

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, 2016 and 2015

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

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December 31, 2016

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Palau National Communications Corporation

We 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, 2016 and 2015, 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, which collectively comprise the PNCC's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the PNCC as of December 31, 2016 and 2015, and the respective changes in the financial position and, where applicable, cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in the Note 2 to the financial statements, the PNCC implemented Governmental Accounting Standard Board (GASB) Statement No. 72, *Fair Value Measurement and Application* during the year ended December 31, 2016. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis (MD&A) on pages 4 through 10, the schedule of budgetary comparison information on page 50, Schedule of Proportionate Share of the Net Pension Liability on page 53, and the Schedule of Pension Contributions on page 54, as listed on 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. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Financial Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Palau National Communications Corporation's basic financial statements as a whole. The Schedules of Functional Expenses on page 51 and 52 are presented for the purposes of additional analysis and are not a required part of the basic financial statements.

These schedules are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information are fairly stated, in all material respects, in relation to the basic financial statements as a whole.

The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 9, 2017, on our consideration of the PNCC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the PNCC's internal control over financial reporting and compliance.



BURGER COMER MAGLIARI

Koror, Republic of Palau
June 9, 2017

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

Management's Discussion and Analysis
December 31, 2016

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, 2016 with comparisons to prior years ended December 31, 2015 and 2014. 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 PalauCel (GSM Mobile) and PalauNet (Internet) grew about 50% and 38%, respectively. 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 launching of 3G service in late 2015 have accelerated usage of mobile telephone services.

Five Year Growth Trend
2012-2016

| Year End December 31 | 2012 | 2013 | 2014 | 2015 | 2016 |
|-------------------------------|---------------|---------------|---------------|---------------|---------------|
| GSM Mobile | 17,151 | 17,945 | 19,114 | 23,743 | 25,770 |
| Postpaid | 1,405 | 1,509 | 1,733 | 2,245 | 2,523 |
| Prepaid | 15,746 | 16,436 | 17,381 | 21,498 | 23,247 |
| Fixed Line (Telephone) | 7,299 | 7,263 | 7,149 | 7,204 | 7,048 |
| Business/Government | 3,162 | 3,166 | 3,108 | 3,298 | 3,110 |
| Residential | 4,137 | 4,097 | 4,041 | 3,906 | 3,938 |
| PalauNet (Internet) | 1,702 | 1,805 | 1,974 | 2,004 | 2,349 |
| Dialup | 781 | 726 | 649 | 579 | 759 |
| DSL | 236 | 240 | 275 | 286 | 293 |
| Web Package | 4 | 3 | 3 | 1 | 1 |
| Domestic Leased Line/VLAN | 52 | 54 | 62 | 60 | 63 |
| Intl Private Line | - | - | - | - | - |
| Wi-Fi Hotspots | 93 | 116 | 150 | 140 | 157 |
| HomeNet | 536 | 666 | 835 | 938 | 1,076 |
| Digital TV | 3,624 | 3,751 | 3,763 | 3,827 | 4,129 |
| Single Dwelling | 2,818 | 2,940 | 2,956 | 3,081 | 3,240 |
| Multi Units | 806 | 811 | 807 | 746 | 889 |

