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, 2013 and 2012

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

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December 31, 2013

J. Scott Magliari & COMPANY
CERTIFIED PUBLIC ACCOUNTANT

SAIPAN	GUAM	PALAU
Family Building, Suite 201	Reflection Center, Suite 207	PIDC Apartment No. 11
PMB 297 Box 10000	P.O. Box 12734	P.O. Box 1266
Saipan, MP 96950	Tamuning, GU 96931	Koror, PW 96940
Tel Nos. (670) 233-1837/0456	Tel Nos. (671) 472-2680/2687	Tel No. (680) 488-8615
Fax No. (670) 233-8214	Fax No. (671) 472-2686	Fax No. (680) 488-8616

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, 2013 and 2012, 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 accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free 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 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, 2013 and 2012, 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.

Other 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, I have also issued a report dated June 18, 2014, on my consideration of PNCC's internal control over financial reporting and my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of my audit.

J. Scott Magliari & Company

Koror, Republic of Palau
June 18, 2014

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, 2013 with comparisons to prior years ended December 31, 2012 and 2011. We encourage readers to consider the information presented here in conjunction with the financial statements and related notes which follows this section.

BUSINESS OVERVIEW

Our Services

PNCC is a full-service telecommunications provider that offers nationwide coverage for all services, including Local and Long Distance Telephone, GSM Mobile, Internet, and Digital TV. The 5-year subscriber trend shows PalauNet (Internet) is clearly the most popular service with an increase of 70% since 2009, followed by GSM mobile which grew by 41%.

The growth in PalauNet subscriptions was mainly due to the increase in HomeNet sign-ups. Internet revenue continues to grow with more customers using HomeNet and prepaid Internet access to Wi-Fi Hotspots.

PNCC's build-up of GSM coverage and system capacity over the past few years has accelerated usage of mobile telephone services.

Five Year Growth Trend
2009 - 2013

	Subscriptions					Growth (2009 v. 2013)	
Year End December 31	2009	2010	2011	2012	2013	#	%
GSM Mobile	**12,744**	**14,512**	**15,445**	**17,151**	**17,945**	5,201	41%
Postpaid	836	987	1,095	1,405	1,509	673	81%
Prepaid	11,908	13,525	14,350	15,746	16,436	4,528	38%
Fixed Line (Telephone)	**7,059**	**6,976**	**6,916**	**7,299**	**7,263**	204	3%
Business/Government	2,779	2,796	2,800	3,162	3,166	387	14%
Residential	4,280	4,180	4,116	4,137	4,097	(183)	-4%
PalauNet (Internet)	**1,086**	**1,087**	**1,297**	**1,709**	**1,844**	758	70%
Dialup	921	827	754	781	729	(192)	-21%
DSL	139	192	220	269	310	171	123%
Web Package	2	1	2	4	3	1	50%
Domestic Leased Line	19	19	22	26	26	7	37%
Intl Private Line	2	1	1	-	-	(2)	-100%
Wi-Fi Hotspots	3	47	72	93	116	113	100%
HomeNet	-	-	226	536	660	660	100%
Digital TV	**3,321**	**3,500**	**3,587**	**3,653**	**3,973**	652	20%
Single Dwelling	2,565	2,704	2,779	2,719	3,028	463	18%
Multi Units	756	796	808	934	945	189	25%

FINANCIAL HIGHLIGHTS

- PNCC's total assets decreased from $25.5 million in 2012 to $23.8 million in 2013, a decrease of $1.7 million or 7% primarily due to the decrease in current assets attributed by the decreased in international carrier settlement receivable.

- PNCC's total liabilities decreased from $30.5 million in 2012 to $28.9 million in 2013, a net decrease of $1.6 million or 5%. The net change was due to decreases in long-term debt.

- Net position increased from a negative $5.1 million in 2012 to $5.2 million in 2013.

- Operating revenues increased by $563,016 or 5% from $9.9 million in 2012 to $10.4 million in 2013. The Palaunet revenues contributed to the current year increase in revenues.

- Operating expenses increased mainly from plant specific operations by $353,412 or 10% over prior year due to the costs incurred related to the damages of Supertyphoon Haiyan that impacted Palau in November 2013. Management has maintained same level of expenditures other than the change in plant specific operation, and the decreased in depreciation expense.

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 does not have *Deferred Outflows of Resources, Deferred Inflows of Resources* for the years ended December 31, 2013 and 2012. Over time, increases or decreases in net position may serve as a useful 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 the PNCC's net position 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

Notes to the Financial Statements

Various notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements and are found immediately following the financial statements to which they refer.

CONDENSED FINANCIAL INFORMATION

Statements of Net Position

	2013	2012	Increase (Decrease)		2011
ASSETS					
Current assets	$ 1,661,658	$ 2,180,934	$ (519,276)	-23.8%	$ 2,796,455
Investments	592,534	500,000	92,534	18.5%	-
Restricted cash and cash equivalent	3,854,182	3,661,576	192,606	5.3%	3,853,481
Other noncurrent assets	51,550	51,550	-	0.0%	51,550
Capital assets, net	17,591,664	19,078,062	(1,486,398)	-7.8%	20,101,930
TOTAL ASSETS	$ 23,751,588	$ 25,472,122	$ (1,720,534)	-6.8%	$ 26,803,416
LIABILITIES AND NET POSITION					
Current liabilities	$ 3,255,111	$ 3,409,460	$ (154,349)	-4.5%	$ 2,731,865
Note payable, net of current portio	25,690,244	27,131,154	(1,440,910)	-5.3%	28,125,621
Total liabilities	28,945,355	30,540,614	(1,595,259)	-5.2%	30,857,486
NET POSITION					
Net investment in capital assets	(9,751,656)	(9,625,569)	(126,087)	1.3%	(9,413,072)
Restricted for:	3,854,182	3,661,576	192,606	5.3%	3,853,481
Debt service and reserve					
Unrestricted	703,707	895,501	(191,794)	-21.4%	1,505,521
Total net position	$ (5,193,767)	$ (5,068,492)	$ (125,275)	2.5%	$ (4,054,070)

During 2013, total assets decreased by $1,720,534, and total liabilities decreased by $1,595,259 as compared to 2012. Significant changes in account balances were:

- Current assets decreased by $519,276 compared to prior year due mainly to decrease in international carrier settlement receivable in 2013.
- Capital assets decreased by $1,486,398 due to current year depreciation expense net of current year additions.
- Long-term debt decreased by $1,440,910, primarily due to payments of principal.

Negative net position increased by $125,275 as compared to 2012. This was the result of a continuing losses incurred in 2013 in which total expenses exceeded total operating revenues by $125,275.

OVERVIEW OF THE FINANCIAL STATEMENTS, CONTINUED

CONDENSED FINACIAL INFORMATION, CONTINUED

Statements of Revenues, Expenses and Changes in Net Position

	2013	2012	Increase (Decrease)		2011
Operating revenues	$ 10,437,496	$ 9,874,480	$ 563,016	5.7%	$ 9,816,815
Operating expenses	(9,081,698)	(8,996,721)	(84,977)	0.9%	(9,231,608)
Earnings from operations	1,355,798	877,759	478,039	54.5%	585,207
Nonoperating income (expenses), net	(1,481,073)	(1,892,181)	411,108	-21.7%	(1,367,214)
Change in net position	$ (125,275)	$ (1,014,422)	$ 889,147	-87.7%	$ (782,007)

Operating revenues increased by $563,016 or 6% from $9.9 million in 2012 to $10.4 million in 2013. An increase in revenues is primarily attributable to the increase in Palaunet operations.

Operating expenses slightly increased by $84,997 or .9% in 2013. The explanation of changes in operating revenues, expenses and non-operating income and expenses are discussed in more details in the following sections.

REVENUE BY SOURCE AND EXPLANATION OF CHANGES

	2013	2012	Increase (Decrease)		2011
Cellular	$ 3,906,624	$ 3,939,731	$ (33,107)	-0.8%	$ 3,359,520
Long distance	1,380,808	1,445,065	(64,257)	-4.4%	1,429,346
Palaunet	2,412,483	2,224,011	188,472	8.5%	2,077,983
Local	1,524,516	1,449,268	75,248	5.2%	1,499,031
Digital television	1,424,674	1,352,538	72,136	5.3%	1,362,971
Miscellaneous	63,314	242,294	(178,980)	-73.9%	396,491
Provision for doubtful accounts	(274,923)	(778,427)	503,504	-64.7%	(308,527)
	$ 10,437,496	$ 9,874,480	$ 563,016	5.7%	$ 9,816,815

<u>PalauCel</u>: Cellular operation has consistently contributed the highest source of revenue. Although there was a slight decline in 2013 due to some cellular cites damaged by Supertyhoon Haiyan in November 2013 particularly in Kayangel island of the Republic of Palau, the brisk demand for the Pre-paid services is expected to continue.

<u>Telephony:</u> Local and miscellaneous revenues combined, decreased by 6% due to the demand shrinkage for long-distance calls via Fixed-line. Miscellaneous charges declined significantly as telephony systems were down as a result of two supertyphoons that struck Palau, December 2012 (Bopha) and in November 2013 (Haiyan) resulting in no disconnection charges.

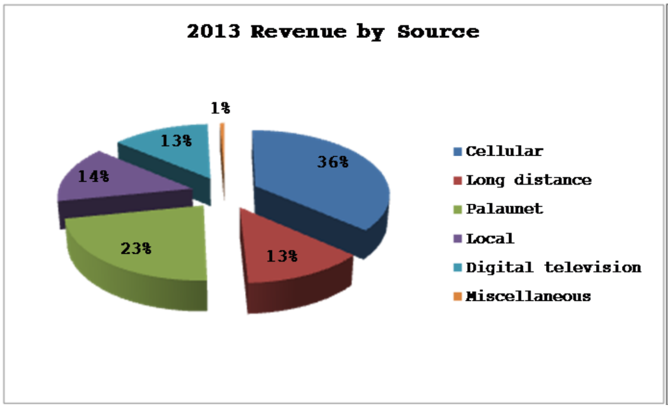
OVERVIEW OF THE FINANCIAL STATEMENTS, CONTINUED

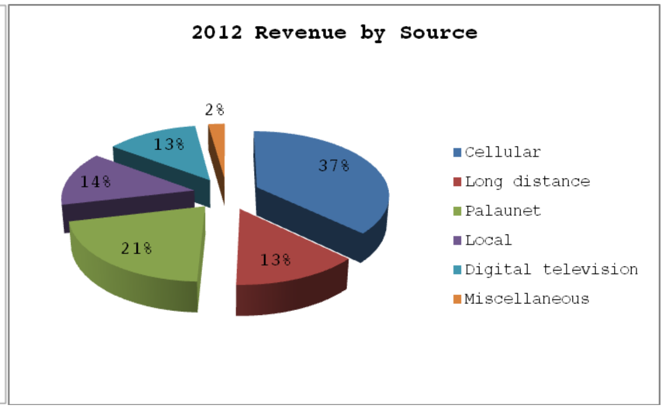
REVENUE BY SOURCE AND EXPLANATION OF CHANGES

PalauNet: Revenues continued to increase steadily (by 9% vs. 2012), reflected by the demand increases for DSL and Wi-Fi Hotspots.

