

YAP STATE PUBLIC SERVICE CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

SEPTEMBER 30, 2006 AND 2005

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Yap State Public Service Corporation:

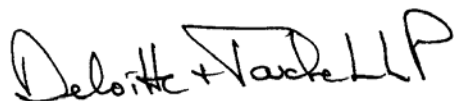
We have audited the accompanying statements of net assets of the Yap State Public Service Corporation, a component unit of Yap State Government, as of September 30, 2006 and 2005, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Yap State Public Service 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, such financial statements present fairly, in all material respects, the financial position of Yap State Public Service Corporation as of September 30, 2006 and 2005, and the changes in its 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 1-5 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 Yap State Public Service Corporation's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2006, on our consideration of the Yap State Public Service 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 read in conjunction with this report in considering the results of our audit.



November 30, 2006

YAP STATE PUBLIC SERVICE CORPORATION

Management's Discussion and Analysis Years Ended September 30, 2006 and 2005

The following Management's Discussion and Analysis of the Yap State Public Service Corporation's (YSPSC) activities and financial performance provides the reader with an introduction and overview to the financial statements for the fiscal 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.

GASB 34 of the U.S. Government Accounting Standards Boards requires that published financial statements must contain a management discussion and analysis. This section of YSPSC's annual report presents our discussion of YSPSC's performance for the years ended September 30, 2006, 2005 and 2004. It should be read in conjunction with financial statements that follow this section.

The following table summarizes the financial condition and operations of YSPSC as of 2006, 2005 and 2004.

ASSETS	<u>2006</u>	<u>2005</u>	<u>2004</u>
Plant in service, net	\$ 9,213,120	\$ 9,563,555	\$ 9,935,836
Work in progress, capital projects	74,890	133,905	388,075
Current and other assets	<u>2,054,301</u>	<u>1,581,330</u>	<u>1,516,549</u>
Total assets	<u>\$ 11,342,311</u>	<u>\$ 11,278,790</u>	<u>\$ 11,840,460</u>
 NET ASSETS AND LIABILITIES			
Invested in capital assets, net of related debt	\$ 6,294,943	\$ 6,640,825	\$ 7,205,204
Restricted	121,443	121,443	277,769
Unrestricted	<u>1,362,169</u>	<u>1,114,334</u>	<u>750,041</u>
Total net assets	<u>7,778,555</u>	<u>7,876,602</u>	<u>8,233,014</u>
Notes payable, net of current portion	2,905,255	2,993,067	3,056,635
Current portion of notes payable	87,812	63,568	62,072
Other current liabilities	<u>570,689</u>	<u>345,553</u>	<u>488,739</u>
Total liabilities	<u>3,563,756</u>	<u>3,402,188</u>	<u>3,607,446</u>
Total net assets and liabilities	<u>\$ 11,342,311</u>	<u>\$ 11,278,790</u>	<u>\$ 11,840,460</u>
 REVENUES, EXPENSES, AND NET ASSETS			
Operating revenues	\$ 4,492,869	\$ 3,549,637	\$ 2,945,230
Operating expenses	<u>4,693,241</u>	<u>4,273,002</u>	<u>3,959,790</u>
Loss from operations	(200,372)	(723,365)	(1,014,560)
Grants	24,017	-	25,000
FEMA proceeds in excess of typhoon expenses	54,061	150,423	209,675
Interest expense	(17,143)	(18,638)	(20,092)
Interest income	3,022	3,475	6,503
Gain on disposal of utility plant	1,282	79	100
Other income/expense	<u>37,086</u>	<u>(2,568)</u>	<u>5,529</u>
Net loss before cumulative effect of a change in Accounting principles	(98,047)	(590,594)	(787,845)
Cumulative effect of a change in accounting principle	<u>-</u>	<u>234,182</u>	<u>-</u>
Net loss	(98,047)	(356,412)	(787,845)
Net assets, beginning	<u>7,876,602</u>	<u>8,233,014</u>	<u>9,020,859</u>
Net assets, ending	<u>\$ 7,778,555</u>	<u>\$ 7,876,602</u>	<u>\$ 8,233,014</u>

