

YEAR ENDED DECEMBER 31, 2009

INDEPENDENT AUDITORS' REPORT
AND
ADDITIONAL INFORMATION
FINANCIAL STATEMENTS AND

KOROR STATE GOVERNMENT

INDEPENDENT AUDITORS' REPORT

Honorable Yositaka Adachi
Governor
Koror State Government:

We were engaged to audit the accompanying financial statements of the governmental activities and the general fund of the Koror State Government (the State), as of and for the year ended December 31, 2009, which collectively comprise the basic financial statements of the State's primary government. These financial statements are the responsibility of the State's management.

We were unable to determine the propriety of land lease receivables and related revenue recorded for the governmental activities and the general fund as of and for the year ended December 31, 2009 as the State has not reconciled sub-ledger balances to general ledger control totals and does not recognize lease revenue on a straight-line basis for leases with scheduled rent increases.

Property records detailing the underlying costs for capital assets or the bases supporting such costs were not made available, and capital outlays, depreciation expense and deletions were not recorded. Therefore, we were not able to determine the propriety of capital assets and related accumulated depreciation and depreciation expense in the accompanying statement of net assets.

Because of the significance of the matters discussed in the second and third paragraphs above, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the respective financial statements of the governmental activities and the general fund.

As discussed in note 7 to the financial statements, the beginning net assets of the governmental activities and the beginning fund balance of the governmental funds have been restated for the correction of errors.

The Management's Discussion and Analysis, on pages 3 through 6, as well as the Schedule of Revenues, Expenditures and Changes in Fund Balance - Budget (GAAP Basis) and Actual - General Fund and notes thereto, on pages 18 and 19, are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board (GASB). This information is the responsibility of the State's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 6, 2011, on our consideration of the State's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Robbie J. Jones LLC

December 6, 2011

Specific responses and corrective actions to individual findings have been submitted by the Director of the Department of Finance; however, some findings have yet to be resolved. For example, Finding No. 2009-2 relates to payment of 25% of public land lease revenues owed to the National Government, and it is anticipated that the National Government will pass legislation to repeal the 25% lease revenue payments for fiscal years 2007 and 2008. Also, any amount that the State may owe for fiscal years 2007 and 2008 may be deducted from the State Block Grant funding authorized and appropriated to the State by the National Government. Currently, the National Government owes \$1,963,162 (exclusive of allowances) to the State, while the State potentially owes \$581,708 to the National Government. Although an offset option remains available, tireless efforts have been made with Oibii! Er A Kelulau (OEK) to repeal the 25% requirement of land lease revenues to be paid to the National Government. This finding may continue in future audits but management is confident that its efforts to find a solution through statutory amendments can be realized.

Overall, the Governor is responsible for the oversight of the State's finances and will continue to take corrective action to improve the fiscal performance by reducing the number of findings in the audits. There is an ongoing effort by the State to implement recommendations from the auditors; thus the number of audit findings has decreased from thirteen in 2007 to eleven in 2008 to six in 2009. Most importantly, personnel involved are diligently working to better understand the findings so that every recommendation can be effected.

Overview of the Financial Statements

It is a vision of this administration that the State becomes a model organization for good governance to protect and serve the people of Koror with the principle spirit of our ancestors: A Oorou a ou rois er a rechad. Servicing the needs of the public can be achieved through a process of improvement which leads to the fact that a timely audit of the State is crucial. A completed audit provides the road map to improve our accounting and reporting on disbursement of public funds. It is a challenge we are facing and management is currently coordinating with its auditors to resolve this issue in a timely manner as required by our Constitution.

The State operates within the Republic of Palau and under its own Constitution. The mission of the State is "To serve and protect citizens of Koror State, the traditional and cultural community, and business agencies by providing accurate and timely information and by preserving assets and records of the government with greater accountability and transparency."

Introductory Section

This section presents the Management's Discussion and Analysis (MD&A) of the Koror State Government's (the State) financial status and performance encompassing the fiscal year ended December 31, 2009. Please read it in conjunction with the State's financial statements, which follow this section. Fiscal year 2008 comparative information has been included where appropriate for comparative purposes.

