

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

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

YEARS ENDED SEPTEMBER 30, 2016 AND 2015

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

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Years Ended September 30, 2016 and 2015

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INDEPENDENT AUDITORS' REPORT

The Board of Directors
Pohnpei Utilities Corporation:

Report on the Financial Statements

We have audited the accompanying financial statements of the Pohnpei Utilities Corporation (PUC), a component unit of the State of Pohnpei, which comprise the statements of net position as of September 30, 2016 and 2015, and the related statements of revenues, expenses and changes in net position and of cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 to 5 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the 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 financial statements, and other knowledge we obtained during our audit of the 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.

Other Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The supplemental combining schedules on pages 23 to 25 are presented for purposes of additional analysis and are not a required part of the financial statements.

The supplemental combining schedules are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such 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 combining schedules are fairly stated, in all material respects, in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 30, 2017, 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* in considering PUC's internal control over financial reporting and compliance.

Deloitte & Touche LLP

June 30, 2017

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

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, 2016 and 2015. 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 utilities services. The General Manager, who is hired by the Board of Directors, oversees the daily operation of PUC.

PUC is operating with three (3) 3516C Caterpillar engines, two (2) 3516B Caterpillars engines, and two (2) 3512 Caterpillar engines. Of the seven (7) gensets, unit #1 3512 is not operational due to generator failure, and unit #3 3516C is not operational due to cracked engine block. PUC has an installed diesel generation capacity of 12250 kW and has been de-rated to 5550 kW. A 2000 kW diesel generation capacity under a *Power Purchase Agreement* with the FSM Petroleum Corporation has been de-rated to 330 kW. Renewables include 725 kW from Nanpil Hydro Plant, 180 kW from Palikir Solar Plant, 200kW from Nett School Solar Plant, and 600 kW from Pohnlangas Solar Plant. A total available diesel capacity of 6540 kW in 2015 has been increased to 7200 kW in 2016 with the peak demand of 5852 kW recorded in May of 2016. PUC produced 34,580,105 kWhr and 36,270,777 kWhr, and sold 27,115,503 kWhr and 28,415,706 kWhr to customers in 2015 and 2016, respectively. The number of households being serviced by PUC is 6,683 (6,490 using cash power meters and 193 using conventional meters) in 2016. The service coverage is 96% of the population.

PUC also provides potable water to the people of Pohnpei. The main water sources are both surface and ground water. PUC has the aptitude to produce 5 million gallons per day. The daily water demand to existing customers varies from 1.8 to 2.8 million gallons per day. PUC produced 792 million gallons and 839 million gallons and sold 643 million gallons and 612 million gallons to customers in 2015 and 2016, respectively, which resulted in total revenue of \$1.6 million and \$1.3 million, respectively. PUC services a total of 3,716 households, 3,317 on conventional postpaid meters and 399 prepaid meters (cash water) which covers about 2/3 of Pohnpei in area or 61% of the population.

The following table summarizes the financial condition and operations of the PUC for years ended September 30, 2016, 2015, and 2014:

Assets:	<u>2016</u>	<u>2015</u>	<u>2014</u>
Utility plant, net	\$ 34,500,711	\$ 32,487,525	\$ 30,632,819
Current assets	3,143,209	2,468,897	4,458,777
Other noncurrent assets	<u>1,665,374</u>	<u>1,373,200</u>	<u>1,071,385</u>
	<u>\$ 39,309,294</u>	<u>\$ 36,329,622</u>	<u>\$ 36,162,981</u>
Liabilities and Net Position:			
Notes payable	\$ 549,131	\$ 389,131	\$ 389,131
Current portion of long-term debt	623,694	666,723	581,804
Other current liabilities	3,821,612	2,948,844	2,662,814
Long-term debt, net of current portion	<u>9,132,336</u>	<u>10,131,442</u>	<u>9,394,411</u>
Total liabilities	<u>14,126,773</u>	<u>14,136,140</u>	<u>13,028,160</u>

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Years Ended September 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Net Position:			
Net investment in capital assets	25,025,628	22,171,629	21,490,412
Restricted	723,150	723,150	721,325
Unrestricted	<u>(566,257)</u>	<u>(701,297)</u>	<u>923,084</u>
Total net position	<u>25,182,521</u>	<u>22,193,482</u>	<u>23,134,821</u>
	<u>\$ 39,309,294</u>	<u>\$ 36,329,622</u>	<u>\$ 36,162,981</u>
Revenues, Expenses and Changes in Net Position:			
Operating revenues	\$ 12,033,847	\$ 13,874,094	\$ 16,738,234
Bad debts	(150,534)	(586,039)	(944,928)
Operating and maintenance expenses	<u>(12,884,420)</u>	<u>(15,495,837)</u>	<u>(17,530,542)</u>
Operating loss	(1,001,107)	(2,207,782)	(1,737,236)
Non-operating revenues (expenses), net	<u>161,840</u>	<u>(150,057)</u>	<u>(1,104,106)</u>
Loss before capital contributions	(839,267)	(2,357,839)	(2,841,342)
Capital contributions	<u>3,828,306</u>	<u>1,416,500</u>	<u>2,154,760</u>
Change in net position	2,989,039	(941,339)	(686,582)
Net position at beginning of year	<u>22,193,482</u>	<u>23,134,821</u>	<u>23,821,403</u>
Net position at end of year	<u>\$ 25,182,521</u>	<u>\$ 22,193,482</u>	<u>\$ 23,134,821</u>

Overall changes in the statements of net position components from September 2015 to 2016 includes an increase of utility plant of \$2,013,186, net increase of current and other noncurrent assets of \$966,486, and a decrease in total liabilities of \$9,367.

Increase in utility plant is the net of capital acquisitions (Pohnlangas Solar Farm and streetlights) and current period depreciation. Please see note 4 to the financial statements for additional information on PUC's utility plant.

Increase in current assets is attributable to a combination of an increase in accounts receivable and an increase in prepayments.

Decrease in current liabilities is due to a line of credit at the Bank of FSM to assist in the maintenance of generators, also an increase of balance due to Pohnpei State Government. Please see note 5 to the financial statements for additional information on PUC's debts.

Decrease in operating revenue before bad debts is mainly due to the decrease in tariff for electricity and a decrease in water sales.

Decrease in operating expenses is mainly due to the decrease in fuel expense and inventory purchases due to less maintenance on new generators.