YAP STATE PUBLIC SERVICE CORPORATION

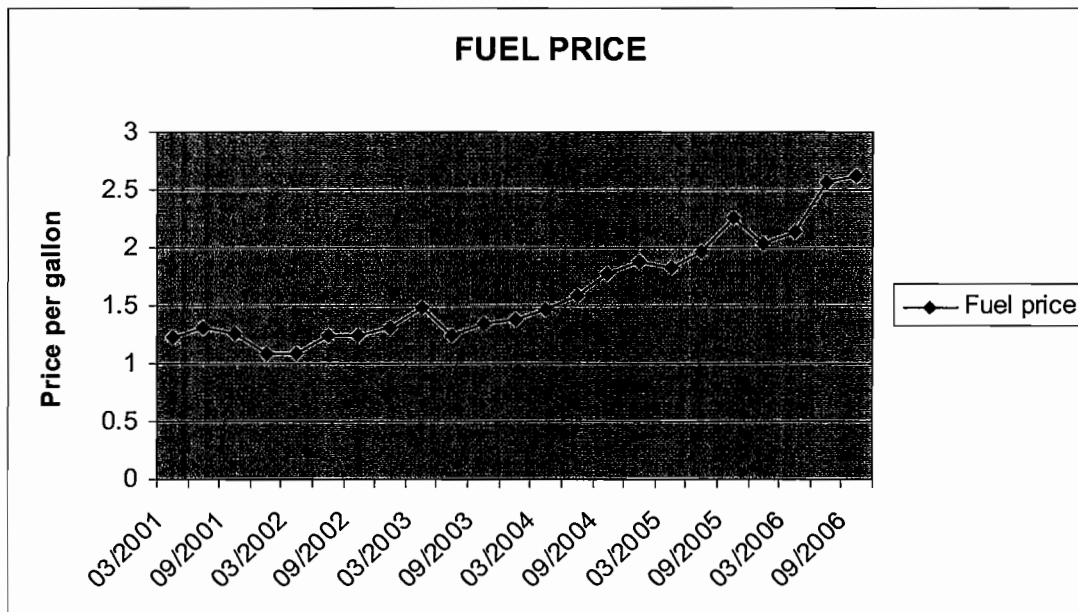
Management's Discussion and Analysis Years Ended September 30, 2006 and 2005

Fiscal year 2006 was no different from prior years in terms of financial challenge and a commitment to quality service to our customers. It was this year that we began to implement the new Utility Rate Structure, with variable fuel charge attached, which became effective in March 2006 billings. This was a follow-up rate increase after the revised 2005 rate. It resulted in a modest growth in revenue to cover the increasing cost of fuel and other operating expenses. However, customer base was not promising as we experienced negative growth for both electric and water consumption. Yet, the commitment for quality service has not wavered.

Key items in Fiscal 2006

Significant financial items during fiscal 2006 include:

- Operating revenues increased 27% from fiscal 2005 to \$4.49 million in fiscal 2006, and net loss decreased 72% to \$98,047.
- Total operating expenses increased by 11% and 8% in fiscal 2006 and 2005 when compared to the previous fiscal year.
- When compared to fiscal 2005, total assets increased by 1%, to \$11.3 million at September 30, 2006.
- The single most significant increase in operating costs over the past two fiscal years has been the increase in cost of diesel fuel. The fuel price from the sole vendor on Yap has almost doubled since September 2003. Management believes that diesel fuel prices will remain at higher levels for the future and that the annual fuel cost at the end of fiscal year 2007 will have increased about half a million dollars as compared to fiscal 2006. The graph below shows the increasing price of fuel.



YAP STATE PUBLIC SERVICE CORPORATION

Management's Discussion and Analysis Years Ended September 30, 2006 and 2005

Other Highlights

In July 2006, Yap State appropriated \$300,000 for the purpose of defraying the cost of electricity for the electric customers of Yap State. This subsidy was made available to YSPSC to pay 100% of the fuel charge for residential customers and 20% of the fuel charge for commercial customers. YSPSC has allocated this amount to customers for the four months ending November 2006. The remaining balance, which is no longer sufficient to pay the fuel charge, is scheduled to be returned back to Yap State.

In the aftermath of Typhoon Sudal in April 2004, YSPSC was awarded \$2.18 million by the Federal Emergency Management Agency (FEMA) for twenty-two separate projects for repair and improvement of YSPSC facilities and equipment. Of these projects obligated by FEMA for Typhoon Sudal repairs, total project cost and funding received through September 30, 2006 is as follows:

<u>Department</u>	<u>Total Project Cost</u>	Reimbursement:
		<u>Total Through September 30, 2006</u>
Power Distribution	\$ 1,906,938	\$ 123,688
Power Generation	237,252	237,252
Water/Sewer	64,093	64,093
Outer Island	43,145	43,145
Administration	37,912	37,912
Total Cost-All Projects	<u>\$ 2,289,340</u>	<u>\$ 506,090</u>

Total cost of the above projects is shared 90% by FEMA and 10% by YSPSC. The Yap State Government is paying 100% of YSPSC's 10% matching share. FEMA funding is made available first to the FSM National Government, which then transfers money to the Yap State Government for payment to YSPSC.