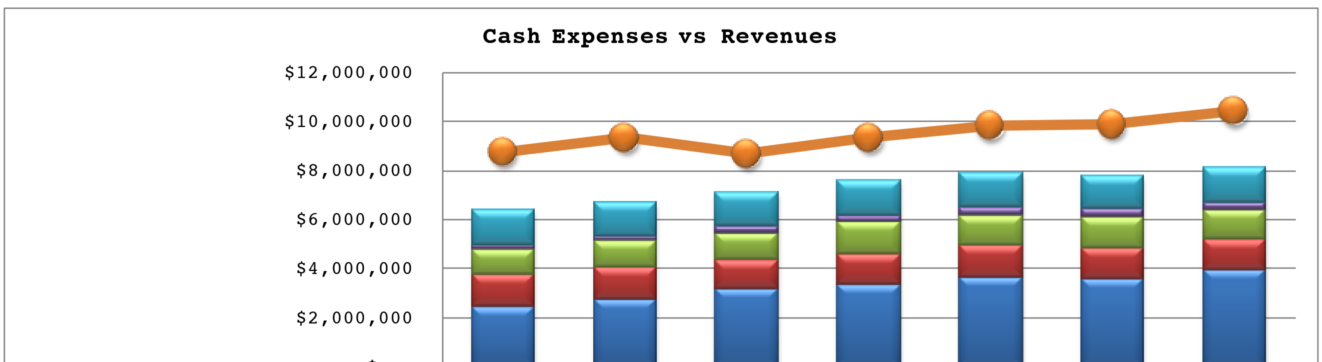
DTV: An 11% increase in residential subscribers contributed increased by $72,136 over prior year or 5% in 2013.

CHART OF 2013 AND 2012 REVENUE TRENDS





Summarized in the chart above are the major revenue sources of PNCC. For 2013, the cellular operations contributed 36% of PNCC's total operating revenues, and 37% in 2012.



	$2,007	$2,008	2009	2010	2011	2012	2013
Interest expense	$1,457,127	$1,417,812	$1,372,457	$1,426,595	$1,387,088	$1,328,295.	$1,420,094
Plant non-specific operations	$166,846	$164,361	$283,241	$271,569	$317,894	$345,371.00	$305,370
Customer service operations	$1,020,600	$1,111,450	$1,104,802	$1,299,026	$1,241,342	$1,279,855.	$1,216,396
Corporate operations	$1,323,992	$1,273,561	$1,154,319	$1,225,889	$1,293,130	$1,244,004.	$1,250,275
Plant specific operations	$2,414,761	$2,756,417	$3,177,532	$3,360,920	$3,645,761	$3,584,420.	$3,937,832
Revenues, net of provision for bad debts	$8,776,138	$9,337,643	$8,690,478	$9,354,886	$9,816,815	$9,874,480.	$10,437,496

OVERVIEW OF THE FINANCIAL STATEMENTS, CONTINUED

REVENUE BY SOURCE AND EXPLANATION OF CHANGES

CHART OF REVENUE TREND

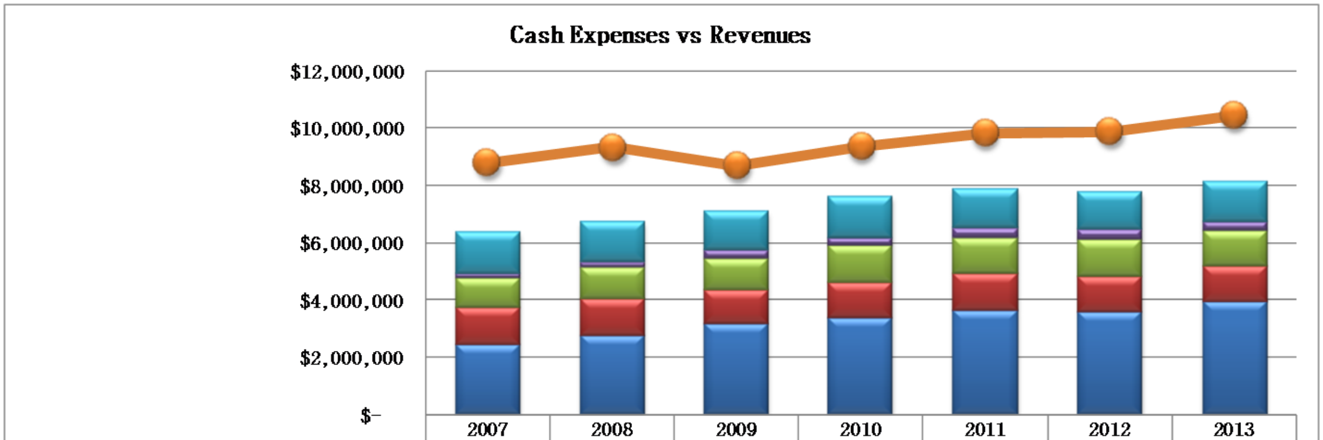
The chart above shows the change in revenues by source over the past seven years. PNCC's cellular operation has consistently contributed the highest source of revenue and continues to grow. PNCC have seen the declining long distance revenues as its internet operation improves. The revenues from local telecommunications and digital television have been fairly consistent over the past seven years. Miscellaneous revenues significantly declined over prior year due to damage of Supertyphoons Bopha in December 2012 and Haiyan in November 2013 which caused phone systems shutdown resulting in no disconnections charges.

EXPENSES BY FUNCTION

	2013	2012	Increase (Decrease)		2011
Operating Expenses					
Plant specific operations	$ 3,937,832	$ 3,584,420	$ 353,412	9.9%	$ 3,645,761
Depreciation	2,371,825	2,543,071	(171,246)	-6.7%	2,733,481
Customer service operations	1,250,275	1,279,855	(29,580)	-2.3%	1,241,342
Corporate operations	1,216,396	1,244,004	(27,608)	-2.2%	1,293,130
Plant non-specific operations	305,370	345,371	(40,001)	-11.6%	317,894
Total operating expenses	9,081,698	8,996,721	84,977	0.9%	9,231,608
Interest expense	1,420,094	1,328,295	91,799	6.9%	1,387,088
	$ 10,501,792	$ 10,325,016	$ 176,776	1.7%	$ 10,618,696

There has been no significant change in PNCC's operating expenses in 2013 compared to 2012, except for depreciation expense which decreased by 7% over 2013 due to certain capital assets that were fully depreciated in prior years. PNCC makes its best effort to control spending and maintain its expenses within budget. See page 47 for the Supplementary Schedule for the Budget versus Actual for the year ended December 31, 2013.

OVERVIEW OF THE FINANCIAL STATEMENTS, CONTINUED
CHART OF CASH EXPENSES OVER REVENUES



	2007	2008	2009	2010	2011	2012	2013
Interest expense	$1,457,127	$1,417,812	$1,372,457	$1,426,595	$1,387,088	$1,328,295	$1,420,094
Plant non-specific operations	$166,846	$164,361	$283,241	$271,569	$317,894	$345,371	$305,370
Customer service operations	$1,020,600	$1,111,450	$1,104,802	$1,299,026	$1,241,342	$1,279,855	$1,216,396
Corporate operations	$1,323,992	$1,273,561	$1,154,319	$1,225,889	$1,293,130	$1,244,004	$1,250,275
Plant specific operations	$2,414,761	$2,756,417	$3,177,532	$3,360,920	$3,645,761	$3,584,420	$3,937,832
Revenues, net of provision for bad debts	$8,776,138	$9,337,643	$8,690,478	$9,354,886	$9,816,815	$9,874,480	$10,437,496

The chart above shows the increase in cash expended over the past seven years compared to the growth of revenues over the same period. Revenues increased at a slightly higher rate than the increase in expenses. 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				Variance Favorable
	Original	Revisions	Final	Actual	(Unfavorable)
Operating revenues:					
Cellular	$ 4,109,233	$ (13,000.00)	$ 4,096,233	$ 3,906,624	$ (189,609)
Palaunet	2,196,988	-	2,196,988	2,412,483	215,495
Local	1,538,698	-	1,538,698	1,524,516	(14,182)
Digital television	1,410,091	-	1,410,091	1,424,674	14,583
Long distance	969,850	-	969,850	1,380,808	410,958
Miscellaneous	286,915	-	286,915	63,314	(223,601)
Provision for doubtful accounts	-	-	-	(274,923)	(274,923)
Total operating revenues	10,511,775	(13,000)	10,498,775	10,437,496	(61,279)
Operating expenses:					
Depreciation	2,669,229	-	2,669,229	2,371,825	297,404
Plant specific operations	3,062,156	-	3,062,156	3,937,832	(875,676)
Corporate operations	1,873,329	-	1,873,329	1,250,275	623,054
Customer service operations	1,028,749	-	1,028,749	1,216,396	(187,647)
Plant non-specific operations	371,887	-	371,887	305,370	66,517
Total operating expenses	9,005,350	-	9,005,350	9,081,698	(76,348)
Operating income (loss)	1,506,425	(13,000)	1,493,425	1,355,798	(137,627)
Nonoperating income (expenses):					
Interest expense	(1,259,668)	-	(1,259,668)	(1,420,094)	(160,426)
Interest income	4,000	-	4,000	8,732	4,732
Other expenses, net	(46,699)	-	(46,699)	(69,711)	(23,012)
Total nonoperating expenses, net	(1,302,367)	-	(1,302,367)	(1,481,073)	(178,706)
Change in net position	$ 204,058	$ (13,000)	$ 191,058	$ (125,275)	$ (316,333)

The PNCC's unfavorable variances in revenues and expenses mainly contributed by the impact of Supertyphoon Haiyan in 2013 and the operations of PNCC. Additionally, 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 over prior year, overall PNCC was able to maintain its operating expenses within the 2013 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

	2013	2012	2011
Property, plant and equipment at cost	$ 62,886,910	$ 62,079,111	$ 61,268,023
Accumulated depreciation	(45,295,246)	(43,001,049)	(41,166,093)
Net book value	17,591,664	19,078,062	20,101,930
Carrying value of long term-debt	(27,343,320)	(28,703,631)	(29,515,002)
Net investment in capital assets	$ (9,751,656)	$ (9,625,569)	$ (9,413,072)
Depreciation expense	$ 2,371,825	$ 2,543,071	$ 2,733,481
Net repayment of loan principal	$ 1,360,311	$ 1,474,797	$ 1,208,884

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.

