

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION
(A COMPONENT UNIT OF THE FEDERATED STATES
OF MICRONESIA NATIONAL GOVERNMENT)**

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

YEARS ENDED SEPTEMBER 30, 2006 AND 2005

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Table of Contents
Years Ended September 30, 2006 and 2005

	<u>Page No.</u>
I. Independent Auditors' Report	1
II. Management's Discussion and Analysis	3
III. Financial Statements and Additional Information:	
Statements of Net Assets	7
Statements of Revenue, Expenses, and Changes in Net Assets	8
Statements of Cash Flows	9
Notes to Financial Statements	10
Schedule of Operating Expenses	22
IV. Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit Performed in Accordance with <i>Government</i> <i>Auditing Standards</i>	23
Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards	25
Schedule of Expenditures of Federal Awards	27
Schedule of Findings and Questioned Costs	28

INDEPENDENT AUDITORS' REPORT

Chairman
Board of Directors
Federated States of Micronesia
Telecommunications Corporation:

We have audited the accompanying statements of net assets of the FSM Telecommunications Corporation (the Corporation), a component unit of the Federated States of Micronesia National Government, as of September 30, 2006 and 2005, and the related statements of revenue, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

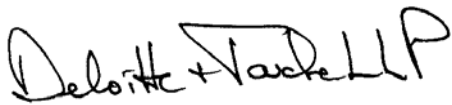
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Corporation as of September 30, 2006 and 2005, and its changes in net assets and its 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 to 6 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 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 Corporation's basic financial statements. The accompanying schedule of operating expenses (page 22) is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule is the responsibility of the management of the Corporation. Such information has been subjected to the auditing procedures applied by us in our audit of the basic financial statements and, in our opinion, 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 December 29, 2006, on our consideration of the Corporation's 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.

A handwritten signature in black ink that reads "Deloitte + Stark LLP". The signature is written in a cursive, flowing style.

December 29, 2006

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Management's Discussion and Analysis
Year Ending September 30, 2006

The following discussion and analysis of the financial performance and activity of the Federated States of Micronesia Telecommunications Corporation (FSMTC) is to provide an introduction and understanding of the basic financial statements of FSMTC for the year ended September 30, 2006. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

FSMTC is a public corporation of the Federated States of Micronesia National Government and is the primary provider of telecommunications services throughout the Federated States of Micronesia (FSM) and to points outside of the FSM. FSMTC also provides Cable TV in the State of Kosrae and a wireless TV broadcasting system in the State of Yap.

FSMTC is under the governance of an appointed five member Board of Directors by the President of the FSM and the governors of each State that have oversight over FSMTC, cable TV in Kosrae, and wireless TV broadcasting in Yap. The General Manager, who is the President and Chief Executive Officer, is also an ex-officio non-voting member of the Board.

The FSMTC provides telecommunications services which include Plain Old Telephone Services (POTS) to 8,750 active subscribers. Other telecommunications services provided are National and International Overseas Calls, Internet Services, Mobile Cellular Services, Cable Television in the State of Kosrae, and wireless TV in the State of Yap.

The FSMTC relies on calls made to and from outside and within the FSM, which account for approximately 47 % of FSMTC's generated revenues.

During FY2006, internet services accounted for \$2,156,067 or 17% of FSMTC's generated revenues. As of September 30, 2006, the total internet subscriber users were 1,455.

The mobile services account for \$2,131,777 or 17 % of FSMTC's generated revenues in FY2006. At September 30, 2006, the total mobile subscribers were 18,018, broken down as follows: Pohnpei 8,101, Chuuk 4,537, Yap 3,880 and Kosrae 1,500.

The following table summarizes the financial condition and operations of the FSMTC as of and for the years ended September 30, 2006, 2005 and 2004:

Assets:	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash and cash equivalents	\$ 2,276,011	\$ 1,663,535	\$ 3,387,526
TCD's and investments in securities	13,840,866	13,066,068	8,887,681
Receivables and prepayments	1,728,573	1,811,303	2,377,162
Other assets	355,316	736,968	1,392,631
Property, plant and equipment	<u>41,008,133</u>	<u>42,509,471</u>	<u>42,699,142</u>
	<u>\$ 59,208,899</u>	<u>\$ 59,787,345</u>	<u>\$ 58,744,142</u>
Current liabilities	\$ 1,576,947	\$ 1,766,254	\$ 1,444,714
Noncurrent liabilities	23,686,864	24,558,245	25,253,521
Net assets	<u>33,945,088</u>	<u>33,462,846</u>	<u>32,045,907</u>
	<u>\$ 59,208,899</u>	<u>\$ 59,787,345</u>	<u>\$ 58,744,142</u>

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Management's Discussion and Analysis
Year Ending September 30, 2006

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Operating revenues	\$ 12,848,046	\$ 11,537,350	\$ 11,256,811
Operating expenses	<u>(12,076,681)</u>	<u>(11,196,215)</u>	<u>(10,671,689)</u>
Earnings from operations	771,365	341,135	585,122
Interest income and others	915,247	2,327,492	950,837
Interest expense	<u>(1,204,370)</u>	<u>(1,251,688)</u>	<u>(1,170,821)</u>
Increase in net assets	482,242	1,416,939	365,138
Net assets at beginning of year	<u>33,462,846</u>	<u>32,045,907</u>	<u>31,680,769</u>
Net assets at end of year	\$ <u>33,945,088</u>	\$ <u>33,462,846</u>	\$ <u>32,045,907</u>

Overall there were only minor changes in the balance sheet components. However, during the year ended September 30, 2006 the total amount received from telecommunication services exceeded the amount paid to suppliers and employees for goods and services. This resulted in net cash provided by operating activities amounting to \$4,224,819 per the cash flows statement.