MANAGEMENT'S DISCUSSION AND ANALYSIS Year Ended December 31, 2009

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Office of the Governor



While the State has procurement regulations in place, greater emphasis on capacity building through appropriate training has been initiated and is ongoing to ensure the current staff will comply with existing policies. Challenges in procurement warrant management oversight.

The State's financial transactions and subsequent statements are prepared in accordance with accounting principles generally accepted in the United States of America and standards mandated by the Governmental Accounting Standards Board, as applicable to governmental entities.

The State operates on the accrual basis wherein revenues are recognized when earned, not when received and expenses are recorded when incurred, not when paid. Grants and similar items are recognized as revenues as soon as all eligibility requirements imposed by the provider have been met. Capital assets are recorded at historical cost or estimated historical cost. Contributed capital assets are recorded at estimated fair market value at the date of donation. Further information is provided in note 3 to the financial statements.

This report consists of the MD&A, the basic financial statements and notes to the financial statements. The basic financial statements consist of the Governmental Funds Balance Sheet/Statement of Net Assets and the Statement of Governmental Fund Revenues, Expenditures and Changes in Fund Balance/Statement of Activities.

The State uses one governmental fund to report on its financial position and results of operations. The State presents a balance sheet and a statement of revenues, expenditures and changes in fund balance for its governmental fund.

A condensed Governmental Funds Balance Sheet/Statement of Net Assets as of December 31, 2009 follows, with comparative information as of December 31, 2008:

Governmental Funds Balance Sheets/Statements of Net Assets

	2009		2008	
	General Fund	Net Assets	General Fund	Net Assets
Current and other assets	\$ 2,032,477	\$ 2,032,477	\$ 3,293,161	\$ 3,293,161
Capital assets	-	3,562,855	-	3,562,855
Total assets	\$ 2,032,477	\$ 5,595,332	\$ 3,293,161	\$ 6,856,016
Other liabilities	\$ 308,287	\$ 504,136	\$ 219,548	\$ 381,595
Total liabilities	308,287	504,136	219,548	381,595
Fund balances:				
Reserved for capital projects	1,644,874	79,316	1,162,847	1,910,766
Unreserved	79,316		1,910,766	
Total liabilities and fund balances	\$ 2,032,477	\$ 2,032,477	\$ 3,293,161	\$ 3,293,161
Net assets:				
Invested in capital assets		3,562,855		3,562,855
Unrestricted		1,528,341		2,911,566
Total net assets		\$ 5,091,196		\$ 6,474,421

A condensed Statement of Governmental Fund Revenues, Expenditures and Changes in Fund Balance/Statement of Activities for the year ended December 31, 2009 follows, with comparative information for the year ended December 31, 2008:

Statements of Governmental Fund Revenues, Expenditures and Changes in Fund Balance/Statements of Activities

	2009	2008	2007	2006
Revenues:				
Local revenues	\$ 5,006,342	\$ 4,893,558	\$ 4,893,558	\$ 4,893,558
Block grants	867,625	867,625	867,625	867,625
Fishing rights fees	233,538	191,433	191,433	191,433
Other	91,948	153,561	153,561	153,561
Bad debts	(1,913,934)	(1,173,784)	(1,173,784)	(1,173,784)
Total revenues	4,285,519	4,932,393	4,932,393	4,932,393
Expenditures/expenses:				
General government	2,350,455	2,362,843	2,362,843	2,524,890
Public works	1,399,170	1,328,516	1,328,516	1,328,516
Koror State projects	572,358	613,002	613,002	613,002
Law enforcement	728,671	780,799	780,799	780,799
Community and cultural affairs	584,288	538,454	538,454	538,454
Total expenditures/expenses	5,634,942	5,623,614	5,623,614	5,785,661
Deficiency of revenues under expenditures	(1,349,423)	-	(691,221)	-
Change in net assets	-	(1,383,225)	-	(853,268)
Fund balance/net assets at beginning of year	3,073,613	6,474,421	3,764,834	7,327,689
Fund balance/net assets at end of year	\$ 1,724,190	\$ 5,091,196	\$ 3,073,613	\$ 6,474,421

