

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2006 AND 2005

INDEPENDENT AUDITORS' REPORT

Board of Directors
Pohnpei State Housing Authority:

We have audited the accompanying special-purpose statements of net assets of the Pohnpei State Housing Authority (the Authority), a component unit of Pohnpei State Government, as of September 30, 2006 and 2005, and the related special-purpose statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

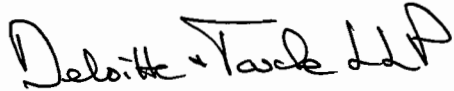
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan 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 Authority'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 reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of allowing the preparation of the government-wide financial statements of the State of Pohnpei as of and for the year ended September 30, 2006 and are not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America. This report is intended solely for the use of the Authority and the State of Pohnpei for the purpose set forth in the preceding sentence and should not be used for any other purpose.

In our opinion, such special-purpose financial statements present fairly, in all material respects, the financial position of the Pohnpei State Housing Authority as of September 30, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended, on the basis of accounting described in Notes 1 and 3.

The Management's Discussion and Analysis (MD&A) on pages 3 through 6 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). This supplementary information is the responsibility of the Authority's management. We did not audit, and do not express an opinion on, such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. As a result of these limited procedures, we believe that the MD&A is not in conformity with guidelines established by GASB as we did not audit the 2004 financial statements of the Authority and such were not audited and are neither provided nor discussed in the accompanying MD&A.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 21, 2007, on our consideration of the Authority's internal control over financial reporting and on 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 read in conjunction with this report in considering the results of our audit.

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

August 21, 2007

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Management Discussion and Analysis
September 30, 2006 and 2005

Our discussion and analysis of the Pohnpei State Housing Authority's financial performance provides an overview of the authority's financial activities for the fiscal year ended September 30, 2006 and 2005. Please read it in conjunction with the Authority's financial statements, which follows this section.

Financial Highlights

- For fiscal year ended September 30, 2006, the Authority's total operating revenues from interest and fees on loans increased by \$6,069 or 4.46% from prior year.
- During the year, the Authority's total operating expenses decreased by \$372,664 or 66.67% from prior year.
- For fiscal year 2006, the Authority collected an aggregate amount of \$142,105 representing the actual interest paid by customers on their loans. The Authority is unable to predict when loans are to be paid; thus, the Authority has effectively recognized interest income received in cash.

Overview of the Financial Statements

The financial statements presented herein include all of the activities of the Housing Authority. Included in this report are the statement of net assets and the statement of revenues, expenses, and changes in net assets. These financial statements present the complete financial picture of the Authority from the economic measurement focus using the accrual basis of accounting, except with respect to the accounting for interest income, which is accounted for on a cash basis. It can be read from these statements whether the Authority is capable to fund additional loans.

The Authority operates on an annual budget appropriated by the Legislature, which is accounted for by the Pohnpei State Department of Treasury.

Financial Analysis

Net Assets

The statement of net assets presents the financial position or condition of the Authority and it shows the information on all of the authority's assets and liabilities, with the difference between the two reported as net assets. This financial statement communicates the lending ability of the Authority through the turn over of its receivables. The passage of time and/or increases or decreases in net assets may serve as a usual indicator whether the financial position of the Authority is improving or deteriorating.

The following table summarizes the changes in net assets for FY2006 and FY2005.

