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

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT

For The Years Ended December 31, 2012 and 2011

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

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December 31, 2012

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

FINANCIAL SECTION

For The Years Ended December 31, 2012 and 2011

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INDEPENDENT AUDITOR'S REPORT

Board of Directors
Palau National Communications Corporation:

Report on the Financial Statements

I have audited the accompanying financial statements of the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, which comprise the statements of net position as of December 31, 2012 and 2011, and the related statements of revenues, expenses and changes in net position and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a reasonable basis for my opinion.

Opinion

In my opinion, the financial statements referred above present fairly, in all material respects, the financial position of PNCC as of December 31, 2012 and 2011, the results of its operations, and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and budgetary comparison information, as listed in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. 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.

Supplementary Information

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 Schedules of Functional Expenses are presented for purposes of additional analysis and are not a required part of the financial basic statements. These Schedules are 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.

Report on the Other Legal and Regulatory Requirements

In accordance with *Government Auditing Standards*, I have also issued a report dated July 8, 2013, 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* in considering PNCC's internal control over financial reporting and compliance.

J. Scott Magliari & Company

Koror, Republic of Palau
July 8, 2013

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, 2012 with comparisons to prior years ended December 31, 2011 and 2010. 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 $26.8 million in 2011 to $25.5 million in 2012, a decrease of $1.3 million or 5% primarily due to the change in property, plant and equipment's depreciation and acquisitions.

- PNCC's total liabilities decreased from $30.9 million in 2011 to $30.5 million in 2012, a net decrease of $316,872 or 1%. The net change was due to decreases in long-term debt.

- Net position increased from a negative $4.1 million in 2011 to $5.1 million in 2012.

- Operating revenues increased by $57,665 or .6% from $9.8 million in 2011 to $9.9 million in 2012. The cellular operation has consistently contributed the highest source of revenue of the PNCC from $3.4 million in 2011 to $3.9 million in 2012.

- There was no significant change in operating expenses, except of the decrease in depreciation from $2.7 million in 2011 to $2.5 million in 2012 due to fully depreciated assets acquired in prior years. Total operating expenses in 2012 decreased by $234,887 or 2.5% from 2011.

- In 2012, PNCC adopted Governmental Accounting Standards Board (GASB) Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. GASB Statement No. 63 establishes financial reporting requirements and related disclosures for certain elements of a statement of financial position that were discussed in the GASB's 2007 Concepts Statement No. 4, *Elements of Financial Statements*. In Concepts Statement No. 4, the GASB defines a *deferred outflow of resources* as a consumption of net assets by a government that is applicable to a future reporting period; and *net position* as the residual of all other elements presented in a statement of financial position (the difference between (a) assets and deferred outflows of resources and (b) liabilities and deferred inflows of resources). Under GASB Statement No. 63, amounts for items that the GASB has designated to be deferred outflows of resources are to be presented in a statement of a financial position. Since the PNCC had no deferred outflows of inflows of resources at December 31, 2012, the implementation of GASB Statement No. 63 had no material effect on the presentation of its 2012 financial statements.

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 Position* includes all PNCC's assets, liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to PNCC creditors (liabilities). GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, requires the separate reporting of deferred outflows and inflows of resources. PNCC has no deferrals for the years ended December 31, 2012 and 2011. Changes in net position 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 Position* reports how net position 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 Position. 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 Position and Statements of Revenues, Expenses and Changes in Net Position.

OVERVIEW OF THE FINANCIAL STATEMENTS, CONTINUED

CONDENSED FINANCIAL INFORMATION

Statements of Net Position

	2012	2011	Increase (Decrease)		2010
ASSETS					
Current assets	$ 2,180,934	$ 2,796,455	$ (615,521)	-22.0%	$ 2,782,129
Investments	500,000	-	500,000	-100.0%	-
Restricted cash and cash equivalents	3,661,576	3,853,481	(191,905)	-5.0%	3,855,830
Other noncurrent assets	51,550	51,550	-	0.0%	51,500
Property, plant and equipment, net	19,078,062	20,101,930	(1,023,868)	-5.1%	21,836,420
TOTAL ASSETS	$ 25,472,122	$ 26,803,416	$ (1,331,294)	-5.0%	$ 28,525,879
LIABILITIES					
Current liabilities	$ 3,409,460	$ 2,731,865	$ 677,595	24.8%	$ 2,400,090
Note payable, net of current portion	27,131,154	28,125,621	(994,467)	-3.5%	29,397,852
Total liabilities	$ 30,540,614	$ 30,857,486	$ (316,872)	-1.0%	$ 31,797,942
NET POSITION					
Net investment in capital assets	$ (9,625,569)	$ (9,413,072)	$ (212,497)	2.3%	$ (8,887,466)
Restricted for:					
Debt service reserve	3,661,576	3,853,481	(191,905)	-5.0%	3,855,830
Unrestricted	895,501	1,505,521	(610,020)	-40.5%	1,759,573
Total net position	$ (5,068,492)	$ (4,054,070)	$ (1,014,422)	25.0%	$ (3,272,063)

	2012	2011	Increase (Decrease)		2010
Operating revenues, net	$ 9,874,480	$ 9,816,815	$ 57,665	0.6%	$ 9,354,886
Operating expenses	(8,996,721)	(9,231,608)	234,887	-2.5%	(9,171,322)
Operating income	877,759	585,207	292,552	50.0%	183,564
Nonoperating income (expenses)	(1,892,181)	(1,367,214)	(524,967)	38.4%	(1,463,196)
Change in net position	$ (1,014,422)	$ (782,007)	$ (232,415)	29.7%	$ (1,279,632)

During 2012, total assets decreased by $1,331,294, and total liabilities decreased by $316,872 as compared to 2011. Significant changes in account balances were:

- Capital assets decreased by $1,023,868 due to current year depreciation expense net of current year additions.

- Long-term debt decreased by $994,467, primarily due to payments of principal.

During 2012, negative net position increased by $1,014,422 as compared to 2011. This was the result of a continuing losses incurred in 2012 in which total expenses exceeded total operating revenues by $1,014,422.

CONDENSED FINACIAL INFORMATION

Statements of Revenues, Expenses and Changes in Net Position

	2012	2011	Increase (Decrease)		2010
Operating revenues, net	$ 9,874,480	$ 9,816,815	$ 57,665	0.6%	$ 9,354,886
Operating expenses	(8,996,721)	(9,231,608)	234,887	-2.5%	(9,171,322)
Operating income	877,759	585,207	292,552	50.0%	183,564
Nonoperating income (expenses)	(1,892,181)	(1,367,214)	(524,967)	38.4%	(1,463,196)
Change in net position	$ (1,014,422)	$ (782,007)	$ (232,415)	29.7%	$ (1,279,632)

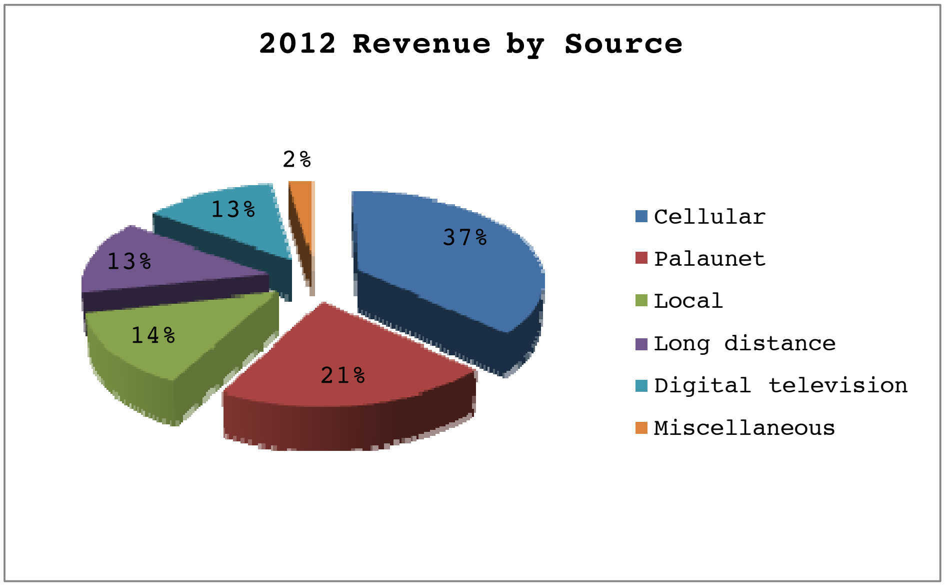
Changes in operating revenues, expenses and non-operating income and expenses are discussed in more details in the following sections.

REVENUE BY SOURCE

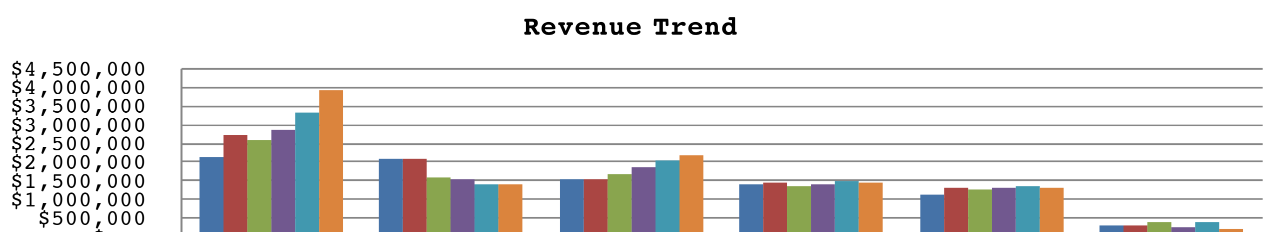
	2012	2011	Increase (Decrease)		2010
Cellular	$ 3,939,731	$ 3,359,520	$ 580,211	17.3%	$ 2,894,006
Palaunet	2,224,011	2,077,983	146,028	7.0%	1,866,938
Local	1,449,268	1,499,031	(49,763)	-3.3%	1,445,873
Long distance	1,445,065	1,429,346	15,719	1.1%	1,541,586
Digital television	1,352,538	1,362,971	(10,433)	-0.8%	1,322,768
Miscellaneous	242,294	396,491	(154,197)	-38.9%	283,715
Provision for doubtful accounts	(778,427)	(308,527)	(469,900)	152.3%	-
	$ 9,874,480	$ 9,816,815	$ 57,665	0.6%	$ 9,354,886

PNCC's cellular operation has consistently contributed the highest source of revenue and continues to grow over the past six 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 six years.