Financial Highlights

- In 2009, total assets decreased by \$1,260,684 from 2008 or 38% in the General Fund and 18% in the Statement of Net Assets. Total liabilities increased by \$88,739 from 2008 or 40% in the General Fund and by \$122,541 from 2008 or 32% in the Statement of Net Assets due to compensated absences. Fund balances decreased by \$1,349,423 or 44% and total net assets decreased by \$1,383,225 or 21% in 2009 over 2008.
- Total revenues decreased by \$646,874 or 13% from 2008. Total expenditures of the General Fund increased by \$11,328 or 0.2% and total expenses in the Statement of Net Assets decreased by \$116,917 or 2% in 2009 over 2008.

Budget

The State Constitution requires that the State Executive Administrator submit to the Legislature an annual budget for State operations. Upon passage by the Legislature, the budget becomes the State's financial plan for the applicable fiscal year. Actual revenues were less than final estimates by \$2,522,163 or 37%, while actual expenditures were less than final estimates by \$1,656,660 or 23%.

Capital Assets

At December 31, 2009 and 2008, the State had \$3,562,855 invested in capital assets. See note 3 to the financial statements for more information on the State's capital assets.

Economic Outlook

Economic indicators show that the Republic of Palau (ROP) as well as the State, will continue to be affected by the global recession, especially the tourism industry. More important, ROP is currently undergoing the Compact Review. As ROP continues the arduous task of revisiting our Compact with the United States, State management must prepare itself to face uncertainties which will continue to affect future fiscal status.

1. Land Lease Revenue

RPPL 8-18 only forgave 2009 to present. The requirement to remit 25% of land lease revenues to the National Government remains in effect for 2007 and 2008. The Office of the Governor worked with the Koror State Public Lands Authority (KSPLA) and signed an amnesty program for all land lease receivables to take effect on November 1, 2009. The management team of the State has been meeting with the KSPLA Board to deliberate on the never ending issue of land lease receivables accumulating every year. Thus, the joint agreement of an amnesty program for land lease receivables was executed. Management felt that the historical trend does not indicate a realistic remedy to the problem. Through the amnesty program, the State can and will realize some actual revenue that can improve the fiscal ability of the State.

2. National Government's Appropriation

Underlying cash flow problems continues to persist thus affecting the State's fiscal ability. The implementation of capital improvement projects for the State and other budgeted programs were put on hold. This policy may be prolonged until the cash shortage problem for ROP improves.

The State will continue to uphold its responsibility by serving the needs of its citizens and residents. As it improves the level of service, it will continue to face foremost challenges to create new revenue sources, improve existing revenue collection and effectively meet the needs of its citizens and sustain the cost of operations.

The construction and the development of the Solid Waste Management (SWM) operation is approaching its final phase. The State management team is satisfied with the completion of the SWM facility along with the Redemption Center. An additional potential new source of revenue can be realized. This project became a reality with great assistance from the Grassroots Japan grant. The State is hoping that this project will be the first model project of a "sustainable development".

Contacting the State's Financial Management

This financial report is designed to provide a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. The Management's Discussion and Analysis for the year ended December 31, 2008 is set forth in the report on the audit of the State's financial statements which is dated July 4, 2011. That Discussion and Analysis explains the major factors impacting the 2008 financial statements. If you have questions about the 2008 report, or need additional information, please contact the Koror State Government Department of Treasury, P.O. Box 116, Koror, Republic of Palau 96940, or email finance@kororstate.org or call 488-5005/8600.

KOROR STATE GOVERNMENT

Statement of Governmental Fund Revenues, Expenditures and Changes in Fund Balance/Statement of Activities
Year Ended December 31, 2009