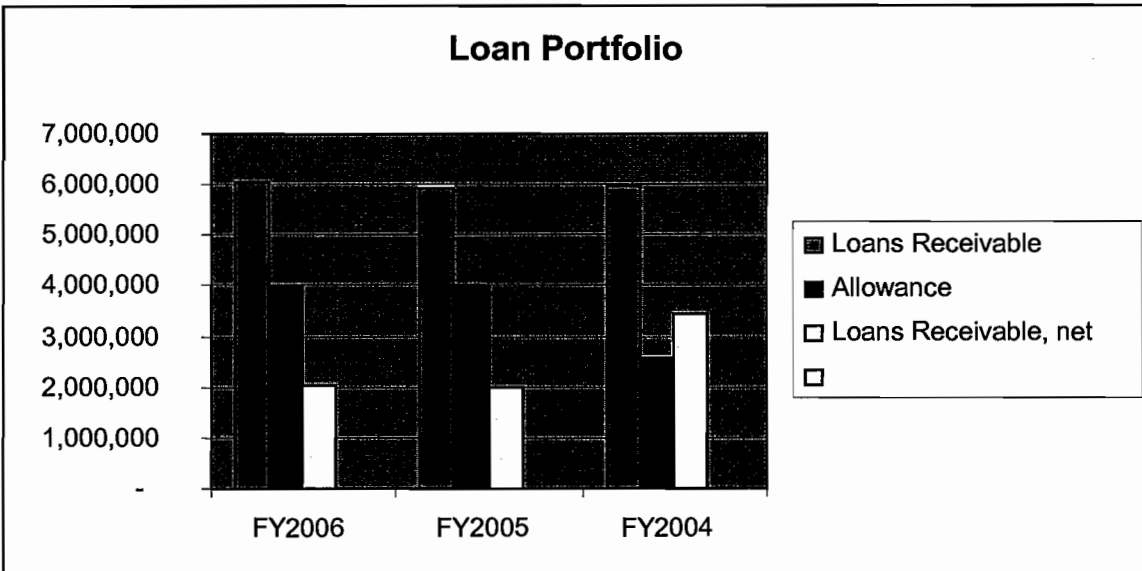
**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Management Discussion and Analysis
September 30, 2006 and 2005

	2006	2005
Current assets	\$ 2,231,410	\$ 2,137,364
Capital assets, net	9,364	14,784
Total assets	2,240,774	2,152,148
Current liabilities	11,847	882
Net Assets		
Invested in capital assets	9,364	14,784
Restricted	2,219,563	2,136,482
Total net assets	\$ 2,228,927	\$ 2,151,266

Total net assets increased by \$77,661 or 3.61% during fiscal year 2006 compared with the prior year. Current assets increased by \$94,046 or 4.40% while capital assets decreased by \$ 5,420 or 36.66% and total liabilities increased by \$10,965.

Follows is a graphical presentation showing the 3-year trend loan portfolio for PSHA:



**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Management Discussion and Analysis
September 30, 2006 and 2005

Changes in Net Assets

The statement of revenues, expenses, and changes in net assets shows the results of operation of the Authority. It reports the revenues earned and expenses incurred and it indicates the effect on the net assets of the Authority.

For the years ended September 30, 2006 and 2005, net assets of the Authority changed as follows:

	<u>2006</u>	<u>2005</u>
Operating Revenues:		
Interest and fees on loans	\$ 142,105	\$ 136,036
Other	31,003	68,168
	<u>173,108</u>	<u>204,204</u>
Operating Expenses:		
Salaries	87,249	94,666
Contractual services	40,312	36,374
Bad debts	31,370	380,047
Depreciation	7,714	13,537
Supplies and materials	5,226	6,390
Transportation and travel	-	7,268
Utilities	4,941	1,848
Repairs and maintenance	2,802	4,011
Miscellaneous and others	6,745	14,882
Total operating expenses	<u>186,359</u>	<u>559,023</u>
Loss from operations	(13,251)	(354,819)
Non-operating revenues:		
Operating subsidy from primary government	<u>90,212</u>	<u>99,017</u>
Increase (decrease) in net assets	<u>\$ 77,661</u>	<u>\$ (255,802)</u>

The result of the Authority's operations for the year ended September 30, 2006 is a favorable variation in the change in net assets of \$333,463 or an increase of 130.36% from the prior year.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Management Discussion and Analysis
September 30, 2006 and 2005

Contacting the PSHA's Financial Management

This Management's Discussion and Analysis is designed to provide our citizens, taxpayers, customers, creditors, and other interested parties, with a general overview of the Pohnpei State Housing Authority's finances and to demonstrate PSHA's accountability for the appropriations it receives. Questions concerning any of the information provided in this discussion and analysis or requests for additional information should be addressed to the Executive Director, Pohnpei State Housing Authority P.O. Box 1109 Kolonia, Pohnpei, FM 96941, or call (691) 320-4225 or (691) 320-1906.

