

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

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

YEARS ENDED SEPTEMBER 30, 2012 AND 2011

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

Table of Contents
Years Ended September 30, 2012 and 2011

	<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	6
Statements of Revenue, Expenses, and Changes in Net Assets	7
Statements of Cash Flows	8
Notes to Financial Statements	10
Combining Statement of Net Assets	22
Combining Statement of Revenues, Expenses and Changes in Net Assets	23
IV. Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based Upon an Audit of Financial Statements Performed In Accordance with <i>Government Auditing Standards</i>	25

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, 2012 and 2011, and the related statements of revenues, expenses and changes in net assets and of 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, 2012 and 2011, 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.

As described in Note 6 to the financial statements, the NanPil Hydropower Station is not operational. Net book value of cumulative plant assets and rehabilitation costs of approximately \$3.5 million and \$3.7 million at September 30, 2012 and 2011, respectively, are included in the statements of net assets.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 5, 2013, on our consideration of PUC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise PUC's financial statements. The supplemental divisional information on pages 22 through 24 are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplemental divisional information are fairly stated in all material respects in relation to the financial statements as a whole.

Deloitte & Touche LLP
June 5, 2013

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

Management Discussion and Analysis
Years Ended September 30, 2012 and 2011

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, 2012 and 2011. 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 (13.65 MW from diesel engines and 1.80 MW from Nanpil Hydro power station) and with the aging condition of the units, the generation capacity is de-rated down to 6.7 MW while the power demand is 6.3MW in 2012 and 2011. PUC generated 36,111 MWh and 38,150 MWh and sold 28,418 and 30,382 MWh to customers in 2012 and 2011, respectively. This resulted in total power revenue of \$14.2 million and \$12.7 million to PUC in 2012 and 2011, respectively. Although, the number of kilowatt hours sold decreased from 2011, sales revenue in 2012 still increased and this is mainly the result of a higher fuel tariff as well as the .04 cents adjustment on the base tariff that was implemented in May 2012. The number of households being serviced by the PUC is 6,684 (6,340 using cash power meters and 344 using conventional meters) in 2012 and 6,488 in 2011. The service coverage is about 96% of the population.

PUC also provides clean water to the people of Pohnpei. PUC has the capacity to produce 4.72 million gallons per day while the daily water demand to existing customers amounts to 2.3 million gallons per day. PUC produced 758 million and 709 million gallons and sold 607 million and 625 million gallons to customers in 2012 and 2011, respectively, which resulted in total revenue to PUC of \$1.22 million and \$1.18 million, respectively. PUC services 3,501 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 2012, 2011 and 2010:

Assets:	<u>2012</u>	<u>2011</u>	<u>2010</u>
Utility plant, net	\$ 25,515,984	\$ 25,575,338	\$ 23,246,150
Current assets	3,333,433	3,679,558	3,149,239
Other non-current assets	<u>1,072,028</u>	<u>878,185</u>	<u>295,112</u>
	<u>\$ 29,921,445</u>	<u>\$ 30,133,081</u>	<u>\$ 26,690,501</u>
Liabilities and Net Assets:			
Notes payable	\$ 390,000	\$ 390,000	\$ 200,000
Current portion of long-term debt	850,835	217,015	225,884
Other current liabilities	1,487,644	1,366,505	1,178,099
Long-term debt, net	<u>8,601,488</u>	<u>8,417,394</u>	<u>3,458,028</u>
Total Liabilities	<u>11,329,967</u>	<u>10,390,914</u>	<u>5,062,011</u>

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

Management Discussion and Analysis
Years Ended September 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Net Assets:			
Invested in capital assets, net of related debt	16,643,452	17,401,879	19,712,238
Restricted	721,325	528,685	145,112
Unrestricted	<u>1,226,701</u>	<u>1,811,603</u>	<u>1,771,140</u>
Total net assets	<u>18,591,478</u>	<u>19,742,167</u>	<u>21,628,490</u>
	<u>\$ 29,921,445</u>	<u>\$ 30,133,081</u>	<u>\$ 26,690,501</u>
Revenues, Expenses and Changes in Net Assets:			
Operating revenues	\$ 15,513,817	\$ 14,002,210	\$ 12,639,486
Bad debt expense	(732,513)	-	(300,000)
Operating expenses	<u>(16,672,725)</u>	<u>(16,211,625)</u>	<u>(14,726,423)</u>
Net operating loss	(1,891,421)	(2,209,415)	(2,386,937)
Non-operating revenues, net	<u>114,561</u>	<u>323,092</u>	<u>73,829</u>
Net loss before capital contributions	(1,776,860)	(1,886,323)	(2,313,108)
Capital Contributions	<u>626,171</u>	<u>-</u>	<u>-</u>
Decrease in net assets	(1,150,689)	(1,886,323)	(2,313,108)
Net assets at beginning of year	<u>19,742,167</u>	<u>21,628,490</u>	<u>23,941,598</u>
Net assets at end of year	<u>\$ 18,591,478</u>	<u>\$ 19,742,167</u>	<u>\$ 21,628,490</u>

Overall changes in the statements of net assets components from September 30, 2011 to 2012 include a slight decrease in utility plant of \$59,354, a decrease in current assets of \$346,125 and an increase in current and long term liabilities of \$939,053.

The slight decrease in utility plant is the net of FY 2012 capitalization (\$1.3 million), depreciation (\$2 million), and the on-going project to rehabilitate the sewer system which is funded by the Asian Development Bank and administered by the FSM National Government (\$768,316). Please see note 6 of the financial statements for additional information on PUC's utility plant.

Decreases in current assets are the net result of increases in cash, a decrease in materials (parts) inventory due to the on-going repair and maintenance of the aging engines and a decrease in accounts receivable that resulted from the allowance for bad debt that was recorded during the year. The increase in non-current assets is attributable to the grant from the Government of Japan that was received in 2012 (\$190,000).