Statement of Activities	Adjustments (Note 2)	General Fund
\$ 5,006,342	\$ -	\$ 5,006,342
867,625	-	867,625
233,538	-	233,538
91,948	-	91,948
(1,913,934)	-	(1,913,934)
4,285,519	-	4,285,519
Revenues:		
Local revenues		
Block grants		
Fishing rights fees		
Other		
Bad debts		
Total revenues		
Expenditures/expenses:		
Public works	12,664	1,399,170
Law enforcement	495	728,671
Community and cultural affairs	7,909	584,288
Koror State projects	-	572,358
Social security and insurance	-	427,555
Planning commission and public lands	6,494	386,188
Legislature	2,102	287,745
Treasury	2,224	212,182
Utility	-	185,885
Administration	2,508	176,461
Pension fund	-	148,719
Hamlet street lights	-	127,130
Traditional leaders	596	99,256
Legal counsel	(1,190)	73,629
Travel and transportation	-	72,128
Communications	-	63,810
Contingency	-	53,294
Prior year debt	-	20,714
Others	-	15,759
Total expenditures/expenses	33,802	5,634,942
Deficiency of revenues under expenditures	33,802	(1,349,423)
Changes in net assets	33,802	-
Fund balance/net assets:		
Beginning of year, as restated	(3,400,808)	3,073,613
End of year	\$ (3,367,006)	\$ 1,724,190

See accompanying notes to financial statements.

KOROR STATE GOVERNMENT

Notes to Financial Statements
December 31, 2009

(1) Organization

The Koror State Government (the State) operates within the Republic of Palau and under its own Constitution.

(2) Summary of Significant Accounting Policies

The accompanying basic financial statements of the State have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Governmental Accounting Standards Board (GASB) is the recognized standard-setting body for establishing governmental accounting and financial reporting principles. The more significant of the State's accounting policies are described below.

Government-Wide Financial Statements

The Statement of Net Assets and the Statement of Activities report information on all nonfiduciary activities of the State.

Primary government activities are defined as either governmental or business-type activities. Governmental activities, which normally are supported by taxes, intergovernmental revenues and other non-exchange revenues, are reported separately from business-type activities, which rely to a significant extent on fees charged to external parties for goods or services.

The Statement of Net Assets presents the State's nonfiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- Invested in capital assets consists of capital assets, net of accumulated depreciation plus construction or improvement of those assets.
- Restricted net assets result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through enabling legislation. The State has no restricted net assets at December 31, 2009.
- Unrestricted net assets consist of net assets, which do not meet the definition of the two preceding categories. Unrestricted net assets often are designated (for example, internally restricted), to indicate that management does not consider them to be available for general operations. They often have resources that are imposed by management, but can be removed or modified.

The degrees to which direct expenses of given functions or segments are offset by program revenues are described as follows:

Governmental activities:	Expenses	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Net (Expense) Revenue and Changes in Net Assets Primary Government
General government	\$ 2,935,547	\$ -	\$ 867,625	\$ -	\$ (2,067,922)
Public works	1,411,834	-	-	-	(1,411,834)
Public safety	729,166	-	-	-	(729,166)
Culture and recreation	592,197	-	-	-	(592,197)
	\$ 5,668,744	\$ -	\$ 867,625	\$ -	\$ (4,801,119)

KOROR STATE GOVERNMENT

Notes to Financial Statements
December 31, 2009

(2) Summary of Significant Accounting Policies, Continued

Government-Wide Financial Statements, Continued

Direct expenses are those that are clearly identifiable within a specific function. Program revenues include charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items do not meet the definition of program revenues.

Fund Financial Statements

The State uses one governmental fund to report on its financial position and results of operations. The operations of this fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures.

Separate financial statements are provided for governmental funds. The State presents a balance sheet and a statement of revenues, expenditures and changes in fund balances for its governmental fund. The ending fund balance on the balance sheet is then reconciled to the ending governmental net assets.

Adjustments required to reconcile total governmental fund balance to net assets of governmental activities in the Statement of Net Assets are as follows:

Total fund balance - governmental funds	\$ 1,724,190
Add:	
Capital assets	3,562,855
Less:	
Compensated absences	(195,849)
Total net assets - governmental activities	<u>\$ 5,091,196</u>

Adjustments required to reconcile the net change in total governmental fund balance to the change in net assets of governmental activities pertains to changes in compensated absences of \$33,802. No capital outlays or depreciation expense were recorded for the year ended December 31, 2009.

Measurement Focus and Basis of Accounting

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of cash flows. Grants and similar items are recognized as revenues as soon as all eligibility requirements imposed by the provider have been met.

