

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

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

YEARS ENDED SEPTEMBER 30, 2010 AND 2009

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

Table of Contents
Years Ended September 30, 2010 and 2009

	<u>Page No.</u>
I. Independent Auditors' Report	1
II. Management's Discussion and Analysis	3
III. Financial Statements and Additional Information:	
Statements of Net Assets	7
Statements of Revenue, Expenses, and Changes in Net Assets	8
Statements of Cash Flows	9
Notes to Financial Statements	10
Combining Statement of Net Assets	21
Combining Statement of Revenues, Expenses and Changes in Net Assets	22
IV. Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit Performed in Accordance with <i>Government</i> <i>Auditing Standards</i>	24

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, 2010 and 2009, 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, 2010 and 2009, 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 6 is not a required part of the basic financial statements but is supplementary information required by the *Governmental Accounting Standards Board*. This supplementary information is the responsibility of PUC's management. We have applied certain limited procedures to such information, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was 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 our audit of the basic financial statements for the year ended September 30, 2010 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 April 11, 2011, 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.

Deloitte & Touche LLP

April 11, 2011

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

Management Discussion and Analysis
Year Ended September 30, 2010

The following discussion and analysis of the financial performance and activities 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, 2010 and 2009. 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.

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.

PUC has an installed generation capacity of 15.46 MW and with the aging condition of the units, the generation capacity is de-rated down to 7.6 MW while the power demand is 6.9 and 6.2 MW in 2010 and 2009, respectively. PUC generated 39,814 MWh and 36,003 MWh and sold 31,182 and 29,797 MWh to customers in 2010 and 2009, respectively. This resulted in total power revenue of \$11.2 million and \$10.2 million to PUC in 2010 and 2009, respectively. The increase in sales revenue in 2010 is mainly the result of increases in fuel tariff and increases in MWh sold. The number of households being serviced by the PUC is 6,546 (6,203 using cash power meters and 343 using conventional meters) in 2010 and 6,526 in 2009. 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 of existing customers amounts to 2.3 million gallons per day. PUC produced 803 million and 709 million gallons and sold 644 million and 609 million gallons to customers in 2010 and 2009, respectively, which resulted in total revenue to PUC of \$1.24 million and \$1.14 million, respectively. The PUC services 3,478 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 2010, 2009 and 2008:

Assets:	<u>2010</u>	<u>2009</u>	<u>2008</u>
Utility plant, net	\$ 23,246,150	\$ 24,380,722	\$ 26,257,924
Current assets	3,149,239	3,517,604	3,480,902
Other non-current assets	<u>295,112</u>	<u>295,082</u>	<u>516,621</u>
	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</u>	<u>\$ 30,255,447</u>
 Liabilities and Net Assets:			
Notes payable	\$ 200,000	\$ -	\$ 100,000
Current portion of long-term debt	222,478	210,385	199,694
Other current liabilities	1,178,099	703,259	900,258
Long-term debt, net	<u>3,461,434</u>	<u>3,338,166</u>	<u>3,550,597</u>
Total liabilities	<u>5,062,011</u>	<u>4,251,810</u>	<u>4,750,549</u>

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

Management Discussion and Analysis
Year Ended September 30, 2010

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net Assets:			
Invested in capital assets, net of related debt	19,712,238	20,982,171	22,879,154
Restricted	145,112	145,082	143,970
Unrestricted	<u>1,771,140</u>	<u>2,814,345</u>	<u>2,481,774</u>
Total net assets	<u>21,628,490</u>	<u>23,941,598</u>	<u>25,504,898</u>
	\$ <u>26,690,501</u>	\$ <u>28,193,408</u>	\$ <u>30,255,447</u>
Revenues, Expenses and Changes in Net Assets:			
Operating revenues	\$ 12,639,486	\$ 11,537,213	\$ 13,799,835
Bad debt expense	(300,000)	(530,500)	(202,600)
Operating expenses	<u>(14,726,423)</u>	<u>(12,911,198)</u>	<u>(16,238,431)</u>
Net operating loss	(2,386,937)	(1,904,485)	(2,641,196)
Non-operating (expenses) revenues, net	<u>73,829</u>	<u>(341,185)</u>	<u>(128,931)</u>
Decrease in net assets	(2,313,108)	(1,563,300)	(2,770,127)
Net assets at beginning of year	<u>23,941,598</u>	<u>25,504,898</u>	<u>28,275,025</u>
Net assets at end of year	\$ <u>21,628,490</u>	\$ <u>23,941,598</u>	\$ <u>25,504,898</u>

Overall changes in the balance sheet components from September 30, 2009 to 2010 include a decrease in utility plant, net (\$1,054,654), a decrease in current assets (\$368,365) and an increase in current and long term liabilities (\$810,201).

Decreases in utility plant are the result of depreciation, asset dispositions, transfers and new acquisitions. Transfers and new acquisitions totaled \$1,073,734. Daihatsu #8, Salapwuk spurline, the hook-up of the new Pohnpei State Administration building, ADB loan consulting fees plus a few other items makes up the total new capitalization in 2010. For more detail regarding movement in PUC's utility plant, please refer to note 5 to the financial statements.

