

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

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

YEARS ENDED SEPTEMBER 30, 2011 AND 2010

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

Table of Contents
Years Ended September 30, 2011 and 2010

	<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 Compliance and Other Matters Based Upon an Audit of Financial on an Audit Performed in Accordance with <i>Government</i> 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, 2011 and 2010, 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, 2011 and 2010, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 27, 2012, 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 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.

The Management Discussion and Analysis on pages 3 through 5 is not a required part of the basic financial statements but is supplementary information required by the *Governmental Accounting Standards Board*. This 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 required 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 22 through 24 is presented for the purpose of additional analysis and is not a required part of the basic financial statements. This additional information is the responsibility of the PUC's management. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended September 30, 2011 and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Deloitte & Touche LLP

May 27, 2012

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

Management Discussion and Analysis
Year Ended September 30, 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, 2011 and 2010. 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 7.2 MW while the power demand is 6.9 in 2011 and 2010. PUC generated 38,150 MWh and 39,814 MWh and sold 30,382 and 31,182 MWh to customers in 2011 and 2010, respectively. This resulted in total power revenue of \$12.7 million and \$11.3 million to PUC in 2011 and 2010, respectively. The increase in sales revenue in 2011 is mainly the result of increases in fuel tariff. The number of households being serviced by the PUC is 6,488 (6,184 using cash power meters and 304 using conventional meters) in 2011 and 6,546 in 2010. 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 709 million and 803 million gallons and sold 625 million and 644 million gallons to customers in 2011 and 2010, respectively, which resulted in total revenue to PUC of \$1.19 million and \$1.24 million, respectively. 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 2011, 2010 and 2009:

Assets:	<u>2011</u>	<u>2010</u>	<u>2009</u>
Utility plant, net	\$ 25,575,338	\$ 23,246,150	\$ 24,380,722
Current assets	3,679,558	3,149,239	3,517,604
Other non-current assets	<u>878,185</u>	<u>295,112</u>	<u>295,082</u>
	<u>\$ 30,133,081</u>	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</u>
 Liabilities and Net Assets:			
Notes payable	\$ 390,000	\$ 200,000	\$ -
Current portion of long-term debt	217,015	225,884	210,385
Other current liabilities	1,366,505	1,178,099	703,259
Long-term debt, net	<u>8,417,394</u>	<u>3,458,028</u>	<u>3,338,166</u>
Total Liabilities	<u>10,390,914</u>	<u>5,062,011</u>	<u>4,251,810</u>

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

Management Discussion and Analysis
Year Ended September 30, 2011

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Net Assets:			
Invested in capital assets, net of related debt	17,401,879	19,712,238	20,982,171
Restricted	145,112	145,112	145,082
Unrestricted	<u>2,195,176</u>	<u>1,771,140</u>	<u>2,814,345</u>
Total net assets	<u>19,742,167</u>	<u>21,628,490</u>	<u>23,941,598</u>
	<u>\$ 30,133,081</u>	<u>\$ 26,690,501</u>	<u>\$ 28,193,408</u>
Revenues, Expenses and Changes in Net Assets:			
Operating revenues	\$ 14,002,210	\$ 12,639,486	\$ 11,537,213
Bad debt expense	-	(300,000)	(530,500)
Operating expenses	<u>(16,211,625)</u>	<u>(14,726,423)</u>	<u>(12,911,198)</u>
Net operating loss	(2,209,415)	(2,386,937)	(1,904,485)
Non-operating revenues, net	<u>323,092</u>	<u>73,829</u>	<u>341,185</u>
Decrease in net assets	(1,886,323)	(2,313,108)	(1,563,300)
Net assets at beginning of year	<u>21,628,490</u>	<u>23,941,598</u>	<u>25,504,898</u>
Net assets at end of year	<u>\$ 19,742,167</u>	<u>\$ 21,628,490</u>	<u>\$ 23,941,598</u>

Overall changes in the balance sheet components from September 30, 2010 to 2011 include an increase in utility plant, net of \$2,329,188, an increase in current assets \$530,319 and an increase in current and long term liabilities \$5,328,903.

