

**POHNPEI UTILITIES CORPORATION
(A COMPONENT UNIT OF THE STATE OF POHNPEI)**

**FINANCIAL STATEMENTS AND
ADDITIONAL INFORMATION AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2007 AND 2006

POHNPEI UTILITIES CORPORATION
(A COMPONENT UNIT OF THE STATE OF POHNPEI)

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Years Ended September 30, 2007 and 2006

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INDEPENDENT AUDITORS' REPORT

The Board of Directors
Pohnpei Utilities Corporation:

We have audited the accompanying statements of net assets of the Pohnpei Utilities Corporation (PUC), a component unit of the State of Pohnpei, as of September 30, 2007 and 2006, 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 PUC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

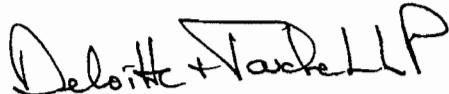
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan 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 PUC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Pohnpei Utilities Corporation as of September 30, 2007 and 2006, 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 Discussion and Analysis on pages 3 through 5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This information is the responsibility of PUC's management. 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. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements of PUC taken as a whole. The additional information on pages 21 through 23 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. This additional information is the responsibility of the PUC's management. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended September 30, 2007 and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 2, 2008, on our consideration of PUC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.


June 2, 2008

POHNPEI UTILITIES CORPORATION
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Management Discussion and Analysis
Years Ended September 30, 2007 and 2006

The following discussion and analysis of the financial performance and activity of the Pohnpei Utilities Corporation (PUC) is to provide an introduction and understanding of the basic financial statements of the PUC for the years ended September 30, 2007 and 2006. The discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

The PUC is a public corporation of the Pohnpei State Government and is the primary provider of Power, Water and Sewer services for the island. It is under the governance of a seven-member Board of Directors that was appointed by the Governor and approved by the Legislature of Pohnpei State, which has oversight over operation of the Power, Water and Sewer utility services. The General Manager who is hired by the Board of Directors oversees the daily operation of PUC.

The PUC has an installed generation capacity of 15.46 MW while the power demand is 6.6 MW in 2007 and 6.5 MW 2006. The PUC generated 38,333 MWh and 38,549 MWh and sold 31,328 and 31,976 MWh to customers in 2007 and 2006, respectively. This resulted in total power revenue of \$10.2 million and \$8.5 million to PUC in 2007 and 2006, respectively. The increase in sales revenue in 2006 is mainly the result of increases in fuel tariff from an average of \$0.1944/kWh in 2006 to \$0.2319/kWh in 2007. The number of households being serviced by the PUC is 6,459 in 2007 and 6,442 in 2006. The service coverage is about 96% of the population.

The PUC also provides clean water to the people of Pohnpei. The PUC has the capacity to produce 4.72 million gallons per day while the daily water demand to existing customers amounts to 1.8 million gallons per day. PUC produced 1.4 billion gallons and sold 640 million and 700 million gallons to customers in 2007 and 2006, respectively, which resulted in total revenue to PUC of \$1.2 million and \$1.3 million, respectively. The PUC services 3,738 households, which covers about 1/3 of Pohnpei in area or 53% of the total population.

The following table summarizes the financial condition and operations of the PUC for FY 2007, 2006 and 2005:

Assets:	<u>2007</u>	<u>2006</u>	<u>2005</u>
Utility plant, net	\$ 28,391,763	\$ 29,912,393	\$ 28,719,385
Current assets	4,521,252	5,602,827	6,330,689
Other non-current assets	<u>494,401</u>	<u>487,516</u>	<u>482,832</u>
	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>	<u>\$ 35,532,906</u>
Liabilities and Net Assets:			
Notes payable	\$ 874,825	\$ 643,647	\$ 506,938
Current portion of long-term debt	134,922	118,536	129,918
Other current liabilities	1,111,791	1,286,008	1,581,671
Long-term debt, net	<u>3,010,853</u>	<u>2,645,682</u>	<u>2,747,515</u>
Total Liabilities	<u>5,132,391</u>	<u>4,693,873</u>	<u>4,966,042</u>

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Management Discussion and Analysis
Years Ended September 30, 2007 and 2006

Net Assets	<u>2007</u>	<u>2006</u>	<u>2005</u>
Invested in capital assets, net of related debt	24,769,163	26,694,528	25,435,014
Restricted	139,390	132,505	127,821
Unrestricted	<u>3,366,472</u>	<u>4,481,830</u>	<u>5,004,029</u>
Total net assets	<u>28,275,025</u>	<u>31,308,863</u>	<u>30,566,864</u>
	\$ <u>33,407,416</u>	\$ <u>36,002,736</u>	\$ <u>35,532,906</u>
 Revenues, Expenses and Changes in Net Assets			
Operating revenues	\$ 11,369,043	\$ 10,071,600	\$ 9,042,447
Bad debt expense	-	(81,000)	(1,962,011)
Operating expenses	<u>(14,585,306)</u>	<u>(11,920,059)</u>	<u>(10,637,095)</u>
Net operating loss	(3,216,263)	(1,929,459)	(3,556,659)
Non-operating revenues, net	57,672	226,087	271,426
Capital contributions	<u>124,753</u>	<u>2,445,371</u>	<u>1,547,796</u>
Increase (decrease) in net assets	(3,033,838)	741,999	(1,737,437)
Net assets at beginning of year	<u>31,308,863</u>	<u>30,566,864</u>	<u>32,304,301</u>
Net assets at end of year	\$ <u>28,275,025</u>	\$ <u>31,308,863</u>	\$ <u>30,566,864</u>

Overall changes in the statement of net assets components from September 30, 2006 to 2007 include a decrease in net utility plant (\$1,521,000), a decrease in current assets (\$1,082,000) and an increase in current and long term debt \$382,000.

