PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT

Years Ended December 31, 2011 and 2010

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

TABLE OF CONTENTS
December 31, 2011

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

FINANCIAL SECTION

Years Ended December 31, 2011 and 2010

J. Scott Magliari & COMPANY

CERTIFIED PUBLIC ACCOUNTANT

SAIPAN
Family Building, Suite 201
PMB 297 Box 10000
Saipan, MP 96950
Tel Nos. (670) 233-1837/0456
Fax No. (670) 233-8214

GUAM
Reflection Center, Suite 204
P.O. Box 12734
Tamuning, GU 96931
Tel Nos. (671) 472-2680/2687
Fax No. (671) 472-2686

PALAU
PIDC Apartment No. 11
P.O. Box 1266
Koror, PW 96940
Tel No. (680) 488-8615
Fax No. (680) 488-8616

INDEPENDENT AUDITOR'S REPORT

Board of Directors
Palau National Communications Corporation:

I have audited the accompanying statements of net deficiency of the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, as of December 31, 2011 and 2010 and the related statements of revenues, expenses and changes in net deficiency and cash flows for the years then ended. These financial statements are the responsibility of the PNCC's management. My responsibility is to express an opinion on these financial statements based on my audits.

I conducted my 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 I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the PNCC's internal control over financial reporting. Accordingly, I express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. I believe that my audit provide a reasonable basis for my opinion.

In my opinion, such financial statements present fairly, in all material respects, the financial position of PNCC as of December 31, 2011 and 2010, and its changes in net deficiency and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, I have also issued a report dated May 7, 2012, on my consideration of PNCC's internal control over financial reporting and my 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 my 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 my audit.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and budgetary comparison information on pages 3 through 11 and 34 presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. I 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 my inquiries, the basic financial statements, and other knowledge I obtained during my audits of the basic financial statements. I 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.

My audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise the Palau National Communications Corporation's financial statements as a whole. The Schedule of Functional Expenses is presented for purposes of additional analysis and is not a required part of the financial statements. This Schedule is the responsibility of management and was derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In my opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

J. Scott Magliari & Company

Koror, Republic of Palau
May 7, 2012

This section of Palau National Communications Corporation's (PNCC) annual financial report presents the analysis of its financial performance during the fiscal year ended December 31, 2011 with comparisons to prior years ended December 31, 2010 and 2009. We encourage readers to consider the information presented here in conjunction with the financial statements and related notes which follows this section.

FINANCIAL HIGHLIGHTS

- PNCC's total assets decreased from $28.5 million in 2010 to $26.8 million in 2011, a decrease of $1.7 million or 6%, this is primarily due to the change in property, plant and equipment for the depreciation and acquisitions. This is consistent with the $2.5 million decrease in 2010 compared to 2009.

- PNCC's total liabilities decreased from $31.8 million in 2010 to $30.9 million in 2011, a decrease of $940 thousand or 3% primarily due to the repayment of long-term debt.

- Net deficiency increased from $3.3 million in 2010 to $4.1 million in 2011.

- Operating revenues increased by $462 thousand or 4% from $9.4 million in 2010 to $9.8 million in 2011. The increase in sales is primarily attributable to the increase in revenues from cellular operations.

- There is no significant change in operating expenses as operating expenses in 2011 increased by approximately $60 thousand or 0.7% from 2010.

OVERVIEW OF THE FINANCIAL STATEMENTS

The financial section of this report presents the PNCC's financial statements as two components: basic financial statements, and the notes to financial statements.

Basic Financial Statements

The *Statements of Net Deficiency* includes all PNCC's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to PNCC creditors (liabilities). Changes in net assets (deficit) over time may provide an indicator as to whether the financial position of the PNCC is improving or deteriorating.

The *Statements of Revenues, Expenses and Changes in Net Deficiency,* reports how net assets (deficit) have changed during the year. All of the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Net Deficiency. This Statement is a tool used to measure profitability and credit worthiness of PNCC.

The *Statement of Cash Flows* reports cash received, cash disbursements and net changes from operations, capital and related financing activities, noncapital financing activities, investing activities and the reconciliation of earnings from operations to net cash provided by operating activities. Changes in cash flows are consistent with operating and non-operating revenues and expenses referenced above in the discussion of the Statement of Net Assets and Statements of Revenues, Expenses and Changes in Net Deficiency.

CONDENSED FINACIAL INFORMATION

Balance Sheet

	2011	2010	Increase (Decrease)		2009
ASSETS					
Current assets	$ 2,796,455	$ 2,782,129	$ 14,326	0.5%	$ 3,096,507
Restricted cash and cash equivalents	3,853,481	3,855,830	(2,349)	-0.1%	3,878,620
Other noncurrent assets	51,550	51,500	50	0.1%	50,972
Property, plant and equipment, net	20,101,930	21,836,420	(1,734,490)	-7.9%	23,972,839
TOTAL ASSETS	$ 26,803,416	$ 28,525,879	$ (1,722,463)	-6.0%	$ 30,998,938
LIABILITIES AND NET DEFICIENCY					
Current liabilities	$ 2,731,865	$ 2,400,090	$ 331,775	13.8%	$ 2,365,506
Note payable, net of current portion	28,125,621	29,397,852	(1,272,231)	-4.3%	30,625,863
Total liabilities	30,857,486	31,797,942	(940,456)	-3.0%	32,991,369
Invested in capital assets, net of related debt	(9,413,072)	(8,887,466)	(525,606)	5.9%	(8,036,968)
Restricted - nonexpendable	3,853,481	3,855,830	(2,349)	-0.1%	3,878,620
Unrestricted	1,505,521	1,759,573	(254,052)	-14.4%	2,165,917
Total net deficiency	(4,054,070)	(3,272,063)	(782,007)	23.9%	(1,992,431)
TOTAL LIABILITIES AND NET DEFICIENCY	$ 26,803,416	$ 28,525,879	$ (1,722,463)	-6.0%	$ 30,998,938

During 2011, total assets decreased by $1,722,463, and total liabilities decreased by $940,456 as compared to 2010. Significant changes in account balances were:

- Capital assets decreased by $1,734,490 due to current year depreciation expense net of current year additions.
- Long-term debt decreased by $1,272,231 million primarily due to payments of principal.

During 2011, net deficiency increased by $782,007 as compared to 2010. This was the result of a continuing losses incurred in 2011 in which total expenses exceeded total operating revenues by $782,007.

CONDENSED FINACIAL INFORMATION

Statements of Revenues, Expenses and Changes in Net Deficiency

	2011	2010	Increase (Decrease)		2009
Operating revenues	$ 9,816,815	$ 9,354,886	$ 461,929	4.9%	$ 8,690,478
Operating expenses	(9,231,608)	(9,171,322)	(60,286)	0.7%	(8,657,372)
Earnings from operations	585,207	183,564	401,643	218.8%	33,106
Nonoperating income (expenses)	(1,367,214)	(1,463,196)	95,982	-6.6%	(1,422,412)
Change in net deficiency	$ (782,007)	$ (1,279,632)	$ 497,625	-38.9%	$ (1,389,306)

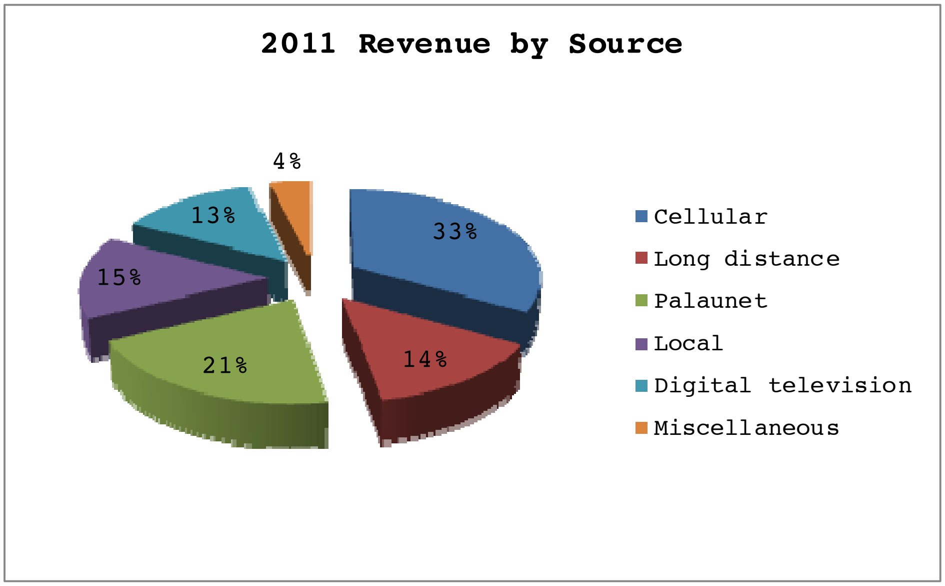
Changes in operating revenues, expenses and non-operating income and expenses are discussed in more details in the following sections.

REVENUE BY SOURCE

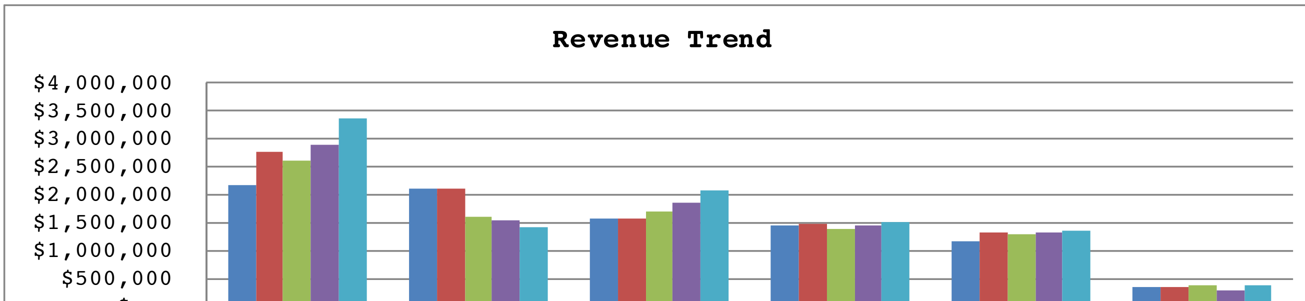
	2011	2010	Increase (Decrease)		2009
Cellular	$ 3,359,520	$ 2,894,006	$ 465,514	16.1%	$ 2,621,751
Long distance	1,429,346	1,541,586	(112,240)	-7.3%	1,614,711
Palaunet	2,077,983	1,866,938	211,045	11.3%	1,703,025
Local	1,499,031	1,445,873	53,158	3.7%	1,387,618
Digital television	1,362,971	1,322,768	40,203	3.0%	1,278,725
Miscellaneous	396,491	283,715	112,776	39.7%	394,756
Provision for doubtful accounts	(308,527)	-	(308,527)	-100.0%	(310,108)
	$ 9,816,815	$ 9,354,886	$ 461,929	4.9%	$ 8,690,478

PNCC's cellular operation has consistently contributed the highest source of revenue and continues to grow over the past five years. PNCC has seen the declining long distance revenues as its internet operation improves. The revenues from local telecommunications, digital television and miscellaneous charges have been fairly consistent over the past five years.