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PUC incurred a loss before capital contributions in 2016. Capital contributions for 2016 is for the Pohnlangas Solar Plant contributed by the United Arab Emirates through the Government of the FSM, as well as the additional amount recorded for the cost of the water and sewer projects. Total amount of capital contributions increased in 2016 by \$2,411,806.

Management Discussion Analysis for the year ended September 30, 2015 is set forth in PUC's report on the audit of financial statement, which is dated June 17, 2016. That Discussion and Analysis explains the major factors impacting the 2015 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 the General Manager at P.O. Box C, Kolonia, Pohnpei.

Economic Outlook

By February 2018, the installation of the 2-545 diesel gensets will be commissioned, and the total available capacity will be 9200 kW, inclusive of 1400 kW from IPP/PPA, and exclusive of the renewable plant. RE includes 725 kW, Nanpil Run of the river plant, 200 kW Nett Elementary School, 170 kW COM and Capital, and 600 kW Pohnlangas Solar farm.

With fuel cost creeping upward, more renewable sources can offset the increase of fuel cost. A 1.1 million PV project has been funded by New Zealand Ministry of Foreign Affairs, more efficient generators under IDA 18, is in the pipeline, including GCF for more PV and Hydro that can drive the cost downward.

PUC is actively looking at ways to improve operational efficiencies by addressing station and distribution losses. Reform in collection had contributed to the improved collection for the interim as we seek funding to increase prepaid cash water to reduce accounts receivable.

PUC had engaged the services of the Graduate School USA to recommend a financial package for a supplemental management team and to invite donors to assist with the CRTISP for PUC. By improving the financial health of PUC the OIDP Sewer Loan can receive repayment from saving.

With the TA from Asian Development Bank (ADB) for the hiring of consultant to carry out the rate adjustment, PUC will be in better position maintain its assets.

PUC's goal is to be able to maintain reliable utility service at affordable rate to the general public.

This concludes the management discussion and analysis of the financial statements for the year ended September 30, 2016.

POHNPEI UTILITIES CORPORATION
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Statements of Net Position
September 30, 2016 and 2015

<u>ASSETS</u>	<u>2016</u>	<u>2015</u>
Current assets:		
Cash and cash equivalents	\$ 455,186	\$ 395,370
Investments	-	173,860
Time certificates of deposit	225,438	54,731
Accounts receivable, net	1,924,777	1,595,754
Prepayments	371,754	27,192
Materials and fuel inventory, net	166,054	221,990
Total current assets	<u>3,143,209</u>	<u>2,468,897</u>
Other noncurrent assets:		
Long-term deposit	1,148,437	888,750
Restricted - cash and cash equivalents	516,937	484,450
Total other noncurrent assets	<u>1,665,374</u>	<u>1,373,200</u>
Utility plant, at cost:		
Electric plant in service	42,321,747	40,131,908
Water and sewer plant in service	30,634,722	21,954,047
	72,956,469	62,085,955
Less accumulated depreciation	<u>(39,021,466)</u>	<u>(37,381,441)</u>
Depreciable assets	33,935,003	24,704,514
Construction work-in-process	565,708	7,783,011
Total utility plant	<u>34,500,711</u>	<u>32,487,525</u>
	<u>\$ 39,309,294</u>	<u>\$ 36,329,622</u>
 <u>LIABILITIES AND NET POSITION</u> 		
Current liabilities:		
Notes payable	\$ 549,131	\$ 389,131
Current portion of long-term debt	623,694	666,723
Accounts payable:		
Operations	2,223,587	1,758,275
Fuel, lubricants and kwh purchased	933,327	540,517
Unearned revenue	307,569	284,385
Accrued taxes and other liabilities	257,062	293,090
Employees' annual leave	100,067	72,577
Total current liabilities	<u>4,994,437</u>	<u>4,004,698</u>
Noncurrent liabilities:		
Long-term debt, net of current portion	<u>9,132,336</u>	<u>10,131,442</u>
Total liabilities	<u>14,126,773</u>	<u>14,136,140</u>
Commitments and contingencies		
Net position:		
Net investment in capital assets	25,025,628	22,171,629
Restricted	723,150	723,150
Unrestricted	<u>(566,257)</u>	<u>(701,297)</u>
Total net position	<u>25,182,521</u>	<u>22,193,482</u>
	<u>\$ 39,309,294</u>	<u>\$ 36,329,622</u>

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION
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Statements of Revenues, Expenses and Changes in Net Position
Years Ended September 30, 2016 and 2015

	2016	2015
Operating revenues:		
Electricity sales	\$ 10,619,198	\$ 12,192,701
Water sales	1,348,004	1,636,527
Other sales	66,645	44,866
Total operating revenues	12,033,847	13,874,094
Bad debts	(150,534)	(586,039)
Net operating revenues	11,883,313	13,288,055
Operating and maintenance expenses:		
Production fuel	5,365,812	6,903,490
Administrative and general	1,932,133	1,843,633
Depreciation	1,878,748	2,028,382
Water and sewer	1,214,390	859,651
Kwh purchased	977,441	1,292,751
Distribution	926,092	1,001,549
Generation	615,564	552,438
(Recoveries from) provisions for inventory obsolescence	(25,760)	1,013,943
Total operating and maintenance expenses	12,884,420	15,495,837
Operating loss	(1,001,107)	(2,207,782)
Nonoperating revenues (expenses), net:		
Interest expense, net	(98,354)	(150,057)
Grants and subsidies	122,500	-
Other income	137,694	-
Total nonoperating income (expenses), net	161,840	(150,057)
Loss before capital contributions	(839,267)	(2,357,839)
Capital contributions:		
Grants from foreign government and others	2,255,716	-
Capital contributions from FSM National Government	1,572,590	1,416,500
Total capital contributions	3,828,306	1,416,500
Change in net position	2,989,039	(941,339)
Net position at beginning of year	22,193,482	23,134,821
Net position at end of year	\$ 25,182,521	\$ 22,193,482

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION
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Statements of Cash Flows
Years Ended September 30, 2016 and 2015