Increases in utility plant are attributable to the on-going project to rehabilitate the sewer system which is funded by the Asian Development Bank and administered by the FSM National Government (\$4,519,382). This resulted in an increase in construction work in progress. An additional amount of \$294,720 was recently allocated from the FSM National Government to PUC relating to a project funded by the ADB completed in 2004 which also contributed to the increase in utility plant. PUC also decommissioned 1 Daihatsu generator resulting in a decrease in electric plant by \$2,855,187, accumulated depreciation by \$2,489,137, and an increase in parts inventory by \$366,050 for the parts that were salvaged from the decommissioned unit. Please see note 6 of the financial statements for additional information on PUC's utility plant.

Increases in current assets are the result of increases in materials (parts) inventory due to the on-going major overhaul of Daihatsu Engine #9, as well as from salvaging of the decommissioned unit as discussed above. PUC's accounts receivable also increased during the year ended September 30, 2011 by approximately \$198,000. The increase in non-current assets is attributable to the grant from the Government of Japan that is now being held by FSM Petroleum Corporation (FSMPC) as collateral for PUC's credit account in the amount of \$383,573. PUC also pledged its TCD with Bank of FSM to secure the outstanding note of \$190,000 against the line of credit at the required 105% of outstanding balance.

Increase in current debt is attributable to the unfavorable cash flow caused by rising costs of fuel which resulted in: 1) the delay in the settlement of short term obligations; 2) the need for PUC to draw on a line of credit with Bank of FSM (\$190,000) and 3) the need for management to negotiate extension of credit with the FSMPC. Increase in long term debt is mainly the result of the on-going ADB funded project to

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

Management Discussion and Analysis
Year Ended September 30, 2011

rehabilitate the sewer system (\$4,519,382) as well as an additional allocation of \$294,720 from FSM Finance regarding an Asian Development Bank funded project that was completed in 2004. 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.

The increase in operating expenses is mainly the result of fuel cost increases. The fuel expense this year alone is \$11,203,108, an increase of \$1,686,927 from 2010.

PUC incurred a loss of \$1,886,323, an improvement of \$426,785 from 2010 made possible by the fuel grant from the Government of Japan as well as Management's efforts to align costs to revenue. It cost PUC \$0.4948 to produce and sell one unit of power (kWh) in 2010; however, PUC charged an average of \$0.4138 per unit of power or (kWh) in 2011. It also cost PUC \$1.88 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.

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 \$400,000 in 2011.
2. In September of 2011, with recommendation from external consultants and management, the board of directors adopted a policy which will enable PUC to recover 100% of its fuel costs. For instance, in 2011, PUC spent \$11,203,108 on fuel alone and with the old policy, PUC recovered \$9,532,675, a short fall of \$1,670,433 and this new policy is intended to address this problem.
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 is set to take effect on May 15 of 2012.

Management's Discussion and Analysis for the year ended September 30, 2010 is set forth in PUC's report on the audit of financial statements, which is dated April 11, 2011. That Discussion and Analysis explains the major factors impacting the 2010 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmopa.fm.

Economic Outlook

The economic outlook for PUC operation next year is similar to 2011. There are no major changes happening on the island for PUC to anticipate significant changes in demand for electricity and water. With the policy changes mentioned above, the outlook for PUC is much brighter compared to prior years as it will open up the door for PUC to acquire the much needed working capital to implement plans already developed for the upgrade of its utility plant to meet current and future demand of electricity and water for the island. For 2012, fuel costs continue to go up and it will force people to conserve their energy consumption. With today's escalating cost of fossil fuel, the Company must start exploring other available options from alternate energy sources to help keep the cost of power in Pohnpei at an affordable level.

This concludes the management discussion and analysis of the financial statements for the year ended September 30, 2011.