SUMMARY OF STRATEGIC PLANNING AND FINANCIAL RESULTS

PNCC STRATEGIC PLANNING PROCESS

In order to improve plans for financial sustainability and long-term growth prospects, in 2012 PNCC submitted a request through the Republic of Palau Ministry of State to the Japan International Cooperation Agency (JICA), for a business strategy advisor. In January 2013, PNCC welcomed Mr. Akira Maeda, a Senior JICA Volunteer, as Senior Business Advisor.

The Senior Business Advisor is responsible for advising PNCC management on its product planning and development strategies in coordination with all PNCC departments, to support corporate goals for revenue growth, profitability and overall efficiency.

PNCC's new 5-year Mid-Term Business Plan (2014-2018), including several corporate improvement projects, was developed with the expert assistance of Mr. Maeda based on many meetings during 2013 with the PNCC employees, management team and Board of Directors. The Business Plan was approved by the Board on September 5, 2013. The plan's purpose is to accelerate sustainable growth and create a world-class telecom environment for the nation of Palau.

The approval of the Mid-Term Business Plan demonstrated the Board of Directors' commitment to leading, supporting, and stabilizing PNCC through the necessary changes required in how the corporation is managed and operated, for PNCC to survive in today's fast-changing and competitive market environment and better serve Palau.

OVERALL FINANCIAL ACHIEVEMENTS

Revenue Increase. Over the period of 2008 to 2012, the corporate revenue increased at a compounded annual growth rate (CAGR) of 1.4%, which outnumbers the growth rate of Palau's GDP (-0.1%) for the same period. PNCC's key strategy—infrastructure upgrading—stimulated the demand increase in Palau's telecommunications market. In 2013, corporate revenue increased by 6%.

Repayment of loan from the U.S. Rural Utilities Service (RUS). In 1992, PNCC signed a loan agreement with the U.S. Rural Utilities Service (USDA/RUS) in the amount of $39,143,000, for 35 years @ 4.59% interest, with monthly payment of $192,181. PNCC has been repaying the RUS debt on its own. The amount of yearly repayment ($2.3 million) accounts for the majority of PNCC non-operating expense. PNCC must continue the repayment until 2029. This repayment contributes to the augmentation of Palau's credibility among the global funding organizations.

Net Income/Loss. PNCC has been unable to generate net income in the past. The Universal Service Obligation (providing telecommunications services at a loss in rural areas with no subsidy) and repayment of the RUS debt have been negatively influencing the PNCC's financial position.

Financial Achievements by Product Line. Although PNCC has been generating healthy profits from Internet and Cellular (PalauCel) services, it has been unable to create such profits from Telephony and DTV. Triggered by a tariff reduction for DSL, the pace of revenue increase for Internet services has been accelerated to a CAGR of 9.2% since 2008, and generates a healthy net operating income – 38% of its revenue in 2012; and 37% of revenue in 2013. Subscriptions increased by 70% from 2009 to 2013.

PalauCel has been the single largest contributor to the corporate net operating income – $3,906,624 in 2013, and $3,939,731 in 2012. Over the period of 2008 to 2012, the revenue of PalauCel increased at CAGR of 9.4%, in parallel with the demand increase for PalauCel Prepaid services. From 2009 to 2013, subscribers grew by 41%. In contrast, over the past five years the revenue of Telephony has decreased at a CAGR of -10.7% in parallel with the decrease in demand for long-distance calls via Telephony. Digital TV revenue increased at a CAGR of 0.8% over the past five years; however, its operating expense has been increasing faster than the revenue, at a CAGR of 5.7% (primarily due to the rising cost of TV programming content), generating deficits since 2011.

Universal Service Obligation (USO) – Expansion of Rural Broadband. During 2012 to 2013, PNCC took major strides to expand access to high-speed internet in rural areas of Palau, as part of its USO for providing nationwide telecommunications coverage. Since infrastructure investment in low-populated, remote areas is not cost-effective, PNCC applied for and received external grant funding from the Asia-Pacific Telecommunity (APT) and the Pacific Telecommunications Council (PTC). Working in partnership with the Japan Telecommunications and Engineering Consultants (JTEC), PNCC established Palau's first-ever rural Telecenter with local partners PCC and Ngeremlengui State (APT). The PTC project installed high-speed access at Ngarchelong Elementary with technical assistance from U.S.-based Inveneo. By year-end 2013, high-speed prepaid DSL was available through HomeNet and WiFi Hotspots in most rural states of Palau.

OVERALL FINANCIAL ACHIEVEMENTS, CONTINUED

Mid-Term Business Plan

PNCC believes that it can accomplish the following objectives for the coming five years by addressing the issues clarified in the past (especially, the Universal Service Obligation) and taking advantage of major growth opportunities that exist in Palau.

The Five-year Corporate Objectives are: Accelerate sustainable growth and optimize self-financing capabilities in order to create world-class telecommunications environment for the nation of Palau; and Create an organization where each individual works inspired, motivated, and aligned as one force for best-serving customers.

PNCC will take a full-pledged, all-corporation approach to capitalize on the primary growth engines, notably PalauCel and DSL (Internet). The new business strategy for PNCC encompasses Financial Goals, Customer Relationship Goals, Human Resources Goals, and Process Improvement Goals.

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 2013 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.

CAPITAL ASSETS AND RELATED LONG TERM DEBT

	2013	2012	2011
Property, plant and equipment at cost	$ 62,886,910	$ 62,079,111	$ 61,268,023
Accumulated depreciation	(45,295,246)	(43,001,049)	(41,166,093)
Net book value	17,591,664	19,078,062	20,101,930
Carrying value of long term-debt	(27,343,320)	(28,703,631)	(29,515,002)
Net investment in capital assets	$ (9,751,656)	$ (9,625,569)	$ (9,413,072)
Depreciation expense	$ 2,371,825	$ 2,543,071	$ 2,733,481
Net repayment of loan principal	$ 1,360,311	$ 1,474,797	$ 1,208,884

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.

SUMMARY OF STRATEGIC PLANNING AND FINANCIAL RESULTS

PNCC STRATEGIC PLANNING PROCESS

In order to improve plans for financial sustainability and long-term growth prospects, in 2012 PNCC submitted a request through the Republic of Palau Ministry of State to the Japan International Cooperation Agency (JICA), for a business strategy advisor. In January 2013, PNCC welcomed Mr. Akira Maeda, a Senior JICA Volunteer, as Senior Business Advisor.

The Senior Business Advisor is responsible for advising PNCC management on its product planning and development strategies in coordination with all PNCC departments, to support corporate goals for revenue growth, profitability and overall efficiency.

PNCC's new 5-year Mid-Term Business Plan (2014-2018), including several corporate improvement projects, was developed with the expert assistance of Mr. Maeda based on many meetings during 2013 with the PNCC employees, management team and Board of Directors. The Business Plan was approved by the Board on September 5, 2013. The plan's purpose is to accelerate sustainable growth and create a world-class telecom environment for the nation of Palau.

The approval of the Mid-Term Business Plan demonstrated the Board of Directors' commitment to leading, supporting, and stabilizing PNCC through the necessary changes required in how the corporation is managed and operated, for PNCC to survive in today's fast-changing and competitive market environment and better serve Palau.

OVERALL FINANCIAL ACHIEVEMENTS

Revenue Increase. Over the period of 2008 to 2012, the corporate revenue increased at a compounded annual growth rate (CAGR) of 1.4%, which outnumbers the growth rate of Palau's GDP (-0.1%) for the same period. PNCC's key strategy—infrastructure upgrading—stimulated the demand increase in Palau's telecommunications market. In 2013, corporate revenue increased by 6%.

Repayment of loan from the U.S. Rural Utilities Service (RUS). In 1992, PNCC signed a loan agreement with the U.S. Rural Utilities Service (USDA/RUS) in the amount of $39,143,000, for 35 years @ 4.59% interest, with monthly payment of $192,181. PNCC has been repaying the RUS debt on its own. The amount of yearly repayment ($2.3 million) accounts for the majority of PNCC non-operating expense. PNCC must continue the repayment until 2029. This repayment contributes to the augmentation of Palau's credibility among the global funding organizations.