	2016	2015
Cash flows from operating activities:		
Cash received from customers	\$ 11,715,168	\$ 13,412,182
Cash payments to suppliers for goods and services	(9,128,568)	(10,941,557)
Cash paid to employees	(2,342,551)	(2,220,751)
Net cash provided by operating activities	244,049	249,874
Cash flows from investing activities:		
Interest and dividends on investments and bank account	376	4,781
Net additions to time certificates of deposit	(29,334)	-
Net cash (used in) provided by investing activities	(28,958)	4,781
Cash flows from noncapital financing activities:		
Proceeds from notes payable	160,000	-
Operating grants received	122,500	-
Net cash provided by noncapital financing activities	282,500	-
Cash flows from capital and related financing activities:		
Interest paid	(98,730)	(115,349)
Proceeds from long-term debt	-	830,000
Principal repayment of long-term debt	(275,417)	(235,605)
Acquisition of utility plant	(63,628)	(1,102,280)
Net cash used in capital and related financing activities	(437,775)	(623,234)
Net change in cash and cash equivalents	59,816	(368,579)
Cash and cash equivalents at beginning of year	395,370	763,949
Cash and cash equivalents at end of year	\$ 455,186	\$ 395,370
<u>Reconciliation of operating loss to net cash provided by operating activities:</u>		
Operating loss	\$ (1,001,107)	\$ (2,207,782)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation	1,878,748	2,028,382
Bad debts	150,534	586,039
(Recoveries from) provisions for inventory obsolescence	(25,760)	1,013,943
Interest expense	-	(37,855)
Other income	137,694	-
(Increase) decrease in assets:		
Accounts receivable	(479,557)	(554,219)
Prepayments	(344,562)	(9,466)
Materials and fuel inventory	81,696	(168,040)
Long-term deposit	(259,687)	(312,537)
Increase (decrease) in liabilities:		
Accounts payable	91,404	(210,348)
Unearned revenue	23,184	92,307
Accrued taxes and other liabilities	(36,028)	18,627
Employees' annual leave	27,490	10,823
Net cash provided by operating activities	\$ 244,049	\$ 249,874

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION
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Statements of Cash Flows, Continued
Years Ended September 30, 2016 and 2015

Supplemental information of noncash operating, capital and related financing activities :

During the years ended September 30, 2016 and 2015, loan payments of \$766,718 and \$374,621, respectively, were made by the Pohnpei State Government. As a result, PUC increased its accounts payable and reduced its long-term debt by the same amount.

During the years ended September 30, 2016 and 2015, PUC recorded capital contributions from the FSM National Government (FSMNG) of \$1,572,590 and \$1,416,500, respectively, for the matching requirement portion which FSMNG paid for the water and sewer infrastructure funded by the Asian Development Bank (ADB) loans, and acquisition of three generators, respectively.

During the year ended September 30, 2015, PUC was allocated increases of \$1,195,974 relating to two projects funded by the master project funds through the FSMNG. As a result, PUC increased its capital assets and long-term debt by the same amounts.

During the year ended September 30, 2015, PUC was allocated a decrease of \$593,798 of balance adjustments relating to currency re-evaluation changes associated with the ADB loans. As a result, PUC decreased its capital assets and its long-term debt by the same amount.

See accompanying notes to financial statements.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

(1) 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.

PUC's financial statements are incorporated into the financial statements of the State of Pohnpei as a component unit.

(2) Summary of Significant Accounting Policies

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Note Disclosures*, establish financial reporting standards for governmental entities, which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements.

To conform to the requirements of GASB 34, equity is presented in the following net position categories:

- Net investment in capital assets - capital assets, net of accumulated depreciation, plus construction or improvement of those assets, net of related debts.
- Restricted: Nonexpendable - net position subject to externally imposed stipulations that requires PUC to maintain such permanently. At September 30, 2016 and 2015, PUC does not have nonexpendable net position. Expendable - net position whose use by PUC is subject to externally imposed stipulations that can be fulfilled by actions of PUC pursuant to those stipulations or that expire by the passage of time.
- Unrestricted - net position that is not subject to externally imposed stipulations. Unrestricted net position may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and deferred outflows of resources, and liabilities and deferred inflows of resources associated with the operation of the fund are included in the statements of net position. Proprietary fund operating statements present increases and decreases in net position. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents and Time Certificates of Deposit

For purposes of the statements of net position and of cash flows, cash and cash equivalents are defined as cash on hand and cash held in bank deposit accounts. Time certificates of deposit with original maturity dates greater than three months and those deposits that are restricted for use are separately classified in the statements of net position.

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, 2016 and 2015, the carrying amount of cash and cash equivalents and time certificates of deposit was \$1,197,561 and \$934,551, respectively, and the corresponding bank balances were \$1,376,662 and \$1,002,759, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2016 and 2015, bank deposits of \$500,000 were FDIC insured. PUC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

Investments

As of September 30, 2015, investments in mutual funds at fair value were \$173,860. The investment account was closed during the year ended September 30, 2016.

Accounts Receivable and Allowance for Doubtful Accounts

All receivables are due from government agencies, businesses and individuals located within the State of Pohnpei and are interest free and uncollateralized. The allowance for uncollectable accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectable based on evaluations of the collectability of these accounts and prior collection experience. Management determines the adequacy of the allowance for uncollectable accounts based upon review of the aged accounts receivable. The allowance is established through a provision for bad debts charged to expense. Accounts deemed uncollectable are written off against the allowance based on the specific identification method.

Inventories

Materials and fuel inventory are substantially carried at the lower of cost (weighted average) or market, net of an allowance for obsolescence relating to parts that have been specifically identified as likely not usable. At September 30, 2016 and 2015, inventory is net of an allowance for obsolescence of \$988,183 and \$1,013,943, respectively.

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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

Utility Plant

Initial 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 subsequent plant acquisitions with original costs in excess of \$5,000, with an estimated useful life in excess of one year.

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.

Deferred Outflows of Resources

In addition to assets, the statements of net position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element represents a consumption of net position that applies to a future period and so will not be recognized as an outflow of resources (deduction of net position) until then. As of September 30, 2016 and 2015, PUC has no items that qualify for reporting in this category.

Deferred Inflows of Resources

In addition to liabilities, the statements of net position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element represents an acquisition of net position that applies to a future period and so will not be recognized as an inflow of resources (additions to net position) until then. As of September 30, 2016 and 2015, PUC has no items that qualify for reporting in this category.

Compensated Absences

Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, vested or accumulated vacation leave is recorded as an expense and liability as the benefits accrue to employees. It is the policy of PUC to record the cost of sick leave when leave is actually taken and an expense is actually incurred. Accordingly, no liability is recorded for nonvesting accumulating rights to receive sick pay benefits.