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

Statements of Net Assets
September 30, 2011 and 2010

<u>ASSETS</u>	<u>2011</u>	<u>2010</u>
Current assets:		
Cash and cash equivalents	\$ 100,855	\$ 160,979
Investments	174,257	174,257
Time certificates of deposit	40,326	234,874
Accounts receivable, net	1,847,911	1,649,571
Prepayments	71,422	9,778
Materials and fuel inventory	1,444,787	919,780
Total current assets	<u>3,679,558</u>	<u>3,149,239</u>
Other noncurrent assets:		
Long-term deposit	383,573	-
Restricted:		
Cash and cash equivalents	349,500	150,000
Investments	145,112	145,112
Total other noncurrent assets	<u>878,185</u>	<u>295,112</u>
Utility plant, at cost:		
Electric plant in service	35,199,987	38,257,135
Water and sewer plant in service	20,020,449	19,725,729
	<u>55,220,436</u>	<u>57,982,864</u>
Less accumulated depreciation	<u>(34,322,564)</u>	<u>(34,906,596)</u>
Depreciable assets	20,897,872	23,076,268
Construction work-in-process	4,677,466	169,882
Total utility plant	<u>25,575,338</u>	<u>23,246,150</u>
	<u>\$ 30,133,081</u>	<u>\$ 26,690,501</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Notes payable	\$ 390,000	\$ 200,000
Current portion of long-term debt	217,015	222,478
Accounts payable:		
Operations	300,612	265,672
Fuel and lubricants	468,140	344,640
Affiliates	212,028	157,993
Deferred revenue	180,831	182,751
Accrued taxes and other liabilities	153,398	171,486
Employees' annual leave	51,496	55,557
Total current liabilities	<u>1,973,520</u>	<u>1,600,577</u>
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>8,417,394</u>	<u>3,461,434</u>
Total liabilities	<u>10,390,914</u>	<u>5,062,011</u>
Commitments and contingencies		
Net assets:		
Invested in capital assets, net of related debt	17,401,879	19,712,238
Restricted	145,112	145,112
Unrestricted	2,195,176	1,771,140
Total net assets	<u>19,742,167</u>	<u>21,628,490</u>
	<u>\$ 30,133,081</u>	<u>\$ 26,690,501</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, 2011 and 2010

	2011	2010
Operating revenues:		
Electricity sales	\$ 12,707,857	\$ 11,274,042
Water sales	1,188,140	1,238,409
Other sales	106,213	127,035
Total operating revenues before bad debts	14,002,210	12,639,486
Bad debts	-	(300,000)
Total operating revenues after bad debts	14,002,210	12,339,486
Operating and maintenance expenses:		
Production fuel	11,203,108	9,516,181
Depreciation	2,214,534	2,128,387
Administrative and general	971,604	963,705
Generation	841,837	859,785
Water and sewer	530,640	772,098
Distribution	449,902	486,267
Total operating expenses	16,211,625	14,726,423
Operating loss	(2,209,415)	(2,386,937)
Nonoperating (expenses) revenues:		
Interest expense, net	(119,260)	(143,465)
Grants and subsidies	442,352	154,116
Spurline projects	-	63,178
Total nonoperating revenues, net	323,092	73,829
Change in net assets	(1,886,323)	(2,313,108)
Net assets at beginning of year	21,628,490	23,941,598
Net assets at end of year	\$ 19,742,167	\$ 21,628,490

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, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Cash received from customers	\$ 13,801,950	\$ 12,257,408
Cash payments to suppliers for goods and services	(12,404,636)	(9,913,278)
Cash paid to employees	(1,676,765)	(1,724,448)
Net cash (used in) provided by operating activities	(279,451)	619,682
Cash flows from investing activities:		
Interest and dividends on investments and bank account	4,809	1,887
Net cash provided by investing activities	4,809	1,887
Cash flows from noncapital financing activities:		
Proceeds from notes payable	190,000	200,000
Advance from affiliate	54,035	58,970
Operating grants received	58,779	154,116
Interest expense	(129,021)	(149,286)
Spurline projects	-	63,178
Net cash provided by noncapital financing activities	173,793	326,978
Cash flows from capital and related financing activities:		
Proceeds from long-term debt	310,950	-
Repayments of long-term debt	(174,555)	(205,731)
Acquisition of utility plant	(95,670)	(713,395)
Net cash provided by (used for) capital and related financing activities	40,725	(919,126)
Net change in cash and cash equivalents	(60,124)	29,421
Cash and cash equivalents at beginning of year	160,979	131,558
Cash and cash equivalents at end of year	\$ 100,855	\$ 160,979
<u>Reconciliation of operating loss to net cash (used in)</u>		
<u>provided by operating activities:</u>		
Operating loss	\$ (2,209,415)	\$ (2,386,937)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	2,214,534	2,128,387
Bad debts	-	300,000
Write off of obsolete inventory	-	139,280
Write off of plant and equipment	-	60,672
(Increase) decrease in assets:		
Accounts receivable	(198,340)	(428,301)
Prepayments	(61,644)	2,531
Materials and fuel inventory	(158,957)	388,180
Increase (decrease) in liabilities:		
Accounts payable	158,440	323,073
Deferred revenue	(1,920)	46,223
Accrued taxes and other liabilities	(18,088)	12,943
Employees' annual leave	(4,061)	33,631
Net cash (used in) provided by operating activities	\$ (279,451)	\$ 619,682

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, 2011 and 2010

Supplemental information of noncash operating financing activities :

During the year ended September 30, 2011, PUC received a sub-grant of \$383,573 from the FSM National Government (FSMNG) through an increase in long-term deposit for its fuel purchase line with the FSM Petroleum Corporation.