Governmental fund financial statements account for the general governmental activities of the State and are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as they become susceptible to accrual; generally when they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the State considers revenues to be available if they are collected within 60 days of the end of the current fiscal period.

KOROR STATE GOVERNMENT

Notes to Financial Statements
December 31, 2009

(2) Summary of Significant Accounting Policies, Continued

Measurement Focus and Basis of Accounting, Continued

Amounts reported as program revenue include 1) charges to customers or applicants for goods, services, or privileges provided, 2) operating grants and contributions, and 3) capital grants and contributions. Internally dedicated resources are reported as general revenues rather than as program revenues. General revenue is derived from taxation and other items that are not allocated to specific programs.

Unrestricted contributions and grants are recorded as revenue in the statement of revenues, expenditures, and changes in fund balances when received (in the case of contributions) or when approved by the grantor agency (in the case of grants).

Cash

Custodial credit risk is the risk that in the event of a bank failure, the State'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 depository-government's name. The State does not have a deposit policy for custodial credit risk.

For purposes of the balance sheet/statement of net assets, cash is defined as cash on hand and cash held in demand accounts. As of December 31, 2009, the carrying amount of the primary government's total cash was \$17,050 and the corresponding bank balance was \$138,166, which is maintained in a financial institution subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2009, bank deposits were FDIC insured.

Receivables

In general, tax revenue is recognized on the government-wide statements, when assessed or levied and on the governmental fund financial statements to the extent that it is both measurable and available. Receivables of the State's Governmental Fund Type consist of land lease receivables, Block Grants receivable from the Republic of Palau National Government (ROP), fishing rights fees receivable from ROP, and actual amounts expected to be collected for taxes, licenses, fees, permits and similar revenues. The State was unable to report future commitments of land lease receivables.

The allowance for doubtful accounts is stated at an amount that management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectability of these accounts and prior collection experience. The allowance is established through a charge to bad debts expense. The State believes an allowance of \$3,087,718 at December 31, 2009 is adequate to absorb currently estimated bad debts in the account balance.

(2) Summary of Significant Accounting Policies, Continued

Capital Assets

Capital assets are reported in the government-wide financial statements. Such assets, whether purchased or constructed, are recorded at historical cost or estimated historical cost. Contributed capital assets are recorded at estimated fair market value at the date of donation.

The State has not developed a capitalization policy and did not record capital outlays during the year ended December 31, 2009 and previous years. The costs of normal maintenance and repairs that do not add to the value of assets or materially extend assets lives are not capitalized. The State has not developed a depreciation policy and did not record depreciation expense during the year ended December 31, 2009. When capital assets are disposed of, the cost and applicable accumulated depreciation are removed from the respective accounts, and the resulting gain or loss is recorded in the statement of activities.

Compensated Absences

Vested or accumulated vacation leave that is expected to be liquidated with expendable available financial resources is accrued when incurred in the government-wide financial statements. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits.

Fund Balance Reserves and Designation

The State's fund balance reserves represent those portions of fund balance (1) not appropriate for expenditures or (2) legally segregated for a specific future use. The State receives appropriations from ROP to finance specific capital projects. The State has specified \$2,570,319 of capital projects to be funded from this source which have not been received. The State has determined that \$925,445 of this amount may be uncollectible and has established an allowance against the ROP receivable. A reserve for capital projects has been established for the remaining net receivable as these amounts will be used for capital projects upon receipt.

Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of revenues and expenditures/expenses during the reporting period. Actual results may differ from those estimates.

New Accounting Standards

During fiscal year 2009, the State implemented the following pronouncements:

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

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*, which improves the quality of financial reporting by requiring endowments to report their land and other real estate investments at fair value, creating consistency in reporting among similar entities that exist to invest resources for the purpose of generating income.
- GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which improves financial reporting by contributing to the GASB's efforts to codify all GAAP for state and local governments so that they derive from a single source.
- GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, which incorporates accounting and financial reporting guidance previously contained in the American Institute of Certified Public Accountants (AICPA) auditing literature into the GASB's accounting and financial reporting literature for state and local governments, and addresses three issues from the AICPA's literature - related party transactions, going concern considerations, and subsequent events.

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

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

In June 2008, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the State.