The total cash and cash equivalents at the end of FY06 is \$2,276,011 as compared to \$1,663,535 in FY2005. The cash flows statement showed that the net cash provided by operating activities exceeded the net cash used for capital and related financing by \$475,278. The statement of cash flows also showed that net cash provided by investing activities was \$137,198, which also contributed to the increase in cash and cash equivalents during FY2006.

The total revenue increased by \$1,310,696 as compared to FY2005. The increase was due to the collection of bad debt reserves which offset against the decrease in net access revenue. The decrease in net access revenue was attributed from the disconnection of subscribers during FY2006 for non compliance of paying debts.

Operating expenses in FY2006 increased by \$880,466 in comparing with the FY2005 operating expenses. Most of the increase was contributed from corporate operations.

FSMTC investments in property, plant, and equipment, net of accumulated depreciation, amounted to \$41,008,133 in FY2006 and \$42,509,471 in FY2005. The decrease was caused by the increase in depreciation expense.

FSMTC's notes payable with the US Department of Agriculture (Rural Utility Services) amounted to \$24,471,604 of which, \$784,740 was classified as current portion of the note. The interest on the funded debts paid during FY2006 was \$1,204,370 net of capitalized interest of \$39,614 in accordance with FASB 34, associated with construction projects that exceed one year. The principal amount paid during FY2006 was \$764,337.

Management's Discussion and Analysis for the year ended September 30, 2005 is set forth in FSMTC's report on the audit of financial statements, which is dated December 9, 2005. That Discussion and Analysis explains the major factors impacting the 2005 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmpublicauditor.fm.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Management's Discussion and Analysis
Year Ending September 30, 2006

On November 1, 2005, The FSMTC Board of Directors approved a comprehensive strategic plan (the Plan) to direct FSMTC for the next five years from 2006 to 2011. The purpose of the Plan is for management directional tool for policy development as well as program delivery. It will guide the board, management, and staff in dealing with the challenges due to the continuous changes in technology.

Based on the plan, FSMTC is committed to spend \$80,301,658 for the next 5 years with and expected revenues of \$67,813,210, the aggregate shortfall is \$12 million. As a result, FSMTC may end up having to borrow from international financial markets to cover the shortfall or to tap into its cash reserve to cover it.

Following are the expected revenues and expenditures for the next five years:

<u>Revenue Source:</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Total</u>
Toll Revenue	\$ 3,535,689	\$ 3,641,760	\$ 3,751,013	\$ 3,863,543	\$ 3,979,449	\$ 18,771,454
Internet	1,839,574	1,894,761	1,951,604	1,951,604	2,010,152	9,647,695
Net Access	1,478,643	1,493,430	1,508,364	1,523,447	1,538,682	7,542,566
Mobil	4,411,083	4,631,637	4,863,219	5,106,380	5,361,699	24,374,018
External Carriers	131,882	134,520	134,520	134,520	134,520	669,962
Miscellaneous	347,329	354,276	361,361	368,589	375,960	1,807,515
Non-Operating Rev	<u>1,000,000</u>	<u>1,000,000</u>	<u>1,000,000</u>	<u>1,000,000</u>	<u>1,000,000</u>	<u>5,000,000</u>
Total	<u>\$ 12,744,200</u>	<u>\$ 13,150,384</u>	<u>\$ 13,570,081</u>	<u>\$ 13,948,083</u>	<u>\$ 14,400,462</u>	<u>\$ 67,813,210</u>

<u>Expenditure Categories:</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Total</u>
On-Going Expenses:						
Operating Expenses	\$ 10,173,293	\$ 10,783,690	\$ 11,430,712	\$ 12,116,554	\$ 12,843,548	\$ 57,347,797
Capital Expenditures	700,000	700,000	700,000	700,000	700,000	3,500,000

<u>Program Expenditures:</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Total</u>
Board of Directors	25,065	26,318	27,634	29,015	30,466	138,498
International; Relations	138,657	145,590	152,869	160,512	168,538	766,166
Government Relations	16,800	17,640	18,522	19,448	20,421	92,831
Public Relations	124,950	131,198	137,757	144,645	151,878	690,428
Annual Report	50,000	50,000	50,000	50,000	50,000	250,000
Community Relations	1,000	1,000	1,000	1,000	502,855	506,855
Back-up System	2,500	2,500	2,500	2,500	2,500	12,500
Critical Spare Parts	20,000	20,000	20,000	20,000	20,000	100,000
Research and Development	381,150	400,208	420,218	441,229	463,290	2,106,095
Training and Development	105,000	110,250	115,763	121,551	127,628	580,192
Educational Programs	15,750	16,538	17,364	18,233	19,144	87,029
Website improvement	5,000	5,000	5,000	5,000	5,000	25,000
Manual Updates	50,400	52,920	55,566	58,344	61,262	278,492
Strategic Plan Update	5,000	5,000	5,000	5,000	5,000	25,000
Integrated MIS	-	-	-	-	-	-

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Management's Discussion and Analysis
Year Ending September 30, 2006

Program Expenditures, Continued:

Maintenance and						
Upgrades	299,250	314,213	329,923	346,419	463,740	1,753,545
Disaster Recovery Plan	15,000	2,500	2,500	2,500	2,500	25,000
Cable and Wireless TV	2,015,000	-	-	-	-	2,015,000
Fiber Optic	1,121,846	1,121,846	1,121,846	1,121,846	1,121,846	5,609,230
Outer Island Project	1,019,000	1,049,000	1,077,000	1,106,000	116,000	4,367,000
Pricing and Tariffs	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>	<u>25,000</u>
 Total	 \$ <u>16,289,661</u>	 \$ <u>14,960,411</u>	 \$ <u>15,696,174</u>	 \$ <u>16,474,796</u>	 \$ <u>16,880,616</u>	 \$ <u>80,301,658</u>

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Statements of Net Assets
September 30, 2006 and 2005

	2006	2005
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 2,276,011	\$ 1,663,535
Time certificates of deposit	107,966	206,834
Investment in securities	13,732,900	12,859,234
Accounts receivable, net of an allowance for doubtful accounts of \$2,966,156 and \$3,692,175 in 2006 and 2005, respectively	587,505	555,223
Receivable from carriers	157,959	389,545
Advance to employees	35,634	22,526
Inventory	355,316	559,035
Accrued interest and other accrued earnings	356,714	248,958
Other receivables and prepaid expenses	590,761	595,051
Total current assets	18,200,766	17,099,941
Deferred charges	-	177,933
Property, plant and equipment, net	41,008,133	42,509,471
	\$ 59,208,899	\$ 59,787,345
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Current maturities of long-term debt	\$ 784,740	\$ 746,523
Accounts payable, trade	96,132	121,386
Deferred revenue-debit cards	137,647	48,080
Accrued leave payable	126,682	115,176
Other payables and accrued expenses	431,746	735,089
Total current liabilities	1,576,947	1,766,254
Long-term contracts payable	-	68,827
Long-term debt, net of current portion	23,686,864	24,489,418
Total liabilities	25,263,811	26,324,499
Commitments and contingencies		
Net assets:		
Invested in capital assets, net of related debt	16,536,529	17,204,703
Unrestricted	17,408,559	16,258,143
Total net assets	33,945,088	33,462,846
	\$ 59,208,899	\$ 59,787,345

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Statements of Revenue, Expenses, and Changes in Net Assets
Years Ended September 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating revenues:		
Overseas tolls	\$ 3,807,920	\$ 3,686,908
Internet	2,156,067	2,034,463
Net access	1,789,530	2,058,468
Mobile charges	2,131,777	2,670,692
External carriers	1,838,676	1,339,341
ICTV Kosrae cable charges	113,781	126,457
ICTV Yap cable charges	86,124	4,250
Bad debts	-	(504,666)
Collection of bad debt reserves	726,019	-
Miscellaneous	198,152	121,437
Total operating revenues	<u>12,848,046</u>	<u>11,537,350</u>
Operating expenses:		
Consumer operations	1,879,989	1,907,596
Corporate operations	2,430,780	1,821,644
Plant operations	1,534,086	1,406,394
Cable and wire	1,204,951	1,242,863
General support	1,202,439	1,092,182
Earth station	1,084,535	1,045,293
Internet expense	977,273	815,543
Central office	671,496	738,887
Wireless telephone - Ulithi	539,522	484,632
Terminal equipment	272,101	456,917
ICTV expense	279,509	184,264
Total operating expenses	<u>12,076,681</u>	<u>11,196,215</u>
Earnings from operations	<u>771,365</u>	<u>341,135</u>
Nonoperating revenues (expenses):		
Interest income - general	38,329	22,742
Interest expense	(1,204,370)	(1,251,688)
Gain on sale of fixed assets	3,251	-
Compact of Free Association Section 215(b)	-	32,068
Investment earnings	873,667	2,272,682
Total nonoperating (expenses) revenues, net	<u>(289,123)</u>	<u>1,075,804</u>
Change in net assets	482,242	1,416,939
Total net assets at beginning of year	<u>33,462,846</u>	<u>32,045,907</u>
Total net assets at end of year	<u>\$ 33,945,088</u>	<u>\$ 33,462,846</u>

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Statements of Cash Flows
Years Ended September 30, 2006 and 2005

	2006	2005
Cash flows from operating activities		
Cash received from customer:	\$ 13,033,451	\$ 12,136,909
Cash paid to suppliers for goods and services	(5,283,764)	(4,405,466)
Cash paid to employees	(3,524,868)	(3,487,934)
Net cash provided by operating activities:	4,224,819	4,243,509
Cash flows from capital and related financing activities		
Repayments of long-term deb	(764,337)	(727,717)
Additions to property, plant and equipmen	(1,784,085)	(3,047,314)
Proceeds from sale of fixed asset:	3,251	-
Interest paid on long-term deb	(1,204,370)	(1,251,688)
Contributions from Compact	-	32,068
Net cash used for capital and related financing activitie:	(3,749,541)	(4,994,651)
Cash flows from investing activities		
Net change in time certificates of deposit:	100,000	(100,000)
Additions to investments	(612,000)	(2,834,003)
Proceeds from sale of Intelsa	-	1,940,016
Investment earnings	649,198	21,138
Net cash provided by (used for) investing activitie:	137,198	(972,849)
Net change in cash and cash equivalents	612,476	(1,723,991)
Cash and cash equivalents at beginning of year:	1,663,535	3,387,526
Cash and cash equivalents at end of year:	\$ 2,276,011	\$ 1,663,535
Reconciliation of earnings from operations and to net cash provided by operating activities		
Earnings from operations:	\$ 771,365	\$ 341,135
Adjustments to reconcile earnings from operation to net cash provided by operating activities		
Depreciation and amortization	3,285,423	3,236,985
Bad debts	-	504,666
Collection of bad debt reserves	(726,019)	-
(Increase) decrease in assets:		
Accounts receivable	693,737	(95,980)
Receivable from carriers	231,586	(1,637)
Advance to employees	(13,108)	11,989
Inventory	203,719	(142,366)
Deferred charges	177,933	(112,085)
Other receivables and prepaid expenses:	(103,466)	146,821
Increase (decrease) in liabilities:		
Accounts payable, trade	(25,254)	(1,527)
Deferred revenue-debit card:	89,567	45,689
Accrued leave payable	11,506	(7,816)
Long-term contracts payable	-	68,827
Other payables and accrued expenses:	(372,170)	248,808
Net cash provided by operating activities:	\$ 4,224,819	\$ 4,243,509