REVENUE BY SOURCE, Continued



Summarized in the chart above are the major revenue sources of PNCC. For 2012, the cellular operations contributed 37% of PNCC's 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
2012	$3,939,731	$1,445,065	$2,224,011	$1,449,268	$1,352,538	$242,294

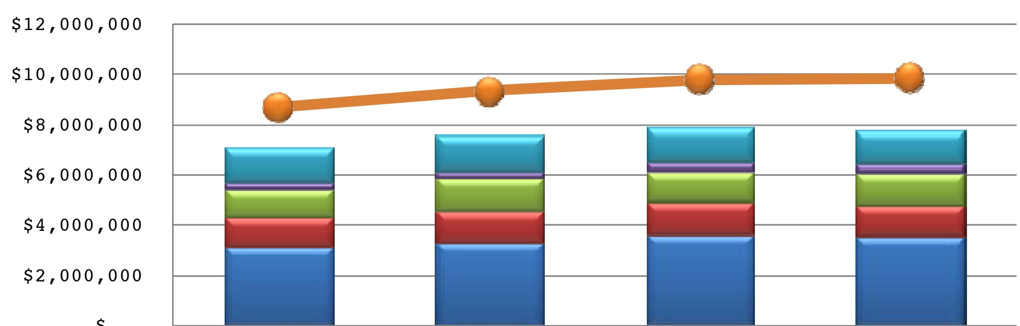
The chart above shows the change in revenues by source over the past six years. PNCC's cellular operation has consistently contributed the highest source of revenue and continues to grow over the past six years. PNCC have seen the declining long distance revenues as its internet operation improves. The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

EXPENSES BY FUNCTION

	2012	2011	Increase (Decrease)		2010
Operating Expenses					
Plant specific operations	$ 3,584,420	$ 3,645,761	$ (61,341)	-1.7%	$ 3,360,920
Depreciation	2,543,071	2,733,481	(190,410)	-7.0%	3,013,918
Customer service operations	1,279,855	1,241,342	38,513	3.1%	1,299,026
Corporate operations	1,244,004	1,293,130	(49,126)	-3.8%	1,225,889
Plant non-specific operations	345,371	317,894	27,477	8.6%	271,569
Total operating expenses	8,996,721	9,231,608	(234,887)	-2.5%	9,171,322
Interest expense	1,328,295	1,387,088	(58,793)	-4.2%	1,426,595
	$ 10,325,016	$ 10,618,696	$ (293,680)	-2.8%	$ 10,597,917

There has been no significant change in PNCC's operating expenses in 2012 compared to 2011, except of the depreciation expense which contributed decreased by 7% over 2011 due to certain capital assets were fully depreciated in prior year. PNCC makes its best effort to control spending and maintain its expenses within budget. See page 44 for the Supplementary Schedule for the Budget versus Actual for the year ended December 31, 2012.

Cash Expenses vs Revenues



	2009	2010	2011	2012
Interest expense	$1,372,457	$1,426,595	$1,387,088	$1,328,295
Plant non-specific operations	$283,241	$271,569	$317,894	$345,371
Customer service operations	$1,104,802	$1,299,026	$1,241,342	$1,279,855
Corporate operations	$1,154,319	$1,225,889	$1,293,130	$1,244,004
Plant specific operations	$3,177,532	$3,360,920	$3,645,761	$3,584,420
Revenues, net of provision for bad debts	$8,690,478	$9,354,886	$9,816,815	$9,874,480

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 increased at a slightly higher rate than 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	$ 3,893,852	$ -	$ 3,893,852	$ 3,939,731	$ 45,879
Palaunet	2,061,803	-	2,061,803	2,224,011	162,208
Local	1,509,845	-	1,509,845	1,449,268	(60,577)
Long distance	1,013,337	-	1,013,337	1,445,065	431,728
Digital television	1,382,441	-	1,382,441	1,352,538	(29,903)
Miscellaneous	273,832	-	273,832	242,294	(31,538)
Provision for doubtful accounts	-	-	-	(778,427)	(778,427)
Total operating revenues	10,135,110	-	10,135,110	9,874,480	(260,630)
Operating expenses:					
Depreciation	2,669,229	-	2,669,229	2,543,071	126,158
Plant specific operations	2,759,843	-	2,759,843	3,584,420	(824,577)
Corporate operations	1,831,614	-	1,831,614	1,244,004	587,610
Customer service operations	1,028,040	-	1,028,040	1,279,855	(251,815)
Plant non-specific operations	340,460	-	340,460	345,371	(4,911)
Total operating expenses	8,629,186	-	8,629,186	8,996,721	(367,535)
Operating income	1,505,924	-	1,505,924	877,759	(628,165)
Nonoperating income (expenses):					
Interest expense	(1,419,287)	-	(1,419,287)	(1,328,295)	90,992
Loss on disposal of equipment	-	-	-	(598,780)	(598,780)
Interest income	4,000	-	4,000	12,312	8,312
Other income (expenses), net	(32,355)	-	(32,355)	22,582	54,937
Total nonoperating expenses, net	(1,447,642)	-	(1,447,642)	(1,892,181)	(444,539)
Change in net position	$ 58,282	$ -	$ 58,282	$ (1,014,422)	$(1,072,704)

PNCC was not able to meet its revenue projections due to economic situations 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 2012 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

	2012	2011	2010
Property, plant and equipment at cost	$ 62,079,111	$ 61,268,023	$ 60,090,309
Accumulated depreciation	(43,001,049)	(41,166,093)	(38,432,612)
Net book value	19,078,062	20,101,930	21,657,697
Carrying value of long term-debt	(28,703,631)	(29,515,002)	(30,723,886)
Net investment in capital assets	$ (9,625,569)	$ (9,413,072)	$ (9,066,189)
Depreciation expense	$ 2,543,071	$ 2,733,481	$ 3,013,918
Repayment of loan principal	$ 1,474,794	$ 1,208,884	$ 1,285,921

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 negative net position includes the excess of the carrying value of the long-term debt over net investment in capital assets. The primary reason for the negative net position 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 seeks 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. Different options are being evaluated by PNCC management to try and reduce expenses associated with telephone service offerings.

GSM Mobile Service

PNCC is in discussions with Chunghwa Telecom Company of Taiwan for upgrade of the PNCC cellular systems to 3rd Generation (3G). This new system should help PNCC improve its cellular services and revenues. Efforts to expand GSM/cellular coverage in Babeldaob and throughout the Republic of Palau are continuing. Plans are in place to provide 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. GSM/cellular service contributes approximately 35% to total revenues and constitutes only 8% of the total operating expenses.

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 a submarine fiber optic cable to connect Palau to the rest of the world. A sub-optic cable will require tremendous amounts 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. This discussion and analysis explains the major factors impacting the 2012 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 Position
December 31, 2012 and 2011

ASSETS

	2012	2011
Current assets:		
Cash (Notes 2, 3, 6 and 8)	$ 442,762	$ 441,384
Time certificate of deposit (Notes 2, 3, 6 and 8)	-	628,899
Receivables: (Notes 2, 6 and 8)		
Trade	4,257,564	4,090,701
Related party (Note 5)	376,421	332,751
Carrier, net	800,351	429,502
Other receivable	133,146	95,637
Allowance for doubtful accounts (Note 2)	(4,083,262)	(3,503,641)
Total receivables, net	1,484,220	1,444,950
Inventories, net (Notes 2 and 6)	183,068	202,083
Prepaid expenses	70,884	79,139
Total current assets	2,180,934	2,796,455
Investments (Notes 2 and 3)	500,000	-
Restricted cash and cash equivalents (Notes 2, 3, 6)	3,661,576	3,853,481
Other noncurrent assets (Note 2)	51,550	51,550
Property, plant and equipment, net (Notes 2, 4, 6 and 7)	19,078,062	20,101,930
	$ 25,472,122	$ 26,803,416

LIABILITIES AND NET POSITION

	2012	2011
Current liabilities:		
Accounts payable (Note 8)	$ 78,626	$ 59,800
Payable to carriers, net (Note 8)	349,097	99,175
Accrued expenses (Notes 2 and 8)	606,078	573,350
Unearned revenues (Notes 2 and 8)	130,049	40,966
Customer deposits (Notes 2 and 8)	673,133	569,193
Current portion of long-term debt (Notes 6 and 8)	1,572,477	1,389,381
Total current liabilities	3,409,460	2,731,865
Note payable, net of current portion (Notes 6 and 8)	27,131,154	28,125,621
Total liabilities	30,540,614	30,857,486
Commitments and contingencies (Note 7)		
Net position (Note 2):		
Net investment in capital assets	(9,625,569)	(9,413,072)
Restricted for:		
Debt service reserve	3,661,576	3,853,481
Unrestricted	895,501	1,505,521
Total net position	(5,068,492)	(4,054,070)
	$ 25,472,122	$ 26,803,416

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 Position
For The Years Ended December 31, 2012 and 2011

	2012	2011
Operating revenues (Note 6):		
Cellular	$ 3,939,731	$ 3,359,520
Palaunet	2,224,011	2,077,983
Local	1,449,268	1,499,031
Long distance	1,445,065	1,429,346
Digital television	1,352,538	1,362,971
Miscellaneous	242,294	396,491
Provision for doubtful accounts	(778,427)	(308,527)
Total operating revenues	9,874,480	9,816,815
Operating expenses:		
Plant specific		
Operations	3,584,420	3,645,761
Depreciation (Note 4)	2,543,071	2,733,481
Corporate office	1,244,004	1,293,130
Customer service	1,279,855	1,241,342
Plant non-specific operations	345,371	317,894
Total operating expenses	8,996,721	9,231,608
Operating income	877,759	585,207
Nonoperating income (expense):		
Interest expense	(1,328,295)	(1,387,088)
Loss on retirement of equipment	(598,780)	-
Interest income	12,312	3,975
Other income (expense), net	22,582	15,899
Total nonoperating income (expense), net	(1,892,181)	(1,367,214)
Change in net position	(1,014,422)	(782,007)
Net position at beginning of year	(4,054,070)	(3,272,063)
Net position at end of year	$ (5,068,492)	$ (4,054,070)

See accompanying notes to financial statements.