Supplemental information of noncash capital and related financing activities :

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 was allocated \$4,519,382 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 \$4,519,382.

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.

See accompanying notes to financial statements.

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

Notes to Financial Statements
September 30, 2011 and 2010

(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 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, 2011 and 2010

(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. Accrued sick leave at September 30, 2011 approximates \$245,000.

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.

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.

New Accounting Standards: During fiscal year 2011, PUC implemented the following pronouncements:

- GASB 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.

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

Notes to Financial Statements
September 30, 2011 and 2010

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- 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 measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans.
- GASB Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools.

The implementation of these pronouncements 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. 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 Financial Accounting Standards Board (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 does not believe that the implementation of this statement will have a material effect on the financial statements of PUC.

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

Notes to Financial Statements
September 30, 2011 and 2010

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In July 2011, GASB issued 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 provisions of this statement are effective 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 PUC.

(2) Concentration of Credit Risk

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

At September 30, 2011 and 2010, 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 all of its fuel inventory from a single entity.

(3) Cash and Cash Equivalents 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. Cash and Cash Equivalents:

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;

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

Notes to Financial Statements
September 30, 2011 and 2010

(3) Cash and Cash Equivalents and Investments, Continued

A. Cash and Cash Equivalents, Continued

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, 2011 and 2010, the carrying amount of PUC's total cash and cash equivalents and time certificates of deposit was \$490,681 and \$545,853, respectively, and the corresponding bank balances were \$612,327 and \$580,926, respectively. Of the bank balances, \$489,909 and \$545,081, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2011 and 2010, 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:

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, 2011 and 2010, investments in mutual funds at fair value are \$319,369.

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

Notes to Financial Statements
September 30, 2011 and 2010

(3) Cash and Cash Equivalents and Investments, Continued

B. Investments, Continued:

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, 2011 and 2010.

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, 2011 and 2010.

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.

(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. The funds are accumulated in a restricted self-insurance fund, held by a trustee, in the name of PUC. As of September 30, 2011 and 2010, the carrying amount of the fund is \$145,112, 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.

(5) Accounts Receivable

PUC read meters on the last day of the month and processes bills on the first of the following month. Therefore, approximately thirty days of service was accrued at September 30, 2010, which is classified as accounts receivable - unbilled. Effective July 15, 2011, PUC changed its policy on large accounts and began reading and billing twice a month. At September 30, 2011, PUC had read and processed majority of accounts as of September 30, 2011. Accounts receivable at September 30, 2011 and 2010, are summarized as follows:

	<u>2011</u>	<u>2010</u>
Accounts receivable - electrical:		
Residential	\$ 1,549,041	\$ 1,387,944
Commercial	544,778	539,965
Government	352,745	261,222
Unbilled	<u>31,376</u>	<u>434,671</u>
	<u>2,477,940</u>	<u>2,623,802</u>

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

Notes to Financial Statements
September 30, 2011 and 2010

(5) Accounts Receivable, Continued

	<u>2011</u>	<u>2010</u>
Accounts receivable - water and sewer:		
Residential	\$ 1,994,617	\$ 1,888,839
Commercial and government	272,532	199,470
Unbilled	<u>169,513</u>	<u>105,044</u>
	<u>2,436,662</u>	<u>2,193,353</u>
Installment receivables	88,012	90,100
Other	<u>100,451</u>	<u>96,559</u>
	5,103,065	5,003,814
Less allowance for doubtful receivables	<u>(3,255,154)</u>	<u>(3,354,243)</u>
	<u>\$ 1,847,911</u>	<u>\$ 1,649,571</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, 2011 and 2010, included in accounts receivable – electrical due from customers enrolled in the cash power meter system are \$753,970 and \$896,214, respectively.