Among the Sudal related projects, the only capital project in progress at September 30, 2006 was the permanent repairs and mitigation under Power Distribution Division with a total cost of \$1,783,250 of which \$20,168 was expended. This large project on the power distribution system is estimated to be completed in December 2007.

After Typhoon Lupit in November 2003 which mainly impacted the island of Ulithi, YSPSC received FEMA funding of \$53,527 and \$84,321 in 2006 and 2004, respectively, to pay for storm related costs. The project funded by the former was completed in October 2006, while the earlier project was completed in the previous year.

YAP STATE PUBLIC SERVICE CORPORATION

Management's Discussion and Analysis
Years Ended September 30, 2006 and 2005

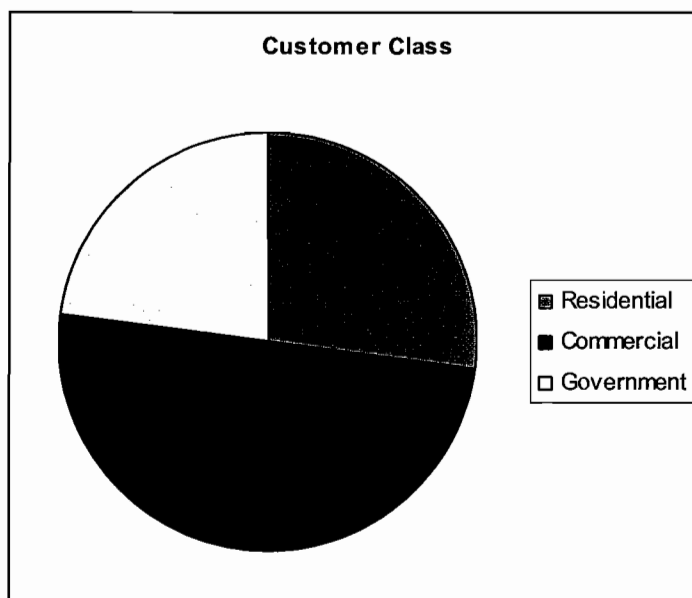
Results of Operations

	<u>2006</u>	<u>% inc.</u> <u>(dec.)</u>	<u>2005</u>	<u>% inc.</u> <u>(dec.)</u>	<u>2004</u>
Total operating revenues	\$ <u>4,492,869</u>	26.6%	\$ <u>3,549,637</u>	20.5%	\$ <u>2,945,230</u>
Total operating expenses	<u>4,693,241</u>	9.8%	<u>4,273,002</u>	7.9%	<u>3,959,790</u>
Loss from operations	\$ (200,372)	-72.3%	\$ (723,365)	-28.7%	\$ (1,014,560)

Our total operating revenues increased by 26.6% and 20.5% in fiscal 2006 and 2005 when compared to the previous fiscal year. These increases resulted from electric rate increases in February 2005 and March 2006. Our total electric sales as a percentage to total revenues was 93.2%, 89.7% and 86.5% in fiscal years 2006, 2005 and 2004, respectively. Water sold and sewer tariff comprise the remaining revenues. YSPSC's kWh billed to customers contracted by 5% in fiscal 2006 while water sold dropped by 12%. One probable reason for this disparity in growth was the dampening of the Yap State economy. Management feels that lack of major infrastructure projects on the island as well as a sluggish tourism sector have contributed to the overall decline. However, the number of customers grew by 5% for both sectors.

During the first half of fiscal 2005, YSPSC lost two of its largest customers – Kingtex (FSM) Inc. and Micronesian Knitting, Inc. The decrease in annual electric and water revenue coming from these customers was estimated at \$900,000.

The chart below shows the kWh sold to customer classes:



YAP STATE PUBLIC SERVICE CORPORATION

Management's Discussion and Analysis Years Ended September 30, 2006 and 2005

Total operating expenses increased by 10% and 8% in fiscal 2006 and 2005, respectively, compared to the previous fiscal year. The increase was primarily due to production fuel and other production cost. However, the salaries and administrative expenses decreased by less than 10% in fiscal 2006.