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

Statements of Cash Flows
For The Years Ended December 31, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	$ 10,113,181	$ 9,649,026
Cash payments to suppliers for goods and services	(4,490,695)	(4,450,037)
Cash payments to employees	(1,696,575)	(1,778,324)
Net cash provided by operating activities	3,925,911	3,420,665
Cash flows from capital and related financing activities:		
Additions to property, plant and equipment	(2,117,983)	(998,991)
Withdrawals from restricted cash and cash equivalents	191,905	2,349
Interest paid	(1,328,295)	(1,387,088)
Additions to long-term note payable	663,423	-
Repayment of long-term note payable	(1,474,794)	(1,208,884)
Net cash used for capital and related financing activities	(4,065,744)	(3,592,614)
Cash flows from investing activities:		
Interest income	12,312	3,975
Investment	(500,000)	-
Decrease (increase) in time certificate of deposits	628,899	(3,440)
Net cash provided by investing activities	141,211	535
Net increase (decrease) in cash	1,378	(171,414)
Cash at beginning of year	441,384	612,798
Cash at end of year	$ 442,762	$ 441,384

See accompanying notes to financial statements.

Statements of Cash Flows, Continued
For The Years Ended December 31, 2012 and 2011

	2012	2011
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 877,759	$ 585,207
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,543,071	2,733,481
Provision for doubtful accounts	778,427	308,527
Allowance for uncollectible account write-off	(198,806)	-
Other income (expense), net	22,582	15,899
(Increase) decrease in assets:		
Receivables:		
Trade	(166,863)	(275,828)
Related party	(43,670)	(61,798)
Carriers, net	(370,849)	(192,958)
Other receivable	(37,509)	(43,156)
Inventories	19,015	103,969
Prepaid expenses	8,255	(21,056)
Other noncurrent assets	-	(50)
Increase (decrease) in liabilities:		
Accounts payable	18,826	54,155
Payable to carriers, net	249,922	50,048
Accrued expenses	32,728	126,358
Customer deposits	103,940	37,867
Unearned revenues	89,083	-
Net cash provided by operating activities	$ 3,925,911	$ 3,420,665

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. In 2012, PNCC adopted Government Accounting Standards Board (GASB) Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This Statement identifies and consolidates accounting and financial reporting provisions that apply to state and local governments. Prior to the issuance of Statement No. 62, PNCC applied the standards and principles outlined in GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary and Other Governmental Entities that Use Proprietary Fund Accounting*. GASB Statement No. 62, which supercedes Statement No. 20, is the primary resource for accounting guidance and principles.

(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,* GASB Statement No. 38, *Certain Financial Statement Note Disclosures, and GASB Statement No. 63, Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position in a statement of financial position*. Statement No. 63 amends the net asset reporting requirements in GASB Statement No. 34, and incorporates deferred outflows of resources and deferred inflows of resources into the required components of financial reporting and residual measure of all components is renamed from net assets to net position. 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 position, statement of revenues, expenses and changes in net position and a statement of cash flows using the direct method; and
- Notes to financial statements

GASB Statement No. 34, as amended by GASB Statement No. 63, established standards for external financial reporting and requires that resources be classified for accounting and reporting purposes into the following three components of net position:

Net investment in capital assets:

Capital assets net of accumulated depreciation, reduced by the outstanding principal balances of debt attributable to the acquisition, construction or improvements of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisitions, construction, or improvement of those assets or related debt should be included in this component of net position. At December 31, 2012 and 2011, PNCC had no deferred outflows of resources, and deferred inflows of resources that needed be included in this component of net position.

Restricted net position:

Restricted assets reduced by liabilities and deferred inflows of resources related to those assets. Generally, a liability relates to restricted assets if the asset results from a resource flow that also results in the recognition of a liability or if the liability will be liquidated with the restricted assets reported. At December 31, 2012 and 2011, PNCC had no deferred outflows of resources, and deferred inflows of resources that needed be included in this component of restricted net position.

(2) Summary of Significant Accounting Policies, Continued

A. Basis of Presentation, Continued

PNCC's component of net position, continued

Restricted net position, continued

The PNCC's restricted net position categories are as follows:

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

Expendable: Net position 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 Position

Net amount of the assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of net investment in capital assets or the restricted components of net position. Unrestricted net position may be designated for specific purposes by action of the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

At December 31, 2012 and 2011, PNCC had no deferred outflows of resources, and deferred inflows of resources that needed be included in this component of net position.

(2) Summary of Significant Accounting Policies, Continued

B. Measurement Focus and Basis of Accounting

Basis of accounting refers to timing of recognition, that is, when revenues and expenditures, expenses, and transfers and assets, deferred outflows of resources, liabilities and deferred inflows of resources 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 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 4 to 13 includes PNCC's analysis of the significant variations and major factors impacting the 2012 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 2012, PNCC implemented the following GASB Statements:

GASB Statement No. 57, *OPEB Measurements by Agent Employers And Agent Multiple-Employer Plans,* which amends Statement No.43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement did not have a material effect on the accompanying financial statements.

GASB 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.

GASB Statement No. 61, *The Financial Reporting Entity: Omnibus*, which is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity, and No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this Statement are effective for periods beginning after June 15, 2012.

(1) Summary of Significant Accounting Policies, Continued

E. New Accounting Standards, Continued

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements. The provisions of this Statement are effective for periods beginning after December 15, 2011.

GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which establishes guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The provisions of this statement are effective for periods beginning after December 15, 2011. Since the PNCC had no deferred outflows or inflows of resources at December 31, 2012, the PNCC''s implementation of GASB Statement No. 63 had no material effect on the accompanying financial statements of PNCC.

Recent Pronouncements

In July 2011, GASB issued Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions* (an amendment of GASB Statement No. 53), which will improve financial reporting by state and local governments by clarifying the circumstances in which hedge accounting continues to be applied when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The provisions of this statement are effective for periods beginning after June 15, 2011. The provisions of Statement 64 did not have a material effect on the accompanying financial statements.

In March 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities,* which establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012. The implementation of this Statement did not have a material effect on the accompanying financial statements of PNCC.

In March 2012, GASB issued Statement No. 66, *Technical Corrections—2012—an amendment of GASB Statements No. 10 and No. 62*. This Statement amends Statement No. 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues, by removing the provision that limits fund-based reporting of an entity's risk financing activities to the general fund and the internal service fund type. This Statement also amends Statement 62 by modifying the specific guidance on accounting for (1) operating lease payments that vary from a straight-line basis, (2) the difference between the initial investment (purchase price) and the principal amount of a purchased loan or group of loans, and (3) servicing fees related to mortgage loans that are sold when the stated service fee rate differs significantly from a current (normal) servicing fee rate.

(1) Summary of Significant Accounting Policies, Continued

E. New Accounting Standards, Continued

Recent Pronouncements, Continued

These changes clarify how to apply Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, and result in guidance that is consistent with the requirements in Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, respectively. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012. The implementation of this Statement did not have a material effect on the accompanying financial statements of PNCC.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25,* and GASB Statement No 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27.* The primary objective of these Statements is to improve accounting and financial reporting by state and local governments for pensions. These statements are effected effective for financial statements for fiscal years beginning after June 15, 2013 and 2014, respectively. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of PNCC.

In June 2012, GASB issued Statement No. 68, "Accounting for Financial Reporting for Pensions – an amendment of Statement No. 27". This Statement is effective for fiscal years beginning after June 15, 2014. The objective of this Statement is to improve financial reporting by state and local governmental pensions. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PNCC.

F. Assets, Liabilities and Net Position

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 Position.

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 Position.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

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.

Investments

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity’s investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the PNCC. As of December 31, 2012, there were no investments in any one issuer that exceeded five percent (5%) of total investments.

PNCC has formal policies in place as of December 31, 2012, to address investment risks. The following investment policy governs the investment of assets of PNCC:

General:

- Any restrictions set forth by applicable law governing limits, size, or quality of investments, if more stringent that those of this investments policy, will be the governing restriction.

- U.S. and non-U.S. common stocks, ADRs (American Depository Receipts), convertible bonds, preferred stocks, fixed-income securities, mutual funds and short-term securities are permissible investments.

- No individual security of any issuer, other than that of the United States Government, shall constitute more than 10% (at cost) of any Investment Manager’s portfolio.

- Holdings of any issuer shall constitute no more than 5% of the outstanding securities of such issuer.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Investments, Continued

General, Continued

- Investments in a registered mutual fund managed by the Investment Manager are subject to prior approval of the Board of Directors.

- The following securities and transactions are not authorized: letter stock and other unregistered securities; non-negotiable securities; commodities or other commodity contracts; and short sales or margin transactions. Options and futures are restricted, except by petition to the Board of Directors for approval.