In December 2008, GASB issued Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution Adjustment for Postemployment Benefits*, which clarifies the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, for calculating the annual required contribution (ARC) adjustment. The provisions of this statement are effective for periods beginning after December 15, 2008. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the State.

KOROR STATE GOVERNMENT

Notes to Financial Statements
December 31, 2009

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

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

Total Columns

Total columns are presented primarily to facilitate financial analysis. The Management's Discussion and Analysis includes certain prior year summarized comparative information in total. Such information does not include sufficient detail to constitute a full comparative presentation. Accordingly, such information should be read in conjunction with the State's financial statements for the year ended December 31, 2008 from which summarized information was derived.

(3) Capital Assets

Capital asset activities for the year ended December 31, 2009, are as follows:

Balance at December 31, 2009	Additions	Deletions	Balance at December 31, 2008
\$ 3,562,855	-	-	\$ 3,562,855
			General Capital Assets

The State does not maintain details of its recorded capital assets and related accumulated depreciation and depreciation expense and has not conducted an inventory of capital assets.

(4) Republic of Palau Civil Service Pension Trust Fund

Under the terms and conditions of Republic of Palau Public Law (RPP) 2-26, the State is to contribute to the Republic of Palau Civil Service Pension Trust Fund, a defined benefit, cost-sharing multi-employer pension plan established and administered by the Republic of Palau National Government.

From the plan's inception, October 1, 1987, to March 1, 1993, the State did not participate in the plan. In March 1993, the State began withholding and making current contributions to the Plan.

KOROR STATE GOVERNMENT

Notes to Financial Statements
December 31, 2009

(4) Republic of Palau Civil Service Pension Trust Fund, Continued

The State entered into a Memorandum of Understanding (MOU) with the Fund whereby employees will only receive credit for contributed years of service subsequent to March 1, 1993. Under the terms of this MOU, the employees must waive their rights in writing to receive benefits prior to March 1, 1993. In the event that such rights are not waived, the State is responsible for payment of balances in arrears, but is allowed to pursue employees for the employee's share. The estimated contribution in arrears is unknown.

The Fund provides retirement, security and other benefits to employees, and their spouses and dependents of the Republic of Palau, Republic of Palau State Governments and Republic of Palau agencies, funds and public corporations, which are paid monthly and are two percent of each member's average monthly salary. Normal benefits are the credited total service up to a maximum of thirty years total service. Generally, benefits vest after three years of credited service. Members, who retire at or after age 60, or with 25 years of vesting service, are entitled to retirement benefits. RPPPL 2-26 is the authority under which benefit provisions are established. Member contribution rates are established by RPPPL 2-26 at six percent (6%) of total payroll and matched dollar for dollar by the employer.

Under the provisions of RPPPL 2-26, the Fund's Board of Trustees adopted a Trust Fund Operation Plan which has the force and effect of law and which sets forth the procedures for the administration and coverage of the Plan. Amendments to the Plan are subject to the requirements of Title 6 of the Palau National Code. The State's payroll for fiscal year 2007 was covered in total by the Fund's pension plan. The Fund utilizes the actuarial cost method termed "agreement cost method" with actuarial assumptions used to compute the pension benefit obligation as follows: (a) a rate of return of 8.5% per year on the investment of present and future assets, (b) a 3% increase in employee salaries until retirement, and (c) members are assumed to retire at their normal retirement date.

The pension benefit obligation, which is the actuarial present value of credited projected benefits, is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and any step-rate benefits, estimated to be payable in the future as a result of employment service to date. The measure is intended to assist users to evaluate the Fund's funding status on a going-concern basis, and evaluate progress made in accumulating adequate assets to pay benefits when due.

The Fund's October 1, 2009 actuarial valuation determined the unfunded pension benefit obligation as follows:

Active participants	\$ 56,060,970
Participants in pay status	47,666,805
Participants with vested deferred benefits	<u>1,779,610</u>
Total pension benefit obligation	105,507,385
Net assets available for benefits, at market value	<u>41,254,319</u>
Unfunded benefit obligation	\$ <u>64,253,066</u>

The actuarial valuation did not provide a breakdown of actuarial present value of vested and non-vested accumulated plan benefits by sponsor or net assets available for benefits by sponsor.