Increase in current debt is attributable to the increase in the current portion of long term debt plus the increase in payables to FSM Petro made possible by the grant received from the Government of Japan discussed above which was put up to secure the additional credit allowed from PUC's fuel supplier. Increase in long term debt is mainly the result of the on-going ADB funded project to rehabilitate the sewer system as well a secured loan from Bank of Guam acquired during the year. Please see note 7 to the financial statements for additional information on PUC's debts.

The increase in operating revenues before bad debts is mainly due to an increase in average fuel tariff during the year plus the electricity base rate adjustment that was implemented in May.

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

Management Discussion and Analysis
Years Ended September 30, 2012 and 2011

The increase in operating expenses is mainly the result of fuel cost increases. The fuel expense this year is \$11,631,683, a slight increase of \$428,575 from 2011 compared to prior years.

PUC incurred a loss of \$1,150,689, an improvement of \$735,634 from 2011. This was made possible by the capital grant from the Government of Japan, Management's efforts to align costs to revenue and most especially the tariff adjustment that was implemented in May 2012.

Changes that the board of directors and management of PUC implemented for the betterment of PUC are:

1. In August of 2010, the board of directors approved and management implemented the inclusion of the costs of lubricating oil in the calculation of the fuel tariff pass through which enabled PUC to recover the costs of lubricants of approximately \$480,000 in 2012.
2. In September of 2011, with recommendation from external consultants and management, the board of directors adopted a policy to address the issue of under recovering its fuel cost. For instance, based on revenue analysis in 2012, PUC spent \$11,631,682.47 on fuel alone and, with the new policy, PUC recovered \$10,860,635.15, which represents an improvement of some \$800,000 compared to 2011.
3. In April of 2012, with recommendation from external consultants and management, the board of directors approved another policy to increase the base charge by 4 cents for Power and another 57 cents per 1,000 gallons for Water. This new policy took effect on May 15 of 2012.

Management's Discussion and Analysis for the year ended September 30, 2011 is set forth in PUC's report on the audit of financial statements, which is dated May 27, 2012. That Discussion and Analysis explains the major factors impacting the 2012 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmopa.fm.

For additional information about this report, please contact Marcelino Actouka, General Manager, P.O. Box C, Kolonia, Pohnpei.

Economic Outlook

The economic outlook for PUC operation next year is projected to be similar or slightly better than 2011. So far, on average, fuel cost had gone up by about .10 cents from 2011. Again, there are no major changes happening on the island for PUC to anticipate significant changes in demand for electricity and water. But with the policy changes mentioned above in full swing for Fiscal Year 2013, PUC will be in a position to implement plans already in place to address the problem of power generation, the main issue with the Company for the last several years. This scheme will bring in new and more efficient engines on the island that will eliminate the occasional power rationing that customers have become accustomed to in the last several years. A stable source of power generation will mean more revenue for the Company that was being lost thru rotating black outs in the past and the massive tree trimming project that is in progress today will address the problem of distribution line loss. With a new and improved infrastructure in place, (new power plant, and improved power distribution system) the Company will be in a position to meet the current demand of energy on the island and operate more efficiently. The improvements that management is anticipating from this new and improved utility infrastructure will be passed on to customers in the form of a reduced tariff which will boost energy consumption. A rise in energy consumption will generate an increase in non-fuel revenue for the Company to support operation, maintenance, and potential expansion of the system.

This concludes the management discussion and analysis of the financial statements for the year ended September 30, 2012.

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

Statements of Net Assets
September 30, 2012 and 2011

<u>ASSETS</u>	<u>2012</u>	<u>2011</u>
Current assets:		
Cash and cash equivalents	\$ 452,169	\$ 100,855
Investments	174,257	174,257
Time certificates of deposit	41,951	40,326
Accounts receivable, net	1,331,304	1,847,911
Prepayments	80,121	71,422
Materials and fuel inventory	1,253,631	1,444,787
Total current assets	<u>3,333,433</u>	<u>3,679,558</u>
Other noncurrent assets:		
Long-term deposit	576,213	383,573
Restricted:		
Cash and cash equivalents	495,815	349,500
Investments	-	145,112
Total other noncurrent assets	<u>1,072,028</u>	<u>878,185</u>
Utility plant, at cost:		
Electric plant in service	36,437,645	35,199,987
Water and sewer plant in service	20,134,811	20,020,449
	<u>56,572,456</u>	<u>55,220,436</u>
Less accumulated depreciation	<u>(36,375,355)</u>	<u>(34,322,564)</u>
Depreciable assets	20,197,101	20,897,872
Construction work-in-process	5,318,883	4,677,466
Total utility plant	<u>25,515,984</u>	<u>25,575,338</u>
	<u>\$ 29,921,445</u>	<u>\$ 30,133,081</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 390,000	\$ 390,000
Current portion of long-term debt	850,835	217,015
Accounts payable:		
Operations	490,636	512,640
Fuel and lubricants	635,434	468,140
Deferred revenue	148,398	180,831
Accrued taxes and other liabilities	159,621	153,398
Employees' annual leave	53,555	51,496
Total current liabilities	<u>2,728,479</u>	<u>1,973,520</u>
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>8,601,488</u>	<u>8,417,394</u>
Total liabilities	<u>11,329,967</u>	<u>10,390,914</u>
Commitments and contingencies		
Net net assets:		
Invested in capital assets, net of related debt	16,643,452	17,401,879
Restricted	721,325	528,685
Unrestricted	1,226,701	1,811,603
Total net assets	<u>18,591,478</u>	<u>19,742,167</u>
	<u>\$ 29,921,445</u>	<u>\$ 30,133,081</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, 2012 and 2011