Production fuel, which represents 54% of the total operating expenses, increased by 16% to \$2,524,000 in fiscal 2006. This was the result of the increasing price of diesel fuel when the highest peak was registered in September 2006 at \$2.63 per gallon as compared to \$2.25 in the same month in 2005.

Other production costs increased by 44% this fiscal year while in fiscal 2005, it decreased by 32% when compared to previous fiscal year. Lower maintenance in 2005 was the result of the cost containment which was implemented in July 2004. This cost containment placed a freeze on pay increases, terminated paid time off cash outs, among other cost cutting measures. Later in fiscal 2006, as funds increased, regular maintenance of operations has resumed that contributed to the cost increase.

In 2006, salaries and administrative expenses decreased by 8% and 4%, respectively. The total decrease of these expenses was \$72,000. The decrease in salaries was attributed to vacancies that were filled only in the later part of the year or not at all.

While the YSPSC has been incurring losses for the past years, it had deferred any salary rate increase that will continue in fiscal 2007. Cost containment measures described in fiscal 2004 discussion will continue in effect until operating costs are effectively managed within its revenues. YSPSC is continuing to research alternatives that will lower all operating costs effectively including the cost of power generation.

Management's Discussion and Analysis for the year ended September 30, 2005 is set forth in YSPSC's report on the audit of financial statements, which is dated November 21, 2005. That Discussion and Analysis explains the major factors impacting the 2005 financial statements and can be viewed at the FSM Office of the Public Auditor's website at www.fsmpublicauditor.fm.

Future Plans

YSPSC has a project proposal for improving the transmission and distribution power lines which is estimated at \$9 million. This program includes underground feeders between the hospital and the Power Plant, airport and the Power Plant, as well as underground lines in Ulithi and Woleai.

The Corporation also has tapped the European Development Fund for funding a renewable energy project for the outer islands of Yap. The project scope is to provide solar/coconut and/or oil/diesel power grid. Detailed scope and specifications of the project are yet to be completed.

YAP STATE PUBLIC SERVICE CORPORATION

Statements of Net Assets
September 30, 2006 and 2005

<u>ASSETS</u>	<u>2006</u>	<u>2005</u>
Non-current assets:		
Utility plant:		
Plant in service	\$ 18,659,174	\$ 18,550,240
Work in progress	74,890	133,905
Less accumulated depreciation	<u>(9,446,054)</u>	<u>(8,986,685)</u>
Utility plant, net	9,288,010	9,697,460
Deposits	<u>-</u>	<u>47,676</u>
Total non-current assets	<u>9,288,010</u>	<u>9,745,136</u>
Current assets:		
Cash	727,343	497,723
Accounts receivable, net of an allowance for doubtful accounts as of \$241,510 in 2006 and \$248,204 in 2005	591,748	430,408
U.S. federal grants receivable	9,017	-
Inventory	705,808	605,523
Prepaid expenses	<u>20,385</u>	<u>-</u>
Total current assets	<u>2,054,301</u>	<u>1,533,654</u>
	<u>\$ 11,342,311</u>	<u>\$ 11,278,790</u>
 <u>NET ASSETS AND LIABILITIES</u>		
Net assets:		
Invested in capital assets, net of related debt	\$ 6,294,943	\$ 6,640,825
Restricted	121,443	121,443
Unrestricted	<u>1,362,169</u>	<u>1,114,334</u>
Total net assets	<u>7,778,555</u>	<u>7,876,602</u>
Contingency		
Current liabilities:		
Current portion of notes payable	87,812	63,568
Accounts payable	218,809	174,012
Employees' annual leave and accrued payroll	75,970	78,937
Accrued taxes and other withholding	31,309	30,494
Deferred revenue	161,268	-
Other payables and customer deposits	<u>83,333</u>	<u>62,110</u>
Total current liabilities	658,501	409,121
Notes payable, net of current portion	<u>2,905,255</u>	<u>2,993,067</u>
Total liabilities	<u>3,563,756</u>	<u>3,402,188</u>
	<u>\$ 11,342,311</u>	<u>\$ 11,278,790</u>

See accompanying notes to financial statements.