Summary disclosure of noncash items:

During the year ended September 30, 2006, the Corporation transferred \$68,827 from long-term contracts payable to accrued expenses.

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(1) Organization and Summary of Significant Accounting Policies

Organization

The Federated States of Micronesia (FSM) Telecommunications Corporation (the Corporation) is established as a public corporation under the laws of the Federated States of Micronesia, the purpose of which is to provide telecommunications services, except radio and television broadcasting, throughout the FSM and to points outside the FSM. The Corporation began its operations in October 1983 and is a component unit of the Federated States of Micronesia National Government.

Basis of Accounting

Funding was made available under Section 215(a)(2) and Section 215(b)(2) of the Compact of Free Association and through loan funds from the United States Department of Agriculture (USDA) Rural Utilities Service (RUS).

The Corporation operates as a component unit-proprietary fund type of the FSM National Government. A component unit-proprietary fund is used to account for those operations that are financed and operated in a manner similar to private business and where the board decides that the determination of revenues earned, costs incurred and/or net income is necessary for management. Because it is a component unit-proprietary fund, the Corporation uses the accrual basis of accounting. Expenses are recorded by function in order to meet the reporting requirements as imposed by the RUS. 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 Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The Corporation has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

The Corporation maintains a chart of accounts as prescribed by the Uniform System of Accounts for telecommunication companies of the United States Federal Communications Commission's Rules.

The Corporation has adopted GASB Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, as amended by GASB Statement No.'s 37 and 38. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following three net asset categories:

- Invested in capital assets, net of related debt:

Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

Basis of Accounting, Continued

- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require the Corporation to maintain them permanently.
 - Expendable – Net assets whose use by the Corporation is subject to externally imposed stipulations that can be fulfilled by actions of the Corporation pursuant to those stipulations or that expire by the passage of time.

The Corporation has no restricted net assets at September 30, 2006 and 2005.

- Unrestricted:

Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Cash and Cash Equivalents and Time Certificates of Deposit

For the purposes of the statements of net assets and of cash flows, cash and cash equivalents are defined as cash on hand, and cash in bank and time certificates of deposit with original maturities of three months or less from the date of acquisition. Time certificates of deposit with original maturities in excess of three months are separately classified in the statements of net assets. Certificate of deposit investment accounts established and set aside for future capital expenditure projects are classified within investment in securities.

Investments

Investments and related investment earnings are reported at fair value using quoted market prices. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Management 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.

Accounts Receivable

Accounts receivable are due from businesses and individuals located within the FSM. Receivables from international carriers are due from entities within the United States and Japan.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is stated at an amount management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

Allowance for Doubtful Accounts, Continued

evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for uncollectible receivables charged to expenses.

Inventory

Materials and supplies are valued at cost, which approximates market, using the first-in-first-out (FIFO) method.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is based on the straight-line method over the estimated useful lives of the respective assets. During the year ended September 30, 2006, the Corporation reassessed the estimated useful lives of its property, plant and equipment. The effect of this change in accounting estimate was not material to the financial statements.

Capitalization Policy

The Corporation capitalizes buildings, land improvements and equipment that have a cost of \$2,000 or more and an estimated useful life of at least five years.

Plant Under Construction

Plant under construction represents the accumulated costs of unfinished capital projects. These costs are capitalized as property, plant and equipment upon completion of each project.

Valuation of Long-Lived Assets

The Corporation, using its best estimates based on reasonable and supportable assumptions and projections, reviews assets for impairment whenever events or changes in circumstances have indicated that the carrying amount of its assets might not be recoverable. Impaired assets are reported at the lower of cost or fair value. At September 30, 2006 and 2005, no assets had been written down.

Compensated Absences

It is the Corporation's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. No liability is reported for unpaid accumulated sick leave. Vacation pay is accrued when incurred.

Advertising Cost

Advertising costs are charged to operations when incurred.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

Income Taxes

Corporate profits are not subject to income tax in the FSM. The FSM National Government imposes a gross revenue tax of 3% on revenues. The Corporation is specifically exempt from any taxes except import taxes in accordance with its enabling legislation.

Operating and Non-Operating Revenues and Expenses

Operating revenues and expenses generally result directly from the operation and maintenance of telecommunication services, except radio and television broadcastings. Non-operating revenues and expenses result from non-recurring income and costs such as interest and investment gains and losses.