Decreases in utility plant are attributable to insufficient replacement of capital assets that are depreciated over the year. The total depreciation for the year is (\$2,084,348), while the Corporation re-invested only \$563,718 in capital assets and construction in progress (CIP). The major additions are the finishing work of the Hydroelectric plant rehabilitation (\$146,000), drilling of an additional well in Lukop (\$84,000), installation of cash power meters (\$96,000) and the installation of the prepaid scratch card system (easypower) (\$122,000). The other additions are for small and various projects, including distribution system expansions and service connections. For additional information concerning capital assets, please refer to the notes to the financial statements, primarily note 6.

Decreases in current assets show the Corporation's re-shifting of priorities to meet escalating cost of fuel. The fuel cost forces the Corporation to collect and improve accounts receivable by (\$438,000). The cash and cash equivalents also decreased from last year by about (\$165,000). The inventory parts also decreased by \$330,000, because of the tight budget. The Corporation also collected almost all grants receivable, an improvement in grants receivable collection of \$209,000.

Increases in current and long term debt from 2006 to 2007 are due to the following: The Corporation obtained loans from banks of \$708,000. The Corporation used the loans to pay all debt with Exxon Mobil (\$452,000) after Exxon Mobil suspended the 30 day credit term with the Corporation. The remaining proceeds were used for fuel purchase. The Corporation also repaid some of its long-term debt

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Management Discussion and Analysis
Years Ended September 30, 2007 and 2006

this year (\$118,000), but because of limited funds, it could not retire some of its current obligations resulting in an increase in accounts payable by \$300,000. The net effect after the payments and borrowings is an increase in total liabilities of \$438,000. For additional information concerning the Corporation's debt, please refer to note 7 to the financial statements.

The changes in revenue, expenses and changes in net assets statement between fiscal year 2006 and 2007 include an increase in operating revenue of \$1,378,000, an increase in operating expense of \$2,665,000, and an increase in net operating loss of \$1,287,000.

The increase in operating revenue is due to an increase in the average fuel tariff from \$0.1944 kWh in 2006 to \$0.2319/kWh in 2007.

The increase in operating expenses is due mainly to increases in the cost of fuel. Total fuel expense this year is \$8,965,000, an increase of \$2,271,000 from 2006.

The Corporation incurred an operating loss of (\$3,216,263), an increase of (\$1,287,000) from 2006. The problem is that while it cost the Corporation \$2,665,000 in fuel, the Corporation did not fully recover its fuel cost from the tariff. The fuel tariff only brought in \$1,287,000 this year. One of the problems is conservation. While customers are conserving, PUC still has to run the generators to energize the grid and act as standby in case some one comes online.

Another problem is the cost of lubrication oil which is not factored into the fuel tariff. The cost of lubrication oil has increased significantly over the recent years.

The ninety (90) day billing cycle is another problem. The customers are paying fuel costs that were incurred three (3) months earlier, while the Corporation is paying the higher cost of today's fuel.

This concludes the management discussion and analysis of the financial statements for the year ended September 30, 2007.

Management's Discussion and Analysis for the year ended September 30, 2006 is set forth in PUC's report on the audit of financial statements, which is dated February 1, 2007. That Discussion and Analysis explains the major factors impacting the 2006 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmpublicauditor.fm.

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Statements of Net Assets
September 30, 2007 and 2006

<u>ASSETS</u>	<u>2007</u>	<u>2006</u>
Current assets:		
Cash and cash equivalents	\$ 357,056	\$ 521,763
Investments	685,000	637,506
Accounts receivable, net	2,167,439	2,605,737
Grants receivable	23,698	232,950
Prepayments	10,186	-
Materials and fuel inventory	1,277,873	1,604,871
Total current assets	<u>4,521,252</u>	<u>5,602,827</u>
Other noncurrent assets:		
Restricted:		
Cash and cash equivalents	3,881	3,881
Time certificates of deposit	350,000	350,000
Investments	139,390	132,505
Interest receivable	1,130	1,130
Total other noncurrent assets	<u>494,401</u>	<u>487,516</u>
Utility plant, at cost:		
Electric plant in service	37,560,131	36,122,868
Water and sewer plant in service	19,307,046	18,086,411
	56,867,177	54,209,279
Less accumulated depreciation	(28,638,532)	(26,554,184)
Depreciable assets	28,228,645	27,655,095
Construction work-in-process	163,118	2,257,298
Total utility plant	<u>28,391,763</u>	<u>29,912,393</u>
	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 874,825	\$ 643,647
Current portion of long-term debt	134,922	118,536
Accounts payable:		
Fuel oil	-	451,635
Operations	463,912	261,414
Affiliate	40,000	-
Deferred revenue	312,752	318,636
Accrued taxes and other liabilities	202,694	177,610
Employees' annual leave	92,433	76,713
Total current liabilities	<u>2,121,538</u>	<u>2,048,191</u>
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>3,010,853</u>	<u>2,645,682</u>
Total liabilities	<u>5,132,391</u>	<u>4,693,873</u>
Commitments and contingencies		
Net assets:		
Invested in capital assets, net of related debt	24,769,163	26,694,528
Restricted	139,390	132,505
Unrestricted	3,366,472	4,481,830
Total net assets	<u>28,275,025</u>	<u>31,308,863</u>
	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>

See accompanying notes to financial statements.

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Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Operating revenues:		
Electricity sales	\$ 10,104,388	\$ 8,657,285
Water sales	1,180,236	1,091,223
Other sales	<u>84,419</u>	<u>323,092</u>
Total operating revenues before bad debts	11,369,043	10,071,600
Bad debts	<u>-</u>	<u>(81,000)</u>
Total operating revenues after bad debts	<u>11,369,043</u>	<u>9,990,600</u>
Operating and maintenance expenses:		
Production fuel	8,965,458	6,694,457
Depreciation	2,084,348	2,009,334
Administrative and general	1,356,059	1,514,636
Water and sewer	911,388	594,515
Generation	835,126	553,686
Distribution	<u>432,927</u>	<u>553,431</u>
Total operating expenses	<u>14,585,306</u>	<u>11,920,059</u>
Operating loss	<u>(3,216,263)</u>	<u>(1,929,459)</u>
Nonoperating revenues:		
Grants and subsidies	99,140	182,548
Spurline projects	16,363	96,465
Interest (expense) income, net	(58,056)	(57,926)
Other income	<u>225</u>	<u>5,000</u>
Total nonoperating revenues	<u>57,672</u>	<u>226,087</u>
Net loss before capital contributions	(3,158,591)	(1,703,372)
Capital contributions:		
Grants from United States Department of Agriculture, Rural Utility Service	-	603,987
Grants passed through from the United States Department of the Interior	<u>124,753</u>	<u>1,841,384</u>
Change in net assets	(3,033,838)	741,999
Net assets at beginning of year	<u>31,308,863</u>	<u>30,566,864</u>
Net assets at end of year	<u>\$ 28,275,025</u>	<u>\$ 31,308,863</u>