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

FINANCIAL SECTION

For The Years Ended December 31, 2013 and 2012

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

Statements of Net Position
December 31, 2013 and 2012

ASSETS

	2013	2012
Current assets:		
Cash (Notes 2, 3, 6 and 8)	$ 449,356	$ 442,762
Receivables: (Notes 2, 6 and 8)		
Trade	4,404,722	4,257,564
Related party (Note 5)	412,226	376,421
Carrier, net	285,304	800,351
Other receivable	104,386	133,146
Allowance for doubtful accounts (Note 2)	(4,214,265)	(4,083,262)
Total receivables, net	992,373	1,484,220
Inventories, net (Notes 2 and 6)	164,472	183,068
Prepaid expenses	55,457	70,884
Total current assets	1,661,658	2,180,934
Investments (Notes 2 and 3)	592,534	500,000
Restricted cash and cash equivalents (Notes 2, 3, 6 and 8)	3,854,182	3,661,576
Other noncurrent assets (Note 2)	51,550	51,550
Capital assets, net (Notes 2, 4, 6)	17,591,664	19,078,062
	$ 23,751,588	$ 25,472,122

LIABILITIES AND NET POSITION

	2013	2012
Current liabilities:		
Accounts payable (Note 8)	$ 195,944	$ 78,626
Payable to carriers, net (Note 8)	69,967	349,097
Accrued expenses (Notes 2 and 8)	520,828	606,078
Unearned revenues (Notes 2 and 8)	107,620	130,049
Customer deposits (Notes 2 and 8)	707,676	673,133
Current portion of long-term debt (Notes 6 and 8)	1,653,076	1,572,477
Total current liabilities	3,255,111	3,409,460
Note payable, net of current portion (Notes 6 and 8)	25,690,244	27,131,154
Total liabilities	28,945,355	30,540,614
Commitments and contingencies (Note 7)		
Net position (Note 2):		
Net investment in capital assets	(9,751,656)	(9,625,569)
Restricted for:		
Debt service and reserve	3,854,182	3,661,576
Unrestricted	703,707	895,501
Total net position	(5,193,767)	(5,068,492)
	$ 23,751,588	$ 25,472,122

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, 2013 and 2012

	2013	2012
Operating revenues (Note 6):		
Cellular	$ 3,906,624	$ 3,939,731
Palaunet	2,412,483	2,224,011
Local	1,524,516	1,449,268
Long distance	1,380,808	1,445,065
Digital television	1,424,674	1,352,538
Miscellaneous	63,314	242,294
Provision for doubtful accounts	(274,923)	(778,427)
Total operating revenues	10,437,496	9,874,480
Operating expenses:		
Plant specific		
Operations	3,937,832	3,584,420
Depreciation (Note 4)	2,371,825	2,543,071
Corporate office	1,250,275	1,244,004
Customer service	1,216,396	1,279,855
Plant non-specific operations	305,370	345,371
Total operating expenses	9,081,698	8,996,721
Operating income	1,355,798	877,759
Nonoperating income (expense):		
Unrealized gain on investments	88,097	-
Realized gain on investments	9,411	-
Interest income	8,732	12,312
Loss on investments	(4,974)	-
Loss on retirement of equipment	(33,450)	(598,780)
Other income (expense), net	(128,795)	22,582
Interest expense (Note 6)	(1,420,094)	(1,328,295)
Total nonoperating income (expense), net	(1,481,073)	(1,892,181)
Change in net position	(125,275)	(1,014,422)
Net position at beginning of year	(5,068,492)	(4,054,070)
Net position at end of year	$ (5,193,767)	$ (5,068,492)

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, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Cash received from customers	$ 10,944,420	$ 10,113,181
Cash payments to suppliers for goods and services	(5,543,054)	(4,490,695)
Cash payments to employees	(1,511,616)	(1,696,575)
Net cash provided by operating activities	3,889,750	3,925,911
Cash flows from capital and related financing activities:		
Additions to capital assets	(918,877)	(2,117,983)
Withdrawals from restricted cash and cash equivalents	(192,606)	191,905
Interest paid	(1,420,094)	(1,328,295)
Additions to long-term note payable	-	663,423
Repayment of long-term note payable	(1,360,311)	(1,474,794)
Net cash used for capital and related financing activities	(3,891,888)	(4,065,744)
Cash flows from investing activities:		
Interest income	8,732	12,312
Proceeds from sale and maturities of investment securities	221,484	-
Investment loss	(4,974)	-
Purchse of investment securities	(216,510)	(500,000)
Redemption in time certificate of deposits	-	628,899
Net cash provided by investing activities	8,732	141,211
Net increase in cash	6,594	1,378
Cash at beginning of year	442,762	441,384
Cash at end of year	$ 449,356	$ 442,762

See accompanying notes to financial statements.

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

Statements of Cash Flows, Continued
For The Years Ended December 31, 2013 and 2012

	2013	2012
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 1,355,798	$ 877,759
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,371,825	2,543,071
Provision for doubtful accounts	274,923	778,427
Allowance for uncollectible account write-off	(143,920)	(198,806)
Other income (expense), net	(128,795)	22,582
(Increase) decrease in assets:		
Receivables:		
Trade	(147,158)	(166,863)
Related party	(35,805)	(43,670)
Carriers, net	515,047	(370,849)
Other receivable	28,760	(37,509)
Inventories	18,596	19,015
Prepaid expenses	15,427	8,255
Increase (decrease) in liabilities:		
Accounts payable	117,318	18,826
Payable to carriers, net	(279,130)	249,922
Accrued expenses	(85,250)	32,728
Customer deposits	34,543	103,940
Unearned revenues	(22,429)	89,083
Net cash provided by operating activities	$ 3,889,750	$ 3,925,911

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. 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. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position,* required the PNCC to establish net position categories as follows:

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, 2013 and 2012, PNCC does not have deferred outflows of resources, and deferred inflows of resources that needed be included in this component of net position.

Restricted:

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, 2013 and 2012, PNCC does not have 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. At December 31, 2013 and 2012, PNCC does not have nonexpendable net position.

Expendable: Net position whose use by PNCC is subject to externally imposed stipulations that can be fulfilled by actions of the 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 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, 2013 and 2012, PNCC does not have 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 14 includes PNCC's analysis of the significant variations and major factors impacting the 2013 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

During the year ended December 31, 2013, PNCC implemented the following GASB Statements:

In April 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources or deferred inflows of resources to ensure consistency in financial reporting. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012. The provisions of Statement 63 did not have a material effect on the accompanying financial statements of PNCC.

In April 2012, GASB issued Statement No. 66, *Technical Corrections—2012*—which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this Statement are effective for periods beginning after December 15, 2012. Management does not believe that the implementation of this statement will have a material effect on the financial statements of PNCC.

Recent Pronouncements

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans,* which revises existing guidance for the financial report of most pension plans, and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions,* which establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement No. 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement No. 68 are effective for fiscal years beginning after June 15, 2014. Management does not believe that the implementation of these statements will have a material effect on the financial statements of PNCC.

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*. The Statement establishes accounting and financial reporting standards related to government combinations and disposals of government operations. Government combinations include mergers, acquisitions and transfers of operations. The Statement requires assets acquired and liabilities assumed to be measured at carrying values in an acquisition. The Statement requires disclosures to be made about government combinations and disposals of government operations so that financial statement users can evaluate the nature and financial effects of those combinations.

(2) Summary of Significant Accounting Policies, Continued

E. New Accounting Standards, Continued

Recent Pronouncements, Continued

GASB issued Statement No. 69, Continued

The Statement is effective for financial statements for periods beginning after December 15, 2013 and should be applied on a prospective basis. Early application is encouraged. Management has not yet determined the effect of implementation of these Statements on the financial statements of PNCC.

In April 2013, GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The provisions in this Statement are effective for fiscal years beginning after June 15, 2013. Earlier application is encouraged.

F. Assets, Liabilities and Net Position

Cash

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

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.

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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Receivables and Allowance for Doubtful Accounts, Continued

An analysis of the Change in allowance for doubtful accounts for the year ended December 31, 2013 and 2012 is as follows:

	2013	2012
Balance, beginning of year	$ 4,083,262	$ 3,503,641
Current year provisions	274,923	778,427
Writte-off	(143,920)	(198,806)
Balance, end of year	$ 4,214,265	$ 4,083,262

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, 2013 and 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, 2013 and 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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Investments, Continued

- 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.

- 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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Investments, Continued

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.

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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Capital Assets

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

Depreciation expense for all capital assets 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 Capital Assets for Impairment

PNCC reviews the carrying value of capital assets 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, 2013 and 2012.

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.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

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, 2013 and 2012, refundable deposit was $51,550 in each year.

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, 2013 and 2012, accrued annual leave totaled $63,350 and $89,022, respectively, and is reported in the Statements of Net Position as a component of accrued expenses. At December 31, 2013 and 2012, all compensated absences are current.

For the years ended December 31, 2013 and 2012, annual vacation leave taken totaled $124,218 and $97,558, 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, 2013 and 2012, unearned revenues from prepaid telecom billings was $107,620 and $130,049, respectively. Management has not determined the unearned revenue from prepaid long distance sales.

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, 2013 and 2012, customer deposits were $707,676 and $673,133, respectively.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

Advertising Costs

Advertising costs are expensed as incurred. At December 31, 2013 and 2012, advertising costs totaled $26,418 and $29,831, respectively, and is included as a component of customer operations expense reported in the Statements of Revenues, Expenses and Changes in Net Position.

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. PNCC contributed $97,249, $94,708 and $93,397 to the Fund for the years ended December 31, 2013, 2012 and 2011, 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 2013 and 2012 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 7.5% (previously 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

Based on the actuarial valuation of the Fund as of October 1, 2011 issued in October 2012, the actuarial valuation determined the unfunded pension benefit obligation as follows:

Present value of accrued benefits as of October 1, 2011:

Active participants	$ 74,716,975
Participants in pay status	62,987,516
Participants with vested deferred benefits	2,323,366
Total pension benefit obligation	140,027,857
Market value of assets	36,128,666
Unfunded benefit obligation	$103,899,191
Funded Ratio as of 10/1/2011 (ratio of assets to liabilities)	25.8%

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

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, 2013, 2012 and 2011, PNCC's share on employees' Healthcare Fund paid to the Social Security Administration were $43,384, $44,425 and 44,487, respectively, and is included as a component of payroll burden in the Schedule of Functional Expenses in page 48.

(2) Summary of Significant Accounting Policies, Continued

F. Assets, Liabilities and Net Position, Continued

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, 2013 and 2012. Therefore, the PNCC'S net position represents the residual interest in PNCC's assets after liabilities. At December 31, 2013 and 2012, 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, 2013 and 2012, PNCC had a deficit net position totaling $5,193,767 and $5,068,492, respectively.

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

(3) Deposits and Investments Risk

Deposits

GASB Statement No. 3 requires government entities to categorize deposits to give an indication of the level of credit risk assumed by the entity at year-end based on the following categories:

Category 1 - deposits that are federally insured or collateralized with securities held by the PNCC or its agent in PNCC's name;

Category 2 - deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the PNCC's name; or

Category 3 - deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in PNCC's name and non-collateralized deposits.

At December 31, 2013 and 2012, the carrying amount of PNCC's cash balances was $449,356 and $442,762, respectively. The corresponding bank balances as of December 31, 2013 and 2012 were $955,731 and $525,650, respectively. From these deposits, only $580,738 and $406,187, respectively, were subject to coverage by the Federal Insurance Deposit Corporation (FDIC) with remaining balance exceeding insurable limits. PNCC does not require collateralization of bank accounts, and therefore, deposits level in excess of FDIC insurance coverage is uncollateralized.