New Accounting Standards

During fiscal year 2006, the Corporation implemented the following pronouncements:

- GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which establishes standards for impairment of capital assets when its serviced utility has declined significantly and unexpectedly.
- GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section, an amendment to NCGA Statement 1*, which improves the understandability and usefulness of statistical section information and adds information from the new financial reporting model for state and local governments required by GASB Statement No. 34.
- GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation (an amendment to GASB Statement No. 34)*, which requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets.
- GASB Statement No. 47, *Accounting for Termination of Benefits*, which establishes guidance for state and local governmental employers on accounting and financial reporting for termination of benefits
- GASB Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefits Expenditures/Expense and Liabilities by Cost-Sharing Employers*, which clarifies the requirements of GASB Statement Nos. 27 and 45 for recognition of pension and other postemployment benefit expenditures/expense and liabilities by cost-sharing employers.

The implementation of these pronouncements did not have a material impact on the accompanying financial statements.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this Statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Corporation.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other post employment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after December 15, 2008. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Corporation.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*. GASB Statement No. 48 establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. The statement also includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. The provisions of this Statement are effective for periods beginning after December 15, 2006. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Corporation.

Reclassification

Certain 2005 balances have been reclassified to conform to the 2006 financial statement presentation.

(2) Investment - IntelSat

In September 1994, the Corporation became a member of the International Telecommunications Satellite organization (IntelSat). The Corporation paid its initial capital investment share of \$910,114 representing a .05% valuation. As of September 30, 2005, the investment was sold for \$1,940,016.

(3) Investment – Island Cable Television

On December 8, 1998, the Corporation acquired a 50% ownership in Island Cable Television - Pohnpei for \$450,000. The Corporation recorded this investment under the equity method of accounting. Goodwill of \$383,062 resulting from the purchase was being amortized over a period of fifteen (15) years. The remaining goodwill balance of \$325,603 as of September 30, 2002 was written-off.

(4) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(4) Deposits and Investments, Continued

The deposit and investment policies of the Corporation are governed by the Board of Directors. As such, the Board of Directors is authorized to delegate certain responsibilities to third parties. Investment managers have discretion to purchase, sell, or hold the specific securities to meet the objectives set forth in the investment policy.

Generally, the Corporation can invest in bonds and other indebtedness of the U.S. and in preferred or common stock of any corporation created or existing under the laws of the U.S. or any U.S. state, territory, or commonwealth. Additionally, a maximum of 20% of the total portfolio may be invested in non-U.S. equities.

A. Deposits

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by the Corporation or its agent in the Corporation's name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Corporation's name; or
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Corporation's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Corporation's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution but not in the Corporation's name. The Corporation does not have a deposit policy for custodial credit risk.

As of September 30, 2006 and 2005, the carrying amount of the Corporation's total cash and cash equivalents and time certificates of deposit were \$2,383,977 and \$1,870,369, respectively, and the corresponding bank balances were \$2,332,980 and \$1,803,167, respectively, all of which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006 and 2005, bank deposits in the amount of \$300,000 were FDIC insured. Accordingly, these deposits are exposed to custodial credit risk. The Corporation does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. The Corporation has not experienced any losses in such accounts and management believes it is not exposed to any significant credit risk on its deposits.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(4) Deposits and Investments, Continued

B. Investments

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

- Category 1 Investments that are insured or registered, or securities held by the Corporation or its agent in the Corporation's name;
- Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Corporation's name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Corporation's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the elements of custodial credit risk in GASB Statement No. 3.

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. With the exception of investments in U.S. government securities, which are explicitly or implicitly guaranteed by the United States government, all other investments must be rated in accordance with the Corporation's investment policy.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Corporation will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. As of September 30, 2006 and 2005, the Corporation's investments are held in the name of the Corporation and are administered by investment managers subject to Securities Investor Protection Corporation insurance in accordance with the Corporation's investment policy. Furthermore, as of September 30, 2006 and 2005, certificates of deposit in the amounts of \$635,873 and \$0, respectively, were FDIC insured.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Corporation's investment policy limits investment maturities to no more than one year to manage its exposure to fair value losses arising from increasing interest rates.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Corporation. As of September 30, 2006 and 2005, there were no investments in any one issuer that exceeded 5% of total investments.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(4) Deposits and Investments, Continued

B. Investments, Continued

As of September 30, 2006 and 2005, investments at fair value are as follows:

	<u>2006</u>	<u>2005</u>
Fixed income:		
U.S. Treasury obligations	\$ 1,165,945	\$ 1,056,316
U.S. Government agencies	821,863	566,039
Corporate bonds	<u>1,755,609</u>	<u>1,924,592</u>
	3,743,417	3,546,947
Other investments:		
Domestic and international equities	8,712,500	8,100,664
Money market funds	641,110	1,211,623
Certificates of deposit	<u>635,873</u>	<u>-</u>
	<u>\$ 13,732,900</u>	<u>\$ 12,859,234</u>

As of September 30, 2006, the Corporation's investments in debt securities were as follows:

	Moody's Credit Rating	Investment Maturities (In Years)				Fair Value
		Less Than 1	1 to 5	6 to 10	Greater Than 10	
U.S. Treasury obligations	Aaa/P-1	\$ -	\$ 825,270	\$ 340,675	\$ -	\$ 1,165,945
U.S. Government agencies	Aaa/P-1	183,225	432,143	206,495	-	821,863
Corporate Notes	A1/P-1	101,930	212,093	-	-	314,023
Corporate Notes	A2/P-1	76,696	264,402	-	-	341,098
Corporate Notes	A3/P-2	126,796	-	-	-	126,796
Corporate Notes	Aaa/P-1	-	98,983	-	-	98,983
Corporate Notes	Aa1/P-1	-	118,268	-	-	118,268
Corporate Notes	Aa2/P-1	-	222,354	-	-	222,354
Corporate Notes	Aa3/P-1	352,755	181,332	-	-	534,087
		<u>\$ 841,402</u>	<u>\$ 2,354,845</u>	<u>\$ 547,170</u>	<u>\$ -</u>	<u>\$ 3,743,417</u>