YAP STATE PUBLIC SERVICE CORPORATION

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

	<u>2006</u>	<u>2005</u>
Operating revenues:		
Electricity sales	\$ 4,186,531	\$ 3,183,519
Water sales	<u>306,338</u>	<u>366,118</u>
Total operating revenues	<u>4,492,869</u>	<u>3,549,637</u>
Operating expenses:		
Production fuel	2,524,375	2,176,124
Salaries and wages and related	751,440	813,323
Depreciation	763,582	740,209
Other production costs	392,970	272,742
Administrative and general	<u>260,874</u>	<u>270,604</u>
Total operating expenses	<u>4,693,241</u>	<u>4,273,002</u>
Loss from operations	(200,372)	(723,365)
Interest and other nonoperating income, net	45,145	3,475
Foreign exchange loss	(5,037)	(2,568)
Operating grant income	24,017	-
FEMA proceeds in excess of typhoon expenses	54,061	150,423
Interest expense	(17,143)	(18,638)
Gain on disposal of utility plant	<u>1,282</u>	<u>79</u>
Net loss before cumulative effect of a change in accounting principle	(98,047)	(590,594)
Cumulative effect of a change in accounting principle	<u>-</u>	<u>234,182</u>
Net loss	(98,047)	(356,412)
Net assets at beginning of year	<u>7,876,602</u>	<u>8,233,014</u>
Net assets at end of year	<u>\$ 7,778,555</u>	<u>\$ 7,876,602</u>

See accompanying notes to financial statements.

YAP STATE PUBLIC SERVICE CORPORATION

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

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Cash received from customers	\$ 4,492,797	\$ 3,459,654
Cash paid to suppliers	(3,149,297)	(2,881,593)
Cash paid to employees	<u>(753,592)</u>	<u>(808,189)</u>
Net cash used in operating activities	<u>589,908</u>	<u>(230,128)</u>
Cash flows from investing activities:		
Interest and other income	<u>4,212</u>	<u>3,475</u>
Net cash provided by investing activities	<u>4,212</u>	<u>3,475</u>
Cash flows from noncapital financing activities:		
Grant proceeds received	122,187	202,779
Cost of typhoon repairs	<u>(53,126)</u>	<u>(17,747)</u>
Net cash provided by noncapital financing activities	<u>69,061</u>	<u>185,032</u>
Cash flows from capital and related financing activities:		
Purchase of utility plant	(354,132)	(113,679)
Proceeds from disposal of utility plant	1,282	-
Interest paid	(17,143)	(18,638)
Repayment of loans	<u>(63,568)</u>	<u>(62,072)</u>
Net cash used in capital and related financing activities	<u>(433,561)</u>	<u>(194,389)</u>
Net decrease in cash	229,620	(236,010)
Cash at beginning of year	<u>497,723</u>	<u>733,733</u>
Cash at end of year	\$ <u><u>727,343</u></u>	\$ <u><u>497,723</u></u>
Reconciliation of loss from operations to net cash used in operating activities:		
Loss from operations	\$ (200,372)	\$ (723,365)
Adjustments to reconcile loss from operations to net cash used in operating activities:		
Depreciation	763,582	740,209
Decrease (increase) in assets:		
Receivables	(161,340)	(42,307)
Inventory	(59,352)	(11,235)
Prepaid expenses and deposits	27,291	(47,676)
Increase (decrease) in liabilities:		
Accounts payable	39,760	(130,936)
Employees' annual leave and accrued payroll	(2,967)	(1,494)
Accrued taxes and other withholdings	815	6,628
Contract retention payable	-	(28,174)
Deferred revenue	161,268	-
Other payables and customer deposits	<u>21,223</u>	<u>8,222</u>
Net cash used in operating activities	\$ <u><u>589,908</u></u>	\$ <u><u>(230,128)</u></u>

Supplemental schedule of noncash financing activity:

During the year ended September 30, 2005, YSPSC changed its method of accounting for certain inventory items which resulted in an increase in inventory of \$234,182.

See accompanying notes to financial statements.

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(1) Organization and Summary of Significant Accounting Policies

Organization

Yap State Public Service Corporation (YSPSC) is a legally separate component unit of the Government of Yap State. YSPSC provides electrical, water and sewer services in the State of Yap. YSPSC commenced operations on April 1, 1996, with the assets and liabilities of the Division of Public Utilities of the Yap State Department of Public Utilities and Contracts transferred as of that date. YSPSC is governed by a seven member Board of Directors who are nominated by the Governor with the advice and consent of the Legislature of the State of Yap.

Basis of Accounting

The accounting policies of YSPSC conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. All proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with operations are included in the statements of 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.

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. YSPSC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

YSPSC has adopted GASB Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB 34) as amended by GASB Statement Nos. 37 and 38. GASB 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 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.