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

Management's Discussion and Analysis
December 31, 2016

FINANCIAL HIGHLIGHTS

STATEMENTS OF NET POSITION

YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014

| | 2016 | 2015 | 2014 |
|--|------------------------|------------------------|------------------------|
| ASSETS | | | |
| Current Assets | | | |
| Cash | \$ 3,025,758 | \$ 1,223,089 | \$ 680,101 |
| Restricted cash and cash equivalents | 3,816,336 | 3,816,336 | 3,724,627 |
| Receivables, net | 951,696 | 807,718 | 1,295,714 |
| Inventories | 253,259 | 170,310 | 175,407 |
| Deposit | 1,891 | - | 180,000 |
| Prepaid expenses | 23,581 | 12,534 | 45,717 |
| Total current assets | \$ 8,072,521.00 | \$ 6,029,987.00 | \$ 6,101,565.82 |
| Investments | 612,313 | 602,737 | 612,157 |
| Other noncurrent assets | 51,550 | 51,550 | 51,550 |
| Plant and equipment, net | 18,189,738 | 19,040,523 | 20,785,952 |
| Total Assets | \$ 26,926,122 | \$ 25,724,797 | \$ 27,551,225 |
| Deferred outflows of resources: | | | |
| Deferred outflows from pension | 763,471 | 570,684 | 457,872 |
| Total Assets | \$ 27,689,593 | \$ 26,295,481 | \$ 28,009,097 |
| LIABILITIES AND NET POSITION | | | |
| Current liabilities | | | |
| Current Portion of Contract Payable | \$ 1,776,834 | \$ 1,199,800 | \$ 1,674,848 |
| Current portion of long-term debt | 945,200 | 1,915,455 | 1,695,600 |
| Accounts payable | 102,182 | 35,939 | 157,390 |
| Payable to carriers, net | 219,389 | 6,875 | 75,925 |
| Accrued expenses | 434,482 | 493,259 | 673,807 |
| Unearned revenues | 7,797 | 107,621 | 143,458 |
| Customer deposits | 590,189 | 600,464 | 698,345 |
| Total current liabilities | \$ 4,076,073 | \$ 4,359,413 | \$ 5,119,373 |
| Contract Payable, net of current portion | - | 945,400 | 2,228,400 |
| Note payable, net of current portion | 20,242,539 | 21,882,079 | 23,999,889 |
| Net Pension Liability | 7,015,927 | 7,163,121 | 7,163,121 |
| Total liabilities | \$ 31,334,539 | \$ 34,350,013 | \$ 38,510,783 |
| Deferred inflows of resources | | | |
| Deferred inflows from Pension | \$ 1,470,707 | \$ 1,049,965 | \$ 1,049,965 |
| Commitment and contingencies | | | |
| Net position: | | | |
| Invested capital assets, net of related debt | (3,829,635) | (4,757,011) | (9,706,236) |
| Restricted - Debt service reserve | 3,816,336 | 3,816,336 | 3,724,627 |
| Unrestricted | (5,102,354) | (8,163,822) | (5,570,042) |
| Total net position | \$ (5,115,653) | \$ (9,104,497) | \$ (11,551,651) |
| Total Liabilities and Net Position | \$ 27,689,593 | \$ 26,295,481 | \$ 28,009,097 |

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Management's Discussion and Analysis
December 31, 2016

At end of 2016, total assets increased by \$1,394,448 where the biggest is on PNCC's cash balance due mainly to increase in the operating revenues mostly from the launching and 3G subscription coverage.

Negative net position ballooned to \$11.4 million in 2014 when Pension liabilities kicked in to comply with GASB 67/68. The net income of \$2,447,154 realized in 2015 helped reduce total negative position down to \$9.1 million at end of 2015 and \$3,988,844 net income in 2016 reduced the negative position to \$5.1 million.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION
Years ended December 31, 2016, 2015, and 2014