As of September 30, 2005, the Corporation's investment in debt securities were as follows:

	Moody's Credit Rating	Investment Maturities (In Years)				Fair Value
		Less Than 1	1 to 5	6 to 10	Greater Than 10	
U.S. Treasury obligations	Aaa/P-1	\$ -	\$ 681,987	\$ 374,329	\$ -	\$ 1,056,316
U.S. Government agencies	Aaa/P-1	-	566,039	-	-	566,039
Corporate Notes	A1/P-1	-	307,289	143,561	-	450,850
Corporate Notes	A2/P-1	-	466,381	-	-	466,381
Corporate Notes	A3/P-2	-	128,612	-	-	128,612
Corporate Notes	Aa1/P-1	-	119,178	-	-	119,178
Corporate Notes	Aa2/P-1	76,268	-	-	-	76,268
Corporate Notes	Aa3/P-1	-	446,194	-	-	446,194
Corporate Notes	Aaa/P-1	-	100,096	-	-	100,096
Corporate Notes	Baa3/P-2	137,013	-	-	-	137,013
		<u>\$ 213,281</u>	<u>\$ 2,815,776</u>	<u>\$ 517,890</u>	<u>\$ -</u>	<u>\$ 3,546,947</u>

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(5) Property, Plant and Equipment

Property, plant and equipment, net of accumulated depreciation, as of September 30, 2006 and 2005, is as follows:

	<u>Estimated Useful Lives</u>	<u>Balance October 1, 2005</u>	<u>Additions</u>	<u>Retirements</u>	<u>Balance September 30, 2006</u>
General support	5-35 years	\$ 14,047,752	\$ 1,089,402	\$ (77,332)	\$ 15,059,822
Central office	20 years	10,437,148	79,398	-	10,516,546
Earth station	20 years	5,044,216	81,488	-	5,125,704
Terminal equipment	5-20 years	4,262,385	138,443	-	4,400,828
Cellular network	10-20 years	5,103,086	390,484	-	5,493,570
Internet equipment	8 years	759,026	53	-	759,079
Pole, cable and wiring	15-20 years	<u>33,192,424</u>	<u>456,945</u>	<u>-</u>	<u>33,649,369</u>
Total		72,846,037	2,236,213	(77,332)	75,004,918
Accumulated depreciation		<u>(32,620,142)</u>	<u>(3,285,423)</u>	<u>77,332</u>	<u>(35,828,233)</u>
		40,225,895	(1,049,210)	-	39,176,685
Plant under construction		<u>2,283,576</u>	<u>1,232,118</u>	<u>(1,684,246)</u>	<u>1,831,448</u>
Property, plant and equipment, net		<u>\$ 42,509,471</u>	<u>\$ 182,908</u>	<u>\$ (1,684,246)</u>	<u>\$ 41,008,133</u>
	<u>Estimated Useful Lives</u>	<u>Balance October 1, 2004</u>	<u>Additions</u>	<u>Retirements</u>	<u>Balance September 30, 2005</u>
General support	5-35 years	\$ 13,724,803	\$ 427,219	\$ (104,270)	\$ 14,047,752
Central office	20 years	9,630,526	806,622	-	10,437,148
Earth station	20 years	5,031,016	13,200	-	5,044,216
Terminal equipment	5-20 years	4,083,339	179,046	-	4,262,385
Cellular network	10-20 years	4,357,616	745,470	-	5,103,086
Internet equipment	8 years	635,633	123,393	-	759,026
Pole, cable and wiring	15-20 years	<u>32,514,847</u>	<u>677,577</u>	<u>-</u>	<u>33,192,424</u>
Total		69,977,780	2,972,527	(104,270)	72,846,037
Accumulated depreciation		<u>(29,487,427)</u>	<u>(3,236,985)</u>	<u>104,270</u>	<u>(32,620,142)</u>
		40,490,353	(264,458)	-	40,225,895
Plant under construction		<u>2,208,789</u>	<u>1,743,604</u>	<u>(1,668,817)</u>	<u>2,283,576</u>
Property, plant and equipment, net		<u>\$ 42,699,142</u>	<u>\$ 1,479,146</u>	<u>\$ (1,668,817)</u>	<u>\$ 42,509,471</u>

(6) Capitalized Interest

Interest is capitalized on all construction-in-progress pursuant to FASB 34, *Capitalization of Interest Costs* provided that the construction period exceeds one year. Interest capitalized on qualifying construction-in-progress was \$39,614 and \$28,915 during the years ended September 30, 2006 and 2005, respectively.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(7) Long-term Debt

	<u>2006</u>	<u>2005</u>
Loan payable to Rural Utilities Service (RUS), with a 35 year term, interest at 5%, collateralized by the Corporation's specific ground leases and essentially all other assets. Pursuant to a loan agreement dated August 1, 1990, the Corporation is required to make monthly payments of both principal and interest to RUS.	\$ 24,471,604	\$ 25,235,941
Less: current portion	<u>784,740</u>	<u>746,523</u>
	\$ <u>23,686,864</u>	\$ <u>24,489,418</u>