Decreases in current assets are the net effect of minor increases in accounts receivable and a material decrease in inventory due to the successful repair of Daihatsu#8. PUC's inability to collect from its water customers make up the increase in accounts receivable despite incurring \$300,000 in bad debt.

Increase in current and long-term debt from 2009 to 2010 is the net effect of PUC's scheduled loan repayments to FSM Development Bank, U.S. Rural Utility Services, Asian Development Bank and the Bank of the FSM and the acquisition of an interest free loan from Pohnpei State Government and a new account with FSM Petro Corp. The ADB loan consulting fees that were recently communicated to PUC also contributed to the increase in long-term debt. For additional information on PUC's financing activities, please refer to note 6 to the financial statements.

The changes in revenue, expenses and changes in net assets statement between fiscal year 2009 and 2010 include an increase in operating revenues before bad debts of \$1,102,273, an increase in operating expenses of \$1,815,225, and an increase in net operating loss of (\$482,452).

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

Management Discussion and Analysis
Year Ended September 30, 2010

The increase in operating revenues before bad debts is due to an increase in average fuel tariff and an increase in KWh sold plus an increase in water sales.

The increase in operating expenses is mainly the result of fuel cost increases. The fuel expense this year alone is \$9,516,181, an increase of \$1,379,863 from 2009.

PUC incurred a loss of (\$2,313,108), an increase of \$749,808 from 2009. It cost PUC \$0.4179 to produce and sell one unit of power (kWh) in 2010; however, PUC charged an average of \$0.3486 per unit of power or (kWh) in 2010. It also cost PUC \$2.18 to produce and sell one thousand gallons of clean water (1,000 gallons), but PUC charged an average of \$1.80 per the thousand gallons of water sold.

Some of the factors affecting the disparity between actual production cost and the tariff are:

1. PUC does not charge depreciation expense to customers. In 2010, the cost of depreciation expense per unit of power is \$.05 and the cost of depreciation per thousand gallons of water is \$1.05.
2. It should also be noted that the existing tariff was approved in 1996, 12 years ago using the revenue requirements and service levels of those years. Tariff reform is overdue for PUC to reflect current economic realities. In addition, freight and insurance costs have more than doubled because of the worldwide increase in fuel prices. PUC's costs are greatly impacted by freight because PUC relies heavily on imports of its engine parts and distribution, water and sewer supplies and materials.
3. PUC is paying for import taxes which it did not pay in 1996.
4. PUC is supposed to recover the actual cost of fuel by the tariff. However, based on the revenue analysis this year, PUC recovered from customers approximately \$7,897,474 in fuel charges, but spent \$9,516,181 on fuel, a shortfall of (\$1,618,707). PUC diverted funds intended for maintenance and operations to cover the shortfall in fuel revenue in 2010. The reasons for the fuel revenue shortfall are as follows:
 - a. PUC spent about \$538,000 in lubrication oil and solvents in 2010. Lubrication oil was not included in the fuel pass-through tariff until September 2010.
 - b. The technical and line loss for PUC this year is 20.8 percent. The fuel used to produce the power that is lost is not recovered by the tariff.
 - c. Although there are 343 customers using conventional meters among the total of 6,546 power customers, their power consumption averages about 44% of the total annual sales. These customers are mainly large commercial customers and government customers. The billing cycle for these customers is 45 days. The fuel price is not charged to these customers until 45 days later and so in times of increasing fuel prices, these customers are charged a lower fuel price than the actual cost of fuel, creating a mismatch of current revenue and fuel expense.

Management's Discussion and Analysis for the year ended September 30, 2009 is set forth in PUC's report on the audit of financial statements, which is dated April 14, 2010. That Discussion and Analysis explains the major factors impacting the 2009 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmopa.fm

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

Management Discussion and Analysis
Year Ended September 30, 2010

Economic Outlook

The economic outlook for PUC operation next year is worse than 2010. All projections are revealing another year of more fuel price increases that will equal 2008 figures or worse. With these projections, the potential for PUC to see another increase in the number of KWh sold is next to none. This will only translate into more conservation that will mean more financial constraints. Without tariff adjustment or external funding assistance, PUC will be facing tough times as the current tariff is out dated and does not reflect current economic realities. An out dated tariff plus more fuel price increases coupled with an aging utility plant is not a good outlook for PUC in 2011.

This concludes the management discussion and analysis of the financial statements for the year ended September 30, 2010.