(6) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2011 and 2010 is as follows:

	<u>Beginning Balance</u> <u>October 1, 2010</u>	<u>Additions</u>	<u>Deletions</u>	<u>Transfers</u>	<u>Ending Balance</u> <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>					
Construction work-in-progress:					
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, 2011 and 2010

(6) Utility Plant, Continued

	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>1,600,013</u>
Electric plant in service	<u>37,555,697</u>	<u>589,433</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>5,255</u>	<u>568,243</u>
Water and sewer plant in service	<u>19,353,434</u>	<u>347,192</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>(34,906,596)</u>
	<u>24,130,922</u>	<u>(1,191,762)</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>23,246,150</u>

The NanPil Hydropower Station is not operational. At September 30, 2011, cumulative costs of \$7.5 million are included in electric production plant with corresponding \$3.8 million in accumulated depreciation. In April 2012, the Secretariat of the Pacific Community (SPC) has issued a Request for Proposal for the rehabilitation of this asset. The project is to be funded via a direct grant from SPC. As a result, related impairment losses on the nonoperational assets have not been recorded as of September 30, 2011.

As part of the infrastructure project for the overhauling of sewage pumps, extension of sewage lines, and treatment plants funded by two Asian Development Bank (ADB) loans administered by the FSM National Government (FSMNG) (see note 7), commitments outstanding on two separate construction contracts approximated \$2.9 million at September 30, 2011.

Subsequent to year end, PUC has committed \$170,000 to purchase two generators.

(7) Notes Payable and Long-Term Debt

Notes payable at September 30, 2011 and 2010 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, 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 5.75% at September 30, 2011) and expires on May 13, 2012. 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, 2011.

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

Notes to Financial Statements
September 30, 2011 and 2010

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

Changes in notes payable during the years ended September 30, 2011 and 2010, are as follows:

	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>
	Outstanding October 1, <u>2009</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2010</u>
Notes payable to BFSM	\$ -	\$ 200,000	\$ -	\$ 200,000

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

Long-term debt consists of the following at September 30, 2011 and 2010:

	<u>2011</u>	<u>2010</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, 2011 and 2010. During 2011, an additional \$294,720 was allocated to PUC which extended the maturity date to February 2052.	\$ 2,541,872	\$ 2,273,521
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%.	543,396	549,206
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.	608,175	668,414
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 of \$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.	421,584	192,771

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

Notes to Financial Statements
September 30, 2011 and 2010

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

	<u>2011</u>	<u>2010</u>
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 project of overhauling sewage pumps, extension of sewage lines, and treatment plants.	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, 2011). Proceeds are used for infrastructure project overhauling sewage pumps, extension of sewage lines, and treatment plants.	<u>1,121,773</u>	<u>-</u>
Total long-term debt	8,634,409	3,683,912
Less: current portion of long-term debt	<u>217,015</u>	<u>222,478</u>
Long-term portion of long-term debt	<u>\$ 8,417,394</u>	<u>\$ 3,461,434</u>

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

At September 30, 2011, 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>
2012	\$ 217,015	\$ 193,882	\$ 410,897
2013	778,576	194,333	972,909
2014	299,749	140,165	439,914
2015	314,707	127,712	442,419
2016	261,560	113,467	375,027
2017-2021	1,172,757	512,914	1,685,671
2022-2026	1,398,888	405,427	1,804,315
2027-2031	1,435,392	274,422	1,709,814
2032-2036	1,183,470	168,997	1,352,467
2037-2041	398,150	96,090	494,240
2042-2046	366,702	53,928	420,630
2047-2051	301,346	33,654	335,000
2052-2056	316,757	18,243	335,000
2057-2062	<u>189,340</u>	<u>3,098</u>	<u>192,438</u>
	<u>\$ 8,634,409</u>	<u>\$ 2,336,332</u>	<u>\$ 10,970,741</u>

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

Notes to Financial Statements
September 30, 2011 and 2010

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

Changes in non-current liabilities for the years ended September 30, 2011 and 2010, are as follows:

	Outstanding October 1, <u>2010</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2011</u>	<u>Current</u>	<u>Noncurrent</u>
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>

	Outstanding October 1, <u>2009</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2010</u>	<u>Current</u>	<u>Noncurrent</u>
Loan payable to:						
ADB no. 1459	\$ 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>

(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, 2011 and 2010:

	<u>2011</u>	<u>2010</u>
U.S. Department of the Interior:		
Operations and maintenance improvement program:		
Cash power meters program	\$ 10,000	\$ 10,031
Repair of power plant engine #8	<u>-</u>	<u>125,000</u>
	10,000	135,031
Other subsidies	<u>432,352</u>	<u>19,085</u>
	<u>\$ 442,352</u>	<u>\$ 154,116</u>

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

Notes to Financial Statements
September 30, 2011 and 2010

(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, 2011 and 2010, respectively.