	2012	2011
Operating revenues:		
Electricity sales	\$ 14,210,389	\$ 12,707,857
Water sales	1,221,151	1,188,140
Other sales	82,277	106,213
Total operating revenues before bad debts	15,513,817	14,002,210
Bad debts	(732,513)	-
Total operating revenues after bad debts	14,781,304	14,002,210
Operating and maintenance expenses:		
Production fuel	11,631,683	11,203,108
Depreciation	2,052,791	2,214,534
Administrative and general	1,049,009	971,604
Generation	736,434	841,837
Water and sewer	598,242	530,640
Distribution	604,566	449,902
Total operating expenses	16,672,725	16,211,625
Operating loss	(1,891,421)	(2,209,415)
Nonoperating (expenses) revenues:		
Interest expense, net	(171,354)	(119,260)
Grants and subsidies	253,972	442,352
Other income	31,943	-
Total nonoperating revenues, net	114,561	323,092
Loss before capital contributions	(1,776,860)	(1,886,323)
Capital contributions:		
Grants from foreign government	626,171	-
Change in net assets	(1,150,689)	(1,886,323)
Net assets at beginning of year	19,742,167	21,628,490
Net assets at end of year	\$ 18,591,478	\$ 19,742,167

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, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	\$ 15,297,421	\$ 13,801,950
Cash payments to suppliers for goods and services	(12,462,694)	(12,404,636)
Cash paid to employees	(1,693,907)	(1,676,765)
Net cash provided by (used in) operating activities	1,140,820	(279,451)
Cash flows from investing activities:		
Interest and dividends on investments and bank account	61	4,809
Cash flows from noncapital financing activities:		
Proceeds from notes payable	-	190,000
Advance from affiliate	-	54,035
Operating grants received	61,332	58,779
Interest paid	(28,027)	(17,839)
Net cash provided by noncapital financing activities	33,305	284,975
Cash flows from capital and related financing activities:		
Interest paid	(146,216)	(111,182)
Proceeds from long-term debt	187,315	310,950
Principal repayment of long-term debt	(211,679)	(174,555)
Acquisition of utility plant	(652,292)	(95,670)
Net cash used in capital and related financing activities	(822,872)	(70,457)
Net change in cash and cash equivalents	351,314	(60,124)
Cash and cash equivalents at beginning of year	100,855	160,979
Cash and cash equivalents at end of year	\$ 452,169	\$ 100,855
<u>Reconciliation of operating loss to net cash provided by</u>		
<u>(used in) operating activities:</u>		
Operating loss	\$ (1,891,421)	\$ (2,209,415)
Adjustments to reconcile operating loss to net cash provided by		
(used in) operating activities:		
Depreciation	2,052,791	2,214,534
Bad debts	732,513	-
Other income	31,943	-
Write off of plant and equipment	127,304	-
(Increase) decrease in assets:		
Accounts receivable	(215,906)	(198,340)
Prepayments	(8,699)	(61,644)
Materials and fuel inventory	191,156	(158,957)
Increase (decrease) in liabilities:		
Accounts payable	145,290	158,440
Deferred revenue	(32,433)	(1,920)
Accrued taxes and other liabilities	6,223	(18,088)
Employees' annual leave	2,059	(4,061)
Net cash provided by (used in) operating activities	\$ 1,140,820	\$ (279,451)

See accompanying notes to financial statements.

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

Statements of Cash Flows, Continued
Years Ended September 30, 2012 and 2011

Supplemental information of noncash operating financing activities :

During the years ended September 30, 2012 and 2011, PUC received a sub-grant of \$192,640 and \$383,573, respectively, from the FSM National Government (FSMNG) through an increase in long-term deposit for its fuel purchase line.

Supplemental information of noncash capital and related financing activities :

During the years ended September 30, 2012 and 2011, PUC was allocated \$842,278 and \$4,519,382, respectively, relating to two projects funded by the Asian Development Bank master project funds through the FSMNG. As a result, PUC increased its construction work-in-progress and long-term debt each by the same amounts.

During the year ended September 30, 2011, PUC was allocated \$294,720 of additional costs related to a 2004 capital project by the FSMNG. As a result, PUC increased its long-term debt by \$294,720, and water plant assets by \$294,720 (net of accumulated depreciation of \$51,576).

During the year ended September 30, 2011, PUC decommissioned an generator. As a result, PUC decreased electric plant in service by \$2,855,187, accumulated depreciation by \$2,489,137, and increased materials inventory by \$366,050.

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

Notes to Financial Statements
September 30, 2012 and 2011

(1) Summary of Significant Accounting Policies

Organization: Pohnpei Utilities Corporation (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.

Basis of Accounting: The accounting policies of PUC conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities, specifically proprietary funds. PUC utilizes the flow of economic resources measurement focus. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. 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 Principles Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989, except those that conflict with a GASB pronouncement. PUC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

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 at September 30, 2012 and 2011 are expendable. All other net assets are unrestricted.

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.

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 or are restricted for use are separately classified on the statement of net assets.

Investments: PUC values its investments based on fair values in accordance with GASB Statement No. 31. 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 and is primarily determined based on quoted market rates.

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

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

Notes to Financial Statements
September 30, 2012 and 2011

(1) Summary of Significant Accounting Policies, Continued

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.

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.

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. Sick leave earned but not taken at September 30, 2012 and 2011, approximated \$250,000 and \$245,000, respectively, and have not been recorded in the accompanying financial statements.

Revenues and Deferred Revenues: Sales of electricity and water are recorded as billed to customers on a semi-monthly or 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.

Grants and Subsidies: PUC receives grants from the U.S Government or other foreign governments or entities either as a direct recipient or as a sub recipient from the Pohnpei State Government or the FSM National Government 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.

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

Notes to Financial Statements
September 30, 2012 and 2011

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards: During fiscal year 2012, PUC implemented the following pronouncements:

- GASB 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 the frequency and timing of measurements for actuarial valuations first used to report funded status information in OPEB plan financial statements. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions* (an amendment of GASB Statement No. 53), which will improve financial reporting by state and local governments by clarifying the circumstances in which hedge accounting continues to be applied when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.