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

Statements of Net Assets
September 30, 2010 and 2009

<u>ASSETS</u>	<u>2010</u>	<u>2009</u>
Current assets:		
Cash and cash equivalents	\$ 160,979	\$ 131,558
Investments	174,257	174,186
Time certificates of deposit	234,874	231,041
Accounts receivable, net	1,649,571	1,521,270
Prepayments	9,778	12,309
Materials and fuel inventory	919,780	1,447,240
Total current assets	<u>3,149,239</u>	<u>3,517,604</u>
Other noncurrent assets:		
Restricted:		
Cash and cash equivalents	150,000	150,000
Investments	145,112	145,082
Total other noncurrent assets	<u>295,112</u>	<u>295,082</u>
Utility plant, at cost:		
Electric plant in service	38,257,135	37,555,697
Water and sewer plant in service	19,725,729	19,353,434
	57,982,864	56,909,131
Less accumulated depreciation	<u>(34,906,596)</u>	<u>(32,778,209)</u>
Depreciable assets	23,076,268	24,130,922
Construction work-in-process	169,882	249,800
Total utility plant	<u>23,246,150</u>	<u>24,380,722</u>
	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 200,000	\$ -
Current portion of long-term debt	222,478	210,385
Accounts payable:		
Operations	265,672	287,239
Fuel and lubricants	344,640	-
Affiliate	157,993	99,023
Deferred revenue	182,751	136,528
Accrued taxes and other liabilities	171,486	158,543
Employees' annual leave	55,557	21,926
Total current liabilities	1,600,577	913,644
Noncurrent liabilities:		
Long-term debt, net of current portion	3,461,434	3,338,166
Total liabilities	<u>5,062,011</u>	<u>4,251,810</u>
Contingencies		
Net assets:		
Invested in capital assets, net of related debt	19,712,238	20,982,171
Restricted	145,112	145,082
Unrestricted	1,771,140	2,814,345
Total net assets	<u>21,628,490</u>	<u>23,941,598</u>
	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</u>

See accompanying notes to financial statements.

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

Statements of Revenues, Expenses and Changes in Net Assets
Years Ended September 30, 2010 and 2009

	2010	2009
Operating revenues:		
Electricity sales	\$ 11,274,042	\$ 10,299,229
Water sales	1,238,409	1,138,576
Other sales	127,035	99,408
Total operating revenues before bad debts	12,639,486	11,537,213
Bad debts	(300,000)	(530,500)
Total operating revenues after bad debts	12,339,486	11,006,713
Operating and maintenance expenses:		
Production fuel	9,516,181	8,136,318
Depreciation	2,128,387	2,053,801
Administrative and general	963,705	934,799
Generation	859,785	713,317
Water and sewer	772,098	717,842
Distribution	486,267	355,121
Total operating expenses	14,726,423	12,911,198
Operating loss	(2,386,937)	(1,904,485)
Nonoperating (expenses) revenues:		
Interest expense, net	(143,465)	(176,887)
Grants and subsidies	154,116	479,969
Spurline projects	63,178	38,103
Total nonoperating revenues	73,829	341,185
Change in net assets	(2,313,108)	(1,563,300)
Net assets at beginning of year	23,941,598	25,504,898
Net assets at end of year	\$ 21,628,490	\$ 23,941,598

See accompanying notes to financial statements.

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

Statements of Cash Flows
Years Ended September 30, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Cash received from customers	\$ 12,257,408	\$ 11,298,287
Cash payments to suppliers for goods and services	(9,913,278)	(9,543,864)
Cash paid to employees	(1,724,448)	(1,717,864)
Net cash provided by operating activities	619,682	36,559
Cash flows from investing activities:		
Interest and dividends on investments and bank account	1,887	5,477
Net cash provided by investing activities	1,887	5,477
Cash flows from noncapital financing activities:		
Proceeds from (payments for) notes payable	200,000	(100,000)
Advance from affiliate	58,970	20,706
Operating grants received	154,116	503,667
Interest expense	(149,286)	(193,022)
Spurline projects	63,178	38,103
Net cash provided by noncapital financing activities	326,978	269,454
Cash flows from capital and related financing activities:		
Repayments of long-term debt	(205,731)	(201,740)
Acquisition of utility plant	(713,395)	(176,599)
Net cash used for capital and related financing activities	(919,126)	(378,339)
Net change in cash and cash equivalents	29,421	(66,849)
Cash and cash equivalents at beginning of year	131,558	198,407
Cash and cash equivalents at end of year	\$ 160,979	\$ 131,558
<u>Reconciliation of operating loss to net cash provided by operating activities:</u>		
Operating loss	\$ (2,386,937)	\$ (1,904,485)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	2,128,387	2,053,801
Bad debts	300,000	530,500
Write off of obsolete inventory	139,280	-
Write off of plant and equipment	60,672	-
(Increase) decrease in assets:		
Accounts receivable	(428,301)	(185,380)
Prepayments	2,531	(12,309)
Materials and fuel inventory	388,180	(227,863)
Increase (decrease) in liabilities:		
Accounts payable	323,073	(70,359)
Deferred revenue	46,223	(53,546)
Accrued taxes and other liabilities	12,943	(24,591)
Employees' annual leave	33,631	(69,209)
Net cash provided by operating activities	\$ 619,682	\$ 36,559

Supplemental information of noncash capital and related financing activities activities:

During the year ended September 30, 2010, PUC was allocated \$341,092 of additional costs related to a 2004 capital project by the FSM National Government (FSMNG). As a result, PUC increased its long-term debt by \$341,092, and water plant assets by \$341,092 (net of accumulated depreciation of \$51,164).

See accompanying notes to financial statements.

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

Notes to Financial Statements
September 30, 2010 and 2009

(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, Interpretations and Accounting Standards Updates 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. The allowance is established through a provision for bad debts charged against earnings.