POHNPEI STATE HOUSING AUTHORITY

Statements of Net Assets
September 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
<u>ASSETS</u>		
Cash	\$ 49,232	\$ 23,224
Employee advances, net of an allowance for doubtful accounts of \$114,018 in 2006 and \$109,127 in 2005	100,127	105,713
Due from primary government	38,207	26,338
Loans receivable, net	2,043,729	1,981,964
Inventory	115	125
Property and equipment, net	<u>9,364</u>	<u>14,784</u>
	<u>\$ 2,240,774</u>	<u>\$ 2,152,148</u>
 <u>LIABILITIES AND NET ASSETS</u>		
Liabilities:		
Accrued liabilities	\$ <u>11,847</u>	\$ <u>882</u>
Total liabilities	<u>11,847</u>	<u>882</u>
Commitments and contingencies		
Net assets:		
Invested in capital assets	9,364	14,784
Restricted	<u>2,219,563</u>	<u>2,136,482</u>
Total net assets	<u>2,228,927</u>	<u>2,151,266</u>
	<u>\$ 2,240,774</u>	<u>\$ 2,152,148</u>

See accompanying notes to financial statements.

POHNPEI STATE HOUSING AUTHORITY

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

	<u>2006</u>	<u>2005</u>
Operating revenues:		
Interest and fees on loans	\$ 142,105	\$ 136,036
Other	<u>31,003</u>	<u>68,168</u>
	<u>173,108</u>	<u>204,204</u>
Operating expenses:		
Provision for loan losses	31,370	380,047
Salaries	87,249	94,666
Contractual services	40,312	36,374
Depreciation	7,714	13,537
Supplies and materials	5,226	6,390
Utilities	4,941	1,848
Repairs and maintenance	2,802	4,011
Communication	765	6,280
Transportation and travel	-	7,268
Miscellaneous and others	<u>5,980</u>	<u>8,602</u>
Total operating expenses	<u>186,359</u>	<u>559,023</u>
Operating loss	<u>(13,251)</u>	<u>(354,819)</u>
Nonoperating revenues:		
Operating subsidy from primary government	<u>90,912</u>	<u>99,017</u>
Net earnings (loss)	77,661	(255,802)
Total net assets at beginning of year	<u>2,151,266</u>	<u>2,407,068</u>
Total net assets at end of year	<u>\$ 2,228,927</u>	<u>\$ 2,151,266</u>

See accompanying notes to financial statements.

POHNPEI STATE HOUSING AUTHORITY

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

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Cash received from customers	\$ 173,108	\$ 204,204
Cash paid to suppliers for goods and services	(44,160)	(102,387)
Cash paid to employees	<u>(86,554)</u>	<u>(94,666)</u>
Net cash provided by operating activities	<u>42,394</u>	<u>7,151</u>
Cash flows from noncapital activities:		
Operating subsidy received from primary government	<u>79,043</u>	<u>99,017</u>
Cash flows from capital and related activities:		
Acquisition of fixed assets	<u>(2,294)</u>	<u>(4,629)</u>
Cash flows from investing activities:		
Net change in loans receivable	(93,135)	(69,781)
Reduction of bank overdraft	<u>-</u>	<u>(8,534)</u>
Net cash used in operating activities	<u>(93,135)</u>	<u>(78,315)</u>
Net increase in cash	26,008	23,224
Cash at beginning of year	<u>23,224</u>	<u>-</u>
Cash at end of year	<u>\$ 49,232</u>	<u>\$ 23,224</u>
Cash flows from operating activities:		
Operating loss	\$ (13,251)	\$ (354,819)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Provision for loan losses	31,370	380,047
Bad debt expense	4,891	-
Depreciation	7,714	13,537
(Increase) decrease in assets:		
Advances	695	(5,754)
Inventory	10	1,464
Increase (decrease) in liabilities:		
Accounts payable	<u>10,965</u>	<u>(27,324)</u>
Net cash provided by operating activities	<u>\$ 42,394</u>	<u>\$ 7,151</u>

See accompanying notes to financial statements.

POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)

Notes to Financial Statements
September 30, 2006 and 2005

(1) Organization and Summary of Significant Accounting Policies

Organization

The Pohnpei State Housing Authority (the Authority) was established in 1988 by Pohnpei State Public Law 2L-81-88. The purpose of the Authority is to facilitate, through low-interest loans, the construction of safe and sanitary residential housing for low income families of Pohnpei State. Additionally, the Authority monitors Housing Preservation Grant (HPG) loan funds extended by the United States Department of Agriculture through the Rural Services.

The affairs of the Authority are managed by a five-member Board of Directors, consisting of representatives of the Pohnpei State Government appointed by the Governor to four-year terms. Daily operation of the Authority is delegated to an executive director, who is also appointed by the Governor and serves at the pleasure of the Board.

The Authority's financial statements are incorporated into the financial statements of the Pohnpei State Government as a component unit.

Basis of Accounting

The accounting policies of the Authority 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 Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The Authority has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

GASB issued Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Note Disclosures*. These statements establish financial reporting standards for governmental entities which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements.

To conform to the requirements of GASB Statement 34, retained earnings are presented in the following net asset categories:

- Investment in capital assets; capital assets, net of accumulated depreciation, plus construction or improvement of those assets.
- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require the Authority to maintain them permanently.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Notes to Financial Statements
September 30, 2006 and 2005

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

Basis of Accounting, Continued

- Expendable – Net assets whose use by the Authority is subject to externally imposed stipulations that can be fulfilled by actions of the Authority pursuant to those stipulations or that expire by the passage of time.
- Unrestricted; net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

All of the Authority assets are restricted for loan programs.

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 statements of net assets. Proprietary fund operating statements present increases and decreases in net 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. The Authority considers interest income and costs that are directly related to lending operations to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

The Authority currently recognizes interest income on a cash basis. This policy varies with accounting principles generally accepted in the United States of America (GAAP). The accompanying financial statements have been prepared to enable the State of Pohnpei to meet its financial reporting responsibilities. Therefore, the accompanying financial statements do not necessarily portray the Authority's financial position and result of operations under GAAP.

Net Assets

Net assets represent the residual interest in the Authority's assets after liabilities are deducted and consist of three sections: invested in capital assets, net of related debt; restricted and unrestricted. Net assets classified as invested in capital assets net of debt, include capital assets, restricted and unrestricted, net of accumulated depreciation and reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation. The Authority's restricted assets are expendable. All other net assets are unrestricted.

Budget

The Authority operates on an annual budget appropriated by the Legislature which is accounted for by the Pohnpei State Department of Treasury. Appropriation Acts require that funds be administered in accordance with the provisions of the Financial Management Act. The enabling legislation does provide the Authority the power to expend revenues generated by projects maintained by the Authority. Such expenditures must, however, be in accordance with the provisions of the Financial Management Act and other applicable laws and regulations.

POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)

Notes to Financial Statements
September 30, 2006 and 2005

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

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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash

Custodial credit risk is the risk that in the event of a bank failure, the Authority'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 or held by the pledging financial institution but not in the depositor-government's name. The Authority does not have a deposit policy for custodial credit risk.

For the purposes of the statements of net assets and cash flows, cash is defined as cash in checking accounts, savings accounts and cash on hand. As of September 30, 2006 and 2005, cash was \$49,232 and \$23,224, respectively, which approximated corresponding bank balances maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006 and 2005, bank deposits were fully FDIC insured.