In December 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, which addresses how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In December 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus*, which is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity*, and No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this statement are effective for periods beginning after June 15, 2012. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain FASB and American Institute of Certified Public Accountants (AICPA) pronouncements. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

In July 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which establishes guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The provisions of this statement are effective for periods beginning after December 15, 2011. Management has not yet determined the effect of implementation of this statement on the financial statements of PUC.

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

Notes to Financial Statements
September 30, 2012 and 2011

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In April 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of PUC.

In April 2012, GASB issued Statement No. 66, *Technical Corrections - 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of PUC.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans, and Statement No. 68, *Accounting and Financial Reporting for Pensions*, which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of these statements on the financial statements of PUC.

Reclassifications

Certain reclassifications have been made to the 2011 financial statements in order to conform with the 2012 presentation.

(2) Concentration of Credit Risk

Financial instruments which potentially subject PUC to concentrations of credit risk consist principally of cash and cash equivalents, investments and accounts receivable.

At September 30, 2012 and 2011, PUC has cash deposits in bank accounts that are not subject to or exceed federal depository insurance limits. PUC has not experienced any losses in such accounts.

Substantially all of PUC's customer accounts receivable are from individuals, companies and government agencies based in Pohnpei. Concentrations largely result from accounts receivable from Pohnpei State Government and various agencies. Management assesses the risk of loss and provides for an allowance for doubtful accounts to compensate for known credit risks. Additionally, PUC purchases virtually its entire fuel inventory from a single entity.

(3) Cash and Cash Equivalents and Investments

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
(A COMPONENT UNIT OF THE STATE OF POHNPEI)

Notes to Financial Statements
September 30, 2012 and 2011

(3) Cash and Cash Equivalents and Investments, Continued

A. Cash and Cash Equivalents:

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. PUC does not have a deposit policy for custodial credit risk.

As of September 30, 2012 and 2011, the carrying amount of PUC's total cash and cash equivalents and time certificates of deposit was \$989,935 and \$490,681, respectively, and the corresponding bank balances were \$1,120,774 and \$612,327, respectively. Of the bank balances, \$989,163 and \$489,909, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2012 and 2011, 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.

B. Investments:

As of September 30, 2012 and 2011, investments in mutual funds at fair value are \$174,257 and \$319,369, 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, 2012 and 2011.

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, 2012 and 2011.

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, 2012 and 2011

(4) 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. Funds were accumulated in a restricted investment fund, held by a trustee, in the name of PUC. As of September 30, 2011, the balance approximated \$145,112 and was presented as a restricted investment in the accompanying statements of net assets. During the year ended September 30, 2012, the trustee notified PUC that it can no longer service the account and as such, the balance was transferred into a bank deposit account that is held as collateral for a new bank loan. The related balance continues to be shown as restricted in the accompanying statements of net asset since restrictions have not been removed by the enabling body.

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.

(5) Accounts Receivable

PUC read meters on the last day of the month and processes bills on the first of the following month. Effective July 15, 2011, PUC changed its policy on large demand power accounts and began reading and billing twice a month. At September 30, 2012 and 2011, PUC had read and processed majority of power accounts on the last day. Accounts receivable at September 30, 2012 and 2011, are summarized as follows:

	<u>2012</u>	<u>2011</u>
Accounts receivable - electrical:		
Residential	\$ 1,319,523	\$ 1,549,041
Commercial	405,572	544,778
Government	319,328	352,745
Unbilled	<u>7,006</u>	<u>31,376</u>
	<u>2,051,429</u>	<u>2,477,940</u>
Accounts receivable - water and sewer:		
Residential	2,533,247	1,994,617
Commercial and government	342,386	272,532
Unbilled	<u>209,048</u>	<u>169,513</u>
	<u>3,084,681</u>	<u>2,436,662</u>
Installment receivables	84,649	88,012
Other	<u>98,212</u>	<u>100,451</u>
	5,318,971	5,103,065
Less allowance for doubtful receivables	<u>(3,987,667)</u>	<u>(3,255,154)</u>
	<u>\$ 1,331,304</u>	<u>\$ 1,847,911</u>

PUC operates 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, 2012 and 2011, included in accounts receivable – electrical due from customers enrolled in the cash power meter system are \$695,525 and \$753,970, respectively.

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

Notes to Financial Statements
September 30, 2012 and 2011

(6) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2012 and 2011 is as follows:

	Beginning Balance <u>October 1, 2011</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	Ending Balance <u>September 30, 2012</u>
<u>Depreciable assets:</u>					
Production plant	\$ 19,477,802	\$ 1,075,368	\$ -	\$ 33,229	\$ 20,586,399
Distribution plant	14,355,396	55,521	-	-	14,410,917
General plant	<u>1,366,789</u>	<u>-</u>	<u>-</u>	<u>73,540</u>	<u>1,440,329</u>
Electric plant in service	<u>35,199,987</u>	<u>1,130,889</u>	<u>-</u>	<u>106,769</u>	<u>36,437,645</u>
Water production plant	6,714,802	10,401	-	-	6,725,203
Sewage collection and treatment plant	5,512,301	-	-	-	5,512,301
Water distribution plant	7,225,103	-	-	-	7,225,103
General plant	<u>568,243</u>	<u>73,961</u>	<u>-</u>	<u>30,000</u>	<u>672,204</u>
Water and sewer plant in service	<u>20,020,449</u>	<u>84,362</u>	<u>-</u>	<u>30,000</u>	<u>20,134,811</u>
Total utility plant in service	55,220,436	1,215,251	-	136,769	56,572,456
Less accumulated depreciation	<u>(34,322,564)</u>	<u>(2,052,791)</u>	<u>-</u>	<u>-</u>	<u>(36,375,355)</u>
	<u>20,897,872</u>	<u>(837,540)</u>	<u>-</u>	<u>136,769</u>	<u>20,197,101</u>
<u>Non-depreciable assets:</u>					
<u>Construction work-in-progress:</u>					
Electric plant	116,220	115,501	(123,493)	(106,769)	1,459
Water and sewer plant	<u>4,561,246</u>	<u>789,989</u>	<u>(3,811)</u>	<u>(30,000)</u>	<u>5,317,424</u>
	<u>4,677,466</u>	<u>905,490</u>	<u>(127,304)</u>	<u>(136,769)</u>	<u>5,318,883</u>
	\$ <u>25,575,338</u>	\$ <u>67,950</u>	\$ <u>(127,304)</u>	\$ <u>-</u>	\$ <u>25,515,984</u>
	Beginning Balance <u>October 1, 2010</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	Ending Balance <u>September 30, 2011</u>
<u>Depreciable assets:</u>					
Production plant	\$ 22,332,988	\$ -	\$ (2,855,186)	\$ -	\$ 19,477,802
Distribution plant	14,324,134	-	-	31,262	14,355,396
General plant	<u>1,600,013</u>	<u>29,279</u>	<u>(309,430)</u>	<u>46,927</u>	<u>1,366,789</u>
Electric plant in service	<u>38,257,135</u>	<u>29,279</u>	<u>(3,164,616)</u>	<u>78,189</u>	<u>35,199,987</u>
Water production plant	6,714,802	-	-	-	6,714,802
Sewage collection and treatment plant	5,512,301	-	-	-	5,512,301
Water distribution plant	6,930,383	294,720	-	-	7,225,103
General plant	<u>568,243</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>568,243</u>
Water and sewer plant in service	<u>19,725,729</u>	<u>294,720</u>	<u>-</u>	<u>-</u>	<u>20,020,449</u>
Total utility plant in service	57,982,864	323,999	(3,164,616)	78,189	55,220,436
Less accumulated depreciation	<u>(34,906,596)</u>	<u>(2,214,534)</u>	<u>2,798,566</u>	<u>-</u>	<u>(34,322,564)</u>
	<u>23,076,268</u>	<u>(1,890,535)</u>	<u>(366,050)</u>	<u>78,189</u>	<u>20,897,872</u>
<u>Non-depreciable assets:</u>					
<u>Construction work-in-progress:</u>					
Electric plant	147,856	65,023	-	(96,659)	116,220
Water and sewer plant	<u>22,026</u>	<u>4,539,220</u>	<u>-</u>	<u>-</u>	<u>4,561,246</u>
	<u>169,882</u>	<u>4,604,243</u>	<u>-</u>	<u>(96,659)</u>	<u>4,677,466</u>
	\$ <u>23,246,150</u>	\$ <u>2,713,708</u>	\$ <u>(366,050)</u>	\$ <u>(18,470)</u>	\$ <u>25,575,338</u>

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

Notes to Financial Statements
September 30, 2012 and 2011

(6) Utility Plant, Continued

The NanPil Hydropower Station is not operational. At September 30, 2012 and 2011, cumulative costs of \$7.5 million are included in electric production plant with corresponding \$4.0 million and \$3.8 million in accumulated depreciation, respectively. In April 2012, the Secretariat of the Pacific Community (SPC) has issued a Request for Proposal (RFP) for the rehabilitation of this asset. The RFP was re-opened in January 2013 and PUC is currently evaluating the proposals. The project is to be funded via a direct grant from SPC and as a result, related impairment losses have not been recorded as of September 30, 2012.

At September 30, 2012, water and sewer plant construction in progress represents infrastructure projects for overhauling sewage pumps, extension of sewage lines, and treatment plants funded by two Asian Development Bank (ADB) loans (ADB Loan No.s 2099 and 2100) administered by the FSM National Government (FSMNG) (see note 7). PUC has no related commitment for project funds through internal sources.

In April 2012, PUC committed to fund \$170,000 of total project costs for the Caroline Fisheries Corporation's purchase and installation of two generators when commissioned. As of June 5, 2013, the generators have not been placed in service and the amount has not been recorded in the accompanying financial statements.

In January 2013, PUC received a solar power generation system valued at approximated \$5.8 million from the Japan Government via a sub-grant through the FSM National Government.

(7) Notes Payable and Long-Term Debt

Notes payable at September 30, 2012 and 2011 include \$200,000 due to Pohnpei State Government (PSG) that are non-interest bearing, uncollateralized and have no set repayment date.

Additionally, notes payable at September 30, 2012 and 2011 include borrowings of \$190,000 against a line of credit with the Bank of the Federated States of Micronesia (BFSM). The \$190,000 line is collateralized by a time certificate deposit (TCD) with the bank, bearing variable interest at 5% over the TCD rate (effective rate of 5.50% and 5.75% at September 30, 2012 and 2011, respectively) and currently expires on May 23, 2013. The agreement restricts 105% of outstanding loan balance as such TCD in the amount of \$199,500 is reflected as restricted in the accompanying statements of net assets as of September 30, 2012 and 2011.