- Restricted:

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

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

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

Basis of Accounting, Continued

- **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.

YSPSC has no nonexpendable restricted net assets at September 30, 2006 and 2005.

Utility Plant

Utility plant assets were transferred from Division of Public Utilities to YSPSC as of April 1, 1996 at the estimated net book value in the absence of documents to support cost. The net book value of the utility plant assets transferred was \$6,805,075 as of April 1, 1996. Depreciation is computed using the straight-line method over the estimated useful lives of the assets (3 - 40 years for plant assets). Depreciation expense for each of the years ended September 30, 2006 and 2005 was approximately four percent of the cost of depreciable properties. YSPSC currently capitalizes all assets that have a life of more than one year.

Cash

For purposes of the statements of net assets and the statements of cash flows, cash includes cash on hand and in bank.

Receivables

All receivables are due from government agencies, businesses and individuals located within the State of Yap and are interest free and uncollateralized. The allowance for uncollectible accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense.

Inventory

Supply inventories are carried at specific identification cost or at estimated values when contributed by the State of Yap.

Fuel inventories are carried at cost determined using the first in-first out method.

Annual and Sick Leave

Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, YSPSC accrues these benefits in the period earned.

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

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

Revenues

Sales of electricity and water are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2006 and 2005, unbilled revenues of \$93,066 and \$50,307, respectively, are estimated and accrued based on the most recent billing cycles.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require 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.

Risk Management

YSPSC is exposed to various risks of loss from torts, theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; and natural disasters. Commercial insurance coverage has been obtained for claims arising from most of these matters.

YSPSC is self-insured for typhoon risks.

Change in Accounting Principle

In prior years, YSPSC has expensed generation inventories as they were acquired. In fiscal year 2005, YSPSC decided to perform a physical inventory of the generation spare parts and record the inventory in the financial statements. The effect of this accounting change is reflected in the financial statements as the cumulative effect of a change in accounting principles.

Operating and Non-operating Revenues and Expenses

YSPSC considers revenues and expenses directly related to utility operations to be operating revenues and expenses. Revenues and expenses related to investing, financing and capital activities and revenues and expenses related to natural disasters are reflected as non-operating.

New Accounting Standards

During fiscal year 2006, YSPSC 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 service utility has declined significantly and unexpectedly.
- 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.

YAP STATE PUBLIC SERVICE CORPORATION

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. 47, *Accounting for Termination 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 Benefit 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 2006 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 YSPSC.

In July 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 YSPSC.

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 YSPSC.

Reclassification

Certain items in the 2005 financial statements have been reclassified to conform with the 2006 presentation.

(2) Cash

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.

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(2) Cash, Continued

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 YSPSC or its agent in YSPSC'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 YSPSC'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 YSPSC'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, YSPSC'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 YSPSC's name. YSPSC does not have a deposit policy for custodial credit risk.

As of September 30, 2006 and 2005, the carrying amount of YSPSC's total cash was \$727,343 and \$497,723, respectively, and the corresponding bank balances were \$631,889 and \$515,451, respectively. All of the bank balances are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006 and 2005, bank deposits of \$100,000 each year, were FDIC insured. YSPSC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. YSPSC has not experienced any losses in such accounts and management believes it is not exposed to any significant credit risk on its deposits.

(3) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2006 and 2005 is as follows:

	<u>Beginning Balance</u> <u>October 1, 2005</u>	<u>Transfers and</u> <u>Additions</u>	<u>Transfers and</u> <u>Deletions</u>	<u>Ending Balance</u> <u>September 30, 2006</u>
Production plant	\$ 9,673,893	\$ 145,081	\$ (145,918)	\$ 9,673,056
Distribution plant	7,044,355	210,710	(116,296)	7,138,769
General plant	1,831,992	57,357	(42,000)	1,847,349
Work in progress	<u>133,905</u>	<u>-</u>	<u>(59,015)</u>	<u>74,890</u>
	18,684,145	413,148	(363,229)	18,734,064
Less accumulated depreciation	<u>(8,986,685)</u>	<u>(763,582)</u>	<u>304,213</u>	<u>(9,446,054)</u>
	\$ <u>9,697,460</u>	\$ <u>(350,434)</u>	\$ <u>(59,016)</u>	\$ <u>9,288,010</u>

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(3) Utility Plant, Continued