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.

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

Notes to Financial Statements
September 30, 2010 and 2009

(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, 2010 approximates \$240,000.

Net Assets: Net assets represent the residual interest in PUC's assets after liabilities are deducted and consist of three 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. Unbilled revenues are accrued based on the most recent billing cycles. Cash power revenue is recognized as revenue upon point of sale; the estimated unearned portion is determined at year end and recorded as deferred revenue in the accompanying statements of net assets.

Federal Grants and Subsidies: PUC receives federal grants either as a direct recipient or as 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.

New Accounting Standards: During fiscal year 2010, PUC implemented the following pronouncements:

- GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which addresses whether and when intangible assets should be considered capital assets for financial reporting purposes.

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

Notes to Financial Statements
September 30, 2010 and 2009

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements.
- GASB Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution Adjustment for Postemployment Benefits*, which clarifies the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, for calculating the annual required contribution (ARC) adjustment.
- GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, which provides guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code, and establishes requirements for recognizing and measuring the effects of the bankruptcy process on assets and liabilities, and for classifying changes in those items and related costs.

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

In March 2009, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of the PUC.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement 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*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method are effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the PUC.

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of the PUC.

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

Notes to Financial Statements
September 30, 2010 and 2009

(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.

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, 2010 and 2009, the carrying amount of PUC's total cash and cash equivalents and time certificates of deposit was \$545,853 and \$512,599, respectively, and the corresponding bank balances were \$580,926 and \$608,200, respectively. Of the bank balances, \$545,081 and \$511,827, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2010 and 2009, bank deposits in the amount of \$500,000 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.

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

Notes to Financial Statements
September 30, 2010 and 2009

(2) Deposits and Investments, Continued

B. Investments:

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

- Category 1 Investments that are insured or registered, or securities held by the 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.

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, 2010 and 2009, investments in mutual funds at fair value are \$319,369 and \$319,268, 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, 2010 and 2009.

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, 2010 and 2009.

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.

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

Notes to Financial Statements
September 30, 2010 and 2009

(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, 2010 and 2009, the carrying amount of the fund is \$145,112 and \$145,082, respectively, which is presented as a restricted investment in the accompanying statements of net assets.

Additionally, PUC is self-insured for all losses such as torts; theft or damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Management is of the opinion that no material losses have been sustained as a result of this practice during the past three years.

(4) Accounts Receivable

Effective July 1, 2008, PUC changed its policy and reads meters on the last day of the month and processes bills on the first of the following month. Therefore, approximately thirty days of service is accrued at September 30, 2010 and 2009, which is classified as accounts receivable - unbilled. Accounts receivable at September 30, 2010 and 2009, are summarized as follows:

	<u>2010</u>	<u>2009</u>
Accounts receivable - electrical:		
Residential	\$ 1,387,944	\$ 1,274,578
Commercial	539,965	620,537
Government	261,222	177,480
Unbilled	<u>434,671</u>	<u>358,995</u>
	<u>2,623,802</u>	<u>2,431,590</u>
Accounts receivable - water and sewer:		
Residential	1,888,839	1,651,653
Commercial and government	199,470	175,937
Unbilled	<u>105,044</u>	<u>125,711</u>
	<u>2,193,353</u>	<u>1,953,301</u>
Installment receivables	90,100	91,748
Other	<u>96,559</u>	<u>98,874</u>
	5,003,814	4,575,513
Less allowance for doubtful receivables	<u>(3,354,243)</u>	<u>(3,054,243)</u>
	<u>\$ 1,649,571</u>	<u>\$ 1,521,270</u>

PUC commenced a prepaid cash power meter system in which a portion of customer payments are used to satisfy balances in arrears. 50% of collections are applied to arrears at the time of purchase, starting October 2007. As of September 30, 2010 and 2009, gross receivables from customers enrolled in the cash power meter system are \$896,214 and \$824,260, respectively.

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

Notes to Financial Statements
September 30, 2010 and 2009

(5) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2010 and 2009 is as follows:

	Beginning Balance <u>October 1, 2009</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	Ending Balance <u>September 30, 2010</u>
<u>Depreciable assets:</u>					
Production plant	\$ 21,750,155	\$ 582,833	\$ -	\$ -	\$ 22,332,988
Distribution plant	14,212,129	-	-	112,005	14,324,134
General plant	<u>1,593,413</u>	<u>6,600</u>	<u>-</u>	<u>-</u>	<u>1,600,013</u>
Electric plant in service	<u>37,555,697</u>	<u>589,433</u>	<u>-</u>	<u>112,005</u>	<u>38,257,135</u>
Water production plant	6,353,862	341,092	-	19,848	6,714,802
Sewage collection and treatment plant	5,512,301	-	-	-	5,512,301
Water distribution plant	6,930,383	-	-	-	6,930,383
General plant	<u>556,888</u>	<u>6,100</u>	<u>-</u>	<u>5,255</u>	<u>568,243</u>
Water and sewer plant in service	<u>19,353,434</u>	<u>347,192</u>	<u>-</u>	<u>25,103</u>	<u>19,725,729</u>
Total utility plant in service	56,909,131	936,625	-	137,108	57,982,864
Less accumulated depreciation	<u>(32,778,209)</u>	<u>(2,128,387)</u>	<u>-</u>	<u>-</u>	<u>(34,906,596)</u>
	<u>24,130,922</u>	<u>(1,191,762)</u>	<u>-</u>	<u>137,108</u>	<u>23,076,268</u>
<u>Non-depreciable assets:</u>					
<u>Construction work-in-progress:</u>					
Electric plant	183,985	99,706	(55,916)	(79,919)	147,856
Water and sewer plant	<u>65,815</u>	<u>18,156</u>	<u>(4,756)</u>	<u>(57,189)</u>	<u>22,026</u>
	<u>249,800</u>	<u>117,862</u>	<u>(60,672)</u>	<u>(137,108)</u>	<u>169,882</u>
	\$ <u>24,380,722</u>	\$ <u>(1,073,900)</u>	\$ <u>(60,672)</u>	\$ <u>-</u>	\$ <u>23,246,150</u>
	Beginning Balance <u>October 1, 2008</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	Ending Balance <u>September 30, 2009</u>
<u>Depreciable assets:</u>					
Production plant	\$ 21,750,155	\$ -	\$ -	\$ -	\$ 21,750,155
Distribution plant	14,221,240	-	(9,111)	-	14,212,129
General plant	<u>1,614,271</u>	<u>-</u>	<u>(20,858)</u>	<u>-</u>	<u>1,593,413</u>
Electric plant in service	<u>37,585,666</u>	<u>-</u>	<u>(29,969)</u>	<u>-</u>	<u>37,555,697</u>
Water production plant	6,357,862	-	(4,000)	-	6,353,862
Sewage collection and treatment plant	5,512,301	-	-	-	5,512,301
Water distribution plant	6,930,383	-	-	-	6,930,383
General plant	<u>556,888</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>556,888</u>
Water and sewer plant in service	<u>19,357,434</u>	<u>-</u>	<u>(4,000)</u>	<u>-</u>	<u>19,353,434</u>
Total utility plant in service	56,943,100	-	(33,969)	-	56,909,131
Less accumulated depreciation	<u>(30,743,463)</u>	<u>(2,053,801)</u>	<u>19,055</u>	<u>-</u>	<u>(32,778,209)</u>
	<u>26,199,637</u>	<u>(2,053,801)</u>	<u>(14,914)</u>	<u>-</u>	<u>24,130,922</u>
<u>Non-depreciable assets:</u>					
<u>Construction work-in-progress:</u>					
Electric plant	13,800	170,185	-	-	183,985
Water and sewer plant	<u>44,487</u>	<u>21,328</u>	<u>-</u>	<u>-</u>	<u>65,815</u>
	<u>58,287</u>	<u>191,513</u>	<u>-</u>	<u>-</u>	<u>249,800</u>
	\$ <u>26,257,924</u>	\$ <u>(1,862,288)</u>	\$ <u>(14,914)</u>	\$ <u>-</u>	\$ <u>24,380,722</u>

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

Notes to Financial Statements
September 30, 2010 and 2009

(6) Notes Payable and Long-Term Debt

The Bank has a \$190,000 credit line with the Bank of the Federated States of Micronesia (BFSM), collateralized by a time certificate deposit (TCD) with the bank, bearing variable interest at 2.5% over the TCD rate. No borrowings against the line were outstanding at September 30, 2010 and 2009.

Notes payable as of September 30, 2010 are due to Pohnpei State Government, are non-interest bearing and are uncollateralized with no set repayment date.

Changes in notes payable for the years ended September 30, 2010 and 2009, are as follows:

	Outstanding October 1, <u>2009</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2010</u>
Notes to Pohnpei State Government	\$ <u> -</u>	\$ <u>200,000</u>	\$ <u> -</u>	\$ <u>200,000</u>
	Outstanding October 1, <u>2008</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2009</u>
Note drawn on Bank credit line	\$ <u>100,000</u>	\$ <u> -</u>	\$ <u>(100,000)</u>	\$ <u> -</u>

The proceeds from the notes payable were used to finance PUC's operating activities.

Long-term debt consists of the following at September 30, 2010 and 2009:

	<u>2010</u>	<u>2009</u>
Loan payable to the State of Pohnpei, facilitated by an Asian Development Bank (ADB) loan to the FSM, original amount of \$2,118,767, due in semi-annual installments of \$33,500 from February 2007 to August 2044. The State of Pohnpei has not imposed collateralization on PUC and has waived its rights to receive 6.82% in interest. The loan 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, 2010 and 2009. During 2010, an additional \$341,092 was allocated to PUC which extended the maturity date to August 2051.	\$ 2,273,521	\$ 1,972,270
Loan payable to United States Department of Agriculture, Rural Utilities Service (RUS), original amount of \$578,000, due in monthly installments of \$2,654 from October 2006 to July 2044. The loan is collateralized by a revenue pledge. The loan bears fixed interest of 4.5%.	549,206	559,418
Loan payable to BFSM, original amount of \$773,122, 5 year term, interest at 9%, collateralized by a diesel power comprehensive generator plant, two Daihatsu model 12D532 engines, building and materials, and existing and future receivables. Monthly principal and interest installments of \$9,794 from September 2008 with unpaid principal due in August 2013.	668,414	722,055

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

Notes to Financial Statements
September 30, 2010 and 2009

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

Loan payable to FSM Development Bank (FSMDB), original amount of \$481,701, 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 from July 2007 to June 2012. A member of the PUC Board is also a member of management of the FSMDB.