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION
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Statements of Cash Flows
Years Ended September 30, 2007 and 2006

	2007	2006
Cash flows from operating activities:		
Cash received from customers	\$ 11,801,682	\$ 10,602,263
Cash payments to suppliers for goods and services	(10,296,963)	(8,604,900)
Cash paid to employees	(1,886,308)	(1,852,717)
Net cash (used for) provided by operating activities	(381,589)	144,646
Cash flows from investing activities:		
Payments to self insurance fund	(6,885)	(4,684)
Increase in internally restricted investments	(47,494)	(36,506)
Interest income	62,622	43,955
Net provided by investing activities	8,243	2,765
Cash flows from noncapital financing activities:		
Proceeds from notes payable to bank	208,000	90,000
Operating grants received	99,140	182,548
Advance from affiliate	40,000	-
Spurline projects	16,363	96,465
Interest expense	(120,678)	(101,881)
Net cash provided by noncapital financing activities	242,825	267,132
Cash flows from capital and related financing activities:		
Proceeds from note payable to investment company	23,178	46,709
Repayments of long-term debt	(118,443)	(113,215)
Proceeds from long-term debt	500,000	-
Proceeds from sale of assets	-	5,000
Acquisition of utility plant	(772,926)	(2,627,858)
Capital contributions	334,005	2,463,270
Net cash used for capital and related financing activities	(34,186)	(226,094)
Net change in cash and cash equivalents	(164,707)	188,449
Cash and cash equivalents at beginning of year	521,763	333,314
Cash and cash equivalents at end of year	\$ 357,056	\$ 521,763
<u>Reconciliation of operating loss to net cash (used for)</u>		
<u>provided by operating activities:</u>		
Operating loss	\$ (3,216,263)	\$ (1,929,459)
Adjustments to reconcile operating loss to net cash		
(used for) provided by operating activities:		
Depreciation	2,084,348	2,009,334
Write off of construction work-in-progress	209,208	-
Bad debts	-	81,000
Other income	225	-
(Increase) decrease in assets:		
Accounts receivable	438,298	361,444
Prepayments	(10,186)	-
Materials and fuel inventory	326,998	(82,010)
Increase (decrease) in liabilities:		
Accounts payable	(249,137)	(515,255)
Deferred revenue	(5,884)	169,219
Accrued taxes and other liabilities	25,084	19,985
Employees' annual leave	15,720	30,388
Net cash (used for) provided by operating activities	\$ (381,589)	\$ 144,646

Supplemental disclosure of non-cash financing activity:

During the year ended September 30, 2006, PUC received a capital contribution of water wells valued at \$574,484 from the FSM National Government, which were originally funded by the United States Department of the Interior.

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Notes to Financial Statements
September 30, 2007 and 2006

(1) Summary of Significant Accounting Policies

The accounting policies of Pohnpei Utilities Corporation (PUC) conform with 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. PUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

General: PUC is a component unit of the Government of the State of Pohnpei. PUC commenced operations on October 1, 1991, with assets and liabilities of the Division of Public Utilities of the Pohnpei State Department of Public Works transferred as of that date. PUC has adopted the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC). As of October 1, 1993, the assets, liabilities, and operations of the Division of Water and Sewer of the Pohnpei State Department of Public Works were also transferred to PUC as the result of Pohnpei State Law 3L-41-93.

Cash and Cash Equivalents: Cash and cash equivalents include cash on hand, demand deposits, and short-term investments with maturity dates within three months of the date acquired by PUC. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified on the statement of net assets.

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

Accounts Receivable and Allowance for Doubtful Accounts: PUC grants credit to companies, individuals and government agencies on an unsecured basis, substantially all of whom are based in Pohnpei. The allowance for doubtful accounts is established through a provision charged to expense. Accounts are charged against the allowance when management believes that the collection of the balance is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing balances that may be uncollectible, based on evaluations of collectibility and prior loss experience.

Inventory: Materials and fuel inventory are substantially carried at the lower of cost (weighted average) or market.

Utility Plant: Utility plant assets were transferred to PUC at the carrying value of the Division of Public Utilities and Division of Water and Sewer of the Pohnpei State Department of Public Works as of October 1, 1991 and 1993, for the electric plant and water and sewer plants, respectively, except as to certain utility plant assets which are stated at estimated net book value in the absence of documents to support cost. The net book value of the electric plant assets transferred was \$17,191,311 as of October 1, 1991, and the net book value of the water and sewer plant assets transferred was \$6,708,112 as of October 1, 1993. PUC capitalizes plant acquisitions with original costs in excess of \$5,000.

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Notes to Financial Statements
September 30, 2007 and 2006

(1) Summary of Significant Accounting Policies, Continued

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Estimated useful lives for utility plant assets are 5-40 years for production plant, 5-30 years for distribution plant and 3-20 years for general plant.

Annual and Sick Leave: Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, PUC accrues these benefits in the period earned. It is the policy of PUC to record the cost of sick leave when leave is actually taken and an expense is actually incurred. Accrued sick leave at September 30, 2007 approximates \$231,000.

Net Assets: Net assets represent the residual interest in PUC's assets after liabilities are deducted and consist of four sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable, and unrestricted. Net assets invested in capital assets, net of related debt include capital assets, restricted and unrestricted, net of accumulated depreciation, 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. All of PUC's restricted net assets are expendable. All other net assets are unrestricted.