Property and Equipment

Property and equipment are stated at cost. Depreciation of property and equipment is calculated using the straight-line method over the estimated useful lives of the respective assets. Lives of property and equipment range from three to ten years.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefit accrues to employees. No liability is recorded for nonvesting accumulating rights to receive sick leave pay benefits. The related sick leave pay expense is recorded when the benefit is actually taken.

New Accounting Standards

During fiscal year 2006, the Authority 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.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Notes to Financial Statements
September 30, 2006 and 2005

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

New Accounting Standards, Continued

- 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*, which 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 Authority.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which 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 Authority.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, which establishes uniform financial reporting for these types of revenues. 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 Authority.

(2) Due From Primary Government

Due from primary government represents the accumulation of the unobligated portion of the State's annual operating subsidy, which under the Authority's enabling legislation (Pohnpei State Public Law 5-37) is to be transferred to the Authority's loan fund.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Notes to Financial Statements
September 30, 2006 and 2005

(3) Loans Receivable

The Authority's loan portfolio is comprised of two loan funds, Pohnpei State Housing Authority (PSHA) loan fund and the Housing Preservation Grant (HPG) loan fund.

The PSHA loans derive from the capital contributions of Compact of Free Association Capital Account Funds - Capital Projects by Pohnpei State to fund the Housing Development Loan Fund. The HPG loans are from a grant extended by the United States Department of Agriculture through the Rural Services Office. Loans are stated at face value, net of an allowance for loan losses. The allowance represents an amount which, in management's judgment, will be adequate to absorb possible losses on existing loans that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectibility of loans. The allowance for loan losses are reported based on certain assumptions pertaining to the Authority's periodic review and evaluation of the loan portfolio, which is subject to change. Due to uncertainties inherent in the estimations and assumptions process, it is at least reasonably possible that changes in the estimates and assumptions in the near term would be material to the financial statements. A summary of loans receivable as of September 30, 2006, is presented below:

	<u>2006</u>	<u>2005</u>
Pohnpei State Housing Authority Loans	\$ 5,707,742	\$ 5,642,202
HPG Loans	<u>322,980</u>	<u>295,415</u>
	6,030,722	5,937,617
Less allowance for loan losses	<u>(3,986,993)</u>	<u>(3,955,653)</u>
Loans receivable, net	\$ <u>2,043,729</u>	\$ <u>1,981,964</u>

All loans are at fixed rates (substantially 4.5%) and the loan terms range from 3 to 25 years.

Future maturities of loans receivable, due to existing nonrepayment cases, will not represent predictive information and therefore, such is not presented.

Additionally, given the inability to predict non-repayment cases, the Authority essentially recognizes interest income as received. The Authority does not believe that the amount of accrued interest at each balance sheet date accruable is material. However, cash basis recognition of interest income does not conform to accounting principles generally accepted in the United States of America.

(4) Property and Equipment

Capital asset activity for the years ended September 30, 2006 and 2005, was as follows:

	2006			
<u>Estimated Useful Life</u>	<u>Balance at October 1, 2005</u>	<u>Additions</u>	<u>Deletions</u>	<u>Balance at September 30, 2006</u>
Building	\$ 26,061	\$ -	\$ -	\$ 26,061
Machinery and equipment	154,920	-	-	154,920
Machinery and equipment	<u>3,415</u>	<u>2,294</u>	<u>-</u>	<u>5,709</u>
	184,396	2,294	-	186,690
Less accumulated depreciation	<u>(169,612)</u>	<u>(7,714)</u>	<u>-</u>	<u>(177,326)</u>
Property and equipment	\$ <u>14,784</u>	\$ <u>(5,420)</u>	\$ <u>-</u>	\$ <u>9,364</u>

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Notes to Financial Statements
September 30, 2006 and 2005