REVENUE BY SOURCE, Continued



Summarized in the chart above are the major revenue sources of PNCC. For 2011, the Cellular operations contributed 33% of PNCC total operating revenues.



	Cellular	Long distance	Palaunet	Local	Digital television	Miscellaneous
2007	$2,179,592	$2,091,242	$1,570,446	$1,439,755	$1,152,633	$342,470
2008	$2,751,678	$2,102,418	$1,564,475	$1,492,236	$1,310,409	$341,016
2009	$2,621,751	$1,614,711	$1,703,025	$1,387,618	$1,278,725	$394,756
2010	$2,894,006	$1,541,586	$1,866,938	$1,445,873	$1,322,768	$283,715
2011	$3,359,520	$1,429,346	$2,077,983	$1,499,031	$1,362,971	$396,491

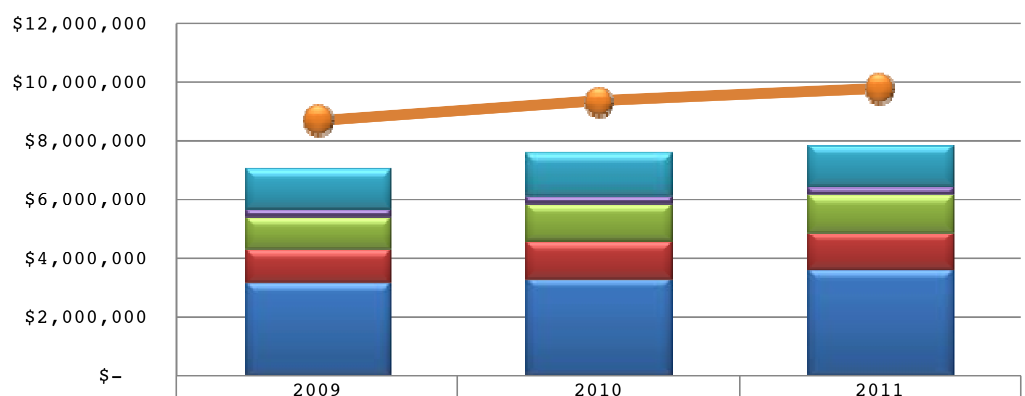
The Chart above shows the change in revenues by source over the past five years. PNCC's cellular operation has consistently contributed the highest source of revenue and continues to grow over the past five years. PNCC have seen the declining long distance revenues as its internet operation improves. The revenues from local telecommunications, digital television and miscellaneous charges have been fairly consistent over the past five years.

EXPENSES BY FUNCTION

	2011	2010	Increase (Decrease)		2009
Operating Expenses					
Depreciation	$ 2,733,481	$ 3,013,918	$ (280,437)	-9.3%	$ 2,937,478
Plant specific operations	3,645,761	3,360,920	284,841	8.5%	3,177,532
Corporate operations	1,293,130	1,225,889	67,241	5.5%	1,154,319
Customer service operations	1,241,342	1,299,026	(57,684)	-4.4%	1,104,802
Plant non-specific operations	317,894	271,569	46,325	17.1%	283,241
Total operating expenses	9,231,608	9,171,322	60,286	0.7%	8,657,372
Interest expense	1,387,088	1,426,595	(39,507)	-2.8%	1,372,457
	$ 10,618,696	$ 10,597,917	$ 20,779	0.2%	$ 10,029,829

There has been no significant change in PNCC's expense in 2011 compared to 2010. PNCC makes its best effort to control spending and maintain its expenses within budget. See pages 9 and 34 for the Supplementary Schedule for the Budget versus Actual for the year ended December 31, 2011.

Cash Expenses vs Revenues



	2009	2010	2011
Interest expense	$1,372,457	$1,426,595	$1,387,088
Plant non-specific operations	$283,241	$271,569	$317,894
Customer service operations	$1,104,802	$1,299,026	$1,241,342
Corporate operations	$1,154,319	$1,225,889	$1,293,130
Plant specific operations	$3,177,532	$3,360,920	$3,645,761
Total Revenues	$8,690,478	$9,354,886	$9,816,815

The chart above shows the increase in cash expended over the past three years compared to the growth of revenues over the same period of time. Revenues increase at a slightly higher rate that the increase in expenditures. This is a positive indicator of the performance of PNCC. Even with this positive trend, PNCC must continue to improve revenues and maintain its operating expenses to be able to repay its long-term debt and also provide a reserve for capital asset replacement costs.

ANALYSIS OF BUDGET AGAINST ACTUAL RESULTS OF OPERATIONS

	BUDGET	REVISIONS	FINAL	ACTUAL	VARIANCE FAVORABLE (UNFAVORABLE)
Operating revenues:					
Cellular	$ 4,074,909	$ -	$ 4,074,909	$ 3,359,520	$ (715,389)
Long distance	1,446,836	-	1,446,836	1,429,346	(17,490)
Palaunet	2,034,409	-	2,034,409	2,077,983	43,574
Local	1,478,607	-	1,478,607	1,499,031	20,424
Digital television	1,366,875	-	1,366,875	1,362,971	(3,904)
Miscellaneous	450,000	-	450,000	396,491	(53,509)
Provision for doubtful accounts	-	-	-	(308,527)	(308,527)
Total operating revenues	10,851,636	-	10,851,636	9,816,815	(1,034,821)
Operating expenses:					
Depreciation	2,964,409	-	2,964,409	2,733,481	230,928
Plant specific operations	3,425,302	-	3,425,302	3,645,761	(220,459)
Corporate operations	1,823,497	-	1,823,497	1,293,130	530,367
Customer service operations	1,014,942	-	1,014,942	1,241,342	(226,400)
Plant non-specific operations	379,723	-	379,723	317,894	61,829
Total operating expenses	9,607,873	-	9,607,873	9,231,608	376,265
Earnings from operations	1,243,763	-	1,243,763	585,207	(658,556)
Nonoperating income (expenses):					
Interest income	12,105	-	12,105	3,975	(8,130)
Interest expense	(1,162,500)	-	(1,162,500)	(1,387,088)	(224,588)
Other income (expenses), net	(42,566)	-	(42,566)	15,899	58,465
Total nonoperating income (expenses), net	(1,192,961)	-	(1,192,961)	(1,367,214)	(174,253)
Change in net deficiency	$ 50,802	$ -	$ 50,802	$ (782,007)	$ (832,809)

PNCC was not able to meet its revenue projections due to economic situation in Palau and throughout the world. Continued increase in the price of commodities and utilities cause PNCC customers to cut back on their communication services spending.

Although there were variances between functions/divisions, PNCC was able to maintain its operating expenses within the 2011 budget. A new procurement process was instituted which requires all purchase requisitions be reviewed by an accounting staff to ensure and certify the availability of funds to support any purchase. This should help ensure all departments of PNCC stay within their approved budget.

CAPITAL ASSETS AND RELATED LONG TERM DEBT

	2011	2010	2009
Property, plant and equipment at cost	$ 61,268,023	$ 60,090,309	$ 59,350,077
Accumulated depreciation	(41,166,093)	(38,432,612)	(35,554,625)
Net book value	20,101,930	21,657,697	23,795,452
Carrying value of long term-debt	(29,515,002)	(30,723,886)	(32,009,807)
Invested in capital assets, net of related debt	$ (9,413,072)	$ (9,066,189)	$ (8,214,355)
Deprecitaion expense	$ 2,733,481	$ 3,013,918	$ 2,937,478
Repayment of loan principal	$ 1,208,884	$ 1,285,921	$ 888,363

The changes in capital assets and long term debt are discussed in Notes 4 and 6 of the accompanying Notes to Financial Statements.

PNCC's deficiency includes the excess of the carrying value of the long-term debt over net assets invested in capital assets. The primary reason for the deficiency is the higher rate of depreciation compared to the repayment of the long-term debt.

HIGHLIGHTS OF PNCC'S STRATEGIC PLANS

PNCC maintains a 5-Year Strategic Plan that seek to continue improvement of telecommunication services throughout the Republic of Palau.

Telephone

Fixed Line service area constitutes 72% of operating expenses while contributing only 37% to total revenues. Plans are in place to optimize revenue opportunities including bundling of service, increase long distance revenues and minimize expenses. Negotiations are continuing with providers to reduce satellite capacity costs which would result in reduction of telephony associated costs.

GSM Mobile Service

The Service Level Agreement (SLA) with Chunghwa Telecom Company of Taiwan has resulted in expanded GSM coverage in Babeldaob and throughout the Republic of Palau. GSM mobile service has continued to increase in revenues since 2005 when PNCC switched from an analog to digital system. GSM mobile service contributes approximately 35% to total revenues and constitutes only 8% of the total operating expenses.

Plans are in place to continue expansion of service coverage in Babeldaob, particularly on Compact Road. Additional GSM services and features including international roaming, General Packet Radio Services (GPRS), load sharing and others are under testing and should become operational in the near future.

Internet

Presently, PNCC pays on average $2,800 a month for 1 mega-bite of satellite bandwidth to support internet service in Palau. This very high cost of bandwidth limits customer ability to subscribe for this service. Negotiations with bandwidth providers are continuing in efforts to reduce costs and to enable PNCC to offer this service at affordable rates to all customers.

PNCC is looking into possibilities of submarine fiber optic cable to connect Palau to the rest of the world. A sub-optic cable will require tremendous amount of upfront capital investment, but this investment would open all sorts of opportunities to PNCC and to the Republic of Palau. Physical cable connection between Palau and outside world will eliminate the need for costly satellite bandwidth.