(11) Related Party Transactions

At September 30, 2011 and 2010, accounts receivable include amounts owed by the State of Pohnpei and its component units to PUC of \$246,260 and \$213,553, respectively. At September 30, 2011 and 2010, PUC also has a non-interest bearing advance from the PUC Social Club of \$157,823 and \$137,289, respectively. Further, at September 30, 2011 and 2010, PUC has a non-interest bearing advance from the State of Pohnpei of \$54,205 and \$20,704, 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 7).

Additionally, PUC purchased 99% and 96% of its production fuel during the years ended September 30, 2011 and 2010 from FSM Petroleum Corporation (FSMPC), a component unit of FSMNG. A long-term deposit in the amount of \$383,573, through a sub-grant from the FSMNG, is held by FSMPC as collateral for a fuel and lubricant purchase line. At September 30, 2011 and 2010, the payable to FSMPC was \$468,140 and \$344,640, respectively.

(12) 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, 2011
(With comparative totals as of September 30, 2010)

<u>Assets</u>	Power and Utility	Water and Sewer	Totals	
			2011	2010
Current assets:				
Cash and cash equivalents	\$ (214,100)	\$ 314,955	\$ 100,855	\$ 160,979
Investments	174,257	-	174,257	174,257
Time certificates of deposit	40,326	-	40,326	234,874
Accounts receivable, net	1,371,119	476,792	1,847,911	1,649,571
Prepayments	71,422	-	71,422	9,778
Fuel and material inventory	1,220,944	223,843	1,444,787	919,780
Total current assets	2,663,968	1,015,590	3,679,558	3,149,239
Other noncurrent assets:				
Long-term deposits	383,573	-	383,573	-
Restricted:				
Cash and cash equivalents	349,500	-	349,500	150,000
Investments	145,112	-	145,112	145,112
Total other noncurrent assets	878,185	-	878,185	295,112
Utility plant, at cost:				
Electric plant in service	35,199,987	-	35,199,987	38,257,135
Water and sewer plant in service	-	20,020,449	20,020,449	19,725,729
	35,199,987	20,020,449	55,220,436	57,982,864
Less accumulated depreciation	(25,136,803)	(9,185,761)	(34,322,564)	(34,906,596)
Depreciable assets	10,063,184	10,834,688	20,897,872	23,076,268
Construction work-in-process	116,220	4,561,246	4,677,466	169,882
Total utility plant	10,179,404	15,395,934	25,575,338	23,246,150
	\$ 13,721,557	\$ 16,411,524	\$ 30,133,081	\$ 26,690,501
<u>Liabilities and Net Assets</u>				
Current liabilities:				
Notes payable	\$ 390,000	\$ -	\$ 390,000	\$ 200,000
Current portion of long-term debt	143,849	73,166	217,015	222,478
Accounts payable:				
Operations	300,612	-	300,612	265,672
Fuel and lubricants	468,140	-	468,140	344,640
Affiliate	212,028	-	212,028	157,993
Deferred revenue	180,831	-	180,831	182,751
Accrued taxes and other liabilities	153,398	-	153,398	171,486
Employees' annual leave	51,496	-	51,496	55,557
Total current liabilities	1,900,354	73,166	1,973,520	1,600,577
Noncurrent liabilities:				
FSM Development Bank loan	342,269	-	342,269	81,024
RUS Water extension loan	-	536,009	536,009	542,078
Bank of the FSM	543,641	-	543,641	609,343
ADB Water extension loan	-	6,995,475	6,995,475	2,228,989
Total liabilities	2,786,264	7,604,650	10,390,914	5,062,011
Net assets:				
Invested in capital assets, net of related debt	9,610,595	7,791,284	17,401,879	19,712,238
Restricted	145,112	-	145,112	145,112
Unrestricted	1,179,586	1,015,590	2,195,176	1,771,140
Total net assets	10,935,293	8,806,874	19,742,167	21,628,490
	\$ 13,721,557	\$ 16,411,524	\$ 30,133,081	\$ 26,690,501

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, 2011
(With comparative totals for the year ended September 30, 2010)

