<u>Receivables</u>	<u>Payables</u>
RepMar	\$ 75,451	\$ 39,186	\$ 196,762	\$ 225,064
Marshalls Energy Company, Inc.	2,489	223,778	8	631,939
Marshall Islands National Telecommunications Authority	19,137	9,032	800	1,628
Marshall Islands Social Security Administration	39,875	52,073	2,405	364,756
Majuro Resort, Inc.	44,167	2,427	4,735	-
Other	<u>27,723</u>	<u>7,911</u>	<u>20,426</u>	<u>-</u>
	<u>\$ 208,842</u>	<u>\$ 334,407</u>	225,136	<u>\$ 1,223,387</u>
Less allowance for doubtful accounts			<u>(35,393)</u>	
			<u>\$ 189,743</u>	

Receivables from and payables to affiliates are uncollateralized, interest free and have no set repayment terms.

(7) Contingencies

An exclusive franchise to construct, maintain and operate the fresh water, waste water and sewer system within Majuro Atoll was granted to MWSC by RepMar on March 9, 1989. Simultaneously, RepMar leased to MWSC, at no cost, the Majuro Atoll fresh water, waste water and sewer system. The term of both the lease and the franchise is for a ten year period commencing on March 9, 1989, and continuing thereafter unless terminated by either party six months after written notice to the other. No notice to terminate has been executed as of September 30, 2002 (see note 9).

MWSC has incurred losses from operations of \$88,359 and \$565,748 during the years ended September 30, 2002 and 2001, respectively, and as of those dates, has working capital deficiencies of \$381,769 and \$11,681,227, respectively, and deficits of \$434,031 and \$3,334,839, respectively. MWSC received cash operating subsidies from RepMar during the years ended September 30, 2002 and 2001 of \$750,000 and \$99,998, respectively. Management believes that the continuation of MWSC's operations is dependent upon the future financial support of RepMar, compensation by RepMar for the cost of actual utility service provided, the collection of long outstanding utility receivables, and/or significant improvements in operations.

(8) Restatement

Effective October 1, 2001, MWSC implemented GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. The provisions of this statement require capital grants and contributions to be recognized as non-operating revenue on the Statements of Income (Loss) and Deficit. In prior periods, capital grants and contributions had been recorded as a direct increase to contributions in aid in the equity section of the Balance Sheet. As a result, contributed capital and deficit as of September 30, 2001 have been restated from the amounts previously reported as follows:

MAJURO WATER AND SEWER COMPANY, INC.

Notes to Financial Statements  
September 30, 2002 and 2001

(8) Restatement, Continued

	<u>As Previously Reported</u>	<u>As Restated</u>
At September 30, 2001:		
Contributed capital	\$ <u>450,875</u>	\$ <u>-</u>
Deficit	\$ <u>(3,785,714)</u>	\$ <u>(3,334,839)</u>

(9) Subsequent Event

On February 19, 2003, RepMar and MWSC entered into a Water and Sewer Franchise Agreement (the Agreement) to provide water and sewer service to the atoll of Majuro. The Agreement incorporates a lease agreement for MWSC to lease from RepMar the water and sewer system for a period of ten years at a rate of \$100,000 per annum, commencing three years after the lease is in effect (February 19, 2006). The Agreement also forgave loans related to the construction of the water and sewer system (see note 5) and transferred the water system infrastructure to RepMar (see note 4). RepMar and MWSC have elected to record the forgiveness of these loans, and the related transfer of the water and sewer system asset from MWSC to RepMar, during the year ended September 30, 2002.