Equities:

- Consistent with the desire to maintain broad diversification, allocations to any economic or industry sector should not be excessive. Comparisons to peer group characteristics will be used to evaluate and to assure consistency of each managers stated strategy and style.

- Equity holdings shall be restricted to readily marketable securities of corporations that are actively traded on the major exchanges and over the counter.

- The Investment Managers shall have the discretion to invest a portion of the assets in cash reserves when they deem appropriate. However, the Investment Managers will be evaluated against their peers on the performance of the total funds under their direct management.

- Common stock and preferred stock of any institution or entity created or existing under the laws of the United States of America or any state, district, territory, or District of Columbia, or of any foreign country are permissible investments.

U.S. Fixed Income:

- All fixed income securities (with the exception of U.S. Treasury or Agency securities which are unrated) shall have a Moody's, Standard & Poor's and/or a Fitch's credit quality rating of no less than "BBB".

- No more than 20% of the market value of the portfolio shall be rated less than single "A" quality, unless the Investment Manager has specific written authorization. Total portfolio quality (capitalization weighted) shall maintain an "A" minimum rating.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Investments, Continued

Cash/Cash Equivalents:

- The following investments will be permitted:

  1. U.S. Government obligations, U.S. Government agency obligations, and U.S Government instrumentality obligations.

  2. Commercial Paper: All commercial paper issuers must maintain an "A-1" rating by Standard & Poor's Corporation and a "P-1" rating by Moody's Investor Service and be issued by corporations having total assets in excess of one billion dollars ($1,000,000,000).

  3. Certificates of Deposit: All certificate of deposit issuers must have a minimum capital of ten million dollars ($10,000,000).

  4. Repurchase Agreements: Repurchase agreements must be collateralized with either: (1) U.S. Treasury or Agency Securities with a market value of 102%, marked to market daily; or, (2) money market instruments which meet the qualifications of the Statement and with a market value of 102%, marked to market daily.

  5. Money Market Funds: Money Market Funds must be registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940.

- No single issue shall have a maturity of greater than one (1) year.

- The money market funds must have an average maturity of less than one (1) year.

GASB Statement No. 40 requires entities to provide information about the credit risk associated with their investments by disclosing the credit quality ratings.

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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Property, Plant and Equipment, Continued

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
Furniture and fixtures	5 – 10 years
Vehicles	6 years

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, 2012 and 2011.

Capitalization of Interest

Interest is capitalized by PNCC when it is determined to be material. PNCC capitalizes interest in accordance with GASB Statement No. 62. Interest is capitalized on for costs incurred on funds used to construct or acquire property, plant and equipment. The capitalized interest is recorded as part of the asset which it relates and is amortized over the asset's estimated useful life. PNCC did not capitalize any interest cost for years ending December 31, 2012 and 2011, respectively.

Other noncurrent assets

Other noncurrent assets represent refundable deposits related to PNCC's subscription of television channels and programs for its digital television services. At December 31, 2012 and 2011, refundable deposit was $51,550 in each year.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Compensated Absences

Compensated absences are those absences for which employees will be 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, 2012 and 2011, accrued annual leave totaled $89,022 and 88,395, respectively, and is reported in the Statements of Net Position as a component of accrued expenses. At December 31, 2012 and 2011, all compensated absences are current.

For the years ended December 31, 2012 and 2011, annual vacation leave taken totaled $97,558 and $90,045, respectively and is reported in the Statements of Revenues, Expenses and Changes in Net Position as a component of operating expenses. No liability is recorded for non-vesting accumulating rights to receive health or sick pay benefits.

Unearned revenues

Unearned revenues consist of cash payments received from customers for which goods or services has not been earned or realized, and prepaid long distance sales which actual traffic minutes were used and processed after the reporting period. At December 31, 2012 and 2011, unearned revenues were $130,049 and $40,966, respectively.

Customer deposits

Customer deposits consist of subscriber deposits, installation fees and amounts received for related services and subscriptions to be provided in future periods. PNCC's requirement of customer deposit amount varies depending on the type of service or subscription applied for. Deposits are eligible for refunding after twelve (12) consecutive months of prompt payment history. If a deposit is held on an account at the time services are terminated, the deposit will be applied to the unpaid balance and refund check is issued for the remainder. Refunds are not automatic, the customer must request a refund. There is no interest paid on customer deposit. At December 31, 2012 and 2011, customer deposits were $673,133 and $569,193, respectively.

Advertising Costs

Advertising costs are expensed as incurred. At December 31, 2012 and 2011, advertising costs totaled $29,831 and $33,909, respectively, and is included as a component of customer operations expense reported in the Statements of Revenues, Expenses and Changes in Net Position.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

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, 2012 and 2011 amounts contributed to the Fund by PNCC totaled $94,708 and $93,397, respectively, and is included 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 Position.

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 2012 and 2011 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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

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

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 Position.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, 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. For the years ended December 31, 2012 and 2011, PNCC's share on employees' Healthcare Fund paid to the Social Security Administration was $44,425 and 44,487, respectively, and is included as a component of payroll burden in the Schedule of Functional Expenses in page 45.

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 Position 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 Position

Net position is the residual of assets and deferred outflows of resources over liabilities and deferred inflows of resources in a statement of financial position. PNCC had no deferred outflows or inflows of resources at December 31, 2012 and 2011. Therefore, the PNCC'S net position represents the residual interest in PNCC's assets after liabilities. At December 31, 2012 and 2011, PNCC had net position in which total liabilities exceeded total assets.

Net position consists of three components: net investment in capital assets net of related debt; restricted expendable and nonexpendable; and unrestricted. Net investment in capital assets component of net position, consists of capital assets, net of accumulated depreciation, reduced by the outstanding balance of the related debt. Net position is reported as restricted when constraints are imposed by third parties or enabling legislation. At December 31, 2012 and 2011, PNCC had a negative net position totaling $5,068,492 and $4,054,070, respectively.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Net Position, Continued

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, 2012 and 2011, PNCC's cash balances were deposited in time certificates of deposit, savings and checking accounts. For the years ended December 31, 2012 and 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 $525,650 in 2012 and 1,120,031 in 2011, only $406,187 and $967,312, 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's restricted cash and cash equivalent 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 at 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").

(3) Deposits and Investments Risk, Continued

Investments (Cash Equivalents), Continued

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.

All of PNCC's restricted cash and cash equivalents with market value of $3,661,576 and $3,853,481 as of December 31, 2012 and 2011, 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.

At December 31, 2012, PNCC's investments at fair value are as follows:

	Allocation		Market Value
2012	Actual	Per Policy	12/31/2012
U.S. Equities	49%	50%	$ 247,197
Fixed income	29%	30%	145,229
Cash deposits	12%	10%	57,974
Non U.S. Equities	10%	10%	49,600
	100%	100%	$ 500,000

(3) Deposits and Investments Risk, Continued

Investments (Cash Equivalents), Continued

As of December 31, 2012, PNCC's fixed income securities had the following maturities:

	2012						
		Investment Maturities (In Years)				Rating	
Investment type	Fair Value	Less than 1	1-5	6-10	More than 10	Moody	Standard & Poor's
Government securities	$ 7,316	$ -	$ 7,316	$ -	$ -	AAA	No rating
Government securities	8,493	-	8,493	-	-	AAA	No rating
Government securities	8,936	-	8,936	-	-	AAA	No rating
Government securities	12,820	-	-	12,820	-	AAA	No rating
Government securities	4,044	-	-	4,044	-	AAA	No rating
Government securities	5,736	-	-	-	5,736	AAA	No rating
Government securities	4,105	-	-	-	4,105	AAA	No rating
Federal Agencies	11,676	-	11,676	-	-	AAA	AA+
Federal Agencies	13,546	-	13,546	-	-	AAA	AA+
Corporate bonds	4,278	-	4,278	-	-	A2	A
Corporate bonds	4,274	-	4,274	-	-	A-3	BBB+
Corporate bonds	5,004	-	-	5,004	-	BBA2	BBB-
Corporate bonds	4,996	-	-	4,996	-	A2-	A-
Corporate bonds	5,128	-	-	5,128	-	A1	AA
Corporate bonds	5,119	-	-	5,119	-	A3	A-
Corporate bonds	4,650	-	-	4,650	-	A3	A-
Corporate bonds	4,014	-	-	4,014	-	BAA3	BBB
Corporate bonds	4,311	-	-	4,311	-	A2	A+
Corporate bonds	4,338	-	-	4,338	-	BAA3	BBB-
Corporate bonds	5,090	-	-	5,090	-	BAA1	BBB
Corporate bonds	4,045	-	-	-	4,045	BAA2	BBB+
Corporate bonds	4,149	-	-	-	4,149	A2	A
Corporate bonds	4,227	-	-	-	4,227	A1	A
Corporate bonds	4,934	-	-	-	4,934	A1	AA+
	$ 145,229	$ -	$ 58,519	$ 59,514	$ 27,196		

2011

At December 31, 2011, PNCC has no concentration of credit risk on fixed income securities.

(4) Property, Plant and Equipment

Summarized below are PNCC's property, plant and equipment for the years ended December 31, 2012 and 2011.