Digital Television (DTV)

Much improvement has gone into cable TV service in Palau. In 2006, PNCC switched from analog to a complete digital system. This new system has enabled PNCC to offer much better quality and varied programs.

Plans are in place to offer more added value services including Near-Video On Demand (NVOD), Pay-Per View (PPV), and video games which are all possible with the digital system.

A sub-optic cable connection to outside world will enable PNCC to access more programs from different sources including those from the United States.

CONTACTING PNCC'S FINANCIAL MANAGEMENT

The Management's Discussion and Analysis is designed to provide a general overview of PNCC's finances and to demonstrate PNCC's transparency and accountability for the money it receives. The discussion and analysis explains the major factors impacting the 2011 financial statements. If you have questions or need additional information, please contact the Chief Financial Officer at the Palau National Communications Corporation, P.O. Box 99, Koror, Republic of Palau 96940, or e-mail leot@palaunet.com or call 587-9000.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Net Deficiency
December 31, 2011 and 2010

ASSETS

	2011	2010
Current assets:		
Cash (Notes 2, 3 and 6)	$ 441,384	$ 612,798
Time certificate of deposit (Notes 2, 3 and 6)	628,899	625,459
Receivables: (Notes 2 and 6)		
Trade	4,090,701	3,814,873
Related party (Note 5)	332,751	270,953
Carrier, net	429,502	236,544
Other receivable	95,637	52,481
Allowance for doubtful accounts (Note 2)	(3,503,641)	(3,195,114)
Total receivables, net	1,444,950	1,179,737
Inventories (Notes 2 and 6)	202,083	306,052
Prepaid expenses	79,139	58,083
Total current assets	2,796,455	2,782,129
Restricted cash and cash equivalents (Notes 2, 3 and 6)	3,853,481	3,855,830
Other noncurrent assets	51,550	51,500
Property, plant and equipment, net (Notes 2, 4, 6 and 7)	20,101,930	21,836,420
	$ 26,803,416	$ 28,525,879

LIABILITIES AND NET DEFICIENCY

	2011	2010
Current liabilities:		
Accounts payable	$ 59,800	$ 5,645
Payable to carriers, net	99,175	49,127
Accrued expenses (Note 2)	573,350	446,992
Deferred revenues (Note 2)	40,966	40,966
Customer deposits (Note 2)	569,193	531,326
Current portion of long-term debt (Note 6)	1,389,381	1,326,034
Total current liabilities	2,731,865	2,400,090
Note payable, net of current portion (Note 6)	28,125,621	29,397,852
Total liabilities	30,857,486	31,797,942
Commitments and contingencies (Note 7)		
Net deficiency (Note 2):		
Invested in capital assets, net of related debt	(9,413,072)	(8,887,466)
Restricted - nonexpendable	3,853,481	3,855,830
Unrestricted	1,505,521	1,759,573
Total net deficiency	(4,054,070)	(3,272,063)
	$ 26,803,416	$ 28,525,879

See accompanying notes to financial statements.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Revenues, Expenses and Changes in Net Deficiency
Years Ended December 31, 2011 and 2010

	2011	2010
Operating revenues (Note 6):		
Cellular	$ 3,359,520	$ 2,894,006
Palaunet	2,077,983	1,866,938
Local	1,499,031	1,445,873
Long distance	1,429,346	1,541,586
Digital television	1,362,971	1,322,768
Miscellaneous	396,491	283,715
Provision for doubtful accounts	(308,527)	-
Total operating revenues	9,816,815	9,354,886
Operating expenses:		
Plant specific		
Operations	3,645,761	3,360,920
Depreciation	2,733,481	3,013,918
Corporate office	1,293,130	1,225,889
Customer service	1,241,342	1,299,026
Plant non-specific operations	317,894	271,569
Total operating expenses	9,231,608	9,171,322
Earnings from operations	585,207	183,564
Nonoperating income (expenses):		
Interest income	3,975	7,073
Interest expense	(1,387,088)	(1,426,595)
Other income (expenses), net	15,899	(43,674)
Total nonoperating income (expenses), net	(1,367,214)	(1,463,196)
Change in net deficiency	(782,007)	(1,279,632)
Net deficiency at beginning of year	(3,272,063)	(1,992,431)
Net deficiency at end of year	$ (4,054,070)	$ (3,272,063)

See accompanying notes to financial statements.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Cash Flows
Years Ended December 31, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Cash received from customers	$ 9,649,026	$ 9,123,743
Cash payments to suppliers for goods and services	(4,450,037)	(3,919,502)
Cash payments to employees	(1,778,324)	(2,166,507)
Net cash provided by operating activities	3,420,665	3,037,734
Cash flows from capital and related financing activities:		
Additions to property, plant and equipment	(998,991)	(877,499)
Withdrawals from restricted cash and cash equivalents	2,349	22,790
Interest paid	(1,387,088)	(1,426,595)
Repayment of long-term note payable, net	(1,208,884)	(1,285,921)
Net cash used for capital and related financing activities	(3,592,614)	(3,567,225)
Cash flows from investing activities:		
Interest income	3,975	7,073
Increase in time certificate of deposits	(3,440)	(6,444)
Net cash used for investing activities	535	629
Net decrease in cash	(171,414)	(528,862)
Cash at beginning of year	612,798	1,141,660
Cash at end of year	$ 441,384	$ 612,798

See accompanying notes to financial statements.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Statements of Cash Flows, Continued
Years Ended December 31, 2011 and 2010

	2011	2010
Reconciliation of earnings from operations to net cash provided by operating activities:		
Earnings from operations	$ 585,207	$ 183,564
Adjustments to reconcile earnings from operations to net cash provided by operating activities:		
Depreciation	2,733,481	3,013,918
Provision for doubtful accounts	308,527	-
Loss on retirement of equipment	-	9,215
Other income (expense), net	15,899	(52,889)
(Increase) decrease in assets:		
Receivables:		
Trade	(275,828)	(309,591)
Related party	(61,798)	(72,916)
Carriers, net	(192,958)	217,998
Other receivable	(43,156)	(1,257)
Inventories	103,969	27,116
Prepaid expenses	(21,056)	(20,263)
Other noncurrent assets	(50)	(528)
Increase (decrease) in liabilities:		
Accounts payable	54,155	(33,218)
Payable to carriers, net	50,048	-
Accrued expenses	126,358	97,760
Customer deposits	37,867	26,222
Deferred revenues	-	(47,397)
Net cash provided by operating activities	$ 3,420,665	$ 3,037,734

See accompanying notes to financial statements.

(1) Organization

Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau (ROP), was created on August 23, 1982, under the provisions of the Republic of Palau Public Law (RPPL) 1-40. The law created a wholly owned government corporation managed by five (5) Board of Directors appointed by the President of the ROP, with the advice and consent of the Senate of the Olbiil Era Kelulau (ROP National Congress).

The primary purpose of PNCC is to establish and operate communications services as a communication common carrier within the ROP. PNCC conducts its operations on land and in buildings provided by the National Government of the ROP. PNCC has four divisions: PNCC, PNCC Wireless (Wireless), Digital Cable Television (DTV) formerly known as Island Cable Television (ICTV), and Palaunet, which provides local and long distance telephone services, cellular telecommunications services and equipment, digital cable television services, and internet services, respectively, within the ROP.

(2) Summary of Significant Accounting Policies

The accounting policies of PNCC conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically propriety funds. 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 disclosure of contingent assets and 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.

A. Basis of Presentation

The financial statements of PNCC have been prepared in conformity with accounting principles generally accepted in the United States of America as applied to governmental entities. Government Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary and Other Governmental Entities that Use Proprietary Fund Accounting,* requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989.

(2) Summary of Significant Accounting Policies, Continued

A. Basis of Presentation, Continued

PNCC implemented GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Government as amended by* GASB Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments: Omnibus* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. PNCC follows the business-type activities requirements of GASB Statement No. 34. This approach requires the following components of PNCC's financial statements:

- Management's discussion and analysis
- Basic financial statements, including a statement of net assets (deficiency), statement of revenues, expenses and changes in net assets (deficiency) and a statement of cash flows using the direct method; and
- Notes to financial statements

GASB Statement No. 34 established standards for external financial reporting and requires that resources be classified for accounting and reporting purposes into the following three net asset categories:

Invested in capital assets, net of related debt:

Capital assets net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvements of those assets.

Restricted net assets:

Nonexpendable: Net assets subject to externally imposed stipulations that require PNCC to maintain them permanently.

Expendable: Net assets whose use by PNCC is subject to externally imposed stipulations that can be fulfilled by actions of PNCC pursuant to those stipulations or release of those stipulations by the passage of time.

Assets that have been assigned as collateral for the Rural Utilities Service (RUS) loan are classified as restricted.

Unrestricted:

Net assets are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

(2) Summary of Significant Accounting Policies, Continued

B. Measurement Focus and Basis of Accounting

Basis of accounting refers to the timing of recognition, that is, when revenues and expenditures are recognized in the accounts and reported in the financial statements. Basis of accounting relates to the timing of the measurement made, regardless of the measurement focus applied.

The accrual basis of accounting is utilized by propriety funds. Under the accrual method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred. The accrual basis of accounting is used by PNCC.

PNCC maintains a chart of accounts in accordance with the Uniform System of Accounts for telephone companies of the United States of America Federal Communication Commission’s Rules, and in conformity with accounting principles generally accepted in the United States of America (GAAP).

C. 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 disclosure of contingent assets and 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.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for uncollectible accounts receivable, and management estimate of depreciation expense which is based on estimated useful lives of the respective assets. The allowance for uncollectible accounts receivable is determined based on management estimates. While management believes the amount is adequate, the ultimate uncollectible balance may differ from the amounts provided.

D. Budget

In accordance with the ROP Code, the Board of Directors of PNCC adopts an annual budget on a proprietary fund basis and is used as a management tool throughout the accounting cycle. All operating and capital expenditures and revenues are identified in the budgeting process. PNCC’s Budget is presented to the Olbiil Era Kelulau (OEK) for its review and comments no later than sixty days (60 days) before the budget’s effective date (November 1). Pursuant to regulation of the ROP, after PNCC has repaid the RUS loan, PNCC is required to submit a detailed and itemized budget to the OEK for its approval no later than 60 days before it is to take effect.

Throughout the fiscal year, PNCC monitors and evaluates expenditure levels and patterns. The Board of Directors may authorize revisions to the budget based on the availability of financial resources. Formal budget revisions are authorized in the same manner as original budget submissions.

