

CHUGACH ELECTRIC ASSOCIATION, INC.
Anchorage, Alaska

March 14, 2008

TO: Bradley Evan, Acting Chief Executive Officer
Mike Cunningham, Chief Financial Officer

FROM: Jody Wolfe, Controller

SUBJECT: *Response to KPMG audit report*

This memo is to identify how Chugach has addressed the deficiencies identified in KPMG's annual Financial Statement Audit.

First it is important to note that the auditing standards have changed significantly in the past few years, including new definitions of deficiencies, significant deficiencies and material weaknesses. Therefore, the scope of the audit has changed. The auditors test many more transactions and at a much lower level of detail than they have in the past. Audit field work that once took two weeks now lasts four to five weeks. Transactions that would not have merited comment by the auditors in the past are now being identified as deficiencies, even though they are too small to require adjustment to the financial statements. Due to these changes, the frequency in which deficiencies, significant deficiencies, and even material weaknesses are identified and reported upon has increased for all companies being audited.

The significant deficiency identified by the auditors was a result of the payment of capital credits in December. The capital credit payable account was not adjusted for the checks held in excess of \$600 that were written December 27, 2007 but were awaiting signed W9 information from members as of December 31, 2007. The entry was made to adjust cash and equity for these checks, but the entry reducing equity and increasing the patronage payable account was not made until the auditors detected it. This difference would have been identified by us in January after the checks were mailed. This entry caused a reclassification between Liabilities and Equity of \$900,000. As KPMG points out, their materiality level for planning purposes is \$1.2 million and generally for reclassifications the amount may be even higher. This misclassification did not have a significant impact on the balance sheet and had no impact on the income statement.

In December 2007 a new general ledger reconciliation process was implemented. The capital credit payable account had not yet been set up in the reconciliation program and did not undergo the scrutiny that it would have had it been set up. This account has since been included in the reconciliation program and the balance in it will be reviewed more closely on a monthly basis. This review and reconciliation should prevent this sort of misclassification from occurring in the future.

The purchase of inventory for \$139,000 that was not accrued was caused by several factors. At the beginning of December we implemented new software for purchasing, accounts payable and inventory. This particular item was ordered in the old system, but was received in December under the new system. The warehousemen had been notified that all receipts of items ordered under the old system would have to be manually entered into the new system. However when this item arrived, a temporary warehouseman was on duty and did not properly receive it into the new system. No one else was notified of the arrival of these parts, so it did not get put on the year end accrual list.

The invoice did not arrive from the vendor until the end of January. In trying to match the invoice to a receipt, it was discovered the receipt had not been recorded. Misstatements like this will occur due to human error, particularly when using temporary staff and implementing new software. While the error was identified as part of the matching process when the invoice arrived in late January, it wasn't identified before the year-end close. This resulted in the misstatement not being detected on a timely basis based on the definition of a deficiency.

Now that the new system is in place, all receipts are recorded against the purchase order and matched to the invoices. This type of error should not occur in the future, as long as the warehousemen are properly performing their assigned functions.

This \$139,000 audit difference did not have a significant impact on the balance sheet and had no impact on the income statement.

The third deficiency identified was caused by the misclassification of the interest portion of a refund paid to the State of Alaska late 2006. The portion of the refund related to interest was paid out of the liability account rather than expensed when paid. The error was discovered by Chugach staff when the liability account was reconciled shortly after year-end, so the \$84,000 in interest was expensed in 2007, rather than in 2006. The controls were in place to identify and correct the misclassification; however, it wasn't uncovered and corrected until after the 2006 year-end close.

The financial statements are comprised of millions of transactions subject to human error. Chugach is continually working on improving our internal controls to prevent or correct these errors or misstatements on a timely basis. None of these transactions identified as deficiencies would have gone undetected by staff, the deficiencies were caused by the time it took staff to identify and correct them.

Identification of deficiencies by the auditors should not be viewed as a cause for alarm, but as an opportunity to further enhance our internal control procedures. The deficiencies identified by the auditors point to a need for more timely reconciliation of accounts. This need has been addressed by implementing a new general ledger reconciliation program and hiring an additional general ledger accountant to complete the reconciliations on a timely basis.