	<u>Beginning Balance</u> <u>October 1, 2004</u>	<u>Transfers and</u> <u>Additions</u>	<u>Transfers and</u> <u>Deletions</u>	<u>Ending Balance</u> <u>September 30, 2005</u>
Production plant	\$ 9,376,331	\$ 313,557	\$ (15,995)	\$ 9,673,893
Distribution plant	7,032,287	26,256	(14,188)	7,044,355
General plant	1,804,049	28,329	(386)	1,831,992
Work in progress	<u>388,075</u>	<u>44,387</u>	<u>(298,557)</u>	<u>133,905</u>
	18,600,742	412,529	(329,126)	18,684,145
Less accumulated depreciation	<u>(8,276,831)</u>	<u>(740,209)</u>	<u>30,355</u>	<u>(8,986,685)</u>
	\$ <u>10,323,911</u>	\$ <u>(327,680)</u>	\$ <u>(298,771)</u>	\$ <u>9,697,460</u>

Utility plant is comprised of the following components:

	<u>2006</u>	<u>2005</u>
Electric plant	\$ 12,137,763	\$ 12,005,248
Water plant	<u>6,521,411</u>	<u>6,544,992</u>
	\$ <u>18,659,174</u>	\$ <u>18,550,240</u>

(4) Notes Payable

Notes payable at September 30, 2006 and 2005 are as follows:

	<u>2006</u>	<u>2005</u>
Loan payable to the Asia Development Bank (ADB) borrowed through the Federated States of Micronesia (FSM) and Yap State for construction of certain water projects. YSPSC was to be liable to Yap State for interest at 6.82% on the outstanding balance; however, Yap State has waived the interest payment requirement. The loan is repayable in Special Drawing Rights commencing August 2007 with the final payment due in February 2032. The loan is collateralized by the guarantee of the FSM National Government.	\$ 2,270,837	\$ 2,270,837
Uncollateralized note payable to Yap State in quarterly interest only payments through March 2003; monthly principal and interest payments of \$5,651 starting June 1, 2003; interest at 2%, maturing in May 2017.	650,875	705,078
Note payable to United States of America, acting through the Rural Housing Service, for the construction of the warehouse facility and main office. The note is payable in monthly installments of \$1,075 including interest at 4.625% starting March 26, 2003 and maturing in September 2013. The note is collateralized by equipment, furniture and fixtures located at YSPSC's office.	<u>71,355</u>	<u>80,720</u>
Total notes payable	2,993,067	3,056,635
Less current portion	<u>87,812</u>	<u>63,568</u>
	\$ <u>2,905,255</u>	\$ <u>2,993,067</u>

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(3) Notes Payable, Continued

The scheduled debt service of these notes payable is as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 87,812	\$ 15,606	\$ 103,418
2008	112,099	14,028	126,127
2009	113,723	12,404	126,127
2010	115,393	10,733	126,126
2011	117,110	9,016	126,126
2012 through 2016	562,676	21,529	584,205
2017 through 2021	612,644	338	612,982
2022 through 2026	605,630	-	605,630
2027 through 2031	605,630	-	605,630
2032	<u>60,350</u>	<u>-</u>	<u>60,350</u>
	<u>\$ 2,993,067</u>	<u>\$ 83,654</u>	<u>\$ 3,076,721</u>

Changes in long-term liabilities for the years ended September 30, 2006 and 2005 are as follows:

	<u>Outstanding September 30, 2005</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2006</u>	<u>Current</u>	<u>Noncurrent</u>
ADB loan	\$ 2,270,837	\$ -	\$ -	\$ 2,270,837	\$ 22,708	\$ 2,248,129
Yap State loan	705,078	-	54,203	650,875	55,298	595,577
USA loan	<u>80,720</u>	<u>-</u>	<u>9,365</u>	<u>71,355</u>	<u>9,806</u>	<u>61,549</u>
	<u>\$ 3,056,635</u>	<u>\$ -</u>	<u>\$ 63,568</u>	<u>\$ 2,993,067</u>	<u>\$ 87,812</u>	<u>\$ 2,905,255</u>
	<u>Outstanding September 30, 2004</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2005</u>	<u>Current</u>	<u>Noncurrent</u>
ADB loan	\$ 2,270,837	\$ -	\$ -	\$ 2,270,837	\$ -	\$ 2,270,837
Yap State loan	758,209	-	53,131	705,078	54,204	650,874
USA loan	<u>89,661</u>	<u>-</u>	<u>8,941</u>	<u>80,720</u>	<u>9,364</u>	<u>71,356</u>
	<u>\$ 3,118,707</u>	<u>\$ -</u>	<u>\$ 62,072</u>	<u>\$ 3,056,635</u>	<u>\$ 63,568</u>	<u>\$ 2,993,067</u>

(5) Contingency

YSPSC does not currently hold title to real property underlying its operating sites. Such property substantially is held in the name of the State of Yap. YSPSC is not charged for use of this property.