(2) Summary of Significant Accounting Policies, Continued

D. Budget, Continued

The supplementary information in the Management Discussion and Analysis in pages 3 to 8 includes PNCC's analysis of the significant variations and major factors impacting the 2011 and prior years within its five year strategic plan and the currently known reasons for those significant variations that PNCC expects to affect its liquidity or ability to provide future services.

E. New Accounting Standards

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus*. The Statement updates and improves existing standards regarding financial reporting of certain financial instruments and external pools. The Statement is effective for financial statements prepared by state and local governments for periods beginning after June 15, 2010, with earlier application encouraged. The implementation of this Statement did not have a material effect on the accompanying financial statements of the PNCC.

In November 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. The objective of this Statement is to improve financial reporting by addressing issues related to service concession arrangements (SCAs), which are a type of public-private or public-public partnership. As used in this Statement, an SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental entity) in which (1) the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset (a "facility") in exchange for significant consideration and (2) the operator collects and is compensated by fees from third parties. The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2011. The provisions of this Statement generally are required to be applied retroactively for all periods presented. PNCC's management has not yet evaluated the effect of this Statement on PNCC's financial statements.

In November 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus* – an amendment of GASB Statements No. 14 and 34. The objective of this Statement is to improve financial reporting for a governmental financial reporting entity. The requirements of Statement No. 14 *The Financial Reporting Entity, and the related financial reporting requirements of Statement No. 34, Basic Financial Statements – and Management's Discussion and Analysis - for Statement and Local Governments* were amended to better meet user needs and to address reporting entity issues that have been arisen since the issuance of those Statements. The provisions of this Statement are effective for financials statements for periods beginning after June 15, 2012. Earlier application is encouraged. PNCC's management has not yet evaluated the effect of this Statement on PNCC's financial statements.

(2) Summary of Significant Accounting Policies, Continued

E. New Accounting Standards, continued

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The objective of this Statement is to incorporates into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the pronouncements issued on before November 30, 1989, which does not conflict with or contradict GASB pronouncements:

1. Financial Accounting Standards Board (FASB) Statements and Interpretations.
2. Accounting Principles Board Opinions.
3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure.

Hereinafter, the pronouncements collectively are referred to as the "FASB and AICPA pronouncements."

This Statement also supersedes Statement No. 20, *Accounting and Financial Reporting for Propriety Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, thereby eliminating the election provided in paragraph 7 of that Statement for enterprise funds and business-type activities to apply post-November 30, 1989 FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements. However, those entities can continue to apply, as other accounting literature, post-November 30, 1989 FASB pronouncements that do not conflict with or contradict GASB pronouncements, including this Statement. The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2011. Earlier application is encouraged. The provisions of this Statement generally are required to be retroactive application for all periods presented.

In June 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The requirements of this Statement will improve financial reporting by standardizing the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. It alleviates uncertainty about reporting those financial statement elements by providing guidance where none previously existed. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2011. Earlier application is encouraged.

PNCC has not yet evaluated the effect of GASB Statement Nos. 62 and 63 on its financial statements.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Deficiency

Cash and Time Certificates of Deposit

Cash in the statement of cash flows includes cash on hand and cash in checking and savings accounts.

Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified in the Statements of Net Deficiency.

Restricted Cash and Cash equivalents

Restricted cash and cash equivalents, including amounts restricted for repayment of debt owed to Rural Utilities Service (RUS), amounts restricted for contracts approved by the RUS and RUS revenues, are separately classified in the Statements of Net Deficiency.

Receivables and Allowance for Doubtful Accounts

PNCC grants credit, on an unsecured basis to individuals, businesses and governmental entities that are situated in the Republic of Palau, the United States of America, Japan and the Territory of Guam.

The allowance for doubtful accounts is stated at an amount which 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 provision for uncollectible receivables charged to expense.

Inventories

Inventories comprise telecommunication equipments, parts and cables and are stated at the lower of cost (average cost method) or market.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Deficiency

Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation and any impairment in value. Depreciation expense is provided using the straight-line method over the estimated useful lives of the respective assets. Major improvements and betterments which increase the usefulness and efficiency or prolong the life of the asset are capitalized, while the costs of maintenance and repairs, including the cost of replacing minor items not constituting substantial betterments, are charged to expense as these costs are incurred.

Depreciation expense for all property, plant and equipment is provided for on the straight-line basis over the following estimated useful lives:

	Estimated Useful Lives
Telecommunications equipment	5 - 25 years
Central office equipment	3 - 17 years
Building and general support equipment	3 - 30 years
Cable television equipment	2 - 20 years
Wireless equipment	3 - 15 years
Vehicles	6 years
Furniture and fixtures	5 – 10 years

Compensated Absences

Compensated absences are those absences for which employees will paid, such as annual vacation leave and health (sick) leave. PNCC recognizes all vested vacation leave benefits accrued by its employees when earned. Employees are credited annual leave with pay of 80, 120, and 160 hours per year depending upon their length of service with PNCC. An employee cannot carry-over to the following calendar year accumulated annual vacation leave in excess of 80 hours for 5 to 9 years of service, and 120 hours for employees with over 10 years of service. However, carry-over of additional annual leave may be allowed upon request and approval by the Management when it is determined to be in the interest of PNCC.

At December 31, 2011 and 2010, accrued annual leave totaled $88,721 and $81,209, respectively, and is reported in the Statements of Net Deficiency as a component of accrued expenses. At December 31, 2011 and 2010, all compensated absences are current.

For the years ended December 31, 2011 and 2010, annual vacation leave taken totaled $90,045 and $82,625, respectively and is reported in the Statement of Revenues, Expenses and Changes in Net Deficiency as a component of operating expenses. No liability is recorded for non-vesting accumulating rights to receive health or sick pay benefits.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Deficiency

Deferred revenues

Deferred revenues consist of prepaid long distance sales which actual traffic minutes were processed after the reporting period. At December 31, 2011 and 2010, deferred revenues were $40,966 in each year.

Customer deposits

Customer deposits consist of subscriber deposits, installation fees and amounts received for related services and subscriptions to be provided in future periods. At December 31, 2011 and 2010, customer deposits were $569,173 and $531,326, respectively.

Advertising Costs

Advertising costs are expensed as incurred. At December 31, 2011 and 2010, advertising costs totaled $33,909 and $29,390, respectively, and is included as a component of customer operations expense reported in the Statements of Revenues, Expenses and Changes in Net Deficiency.

Retirement Plan, Republic of Palau Civil Service Pension Trust Fund

PNCC contributes to the Palau Civil Service Pension Trust Fund (the Fund), a defined benefit, cost-sharing, multi-employer pension plan established and administered by the Republic of Palau.

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 (2%) 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. RPPL 2-26 is the authority under which benefit provisions are established. Member contribution rates are established by RPPL 2-26 at six percent (6%) of total payroll and matched dollar-for-dollar by the employer. For the years ended December 31, 2011 and 2010 amounts contributed to the Fund by PNCC totaled $94,708 and $93,397, respectively, and is include in the functional expenses and allocated between plant specific operations, corporate operations, customer service operations, and plant non-specific operations reported in the Statements of Revenues, Expenses and Changes in Net Deficiency.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Deficiency

Retirement Plan, Republic of Palau Civil Service Pension Trust Fund, Continued

Under the provisions of RPPL 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. PNCC's payroll for fiscal years 2011 and 2010 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 issued in August 2010 determined the unfunded pension benefit obligation as follows:

Present value of accrued benefits as of October 1, 2009:	
Participants in pay status	$ 47,666,805
Active Participants	56,060,970
Inactive Participants with vested deferred benefits	1,779,610
Total pension benefit obligation	105,507,385
Less net assets available for benefits, at market value	41,254,319
Unfunded benefit obligation	$ 64,253,066
Funded Ratio as of 10/1/2009 (ratio of assets to liabilities)	39.1%

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. The amount of the unfunded liability that the Fund, and therefore, PNCC, may be liable for, has not been determined and is not included as a liability in the accompanying Statements of Net Deficiency.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Deficiency, Continued

Medical and Life Insurance Benefit

In April 2010, the Republic of Palau (ROP) enacted RPPL No. 8-14 "*The National Healthcare Financing Act*". The law requires each resident in the Republic of Palau to have coverage for healthcare costs. The law establishes a national Medical Savings Fund and a Health Insurance System in the ROP.

In October 2010, in compliance to the requirement of RPPL 8-14, PNCC began withholding amounts from its employees a rate of 2.5% of employee gross earnings each pay period, with a matching employer share (5% for a combined contribution) for remittance to ROP Social Security Administration that administers the Medical Savings Fund and Palau Health Insurance. At December 31, 2011, the liability to the Social Security Administration for the Healthcare Fund was $19,769 and is included as a component of accrued expenses in the Statements of Net Deficiency.

Taxes

Based on the enactment of RPPL 1-40, PNCC is exempt from all national and state non-payroll taxes or fees.

Operating and Non-operating Revenues and Expenses

PNCC's Statements of Revenues, Expenses and Changes in Net Deficiency distinguishes between operating and non-operating revenues and expenses. Operating revenues and expenses result from exchange transactions associated directly from the operation and maintenance of telecommunication services and equipment, cellular telecommunication operations, DTV operations, and palaunet operation services. Nonexchange revenues and expenses results from nonrecurring income and costs such as interest income and expense are reported as non-operating revenues.

Net assets (deficiency)

Net assets represent the residual interest in PNCC's assets after liabilities while net deficit/deficiency represents the excess liability over assets. Net assets deficit consist of three sections: invested in capital assets, net of related debt; restricted expendable and nonexpendable; and unrestricted. Net assets invested in capital assets, net of related debt include capital assets, restricted and unrestricted, net of accumulated depreciate, reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation. At December 31, 2011 and 2010, PNCC has net deficiency totaling $4,054,070 and $3,272,063, respectively.

When program expenses are incurred, were there are both restricted and unrestricted resources available to finance the program, expenses are first applied to restricted resources before using unrestricted resources.