Investments

Governmental accounting standards require that the investments reported as of the balance sheet date be categorized according to level of credit risk. The level of credit risk is defined as follows:

Category 1 - insured and registered for which the securities are held by the PNCC or its agent in the PNCC'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 PNCC'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 PNCC's name.

(3) Deposits and Investments Risk, Continued

Investments, Continued

Restricted Cash and Cash Equivalents

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"). 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 $3,854,182 and $3,661,576 as of December 31, 2013 and 2012, 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.

Investments

PNCC's Emergency Reserve Fund (the Fund) is placed in Morgan Stanley Smith Barney, an investment management firm held in the name of PNCC. The PNCC's Board of Directors is responsible for directing and monitoring the investment management of the Fund. The Board of Directors currently has no specific projected contribution or distribution requirements for the Fund. The Board of Directors shall, from time to time, designate accumulated reserves to be contributed to and managed under the auspices of the Fund. The Fund will be invested in such a way that adequate funds can be made available within a short period time, should a distribution need arise.

(3) Deposits and Investments Risk, Continued

Investments, Emergency Reserve Fund Continued

At December 31, 2013 and 2012, PNCC's investment portfolios at fair value are as follows:

2013

	Allocation		Market Value
	Actual	Per Policy	12/31/2013
Fixed income securities:			
Corporate bonds			$ 67,260
Government			46,869
Federal agencies			24,832
Total fixed income	23%	30%	138,961
Other investments:			
U.S. equities	55%	50%	324,791
Non U.S. equities	11%	10%	65,601
Cash and cash equivalents	11%	10%	63,181
			453,573
	100%	100%	$ 592,534

2012

	Allocation		Market Value
	Actual	Per Policy	12/31/2012
Fixed income securities:			
Corporate bonds			$ 68,557
Government			51,450
Federal agencies			25,222
Total fixed income	29%	30%	145,229
Other investments:			
U.S. equities	49%	50%	247,197
Non U.S. equities	10%	10%	49,600
Cash and cash equivalents	12%	10%	57,974
			354,771
	100%	100%	$ 500,000

(3) Deposits and Investments Risk, Continued

Investments, Emergency Reserve Fund Continued

As of December 31, 2013 and 2012, PNCC's fixed income securities had the following ratings and maturities:

	2013						
		Investment maturities (In Years)				Rating	
Investment type	Fair Value	Less than 1	1-5	6-10	More than 10	Moody	Standard & Poor
Corporate bonds	$ 3,996	$ -	$ 3,996	$ -	$ -	A3	A
Corporate bonds	4,005	-	4,005	-	-	BAA1	BBB+
Corporate bonds	4,673	-	4,673	-	-	A3	A
Corporate bonds	4,815	-	4,815	-	-	A1	AA
Corporate bonds	4,765	-	4,765	-	-	BAA1	BBB+
Corporate bonds	4,482	-	-	4,482	-	BAA1	A
Corporate bonds	3,849	-	-	3,849	-	BAA3	BBB
Corporate bonds	4,045	-	-	4,045	-	A2	A+
Corporate bonds	4,063	-	-	4,063	-	BAA2	BBB-
Corporate bonds	4,081	-	-	4,081	-	BAA3	BBB
Corporate bonds	4,733	-	-	4,733	-	BAA1	BBB
Corporate bonds	3,756	-	-	3,756	-	A3	A-
Corporate bonds	3,786	-	-	3,786	-	A2	A
Corporate bonds	3,706	-	-	3,706	-	A2	A
Corporate bonds	3,840	-	-	-	3,840	A1	A
Corporate bonds	4,665	-	-	-	4,665	A1	AA+
Federal Agencies	11,459	-	11,459	-	-	AAA	AA+
Federal Agencies	13,373	-	13,373	-	-	AAA	AA+
Government securities	6,170	-	6,170	-	-	AAA	No rating
Government securities	9,393	-	9,393	-	-	AAA	No rating
Government securities	5,410	-	5,410	-	-	AAA	No rating
Government securities	9,750	-	-	9,750	-	AAA	No rating
Government securities	3,708	-	-	3,708	-	AAA	No rating
Government securities	3,879	-	-	3,879	-	AAA	No rating
Government securities	6,266	-	-	-	6,266	AAA	No rating
Government securities	2,293	-	-	-	2,293	AAA	No rating
	$ 138,961	$ -	$ 68,059	$ 53,838	$ 17,064		

(3) Deposits and Investments Risk, Continued

Investments, Emergency Reserve Fund, Continued

Fixed income securities and ratings, Continued

	2012						
		Investment maturities (In Years)				Rating	
Investment type	Fair Value	Less than 1	1-5	6-10	More than 10	Moody	Standard & Poor
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	5,129	-	-	5,129	-	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	4,150	-	-	-	4,150	A2	A
Corporate bonds	4,227	-	-	-	4,227	A1	A
Corporate bonds	4,934	-	-	-	4,934	A1	AA+
Federal Agencies	11,675	-	11,675	-	-	AAA	AA+
Federal Agencies	13,546	-	13,546	-	-	AAA	AA+
Government securities	7,316	-	7,316	-	-	AAA	No rating
Government securities	8,492	-	8,492	-	-	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
	$ 145,229	$ -	$ 58,517	$ 59,515	$ 27,197		

(4) Capital Assets

Summarized below are PNCC's capital assets for the years ended December 31, 2013 and 2012.

December 31, 2013:

	Balance at December 31, 2012	Additions	Transfers/ Retirements	Balance at December 31, 2013
Regulated capital assets				
Cables and transmission lines	$ 26,264,758	$ 432,241	$ -	$ 26,696,999
Transmission equipment	9,261,018	76,654	-	9,337,672
Buildings	8,839,503	34,887	(17,220)	8,857,170
Central office equipment	4,027,010	-	-	4,027,010
General support equipment	2,169,331	39,779	-	2,209,110
Customer premises wiring and equipment	1,209,800	62,359	-	1,272,159
Vehicles	616,144	-	-	616,144
Furniture and fixtures	28,517	5,496	-	34,013
Regulated capital assets, at cost	52,416,081	651,416	(17,220)	53,050,277
Accumulated depreciation	(38,118,960)	(1,810,003)	223	(39,928,740)
Regulated capital assets, at net book value	14,297,121	(1,158,587)	(16,997)	13,121,537
Non-regulated capital assets				
Cable television	3,048,243	77,106	(93,858)	3,031,491
Cellular	5,150,100	26,162	-	5,176,262
Palaunet	909,905	153,396	-	1,063,301
Non-regulated capital assets, at cost	9,108,248	256,664	(93,858)	9,271,054
Accumulated depreciation	(4,882,089)	(561,822)	77,405	(5,366,506)
Non-regulated capital assets, at net book value	4,226,159	(305,158)	(16,453)	3,904,548
Construction in progress	554,782	923,520	(912,723)	565,579
Total	$ 19,078,062	$ (540,225)	$ (946,173)	$ 17,591,664

(4) Capital Assets, Continued

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

Depreciation expense for the years ended December 31, 2013 and 2012 was $2,371,825 and $2,543,071, 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, 2013 and 2012, amounts due from the Republic of Palau and its component units totaled $412,226 and $376,421, respectively.

(6) Long-term debt

Long-term debt as of December 31, 2013 and 2012 are summarized below:

	2013	2012
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.	$25,438,349	$26,391,326
Note payable to Chunghwa Telecom Company in monthly installments of $34,087, non-interest bearing (net of unamortized discount of $123,972 and $191,816 at December 31, 2013 and 2012, respectively) due in July 2017, secured by earth station and ground common equipment.	1,341,769	1,648,882
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 $49,729 and $100,875 at December 31, 2013 and 2012, respectively), uncollateralized.	563,202	663,423
Total debt	27,343,320	28,703,631
Less current portion	1,653,076	1,572,477
Long-term debt, net of current portion	$25,690,244	$27,131,154

(6) Long-term debt, Continued

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, 2013 and 2012.

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
2014	$ 1,162,816	$ 1,143,360	$ 2,306,176
2015	1,217,326	1,088,849	2,306,175
2016	1,274,392	1,031,783	2,306,175
2017	1,334,133	972,042	2,306,175
2018	1,396,675	909,501	2,306,176
2019-2023	8,029,058	3,501,820	11,530,878
2024-2028	10,095,900	1,434,978	11,530,878
2029	928,049	10,507	938,556
	$ 25,438,349	$10,092,840	$ 35,531,189

(6) Long-term debt, Continued

ESLA with Chunghwa Telecom Co. Ltd., Continued

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

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 with 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, 2013, the future note payments to CHT are as follows:

Year ending December 31,	Present value of note	Discount amortization	Total note payments
2014	$ 351,113	$ 57,931	$ 409,044
2015	368,709	40,335	409,044
2016	387,187	21,857	409,044
2017	234,760	3,849	238,609
	$ 1,341,769	$ 123,972	$ 1,465,741

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, 2013 and 2012, bandwidth fees paid to CHT under this ESLA agreement totaled $168,000 in each year and is included as a component of plant specific operations expense reported in the Statements of Revenues, Expenses and Changes in Net Position.

(6) Long-term debt, Continued

New billing and customer care information technology system

In August 2012, PNCC entered into a note agreement with the National Information Solutions Cooperative (NISC) for the acquisition of a new billing and customer care information technology system, and for the improvement of the communication system between the PNCC sales sites and its main office. In 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 as of December 31, 2012. The note was non-interest bearing 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, 2013. At December 31, 2013, the future note payments to NISC are as follows:

Year ending December 31,	Present value of note	Discount amortization	Total note payments
2014	$ 139,147	$ 20,748	$ 159,895
2015	143,423	16,472	159,895
2016	150,147	9,748	159,895
2017	130,485	2,761	133,246
	$ 563,202	$ 49,729	$ 612,931

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. For the years ended December 31, 2013 and 2012, amounts paid to NISC for technical support under the agreement totaled $20,769 and $1,829, respectively, and is reported as a component of plant specific operations expense reported in the Statements of Revenues, Expenses and Changes in Net Position. As of December 31, 2013, the remaining commitments chargeable to operations are included in the Note 7.