Revenues Recognition

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 and water revenue is recognized as revenue upon point of sale; the estimated unearned portion is determined at the end of each year. At September 30, 2016 and 2016, the estimated unearned cash power revenue of \$172,000 and \$188,000 is included as part of unearned revenue in the accompanying statements of net position.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

Operating and Nonoperating Revenues and Expenses

PUC considers utility 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.

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 subrecipient from the Pohnpei State Government (PSG) or the FSM National Government (FSMNG) in addition to Pohnpei State Legislature appropriated subsidies and matching funds for federal programs as required.

New Accounting Standards

During fiscal year 2016, PUC implemented the following pronouncements:

- GASB Statement No. 72, *Fair Value Measurement and Application*, which addresses accounting and financial reporting issues related to fair value measurements and requires entities to expand their fair value disclosures by determining major categories of debt and equity securities within the fair value hierarchy on the basis of the nature and risk of the investment. The implementation of this standard did not have a material effect on the accompanying financial statements.
- GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which eliminates two of the four categories of authoritative GAAP that exist under the existing hierarchy prescribed by Statement No. 55. The two categories that will remain under the new standard are (1) GASB Statements and (2) GASB technical bulletins and implementation guides in addition to AICPA guidance that the GASB clears. The implementation of this standard did not have a material effect on the accompanying financial statements.
- GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*, which addresses for certain external investment pools and their participants the accounting and financial reporting implications that result from changes in the regulatory provisions referenced by previous accounting and financial reporting standards. Those provisions were based on the Investment Company Act of 1940, Rule 2a7. Rule 2a7 contains the Securities and Exchange Commission's regulations that apply to money market funds and were significantly amended in 2014. The implementation of this standard did not have a material effect on the accompanying financial statements.

In June 2015, GASB issued Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement No. 68, and Amendments to Certain Provisions of GASB Statements No. 67 and No. 68*, which aligns the reporting requirements for pensions and pension plans not covered in GASB Statements No. 67 and No. 68 with the reporting requirements in Statement No. 68. The provisions in Statement No. 73 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2015, GASB issued Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which replaces Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, and addresses financial reporting requirements for governments whose employees are provided with postemployment benefits other than pensions (other postemployment benefits or OPEB). The provisions in Statement No. 74 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In June 2015, GASB issued Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which replaces the requirements of Statements No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, and provides guidance on reporting by governments that provide OPEB to their employees and for governments that finance OPEB for employees of other governments. The provisions in Statement No. 75 are effective for fiscal years beginning after June 15, 2017. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In August 2015, GASB issued Statement No. 77, *Tax Abatement Disclosures*, which requires governments that enter into tax abatement agreements to disclose certain information about the agreements. The provisions in Statement No. 77 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In December 2015, GASB issued Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*, which addresses a practice issue regarding the scope and applicability of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The provisions in Statement No. 78 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In January 2016, GASB issued Statement No. 80, *Blending Requirements for Certain Component Units - an amendment of GASB Statement No. 14*, which improves financial reporting by clarifying the financial statement presentation requirements for certain component units. The provisions in Statement No. 80 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In March 2016, GASB issued Statement No. 81, *Irrevocable Split-Interest Agreements*, which improves accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. The provisions in Statement No. 81 are effective for fiscal years beginning after December 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

POHNPEI UTILITIES CORPORATION
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September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In March 2016, GASB issued Statement No. 82, *Pension Issues - an amendment of GASB Statements No. 67, No. 68, and No. 73*, which addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The provisions in Statement No. 82 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

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.

(3) Accounts Receivable

Accounts receivable at September 30, 2016 and 2015, are summarized as follows:

	<u>2016</u>	<u>2015</u>
Accounts receivable - electrical:		
Residential	\$ 1,640,191	\$ 1,509,404
Commercial	719,175	690,873
Government	<u>518,388</u>	<u>542,932</u>
	<u>2,877,754</u>	<u>2,743,209</u>
Accounts receivable - water and sewer:		
Residential	4,151,240	3,769,228
Commercial and government	487,347	511,159
Unbilled	<u>70,596</u>	<u>78,144</u>
	<u>4,709,183</u>	<u>4,358,531</u>
Installment receivables	74,061	75,710
Other	<u>92,467</u>	<u>96,458</u>
	7,753,465	7,273,908
Less allowance for doubtful accounts	<u>(5,828,688)</u>	<u>(5,678,154)</u>
	<u>\$ 1,924,777</u>	<u>\$ 1,595,754</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. As of September 30, 2016 and 2015, included in accounts receivable – electrical due from customers enrolled in the cash power meter system are \$924,687 and \$881,455, respectively.

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

(4) Utility Plant

A summary of changes in capital assets for the years ended September 30, 2016 and 2015 is as follows:

	<u>Beginning Balance</u> <u>October 1, 2015</u>	<u>Additions and</u> <u>Transfers</u>	<u>Deletions and</u> <u>Transfers</u>	<u>Ending Balance</u> <u>September 30, 2016</u>
<u>Depreciable assets:</u>				
Production plant	\$ 23,583,083	\$ 2,279,216	\$ -	\$ 25,862,299
Distribution plant	14,791,289	128,583	-	14,919,872
General plant	<u>1,757,536</u>	<u>12,500</u>	<u>(230,460)</u>	<u>1,539,576</u>
Electric plant in service	<u>40,131,908</u>	<u>2,420,299</u>	<u>(230,460)</u>	<u>42,321,747</u>
Water production plant	6,762,885	-	-	6,762,885
Sewage collection and treatment plant	5,512,301	8,688,938	-	14,201,239
Water distribution plant	8,827,482	-	-	8,827,482
General plant	<u>851,379</u>	<u>-</u>	<u>(8,263)</u>	<u>843,116</u>
Water and sewer plant in service	<u>21,954,047</u>	<u>8,688,938</u>	<u>(8,263)</u>	<u>30,634,722</u>
Total utility plant in service	62,085,955	11,109,237	(238,723)	72,956,469
Less accumulated depreciation	<u>(37,381,441)</u>	<u>(1,878,748)</u>	<u>238,723</u>	<u>(39,021,466)</u>
	<u>24,704,514</u>	<u>9,230,489</u>	<u>-</u>	<u>33,935,003</u>
<u>Non-depreciable assets:</u>				
Construction work-in-process:				
Electric plant	29,162	89,452	-	118,614
Water and sewer plant	<u>7,753,849</u>	<u>1,382,183</u>	<u>(8,688,938)</u>	<u>447,094</u>
	<u>7,783,011</u>	<u>1,471,635</u>	<u>(8,688,938)</u>	<u>565,708</u>
	\$ <u>32,487,525</u>	\$ <u>10,702,124</u>	\$ <u>(8,688,938)</u>	\$ <u>34,500,711</u>
	<u>Beginning Balance</u> <u>October 1, 2014</u>	<u>Additions and</u> <u>Transfers</u>	<u>Deletions and</u> <u>Transfers</u>	<u>Ending Balance</u> <u>September 30, 2015</u>
<u>Depreciable assets:</u>				
Production plant	\$ 20,756,331	\$ 2,826,752	\$ -	\$ 23,583,083
Distribution plant	14,612,657	178,632	-	14,791,289
General plant	<u>1,651,744</u>	<u>105,792</u>	<u>-</u>	<u>1,757,536</u>
Electric plant in service	<u>37,020,732</u>	<u>3,111,176</u>	<u>-</u>	<u>40,131,908</u>
Water production plant	6,762,885	-	-	6,762,885
Sewage collection and treatment plant	5,512,301	-	-	5,512,301
Water distribution plant	8,827,482	-	-	8,827,482
General plant	<u>837,379</u>	<u>14,000</u>	<u>-</u>	<u>851,379</u>
Water and sewer plant in service	<u>21,940,047</u>	<u>14,000</u>	<u>-</u>	<u>21,954,047</u>
Total utility plant in service	58,960,779	3,125,176	-	62,085,955
Less accumulated depreciation	<u>(35,353,059)</u>	<u>(2,028,382)</u>	<u>-</u>	<u>(37,381,441)</u>
	<u>23,607,720</u>	<u>1,096,794</u>	<u>-</u>	<u>24,704,514</u>
<u>Non-depreciable assets:</u>				
Construction work-in-process:				
Electric plant	7,280	2,848,634	(2,826,752)	29,162
Water and sewer plant	<u>7,017,819</u>	<u>1,523,043</u>	<u>(787,013)</u>	<u>7,753,849</u>
	<u>7,025,099</u>	<u>4,371,677</u>	<u>(3,613,765)</u>	<u>7,783,011</u>
	\$ <u>30,632,819</u>	\$ <u>5,468,471</u>	\$ <u>(3,613,765)</u>	\$ <u>32,487,525</u>

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

(4) Utility Plant, Continued

At September 30, 2015, water and sewer plant construction work-in-process represents infrastructure projects for overhauling sewage pumps, extension of sewage lines, and treatment plants funded by two Asian Development Bank (ADB) loans (ADB Loan Nos. 2099 and 2100) administered by the FSMNG (see note 5). PUC has no related commitment for project funds through internal sources. The projects were mostly completed and placed in service during the year ended September 30, 2016. During the project close-out, FSMNG determined that additional contributions of \$1,572,590 were made as matching contributions to the project, and PUC accordingly, recorded an increase in asset cost and related capital contribution.

During the year ended September 30, 2016, PUC received a contributed 600 kWh solar farm grid tied system from the United Arab Emirates valued at \$2,255,716 based on the grant award. The plant was placed in service in March 2016.

During the year ended September 30, 2015, PUC purchased and installed three generators with a total cost of approximately \$2.826 million of which \$2 million was funded by FSMNG appropriations (see note 7) and \$826,000 through a bank loan (see note 5).

(5) Notes Payable and Long-Term Debt

Notes payable at September 30, 2016 and 2015 include \$200,000 due to Pohnpei State Government (PSG) that is non-interest bearing, uncollateralized and has no set repayment date.

Additionally, notes payable at September 30, 2016 and 2015 include an outstanding balance of \$349,131 and \$189,131, respectively, against a line of credit with the Bank of the Federated States of Micronesia (BFSM) of \$370,000 and \$190,000, respectively. The line is collateralized by time certificates of deposit (TCD) with the bank, bearing variable interest at 5% over the TCD rate (effective rate of 5.25% at September 30, 2016 and 2015) and currently expires August 2017. The agreements restrict 100% of the line at September 30, 2016 and 2015, respectively, and as such, the related TCD balances of \$370,000 and \$190,000 are reflected as restricted cash and cash equivalents in the accompanying statements of net position as of September 30, 2016 and 2015, respectively.

Changes in notes payable during the years ended September 30, 2016 and 2015, are as follows:

	Outstanding October 1, <u>2015</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2016</u>
Notes payable to PSG	\$ 200,000	\$ -	\$ -	\$ 200,000
Notes payable to BFSM	<u>189,131</u>	<u>160,000</u>	<u>-</u>	<u>349,131</u>
	<u>\$ 389,131</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 549,131</u>
	Outstanding October 1, <u>2014</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2015</u>
Notes payable to PSG	\$ 200,000	\$ -	\$ -	\$ 200,000
Notes payable to BFSM	<u>189,131</u>	<u>-</u>	<u>-</u>	<u>189,131</u>
	<u>\$ 389,131</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 389,131</u>

POHNPEI UTILITIES CORPORATION
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Notes to Financial Statements
September 30, 2016 and 2015

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

Long-term debt consists of the following at September 30, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Payable on ADB loan no. 1459, administered by the FSMNG. Repayments as allocated by FSMNG indicates annual principal payments of \$56,498 through FY2016 and \$113,083 for FY2017 through FY2036, plus interest at 1.0%.	\$ 1,942,103	\$ 2,000,695
Payable on ADB loan no. 2099, administered by the FSMNG. Repayments as allocated by FSMNG indicates annual principal payments of \$255,678 through FY2035, with interest 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.	4,611,038	4,955,287
Payable on ADB loan no. 2100, administered by the FSMNG, principal due in semi-annual installments of varying amounts as a percentage of total drawings through 2029. Interest is payable at LIBOR plus 0.6% (effective rate of 0.88% and 2.1% at September 30, 2016 and 2015, respectively). Proceeds are used for infrastructure projects to overhaul sewage pumps, extend sewage lines, and for treatment plants.	1,644,488	2,042,089
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 bears fixed interest of 4.5%.	504,730	513,351
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, upon which the loan was refinanced for another 5 years maturing on November 30, 2018, with essentially the same terms.	230,776	313,618
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 December 25, 2011 and maturing November 25, 2016. A member of the PUC Board is also a member of management of the FSMDB.	50,163	147,513