(6) Significant Revenue Sources

Power and water billings to Yap State Government agencies accounted for 28% and 23%, respectively, of total operating revenues for the years ended September 30, 2006 and 2005.

(7) Restricted Net Assets

Restricted net assets at September 30, 2006 and 2005 consist of unexpended balances of a Yap State capital grant.

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(8) Grants

YSPSC received the following grants during the years ended September 30, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
U.S. Federal Emergency Management Agency (FEMA) grants (netted with typhoon costs)	\$ 108,377	\$ 168,170
U.S. Department of the Interior grant	9,017	-
Yap State grant	<u>15,000</u>	<u>-</u>
	\$ <u>132,394</u>	\$ <u>168,170</u>

(9) Related Party Transactions

In the ordinary course of business, YSPSC enters into transactions with the State of Yap and private businesses in which certain of YSPSC's board members hold positions of influence. Several board members hold management positions with the State of Yap, of which YSPSC is a component unit. Several board members hold management positions with private companies with which YSPSC, from time to time, engages in business transactions. YSPSC management is of the opinion that its transactions with related parties are executed under the same laws and conditions as are entered into with unrelated entities.

(10) Rate Increase

In December 2005, the Board of Directors approved a new rate structure to be effective with the March 2006 meter readings. The new rate structure included adjustments in electrical rates for all classes of customers and the addition of a variable fuel charge for electrical customers. The fuel charge varies month-to-month based on the cost of fuel to the Corporation.

(11) Fuel Charge Subsidy

In July 2006, Yap State appropriated and paid \$300,000 to YSPSC for the purpose of defraying the effects of the fuel charge for certain rate payers. The funds are to be applied to 100% of the fuel charge for residential customers and 20% of the fuel charge for commercial customers. When there are no longer sufficient funds to pay 100% of the residential fuel charges and 20% of the commercial fuel charges for a given month, the remaining funds are to be returned to Yap State.

At September 30, 2006, YSPSC had applied \$153,313 of this fuel charge subsidy to customer billings and the remaining \$146,687 is included in deferred revenue in the accompanying financial statements.

(12) Typhoon Damages

YSPSC is self-insured for typhoon risks. In November 2003 and April 2004, the islands of Yap were struck by typhoons causing significant damage to YSPSC's plant. Remaining damages at September 30, 2006 are estimated at \$1.6 to \$1.7 million. YSPSC has sought assistance from FEMA in funding the cost of repairs. At September 30, 2006 and 2005, no significant damages have been accrued because most of the repair costs are anticipated to be recovered from FEMA assistance and many of the costs incurred will be capitalized. Typhoon damages and the related FEMA recoveries are estimated amounts and actual amounts may vary significantly from these estimates.

YAP STATE PUBLIC SERVICE CORPORATION

Notes to Financial Statements
September 30, 2006 and 2005

(12) Typhoon Damages, Continued

A summary of typhoon costs and related recoveries for the years ended September 30, 2006 and 2005 are as follows:

	<u>2006</u>	<u>2005</u>
Typhoon costs	\$ (186,189)	\$ (17,747)
Less capitalized items	<u>133,063</u>	<u>-</u>
	(53,126)	(17,747)
FEMA recoveries	<u>107,187</u>	<u>168,170</u>
	\$ <u>54,061</u>	\$ <u>150,423</u>

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

The Board of Directors
Yap State Public Service Corporation:

We have audited the financial statements of the Yap State Public Service Corporation (YSPSC), as of and for the year ended September 30, 2006, and have issued our report thereon dated November 30, 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

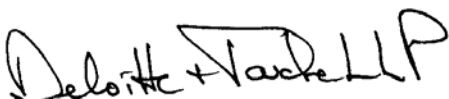
In planning and performing our audit, we considered YSPSC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our 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 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.

However, we noted other matters involving the internal control over financial reporting that we have reported to management of YSPSC in a separate letter dated November 30, 2006.

Compliance

As part of obtaining reasonable assurance about whether YSPSC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended for the information of the Board of Directors and management of YSPSC and 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.



November 30, 2006