Revenues: Sales of electricity and water are recorded as billed to customers on a monthly billing cycle basis. At September 30, 2007 and 2006, unbilled revenues are accrued based on the most recent billing cycles.

Federal Grants and Subsidies: PUC receives federal grants either as a direct recipient or a subrecipient from Pohnpei State in addition to Pohnpei State Legislature appropriated subsidies and matching funds for federal programs as required.

Operating and Non-operating Revenues and Expenses: PUC considers revenues and costs that are directly related to utility operations to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

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 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.

Reclassification: Certain reclassifications have been made to the 2006 financial statements to correspond with the 2007 presentation.

New Accounting Standards

During fiscal year 2007, PUC implemented GASB 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 implementation of this statement did not have a material effect on the accompanying financial statements of PUC.

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Notes to Financial Statements
September 30, 2007 and 2006

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

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, 2006. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

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 postemployment 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, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. 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 PUC.

In May 2007, GASB issued Statement No. 50, *Pension Disclosures-an Amendment of GASB Statements No. 25 and 27*, which amends applicable note disclosure and RSI requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27 *Accounting for Pensions by State and Local Governmental Employers*, to conform with requirements of Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and Statement No. 45 *Accounting and Financial Reporting by Employers for Postemployment Benefits other than Pensions*. The provisions of this statement are effective for periods beginning after June 15, 2007. Management does not believe the implementation of this statement will have a material effect on the financial statements of PUC.

In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

(2) Deposits and Investments

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

The deposit and investment policies of PUC are governed by its enabling legislation. The Board of Directors is required to engage one or more fund custodians to assume responsibility for the physical possession of the PUC's investments.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(2) Deposits and Investments, Continued

A. Deposits:

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

- Category 1 Deposits that are federally insured or collateralized with securities held by PUC or its agent in PUC'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 PUC's name;
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in PUC'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 in 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, PUC'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 PUC does not have a deposit policy for custodial credit risk.

As of September 30, 2007 and 2006, the carrying amount of the PUC's total cash and cash equivalents and time certificates of deposit was \$710,937 and \$875,644, respectively, and the corresponding bank balances were \$776,617 and \$981,749, respectively. Of the bank balances, \$710,165 and \$874,872, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2007 and 2006, bank deposits in the amount of \$200,000 were FDIC insured. PUC 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. PUC has not experienced any losses on such accounts and management believes it is not exposed to any significant credit risk on its deposits.

B. Investments:

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

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

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(2) Deposits and Investments, Continued

B. Investments, Continued:

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

As of September 30, 2007 and 2006, investments in mutual funds at fair value are \$824,390 and \$770,011, respectively.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, PUC will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. PUC's investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in PUC's name by PUC's custodial financial institutions at September 30, 2007 and 2006.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for PUC. There was no concentration of credit risk for investments as of September 30, 2007 and 2006.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. PUC does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

(3) Self Insurance Fund and Risk Management

In accordance with section 2(5) of State Law 3L-41-93, an amendment to the enabling legislation for PUC, a self-insurance fund was established to defray costs of any unforeseen accidents or disasters. The funds are accumulated in a restricted self-insurance fund, held by a trustee, in the name of PUC. As of September 30, 2007 and 2006, the carrying amount of the fund is \$139,390 and \$132,505, respectively, which is presented as a restricted investment in the accompanying statements of net assets.

Additionally, PUC carries life insurance on behalf of its employees and maintains commercial coverage of a comprehensive business policy and workmen's compensation insurance. PUC 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 during the past three years.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(4) Scholarship Fund

The scholarship fund is designated to account for funds to be used for scholarships in exchange for a related term of employment with PUC subsequent to graduation. Funds are provided by voluntary donations. As of September 30, 2007 and 2006, the carrying amount of the fund is \$3,881, which is presented as restricted cash and cash equivalents in the accompanying statements of net assets.

(5) Accounts Receivable

Bills are issued to customers near mid-month approximately one month subsequent to providing utilities services. Therefore, approximately forty-five days of service is accrued at September 30, 2007 and 2006, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2007 and 2006, are summarized as follows:

	<u>2007</u>	<u>2006</u>
Accounts receivable - electrical:		
Residential	\$ 1,451,662	\$ 2,005,876
Commercial	532,895	1,140,852
Government	184,560	504,744
Unbilled	<u>573,426</u>	<u>647,520</u>
	<u>2,742,543</u>	<u>4,298,992</u>
Accounts receivable - water and sewer:		
Residential	1,246,901	983,299
Commercial and government	118,659	226,462
Unbilled	<u>147,606</u>	<u>143,117</u>
	<u>1,513,166</u>	<u>1,352,878</u>
Installment receivables	<u>96,962</u>	<u>122,662</u>
	4,352,671	5,774,532
Other	<u>135,911</u>	<u>150,988</u>
	4,488,582	5,925,520
Less allowance for doubtful receivables	<u>(2,321,143)</u>	<u>(3,319,783)</u>
	<u>\$ 2,167,439</u>	<u>\$ 2,605,737</u>

PUC commenced a prepaid cash power meter system in which a portion of customer payments are used to satisfy balances in arrears. Percentages are applied depending on the amount of arrears (45% for arrears \$1,000 and above, 35% for \$500 to \$999 and 25% for under \$500) through June 2006, at which time PUC changed its policy to apply 50% of collections to arrears. In April 2007, the policy was changed to 90%, which was reduced to 75% in June 2007. The rate was subsequently returned to 50% in October 2007. As of September 30, 2007 and 2006, gross receivables from customers enrolled in the cash power meter system are \$1,063,534 and \$1,637,089, respectively.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(6) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2007 and 2006 is as follows:

	<u>Beginning Balance</u> <u>October 1, 2006</u>	<u>Transfers and</u> <u>Additions</u>	<u>Transfers and</u> <u>Deletions</u>	<u>Ending Balance</u> <u>September 30, 2007</u>
<u>Depreciable assets:</u>				
Production plant	\$ 20,743,497	\$ 1,006,658	\$ -	\$ 21,750,155
Distribution plant	13,903,490	292,215	-	14,195,705
General plant	<u>1,475,881</u>	<u>138,390</u>	<u>-</u>	<u>1,614,271</u>
Electric plant in service	<u>36,122,868</u>	<u>1,437,263</u>	<u>-</u>	<u>37,560,131</u>
Water production plant	5,365,165	992,697	-	6,357,862
Sewage collection and treatment plant	5,512,301	-	-	5,512,301
Water distribution plant	6,652,057	227,938	-	6,879,995
General plant	<u>556,888</u>	<u>-</u>	<u>-</u>	<u>556,888</u>
Water and sewer plant in service	<u>18,086,411</u>	<u>1,220,635</u>	<u>-</u>	<u>19,307,046</u>
Total utility plant in service	54,209,279	2,657,898	-	56,867,177
Less accumulated depreciation	<u>(26,554,184)</u>	<u>(2,084,348)</u>	<u>-</u>	<u>(28,638,532)</u>
	<u>27,655,095</u>	<u>573,550</u>	<u>-</u>	<u>28,228,645</u>
<u>Non-depreciable assets:</u>				
<u>Construction work-in-progress:</u>				
Electric plant	1,098,520	445,572	(1,511,386)	32,706
Water and sewer plant	<u>1,158,778</u>	<u>225,122</u>	<u>(1,253,488)</u>	<u>130,412</u>
	<u>2,257,298</u>	<u>670,694</u>	<u>(2,764,874)</u>	<u>163,118</u>
	\$ <u>29,912,393</u>	\$ <u>1,244,244</u>	\$ <u>(2,764,874)</u>	\$ <u>28,391,763</u>
	<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>
<u>Depreciable assets:</u>				
Production plant	\$ 20,743,497	\$ -	\$ -	\$ 20,743,497
Distribution plant	13,841,848	61,642	-	13,903,490
General plant	<u>1,427,831</u>	<u>48,050</u>	<u>-</u>	<u>1,475,881</u>
Electric plant in service	<u>36,013,176</u>	<u>109,692</u>	<u>-</u>	<u>36,122,868</u>
Water production plant	5,365,165	-	-	5,365,165
Sewage collection and treatment plant	5,448,827	63,474	-	5,512,301
Water distribution plant	3,372,026	3,280,031	-	6,652,057
General plant	<u>530,941</u>	<u>25,947</u>	<u>-</u>	<u>556,888</u>
Water and sewer plant in service	<u>14,716,959</u>	<u>3,369,452</u>	<u>-</u>	<u>18,086,411</u>
Total utility plant in service	50,730,135	3,479,144	-	54,209,279
Less accumulated depreciation	<u>(24,544,850)</u>	<u>(2,009,334)</u>	<u>-</u>	<u>(26,554,184)</u>
	<u>26,185,285</u>	<u>1,469,810</u>	<u>-</u>	<u>27,655,095</u>

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Notes to Financial Statements
September 30, 2007 and 2006

(6) Utility Plant, Continued

	<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>
<u>Non-depreciable assets:</u>				
<u>Construction work-in-progress:</u>				
Electric plant	23,769	1,136,393	(61,642)	1,098,520
Water and sewer plant	<u>2,510,331</u>	<u>2,017,899</u>	<u>(3,369,452)</u>	<u>1,158,778</u>
	<u>2,534,100</u>	<u>3,154,292</u>	<u>(3,431,094)</u>	<u>2,257,298</u>
	<u>\$ 28,719,385</u>	<u>\$ 4,624,102</u>	<u>\$ (3,431,094)</u>	<u>\$ 29,912,393</u>

(7) Notes Payable and Long-Term Debt

Notes payable consist of the following at September 30, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Notes drawn on a bank line of credit of \$190,000 (line expiry March 24, 2008), interest at time certificate of deposit (TCD) rate plus 2% (5.94% and 4.50% at September 30, 2007 and 2006, respectively), collateralized by TCD, due on January 22, 2008.	\$ 190,000	\$ 190,000
Two \$104,000 notes drawn on a bank line of credit of \$850,000 (line expiry May 9, 2008), interest at bank prime rate plus 2% (9.75% at September 30, 2007) collateralized by TCD, due on November 27, 2007 and December 27, 2007, collateralized by equipment.	208,000	-
Note to an investment company, interest at 9.25% at September 30, 2007 and 2006, collateralized by investments.	<u>476,825</u>	<u>453,647</u>
Total notes payable	<u>\$ 874,825</u>	<u>\$ 643,647</u>

Changes in notes payable for the years ended September 30, 2007 and 2006, are as follows:

	<u>Outstanding</u> <u>September 30,</u> <u>2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding</u> <u>September 30,</u> <u>2007</u>
Notes to a bank	\$ 190,000	\$ 208,000	\$ -	\$ 398,000
Note to an investment company	<u>453,647</u>	<u>23,178</u>	<u>-</u>	<u>476,825</u>
	<u>\$ 643,647</u>	<u>\$ 231,178</u>	<u>\$ -</u>	<u>\$ 874,825</u>
	<u>Outstanding</u> <u>September 30,</u> <u>2005</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding</u> <u>September 30,</u> <u>2006</u>
Notes to a bank	\$ 100,000	\$ 90,000	\$ -	\$ 190,000
Note to an investment company	<u>406,938</u>	<u>46,709</u>	<u>-</u>	<u>453,647</u>
	<u>\$ 506,938</u>	<u>\$ 136,709</u>	<u>\$ -</u>	<u>\$ 643,647</u>

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(7) Notes Payable and Long-Term Debt, Continued