(3) Deposits and Investments Risk

Deposits

At December 31, 2011 and 2010, PNCC's cash balances were deposited in time certificates of deposit, savings and checking accounts. For the years ended December 31, 2011 and 2010, the Federal Deposit Insurance Corporation (FDIC) insures interest bearing accounts up to $250,000 while non-interest bearing accounts are insured without limit until December 31, 2012. From the total bank balance of $1,120,031 in 2011 and $1,339,810 in 2010, only $967,312 and $834,614, respectively are subject to coverage by the FDIC with the remaining balance exceeding insurable limits. PNCC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

Investments (Cash Equivalents)

Governmental accounting standards require that the investments reported as of the balance sheet date be categorized according to level of credit risk associated with the Fund's custodial arrangements at that time. The level of credit risk is defined as follows:

> Category 1 - insured and registered for which the securities are held by the Fund or its agent in the Fund's name;
>
> Category 2 - uninsured and registered for which the securities are held by the broker's or dealer's trust department or agent in the Fund's name; and
>
> Category 3 - uninsured and unregistered for which the securities are held by the broker or dealer or by its trust department or agent but not in the Fund's name.

PNCC does not have a formal investment policy. However, PNCC's investment must comply with Section 22 of the Pledge of Assets and Agreement to Create Trust (Rural Electrification Administration "REA" Loan Agreement), wherein, PNCC is required maintain a funded reserve in such amount that the balance of the funds covered by the First Note shall no time be less than the outstanding principal and unpaid interest of the First Note. The reserve shall be maintained in accordance with a plan submitted to and approved in writing by the Administrator of REA (now the Rural Utilities Service or "RUS"). The balance of the reserve shall comply with this section no later than one year from the date of this first advance of funds covered by the First Note. Thereafter, PNCC must maintain such compliance continuously. Assets held in the reserve must be held by a bank or institution or other depository whose funds are insured by the Federal government and shall consist of (a) Federal government securities held in PNCC's name; (b) other securities by an institution whose senior unsecured debt obligations are rated in any of the top three categories by a nationally recognized rating organization; or (c) cash.

(3) Deposits and Investments Risk

All of PNCC's restricted cash and cash equivalents with market value of $3,853,481 and $3,855,830 as of December 31, 2011 and 2010, respectively, are placed in short-term money market mutual funds held by the Bank of New York Mellon, a FDIC insured financial institutions. Although the money market mutual fund is not insured by the FDIC, this mutual fund portfolio consists of US Treasury bills and obligations guaranteed by the US Department of the Treasury as well as repurchase agreements which are fully collateralized by such obligation. This mutual fund has a weighted average maturity of 45 days and is rated AAAm by Standard and Poor's and AAA-mf by Moody's.

(4) Property, Plant and Equipment

Summarized below are PNCC's property, plant and equipment for the years ended December 31, 2011 and 2010.

December 31, 2011:

	Balance at December 31, 2010	Additions	Transfers/ Retirements	Balance at December 31, 2011
Regulated capital assets				
Cables and transmission lines	$25,765,569	$ 251,477	$ -	$ 26,017,046
Transmission equipment	9,113,000	97,046	-	9,210,046
Buildings	8,839,503	-	-	8,839,503
Central office equipment	3,953,263	58,330	-	4,011,593
General support equipment	2,127,197	94,946	-	2,222,143
Customer premises wiring and equipment	1,050,441	97,302	-	1,147,743
Vehicles	628,882	20,179	-	649,061
Furniture and fixtures	28,517	-	-	28,517
Regulated capital assets, at cost	51,506,372	619,280	-	52,125,652
Accumulated depreciation	(34,603,492)	(2,195,644)	-	(36,799,136)
Regulated capital assets, at net book value	16,902,880	(1,576,364)	-	15,326,516
Non-regulated capital assets				
Cable television	2,864,798	116,004	-	2,980,802
Cellular	5,035,507	114,593	-	5,150,100
Palaunet	683,632	114,651	-	798,283
Non-regulated capital assets, at cost	8,583,937	345,248	-	8,929,185
Accumulated depreciation	(3,829,120)	(537,837)	-	(4,366,957)
Non-regulated capital assets, at net book value	4,754,817	(192,589)	-	4,562,228
Construction in progress	178,723	34,463	-	213,186
Total	$ 21,836,420	$ (1,734,490)	$ -	$ 20,101,930

(4) Property, Plant and Equipment, Continued

December 31, 2010:

	Balance at December 31, 2009	Additions	Transfers/ Retirements	Balance at December 31, 2010
Regulated capital assets				
Cables and transmission lines	$25,694,850	$ 76,874	$ (6,155)	$ 25,765,569
Transmission equipment	9,040,862	72,138	-	9,113,000
Buildings	8,839,503	-	-	8,839,503
Central office equipment	3,890,990	62,273	-	3,953,263
General support equipment	2,038,329	109,595	(20,727)	2,127,197
Customer premises wiring and equipment	932,681	139,757	(21,997)	1,050,441
Vehicles	622,112	12,095	(5,325)	628,882
Furniture and fixtures	28,517	-	-	28,517
Regulated capital assets, at cost	51,087,844	472,732	(54,204)	51,506,372
Accumulated depreciation	(32,155,893)	(2,501,803)	54,204	(34,603,492)
Regulated capital assets, at net book value	18,931,951	(2,029,071)	-	16,902,880
Non-regulated capital assets				
Cable television	2,667,854	267,371	(70,427)	2,864,798
Cellular	5,023,083	23,724	(11,300)	5,035,507
Palaunet	571,296	112,336	-	683,632
Non-regulated capital assets, at cost	8,262,233	403,431	(81,727)	8,583,937
Accumulated depreciation	(3,398,732)	(512,115)	81,727	(3,829,120)
Non-regulated capital assets, at net book value	4,863,501	(108,684)	-	4,754,817
Construction in progress	177,387	1,336	-	178,723
Total	$ 23,972,839	$ (2,136,419)	$ -	$ 21,836,420

Depreciation expense for the years ended December 31, 2011 and 2010 was $2,733,481 and $3,013,918, respectively, and is reported in the Statements of Revenues, Expenses and Changes in Net Deficiency.

(5) Related Party Transactions

In the ordinary course of business, PNCC provides local and long distance telephone services, cellular telecommunications services and equipment, digital cable television services, and internet services, to the National government of the Republic of Palau and its component units. These services are provided at the same service rates and delinquent fees charged to all third-party customers. As of December 31, 2011 and 2010, amounts due from the Republic of Palau and its component units totaled $332,751 and $270,953, respectively.

(6) Long-term debt

Long-term debt as of December 31, 2011 and 2010 are summarized below:

	2011	2010
Mortgage note payable to Rural Utilities Services (RUS) at 4.59% per annum payable in monthly installments of $192,181 and due October 2029. The note is collateralized by substantially all PNCC's assets and a pledge of its revenues.	$27,622,579	$28,450,860
Note payable to Chunghwa Telecom Company in monthly installments of $34,087, non-interest bearing (net of unamortized discount of $281,160 and $385,761 at December 31, 2011 and 2010, respectively) due in July 2017, secured by earth station and ground common equipment.	1,892,423	2,273,026
Total debt	29,515,002	30,723,886
Less current portion	1,389,381	1,326,034
Long-term debt, net of current portion	$28,125,621	$29,397,852

RUS Mortgage Note

The original RUS note of $39,143,000 approved in 1992 was unconditionally guaranteed by ROP, stipulates that ROP will make debt service payments to RUS in the event of default. On April 8, 2009, RUS approved the request of PNCC to rescind the remaining balance of $395,047 of the mortgage note which had not been advanced. The RUS Mortgage and Security Agreement sets out certain financial ratios that must be met before a dividend can be declared. If these ratios are not met, dividends may only be declared with a written approval of RUS.

The management of PNCC believes it is in compliance with the RUS mortgage loan covenants at December 31, 2011 and 2010.

(6) Long-term debt, Continued

Future minimum principal and interest payments for RUS mortgage note for the years ended December 31, are as follows:

Year ending December 31,	Principal	Interest	Total
2012	$ 1,069,682	$ 1,236,490	$ 2,306,172
2013	1,119,826	1,186,346	2,306,172
2014	1,172,321	1,133,851	2,306,172
2015	1,227,278	1,078,894	2,306,172
2016	1,284,810	1,021,362	2,306,172
2017-2021	7,385,982	4,144,878	11,530,860
2022-2026	9,287,284	2,243,576	11,530,860
2027-2029	5,075,396	263,190	5,338,586
	$ 27,622,579	$ 12,308,587	$ 39,931,166

In December 2009, PNCC recorded and capitalized the costs of the build-up of the earth station and related equipment and improvements for PNCC's mobile and satellite network services, in exchange for a non-interest bearing note to Chunghwa Telecom Co. Ltd (CHT), a contractor from Taiwan, Republic of China, totaled $3,067,830, payable monthly in ninety (90) installments of $34,087 including interest, started January 2010 through July 2017. However, to reflect the time value of money, the liability recorded in the financial statements reflects future payments discounted at an imputed interest rate of 4.90%, which was the assumed long-term borrowing rate in December 2009.

At December 31, 2011, the future note payments to CHT are as follows:

Year ending December 31,	Present value of note	Discount Amortization	Total note payments
2012	$ 319,699	$ 89,345	$ 409,044
2013	335,722	73,322	409,044
2014	352,547	56,497	409,044
2015	370,215	38,829	409,044
2016	388,768	20,276	409,044
2017	125,472	2,891	128,363
	$ 1,892,423	$ 281,160	$ 2,173,583

(6) Long-term debt, Continued

Extended Service Level of Agreement (ESLA) with Chunghwa Telecom Co. Ltd.(CHT)

Pursuant to the repayment terms stated in the ESLA, in addition to non-interest bearing note disclosed in the preceding paragraph, PNCC is required to pay a monthly bandwidth fee of $14,000, net of a $1,000 courtesy discount, throughout the term of the note agreement maturing July 2017. Future commitments of PNCC related to the satellite network bandwidth fees with CHT are further discussed in Note 7. For the years ended December 31, 2011 and 2010, bandwidth fees paid to CHT under this ESLA agreement totaled $168,000 and $84,000, respectively, and is included as a component of plant specific operations expense reported in the Statements of Revenues, Expenses and Changes in Net Deficiency.