December 31, 2012:

	Balance at December 31, 2011	Additions	Transfers/ Retirements	Balance at December 31, 2012
Regulated capital assets				
Cables and transmission lines	$ 26,017,046	$ 247,712	$ -	$ 26,264,758
Transmission equipment	9,210,046	50,972	-	9,261,018
Buildings	8,839,503	-	-	8,839,503
Central office equipment	4,011,593	15,417	-	4,027,010
General support equipment	2,222,143	1,212,329	(1,265,141)	2,169,331
Customer premises wiring and equipment	1,147,743	62,057	-	1,209,800
Vehicles	649,061	8,837	(41,754)	616,144
Furniture and fixtures	28,517	-	-	28,517
Regulated capital assets, at cost	52,125,652	1,597,324	(1,306,895)	52,416,081
Accumulated depreciation	(36,799,136)	(2,027,939)	708,115	(38,118,960)
Regulated capital assets, at net book value	15,326,516	(430,615)	(598,780)	14,297,121
Non-regulated capital assets				
Cable television	2,980,802	67,441	-	3,048,243
Cellular	5,150,100	-	-	5,150,100
Palaunet	798,283	111,622	-	909,905
Non-regulated capital assets, at cost	8,929,185	179,063	-	9,108,248
Accumulated depreciation	(4,366,957)	(515,132)	-	(4,882,089)
Non-regulated capital assets, at net book value	4,562,228	(336,069)	-	4,226,159
Construction in progress	213,186	341,596	-	554,782
Total	$ 20,101,930	$ (425,088)	$ (598,780)	$ 19,078,062

(4) Property, Plant and Equipment, Continued

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

Depreciation expense for the years ended December 31, 2012 and 2011 was $2,543,071 and $2,733,481, respectively, and is reported in the Statements of Revenues, Expenses and Changes in Net Position.

(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, 2012 and 2011, amounts due from the Republic of Palau and its component units totaled $376,421 and $332,751, respectively.

(6) Long-term debt

Long-term debt as of December 31, 2012 and 2011 are summarized below:

	2012	2011
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.	$26,391,326	$27,622,579
Note payable to Chunghwa Telecom Company in monthly installments of $34,087, non-interest bearing (net of unamortized discount of $191,816 and $281,160 at December 31, 2012 and 2011, respectively) due in July 2017, secured by earth station and ground common equipment.	1,648,882	1,892,423
Note payable to National Information Solutions Cooperative (NISC), non-interest bearing, payable in monthly installment of $10,482 from January 2013 through March 2013, and thereafter $13,325 monthly, due October 2017 (net of of unamortized discount of $100,875), uncollateralized.	663,423	-
Total debt	28,703,631	29,515,002
Less current portion	1,572,477	1,389,381
Long-term debt, net of current portion	$27,131,154	$28,125,621

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, 2012 and 2011.

(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
2013	$ 1,118,142	$ 1,188,034	$ 2,306,176
2014	1,170,558	1,135,617	2,306,175
2015	1,225,432	1,080,744	2,306,176
2016	1,282,878	1,023,298	2,306,176
2017	1,343,016	963,159	2,306,175
2018-2022	7,720,593	3,810,285	11,530,878
2023-2027	9,708,030	1,822,848	11,530,878
2028-2029	2,822,677	87,988	2,910,665
	$ 26,391,326	$ 11,111,973	$ 37,503,299

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, 2012, the future note payments to CHT are as follows:

Year ending December 31,	Present value of note	Discount Amortization	Total note payments
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	201,630	2,892	204,522
	$ 1,648,882	$ 191,816	$ 1,840,698

(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, 2012 and 2011, 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 Position.

New billing and customer care information technology system

In August 2012, PNCC entered into a note agreement for the acquisition of a new billing and customer care information technology system from the National Information Solutions Cooperative (NISC) for the improvement of its billing and customer care and communication system between the PNCC sales sites and its main office. At December 31, 2012, the capitalized costs of the new information system approximates $1,180,000 with an outstanding note payable balance with NISC amounted to $764,298, non-interest bearing note, with remaining payable in fifty-eight (58) monthly installments of $10,482 from January 2013 through March 2013, and thereafter of $13,325 from April 2013 through October 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 4.59%, which was the assumed long-term borrowing rate of PNCC from the Federal Government at December 31, 2012. At December 31, 2012, the future note payments to NISC are as follows:

Year ending December 31,	Present value of note	Discount Amortization	Total note payments
2013	$ 118,613	$ 32,754	$ 151,367
2014	133,034	26,861	159,895
2015	139,270	20,625	159,895
2016	145,799	14,096	159,895
2017	126,707	6,539	133,246
	$ 663,423	$ 100,875	$ 764,298

The operational commitments of PNCC related to the NISC's technical support performance during the terms of the notes totaled $103,845, payable in monthly of $540 commencing from January 2013 to October 2017, and a $14,289 annual payment for five years from 2013 through 2017. These commitments chargeable to operations are included in the Note 7.

(6) Long-term debt, Continued

At December 31, 2012 and 2011, the changes in the long-term liabilities are as follows:

2012	Balance January 1, 2012	Additions	Reductions	Balance December 31, 2012	Current	Noncurrent
Rural Utilities Services	$ 27,622,579	$ -	$ 1,231,253	$26,391,326	$ 1,118,142	$ 25,273,184
Chunghwa Telecom Company, Ltd.(net of unamortized discount of $191,816 in 2012 and $281,160 in 2011)	1,892,423	-	243,541	1,648,882	335,722	1,313,160
National Information Solutions Cooperative (net of unamortized discount of $100,875 at 12/31/2012)	-	1,179,561	516,138	663,423	118,613	544,810
	$ 29,515,002	$1,179,561	$ 1,990,932	$28,703,631	$ 1,572,477	$ 27,131,154

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

Interest expense paid in 2012 and 2011 amounted to $1,328,295 and $1,387,088, 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, satellite bandwidth capacity services, and innovation in information technology. The approximate future minimum annual payments under these agreements are as follows:

Year ending December 31,	Amount
2013	$ 853,261
2014	455,415
2015	188,769
2016	188,769
2017	187,689
	$ 1,873,903

At December 31, 2012, PNCC has outstanding purchase commitments for the procurement of submarine cable with an off-island vendor, and security services. The accrual basis of accounting provides that expenses include only amounts associated with goods and services received and liabilities include only the unpaid amounts associated with such expenses. Accordingly, $254,600 of outstanding purchase commitments are not reported in the financial statements for the year ended December 31, 2012.

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. PNCC has elected to purchase commercial insurance coverage for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the past three years. PNCC is self-insured for buried cables and customer premises wirings. Claims expenditures and liabilities will be reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Losses, if reported, would include an estimate of claims that have been incurred but not reported. No losses as a result of these risks have occurred or have been reported within the last three years.

(7) Commitments and Contingencies

Contingencies, Continued

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.

Health (Sick) Leave

It is the policy of PNCC to record expenditures for health (sick) leave when the leave is actually taken. Sick leave is compensated time for absence during working hours arising from employee illness or injury. The estimated accumulated sick leave at December 31, 2012 and 2011 is $1,031,351 and $1,041,584, respectively.

(8) Fair Value of Financial Instruments

PNCC's financial instruments are cash and cash equivalents, accounts receivable, other assets, accounts payable, payable to carriers, accrued expenses, deferred revenue, customer deposits, and notes payable, and long-term debt. The recorded values of these instruments for cash and cash equivalents, accounts receivable, and accounts payable, payable to carriers, 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 NISC 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) Reclassifications

Certain amounts presented in 2011 have been reclassified to conform to 2012 financial statement presentation. These reclassifications did not affect the change in net position or the total net position.

(10) Subsequent Events

PNCC evaluated subsequent events from December 31, 2012 through July 8, 2013 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 Position.

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

SUPLEMENTARY SCHEDULES

Year Ended December 31, 2012

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

Supplementary Schedule of
Budget vs Actual (GAAP Basis)
For The Year Ended December 31, 2012

	Budget				Variance
	Original	Revisions	Final	Actual	Favorable (Unfavorable)
Operating revenues:					
Cellular	$ 3,893,852	$ -	$ 3,893,852	$ 3,939,731	$ 45,879
Palaunet	2,061,803	-	2,061,803	2,224,011	162,208
Local	1,509,845	-	1,509,845	1,449,268	(60,577)
Long distance	1,013,337	-	1,013,337	1,445,065	431,728
Digital television	1,382,441	-	1,382,441	1,352,538	(29,903)
Miscellaneous	273,832	-	273,832	242,294	(31,538)
Provision for doubtful accounts	-	-	-	(778,427)	(778,427)
Total operating revenues	10,135,110	-	10,135,110	9,874,480	(260,630)
Operating expenses:					
Depreciation	2,669,229	-	2,669,229	2,543,071	126,158
Plant specific operations	2,759,843	-	2,759,843	3,584,420	(824,577)
Corporate operations	1,831,614	-	1,831,614	1,244,004	587,610
Customer service operations	1,028,040	-	1,028,040	1,279,855	(251,815)
Plant non-specific operations	340,460	-	340,460	345,371	(4,911)
Total operating expenses	8,629,186	-	8,629,186	8,996,721	(367,535)
Operating income	1,505,924	-	1,505,924	877,759	(628,165)
Nonoperating income (expenses):					
Interest expense	(1,419,287)	-	(1,419,287)	(1,328,295)	90,992
Loss on disposal of equipments	-	-	-	(598,780)	(598,780)
Interest income	4,000	-	4,000	12,312	8,312
Other income (expenses), net	(32,355)	-	(32,355)	22,582	54,937
Total nonoperating expenses, net	(1,447,642)	-	(1,447,642)	(1,892,181)	(444,539)
Change in net position	$ 58,282	$ -	$ 58,282	$ (1,014,422)	$ (1,072,704)

See Accompanying Independent Auditor's Report.