Changes in notes payable during the years ended September 30, 2012 and 2011, are as follows:

	Outstanding October 1, <u>2011</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2012</u>
Notes payable to PSG	\$ 200,000	\$ -	\$ -	\$ 200,000
Notes payable to BFSM	<u>190,000</u>	<u>190,000</u>	<u>(190,000)</u>	<u>190,000</u>
	<u>\$ 390,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 390,000</u>
	Outstanding October 1, <u>2010</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2011</u>
Notes payable to PSG	\$ 200,000	\$ -	\$ -	\$ 200,000
Notes payable to BFSM	<u>-</u>	<u>190,000</u>	<u>-</u>	<u>190,000</u>
	<u>\$ 200,000</u>	<u>\$ 190,000</u>	<u>\$ -</u>	<u>\$ 390,000</u>

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

Notes to Financial Statements
September 30, 2012 and 2011

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

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

Long-term debt consists of the following at September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Payable on ADB loan no. 1459, administered by the FSMNG; original amount of \$2,118,767, due in semi-annual installments of \$33,500 from February 2007 to August 2044. 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, 2012 and 2011. During 2011, an additional \$294,720 was allocated to PUC which extended the maturity date to February 2052.	\$ 2,487,450	\$ 2,541,872
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%.	535,507	543,396
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.	542,757	608,175
Loan payable to FSM Development Bank (FSMDB), original amount of \$481,701, interest at 9% and monthly installment of \$10,379. In August 2011, the loan was refinanced to increase borrowing by \$310,950, which was used in operations. Interest remains fixed at 9%, with monthly principal and interest installments of \$9,807 beginning on December 25, 2011 and matures on November 25, 2016. The loan is also secured by PUC's TCD for \$150,000, which is reflected as restricted in the accompanying statements of net assets. A member of the PUC Board is also a member of management of the FSMDB.	405,799	421,584
Payable on ADB loan no. 2099, administered by the FSMNG, drawn against the total Standard Drawing Rights (SDR) of \$9,868 million (PUC allocation of \$3,752 million), principal due in semi-annual installments of \$85,883 from January 15, 2013 to July 15, 2036. Interest is payable at 1.0% per annum during the grace period and at 1.5% thereafter. Proceeds are used for infrastructure projects to overhaul sewage pumps, extend sewage lines, and for treatment plants.	4,222,128	3,397,609
Payable on ADB loan no. 2100, administered by the FSMNG, drawn against the total SDR of \$4.8 million (PUC allocation of \$2 million), principal due in semi-annual installments of varying amounts as a percentage of total SDRs through January 15, 2029. Interest is payable at LIBOR plus 0.6% (effective of 2.1% at September 30, 2012 and 2011). Proceeds are used for infrastructure projects to overhaul sewage pumps, extend sewage lines, and for treatment plants.	1,129,730	1,121,773

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

Notes to Financial Statements
September 30, 2012 and 2011

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

	<u>2012</u>	<u>2011</u>
Loan payable to Bank of Guam, original amount of \$140,000, due in monthly installments of \$3,039 from May 30, 2012 to April 30, 2016. The loan is secured by a saving account for \$140,000. The loan bears interest fixed at 2%.	<u>128,952</u>	<u>-</u>
Total long-term debt	9,452,323	8,634,409
Less: current portion of long-term debt	<u>850,835</u>	<u>217,015</u>
Long-term portion of long-term debt	\$ <u>8,601,488</u>	\$ <u>8,417,394</u>

The proceeds from long-term debt were used for various infrastructure upgrades and acquisitions.

Total interest capitalized in construction work-in progress and long-term debt (no. 2099 and no. 2100) approximated \$38,000 and \$22,400 during the years ended September 30, 2012 and 2011, respectively.

At September 30, 2012, 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>
2013	\$ 850,835	\$ 205,861	\$ 1,056,696
2014	318,716	155,623	474,339
2015	333,799	143,220	477,019
2016	337,671	130,029	467,700
2017	224,215	119,817	344,032
2018-2022	1,153,905	545,474	1,699,379
2023-2027	1,399,039	442,734	1,841,773
2028-2032	1,282,350	323,080	1,605,430
2033-2037	1,123,403	229,063	1,352,466
2038-2042	1,221,826	130,640	1,352,466
2043-2047	481,195	48,042	529,237
2048-2052	305,624	29,376	335,000
2053-2057	321,210	13,790	335,000
2058-2059	<u>98,535</u>	<u>1,965</u>	<u>100,500</u>
	\$ <u>9,452,323</u>	\$ <u>2,518,714</u>	\$ <u>11,971,037</u>

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

Notes to Financial Statements
September 30, 2012 and 2011

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

Changes in long-term debt for the years ended September 30, 2012 and 2011, are as follows:

	Outstanding October 1, 2011	Increases	Decreases	Outstanding September 30, 2012	Current	Noncurrent
Loan payable to:						
ADB no. 1459	\$ 2,541,872	\$ -	\$ (54,422)	\$ 2,487,450	\$ 42,298	\$ 2,445,152
ADB no. 2099	3,397,609	824,519	-	4,222,128	108,720	4,113,408
ADB no. 2100	1,121,773	17,759	(9,802)	1,129,730	27,178	1,102,552
RUS	543,396	-	(7,889)	535,507	7,795	527,712
BFSM	608,175	-	(65,418)	542,757	542,757	-
BOG	-	140,000	(11,048)	128,952	34,237	94,715
FSMDB	<u>421,584</u>	<u>47,315</u>	<u>(63,100)</u>	<u>405,799</u>	<u>87,850</u>	<u>317,949</u>
	<u>\$ 8,634,409</u>	<u>\$ 1,029,593</u>	<u>\$ (211,679)</u>	<u>\$ 9,452,323</u>	<u>\$ 850,835</u>	<u>\$ 8,601,488</u>
	Outstanding October 1, 2010	Increases	Decreases	Outstanding September 30, 2011	Current	Noncurrent
Loan payable to:						
ADB no. 1459	\$ 2,273,521	\$ 294,720	\$ (26,369)	\$ 2,541,872	\$ 41,699	\$ 2,500,173
ADB no. 2099	-	3,397,609	-	3,397,609	-	3,397,609
ADB no. 2100	-	1,121,773	-	1,121,773	24,080	1,097,693
RUS	549,206	-	(5,810)	543,396	7,387	536,009
BFSM	668,414	-	(60,239)	608,175	64,534	543,641
FSMDB	<u>192,771</u>	<u>310,950</u>	<u>(82,137)</u>	<u>421,584</u>	<u>79,315</u>	<u>342,269</u>
	<u>\$ 3,683,912</u>	<u>\$ 5,125,052</u>	<u>\$ (174,555)</u>	<u>\$ 8,634,409</u>	<u>\$ 217,015</u>	<u>\$ 8,417,394</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 (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.