| | 2016 | 2015 | 2014 |
|--|-------------------------|------------------------|------------------------|
| Operating revenues | | | |
| Long Distance | \$ 885,996 | \$ 1,277,358 | \$ 1,339,854 |
| Local | 1,525,895 | 1,488,461 | 1,487,049 |
| PalauNet | 3,109,626 | 2,626,066 | 2,936,599 |
| Digital TV | 1,585,141 | 1,480,427 | 1,451,216 |
| GSM Mobile | 7,547,338 | 5,959,990 | 4,289,077 |
| Miscellaneous | 140,936 | 139,692 | 89,659 |
| Provision for doubtful accounts | (109,623) | (53,636) | (249,588) |
| Total Operating Revenues | \$ 14,685,309.00 | \$ 12,918,358 | \$ 11,343,867 |
| Operating expenses | | | |
| Depreciation | 2,360,130 | 2,437,603 | 2,128,506 |
| Plant specific operations | 3,938,385 | 4,463,780 | 3,912,022 |
| Corporate operations | 1,495,029 | 1,171,082 | 1,078,695 |
| Customer service operations | 1,213,678 | 1,232,897 | 1,245,085 |
| Plant non-specific operations | 342,353 | 310,624 | 279,170 |
| Total Operating Expenses | \$ 9,349,575 | \$ 9,615,986 | \$ 8,643,478 |
| Earnings from operations | \$ 5,335,734 | \$ 3,302,372 | \$ 2,700,389 |
| Nonoperating income (expenses): | | | |
| Unrealized gain (loss) on investments | (434,594) | (19,624) | 22,387 |
| Realized gain on investments | 435,134 | - | 10,181 |
| Interest income | - | 288 | 596 |
| Interest (expense) | (1,150,333) | (867,300) | (1,433,267) |
| Gain/(Loss) on investments | 11,486 | 18,533 | - |
| Gain/(Loss) on retirement of equipment | (211,155) | - | 1,806 |
| Other income (expense) | 2,572 | 12,885 | 95,238 |
| Total nonoperating income (expenses), net | \$ (1,346,890) | \$ (855,218) | \$ (1,303,059) |
| Change in net position | \$ 3,988,844 | \$ 2,447,154 | \$ 1,397,330 |
| Net position at beginning of year | \$ (9,104,497) | \$ (11,551,651) | \$ (12,948,981) |
| Net position at end of year | \$ (5,115,653) | \$ (9,104,497) | \$ (11,551,651) |

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Management's Discussion and Analysis
December 31, 2016

Total operating revenues increased by 13.9% from \$12.9 million in 2015 to \$14.7 million in 2016. Increase in total revenues is attributable to increase in the revenues from GSM Mobile operations.

Operating expenses decreased by 2.8% or \$266,411 in 2016 over 2015 attributed to Plant-Specific operations.

Earnings from operation increased by 61.6% from \$3,302,372 in 2015 to \$5,335,734 in 2016. In compliance with GASB 67&68, \$7.1 million in 2015 and \$7.1 million in 2016 liabilities resulted in cumulative deficit of \$5.1 million at end of 2016.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

| | 2016 | 2015 | Increases/(Decrease) | | 2014 |
|---------------------------------|----------------|----------------|----------------------|---------|----------------|
| | | | Dollar | Percent | |
| Operating revenues | \$ 14,685,309 | \$ 12,918,358 | \$ 1,766,951 | 13.7% | \$ 11,343,867 |
| Operating expenses | \$ (9,349,575) | \$ (9,615,986) | \$ 266,411 | (2.8%) | \$ (8,643,478) |
| Operating income | \$ 5,335,734 | \$ 3,302,372 | \$ 2,033,362 | 61.6% | \$ 2,700,389 |
| Non-operating income (expenses) | \$ (1,346,890) | \$ (855,218) | \$ (491,672) | 57.5% | \$ (1,303,059) |
| Change in net position | \$ 3,988,844 | \$ 2,447,154 | \$ 1,541,690 | 63% | \$ 1,397,330 |