Long-term debt consists of the following at September 30, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Amount drawn on a note payable to the State of Pohnpei, facilitated by an Asian Development Bank loan to the FSM, due in semi-annual installments of \$33,500 commencing February 28, 2007. The State of Pohnpei has not imposed collateralization on PUC and has waived its rights to receive 6.82% in interest. The loan agreement includes a 1% service charge to be added to the principal until installment payments commence. This service charge was paid by the State of Pohnpei during the years ended September 30, 2007 and 2006.	\$ 2,096,260	\$ 2,118,767
Loan payable to United States Department of Agriculture, Rural Utilities Service, due in monthly installments of \$2,654 commencing October 28, 2006. The loan is collateralized by a revenue bond. The loan bears a fixed interest rate of 4.5%.	569,552	578,000
Loan payable to FSM Development Bank, 5 year term, interest at 9%, collateralized by a \$150,000 time certificate of deposit, fully paid during the year ended September 30, 2007.	-	67,451
Loan payable to FSM Development Bank, 5 year term, interest at 9%, collateralized by a \$150,000 time certificate of deposit, receivables, inventory and property, plant and equipment). Monthly principal and interest installments of \$10,379 commenced in July 2007. A member of the PUC Board is also a member of management of the FSM Development Bank.	<u>479,963</u>	<u>-</u>
Total long-term debt	3,145,775	2,764,218
Less: current portion of long-term debt	<u>134,922</u>	<u>118,536</u>
Long-term portion of long-term debt	\$ <u>3,010,853</u>	\$ <u>2,645,682</u>

Future minimum principal and interest payments on all long-term debt for subsequent years ending September 30, are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2008	\$ 134,922	\$ 86,738	\$ 221,660
2009	145,938	77,460	223,398
2010	155,385	68,013	223,398
2011	165,664	57,734	223,398
2012	149,132	46,683	195,815
2013-2017	291,764	202,476	494,240
2018-2022	315,231	179,009	494,240
2023-2027	342,058	152,182	494,240
2028-2032	372,959	121,281	494,240
2033-2037	408,825	85,415	494,240
2038-2042	450,762	43,478	494,240
2043-2047	<u>213,135</u>	<u>4,082</u>	<u>217,217</u>
	\$ <u>3,145,775</u>	\$ <u>1,124,551</u>	\$ <u>4,270,326</u>

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(7) Notes Payable and Long-Term Debt, Continued

Changes in non-current liabilities for the years ended September 30, 2007 and 2006, are as follows:

	Outstanding September 30, <u>2006</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2007</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to FSM Development Bank	\$ 67,451	\$ 500,000	\$ (87,488)	\$ 479,963	\$ 46,444	\$ 433,519
Loan payable to Rural Utilities Service	578,000	-	(8,448)	569,552	6,234	563,318
Loan payable to Asian Development Bank	<u>2,118,767</u>	<u>-</u>	<u>(22,507)</u>	<u>2,096,260</u>	<u>82,244</u>	<u>2,014,016</u>
	<u>\$ 2,764,218</u>	<u>\$ 500,000</u>	<u>\$ (118,443)</u>	<u>\$ 3,145,775</u>	<u>\$ 134,922</u>	<u>\$ 3,010,853</u>
	Outstanding September 30, <u>2005</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2006</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to FSM Development Bank	\$ 180,666	\$ -	\$ (113,215)	\$ 67,451	\$ 67,451	\$ -
Loan payable to Rural Utilities Service	578,000	-	-	578,000	5,960	572,040
Loan payable to Asian Development Bank	<u>2,118,767</u>	<u>-</u>	<u>-</u>	<u>2,118,767</u>	<u>45,125</u>	<u>2,073,642</u>
	<u>\$ 2,877,433</u>	<u>\$ -</u>	<u>\$ (113,215)</u>	<u>\$ 2,764,218</u>	<u>\$ 118,536</u>	<u>\$ 2,645,682</u>

(8) Contributions

During the year ended September 30, 1995, sole use rights for the Nanpohnmal Power Plant were contributed to PUC by the FSM National Government through the State of Pohnpei. These assets were donated to the FSM National Government through the Japanese Foreign Aid Program. Official title to the ownership of these assets rests with the FSM National Government. However, substantial revenue is generated by PUC from the use of these assets and PUC bears responsibility for all costs associated with their operation.

(9) Grants, Subsidies and Capital Contributions

Grants, subsidies and capital contributions comprise the following for the years ended September 30, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Grants and Subsidies:		
U.S. Department of the Interior:		
Operations and maintenance improvement program:		
Easy power	\$ 50,000	\$ -
Leak detection	20,000	-
Training	9,200	10,812
Tariff study	-	50,000
OMIP three phase prepaid meter	-	43,000
Strategic plan	-	26,340
Power study	-	23,835
Hydrologist for the Military wells	-	10,000
Utility development	-	8,591
	<u>79,200</u>	<u>172,578</u>

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2007 and 2006

(9) Grants, Subsidies and Capital Contributions, Continued

South Pacific Applied Geoscience Commission:		
Tariff study	19,940	9,970
Total grants and subsidies	99,140	182,548
Capital Contributions:		
Rural Utilities Service (RUS)	-	603,987
Department of the Interior (DOI)	124,753	1,841,384
	\$ 223,893	\$ 2,627,919

During the year ended September 30, 2006, DOI approved \$1,074,484 under the FSM Public Infrastructure Sector Grant to be used for the Pohnpei Water Well Drilling project. \$574,484 of the project amount was paid to the US Department of Defense to cover mobilization cost of military personnel, who assisted in this project. The remaining \$500,000 was passed through to PUC in the form of a sub-grant.

(10) Commitments and Contingencies

In August 2005, PUC entered into a contract with an engineering firm to provide design, procurement, and construction management services relating to the Hydro Rehabilitation Project for a total cost of \$1,117,040. As of September 30, 2007, total costs of \$942,049 were billed and a payable of \$124,810 is included in accounts payable: operations in the accompanying statement of net assets. In January 2008, the parties agreed to dissolve the contract without incurring further costs.

PUC is party to various legal proceedings, the ultimate impact of which is not currently predictable. Therefore, no liability has been recorded in the accompanying financial statements due to management's inability to predict the ultimate outcome of these proceedings.

(11) Sinking Fund

During fiscal year 1998, PUC management established a sinking fund to finance future expansion and upgrade of the power plant and equipment. The goal of PUC is to build this fund to \$2,000,000 in anticipation of certain equipment purchases and upgrades.