Future minimum principal and interest payments on notes payable for subsequent years ending September 30, are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 784,740	\$ 1,223,580	\$ 2,008,320
2008	823,977	1,184,343	2,008,320
2009	865,176	1,143,144	2,008,320
2010	908,434	1,099,886	2,008,320
2011	953,856	1,054,464	2,008,320
2012 through 2016	5,534,190	4,507,410	10,041,600
2017 through 2021	7,063,185	2,978,415	10,041,600
2022 through 2026	<u>7,538,046</u>	<u>1,001,666</u>	<u>8,539,712</u>
	\$ <u>24,471,604</u>	\$ <u>14,192,908</u>	\$ <u>38,664,512</u>

A summary of changes in long-term liabilities during fiscal years 2006 and 2005, is as follows:

	<u>Balance</u> <u>October 1, 2005</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance</u> <u>September 30, 2006</u>	<u>Due Within</u> <u>one Year</u>
Note payable to Rural Utilities Service	\$ 25,235,941	\$ -	\$ (764,337)	\$ 24,471,604	\$ 784,740
Long-term contracts	<u>68,827</u>	<u>-</u>	<u>(68,827)</u>	<u>-</u>	<u>-</u>
	\$ <u>25,304,768</u>	\$ <u>-</u>	\$ <u>(833,164)</u>	\$ <u>24,471,604</u>	\$ <u>784,740</u>
	<u>Balance</u> <u>October 1, 2004</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance</u> <u>September 30, 2005</u>	<u>Due Within</u> <u>one Year</u>
Note payable to Rural Utilities Service	\$ 25,963,658	\$ -	\$ (727,717)	\$ 25,235,941	\$ 746,523
Long-term contracts	<u>-</u>	<u>68,827</u>	<u>-</u>	<u>68,827</u>	<u>-</u>
	\$ <u>25,963,658</u>	\$ <u>68,827</u>	\$ <u>(727,717)</u>	\$ <u>25,304,768</u>	\$ <u>746,523</u>

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(8) Commitments and Contingencies

Leases

The Corporation has fifteen operating leases as of September 30, 2006. Seven are residential real estate leases for contract employees, which have a term of one or two years. Three represent leases for satellite stations of Yap, Pohnpei, and Kosrae with thirty-year leases. Three are for land site for three of state offices with 25-35 year terms beginning in 1988 for Pohnpei and Yap and 1990 for Kosrae. One is for a training center and one is for the previous central office on Pohnpei; both for 25 year terms beginning in 1983 for the training center and 1994 for the old central office. The Corporation has also entered into various circuit leases expiring through 2015 and 2025.

The approximate future minimum annual lease payments payable by the Corporation are as follows:

<u>Year ending September 30:</u>	<u>Total</u>
2007	\$ 574,813
2008	551,213
2009	540,113
2010	540,113
2011	540,113
2012-2016	2,143,090
2017-2021	30,225
2022-2025	<u>12,348</u>
	\$ <u>4,932,028</u>

Self Insurance

The Corporation purchases insurance to cover risks associated with its buildings and equipment (\$17,530,500 of coverage) and vehicles (up to \$1 million of coverage and \$500 per vehicle per incident). Additionally, the Corporation purchases fidelity insurance coverage for selected employees (total coverage of \$2,204,000) and workmen's compensation insurance (coverage of up to \$50,000 per employee). The Corporation also purchases general liability insurance in connection with operations (up to \$1 million per occurrence). There have been no significant reductions in coverage, and there have been no settlements in excess of insurance coverage for the past three years. The Corporation does not purchase insurance for its Outside Plant. As most of these items are underground, the Corporation is of the opinion that losses from such, if any, will be minimal. Therefore, the Corporation is self insured for Outside Plant and all other risks not encompassed in the forgoing. Management is of the opinion that no material losses have resulted from this practice.

Construction Commitments

During the year ended September 30, 2006, the Corporation entered into various contracts for construction and expansion of its facilities and services. Approximately \$2,634,849 is outstanding under these contracts as of September 30, 2006.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2006 and 2005

(9) Related Party Transactions

The Corporation's services are provided to its affiliates at the same rates as are charged to third parties. The Corporation is a component unit of the Federated States of Micronesia National Government. As of September 30, 2006, the Corporation has receivables from the FSM National Government of approximately \$315,681 (\$264,470 at September 30, 2005).

(10) Retirement Plan

The Corporation's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees received from the FSM Social Security System. The Plan is a contributory plan in which the Corporation contributes 10 percent of the participant's annual salary, and the participant contributes 3 or more percent from his or her annual salary. Participation is optional. The Corporation's controller is the designated Plan administrator. Contributions to the Plan during the years ended September 30, 2006 and 2005 were \$237,886 and \$230,485, respectively. Management is of the opinion that the plan does not represent an asset or liability of the Corporation. For the years ended September 30, 2006 and 2005, plan assets were \$3,443,200 and \$3,128,162, respectively.