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

Supplementary Schedule of Functional Expenses
For The Year Ended December 31, 2012
(With Comparative Totals for 2011)

	Plant Specific					Plant	Total	
				Customer		non-specific	Operating Expenses	
	Depreciation	Operation	Corporate	Relations	Total	operations	2012	2011
Outside services	$ -	$ 1,790,068	$ 140,273	$ 906,164	$ 2,836,505	$ 625	$ 2,837,130	$ 2,647,327
Depreciation	2,543,071	-	-	-	2,543,071	-	2,543,071	2,733,481
Salaries and wages	-	535,356	554,227	242,665	1,332,248	193,405	1,525,653	1,526,964
Utilities	-	777,722	-	-	777,722	-	777,722	758,435
Payroll burden	-	209,686	189,480	105,683	504,849	61,177	566,026	704,987
Others	-	44,553	88,354	4,687	137,594	10,635	148,229	101,353
Training	-	5,160	134,736	3,033	142,929	20,660	163,589	299,830
Materials and supplies	-	106,423	13,750	13,169	133,342	4,002	137,344	111,690
Clearance	-	84,662	-	-	84,662	46,714	131,376	106,913
Fuel	-	30,790	11,055	4,454	46,299	8,153	54,452	42,638
Legal fees	-	-	24,335	-	24,335	-	24,335	11,000
Postage	-	-	19,686	-	19,686	-	19,686	20,652
Board fees	-	-	8,968	-	8,968	-	8,968	11,113
Inventory obsolescence	-	-	-	-	-	-	-	90,791
Insurance	-	-	59,140	-	59,140	-	59,140	59,616
Rent	-	-	-	-	-	-	-	4,818
	$ 2,543,071	$ 3,584,420	$ 1,244,004	$ 1,279,855	$ 8,651,350	$ 345,371	$ 8,996,721	$ 9,231,608

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
For The Year Ended December 31, 2012

	Depreciation	Operation	Corporate	Customer Relations	Total
Telephony					
Depreciation	$ 2,027,938	$ -	$ -	$ -	$ 2,027,938
Salaries and wages	-	305,642	544,259	242,665	1,092,566
Utilities	-	733,999	-	-	733,999
Outside services	-	423,249	139,311	29,946	592,506
Payroll burden	-	117,888	184,970	105,683	408,541
Others	-	27,539	71,257	3,726	102,522
Training	-	5,160	134,641	3,033	142,834
Materials and supplies	-	88,708	13,517	13,169	115,394
Insurance	-	-	59,140	-	59,140
Clearance	-	46,030	-	-	46,030
Fuel	-	30,790	6,453	4,454	41,697
Legal fees	-	-	24,335	-	24,335
Postage	-	-	19,686	-	19,686
Board fees	-	-	8,968	-	8,968
Allocation	-	-	(201,706)	(68,634)	(270,340)
	2,027,938	1,779,005	1,004,831	334,042	5,145,816
Cellular					
Depreciation	327,606	-	-	-	327,606
Outside services	-	191,644	132	-	191,776
Allocation	-	-	67,729	25,016	92,745
Salaries and wages	-	45,381	9,909	-	55,290
Utilities	-	41,963	-	-	41,963
Others	-	6,129	16,957	54	23,140
Payroll burden	-	16,844	4,510	-	21,354
Fuel	-	-	4,602	-	4,602
Materials and supplies	-	-	233	-	233
	327,606	301,961	104,072	25,070	758,709
Palaunet					
Outside services	-	1,129,520	-	-	1,129,520
Depreciation	70,283	-	-	-	70,283
Allocation	-	-	40,425	24,528	64,953
Salaries and wages	-	60,308	-	-	60,308
Payroll burden	-	23,183	-	-	23,183
Others	-	10,124	-	-	10,124
Clearance	-	9,525	-	-	9,525
Materials and supplies	-	1,194	-	-	1,194
	70,283	1,233,854	40,425	24,528	1,369,090
Digital TV					
Outside services	-	45,655	830	876,218	922,703
Salaries and wages	-	124,025	59	-	124,084
Depreciation	117,244	-	-	-	117,244
Allocation	-	-	93,552	19,090	112,642
Payroll burden	-	51,771	-	-	51,771
Clearance	-	29,107	-	-	29,107
Materials and supplies	-	16,521	-	-	16,521
Others	-	761	140	907	1,808
Utilities	-	1,760	-	-	1,760
Training	-	-	95	-	95
	117,244	269,600	94,676	896,215	1,377,735
	$ 2,543,071	$ 3,584,420	$ 1,244,004	$ 1,279,855	$ 8,651,350

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, 2012

J. Scott Magliari & COMPANY
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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, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, the financial statements of Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, as of and for the year ended December 31, 2012, and the related notes to the financial statements, which collectively comprise PNCC's basic financial statements, and have issued my report thereon dated July 8, 2013.

Internal Control Over Financial Reporting

In planning and performing my audit of the financial statements, I considered PNCC's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing my opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of PNCC's internal control. Accordingly, I do not express an opinion on the effectiveness of PNCC's internal control.

My consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and responses, I identified certain deficiencies in internal control that I consider to be material weaknesses and 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 12-01 through 12-05, and item 12-09 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 the deficiencies described in the accompanying Schedule of Findings and Responses as items 12-06, 12-07 and 12-08 to be significant deficiencies.

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 July 8, 2013.

PNCC's Response to Findings

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.

Purpose of this Report

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

J. Scott Magliari & Company

Koror, Republic of Palau
July 8, 2013

Finding No.: 12-01
Area : Financial Reporting

Criteria:

Pursuant to GASB Statement No. 34, and as amended by GASB Statement No. 63, the reporting requirements for contributed capital and retained earnings have completely changed. GASB Statement No. 34, as amended by GASB Statement No. 63, governments are required to report proprietary fund net position (prior to GASB Statement No. 63 the net position was previously named net assets) into three categories (Net investment in capital assets, which consist of capital assets net of accumulated depreciation, reduced by the outstanding balances of any borrowings used for the acquisition, construction or improvement of those assets, 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 position.

Condition:

The PNCC's internal financial statements and current design of financial reporting at December 31, 2012, 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, and as amended by GASB Statement No.63. Additionally, the PNCC's financial statements still reflect fund equity terms such as "Contributed Capital", "Retained Earnings" and "Current Year Earnings" instead of Net Position and Changes in Net Position.

Cause:

The current upgraded general ledger system of PNCC used for financial reporting was not properly designed or mapped to be able to generate the financial statements that meet the current changes implemented by the Governmental Accounting Standards Board.

Effect:

Management may see the components of its equity section reported under GASB Statement 34, and as amended by GASB Statement 63 at year-end in its audited financial statements.

Prior Year Status:

The above condition is cited in the 2009 through 2011 audits of PNCC.

Finding No.: 12-01, 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 outside vendor for technical assistance to make the necessary revisions.

Auditee Response and Corrective Action Plan:

PNCC concurs with Auditors' recommendation and therefore will work with systems provider (NISC) to change report format to comply with GASB standards.

Finding No.: 12-02
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:

There was no periodic analysis and reconciliation of the accounts receivable subsidiary ledger to the general ledger. At December 31, 2012, the variance between the overall Aging Debtor's Report and the general ledger was $53,129.96. An auditor adjustment was made to correct the misstatement.

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 2011.

Finding No.: 12-02, 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:

The Chief Financial Officer in consultation with Accounting Manager and Billing Manager will institute reconciliation and internal audit schedules to ensure regular timely reconciliations of all accounts in compliance with established policies and procedures.

Finding No.: 12-03
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:

Corrected misstatements:

Account Name	General ledger Acct.Code	Per General Ledger 12/31/2012 Debit (Credit)	Per Subsidiary Ledger/ and or provided schedule 12/31/2012 Debit (Credit)	Misstatement
Bank of Hawaii-checking	1131.1	$ 84,821.16	$ 76,419.91	$ 8,401.25
Bank Pacific-checking	1132.1	223,942.29	181,283.00	42,659.29
General Trade Receivable	1180.1	4,687,114.87	4,633,984.91	53,129.96
Allowance for obsolete inventory	1220.9	-	(90,791.00)	90,791.00
Net deficiency, beginning	4550	3,856,937.35	4,054,070.18	(197,132.83)
Accrued salaries and wages	4120.1	35,172.27	(68,888.73)	104,061.00
Accrued health (sick)leave	4121.2	(134,897.03)	-	(134,897.03)
Restricted cash-RUS 1994 debt service fund	1136.2	220,765.43	28,584.14	192,181.29
Accounts receivable-Palaunet	1181.2	198,806.31	-	198,806.31
Allowance for bad debt-Palaunet	1184	(198,806.31)	-	(198,806.31)
Customer deposits	4040	(598,730.18)	(673,133.22)	74,403.04
Deferred revenue	4041	(40,966.36)	(130,048.90)	89,082.54
Current maturities,long-term debt-RUS	4050	(1,021,591.44)	(1,118,142.00)	96,550.56
Current portion,long-term debt-CHT	4051.1	(408,504.00)	(335,722.00)	(72,782.00)
Long-term, net of current-RUS	4211.1	(25,331,322.08)	(25,273,184.00)	(58,138.08)
Note payable - NISC	4010.1	-	(764,298.00)	764,298.00
Unamortized discount on note payable-NISC	4051.2	-	100,875.00	(100,875.00)
Provision of allowance for uncollectable	1184	-	(778,426.89)	778,426.89
Loss on retirement of equipment	7350	-	598,780.02	(598,780.02)
Interest expense on loan -RUS	7510	1,200,538.68	1,238,951.16	(38,412.48)
Interest expense on loan from CHT	7530	-	89,344.00	(89,344.00)
		$(17,226,719.04)	$ (18,230,342.42)	$ 1,003,623.38

Finding No.: 12-03, Continued
Area : Reconciliations

Condition, Continued

Uncorrected misstatements:

Account Name	General ledger Acct.Code	Per General Ledger 12/31/2012 Debit (Credit)	Per Subsidiary Ledger/ and or provided schedule 12/31/2012 Debit (Credit)	Misstatement
Miscellaneous receivable	1193	$ 57,898.08	$ 57,898.08	$ -
Other receivable	1193	69,450.92	64,170.78	5,280.14
		127,349.00	122,068.86	5,280.14
Payment holding account	1180.99	(17,075.15)	No details provided	(17,075.15)
Accrued leave	4121.1	89,021.62	91,934.12	(2,912.50)
TPUC short-term contract	2003.1	554,748.97	514,263.00	40,485.97
		$ 754,044.44	$ 728,265.98	$ 25,778.46

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 $25,778.46. There is no material effect on the financial statements, therefore, a passed adjustment has been made. 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 timely reconciliation was cited as finding in the prior year audits of PNCC for the years 2005 through 2011.