The sinking fund consists of investments in three mutual funds that have the following asset allocations at September 30, 2007 and 2006:

	2007	2006
Money market funds	\$ 17,355	\$ 16,050
U.S. Government obligations	163,083	143,642
Corporate bonds and others	140,655	146,856
Common stock	363,907	330,958
	\$ 685,000	\$ 637,506

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Notes to Financial Statements
September 30, 2007 and 2006

(12) Retirement Plan

PUC's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees receive from the FSM Social Security System. The Plan is a contributory, defined contribution plan in which PUC contributes a matching percentage of the participant's contribution, up to 10% of the participant's annual salary. The participant may contribute three or more percent from his or her annual salary. Participation is optional. PUC's comptroller is the designated Plan administrator. Contributions to the Plan during the years ended September 30, 2007 and 2006 were \$83,523 and \$82,554, respectively. Management is of the opinion that the plan does not represent an asset or liability of PUC. At September 30, 2007 and 2006, plan assets were \$1,130,264 and \$899,691, respectively.

(13) Related Party

During the year ended September 30, 2007, PUC received a \$40,000 non-interest bearing advance from the PUC Social Club. The advance has no set repayment term and is classified as current due to the mutual consent of the parties.

POHNPEI UTILITIES CORPORATION
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Combining Statement of Net Assets
September 30, 2007
(With comparative totals as of September 30, 2006)

<u>Assets</u>	<u>Power and Utility</u>	<u>Water and Sewer</u>	<u>Eliminating Entries</u>	<u>Totals</u>	
				2007	2006
Current assets:					
Cash and cash equivalents	\$ 539,188	\$ (182,132)	\$ -	\$ 357,056	\$ 521,763
Investment	685,000	-	-	685,000	637,506
Accounts receivable, net	1,397,302	770,137	-	2,167,439	2,605,737
Grants receivable	0	23,698	-	23,698	232,950
Prepayments	10,186	0	-	10,186	-
Fuel and material inventory	843,773	434,100	-	1,277,873	1,604,871
Total current assets	<u>3,475,449</u>	<u>1,045,803</u>	<u>-</u>	<u>4,521,252</u>	<u>5,602,827</u>
Other noncurrent assets:					
Restricted:					
Cash and cash equivalents	3,881	-	-	3,881	3,881
Time certificates of deposit	350,000	-	-	350,000	350,000
Investments	139,390	-	-	139,390	132,505
Interest receivable	1,130	-	-	1,130	1,130
Total other noncurrent assets	<u>494,401</u>	<u>-</u>	<u>-</u>	<u>494,401</u>	<u>487,516</u>
Utility plant, at cost:					
Electric plant in service	37,560,131	-	-	37,560,131	36,122,868
Water and sewer plant in service	-	19,307,046	-	19,307,046	18,086,411
	<u>37,560,131</u>	<u>19,307,046</u>	<u>-</u>	<u>56,867,177</u>	<u>54,209,279</u>
Less accumulated depreciation	<u>(22,019,406)</u>	<u>(6,619,126)</u>	<u>-</u>	<u>(28,638,532)</u>	<u>(26,554,184)</u>
Depreciable assets	15,540,725	12,687,920	-	28,228,645	27,655,095
Construction work-in-process	32,706	130,412	-	163,118	2,257,298
Total utility plant	<u>15,573,431</u>	<u>12,818,332</u>	<u>-</u>	<u>28,391,763</u>	<u>29,912,393</u>
	<u>\$ 19,543,281</u>	<u>\$ 13,864,135</u>	<u>\$ -</u>	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>
<u>Liabilities and Net Assets</u>					
Current liabilities:					
Notes payable to bank	\$ 398,000	\$ -	\$ -	\$ 398,000	\$ 190,000
Note payable to investment company	-	476,825	-	476,825	453,647
Current portion of long-term debt	46,444	88,478	-	134,922	118,536
Accounts payable:					
Fuel oil	-	-	-	-	451,635
Operations	463,912	-	-	463,912	261,414
Affiliate	40,000	-	-	40,000	-
Deferred revenue	312,752	-	-	312,752	318,636
Accrued taxes and other liabilities	202,694	-	-	202,694	177,610
Employees' annual leave	92,433	-	-	92,433	76,713
Total current liabilities	<u>1,556,235</u>	<u>565,303</u>	<u>-</u>	<u>2,121,538</u>	<u>2,048,191</u>
Noncurrent liabilities:					
FSM Development Bank loan	433,519	-	-	433,519	-
RUS Water Extension loan	-	563,318	-	563,318	572,040
ADB Water Extension loan	-	2,014,016	-	2,014,016	2,073,642
Total liabilities	<u>1,989,754</u>	<u>3,142,637</u>	<u>-</u>	<u>5,132,391</u>	<u>4,693,873</u>
Net assets:					
Invested in capital assets, net of related debt	15,093,468	9,675,695	-	24,769,163	26,694,528
Restricted	139,390	-	-	139,390	132,505
Unrestricted	2,320,669	1,045,803	-	3,366,472	4,481,830
Total net assets	<u>17,553,527</u>	<u>10,721,498</u>	<u>-</u>	<u>28,275,025</u>	<u>31,308,863</u>
	<u>\$ 19,543,281</u>	<u>\$ 13,864,135</u>	<u>\$ -</u>	<u>\$ 33,407,416</u>	<u>\$ 36,002,736</u>

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION
(A COMPONENT UNIT OF THE STATE OF POHNPEI)