(6) Long-term debt, Continued

At December 31, 2013 and 2012, the changes in the long-term liabilities are as follows:

2013	Balance January 1, 2013	Additions	Reductions	Balance December 31, 2013	Current	Noncurrent
Rural Utilities Services	$ 26,391,326	$ -	$ 952,977	$25,438,349	$ 1,162,816	$ 24,275,533
Chunghwa Telecom Company, Ltd.(net of unamortized discount of $123,972 in 2013 and $191,816 in 2012)	1,648,882	-	307,113	1,341,769	351,113	990,656
National Information Solutions Cooperative (net of unamortized discount of $49,729 in 2013 and $100,875 in 2012)	663,423	-	100,221	563,202	139,147	424,055
	$ 28,703,631	$ -	$1,360,311	$27,343,320	$ 1,653,076	$ 25,690,244

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

Interest expense paid in 2013 and 2012 amounted to $1,420,094 and $1,328,295, 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
2014	$ 720,185
2015	188,769
2016	188,769
2017	187,689
	$ 1,285,412

At December 31, 2013, PNCC has outstanding purchase order commitments for remote support and software maintenance and upgrade of softswitch from an off-island vendor, and some local procurement of supplies which have not been received as of December 31, 2013. 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, $302,671 of outstanding purchase commitments are not reported in the financial statements for the year ended December 31, 2013.

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, Continued

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, 2013 and 2012 is $1,037,753 and $1,031,351, respectively.

(8) Fair Value of Financial Instruments

PNCC's financial instruments are cash and cash equivalents, accounts receivable, other assets, investments, accounts payable, payable to carriers, accrued expenses, unearned revenue, customer deposits, and notes payable, and long-term debt. The recorded values of these instruments for cash and cash equivalents, accounts receivable, other assets, investments and accounts payable, payable to carriers, accrued expenses, and unearned 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 2012 have been reclassified to conform to 2013 financial statement presentation. These reclassifications did not affect the change in net position or the total net position.

(10) Subsequent Events

During April 2014, a lawsuit alleging several claims was filed against PNCC by a former employee for wrongful termination. A motion to dismiss is currently pending the court based on lack of personal jurisdiction over PNCC due to an insufficiency of service of process. PNCC's legal counsel's preliminary assessment is that if the lawsuit is allowed to proceed, as a legal matter the claims are tenuous, at best. An analysis of potential monetary liability has not yet been conducted. Therefore, no additional provision for the potential liability that may exist from this lawsuit has been recorded in the accompanying financial statements.

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

SUPLEMENTARY SCHEDULES

Year Ended December 31, 2013

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, 2013

	Budget				Variance
	Original	Revisions	Final	Actual	Favorable (Unfavorable)
Operating revenues:					
Cellular	$ 4,109,233	$ (13,000)	$ 4,096,233	$ 3,906,624	$ (189,609)
Palaunet	2,196,988	-	2,196,988	2,412,483	215,495
Local	1,538,698	-	1,538,698	1,524,516	(14,182)
Digital television	1,410,091	-	1,410,091	1,424,674	14,583
Long distance	969,850	-	969,850	1,380,808	410,958
Miscellaneous	286,915	-	286,915	63,314	(223,601)
Provision for doubtful accounts	-	-	-	(274,923)	(274,923)
Total operating revenues	10,511,775	(13,000)	10,498,775	10,437,496	(61,279)
Operating expenses:					
Depreciation	2,669,229	-	2,669,229	2,371,825	297,404
Plant specific operations	3,062,156	-	3,062,156	3,937,832	(875,676)
Corporate operations	1,873,329	-	1,873,329	1,250,275	623,054
Customer service operations	1,028,749	-	1,028,749	1,216,396	(187,647)
Plant non-specific operations	371,887	-	371,887	305,370	66,517
Total operating expenses	9,005,350	-	9,005,350	9,081,698	(76,348)
Operating income (loss)	1,506,425	(13,000)	1,493,425	1,355,798	(137,627)
Nonoperating income (expenses):					
Interest expense	(1,259,668)	-	(1,259,668)	(1,420,094)	(160,426)
Interest income	4,000	-	4,000	8,732	4,732
Other expenses, net	(46,699)	-	(46,699)	(69,711)	(23,012)
Total nonoperating expenses, net	(1,302,367)	-	(1,302,367)	(1,481,073)	(178,706)
Change in net position	$ 204,058	$ (13,000)	$ 191,058	$ (125,275)	$ (316,333)

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, 2013
(With Comparative Totals for 2012)

	Plant Specific					Plant	Total	
				Customer		non-specific	Operating Expenses	
	Depreciation	Operation	Corporate	Relations	Total	operations	2013	2012
Outside services	$ -	$ 1,953,995	$ 81,701	$ 874,400	$ 2,910,096	$ 508	$ 2,910,604	$ 2,837,130
Depreciation	2,371,825	-	-		2,371,825	-	2,371,825	2,543,071
Salaries and wages	-	545,081	553,388	207,741	1,306,210	198,838	1,505,048	1,525,653
Utilities	-	866,858	-		866,858	-	866,858	777,722
Payroll burden	-	262,830	170,409	111,525	544,764	74,000	618,764	566,026
Training	-	11,383	186,736	6,400	204,519	8,030	212,549	163,589
Materials and supplies	-	129,836	31,785	11,451	173,072	3,044	176,116	137,344
Others	-	16,049	107,794	2,084	125,927	13,919	139,846	148,229
Clearance	-	114,172	-	-	114,172	358	114,530	131,376
Fuel	-	37,628	12,260	2,605	52,493	6,673	59,166	54,452
Insurance	-	-	51,567	-	51,567	-	51,567	59,140
Postage	-	-	25,407	190	25,597	-	25,597	19,686
Legal fees	-	-	15,925	-	15,925	-	15,925	24,335
Board fees	-	-	13,303	-	13,303	-	13,303	8,968
	$ 2,371,825	$ 3,937,832	$ 1,250,275	$ 1,216,396	$ 8,776,328	$ 305,370	$ 9,081,698	$ 8,996,721

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, 2013

(With Comparative Totals for 2012)

	Depreciation	Operation	Corporate	Customer Relations	Total Operating Expenses By Division 2013	Total Operating Expenses By Division 2012
Telephony						
Depreciation	$ 1,810,003	$ -	$ -	$ -	$ 1,810,003	$ 2,027,938
Salaries and wages	-	308,046	540,512	207,741	1,056,299	1,092,566
Utilities	-	818,246	-	-	818,246	733,999
Payroll burden	-	146,739	163,412	111,525	421,676	408,541
Outside services	-	239,777	81,209	18,683	339,669	592,506
Training	-	11,383	186,736	6,400	204,519	142,834
Materials and supplies	-	87,543	31,745	11,451	130,739	115,394
Others	-	2,165	92,155	171	94,491	102,522
Clearance	-	64,773	-	-	64,773	46,030
Insurance	-	-	51,567	-	51,567	59,140
Fuel	-	37,628	9,019	2,605	49,252	41,697
Postage	-	-	25,407	-	25,407	19,686
Legal fees	-	-	15,925	-	15,925	24,335
Board fees	-	-	13,303	-	13,303	8,968
Allocation	-	-	(281,466)	(90,116)	(371,582)	(270,340)
	1,810,003	1,716,300	929,524	268,460	4,724,287	5,145,816
Cellular						
Depreciation	360,258	-	-	-	360,258	327,606
Outside services	-	244,853	455	-	245,308	191,776
Allocation	-	-	95,456	33,472	128,928	92,745
Salaries and wages	-	32,938	12,876	-	45,814	55,290
Utilities	-	46,712	-	-	46,712	41,963
Others	-	5,099	15,092	-	20,191	23,140
Payroll burden	-	14,213	5,860	-	20,073	21,354
Fuel	-	-	3,241	-	3,241	4,602
Materials and supplies	-	-	40	-	40	233
	360,258	343,815	133,020	33,472	870,565	758,709
Palaunet						
Outside services	-	1,436,331	-	-	1,436,331	1,129,520
Allocation	-	-	55,803	28,322	84,125	64,953
Depreciation	80,145	-	-	-	80,145	70,283
Salaries and wages	-	50,414	-	-	50,414	60,308
Payroll burden	-	25,496	-	-	25,496	23,183
Clearance	-	13,460	-	-	13,460	9,525
Materials and supplies	-	3,066	-	-	3,066	1,194
Others	-	3,306	-	-	3,306	10,124
	80,145	1,532,073	55,803	28,322	1,696,343	1,369,090
Digital TV						
Outside services	-	33,034	37	855,717	888,788	922,703
Allocation	-	-	130,207	28,322	158,529	112,642
Salaries and wages	-	153,683	-	-	153,683	124,084
Depreciation	121,419	-	-	-	121,419	117,244
Payroll burden	-	76,382	1,137	-	77,519	51,771
Materials and supplies	-	39,227	-	-	39,227	16,521
Clearance	-	35,939	-	-	35,939	29,107
Others	-	5,479	547	1,913	7,939	1,808
Utilities	-	1,900	-	-	1,900	1,760
Postage	-	-	-	190	190	-
Training	-	-	-	-	-	95
	121,419	345,644	131,928	886,142	1,485,133	1,377,735
	$ 2,371,825	$ 3,937,832	$ 1,250,275	$ 1,216,396	$ 8,776,328	$ 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, 2013

J. Scott Magliari & COMPANY

CERTIFIED PUBLIC ACCOUNTANT

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

GUAM
Reflection Center, Suite 207
P.O. Box 12734
Tamuning, GU 96931
Tel Nos. (671) 472-2680/2687
Fax No. (671) 472-2686

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

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMEDIN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To 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 the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, as of and for the year ended December 31, 2013, and the related notes to the financial statements, which collectively comprise PNCC's basic financial statements and have issued my report thereon dated June 18, 2014.

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 our 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 the deficiencies described in the accompanying schedule of findings and responses as Findings 13-01, 13-02, 13-03, and 13-05 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 accompany schedule of findings and responses as Findings 13-04, 13-05 and 13-07 to be significant deficiencies.

Compliance and Other Matters

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

PNCC's Response to Findings

PNCC's response to the findings identified in my audit is described in the accompanying schedule of findings and responses. PNCC's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, I express no opinion on it.

Purpose of this Report

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

J. Scott Magliari & Company

Koror, Republic of Palau
June 18, 2014

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

Schedule of Findings and Responses
Year Ended December 31, 2013

SECTION I – SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of auditor's report issued: Unmodified

Internal control over financial reporting:

• Material weakness(es) identified?	X yes	___ no
• Significant deficiency(ies) identified that are not considered to be material weaknesses?	X yes	___ no
• Noncompliance material to financial statements?	___ yes	X no

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-01
Area : General Trade Receivable Collectability Status

Criteria:

Management should enhance collection efforts through the use of collection agencies to aid in collecting delinquent accounts. A write-off policy should be implemented to determine when accounts are determined uncollectible.