	<u>192,771</u>	<u>294,808</u>
Total long-term debt	3,683,912	3,548,551
Less: current portion of long-term debt	<u>222,478</u>	<u>210,385</u>
Long-term portion of long-term debt	\$ <u>3,461,434</u>	\$ <u>3,338,166</u>

The proceeds from long-term debt were used to acquire utility plant.

At September 30, 2010, PUC is not in compliance with several debt covenants contained in the loan agreement with the BFSM. PUC is in the process of obtaining a waiver from the Bank and is of the opinion that no impact on the accompanying financial statements would result from resolution of this matter.

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>
2011	\$ 222,478	\$ 118,448	\$ 340,926
2012	197,987	102,189	300,176
2013	598,096	88,554	686,650
2014	54,102	44,746	98,848
2015	54,937	43,911	98,848
2016-2020	287,869	206,371	494,240
2021-2025	312,454	181,786	494,240
2026-2030	340,700	153,540	494,240
2031-2035	373,481	120,759	494,240
2036-2040	411,791	82,449	494,240
2041-2045	415,054	38,230	453,284
2046-2050	322,535	12,465	335,000
2051	<u>92,428</u>	<u>540</u>	<u>92,968</u>
	\$ <u>3,683,912</u>	\$ <u>1,193,988</u>	\$ <u>4,877,900</u>

Changes in non-current liabilities for the years ended September 30, 2010 and 2009, are as follows:

	Outstanding October 1, 2009	Increases	Decreases	Outstanding September 30, 2010	Current	Noncurrent
Loan payable to:						
ADB	\$ 1,972,270	\$ 341,092	\$ (39,841)	\$ 2,273,521	\$ 44,532	\$ 2,228,989
RUS	559,418	-	(10,212)	549,206	7,128	542,078
BFSM	722,055	-	(53,641)	668,414	59,071	609,343
FSMDB	<u>294,808</u>	<u>-</u>	<u>(102,037)</u>	<u>192,771</u>	<u>111,747</u>	<u>81,024</u>
	\$ <u>3,548,551</u>	\$ <u>341,092</u>	\$ <u>(205,731)</u>	\$ <u>3,683,912</u>	\$ <u>222,478</u>	\$ <u>3,461,434</u>

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

Notes to Financial Statements
September 30, 2010 and 2009

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

	Outstanding October 1, <u>2008</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2009</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to:						
ADB	\$ 2,022,848	\$ -	\$ (50,578)	\$ 1,972,270	\$ 48,829	\$ 1,923,441
RUS	565,803	-	(6,385)	559,418	6,815	552,603
BFSM	773,122	-	(51,067)	722,055	52,578	669,477
FSMDB	<u>388,518</u>	<u>-</u>	<u>(93,710)</u>	<u>294,808</u>	<u>102,163</u>	<u>192,645</u>
	<u>\$ 3,750,291</u>	<u>\$ -</u>	<u>\$ (201,740)</u>	<u>\$ 3,548,551</u>	<u>\$ 210,385</u>	<u>\$ 3,338,166</u>

(7) 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 (FSMNG) through the State of Pohnpei. These assets were donated to the FSMNG 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.

(8) Grants, Subsidies and Capital Contributions

Grants and subsidies comprise the following for the years ended September 30, 2010 and 2009:

	<u>2010</u>	<u>2009</u>
U.S. Department of the Interior:		
Operations and maintenance improvement program:		
Cash power meters program	\$ 10,031	\$ 129,969
Repair of power plant engine #8	<u>125,000</u>	<u>350,000</u>
	135,031	479,969
Other subsidies	<u>19,085</u>	<u>-</u>
	<u>\$ 154,116</u>	<u>\$ 479,969</u>

(9) 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 mutual funds of \$174,257 and \$174,186 at September 30, 2010 and 2009, respectively.

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

Notes to Financial Statements
September 30, 2010 and 2009

(10) Related Party

At September 30, 2010 and 2009, accounts receivable include amounts owed by the State of Pohnpei and its component units to PUC of \$213,553 and \$242,050, respectively. At September 30, 2010 and 2009, PUC also has a non-interest bearing advance from the PUC Social Club of \$137,289 and \$44,817, respectively. Further, at September 30, 2010 and 2009, PUC has a non-interest bearing advance from the State of Pohnpei of \$20,704 and \$54,206, respectively. These advances have no set repayment terms and are classified as current due to the mutual consent of the parties. At September 30, 2010, PUC has a non-interest bearing note payable to the State of Pohnpei of \$200,000 (note 6).

Additionally, PUC purchased 99% and 96% of its production fuel during the years ended September 30, 2010 and 2009 from FSM Petroleum Corporation, a component unit of FSMNG.