(9) Grants, Subsidies and Capital Contributions

Grants and subsidies comprise the following for the years ended September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
U.S. Department of the Interior:		
Operations and maintenance improvement program:		
Cash power meters program	\$ -	\$ 10,000
Other FSM or U.S grants and subsidies	38,832	29,279
Other foreign governments and organizations	<u>215,140</u>	<u>403,073</u>
Operating grants	253,972	442,352
Capital contributions from Japan Government for the repair of engine no. 9	<u>626,171</u>	<u>-</u>
Total	<u>\$ 880,143</u>	<u>\$ 442,352</u>

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

Notes to Financial Statements
September 30, 2012 and 2011

(10) 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 at September 30, 2012 and 2011, respectively.

(11) Related Party Transactions

At September 30, 2012 and 2011, accounts receivable include amounts owed by the State of Pohnpei and its component units to PUC of \$265,725 and \$246,260, respectively.

At September 30, 2012 and 2011, PUC also has a non-interest bearing advance from the PUC Social Club of \$164,165 and \$157,823, respectively. Further, at September 30, 2012 and 2011, PUC has a non-interest bearing advance from the State of Pohnpei of \$96,520 and \$54,205, respectively. These advances have no set repayment terms, are classified as current due to the mutual consent of the parties and are included as accounts payable – operations in the accompanying statements of net assets.

At September 30, 2012 and 2011, PUC has a non-interest bearing note payable to the State of Pohnpei of \$200,000 (note 7).

PUC purchased 99% of its production fuel during the years ended September 30, 2012 and 2011 from FSM Petroleum Corporation (FSMPC), a component unit of FSMNG. At September 30, 2012 and 2011, long-term deposits in the amount of \$576,213 and \$383,573, through a sub-grant from the FSMNG, are held by FSMPC as collateral for a fuel and lubricant purchase line. At September 30, 2012 and 2011, payables to FSMPC were \$635,434 and \$468,140, respectively.

(12) Restricted Net Assets

At September 30, 2012 and 2011, net assets are restricted for the following purposes:

	<u>2012</u>	<u>2011</u>
Self-insurance fund	\$ 145,112	\$ 145,112
Fuel deposit from fuel operating grant	<u>576,213</u>	<u>383,573</u>
	\$ <u>720,325</u>	\$ <u>528,685</u>

(13) 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 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 the 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, 2012
(With comparative totals as of September 30, 2011)

<u>Assets</u>	Power and Utility	Water and Sewer	Totals	
			2012	2011
Current assets:				
Cash and cash equivalents	\$ 222,669	\$ 229,500	\$ 452,169	\$ 100,855
Investments	174,257	-	174,257	174,257
Time certificates of deposit	41,951	-	41,951	40,326
Accounts receivable, net	836,443	494,861	1,331,304	1,847,911
Prepayments	80,121	-	80,121	71,422
Fuel and material inventory	1,032,466	221,165	1,253,631	1,444,787
Total current assets	2,387,907	945,526	3,333,433	3,679,558
Other noncurrent assets:				
Long-term deposits	576,213	-	576,213	383,573
Restricted:				
Cash and cash equivalents	495,815	-	495,815	349,500
Investments	-	-	-	145,112
Total other noncurrent assets	1,072,028	-	1,072,028	878,185
Utility plant, at cost:				
Electric plant in service	36,437,645	-	36,437,645	35,199,987
Water and sewer plant in service	-	20,134,811	20,134,811	20,020,449
	36,437,645	20,134,811	56,572,456	55,220,436
Less accumulated depreciation	(26,573,358)	(9,801,997)	(36,375,355)	(34,322,564)
Depreciable assets	9,864,287	10,332,814	20,197,101	20,897,872
Construction work-in-process	1,459	5,317,424	5,318,883	4,677,466
Total utility plant	9,865,746	15,650,238	25,515,984	25,575,338
	\$ 13,325,681	\$ 16,595,764	\$ 29,921,445	\$ 30,133,081
<u>Liabilities and Net Assets</u>				
Current liabilities:				
Notes payable	\$ 390,000	\$ -	\$ 390,000	\$ 390,000
Current portion of long-term debt	664,844	185,991	850,835	217,015
Accounts payable:				
Operations	490,636	-	490,636	512,640
Fuel and lubricants	635,434	-	635,434	468,140
Deferred revenue	148,398	-	148,398	180,831
Accrued taxes and other liabilities	159,621	-	159,621	153,398
Employees' annual leave	53,555	-	53,555	51,496
Total current liabilities	2,542,488	185,991	2,728,479	1,973,520
Noncurrent liabilities:				
FSM Development Bank loan	317,949	-	317,949	342,269
RUS Water extension loan	-	527,712	527,712	536,009
Bank of Guam	94,715	-	94,715	-
Bank of the FSM	-	-	-	543,641
ADB Water extension loan	-	7,661,112	7,661,112	6,995,475
Total liabilities	2,955,152	8,374,815	11,329,967	10,390,914
Net assets:				
Invested in capital assets, net of related debt	9,368,029	7,275,423	16,643,452	17,401,879
Restricted	721,325	-	721,325	528,685
Unrestricted	281,175	945,526	1,226,701	1,811,603
Total net assets	10,370,529	8,220,949	18,591,478	19,742,167
	\$ 13,325,681	\$ 16,595,764	\$ 29,921,445	\$ 30,133,081

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, 2012
(With comparative totals for the year ended September 30, 2011)