At December 31, 2011 and 2010, the changes in the long-term liabilities are as follows:

2011	Balance January 1, 2011	Additions	Reductions	Balance December 31, 2011	Current	Noncurrent
Rural Utilities Services	$ 28,450,860	$ -	$ 828,281	$27,622,579	$ 1,069,682	$ 26,552,897
Chunghwa Telecom Company, Ltd.(net of unamortized discount of $281,160 in 2011 and $385,761 in 2010)	2,273,026	-	380,603	1,892,423	319,699	1,572,724
	$ 30,723,886	$ -	$ 1,208,884	$29,515,002	$ 1,389,381	$ 28,125,621

2010	Balance January 1, 2010	Additions	Reductions	Balance December 31, 2010	Current	Noncurrent
Rural Utilities Services	$ 29,446,868	$ -	$ 996,008	$28,450,860	$ 1,021,591	$ 27,429,269
Chunghwa Telecom Company, Ltd.(net of unamortized discount of $385,761 in 2010 $504,891 in 2009)	2,562,939	-	289,913	2,273,026	304,443	1,968,583
	$ 32,009,807	$ -	$ 1,285,921	$30,723,886	$ 1,326,034	$ 29,397,852

Interest expense paid in 2011 and 2010 amounted to $1,387,088 and $1,426,595, respectively.

(7) Commitments and Contingencies

Commitments

PNCC has entered into long-term commitments for non-cancelable channel distribution agreements, transition and support services for providers of telecommunication network services, and satellite bandwidth capacity services. The approximate future minimum annual payments under these agreements are as follows:

Year ending December 31,	Amount
2012	$ 713,240
2013	326,881
2014	168,000
2015	168,000
2016	168,000
2017	168,000
	$ 1,712,121

Contingencies

Risk Management

PNCC is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; errors and omissions; employee injuries and illnesses; natural disasters, employee health, dental and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. PNCC is self-insured for buried cables and customer premises wirings.

Claims and Litigation

In the normal course of business, PNCC is involved in various claims and litigation or has received several claims that are pending review or are expected to go to litigation. Management believes that any liability it may incur would not have a material adverse effect on its financial condition or its results of operations.

(8) Fair Value of Financial Instruments

PNCC's financial instruments are cash and cash equivalents, accounts receivable, other assets, accounts payable, accrued expenses, deferred revenue, customer deposits, notes payable, and long-term debt. The recorded values of these instruments for cash and cash equivalents, accounts receivable, and accounts payable, accrued expenses, and deferred revenues, current portion of long-term debt, approximate their fair values based on their short-term nature. The recorded value of customer deposits approximate its fair value as it is the amount payable on demand at the reporting date. The recorded value of RUS note payable approximates its fair value, as interest approximates market rates. The fair value of long-term debt with CHT and related unamortized discount on long-term debt is estimated by discounting the future cash flow using the PNCC'S current borrowing rate for similar types and maturities of debt.

(9) Review of Carrying Value of Property Equipment for Impairment

PNCC reviews the carrying value of property, plant, and equipment for impairment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of assets. The factors considered by management in performing this assessment include current operating results, trends, and prospects, as well as the effects of obsolescence, demand, competition, and other economic factors. The management of PNCC does not believe that any impairment exists for the years ending December 31, 2011 and 2010.

(10) Reclassifications of Account Balances

Certain amounts presented in 2010 have been reclassified to conform to 2011 financial statement presentation. These reclassifications had no effect on previously reported results of operations or net assets.

(11) Subsequent Events

PNCC evaluated subsequent events from December 31, 2011 through May 7, 2012 the date the financial statements were available to be issued. PNCC did not note any subsequent events requiring disclosure or adjustments to the Statements of Net Deficiency.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

SUPLEMENTARY SCHEDULES

Year Ended December 31, 2011

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Supplementary Schedule of
Budget vs Actual (GAAP Basis)
Year Ended December 31, 2011

	Budget				Variance
	Original	Revisions	Final	Actual	Favorable (Unfavorable)
Operating revenues:					
Cellular	$ 4,074,909	$ -	$ 4,074,909	$ 3,359,520	$ (715,389)
Long distance	1,446,836	-	1,446,836	1,429,346	(17,490)
Palaunet	2,034,409	-	2,034,409	2,077,983	43,574
Local	1,478,607	-	1,478,607	1,499,031	20,424
Digital television	1,366,875	-	1,366,875	1,362,971	(3,904)
Miscellaneous	450,000	-	450,000	396,491	(53,509)
Provision for doubtful accounts	-	-	-	(308,527)	(308,527)
Total operating revenues	10,851,636	-	10,851,636	9,816,815	(1,034,821)
Operating expenses:					
Depreciation	2,964,409	-	2,964,409	2,733,481	230,928
Plant specific operations	3,425,302	-	3,425,302	3,645,761	(220,459)
Corporate operations	1,823,497	-	1,823,497	1,293,130	530,367
Customer service operations	1,014,942	-	1,014,942	1,241,342	(226,400)
Plant non-specific operations	379,723	-	379,723	317,894	61,829
Total operating expenses	9,607,873	-	9,607,873	9,231,608	376,265
Earnings from operations	1,243,763	-	1,243,763	585,207	(658,556)
Nonoperating income (expenses):					
Interest income	12,105	-	12,105	3,975	(8,130)
Interest expense	(1,162,500)	-	(1,162,500)	(1,387,088)	(224,588)
Other income (expenses), net	(42,566)	-	(42,566)	15,899	58,465
Total nonoperating income (expenses), net	(1,192,961)	-	(1,192,961)	(1,367,214)	(174,253)
Change in net deficiency	$ 50,802	$ -	$ 50,802	$ (782,007)	$ (832,809)

See Accompanying Independent Auditor's Report.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Supplementary Schedule of Functional Expenses
Year Ended December 31, 2011
(With Comparative Totals for 2010)

	Plant Specific					Plant	Total	
				Customer		non-specific	Operating Expenses	
	Depreciation	Operation	Corporate	Relations	Total	operations	2011	2010
Depreciation	$ 2,733,481	$ -	$ -	$ -	$ 2,733,481	$ -	$ 2,733,481	$ 3,013,918
Outside services	-	1,632,656	152,976	860,122	2,645,754	1,573	2,647,327	2,646,907
Salaries and wages	-	532,920	565,798	235,948	1,334,666	192,298	1,526,964	1,490,001
Utilities	-	758,145	290	-	758,435	-	758,435	671,917
Payroll burden	-	261,721	223,991	123,057	608,769	96,218	704,987	563,727
Training	-	149,450	138,432	7,713	295,595	4,235	299,830	235,340
Others	-	22,634	69,039	2,749	94,422	6,931	101,353	137,225
Materials and supplies	-	67,714	29,852	9,828	107,394	4,296	111,690	132,927
Clearance	-	106,563	-	-	106,563	350	106,913	149,732
Inventory obsolescence	-	90,791	-	-	90,791	-	90,791	-
Insurance	-	-	59,616	-	59,616	-	59,616	52,869
Fuel	-	21,267	7,621	1,925	30,813	11,825	42,638	18,134
Postage	-	-	20,652	-	20,652	-	20,652	17,955
Board fees	-	-	11,113	-	11,113	-	11,113	8,365
Legal fees	-	-	11,000	-	11,000	-	11,000	26,000
Rent	-	1,900	2,750	-	4,650	168	4,818	6,305
	$ 2,733,481	$ 3,645,761	$ 1,293,130	$ 1,241,342	$ 8,913,714	$ 317,894	$ 9,231,608	$ 9,171,322

See Accompanying Independent Auditor's Report.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Supplementary Schedule of Functional Expenses by Division
Year Ended December 31, 2011

	Depreciation	Operation	Corporate	Customer Relations	Total
Telephony					
Depreciation	$ 2,195,644	$ -	$ -	$ -	$ 2,195,644
Salaries and wages	-	296,099	555,414	235,948	1,087,461
Outside services	-	538,749	151,369	46,424	736,542
Utilities	-	714,869	-	-	714,869
Payroll burden	-	151,792	217,023	123,057	491,872
Training	-	11,415	138,432	7,713	157,560
Materials and supplies	-	55,967	29,066	9,788	94,821
Inventory obsolescence	-	90,791	-	-	90,791
Clearance	-	68,768	-	-	68,768
Insurance	-	-	59,616	-	59,616
Others	-	5,462	42,102	1,165	48,729
Fuel	-	21,267	5,283	1,925	28,475
Postage	-	-	20,652	-	20,652
Board fees	-	-	11,113	-	11,113
Legal fees	-	-	11,000	-	11,000
Rent	-	-	2,750	-	2,750
Allocation	-	-	(277,194)	(97,097)	(374,291)
	2,195,644	1,955,179	966,626	328,923	5,446,372
Cellular					
Depreciation	359,052	-	-	-	359,052
Training	-	137,183	-	-	137,183
Salaries and wages	-	46,067	8,738	-	54,805
Utilities	-	42,002	290	-	42,292
Others	-	3,485	26,843	-	30,328
Payroll burden	-	17,501	4,329	-	21,830
Fuel	-	-	2,338	-	2,338
Rent	-	1,900	-	-	1,900
Materials and supplies	-	436	588	-	1,024
Outside services	-	-	661	-	661
Allocation	-	-	92,694	35,671	128,365
	359,052	248,574	136,481	35,671	779,778
Palaunet					
Outside services	-	1,005,184	-	-	1,005,184
Depreciation	65,890	-	-	-	65,890
Salaries and wages	-	54,414	-	-	54,414
Payroll burden	-	23,348	-	-	23,348
Clearance	-	13,255	-	-	13,255
Others	-	12,073	-	-	12,073
Materials and supplies	-	2,200	-	-	2,200
Training	-	852	-	-	852
Allocation	-	-	55,350	31,255	86,605
	65,890	1,111,326	55,350	31,255	1,263,821
Digital TV					
Outside services	-	88,723	946	813,698	903,367
Salaries and wages	-	136,340	1,646	-	137,986
Depreciation	112,895	-	-	-	112,895
Payroll burden	-	69,080	2,639	-	71,719
Clearance	-	24,540	-	-	24,540
Materials and supplies	-	9,111	198	40	9,349
Others	-	1,614	94	1,584	3,292
Utilities	-	1,274	-	-	1,274
Allocation	-	-	129,150	30,171	159,321
	112,895	330,682	134,673	845,493	1,423,743
	$ 2,733,481	$ 3,645,761	$ 1,293,130	$ 1,241,342	$ 8,913,714

See Accompanying Independent Auditor's Report.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

Year Ended December 31, 2011

J. Scott Magliari & COMPANY

CERTIFIED PUBLIC ACCOUNTANT

SAIPAN
Family Building, Suite 201
PMB 297 Box 10000
Saipan, MP 96950
Tel Nos. (670) 233-1837/0456
Fax No. (670) 233-8214

GUAM
Reflection Center, Suite 204
P.O. Box 12734
Tamuning, GU 96931
Tel Nos. (671) 472-2680/2687
Fax No. (671) 472-2686

PALAU
PIDC Apartment No. 11
P.O. Box 1266
Koror, PW 96940
Tel No. (680) 488-8615
Fax No. (680) 488-8616

INDEPENDENT AUDITOR'S 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*

The Board of Directors
Palau National Communications Corporation

I have audited the financial statements of the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, as of and for the year ended December 31, 2011, and have issued my report thereon dated May 7, 2012. I conducted my audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing my audit, I considered PNCC's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PNCC's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of PNCC's internal control over financial reporting.

My consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings and Responses, I identified certain deficiencies in internal control over financial reporting that I consider to be material weaknesses and other deficiencies that I consider to be significant deficiencies.

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. I consider that deficiencies described in the accompanying Schedule of Findings and Responses as items 11-01 through 11-04, to be material weaknesses.

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. I consider that deficiency described in the accompanying Schedule of Findings and Responses as item 11-05 to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PNCC's financial statements are free of material misstatement, I 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 my audit and, accordingly, I do not express such an opinion. The results of my tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

I noted certain matters that I reported to the management of PNCC in a separate letter dated May 7, 2012.

PNCC's responses to the findings identified in my audit are described in the accompanying Schedule of Findings and Responses. I did not audit PNCC's responses and, accordingly, I express no opinion on them.

This report is intended solely for the information of the management of PNCC, the Board of Directors, the Rural Utilities Service and the cognizant audit and other federal agencies and is not intended to be and should not be used by anyone other than these specified parties. However, this report is also a matter of public record.

J. Scott Magliari & Company

Koror, Republic of Palau
May 7, 2012

Finding No.: 11-01
Area : Financial Reporting

Criteria:

Pursuant to GASB Statement No. 34, the reporting requirements for contributed capital and retained earnings have completely changed. As stated in paragraph 98 of GASB Statement No. 34, governments are now required to report proprietary fund net assets or fund equity in three net assets categories (Invested in capital assets, net of related debt, restricted net assets, and unrestricted net assets). "Retained earnings", "contributed capital" and "designations" should no longer be used on the face of the proprietary fund financial statements. Also, capital contributions are no longer reported as direct additions to the fund equity but are reported in the all-inclusive statement of revenues, and changes in net assets.

Condition:

The PNCC's internal financial statements and current design of financial reporting at December 31, 2011, required the auditor's assistance to perform annual procedures to convert the PNCC's internal financial reporting to the reporting requirement of GASB Statement 34. Additionally, the PNCC's financial statements still reflect fund equity terms such as "Contributed Capital", "Retained Earnings" and "Current Year Earnings" instead of Net Assets and Changes in Net Assets.

Cause:

The existing JSI Solutions Accounting System used for financial reporting has not been updated to conform to current changes implemented by the Governmental Accounting Standards Board.

Effect:

Management may only be able to see the components of its equity section reported under GASB Statement 34 at year-end in its audited financial statements.

Prior Year Status:

The above condition is cited in the 2009 and 2010 audits of PNCC.

Finding No.: 11-01, Continued
Area : Financial Reporting

Recommendation:

The Chief Financial Officer and the Accounting Manager should convert the existing account structure in the accounting system to conform to the GASB Statement No. 34 equity reporting requirements. Management may need the assistance of the JSI Technical support personnel to make the necessary revisions.

Auditee Response and Corrective Action Plan:

PNCC agrees that the current accounting (JSI) system does have technical deficiencies including inability to conform to GASB reporting requirements. We have received notice from the system's vendor that a new upgraded version is to be rolled out in December 2012. In the meantime, PNCC is in the final stage of procuring a new Customer Care & Billing System (CCBS) with option to include a complete accounting module able to serve the accounting needs of PNCC.

Therefore, PNCC is seriously looking at the two options: (1) stay with JSI and get the upgrades; or (2) go with new accounting module with the CCBS system. Whichever system is chosen, PNCC will make sure the system is be able conform to RUS and more importantly GASB accounting standards. The new system should be able to link with new Customer Care (Billing) system so as to provide accurate real time data which should help alleviate many of the issues we currently face.

Person(s) responsible: General Manager, CFO and the whole Management Team of PNCC.

Timeline: On April 2012, PNCC received the approval from RUS for the purchase of the CCBS System. It is anticipated the new CCBS system and the accounting system will be commissioned by end of 2012.

Finding No.: 11-02
Area : Accounts receivable

Criteria:

Accounting principles generally accepted in the United States of America require the reconciliation of the general ledger accounts to the subsidiary ledgers on a periodic and timely basis. Any differences should be investigated and resolved in a timely manner.

Condition:

The periodic analysis and reconciliation of the accounts receivable subsidiary ledger to the general ledger and the resulting variances noted do not correct the misstatements between the two controlling accounts. Current efforts are being made to periodically evaluate and analyze the cause of the variances; however, a deficiency in internal control still exists over reconciliation of accounts receivable.

There appears a timing difference for when reconciling items in the Monthly Billed Revenue Report are posted in the general ledger. At December 31, 2011, the variance between the accounts receivable per the Monthly Billed Revenue Report balance and the general ledger balance was $60,301. There were also a variance between the receivable from the Monthly Billed Revenue Report and the overall Aging Debtor's Report of $52,061. The total variance between the general ledger the Aging Debtor's Report was 112,362.

Cause:

There are no procedures or internal controls in place to monitor and ensure reconciling amounts are ultimately posted in the general ledger control account for accounts receivable.

Effect:

There is no material effect in the financial statements; however, when variances occur and are not properly identified and reconciled, the possibility of fraud, errors or irregularities may exist and not be detected or corrected in a timely manner.

Prior Year Status:

The lack of reconciliation and inadequate control over accounts receivable, was cited as finding in the audits of PNCC for the years 2005 through 2010.

Finding No.: 11-02, Continued
Area : Accounts receivable

Recommendation:

The Chief Financial officer (CFO), in coordination with the Accounting Manager, should establish and implement internal control policies and procedures to reconcile accounts receivables in a timely manner. The reconciliation should be performed by the Senior Accountant and reconciling items identified should be substantiated and reviewed by the Accounting Manager for completeness, approved by the CFO prior to posting in the general ledger and monitored to ensure that such reconciling are properly posted in a timely manner.

Auditee Response and Corrective Action Plan:

It is a general practice and common expectation that monthly reconciliations take place to reconcile subsidiary ledgers with the general ledger. Existing reconciliation procedures will be reviewed and if necessary improved to ensure full compliance. PNCC agrees with the recommendation that reconciliation should be performed and reconciling items identified are substantiated, reviewed and approved prior to posting. It is anticipated that the new accounting system should be able to eliminate some of the recurring discrepancies between account balances.

Person(s) responsible: CFO and Accounting Manager

Timeline: Immediately and on-going even after the new system is fully operational.

Finding No.: 11-03
Area : Reconciliations

Criteria:

Generally accepted accounting principles require general ledger balances be reconciled to the detail subsidiary ledgers in a timely manner.

Condition:

The audit schedules and subsidiary ledgers provided did not agree with the general ledger balances for the following accounts:

General ledger account	Per General Ledger 12/31/2011	Per Subsidiary Ledger/ and or provided schedule 12/31/2011	Overstated (Understated)
Materials inventory	$ 292,863.20	$ 304,745.60	$ (11,882.40)
Prepaid insurance	22,907.10	14,808.42	8,098.68
Prepaid others	56,231.79	55,308.11	923.68
Receivable from CHT	32,511.69	21,906.29	10,605.40
Other receivable	95,637.22	100,956.09	(5,318.87)
Accrued annual leave	88,395.22	85,874.60	2,520.62
Customer deposits	569,192.20	552,057.04	17,135.16
Accrued expenses	333,538.25	322,779.11	10,759.14
	$ 1,491,276.67	$ 1,458,435.26	$ 32,841.41

Cause:

There is a lack of internal policies and procedures to monitor and ensure that the general ledger balances are reconciled in a timely manner.

Effect:

The net possible misstatements in the operating results arising from the above variances is $32,841.41.

Prior Year Status:

The lack of timely reconciliation was cited as finding in the prior year audits of PNCC for the years 2005 through 2010.

Recommendation:

PNCC Management should strengthen existing internal control over reconciliations and timely postings of bookkeeping adjustments arising from reconciliation procedures. Periodic monitoring and review should be independently performed and documented to ensure policies and procedures are being adhered to and reconciliations are being performed in a timely manner.

Finding No.: 11-03, Continued
Area : Reconciliations

Auditee Response and Corrective Action Plan:

Despite the shortcomings of the current Accounting System, if timely and consistent reconciliations are carried out, discrepancies between subsidiary ledger and general ledger amounts should not be an issue. Therefore, PNCC agrees that control and monitoring efforts will be strengthened to ensure timely reconciliations and postings booking adjustments take place. To demonstrate PNCC's commitment to improving the reconciliation process, the number of accounts with variance decreased from 14 in 2010 to 8 in 2011.

Person(s) responsible: CFO will work closely with the Accounting Manager to ensure timely and proper reconciliations take place as required.

Timeline: Immediately

Finding No.: 11-04
Area : Allowance for Doubtful Accounts

Criteria:

Policies and procedures should be maintained related to calculating an allowance for uncollectible accounts receivable. The purpose of this policy and procedure is to document the process for estimating the allowance for doubtful accounts for accounts receivable. Proper internal controls over financial reporting require that an allowance for uncollectible accounts receivable be calculated and reported in a timely manner. These policies and procedures should include a formal written credit approval policies and procedures to manage and reduce the risk of write off of uncollectible accounts receivable.

Condition:

PNCC has no written policies and procedures for calculating allowance for doubtful accounts, recording of bad debts expense, and write-off of accounts receivable.

At December 31, 2011, before audit adjustments, the allowance for doubtful accounts was at $3,195,114 which remains at the same level since 2009. This bad debt reserve represents 65% of the PNCC's total accounts receivable. The individual account balances comprising the allowance of $3,195,114 have not been properly evaluated for collectability and potential write-off.