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Notes to Financial Statements
September 30, 2016 and 2015

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

	<u>2016</u>	<u>2015</u>
Loan payable to Bank of Guam, original amount of \$830,000, interest at 7% and monthly installments of \$7,529 from December 15, 2014 to November 15, 2019, upon which the unpaid principal is due and payable. The loan is collateralized by a certain chattel mortgage on the three generators purchased in 2015 (see note 4).	772,732	804,474
Loan payable to Bank of Guam, original amount of \$140,000, interest fixed at 2%, due in monthly installments of \$3,039 from May 30, 2012 to April 30, 2016.	<u>-</u>	<u>21,138</u>
Total long-term debt	9,756,030	10,798,165
Less: current portion of long-term debt	<u>623,694</u>	<u>666,723</u>
Long-term portion of long-term debt	<u>\$ 9,132,336</u>	<u>\$ 10,131,442</u>

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

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2017	\$ 623,694	\$ 195,795	\$ 819,489
2018	586,071	178,027	764,098
2019	498,946	162,639	661,585
2020	1,105,259	120,161	1,225,420
2021	461,781	102,606	564,387
2022-2026	2,475,418	401,378	2,876,796
2027-2031	2,423,249	253,931	2,677,180
2032-2036	1,346,526	101,131	1,447,657
2037-2041	123,477	39,399	162,876
2042-2044	<u>111,609</u>	<u>10,073</u>	<u>121,682</u>
	<u>\$ 9,756,030</u>	<u>\$ 1,565,140</u>	<u>\$ 11,321,170</u>

Changes in long-term debt for the years ended September 30, 2016 and 2015, are as follows:

	<u>Outstanding October 1, 2015</u>	<u>Increases</u>	<u>Decreases</u>	<u>Outstanding September 30, 2016</u>	<u>Current</u>
Loan payable to:					
ADB no. 1459	\$ 2,000,695	\$ -	\$ (58,592)	\$ 1,942,103	\$ 96,925
ADB no. 2099	4,955,287	-	(344,249)	4,611,038	256,327
ADB no. 2100	2,042,089	-	(397,601)	1,644,488	65,960
BOG	804,474	-	(31,742)	772,732	38,022
RUS	513,351	-	(8,621)	504,730	9,299
BFSM	313,618	-	(82,842)	230,776	106,998
FSMDB	147,513	-	(97,350)	50,163	50,163
BOG	<u>21,138</u>	-	<u>(21,138)</u>	<u>-</u>	<u>-</u>
	<u>\$ 10,798,165</u>	<u>\$ -</u>	<u>\$ (1,042,135)</u>	<u>\$ 9,756,030</u>	<u>\$ 623,694</u>

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Notes to Financial Statements
September 30, 2016 and 2015

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

	Outstanding October 1, <u>2014</u>	<u>Increases</u>	<u>Decreases</u>	Outstanding September 30, <u>2015</u>	<u>Current</u>
Loan payable to:					
ADB no. 1459	\$ 2,377,669	\$ -	\$ (376,974)	\$ 2,000,695	\$ 48,703
ADB no. 2099	5,114,941	370,197	(529,851)	4,955,287	262,523
ADB no. 2100	1,277,906	825,777	(61,594)	2,042,089	71,739
RUS	521,890	-	(8,539)	513,351	8,594
BFSM	390,186	-	(76,568)	313,618	88,758
FSMDB	236,833	-	(89,320)	147,513	132,284
BOG	56,790	-	(35,652)	21,138	21,138
BOG	<u>-</u>	<u>830,000</u>	<u>(25,526)</u>	<u>804,474</u>	<u>32,984</u>
	\$ <u>9,976,215</u>	\$ <u>2,025,974</u>	\$ <u>(1,204,024)</u>	\$ <u>10,798,165</u>	\$ <u>666,723</u>

(6) Grants, Subsidies and Capital Contributions

Grants, subsidies and capital contributions comprise the following for the years ended September 30, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Operating Grants:		
FSMNG Congress appropriations	\$ <u>122,500</u>	\$ <u>-</u>
Capital Contributions:		
FSM National Government – generators	\$ -	\$ 1,416,500
FSMNG – waste water treatment plant	1,572,590	-
Foreign government – solar power system	<u>2,255,716</u>	<u>-</u>
Total capital contributions	\$ <u>3,828,306</u>	\$ <u>1,416,500</u>

(7) Contributions

During the year ended September 30, 1995, sole use rights for the Nanpohnmal Power Plant were contributed to PUC by the 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 FSMNG. However, substantial revenue is generated by PUC from the use of these assets and PUC bears responsibility for all costs associated with their operation.

(8) Self Insurance Fund and Risk Management

In accordance with section 2(5) of State Law 3L-41-93, an amendment to the PUC enabling legislation for PUC, a self-insurance fund was established to defray costs of any unforeseen accidents or disasters. At September 30, 2016 and 2015, balances of \$146,937, are maintained in a bank deposit account that was held as collateral for a bank loan which was paid off during the year-ended September 30, 2016. The deposit balances continued to be shown as restricted in the accompanying financial statements since restrictions have not been removed by the enabling body.

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September 30, 2016 and 2015

(8) Self Insurance Fund and Risk Management, Continued

Additionally, PUC purchases commercial insurance to cover its potential risks of loss from fire on its building and the contents and full coverage on property damages, but is self-insured for all other losses such as 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.

(9) Related Party Transactions

At September 30, 2016 and 2015, accounts receivable include amounts owed by the State of Pohnpei and its component units to PUC of \$753,834 and \$806,274, respectively.

At September 30, 2016 and 2015, PUC has a non-interest bearing advance from the PUC Social Club of \$46,450 and \$146,180, respectively. Further, at September 30, 2016 and 2015, PUC has a non-interest bearing advance from the State of Pohnpei of \$1,800,593 and \$1,033,875, respectively, resulting from the ADB loan repayments made by the State of Pohnpei for PUC. 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 position.

At September 30, 2016 and 2015, PUC has a non-interest bearing note payable to the State of Pohnpei of \$200,000 (note 5).