KOROR STATE GOVERNMENT

Notes to Financial Statements
December 31, 2009

(5) Contingencies

Insurance Coverage

The State does not maintain insurance coverage for a significant amount of fixed assets. In the event of a catastrophe, the State may be self-insured to a material extent.

Land Leases

The State is required to remit 25% of all revenue derived from State public land leases to the Republic of Palau National Treasury for the period January 1, 2007 through December 31, 2008. The State has not recorded a liability for amounts owed as it believes such amounts will be forgiven. The State's potential liability could approximate \$581,708.

(6) Risk Management

The State is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The State has elected to purchase commercial insurance coverage from independent third parties for the risks of loss to which it is exposed. Settled claims from these risks have not exceeded commercial insurance coverage for the past three years.

(7) Restatement

The beginning net assets of the governmental activities and the beginning fund balance of the governmental funds have been restated to reflect the recognition of compensated absences and to correct an error in accrued expenses, as follows:

Fund balance/net assets as previously reported, December 31, 2008	\$ 3,185,667	\$ 6,748,522
Recognition of compensated absences	-	(162,047)
Correction of social security payable	(112,054)	(112,054)
Fund balance/net assets, as restated, December 31, 2008	\$ 3,073,613	\$ 6,474,421
<u>General Fund</u>		<u>Government-</u>
		<u>Wide</u>

KOROR STATE GOVERNMENT
REQUIRED SUPPLEMENTARY INFORMATION
YEAR ENDED DECEMBER 31, 2009

KOROR STATE GOVERNMENT

Schedule of Revenues, Expenditures and Changes in Fund Balance
Budget (GAAP Basis) and Actual - General Fund
Year Ended December 31, 2009

Variance Favorable (Unfavorable)	Budgeted Amounts		Actual
	Original	Final	
	\$ 5,273,875	\$ 5,273,875	\$ 5,006,342
Local revenues			\$ (267,533)
Block grants and capital projects grants	1,218,807	1,218,807	(351,182)
Fishing rights fees	260,000	260,000	(26,462)
Other	55,000	55,000	36,948
Bad debts	-	-	(1,913,934)
Total revenues	6,807,682	6,807,682	4,285,519
Expenditures:			
Public works	1,445,600	1,470,626	1,399,170
Law enforcement	850,500	850,500	728,671
Community and cultural affairs	605,000	613,386	584,288
State programs and projects	651,000	1,107,508	572,358
Social security and insurance	490,000	490,000	427,555
Planning commission and public lands	482,800	482,800	386,188
Legislature	311,800	311,800	287,745
Treasury	243,000	243,000	212,182
Utility	200,000	200,000	185,885
Administration	187,500	187,500	176,461
Pension fund	150,000	150,000	148,719
Hamlet street lights	322,000	322,000	127,130
Traditional leaders	153,300	153,300	99,256
Legal counsel	112,000	112,000	73,629
Travel and transportation	90,000	76,500	72,128
Communications	70,000	70,000	63,810
Contingency	50,000	63,500	53,294
Prior year debt	40,000	34,000	20,714
Capital improvement projects	351,182	351,182	-
Others	-	-	15,759
Total expenditures	6,807,682	7,291,602	5,634,942
Deficiency of revenues under expenditures	-	(483,920)	(1,349,423)
Other changes in fund balance:			
Increase in reserve for continuing appropriations	-	483,920	-
Unreserved fund balance at beginning of year	-	-	3,073,613
Unreserved fund balance at end of year	\$ -	\$ -	\$ 1,724,190

See accompanying Independent Auditors' Report.

KOROR STATE GOVERNMENT

Notes to Required Supplementary Information - Budgetary Reporting
December 31, 2009

(1) Budgetary Information

The State Constitution requires that the State Executive Administrator submit to the Legislature an annual budget for State operations. Upon passage by the Legislature and the House of Traditional Leaders, the budget becomes the State's financial plan for the applicable fiscal year.

Encumbrance accounting for budgetary control purposes is not followed by the State; however, management has determined that no material encumbrances exist at year end.