Combining Statement of Revenues, Expenses and Changes in Net Assets
Year Ended September 30, 2007
(With comparative totals for the year ended September 30, 2006)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2007	2006
Operating revenues:					
Residential	\$ 339,723	\$ 928,782	\$ -	\$ 1,268,505	\$ 1,447,753
Commercial	2,167,025	126,327	-	2,293,352	2,542,146
Government	1,934,488	125,127	-	2,059,615	2,088,390
Cash power	5,663,152	-	-	5,663,152	3,670,219
Intercompany sales	65,087	-	(65,087)	-	-
Other sales	39,393	45,026	-	84,419	323,092
Total operating revenues before bad debts	10,208,868	1,225,262	(65,087)	11,369,043	10,071,600
Bad debts	-	-	-	-	(81,000)
Total operating revenues after bad debts	10,208,868	1,225,262	(65,087)	11,369,043	9,990,600
Operating and maintenance expenses:					
Production fuel	8,965,458	-	-	8,965,458	6,694,457
Depreciation	1,411,540	672,808	-	2,084,348	2,009,334
Administrative and general:					
Employee benefits	366,554	-	-	366,554	404,477
Salaries and wages	420,631	-	-	420,631	377,438
Vehicle, POL	157,999	-	-	157,999	264,361
General repairs	45,158	-	-	45,158	102,472
Consumables	51,732	-	-	51,732	94,381
Travel	21,461	-	-	21,461	80,140
Communications	48,793	-	-	48,793	59,362
Insurance	54,512	-	-	54,512	57,319
Contractual services	176,355	-	-	176,355	40,000
Training and safety	9,108	-	-	9,108	23,212
Customer service and collection	3,731	-	-	3,731	8,721
Legal fees	25	-	-	25	2,753
Utility	16,850	-	(16,850)	-	-
	1,372,909	-	(16,850)	1,356,059	1,514,636
Generation:					
Salaries and wages	393,498	-	-	393,498	429,605
Repairs and maintenance	426,499	-	-	426,499	90,701
Other production	15,129	-	-	15,129	33,380
	835,126	-	-	835,126	553,686
Water and sewer:					
Salaries and wages	-	568,339	-	568,339	427,685
Repairs and maintenance	-	91,825	-	91,825	14,971
Chemicals	-	59,391	-	59,391	26,137
Employee benefits	-	62,143	-	62,143	59,541
Other production	-	105,636	-	105,636	48,038
Training and safety	-	24,054	-	24,054	18,143
Utility expense	-	48,237	(48,237)	-	-
	-	959,625	(48,237)	911,388	594,515
Distribution:					
Salaries and wages	341,425	-	-	341,425	381,849
Repairs and maintenance	91,502	-	-	91,502	171,582
	432,927	-	-	432,927	553,431
Total operating expenses	13,017,960	1,632,433	(65,087)	14,585,306	11,920,059
Operating loss	(2,809,092)	(407,171)	-	(3,216,263)	(1,929,459)

See accompanying Independent Auditors' Report.

POHNPEI UTILITIES CORPORATION
(A COMPONENT UNIT OF THE STATE OF POHNPEI)

Combining Statement of Revenues, Expenses and Changes in Net Assets, Continued
Year Ended September 30, 2007
(With comparative totals for the year ended September 30, 2006)

	Power and Utility	Water and Sewer	Eliminating Entries	Totals	
				2007	2006
Nonoperating revenues:					
Federal grants and subsidies	99,140	-	-	99,140	182,548
Spurline projects	16,363	-	-	16,363	96,465
Interest (expense) income, net	(58,056)	-	-	(58,056)	(57,926)
Other income	225	-	-	225	5,000
	<u>57,672</u>	<u>-</u>	<u>-</u>	<u>57,672</u>	<u>226,087</u>
Total nonoperating revenues					
Net earnings (loss) before capital contributions	(2,751,420)	(407,171)	-	(3,158,591)	(1,703,372)
Capital contributions:					
Grants from United States Department of Agriculture	-		-	-	603,987
Grants passed through from the United States Department of the Interior	124,753		-	124,753	1,841,384
	<u>124,753</u>		<u>-</u>	<u>124,753</u>	<u>1,841,384</u>
Change in net assets	(2,626,667)	(407,171)	-	(3,033,838)	741,999
Net assets at beginning of year	<u>20,180,194</u>	<u>11,128,669</u>	<u>-</u>	<u>31,308,863</u>	<u>30,566,864</u>
Net assets at end of year	<u>\$ 17,553,527</u>	<u>\$ 10,721,498</u>	<u>\$ -</u>	<u>\$ 28,275,025</u>	<u>\$ 31,308,863</u>

See accompanying Independent Auditors' Report.

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

Board of Directors
Pohnpei Utilities Corporation:

We have audited the financial statements of Pohnpei Utilities Corporation (PUC) as of and for the year ended September 30, 2007 and have issued our report thereon dated June 2, 2008. 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 PUC's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of PUC's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects PUC's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of PUC's financial statements that is more than inconsequential will not be prevented or detected by PUC's internal control. We consider the deficiency described in the accompanying Schedule of Findings and Response (pages 26) as item 2007-1 to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by PUC's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiency described above is not a material weakness.

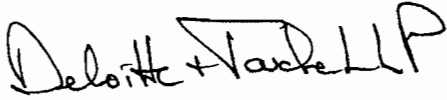
Compliance and Other Matters

As part of obtaining reasonable assurance about whether PUC'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 PUC in a separate letter dated June 2, 2008.

PUC's response to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. We did not audit PUC's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Board of Directors and management of Pohnpei Utilities Corporation, the Office of the Public Auditor, federal awarding agencies, 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. However, this report is also a matter of public record.

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

June 2, 2008

POHNEPI UTILITIES CORPORATION

Schedule of Findings and Response
Year Ended September 30, 2007

Finding No. 2007-1

Year-end Adjustments

Criteria: Adjustments should be recorded prior to year end closing.

Condition: Numerous adjustments were made to the general ledger accounts at and after year-end. The size and number of adjustments may have been reduced if a thorough review of general ledger accounts was performed each month.

Cause: General ledger accounts are not always thoroughly analyzed until the audit time frame.

Effect: Interim and unaudited year-end financial statements may be materially misstated.

Recommendation: We recommend that month end and year end closing timetables be implemented which would include the analysis of major balance sheet accounts. All such accounts should be reviewed by the controller or chief financial officer.

Auditee Response and Corrective Action Plan: PUC concurs with the finding and would implement a policy whereby analysis of major balance sheet accounts are performed and updated each month. Such updates should be reviewed by the controller or the Chief Accountant. The implementation of this corrective action plan is set to start on June 30, 2008.