PUC purchased all of its production fuel during the years ended September 30, 2016 and 2015 from FSM Petroleum Corporation (FSMPC), a component unit of FSMNG. At September 30, 2016 and 2015, long-term deposits in the amount of \$1,148,437 and \$888,750, respectively, for which \$576,213 was received through a sub-grant from the FSMNG, are held by FSMPC as collateral for a fuel and lubricant purchase line. Starting November 2013, PUC also purchases power generated by FSMPC. At September 30, 2016 and 2015, payables to FSMPC were \$933,327 and \$540,517, respectively.

During the year ended September 30, 2016, PUC received \$112,000 from Chuuk Public Utilities Corporation (CPUC), which is included as a component of other income, for services rendered in connection with CPUC's disaster recovery efforts.

(10) Retirement Plan

PUC's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees receive from the FSM Social Security System. Starting August 2014, PUC matches a percentage of participants' contributions. Matching contributions to the Plan during the years ended September 30, 2016 and 2015 were \$87,349 and \$89,780, respectively. Management is of the opinion that the Plan does not represent an asset or a liability of PUC and as such no related assets or liabilities have been recorded in the accompanying statements of net position.

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

Notes to Financial Statements
September 30, 2016 and 2015

(11) Restricted Net Position

At September 30, 2016 and 2015, net position is restricted for the following purposes:

	<u>2016</u>	<u>2015</u>
Self-insurance fund (note 8)	\$ 146,937	\$ 146,937
Fuel deposit from sub-grant (note 9)	<u>576,213</u>	<u>576,213</u>
	\$ <u>723,150</u>	\$ <u>723,150</u>

(12) 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, 2016 and 2015, 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.

(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 a future period.

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

Combining Statement of Net Position
September 30, 2016
(With comparative totals as of September 30, 2015)

<u>Assets</u>	Power and Utility	Water and Sewer	Totals	
			2016	2015
Current assets:				
Cash and cash equivalents	\$ 455,186	\$ -	\$ 455,186	\$ 395,370
Investments	-	-	-	173,860
Time certificates of deposit	225,438	-	225,438	54,731
Accounts receivable, net	1,271,336	653,441	1,924,777	1,595,754
Divisional (payable) receivable	(1,058,972)	1,058,972	-	-
Prepayments	371,754	-	371,754	27,192
Materials and fuel inventory, net	160,779	5,275	166,054	221,990
Total current assets	<u>1,425,521</u>	<u>1,717,688</u>	<u>3,143,209</u>	<u>2,468,897</u>
Other noncurrent assets:				
Long-term deposit	1,148,437	-	1,148,437	888,750
Restricted - cash and cash equivalents	516,937	-	516,937	484,450
Total other noncurrent assets	<u>1,665,374</u>	<u>-</u>	<u>1,665,374</u>	<u>1,373,200</u>
Utility plant, at cost:				
Electric plant in service	42,321,747	-	42,321,747	40,131,908
Water and sewer plant in service	-	30,634,722	30,634,722	21,954,047
	42,321,747	30,634,722	72,956,469	62,085,955
Less accumulated depreciation	(26,994,791)	(12,026,675)	(39,021,466)	(37,381,441)
Depreciable assets	15,326,956	18,608,047	33,935,003	24,704,514
Construction work-in-process	118,614	447,094	565,708	7,783,011
Total utility plant	<u>15,445,570</u>	<u>19,055,141</u>	<u>34,500,711</u>	<u>32,487,525</u>
	<u>\$ 18,536,465</u>	<u>\$ 20,772,829</u>	<u>\$ 39,309,294</u>	<u>\$ 36,329,622</u>
<u>Liabilities and Net Position</u>				
Current liabilities:				
Notes payable	\$ 549,131	\$ -	\$ 549,131	\$ 389,131
Current portion of long-term debt	195,183	428,511	623,694	666,723
Accounts payable:				
Operations	422,994	1,800,593	2,223,587	1,758,275
Fuel, lubricants and kwh purchased	933,327	-	933,327	540,517
Unearned revenue	307,569	-	307,569	284,385
Accrued taxes and other liabilities	257,062	-	257,062	293,090
Employees' annual leave	100,067	-	100,067	72,577
Total current liabilities	<u>2,765,333</u>	<u>2,229,104</u>	<u>4,994,437</u>	<u>4,004,698</u>
Noncurrent liabilities:				
Loan payable - FSM Development Bank	-	-	-	15,229
Loan payable - RUS	-	495,431	495,431	504,757
Loans payable - Bank of Guam	734,718	-	734,718	771,490
Loan payable - Bank of the FSM	123,778	-	123,778	224,860
Loans payable - ADB	-	7,778,409	7,778,409	8,615,106
Total liabilities	<u>3,623,829</u>	<u>10,502,944</u>	<u>14,126,773</u>	<u>14,136,140</u>
Net position:				
Net investment in capital assets	14,672,838	10,352,790	25,025,628	22,171,629
Restricted	723,150	-	723,150	723,150
Unrestricted	(483,352)	(82,905)	(566,257)	(701,297)
Total net position	<u>14,912,636</u>	<u>10,269,885</u>	<u>25,182,521</u>	<u>22,193,482</u>
	<u>\$ 18,536,465</u>	<u>\$ 20,772,829</u>	<u>\$ 39,309,294</u>	<u>\$ 36,329,622</u>

See accompanying Independent Auditors' Report.