(11) Contingencies

PUC is involved in various legal actions in the normal course of business, including a variety of legal actions and claims that seek monetary damages or punitive damages. Based on current information, including legal consultation, management believes any ultimate liability that may arise from these actions would not materially affect PUC's financial position, results of operations or cash flows. However, management's evaluation of likely impact of these actions could change in the future and an unfavorable outcome, depending upon the amount and timing, could have a material effect on PUC's results of operations or cash flows in the future period.

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

Combining Statement of Net Assets
September 30, 2010
(With comparative totals as of September 30, 2009)

<u>Assets</u>	<u>Power and Utility</u>	<u>Water and Sewer</u>	<u>Totals</u>	
			<u>2010</u>	<u>2009</u>
Current assets:				
Cash and cash equivalents	\$ 196,065	\$ (35,086)	\$ 160,979	\$ 131,558
Investments	174,257	-	174,257	174,186
Time certificates of deposit	234,874	-	234,874	231,041
Accounts receivable, net	1,101,125	548,446	1,649,571	1,521,270
Prepayments	9,778	-	9,778	12,309
Fuel and material inventory	680,464	239,316	919,780	1,447,240
Total current assets	<u>2,396,563</u>	<u>752,676</u>	<u>3,149,239</u>	<u>3,517,604</u>
Other noncurrent assets:				
Restricted:				
Cash and cash equivalents	150,000	-	150,000	150,000
Investments	145,112	-	145,112	145,082
Total other noncurrent assets	<u>295,112</u>	<u>-</u>	<u>295,112</u>	<u>295,082</u>
Utility plant, at cost:				
Electric plant in service	38,257,135	-	38,257,135	37,555,697
Water and sewer plant in service	-	19,725,729	19,725,729	19,353,434
	38,257,135	19,725,729	57,982,864	56,909,131
Less accumulated depreciation	<u>(26,368,211)</u>	<u>(8,538,385)</u>	<u>(34,906,596)</u>	<u>(32,778,209)</u>
Depreciable assets	11,888,924	11,187,344	23,076,268	24,130,922
Construction work-in-process	147,856	22,026	169,882	249,800
Total utility plant	<u>12,036,780</u>	<u>11,209,370</u>	<u>23,246,150</u>	<u>24,380,722</u>
	<u>\$ 14,728,455</u>	<u>\$ 11,962,046</u>	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</u>
<u>Liabilities and Net Assets</u>				
Current liabilities:				
Notes payable	\$ 200,000	\$ -	\$ 200,000	\$ -
Current portion of long-term debt	170,818	51,660	222,478	210,385
Accounts payable:				
Operations	265,672	-	265,672	287,239
Fuel and lubricants	344,640	-	344,640	-
Affiliate	137,288	20,705	157,993	99,023
Deferred revenue	182,751	-	182,751	136,528
Accrued taxes and other liabilities	171,486	-	171,486	158,543
Employees' annual leave	55,557	-	55,557	21,926
Total current liabilities	<u>1,528,212</u>	<u>72,365</u>	<u>1,600,577</u>	<u>913,644</u>
Noncurrent liabilities:				
FSM Development Bank loan	81,024	-	81,024	192,645
RUS Water extension loan	-	542,078	542,078	552,603
Bank of the FSM	609,343	-	609,343	669,477
ADB Water extension loan	-	2,228,989	2,228,989	1,923,441
Total liabilities	<u>2,218,579</u>	<u>2,843,432</u>	<u>5,062,011</u>	<u>4,251,810</u>
Net assets:				
Invested in capital assets, net of related debt	11,325,595	8,386,643	19,712,238	20,982,171
Restricted	145,112	-	145,112	145,082
Unrestricted	1,039,169	731,971	1,771,140	2,814,345
Total net assets	<u>12,509,876</u>	<u>9,118,614</u>	<u>21,628,490</u>	<u>23,941,598</u>
	<u>\$ 14,728,455</u>	<u>\$ 11,962,046</u>	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</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, 2010
(With comparative totals for the year ended September 30, 2009)