During the 2011 audit I proposed a $308,527 adjustment to increase the allowance for doubtful accounts as follows:

	Allowance Per PNCC	Audit Adjustment	Adjusted	
Trade	$ 2,859,719	$ 308,527	$ 3,168,246	To agree to accounts over 151 days past due
Others	335,395	-	335,395	Direct identification
	$ 3,195,114	$ 308,527	$ 3,503,641	

Cause:

There is a lack of established internal control policies and procedures requiring a monthly and year-end review and assessment of the adequacy of allowance for doubtful of accounts.

Effect:

The accounts receivable and related revenue accounts may be materially misstated by the amounts recorded as revenue that may not collectible. Additionally, the potential exists for inappropriate or fraudulent write-offs to occur and not be detected in a timely manner. Management may make significant decisions based on inaccurate information.

Prior Year Status:

The above condition was cited in the 2009 and 2010 audits of PNCC.

Finding No.: 11-04, Continued
Area : Allowance for doubtful Accounts

Recommendation:

PNCC management should develop and implement internal control policies and procedures related to calculating an allowance for uncollectible for financial reporting purposes and such should performed on a monthly and year-end basis. These policies and procedures should include a formal written credit approval policies and procedures for existing credit; determining of allowance for doubtful accounts, the recording of bad debts; write-off procedures, and formal documentation of the approval process for such determinations.

Management should review its current allowance for doubt and evaluate the potential collectability of the individual customer accounts for potential write-off for financial reporting purposes. Among the significant accounts that should be reviewed are the long outstanding balance due from an international carrier amounting to $136,588.94, which remains unchanged since 2006; and the balance due from a Pachinko Operator amounting to $198,806.45, which has been outstanding since 2002.

Auditee Response and Corrective Action Plan:

After discussions with the auditors, PNCC agrees that more management efforts should be focused on Account Receivables as it has direct impact on revenues. Policies and procedures related to calculating allowance for uncollectible accounts should be established and instituted to address the matter. More efforts will be put into collection of outstanding accounts in order to help PNCC improve its bottom lines and cash position.

Person(s) responsible: CFO, Accounting Manager and the Billing Manager

Timeline: Immediately

Finding No.: 11-05
Area : Reconciliations – Long distance revenue controls

Criteria:

A written policy and procedures should exist to reconcile long distance minutes billed by international carrier amounts to the general ledger control accounts on a monthly and year-end basis.

Condition:

Periodic reconciliations are not performed for long distance revenue particularly for GSM wireless airtime long distance toll. Based on audit procedures performed, using minutes billed by international carriers, the long distance messages revenues recorded per general ledger did not agree to the total long distance minutes billed by International carriers as follows:

	Outbound minutes billed	Long distance revenue rate per minute		Expected long distance revenue totals
Outbound minutes traffic to Philippines	1,277,934	$ 0.28		$ 357,822
Outbound minutes traffic to all other other countries	2,431,319	$ 0.35		850,962
Long distance outbound minutes billed by International carriers during the year ended December 31, 2011	3,709,253	Total long distance revenue		1,208,784
		Less: Long distance revenue per books:		
		Residential		114,475
		Business		569,001
		Government		38,731
		GSM postpaid international		44,820
		Per books, long distance revenue		767,027
		Revenue posted in the cellular operations		$ 441,757

Cause:

There is a lack of internal control policies and procedures to ensure that long distance revenue general ledger control are reconciled with outbound minutes billed by international carriers. There is a deficiency in the system for calculating the actual long distance toll minutes revenue for GSM wireless airtime prepaid card to long distance revenue control totals.

Finding No.: 11-05, Continued
Area : Reconciliations – Long distance revenue controls

Effect:

As a result, the long distance messages revenue totals and cellular prepaid airtime card revenues were misstated. An audit adjustment was made to correct the misstatement.

Cause:

There is a lack of compliance with established internal control policies and procedures over reconciliation of accounts are performed in a timely manner. Additionally, toll call minutes from soft switch maybe not use as basis in determination and recording of actual long distance messages revenue.

Prior Year Status:

The lack of reconciliation of minutes billed by international carriers to long distance revenue control totals was reported as finding in the audit of PNCC for the years 2007 through 2010.

Recommendation:

PNCC should adhere to existing policies and procedures policy over reconciliation of records. Minutes billed by internationals carriers should be reconciled to long distance revenue control on a periodic basis.

Auditee Response and Corrective Action Plan:

Similar to Finding No. 11-03, PNCC will strengthen efforts and focus on control and monitoring of timely reconciliations. Policies and procedures will be enforced to ensure reconciliations take place without fail. PNCC would also ensure that the new CCBS System will address the proper and timely recording of revenues.

Person(s) responsible: CFO

Timeline: Immediately and will continue to improve upon the implementation of the new CCBS system.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

Unresolved Prior Year Comments
Year Ended December 31, 2011

STATUS OF PRIOR YEAR FINDINGS

The status of unresolved prior year findings are disclosed within the Schedule of Findings and Responses section of this report on pages 39 through 48.

PALAU NATIONAL COMMUNICATIONS CORPORATION
(A Component Unit of the Republic of Palau)

MANAGEMENT LETTER

Year Ended December 31, 2011

J. Scott Magliari & COMPANY

CERTIFIED PUBLIC ACCOUNTANT

SAIPAN
Family Building, Suite 201
PMB 297 Box 10000
Saipan, MP 96950
Tel Nos. (670) 233-1837/0456
Fax No. (670) 233-8214

GUAM
Reflection Center, Suite 204
P.O. Box 12734
Tamuning, GU 96931
Tel Nos. (671) 472-2680/2687
Fax No. (671) 472-2686

PALAU
PIDC Apartment No. 11
P.O. Box 1266
Koror, PW 96940
Tel No. (680) 488-8615
Fax No. (680) 488-8616

MANAGEMENT LETTER

Board of Directors
Palau National Communications Corporation

I have audited the financial statements of the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, as of and for the year ended December 31, 2011, and have issued my report thereon dated May 7, 2012. I conducted my audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service (RUS) Borrowers*. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing my audit of the financial statements of PNCC for the year ended December 31, 2011, I considered its internal control over financial reporting in order to determine my auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

Management is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

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.

My consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, I identified certain deficiencies in internal control over financial reporting, described in the Independent Auditor’s 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 dated May 7, 2012, (pages 37 through 38) that I consider to be material weaknesses in internal control over financial reporting.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. However, I identified certain deficiency in internal control over financial reporting, described in the Independent Auditor’s 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 dated May 7, 2012, (pages 37 through 38) that I consider to be a significant deficiency.

7 CFR Part 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. I have grouped my comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, I performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.33(e)(2) and related party transactions. In addition, my audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38-.45. My objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, I express no opinion thereon.

No reports (other than my Independent Auditor’s Report on Financial Statements, my Independent Auditor’s Report on Compliance and 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*, and my separate letter regarding recommendations concerning certain matters related to internal control, all dated May 7, 2012) related to my audit have been furnished to management.

My comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR Part 1773.33 are presented below.

COMMENTS ON CERTAIN SPECIFIC ASPECTS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

I noted no matters regarding PNCC's internal control over financial reporting and its operation that I consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records;

- The process for accumulating and recording labor, material and overhead costs, and the distribution of those costs to construction, retirement, and maintenance or other expense accounts; and

- The materials control.

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS

Management's responsibility for compliance with laws, regulations, contracts, and grants is set forth in my Independent Auditors' Report on Compliance and 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* dated May 7, 2012, and should be read in conjunction with this report. At your request, I have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures I performed are summarized as follows:

- Procedure performed with respect to the requirement to maintain all funds in institutions whose accounts insured by Agency of the Federal Government.

  1. Obtained information from financial institutions with which PNCC maintains funds that indicated that institution were insured by an Agency of the Federal Government.

     At December 31, 2011, PNCC's cash balances were deposited in time certificates of deposit, savings and checking accounts. For the year ended December 31, 2011 the Federal Deposit Insurance Corporation (FDIC) insures interest bearing accounts up to $250,000 while non-interest bearing accounts are insured without limit until December 31, 2012. From the total bank balance of $1,120,031 in 2011 only $967,312 are subject to coverage by the FDIC with the remaining $152,719 balance exceeding insurable limits. PNCC does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

All of PNCC's restricted investments with market value of $3,853,481 as of December 31, 2011, are placed in short-term money market mutual funds held by the Bank of New York Mellon, a FDIC insured financial institutions. Although the money market mutual fund is not insured by the FDIC, this mutual fund portfolio is consists of US Treasury bills and obligations guaranteed by the US Treasury as well as repurchase agreements which are fully collateralized by such obligation. This mutual fund has a weighted average maturity of 45 days and is rated AAAm by Standard and Poor's and AAA-mf by Moody's.

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract, agreement or lease between the borrower and an affiliate for the year ended December 31, 2011:

  1. No procedures were performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract, agreement, or lease between the borrower and an affiliate of PNCC for the year ended December 31, 2011 as no such contracts, agreements or leases with an affiliate as defined in 7 CFR 1773.33(e)(2) (i) were executed.

- Procedure performed with respect to the requirement to submit RUS Form 479 to the RUS:

  1. Agreed amounts reported in RUS Form 479 to PNCC's records.

<u>COMMENTS ON OTHER ADDITIONAL MATTERS</u>

In connection with my audit of the financial statements of PNCC, nothing came to my attention that caused me to believe that PNCC failed to comply with respect to:

- The reconciliation of subsidiary plant records to the controlling general ledger plant accounts addressed at 7 CFR Part 1773.33(c)(1);

- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2);

- The retirement of plant addressed at 7 CFR Part 1773.33(c)(3) and (4);

- The approval of sale, lease, or transfer of capital assets and disposition of proceeds for the sale of lease of plant, material, or scrap addressed at 7 CFR Part 1773.33(c)(5);

- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standards (SFAS) No. 57, "Related Party Transactions," for the year ended December 31, 2009, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR Part 1773.33(f);

- Depreciation rates addressed at 7 CFR Part 1733.33(g); and

- The detailed schedule of investments.

My audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. At December 31, 2011, PNCC had no investments in subsidiary and affiliated companies that needed to be accounted for on either the cost or equity basis in accordance with the requirement of 7 CFR Part 1733.33(i).

* * * * * * * * * *

This report is intended solely for the information and use of the management of PNCC, the Board of Directors and the Rural Utilities Service and supplemental lenders and is not intended to be and should not be used be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

J. Scott Magliari & Company

Koror, Republic of Palau
May 7, 2012