(11) External Carriers

External carriers located in other countries are subject to oversight policies from their respective regulatory agencies. Currently, U.S. regulatory agencies are contemplating a reduction of the tariff rate used by the Corporation for settlement with certain U.S. carriers. The ultimate outcome of this matter and the related impact on FSM Telecommunications Corporation cannot be predicted at this time.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Schedule of Operating Expenses
Years Ended September 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Salaries and wages	\$ 3,523,266	\$ 3,492,107
Depreciation	3,285,423	3,236,985
Circuit lease	1,207,367	1,183,284
Utilities	656,798	618,519
Repairs and maintenance	534,155	362,860
Travel	435,834	346,165
Contractual services	435,686	402,990
Advertising	408,146	318,769
Cost of sales	376,163	285,500
Communications	251,250	260,943
Supplies	120,011	100,844
Professional fees	107,613	42,712
Insurance	72,373	74,886
Petroleum and lubricants	72,199	47,983
ICTV affiliated	61,050	14,933
Import tax expense	56,325	71,243
Rental expenses	44,605	35,042
Representation	38,005	31,922
Freight	34,317	36,453
Publications and printing	26,262	41,880
Training	11,754	-
ICTV taping services	-	40,577
Miscellaneous	<u>318,079</u>	<u>149,618</u>
Total	\$ <u>12,076,681</u>	\$ <u>11,196,215</u>

See Accompanying Independent Auditors' Report.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Chairman
Board of Directors
Federated States of Micronesia
Telecommunications Corporation:

We have audited the financial statements of the Federated States of Micronesia Telecommunications Corporation (the Corporation), as of and for the year ended September 30, 2006, and have issued our report thereon dated December 29, 2006. 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.

Internal Control Over Financial Reporting

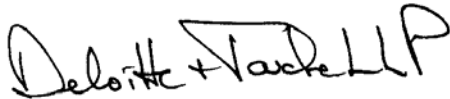
In planning and performing our audit, we considered the Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable 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 caused by error or fraud 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, 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 no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Corporation in a separate letter dated December 29, 2006.

This report is intended solely for the information and use of the Board of Directors and management of the Corporation, federal awarding agencies, the Rural Utilities Service, supplemental lenders, pass-through entities, the cognizant audit and other federal agencies, and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Deloitte + Stark LLP". The signature is written in a cursive, stylized font.

December 29, 2006

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

Chairman
Board of Directors
Federated States of Micronesia
Telecommunications Corporation:

Compliance

We have audited the compliance of the Federated States of Micronesia Telecommunications Corporation (the Corporation) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended September 30, 2006. The Corporation's major federal programs are identified in the summary of auditors' results section of the accompanying Schedule of Findings and Questioned Costs (page 27). Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Corporation's management. Our responsibility is to express an opinion on the Corporation's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Corporation's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Corporation's compliance with those requirements.

In our opinion, the Corporation complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2006.

Internal Control Over Compliance

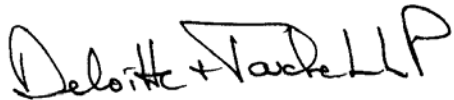
The management of the Corporation is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Corporation's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable 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 noncompliance caused by error or fraud with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control on compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of the Federated States of Micronesia Telecommunications Corporation (the Corporation) as of and for the year ended September 30, 2006, and have issued our report thereon dated December 29, 2006. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards (page 27) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of the Corporation. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects when considered in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the Board of Directors and management of the Corporation, federal awarding agencies, the Rural Utilities Service, supplemental lenders, pass-through entities, the cognizant audit and other federal agencies, and is not intended to be and should not be used by anyone other than those specified parties.

A handwritten signature in black ink that reads "Deloitte + Tatchell LLP". The signature is written in a cursive, stylized font.

December 29, 2006

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Schedule of Expenditures of Federal Awards
Schedule of Contracts
Rural Utilities Service Loan Funding (CFDA #10.851)
Year Ended September 30, 2006

	Loan Proceeds Approved as of <u>September 30, 2006</u>	Loan Proceeds Received During <u>FY 2006</u>	Total Disbursements On Contracts During <u>FY2006</u>
F/A 1	\$ 411,584	\$ -	\$ -
Work Orders	422,905	-	-
CT. A-4	90,688	-	-
CT. A-5	1,191,004	-	-
CT. A-6	650,676	-	-
CT. A-7	3,108,615	-	-
CT. A-8	3,500,000	-	-
CT. A-9	1,108,149	-	-
CT. A-10	636,505	-	-
CT. A-11	1,193,317	-	-
CT. A-12	1,422,800	-	-
CT. A-13	19,440,795	-	-
CT. A-14X	1,988,002	-	-
CT. A-1E	275,625	-	-
CT. A-2E	4,008,263	-	-
CT. A-3A	304,109	-	-
Operating equipment	387,263	-	-
Pre-Loan	<u>55,000</u>	<u>-</u>	-
	<u>\$ 40,195,300</u>		
Excess of Disbursements over Proceeds		\$ -	
Unused Loan Funds as of September 30, 2006		\$ -	
Interest earned on RUS account net of miscellaneous bank charges		<u>-</u>	
Unused Loan Funds as of September 30, 2006		<u><u>-</u></u>	

The above loan program is received in a direct capacity from the grantor. In addition, the loan payable to Rural Utilities Service, totaling \$24,471,604 at September 30, 2006, was tested for detailed compliance in accordance with OMB Circular A-133 requirements.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Schedule of Findings and Questioned Costs
Year Ended September 30, 2006

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the basic financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were not identified.
3. No instance of noncompliance considered material to the basic financial statements was disclosed by the audit.
4. Reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were not identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. The Corporation's major programs were:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
Rural Utilities Service	10.851

8. A threshold of \$734,148 was used to distinguish between Type A and Type B programs.
9. The Organization did qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

Part II - Financial Statement Findings Section

No matters are reportable.

Part III - Federal Award Findings and Questioned Cost Section

No matters are reportable.