Condition:

Based on the review of the status of the collectability of PNCC's general trade receivables as of December 31, 2013, certain accounts receivable totaling $3.8 million are over 5 years old and accounts receivables outstanding over 120 days as of December 31, 2013 approximated $420,000. There was no write-off procedures performed as of December 31, 2013 for the accounts determined uncollectible as of December 31, 2013. Based on the review of subsequent cash receipts and examination of delinquency reports and payments as of March 31, 2014, the collectability of PNCC's overall general trade receivable was estimated to be 19% with the remaining balance of 81% deemed uncollectable, as evaluated below:

Regulated Receivables	Total	Collections based on analysis of Monthly Delinquent Report as of 3/31/2014	Estimated Uncollectable	% of estimated uncollectable as of 3/31/14
Aged 91 days and over	$ 3,643,943	$ 63,893	$ 3,580,050	98%
Aged 61-90 days old	124,613	9,969	114,644	92%
Aged 31-60 days old	222,250	37,783	184,467	83%
Current	420,924	290,438	130,486	31%
	4,411,730	402,083	4,009,647	
Non-regulated Receivable	794,908	590,290	204,618	26%
	$ 5,206,638	$ 992,373	$ 4,214,265	
Percentage	100%	19%	81%	

Cause:

When accounts are past due and service is eventually disconnected, no further action made to collect the outstanding receivable. PNCC does not have a collection agency to refer delinquent accounts for further collection effort.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-01, Continued
Area : General Trade Receivable Collectability Status

Effect:

PNCC's cash flows are negatively affected and may experience cash shortages to support operations in the future.

Prior Year Status:

The lack of inadequate control over accounts receivable was cited as a finding in the audits of PNCC for the years 2005 through 2012.

Recommendation:

Internal control policies and procedures should be implemented to evaluate customer's ability to pay for services and to monitor accounts receivable on a monthly basis. PNCC should re-evaluate its disconnection policy for past-due accounts and consider revisions to shorten the length of time before services are disconnected. This could limit PNCC's exposure of lost revenues and relieve negative cash flow.

Management should consider procuring services of an outside collection agency for collection efforts or assigned an individual(s) for the responsibility of reviewing all of the customer accounts and establish a workable plan to increase collection efforts from past due and accounts becoming past due. This action should help the PNCC save time and resources, and further increase cash-flows.

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding. More efforts will be put into strengthening in-house collection efforts. At the same time, Finance & Administration Department will look into all options including the possibility of sourcing out collection of past due accounts. The Chief Financial Officer will work with appropriate personnel and PNCC Management to ensure collection issues are addressed.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-02
Area : Allowance for Doubtful Accounts

Criteria:

Policies and procedures should be documented and maintained for calculating the 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 control over financial reporting requires that an allowance for uncollectible accounts receivable be calculated and reported in a timely manner. These policies and procedures should include formal written credit approval policies and procedures to manage and reduce the risk of write off of uncollectible accounts.

Condition:

PNCC performs evaluation of its doubtful accounts on year-end basis only, and not on a periodic basis. A provision for uncollectible accounts for 2013 was calculated and determined in March 2014 totaling $274,923 which was simply added to the accumulated beginning balance. The analysis of changes of allowances for bad debts for the last six (6) years is as follows:

	As of December 31,					
	2013	2012	2011	2010	2009	2008
Balance, beginning of year	$ 4,083,262	$ 3,503,641	$ 3,195,114	$ 3,195,114	$ 2,908,271	$ 2,685,682
Current year provisions	274,923	778,427	308,527	-	310,108	222,589
Writte-off	(143,920)	(198,806)	-	-	(23,265)	-
Balance, end of year	$ 4,214,265	$ 4,083,262	$ 3,503,641	$ 3,195,114	$ 3,195,114	$ 2,908,271

Cause:

PNCC does not have formalized policies and procedures for estimating the amount of uncollectible accounts receivable to be recorded as an allowance for doubtful accounts.

Effect:

Uncollectible old accounts estimated at $4 million are ageing in the receivable trial balance and are not written-off and removed from the general ledger and subsidiary ledger. 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 conditions of untimely review and evaluation of accounts receivable ageing trial balance was cited as finding in the 2009 through 2012 audits of PNCC.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-02, Continued
Area : Allowance for Doubtful Accounts

Recommendation:

PNCC management should formalize collection procedures over control of accounts receivable. These policies and procedures should provide guidance on recording, collecting, and writing off accounts receivable and returned checks. I recommend that past-due balances be reviewed monthly. When truly uncollectible accounts are indentified, they should be written-off and removed from the books. This process, however, should not occur until all collection efforts are exhausted and the account is no longer worth pursuit.

Auditee Response and Corrective Action Plan:

PNCC agrees with this Finding. The PNCC Board of Directors has adopted "Accounts Receivable Policy". The Chief Financial Officer will work with Finance & Administration Department staff to prepare clear procedures for account write-off, procedures for account reconciliations and procedures for collections. Once procedures are implemented, CFO will ensure they are adhered to at all times.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-03
Area : Timely Reconciliation of Accounts

Criteria:

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

Condition:

General ledger account balances were not reviewed and reconciled monthly. Most general ledger accounts were only reconciled during the audit of PNCC. Bookkeeping reconciliations and financial close entries were concurrently done while auditor was performing its audit procedures. The following adjusting journal entries and client journal entries were additionally provided to include in the financial statements that was provided late on May 16, 2014:

2013 REFERENCE JOURNAL ENTRIES	Description of Entries	Accounts Affected	Net income (loss) before Adjustments	Adjustments effect to Income Statement	Net income (loss) after Adjustments
	Net Income (loss) per trial balance provided 5/16/2014.		$ 19,414	$ -	$ 19,414
2013-AJE-01 &2013- AJE 03, 2013-AJE-04	To correct debit balance in accrued liabilities.	Accrued liabilities, Notes payable, Interest expense, Intl. Carrier Sttlmnt expense	-	140,489	(140,489)
2013 -AJE-02	To provide additional allowance for uncollectible accounts.	Allowance for bad debts and provision for bad debts	-	136,589	(136,589)
2013-AJE-05	To agree general trade receivable and unearned revenue to actual at 12-31-2013.	Trade receivable, unearned revenue, revenue	-	(91,636)	91,636
RJE-04	To reclass mispostings of revenues to proper revenue accounts to correct general ledger.	Other basic revenues 5060.1 posted to 5060.2 for $305,445.70	-	-	-
RJE-01 through RJE-04	Reclassification of correct current portion of long-term debts from noncurrent, and related party reclassification.	General trade, Longterm debt, current and noncurrent for $472.291.47	-	-	-
CAJE -01 through CAJE-08	Bookkeeping adjusting journal entries provided by client to reconcile general ledger control accounts.	Carrier settlement expense/revenues, insurance expense, adjustments on depreciation, and inventory	-	(40,753)	40,753
			$ 19,414	$ 144,689	$ (125,275)

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-03
Area : Timely Reconciliation of Accounts

Cause:

Management transition occurred from October 2013 through December 31, 2013 and efforts were not made to plan for and ensure continuity of daily and monthly accounting and reconciliation. Furthermore, the new accounting and billing system lack of training contributed to slow down reconciliation procedures in 2013.

Effect:

PNCC was delayed in providing the 2013 financial trial balance and audit accounts schedules due to late reconciliation of various accounts and financial close.

Prior Year Status:

The lack of timely reconciliation was cited as finding in the prior year audits of PNCC for the years 2005 through 2012.

Recommendation:

PNCC Management should strengthen existing internal control over general ledger account 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 on a timely manner.

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding. The PNCC organizational restructuring is now complete and personnel are in place. The software vendor will continue to provide necessary training to staff to help improve their skills and knowledge in use of the new billing and accounting systems. Improved knowledge and skills in use of the systems should help ensure proper and regular reconciliation of accounts.

<u>SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING</u>

Finding No.: 13-04
Area : Cash Accounts – Bank Reconciliations

<u>Criteria</u>:

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

<u>Condition</u>:

Monthly bank reconciliations of PNCC's general checking and wire checking accounts did not commence until March 2014. Additionally, the wire checking account was not properly reconciled with an unidentified adjustment of $30,387.92 to reduce a cash balance overstatement at December 31, 2013.

The trial balance for the year ended December 31, 2013 was only provided on May 16, 2014 due to the late preparation of bank reconciliation and year-end audit schedules, which resulted in delay in the audit process and delivery of the report.

<u>Cause</u>:

PNCC implemented new accounting software and staff were not sufficiently trained. Personnel are unfamiliar with the accounting system and did not understand how to perform reconciling the cash module to general ledger.

<u>Effect</u>:

Errors, fraud, and theft could exist and not be detected in a timely manner. The potential exist for management to make financial decisions using incorrect or out-dated information.

<u>Prior Year Status</u>:

Similar condition of untimely bank reconciliations was cited in the 2012 audit of PNCC.

<u>Recommendation</u>:

Bank reconciliations should be prepared each month in a timely manner. Although there were issues with inadequate training, the bank reconciliation should be prepared manually. 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.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-04, Continued
Area : Cash Accounts – Bank Reconciliations

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding. The Chief Financial Officer has addressed the matter with concerned personnel. Regular monthly updates are now required to ensure reconciliations are carried out on all accounts.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-05
Area : Review of Customer Deposits

Criteria:

PNCC's customer deposits consist of subscriber deposits, installation fees and amounts received for related services and subscriptions to be provided in future periods. PNCC's policy 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.

Condition:

The year-end deposit listings totaled $707,675.94 representing numerous inactive customer deposits over 10 years old, and whose deposits can be applied to the customer's unpaid balance. As noted in Finding No. 13-01, accounts receivable that are potential for write-off approximate $3.8 million and the corresponding customer deposit was not applied to reduce the write-off.

Cause:

Because there is no formalized accounts receivable collection policy, internal control policies have not been implemented to determine when and how customer deposits should be applied to past-due or terminated account balances. Additionally, some customers no longer pursue request for a deposit refund because of the time and effort involved.