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

Combining Statement of Revenues, Expenses and Changes in Net Position
Year Ended September 30, 2016
(With comparative totals for the year ended September 30, 2015)

	Power and Utility	Water and Sewer	Totals	
			2016	2015
Operating revenues:				
Residential	\$ 171,044	\$ 1,031,348	\$ 1,202,392	\$ 1,319,214
Cash power	6,179,801	-	6,179,801	7,015,789
Cash water	-	25,004	25,004	24,266
Commercial	2,395,169	173,588	2,568,757	3,210,020
Government	1,873,184	118,064	1,991,248	2,259,939
Other sales	66,645	-	66,645	44,866
Total operating revenues	10,685,843	1,348,004	12,033,847	13,874,094
Bad debts	(53,849)	(96,685)	(150,534)	(586,039)
Net operating revenues	10,631,994	1,251,319	11,883,313	13,288,055
Operating and maintenance expenses:				
Production fuel	5,365,812	-	5,365,812	6,903,490
Administrative and general:				
Salaries and wages	498,617	-	498,617	497,007
Employee benefits	490,370	-	490,370	456,107
Travel	65,013	-	65,013	113,011
Vehicle, POL	94,289	-	94,289	110,035
Insurance	123,346	-	123,346	102,953
Communications	67,075	-	67,075	95,358
Contractual services	127,965	-	127,965	92,077
Consumables and supplies	44,294	-	44,294	79,460
Customer service and collection	93,236	-	93,236	71,887
Repairs and maintenance	52,125	-	52,125	71,526
Other	275,803	-	275,803	154,212
	1,932,133	-	1,932,133	1,843,633
Depreciation	1,343,078	535,670	1,878,748	2,028,382
Water and sewer:				
Salaries and wages	-	577,820	577,820	518,438
Chemicals	-	47,987	47,987	119,490
Consumables and supplies	-	73,787	73,787	75,202
Employee benefits	-	68,891	68,891	60,886
Repairs and maintenance	-	426,538	426,538	54,843
Other	-	19,367	19,367	30,792
	-	1,214,390	1,214,390	859,651
Kwh purchased	977,441	-	977,441	1,292,751
Distribution:				
Salaries and wages	797,060	-	797,060	764,379
Repairs and maintenance	90,910	-	90,910	146,367
Consumables and supplies	38,122	-	38,122	90,803
	926,092	-	926,092	1,001,549
Generation:				
Salaries and wages	496,544	-	496,544	451,750
Repairs and maintenance	73,684	-	73,684	49,060
Other	45,336	-	45,336	51,628
	615,564	-	615,564	552,438
(Recoveries from) provisions for inventory obsolescence	(25,760)	-	(25,760)	1,013,943
Total operating and maintenance expenses	11,134,360	1,750,060	12,884,420	15,495,837
Operating loss	(502,366)	(498,741)	(1,001,107)	(2,207,782)

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 Position, Continued
Year Ended September 30, 2016
(With comparative totals for the year ended September 30, 2015)

	Power and Utility	Water and Sewer	Totals	
			2016	2015
Nonoperating revenues (expenses), net:				
Interest expense, net	(75,361)	(22,993)	(98,354)	(150,057)
Grants and subsidies	122,500	-	122,500	-
Other income	137,694	-	137,694	-
	184,833	(22,993)	161,840	(150,057)
Total nonoperating revenues (expenses), net				
Loss before capital contributions	(317,533)	(521,734)	(839,267)	(2,357,839)
Capital contributions:				
Grants from foreign government and others	2,255,716	-	2,255,716	-
Capital contribution from FSM National Government	-	1,572,590	1,572,590	1,416,500
	2,255,716	1,572,590	3,828,306	1,416,500
Total capital contributions				
Change in net position	1,938,183	1,050,856	2,989,039	(941,339)
Net position at beginning of year	12,974,453	9,219,029	22,193,482	23,134,821
Net position at end of year	\$ 14,912,636	\$ 10,269,885	\$ 25,182,521	\$ 22,193,482

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, in accordance with the 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, the financial statements of Pohnpei Utilities Corporation (PUC), a component unit of the State of Pohnpei, which comprise the statement of net position as of September 30, 2016, and the related statements of revenues, expenses and changes in net position, and of cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated June 30, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered PUC's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of PUC's internal control.

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. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described in the accompanying Schedule of Findings and Responses as items 2016-01 and 2016-02 that we consider to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PUC's financial statements are free from 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*.

PUC's Response to Findings

PUC's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. PUC's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of this Report

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 30, 2017

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

Schedule of Findings and Responses
Year Ended September 30, 2016

Finding No.2016-01

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: During the year ended September 30, 2012, PUC implemented a system requiring all inventory movements to be recorded through inventory accounts. Previously, PUC did not properly account for materials inventory. Inventory purchases and uses were directly recorded in the repairs and maintenance or construction work-in-process 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. It appears that full compliance has not been achieved as inventory uses and adjustments of approximately \$240,000 during the year ended September 30, 2016 were recorded only as post-closing adjustments in June 2017.

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.

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 of all inventory items, PUC may consider performing cycle counts of its inventory. This process will assist in timely identification of variances and discrepancies.

Auditee Response and Corrective Action Plan:

We concur and would implement auditor's recommendation by ensuring enforcement of the current procedures that are already in place. Physical counts will be more frequent throughout the fiscal year, quarterly, to ensure accuracy of inventory movement. This process will be prioritized until PUC achieve full compliance of the corrective action plan.

Personnel who will be responsible for the enforcement of this corrective plan are:

1. Accounting Division Manager
2. Inventory Technician
3. AGMs for Power and Water & Sewer Depts.
4. Stockman for each Department

Upon receipt of purchases, all receiving reports and invoices are to be prepared and submitted to the Accounting Division (Inventory Tech) who will enter data in the inventory system. Storage will be in the respective warehouse of each Department. Usage of inventory items will be documented by each division using issue slips that will be submitted to Accounting Division (Inventory tech.) at the end of each month for entry in the system. Finance/Inventory record will then be reconciled against what is in stock.

September 30, 2017 will be our target date.

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

Schedule of Findings and Responses, Continued
Year Ended September 30, 2016

Finding No.2016-02

Criteria: Monthly reconciliations of significant accounts should be performed and financial statements adjusted during the year to facilitate a timely year-end closing, as well as providing accurate interim financial statements for management and Board of Director reviews during the year.

Condition: Delays in performing monthly reconciliations resulted in a high number of post-closing adjustments that impacted all areas of PUC's internal financial statements. Additionally, this resulted in a delayed audit process.

Cause: The cause of this condition is due to insufficient accounting personnel and resources.

Effect: Inaccurate internal financial statements during the year and delay in the audit process resulted.

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

Recommendation: PUC should assess the resource needs of its accounting and finance function. A monthly reconciliation and closing checklist should be developed, with a target deadline be established for each significant areas.

Auditee Response and Corrective Action Plan:

We concur with the auditor's recommendation. PUC should assess the resource needs of its accounting and finance function. Currently, the accountant is picking up duties of a vacant position, which may contribute to the delay in meeting monthly reconciliations, therefore PUC shall hire personnel to fill up the vacancy. A monthly reconciliation and closing checklist will be developed with a target deadline to be established for each significant area.