(4) Property and Equipment, Continued

		2005			
	<u>Estimated Useful Life</u>	<u>Balance at October 1, 2004</u>	<u>Additions</u>	<u>Deletions</u>	<u>Balance at September 30, 2005</u>
Building	10 years	\$ 26,061	\$ -	\$ -	\$ 26,061
Machinery and equipment	3-5 year	150,291	4,629	-	154,920
Machinery and equipment	2 years	<u>3,415</u>	<u>-</u>	<u>-</u>	<u>3,415</u>
		179,767	4,629	-	184,396
Less accumulated depreciation		<u>(156,075)</u>	<u>13,537</u>	<u>-</u>	<u>(169,612)</u>
Property and equipment		<u>\$ 23,692</u>	<u>\$ (8,908)</u>	<u>\$ -</u>	<u>\$ 14,784</u>

(5) Commitments and Contingencies

Loan Commitments

The Authority has loan commitments to borrowers aggregating \$74,550 as of September 30, 2006. These loan commitments represent the remaining balances of approved loans for borrower housing projects.

Federal Program Questioned Costs

The Authority is a subrecipient of U.S. Federally assisted programs subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Currently, \$184,842 in questioned costs exist for fiscal year 1993 through 2006 grants. If these questioned costs are ultimately disallowed, the Authority may bear responsibility for absorbing the amount disallowed. No provision for any liability that may result from this matter has been recorded in the accompanying financial statements.

(6) Risk Management

The Authority carries life insurance. The Authority is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

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

Chairman
Board of Directors
Pohnpei State Housing Authority:

We have audited the special-purpose financial statements of the Pohnpei State Housing Authority (the Authority), as of and for the year ended September 30, 2006, and have issued our report thereon dated August 21, 2007, which report indicates that interest income is essentially recognized on a cash basis. 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 Authority'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. However, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Authority's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs (pages 21 to 26) as items 06-1 through 06-5.

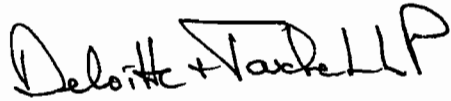
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered material weaknesses. However, we consider all of the reportable conditions described above to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority'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 or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Authority in a separate letter dated August 21, 2007.

This report is intended solely for the information and use of the Board of Directors and management of PSHA, 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 + Tatchell LLP". The signature is written in a cursive, slightly stylized font.

August 21, 2007

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
Pohnpei State Housing Authority:

Compliance

We have audited the compliance of the Pohnpei State Housing Authority (the Authority) 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 Authority's major federal programs are identified in the summary of auditors' results section of the accompanying Schedule of Findings and Questioned Costs (page 21). Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Authority's management. Our responsibility is to express an opinion on the Authority'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 Authority'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 Authority's compliance with those requirements.

In our opinion, the Authority 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

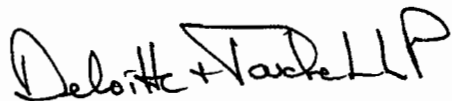
The management of the Authority is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Authority's internal control 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 with applicable requirements of laws, regulations, contracts, and grants caused by error or fraud 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 special-purpose financial statements of the Authority as of and for the year ended September 30, 2006, and have issued our report thereon dated August 21, 2007, which report indicates that interest income is essentially recognized on a cash basis. Our audit was performed for the purpose of forming an opinion on the special-purpose financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards (page 20) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the special-purpose financial statements. This schedule is the responsibility of the management of the Authority. Such information has been subjected to the auditing procedures applied in our audit of the special-purpose financial statements and, in our opinion, is fairly stated, in all material respects when considered in relation to the special-purpose 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 Authority, federal awarding agencies, 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 + Touche LLP". The signature is written in a cursive, stylized font.