	Power and Utility	Water and Sewer	Totals	
			2011	2010
Operating revenues:				
Residential	\$ 407,572	\$ 910,972	\$ 1,318,544	\$ 1,196,613
Cash power	6,907,262	-	6,907,262	6,339,530
Commercial	3,217,763	134,122	3,351,885	2,874,028
Government	2,175,260	143,046	2,318,306	2,102,280
Other sales	98,672	7,541	106,213	127,035
Total operating revenues before bad debts	12,806,529	1,195,681	14,002,210	12,639,486
Bad debt (recovery) expense	314,971	(314,971)	-	(300,000)
Total operating revenues after bad debts	13,121,500	880,710	14,002,210	12,339,486
Operating and maintenance expenses:				
Production fuel	11,203,108	-	11,203,108	9,516,181
Depreciation	1,567,158	647,376	2,214,534	2,128,387
Administrative and general:				
Salaries and wages	398,105	-	398,105	376,305
Employee benefits	255,625	-	255,625	299,127
Vehicle, POL	95,231	-	95,231	84,654
Customer service and collection	84,452	-	84,452	76,532
Consumables	41,250	-	41,250	70,550
Communications	36,752	-	36,752	26,185
Travel	35,319	-	35,319	744
Contractual services	12,500	-	12,500	-
General repairs	12,370	-	12,370	28,549
Training and safety	-	-	-	897
Legal fees	-	-	-	162
	971,604	-	971,604	963,705
Generation:				
Salaries and wages	436,598	-	436,598	372,656
Repairs and maintenance	384,164	-	384,164	457,761
Other production	21,075	-	21,075	29,368
	841,837	-	841,837	859,785
Water and sewer:				
Salaries and wages	-	420,492	420,492	507,467
Employee benefits	-	49,140	49,140	57,549
Chemicals	-	48,320	48,320	52,346
Other production	-	8,137	8,137	17,460
Repairs and maintenance	-	4,551	4,551	137,276
	-	530,640	530,640	772,098
Distribution:				
Salaries and wages	369,532	-	369,532	350,214
Repairs and maintenance	80,370	-	80,370	136,053
	449,902	-	449,902	486,267
Total operating expenses	15,033,609	1,178,016	16,211,625	14,726,423
Operating loss	(1,912,109)	(297,306)	(2,209,415)	(2,386,937)

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, 2011
(With comparative totals for the year ended September 30, 2010)

	Power and Utility	Water and Sewer	Totals 2011	Totals 2010
Nonoperating revenues:				
Interest (expense) income, net	(85,326)	(33,934)	(119,260)	(143,465)
Federal grants and subsidies	422,852	19,500	442,352	154,116
Spurline projects	-	-	-	63,178
	<u>337,526</u>	<u>(14,434)</u>	<u>323,092</u>	<u>73,829</u>
Total nonoperating revenues (expenses), net				
Change in net assets	(1,574,583)	(311,740)	(1,886,323)	(2,313,108)
Net assets at beginning of year	<u>12,509,876</u>	<u>9,118,614</u>	<u>21,628,490</u>	<u>23,941,598</u>
Net assets at end of year	\$ <u><u>10,935,293</u></u>	\$ <u><u>8,806,874</u></u>	\$ <u><u>19,742,167</u></u>	\$ <u><u>21,628,490</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 OF FINANCIAL STATEMENTS 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, 2011, and have issued our report thereon dated May 27, 2012. 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.

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 and Questioned Costs, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

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 deficiencies described in the accompanying Schedule of Findings and Questioned Costs as item 2011-1 to be a material weaknesses.

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 the management of PUC in a separate letter dated May 27, 2012.

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.

This report is intended solely for the information and use of the Board of Directors and management of Pohnpei Utilities Corporation, others within the entity, 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 these specified parties. However, this report is also a matter of public record.

Deloitte & Touche LLP

May 27, 2012

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

Schedule of Findings and Questioned Costs
September 30, 2011

Finding No. 2011-1 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, 2011, it appears that inventory uses and adjustments in excess of \$167,000 were not supported by issue slips. Additionally, some of the issue slips that we examined contained errors and discrepancies.

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.

Prior Year Status: This condition is reiterative of conditions identified in our prior year audit of PUC.

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 completion of the physical inventory count, investigation should be performed of significant variances between recorded balances and quantities 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)

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

Schedule of Findings and Questioned Costs, Continued
September 30, 2011

Finding No. 2011-1 Accounting for Materials and Supplies Inventory, Continued

Auditee Response and Corrective Action Plan, Continued:

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.

July 31 2012 is the target date

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

Schedule of Prior Audit Findings
Year Ended September 30, 2011

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.