	Power and Utility	Water and Sewer	Totals	
			2012	2011
Operating revenues:				
Residential	\$ 312,338	\$ 915,194	\$ 1,227,532	\$ 1,318,544
Cash power	7,775,831	-	7,775,831	6,907,262
Commercial	3,588,020	164,037	3,752,057	3,351,885
Government	2,534,200	141,920	2,676,120	2,318,306
Other sales	71,488	10,789	82,277	106,213
Total operating revenues before bad debts	14,281,877	1,231,940	15,513,817	14,002,210
Bad debt expense	(102,571)	(629,942)	(732,513)	-
Total operating revenues after bad debts	14,179,306	601,998	14,781,304	14,002,210
Operating and maintenance expenses:				
Production fuel	11,631,683	-	11,631,683	11,203,108
Depreciation	1,436,555	616,236	2,052,791	2,214,534
Administrative and general:				
Salaries and wages	404,181	-	404,181	398,105
Employee benefits	269,130	-	269,130	255,625
Vehicle, POL	139,687	-	139,687	95,231
Customer service and collection	78,396	-	78,396	84,452
Communications	36,111	-	36,111	36,752
Consumables and supplies	23,123	-	23,123	15,768
Insurance	19,946	-	19,946	14,900
Repairs and maintenance	15,180	-	15,180	12,370
Travel	13,549	-	13,549	35,319
Contractual services	12,500	-	12,500	12,500
Other	37,206	-	37,206	10,582
	1,049,009	-	1,049,009	971,604
Generation:				
Salaries and wages	383,367	-	383,367	384,164
Repairs and maintenance	332,890	-	332,890	436,598
Other production	20,177	-	20,177	21,075
	736,434	-	736,434	841,837
Water and sewer:				
Salaries and wages	-	459,753	459,753	420,492
Employee benefits	-	51,033	51,033	48,320
Chemicals	-	42,065	42,065	49,140
Consumables and supplies	-	19,127	19,127	7,909
Repairs and maintenance	-	16,622	16,622	3,066
Other	-	9,642	9,642	1,713
	-	598,242	598,242	530,640
Distribution:				
Salaries and wages	379,896	-	379,896	369,532
Repairs and maintenance	159,782	-	159,782	67,177
Consumables and supplies	64,888	-	64,888	13,193
	604,566	-	604,566	449,902
Total operating expenses	15,458,247	1,214,478	16,672,725	16,211,625
Operating loss	(1,278,941)	(612,480)	(1,891,421)	(2,209,415)

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, 2012
(With comparative totals for the year ended September 30, 2011)

	Power and Utility	Water and Sewer	Totals	
			2012	2011
Nonoperating revenues:				
Interest expense, net	(136,577)	(34,777)	(171,354)	(119,260)
Grants and subsidies	192,640	61,332	253,972	442,352
Other income	31,943	-	31,943	31,943
	<u>88,006</u>	<u>26,555</u>	<u>114,561</u>	<u>355,035</u>
Total nonoperating revenues, net				
Loss before capital contributions	(1,190,935)	(585,925)	(1,776,860)	(1,886,323)
Capital contributions:				
Grants from foreign government	626,171	-	626,171	-
	<u>(564,764)</u>	<u>(585,925)</u>	<u>(1,150,689)</u>	<u>(1,886,323)</u>
Change in net assets				
Net assets at beginning of year	10,935,293	8,806,874	19,742,167	21,628,490
Net assets at end of year	<u>\$ 10,370,529</u>	<u>\$ 8,220,949</u>	<u>\$ 18,591,478</u>	<u>\$ 19,742,167</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 OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Board of Directors
Pohnpei Utilities Corporation:

We have audited the financial statements of the Pohnpei Utilities Corporation (PUC) as of and for the year ended September 30, 2012, and have issued our report thereon dated June 5, 2013. 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

Management of PUC is responsible for establishing and maintaining effective 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.

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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified a deficiency in internal control over financial reporting, described in the accompanying Schedule of Findings and Questioned Costs as item 2012-1 that we consider to be a significant deficiency in internal control over financial reporting. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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 5, 2013.

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

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deloitte & Touche LLP
June 5, 2013

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

Schedule of Findings and Questioned Costs
September 30, 2012

Finding No. 2012-1

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

Condition: In the prior years, PUC did not properly account for materials inventory. Inventory purchases and uses were directly recorded in the repair and maintenance or construction-in-progress accounts. At the end of each year, inventory accounts were adjusted based on results of physical counts. The differences therefore cannot be investigated due to lack of controls over inventory receipts and issuances. During the year ended September 30, 2012, PUC implemented a system requiring all inventory movements to be recorded through inventory accounts. However, it appears that full compliance has not been achieved as inventory uses and adjustments of approximately \$80,000 during the year were not supported by issue slips.

Cause: PUC has not fully 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.

Prior Year Status: This condition is reiterative of conditions identified in our prior year audit of PUC. However, PUC has implemented a system during the year and thus improved on the condition as noted in the prior year audit.

Recommendation: PUC should continue to enforce and train its users on the procedures implemented over inventory receipts and issuances. Also, in addition to the year-end physical count on all inventory items, PUC may consider performing cycle counts of its inventory items to spot check items during the year. This will assist in the timely identification of variances and discrepancies.

Auditee Response and Corrective Action Plan:

We concur and would implement auditor's recommendation by ensuring that the staff is properly trained on the procedures already in place. Enforcement of the current process will be prioritized until PUC achieve full compliance of the corrective action plan.

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

1. Inventory Technician/Acting Accounting Division Manager
2. AGMs for Power and Water & Sewer
3. Stockman for each Department stockroom

Upon receipt of purchases, all receiving reports and invoices are to be prepared and submitted to the Accounting division (Inventory Technician) 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 Accounting (Inventory Technician) at the end of the month for entry in the inventory system. Finance/Inventory record will then be reconciled against what is in stock.

September 30, 2013 is the target date.

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

Schedule of Prior Audit Findings
Year Ended September 30, 2012

Unresolved Prior Audit Findings and Responses

The status of unresolved prior year finding is stated on page 27.

There are no unresolved prior year questioned costs.