August 21, 2007

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2006

<u>Grant Title</u>	<u>Grantor Agency</u>	<u>CFDA No.</u>	<u>Amount</u>
Compact of Free Association: Capital Accounts Funds - Capital Projects, Section 211 (A)	U.S. Department of the Interior – OIA	15.875	\$ <u>5,707,742</u>
Rural Services: Housing Preservation Grant	U.S. Department of Agriculture	10.433	\$ <u>322,980</u>

Note: The Compact of Free Association funds are disbursed through the U.S. Department of the Interior (DOI), Office of Insular Affairs (OIA), to the FSM National Government which reallots such to the component States. Pohnpei State subsequently passed certain of these funds through the Pohnpei State Housing Authority. The Housing Preservation Grant Funds are received in a subgrantee capacity through the Rural Services to the Pohnpei State Government. Therefore, all of the above funding has been received in a subrecipient capacity.

The above represents funding for loan portfolios carried on the Authority's books. No cash receipts attendant to these portfolios was received from grantor agencies during the year ended September 30, 2006.

The Schedule of Expenditures of Federal Awards is prepared on the accrual basis of accounting.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the special-purpose financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were identified, some of which are considered to be material weaknesses.
3. No instances of noncompliance considered material to the financial statements were disclosed by the audit.
4. No reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were 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 Organization's major programs were:

<u>Name of Federal Program</u>	<u>CFDA Number</u>
Housing Preservation Grant	10.433
Compact of Free Association	15.875

8. The Authority did not administer Type B programs during the year ended September 30, 2006, as that term is defined in OMB Circular A-133.
9. The Authority did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

Part II – Federal Award Findings and Questioned Cost Section

No matters are reportable.

Part III – Financial Statement Findings Section

<u>Reference Number</u>	<u>Finding</u>
2006-01	Accrued Interest
2006-02	Accounting Period
2006-03	Loan Portfolio Maintenance
2006-04	Employee Advances
2006-05	Loan Receivable Documentation

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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

Finding 2006-01 - Accrued Interest

Criteria: Accounting principles generally accepted in the United States of America require that income be recorded when earned.

Condition: Based on past accounting problems and an inability to predict the frequency of loan payments, the Authority recognizes interest income on a cash basis.

Cause: There appears to be a lack of data that allows the Authority to predict the collectibility of accrued interest.

Effect: The financial statements could be materially misstated due to this condition.

Recommendation: We recommend that the accounting division work to obtaining sufficient information to be able to accrue interest as of each period end.

Auditee Response: The Authority is calculating interest on loans manually at the end of each month based on the declining balance method. The accounting division exerts more effort to be able to determine and accrue interest as of each period end.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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

Finding 2006-02 - Accrual Accounting

Criteria: Expenses should be recorded when incurred.

Condition: The Authority has recorded expenses substantially on a cash basis.

Cause: Given past accounting problems experienced by the Authority, the Authority converts to an accrual basis only at year end.

Effect: The financial statements could be materially misstated due to this condition.

Recommendation: We recommend that the accounting division work to recording expenses on the accrual basis of accounting.

Auditee Response: We agree with your recommendation. Currently, the accounting division records all the Authority's expenses when incurred.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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

Finding 2006-3 - Loan Portfolio Maintenance

Criteria: The loan portfolio should be accounted for in an appropriate manner in accordance with the Authority's policies.

Condition: The Authority utilizes a manual accounting system that does not appear to have changed in recent years and also appears to be inadequate for the Authority's requirements. For example, due to inadequate accounting systems, loan principal balances contain both principal and unpaid interest. Statements are rarely provided borrowers and interest continues to be accrued, even if the balance is seriously delinquent. However, such interest is not recognized in the financial statements until collected in cash.

Additionally, loan enforcement procedures appear virtually non-existent. It does not appear as if loan foreclosures occur, a policy that may contravene grant requirements. Additionally, the non-enforcement of loan criteria and repayment appear to have a negative effect on the Authority's cash flows. Management of the Authority is tasked with forming an allowance for doubtful accounts on the financial statements. Given the lack of enforcement, it appears that the loan reserve should be evaluated by management and the reserve may increase in line with delinquent accounts. Management has not fully addressed this matter and has left the allowance to a year end audit consideration.