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.: 12-03, Continued
Area : Reconciliations

Auditee Response and Corrective Action Plan:

Schedules of regular reconciliation of accounts will be instituted and adhered to so regular timely reconciliations will be performed. Review and certification of reconciliation reports will be done by Accounting Manager and Chief Financial Officer.

Finding No.: 12-04
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:

At December 31, 2012, the overall debtor’s account of general trade receivable or ageing of debtors’ analysis report was not generated at the cut-off date on a timely manner. This significant report is use to support the general trade receivable and for the determination and evaluation of uncollectable accounts at December 31, 2012. The Debtors’ Ageing Report was actually run on January 14, 2013, which already included payments from January 1-14, 2013. Additionally, the required work back procedure and the determination of provision for uncollectable of $778,427 was not timely done and was not included in the general ledger at December 31, 2012 until an audit adjustments was proposed.

Cause:

PNCC has procured new billing system during the last quarter of 2012 replacing the old AVABILL system. The employees were not properly trained for the reporting features of the new system, as a result, caused delay in the closing and generating of required year-end reports.

Effect:

The untimely evaluation of delinquent accounts and determination of provision for uncollectable accounts contributed significantly the delay in the performance of the audit for 2012. 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:

Similar condition of untimely performance of evaluation of doubtful of collection accounts was cited in the 2009 and 2011 audits of PNCC.

Finding No.: 12-04, Continued
Area : Allowance for doubtful Accounts

Recommendation:

PNCC management should develop and implement internal control policies and procedures ensuring that year-end reports of general trade receivable and delinquent accounts report are generated in a timely manner. The determination of an allowance for uncollectible for financial reporting purposes and should be 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.

Auditee Response and Corrective Action Plan:

The Chief Financial Officer in consultation with Accounting Manager and Billing Manager will institute reconciliation and internal audit schedules to ensure regular timely reconciliations of all accounts in compliance with established policies and procedures. In addition, proper and timely evaluation of the collectability of accounts will be carried out to support management decisions on accounts receivable issues.

Finding No.: 12-05
Area : Reconciliations – Long distance revenue controls and unearned revenue from prepaid airtime

Criteria:

A written policy and procedures should exist to reconcile actual long distance minutes billed by international carrier amounts to the general ledger control accounts on a monthly and year-end basis. Recognition of revenues from international prepaid calling cards/airtime should only be recognized when actual minutes are used.

Condition:

Periodic reconciliations and evaluation are not performed for long distance revenue particularly for prepaid Debusch international calling card and GSM wireless airtime long distance minutes. 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 from minutes billed by International Carrier
Outbound minutes traffic for Philippines	1,584,080	$ 0.28		$ 443,542
Outbound minutes traffic for all other other countries	2,188,331	$ 0.35		765,916
Actual long distance outbound minutes billed by International carriers during the year ended December 31, 2012	3,772,411	Total		1,209,458
		International Carrier Settlement revenue,net		235,607
		Total long distance revenues		1,445,065
		Control Ledgers for long distance revenue, net		(1,069,251)
		Long distance revenue posted in the cellular operations		$ 375,814

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 also a deficiency in the system for determining unused minutes representing unearned revenue from sold GSM wireless prepaid airtime.

Finding No.: 12-05, Continued
Area : Reconciliations – Long distance revenue controls and unearned revenue from prepaid airtime

Effect:

As a result, the long distance messages revenue totals and cellular airtime revenues were misstated. An audit adjustment was made to correct the misstatement. However, the remaining cellular airtime revenue maybe still be overstated by the unused minutes representing unearned revenue and is not determined.

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 minutes from soft switch maybe not use as basis in determination and recording of actual long distance messages revenue, and actual airtime revenue based on actual usage.

Prior Year Status:

The lack of reconciliation of actual minutes billed by international carriers and actual minutes used for prepaid airtime to revenue control totals was reported as finding in the audit of PNCC for the years 2007 through 2011.

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. Recognition of revenues from international prepaid calling cards/airtime should only be recognized when actual minutes are used. Unearned revenues should be recognized from unused prepared debusch and airtime.

Auditee Response and Corrective Action Plan:

The Chief Financial Officer in consultation with Accounting Manager and Billing Manager will institute reconciliation and internal audit schedules to ensure regular timely reconciliation of all accounts in compliance with established policies and procedures.

Finding No.: 12-06
Area : Property and Equipment – Imputation of Interest

Criteria:

In accordance with paragraphs 5 through 22 and 173 through 187 of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* and FASB Accounting Standards Codification (ASC) Topic 835-30, interest should be imputted and capitalized on qualified assets for that portion of the interest cost incurred during the assets' acquisition periods that theoretically could have been avoided (for example, by avoiding additional borrowings or by using the resources expended for the assets to repay existing borrowings) if outlays for the assets had not been made.

Condition:

PNCC did not calculate the imputation of interest and record the liability at its present value incurred to reflect the future payments discounted at an imputed interest rate for the acquisition of the NICS software acquired on an installment payment basis. The amount initially recorded was $492,869 but the actual contract amount was $1,462,085. The initial payment was the down payment and the remaining balance is required to be paid over period of 60 months. The installment payments were being debited to the Main Frame computer account as paid. The difference before any adjustment for consideration of interest expense was $795,444 for the initial purchase and continuing assistance. Since the installment payments do not include interest, the amount should have been adjusted to include PNCC's incremental borrowing rate for the cost of the new software.

Cause:

PNCC accounting personnel were familiar with the method of recording capitalized equipment/service contracts to be paid over a several year period.

Effect:

Property and equipment and notes payable, are understated by a material amount. These accounts were corrected by an auditor adjustment.

Recommendation:

PNCC personnel responsible for Property and Equipment accounting should take a refresher course in Fixed Asset accounting. Management should scrutinize more closely unusual and nonrecurring transactions.

Auditee Response and Corrective Action Plan:

Management concurs with this finding. Staff and management will complete a refresher course in Fixed Asset Accounting by December 31, 2013. Year-end cut-off procedures will be developed and then performed prior to closing year-end financial statements. Management will immediately scrutinize unusual and nonrecurring transactions more closely.

Finding No.: 12-07
Area : Property and Equipment – Disposal

Criteria:

Accounting principles generally accepted in the United States of America and best practices recommends removing assets when they were no longer in service.

Condition:

During 2012, PNCC acquired a new General Ledger and Billing software systems. The old general ledger accounting and billing software systems were taken out of service effective November 1, 2012 but were not properly written-off and removed from the fixed asset subsidiary ledger and the general ledger. The total cost of the old computer system software was $1,263,450.90 with related accumulated depreciation of $664,671.90. The software should have been written off and removed and the PNCC should have recognized $598,779 as a loss on the disposal of fixed assets. Therefore, property, plant and equipment, accumulated depreciation and net income are overstated. A material auditor adjustment was made to the financial statements to correct the misstatement.

Cause:

PNCC accounting personnel were unfamiliar with the method of recording the removal and recognition of gain or loss on disposal of fixed assets.

Effect:

Property and equipment and accumulated depreciation are overstated and loss on disposal is understated by a material amount. These accounts were corrected by an auditor adjustment.

Recommendation:

PNCC personnel responsible for Property and Equipment accounting should exercise due care and scrutinize unusual and nonrecurring transactions. Year-end reconciliation procedures should be performed to ensure that general ledger account balances are properly reconciled to subsidiary ledgers or other supporting schedules. Accounting personnel should take a refresher course on fixed asset accounting.

Auditee Response and Corrective Action Plan**:**

Management concurs with this finding. Staff and management will complete a refresher course in Fixed Asset Accounting by December 31, 2013. Year-end cut-off procedures will be developed and then performed prior to closing year-end financial statements. Management will immediately scrutinize unusual and nonrecurring transactions more closely.

Finding No.: 12-08
Area : Prepaid Phone Cards

Criteria:

PNCC must establish physical controls to secure, safeguard and account for vulnerable assets such as prepaid phone cards which might be vulnerable to risk of loss, theft or unauthorized use.

Condition:

Under the previous AVA Bill system, accounting personnel would manually control the issuance and recording of sales by card number, agreeing receipts to prepaid phone cards sold and thereby determine if there were cards released for which no sales reported. The sale is recorded when the prepaid phone cards are released to the sales department. Several years ago, a material embezzlement occurred and the manual control system under the AVA Bill system was put in place to detect and prevent further embezzlement due to unreported sale proceeds that were kept by sales personnel and funds not transmitted to PNCC accounting.

The new system was to perform electronically what was previously accomplished manually beginning November 2012. However, the new system can only accommodate serial numbers up to the number 1000 and the prepaid card serial number exceeds that number. According to accounting personnel, the new billing system will “freeze” or “lock up” when too many numbers are issued. As a result, no accountability for the prepaid cards sold has occurred since November 2012.

Cause:

PNCC personnel placed reliance on the new system control when such controls were not properly functioning or did not exist.

Effect:

The potential for theft and fraud exist due the lack of internal control and no accountability. The amount is known for sales reported, but there no assurance that all sales for prepaid cards issued have been sold, reported and properly accounted for. Accounts receivable could be overstated. Cash flows could be negatively affected.

Finding No.: 12-08, Continued
Area : Prepaid Phone Cards

Recommendation:

Internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form.

Internal control serves as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. Internal control should be designed to provide reasonable assurance regarding prevention of or prompt detection of unauthorized acquisition, use, or disposition of an agency's assets.