Effect:

The propriety of some customer deposits may not be a liability and might be a recovery of previously provided allowance for uncollectibility of accounts receivable outstanding for over 10 years.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-05, Continued
Area : Review of Customer Deposits

Recommendation:

Management should review and revise its procedures over maintaining, accounting for and application of customer deposits in relation to accounts receivables and the allowance for doubtful accounts. Management review of this area can result in a reduction in the number and amount of delinquent and potential uncollectible accounts receivable. An in-house study should be conducted to determine to what extent, if any, deposits should be applied to the receivable allowance account.

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding. The same efforts to address accounts receivables cited in Finding No. 13-02 will be undertaken and procedures will be established for proper application and handling of customer deposits. The CFO will ensure procedures are adhered to.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-06
Area : Unearned revenues from prepaid long distance sales and prepaid airtime

Criteria:

Written policies 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 or for prepaid international calling card and prepaid airtime based on actual minutes used. When customers do not use all of the time value of international prepaid calling card, the unused portion of the dollar value of the prepaid calling card (commonly known as breakage), maybe estimated based on historical trends. At December 31, 2013, deferred revenues from unused long distance prepaid card and wireless airtime were not calculated and recognized.

Cause:

There is a deficiency in the network system for determining unused minutes representing unearned revenue from prepaid long-distance card and prepaid airtime wireless. There also a lack of internal control policies and procedures to ensure that long distance revenue are reconciled with outbound minutes billed by international carriers on a periodic basis.

Effect:

Prepaid long distance card sales and prepaid wireless card sales may be overstated by deferred revenues from unused minutes.

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 2012.

Recommendation:

PNCC should document and adhere to existing policies and procedures over the reconciliation of long distance minutes and international prepaid calling card/airtime. 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.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-06, Continued
Area : Unearned revenues from prepaid long distance sales and prepaid airtime

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding. The Chief Financial Officer will ensure regular monthly reconciliation of long distance revenues will be carried out. Efforts will continue to procure and implement a system capable of generating data needed to support accounting of deferred/unearned airtime minutes.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-07
Area : RUS Form 479 Compliance Reporting -Comparison Comments

Criteria:

Accounting and information systems should be able to facilitate the production of accurate and timely financial information and related preparation of financial statements and the maintenance of accurate historical record of operations.

Condition:

In accordance with RUS compliance requirements, we agreed the 2012 RUS Form 479 filed on February 21, 2013 to the 2012 financial records of PNCC and noted the following variances:

	RUS Form 479 2012 Report Filed 2/21/2013	2012 Audited Report issued 7/8/2013	Variance
Part A. Assets			
Line 1. Cash and equivalents	$ 1,382,735	$ 442,762	$ 939,973
Line 3a. Telecomm, accounts receivable	1,778,049	1,351,074	426,975
Line 3b. Other receivable	116,960	133,146	(16,186)
Line 6. Material regulated	251,359	88,982	162,377
Line 7. Material non-regulated	-	94,086	(94,086)
Line 13. Nonregulated investments	-	500,000	(500,000)
Line 14. Other noncurrent assets	1,061,332	4,277,709	(3,216,377)
Line 18. Telecomm, plant in service	62,124,358	52,416,081	9,708,277
Line 22. Less Accumulated depreciation	(43,699,117)	(38,118,960)	(5,580,157)
Line 23. Net Plan (Line 18 less 22)	18,425,241	14,297,121	4,128,120
	$ 23,015,676	$21,184,880	$ 1,830,796

	RUS Form 479 2012 Report Filed 2/21/2013	2012 Audited Report issued 7/8/2013	Variance
Part A. Liabilites and stockholders' equity			
Line 25. Accounts payable	$ 78,262	$ 78,626	$ (364)
Line 27. Advance billings and payments	413,767	349,097	64,670
Line 28. Customer deposits	598,730	673,133	(74,403)
Line 29. Current maturities L/T debt	-	454,335	(454,335)
Line 30. Current maturities L/T debt -RUS	1,430,095	1,118,142	311,953
Line 34. Other current liabilities	241,333	606,078	(364,745)
Line 36. Funded debt long-term debt (RUS Note)	27,614,872	25,273,184	2,341,688
Line 45 Other long-term debt	-	1,857,970	(1,857,970)
Line 48. Other deferred credits	40,966	130,049	(89,083)
Line 58. Total equity (deficit)	(2,832,651)	(5,068,492)	2,235,841
	$ 27,585,374	$25,472,122	$ 2,113,252

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-07, Continued
Area : RUS Form 479 Compliance Reporting -Comparison Comments

Condition, continued

	RUS Form 479 2012 Report Filed 2/21/2013	2012 Audited Report issued 7/8/2013	Variance
Part B. Statements of Income and Retained Earnings			
Line 1. Local network service revenues	$ 1,339,278	$ 1,311,656	$ 27,622
Line 2. Network access service revenues	147,801	137,611	10,190
Line 3. Long distance network services	792,741	1,217,542	(424,801)
Line 4. Carrier Billing & collection revenues	265,634	227,523	38,111
Line 5. Miscellaneous revenues	230,695	242,294	(11,599)
Line 6. Uncollectible revenues	-	(778,427)	778,427
Line 7. Net operating revenues	$ 2,776,149	$ 2,358,199	$ 417,950
Line 8. Plant specific operation	$ 278,622	$ 1,779,004	$ (1,500,382)
Line 9. Plant non-specific operations	$ 320,676	$ 345,371	$ (24,695)
Line 12. Customer operations expense	$ 344,954	$ 334,042	$ 10,912
Line 13. Corporate operations	$ 973,320	$ 1,004,831	$ (31,511)
Line 24 Other expense (income)	$ (38,407)	$ 43,399	$ (81,806)
Line 30. Nonregulated net income	$ 4,780,595	$ 3,987,383	$ 793,212
Line 31. Net income (loss) or margins	$ 2,518,549	$(1,014,422)	$ 3,532,971
Line 39. Retained earnings (deficit), end	$ (5,068,492)	$(1,535,521)	$ (3,532,971)

Cause:

The above variances were due to financial records used by PNCC that did not include year-end reconciliations and financial closing adjustments which were made and posted subsequent to the filing date of February 21, 2013.

Effect:

There is no known material effect on the year-end financial statements as a result of this condition. The variances were corrected and adjusted. The potential exist for PNCC to be in noncompliance with RUS requirements.

Prior Year Status:

A similar condition was reported in the 2012 Management Letter submitted in accordance with 7 CFR Part 1773, *Policy on Audits of Rural Utilities Service (RUS)Borrowers*.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 13-07, Continued
Area : RUS Form 479 Compliance Reporting -Comparison Comments

Recommendation:

Management should ensure that RUS Form 479 is completed with updated and accurate financial data. PNCC should establish more effective review and reconciliation policies and procedures as a customary part of the accounting process. This would involve monthly reconciliations of all accounts, making adjustments throughout the year that have typically been made at year-end only, and performing more frequent reviews of the general ledger throughout the year, including making any necessary adjustments.

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding. Proper procedures for handling and timely reconciliation of accounts should produce accurate up-to-date financial records. The Chief Financial Officer will make sure procedures are followed and monthly reconciliations are carried out and monitored to prevent, detect and correct discrepancies in financial reports.

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

Independent Auditor's Report on Compliance with Aspects of Contractual Agreements and Regulatory Requirements for Telecommunications Borrowers

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Year Ended December 31, 2013

J. Scott Magliari & COMPANY
CERTIFIED PUBLIC ACCOUNTANT

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

GUAM
Reflection Center, Suite 207
P.O. Box 12734
Tamuning, GU 96931
Tel Nos. (671) 472-2680/2687
Fax No. (671) 472-2686

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

**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE WITH ASPECTS OF CONTRACTUAL AGREEMENTS
AND REGULATORY REQUIREMENTS FOR TELECOMMUNICATIONS BORROWERS**

Board of Directors
Palau National Communications Corporation:

I have audited 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, the financial statements of the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, which comprise the statement of net position as of December 31, 2013, and the related statement of revenues, expenses and changes in net position, and cash flows for the year then ended, and the related notes to the financial statements, and have issued my report thereon dated June 18, 2014. In accordance with Government Auditing Standards, I have also issued my report dated June 18, 2014, on my consideration of PNCC's internal control over financial reporting on my tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. No reports other than the reports referred above and my separate letter regarding recommendations concerning certain matters related to internal control, also dated June 18, 2014 related to my audit, have been furnished to management.

In connection with my audit, nothing came to my attention that caused me to believe that PNCC failed to comply with the terms, covenants, provisions, or conditions of their loan, grant, and security instruments as set forth in 7 CFR Part 1773, Policy on Audits of Rural Utilities Service Borrowers, Section 1773.33 and clarified in the RUS policy memorandum dated February 7, 2014, insofar as they relate to accounting matters as enumerated below. However, my audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to my attention regarding PNCC's noncompliance with above-referenced terms, covenants, provisions, or conditions of the contractual agreements and regulatory requirements, insofar as they relate to accounting matters. In connection with my audit, as except of the comments noted below, I noted no matters regarding PNCC's accounting and records to indicate that PNCC did not:

- Maintain adequate and effective accounting procedures;
- Utilize adequate and fair methods for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts;
- Reconcile continuing property records to the controlling general ledger plant accounts;
- Clear construction accounts and accrue depreciation on completed construction;
- Record and properly price the retirement of plant;

- Seek approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap;
- Maintain adequate control over materials and supplies.
- Prepare accurate and timely Financial and Operating Reports;

Comments:

- Finding No. 13-03 in the Schedule of Findings and Responses noted untimely reconciliation of certain accounts.

- Finding No. 13-07 in the Schedule of Findings and Responses noted results of untimely reconciliation of financial accounts caused variances noted in the RUS Form 479 reporting which reported figures was agreed to unaudited financial reports of PNCC as of 12-31-2012.

- Obtain written RUS approval to enter into any contract for the management, operation, or maintenance of the borrower's system in the contract covers all or substantially all of the telecommunication system;
- Disclose material related party transactions in the financial statements, in accordance with requirements for related parties in generally accepted accounting principles;
- Record depreciation in accordance with RUS requirements addressed in 7 CFR Part 1733.33(g); and
- Comply with the requirements for the detailed schedule of deferred debits and deferred credits; and
- Comply with the requirements for 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, 2013, 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).

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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
June 18, 2014

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

Unresolved Prior Year Comments
Year Ended December 31, 2013

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 52 through 67.