	Power and Utility	Water and Sewer	Totals	
			2010	2009
Operating revenues:				
Residential	\$ 214,354	\$ 982,259	\$ 1,196,613	\$ 1,132,420
Commercial	2,731,817	142,211	2,874,028	2,619,332
Government	1,988,341	113,939	2,102,280	1,973,079
Cash power	6,339,530	-	6,339,530	5,712,974
Other sales	106,985	20,050	127,035	99,408
Total operating revenues before bad debts	11,381,027	1,258,459	12,639,486	11,537,213
Bad debts	-	(300,000)	(300,000)	(530,500)
Total operating revenues after bad debts	11,381,027	958,459	12,339,486	11,006,713
Operating and maintenance expenses:				
Production fuel	9,516,181	-	9,516,181	8,136,318
Depreciation	1,450,270	678,117	2,128,387	2,053,801
Administrative and general:				
Salaries and wages	376,305	-	376,305	415,662
Employee benefits	299,127	-	299,127	220,068
Vehicle, POL	84,654	-	84,654	91,768
Customer service and collection	76,532	-	76,532	31,432
Consumables	70,550	-	70,550	54,848
General repairs	28,549	-	28,549	43,616
Communications	26,185	-	26,185	30,508
Training and safety	897	-	897	2,074
Travel	744	-	744	19,323
Legal fees	162	-	162	500
Contractual services	-	-	-	25,000
	963,705	-	963,705	934,799
Generation:				
Repairs and maintenance	457,761	-	457,761	328,132
Salaries and wages	372,656	-	372,656	357,035
Other production	29,368	-	29,368	28,150
	859,785	-	859,785	713,317
Water and sewer:				
Salaries and wages	-	507,467	507,467	511,773
Repairs and maintenance	-	137,276	137,276	102,924
Employee benefits	-	57,549	57,549	41,131
Chemicals	-	52,346	52,346	33,205
Other production	-	17,460	17,460	19,378
Training and safety	-	-	-	9,431
	-	772,098	772,098	717,842
Distribution:				
Salaries and wages	350,214	-	350,214	315,065
Repairs and maintenance	136,053	-	136,053	40,056
	486,267	-	486,267	355,121
Total operating expenses	13,276,208	1,450,215	14,726,423	12,911,198
Operating loss	(1,895,181)	(491,756)	(2,386,937)	(1,904,485)

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, 2010
(With comparative totals for the year ended September 30, 2009)

	Power and Utility	Water and Sewer	Totals	
			2010	2009
Nonoperating revenues:				
Interest (expense) income, net	(99,215)	(44,250)	(143,465)	(176,887)
Federal grants and subsidies	154,116	-	154,116	479,969
Spurline projects	63,178	-	63,178	38,103
	<u>118,079</u>	<u>(44,250)</u>	<u>73,829</u>	<u>341,185</u>
Total nonoperating revenues (expenses)				
Change in net assets	(1,777,102)	(536,006)	(2,313,108)	(1,563,300)
Net assets at beginning of year	<u>14,286,978</u>	<u>9,654,620</u>	<u>23,941,598</u>	<u>25,504,898</u>
Net assets at end of year	\$ <u><u>12,509,876</u></u>	\$ <u><u>9,118,614</u></u>	\$ <u><u>21,628,490</u></u>	\$ <u><u>23,941,598</u></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, 2010 and have issued our report thereon dated April 11, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the 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 the PUC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the 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 was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings, we identified a deficiency in internal control over financial reporting that we consider to be a material weakness.

A *deficiency* in internal control 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described in the accompanying Schedule of Findings as item 2010-1 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the 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 the PUC in a separate letter dated April 11, 2011.

PUC's response to the finding identified in our audit is described in the accompanying Schedule of Findings. 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.

Deloitte & Touche LLP

April 11, 2011

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

Schedule of Finding
September 30, 2010

Finding No. 2010-1 Accounting for Materials and Supplies Inventory

Criteria: Perpetual inventory records should reflect inventory quantities on-hand, with inventory receipts and issuances properly recorded in related inventory general ledger accounts. Furthermore, underlying records should reconcile to the general ledger and differences should be investigated and reconciled in a timely manner.

Condition: Inventory receipts and issuances are not recorded through related inventory general ledger accounts. Instead, they are directly expensed in the repair and maintenance accounts or are recorded directly to construction-in-progress accounts. At the end of each year, the inventory accounts are adjusted based on results of the physical count. The differences cannot be investigated due to lack of controls over inventory receipts and issuances during the year. Based on incomplete inventory receipt and issuance registers maintained for the fiscal year ended September 30, 2010, it appears that inventory uses and adjustments in excess of \$600,000 were not supported by issue slips.

Cause: PUC has not implemented a perpetual inventory system.

Effect: The potential for misappropriation of assets exists and it appears that such would not be prevented or detected in a timely manner.

Recommendation: PUC should attempt to maintain perpetual inventory records which reflect material and supplies inventory on hand. All inventory receipts and issuances should be recorded through the inventory system, with transactions properly recorded in the underlying general ledger accounts. The subsidiary ledger should be reconciled with the general ledger on a monthly basis to detect any unrecorded transactions. Upon the completion of physical inventory count, investigation should be performed for significant variance between recorded balance and quantity on hand.

Auditee Response and Corrective Action Plan:

We concur and would implement auditor's recommendation the best we can with the available staff currently on board.

The names and job title of the personnel who will be responsible for the implementation of the corrective action plan are:

1. Melinda Mallarme, Inventory Technician/Acting Accounting Division Manager
2. Hendy Edmund, Power Generation Stockman
3. Barney Daniel, Power Distribution Stockman
4. Rodney Lebehn, Water & Sewer Stockman
5. AGMs for Power and Water & Sewer (Nixon Anson & Bradley Henry)

Upon receipt of purchases, all receiving reports and invoices are to be prepared and submitted to Melinda Mallarme who will enter data in the inventory system. Storage will be in the respective warehouses of each division. Usage of inventory items will be documented by each division using issue slips that will be submitted to Melinda at the end of the month for entry in the inventory system. Melinda's record will then be reconciled against what's in stock.

April 30, 2011 is the target date for this interim count.