Cause: The cause of the condition appears to be a historical lack of concern exhibited by prior Authority management with achieving correct levels of financial reporting.

Effect: The effect of the condition is that the Authority must undertake additional corrective action to achieve an adequate level of loan portfolio maintenance.

Recommendation: Given the state of the Authority's accounting, we recommend consideration of acquiring adequate loan software or contracting with a financial institution to maintain the loan portfolio.

We additionally recommend that the Board of Directors review existing policy with respect to loan limits, loan documents required and loan enforcement and determine if existing policies should be modified, since frequent noncompliance has occurred with these policies in the past.

Auditee Response: We agree with your recommendation. The Authority will make sure that adequate loan software be obtained to properly maintain our loan portfolio.

The Board of Directors and the management currently contracted an individual to installed a loan base program to maintain our loan portfolio.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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

Finding 2006-4 – Employee Advances

Criteria: Employee advances should be promptly collected.

Condition: The Authority has some \$214,000 outstanding as advances as of September 30, 2006 and has provided a reserve of \$114,018. The advances arose in prior years. The amounts have not been timely collected. While the Authority appears to have discontinued the practice of making such advances, the Authority does not appear to have exercised all legal capabilities of attempting to obtain repayments of the advances. Therefore, the allowance provided of \$114,018 for these receivables is required.

Cause: The cause of this condition is actions by management in prior years.

Effect: The effect of this condition is that the Authority has limited funds for lending purposes.

Recommendation: The Authority should take all legal means to ensure recovery of these advances.

Auditee Response: The current board and management had totally ceased the lending of cash to employees.

Employees who are still on board are allotting payment to their cash advances on a bi-weekly basis. The Authority is currently working with the AG's office on the collection procedures to be done for those individuals who are no longer working for the Authority.

**POHNPEI STATE HOUSING AUTHORITY
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

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

Finding 2006-5 - Loan Receivable Documentation

Criteria: A recordkeeping system should be established to ensure that accounting records are retained for the time period required by applicable laws and regulation.

Condition: For 9 of 93 (10%) transactions tested, the Authority was not able to provide the official receipts and bank validated deposit slips.

For 13 of 93 (14%) transactions tested, the Authority was not able to provide the applicable loan agreement.

For 54 of 93 (58%) transactions tested, the Authority was not able to provide the collection report and/or the employer's allotment report.

Cause: Internal controls over recordkeeping appear to be weak.

Effect: This condition has no known material effect on the financial statements. However, there is a risk that cash collections could be misappropriated due to absence of official receipts and bank validated deposit slips.

Recommendation: We recommend that the Authority exercise more stringent document policies to prevent the disappearance of necessary supporting documents.

Auditee Response:

Condition (a): The Authority had provided all official receipts and bank validated deposit slips requested by the auditor.

Condition (b): The Authority had provided all loan agreements and other documents for the PSHA regular loans which have been requested by the auditor. However, in the case of the Low Cost Housing loans, only promissory note agreements are being maintained on file and the mortgage agreements are written in Pohnpeian language.

Condition (c): The recommendation is well noted. The Authority will do its best and make sure that collection reports and all documents are in place. The accounting and loan division are carefully keeping records to resolve the above findings.

POHNPEI STATE HOUSING AUTHORITY

**Schedule of Unresolved Prior Year Questioned Costs
Year Ended September 30, 2006**

The following is a summary of questioned costs noted and prior year unresolved federal questioned costs for the Pohnpei State Housing Authority:

	<u>Questioned Costs Set Forth in 2005 Audit Report</u>	<u>Questioned Costs Resolved in Fiscal Year 2006</u>	<u>Questioned Costs at September 30, 2006</u>
	\$ 184,842	\$ -	\$ 184,842
Questioned Costs per the 2006 Audit Report	-	-	<u>-</u>
			\$ <u>184,842</u>