PNCC must establish physical control to secure and safeguard prepaid phone cards. Examples include security; dual access and distribution of phone cards; periodic inventory of cards received, issued and verification of remaining inventory.

PNCC must should evaluate and strengthen existing internal control over the accountability of prepaid cards. An analysis should be conducted from November 2012 to current to ensure that all prepaid cards have been properly accounted for and only collectable amounts remain booked as receivables and that missing cards are identified and properly accounted for.

Auditee Response and Corrective Action Plan:

PNCC concurs with this finding. The new billing system was evaluated over a long-term period and a PNCC focus group of key staff made clear to the software provider its needs and process requirements. The system did not perform as intended. PNCC is working with the software provider to develop system generated controls over prepaid cards. A manual reconciliation will take place to bring the system and continue until the system can generate internal controls and generate audit reports to take place beginning July 2013.

Finding No.: 12-09
Area : Cash Accounts – Bank Reconciliations

Criteria:

Accounting principles generally accepted in the United States of America require that cash checking accounts be reconciled in a timely manner.

Condition:

The bank reconciliations were not completed in a timely manner. There were material differences between the system generated bank balance and the actual cash balance. Manual adjustments were made to adjust the bank reconciliation to the general ledger. After completing a manual reconciliation, it was determined that the cash accounts were overstated by over $50,000.

Cause:

Staff made errors on wrong screens when clearing checks that could not be reversed, overridden or any other way corrected in-house. Staff and management appear to have been overwhelmed implementing new systems and adjusting errors caused by inadequate training resulting in delayed bank reconciliation preparation. The software provider has not corrected the entries as of 5/9/13.

Effect:

Management might make decision based on erroneous and not up to day information that could have negative consequences. Account balances could be overstated or understated and not be detected in a timely manner. Fraud and other irregularities could exist and not be detected in a timely manner. No adjustment was required to the financial statements as a result of this finding.

Recommendation:

Bank reconciliations should be prepared each month in a timely manner. Although there were issues with inadequate training, not fully understanding how the bank reconciliation should be prepared and the actual physical reconciliation, the time between knowing there was an issue and requesting assistance from the software provider appears excessive. Management should ensure that bank reconciliations are completed and agreed to the general ledger at month-end and year-end closing. These procedures should be properly monitored for internal control over financial reporting.

Finding No.: 12-09, Continued
Area : Cash Accounts – Bank Reconciliations

Auditee Response and Corrective Action Plan:

PNCC agrees with the finding and is determined to maintain financial accuracy.

There was a learning curve in using the new system and input errors were made on the bank reconciliation module that could not be corrected by the software provider. PNCC has contacted the software provider and they are currently analyzing how to be correct the postings to the bank reconciliation module.

Time frame – currently being corrected by software provider.

Unresolved Prior Year Comments
Year Ended December 31, 2012

STATUS OF PRIOR YEAR FINDINGS

The status of unresolved prior year findings are disclose within the Schedule of Findings and Responses section of this report on pages 46 through 56.

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

MANAGEMENT LETTER

Year Ended December 31, 2012

J. Scott Magliari & COMPANY
CERTIFIED PUBLIC ACCOUNTANT

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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, 2012, and have issued my report thereon dated July 8, 2013. 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, 2012, 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 July 8, 2013, (pages 47 through 48) 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 July 8, 2013, (pages 47 through 48) 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 July 8, 2013) 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 July 8, 2013, 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, 2012, PNCC's cash balances were deposited in time certificates of deposit, savings and checking accounts. For the years ended December 31, 2012, 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 $525,650 at December 31, 2012, only $406,187 is 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.

All of PNCC's restricted cash and cash equivalent investments with market value of $3,661,576 as of December 31, 2012, 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.

At December 31, 2012, PNCC's list of investments placed at Morgan and Stanley Smith and Barney LLC, at fair value are as follows:

	Allocation		Market Value
2012	Actual	Per Policy	12/31/2012
U.S. Equities	49%	50%	$ 247,197
Fixed income	29%	30%	145,229
Cash deposits	12%	10%	57,974
Non U.S. Equities	10%	10%	49,600
	100%	100%	$ 500,000

At December 31, 2012, PNCC's fixed income securities had the following maturities and ratings:

	2012						
		Investment Maturities (In Years)				Rating	
Investment type	Fair Value	Less than 1	1-5	6-10	More than 10	Moody	Standard & Poor's
Government securities	$ 7,316	$ -	$ 7,316	$ -	$ -	AAA	No rating
Government securities	8,493	-	8,493	-	-	AAA	No rating
Government securities	8,936	-	8,936	-	-	AAA	No rating
Government securities	12,820	-	-	12,820	-	AAA	No rating
Government securities	4,044	-	-	4,044	-	AAA	No rating
Government securities	5,736	-	-	-	5,736	AAA	No rating
Government securities	4,105	-	-	-	4,105	AAA	No rating
Federal Agencies	11,676	-	11,676	-	-	AAA	AA+
Federal Agencies	13,546	-	13,546	-	-	AAA	AA+
Corporate bonds	4,278	-	4,278	-	-	A2	A
Corporate bonds	4,274	-	4,274	-	-	A-3	BBB+
Corporate bonds	5,004	-	-	5,004	-	BBA2	BBB-
Corporate bonds	4,996	-	-	4,996	-	A2-	A-
Corporate bonds	5,128	-	-	5,128	-	A1	AA
Corporate bonds	5,119	-	-	5,119	-	A3	A-
Corporate bonds	4,650	-	-	4,650	-	A3	A-
Corporate bonds	4,014	-	-	4,014	-	BAA3	BBB
Corporate bonds	4,311	-	-	4,311	-	A2	A+
Corporate bonds	4,338	-	-	4,338	-	BAA3	BBB-
Corporate bonds	5,090	-	-	5,090	-	BAA1	BBB
Corporate bonds	4,045	-	-	-	4,045	BAA2	BBB+
Corporate bonds	4,149	-	-	-	4,149	A2	A
Corporate bonds	4,227	-	-	-	4,227	A1	A
Corporate bonds	4,934	-	-	-	4,934	A1	AA+
	$ 145,229	$ -	$ 58,519	$ 59,514	$ 27,196		

- 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, 2012:

  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, 2012 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.

The results of my tests indicate that, with respect to the items tested; PNCC complied, except as noted below, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested, as well as exceptions noted, include the requirements that:

➢ The borrower has submitted Form 479 to RUS and the Form 479, Financial and Statistical Report for the year ended December 31, 2011 (most recent December 31 RUS Form 479) filed on March 30, 2012, represented by PNCC as having been submitted to RUS is in agreement with the PNCC's records prior to audited report issued in May 7, 2012. Auditors' adjustments in 2011 with net effect of $455,306 increased in net position was subsequently posted, in all material respects, appears reasonable based upon the audit procedures performed.

  Results of agreed amounts with respect to 2011 RUS 479 filed before audit issued date report are as follows:

	RUS Form 479 2011 Report Filed 3/30/12	2011 Audited Report issued 5/7/2012	Variance
Part A. Assets			
Line 1. Cash and equivalents	$ 1,072,564	$ 1,070,283	$ 2,281
Line 3a. Telecomm, accounts receivable	1,883,626	1,349,313	534,313
Line 6. Material regulated	292,874	202,083	90,791
Line 15. Other noncurrent assets	5,623,559	4,613,778	1,009,781
Line 18. Telecomm, plant in service	15,637,791	15,637,791	-
Line 20. Plant under construction-regulated	311,273	213,184	98,089
	$ 24,821,687	$23,086,432	$ 1,735,255

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS, Continued

Results of agreed amounts reported in RUS Form 479 to PNCC's audited report, continued:

	RUS Form 479 2011 Report Filed 3/30/12	2011 Audited Report issued 5/7/2012	Variance
Part A. Liabilites and stockholders' equity			
Line 27. Advance billings and payments	$ 375,336	$ 99,175	$ 276,161
Line 28. Customer deposits	569,173	569,193	(20)
Line 29. Current maturities L/T debt-	1,326,034	1,389,381	(63,347)
Line 34. Other current liabilities	793,394	573,350	220,044
Line 36. Funded debt long-term debt (RUS Note)	28,972,732	26,552,897	2,419,835
Line 45 Other long-term debt	-	1,572,724	(1,572,724)
Line 58. Total equity	(3,598,764)	(4,054,070)	455,306
	$ 28,437,905	$26,702,650	$ 1,735,255
Part B. Statements of Income and Retained Earnings			
Line 1. Local network service revenues	$ 1,310,957	$ 1,348,858	$ (37,901)
Line 3. Long distance network services	1,067,400	1,429,346	(361,946)
Line 5. Miscellaneous revenues	386,319	396,491	(10,172)
Line 6. Uncollectible revenues	-	(308,527)	308,527
Line 7. Net operating revenues	$ 2,764,676	$ 2,866,168	$ (101,492)
Line 8. Plant specific operation	$ 1,864,388	$ 1,955,180	$ 90,792
Line 24 Other expense (income)	$ 19,871	$ 19,874	$ (3)
Line 30. Nonregulated net income	$ 3,695,077	$ 3,229,071	$ 466,006
Line 31. Net income (loss) or margins	$ (326,704)	$ (782,007)	$ 455,303
Line 33. Retained earnings (deficit), beginning	$ (3,372,060)	$(3,372,063)	$ 3
Line 39. Retained earnings (deficit), end	$ (3,698,764)	$(4,154,070)	$ 455,306

COMMENTS ON OTHER ADDITIONAL MATTERS

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 FASB Accounting Standards Codification (ASC) 850 *Related Party Disclosures*, for the year ended December 31, 2009, in the financial statements referenced in the first paragraph of this report addressed at 7 CF,R 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, 2012, 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
July 8, 2013