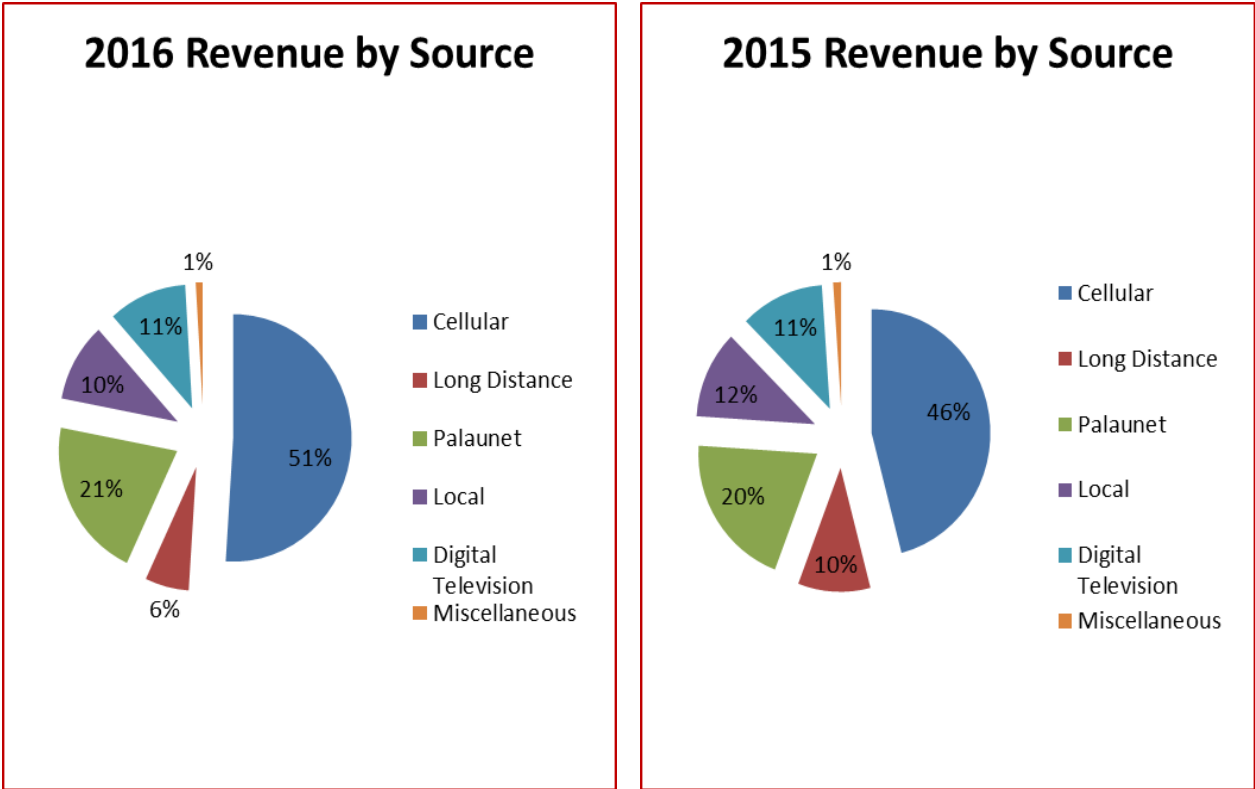
REVENUE BY SOURCE

| Revenue Source | 2016 | 2015 | Increase/(Decrease) | | 2014 |
|------------------------------|----------------------|----------------------|---------------------|--------------|----------------------|
| | | | Dollar | Percent | |
| Cellular | \$ 7,547,338 | \$ 5,959,990 | \$ 1,587,348 | 26.6% | \$ 4,289,077 |
| Long Distance | 885,996 | 1,277,358 | (391,362) | -30.6% | 1,339,854 |
| Palaunet | 3,109,626 | 2,626,066 | 483,560 | 18.4% | 2,936,599 |
| Local | 1,525,895 | 1,488,461 | 37,434 | 2.5% | 1,487,049 |
| Digital Television | 1,585,141 | 1,480,427 | 104,714 | 7.1% | 1,451,216 |
| Miscellaneous | 140,936 | 139,692 | 1,244 | 0.9% | 89,659 |
| Provision for doubtful accts | (109,623) | (53,636) | (55,987) | 104.4% | (249,587) |
| Total | \$ 14,685,309 | \$ 12,918,358 | \$ 1,766,951 | 13.7% | \$ 11,343,867 |

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Management’s Discussion and Analysis
December 31, 2016

Cellular operations have consistently contributed the highest source of revenue and continue to grow over the past five years. There is continued decline in long distance revenues. Internet revenues increased by 18.4% in 2016 as customers opt to subscribe with Homenet and Palaunet accounts while others used 3G service. The revenues from local telecommunications and digital television have been fairly consistent over the past five years.

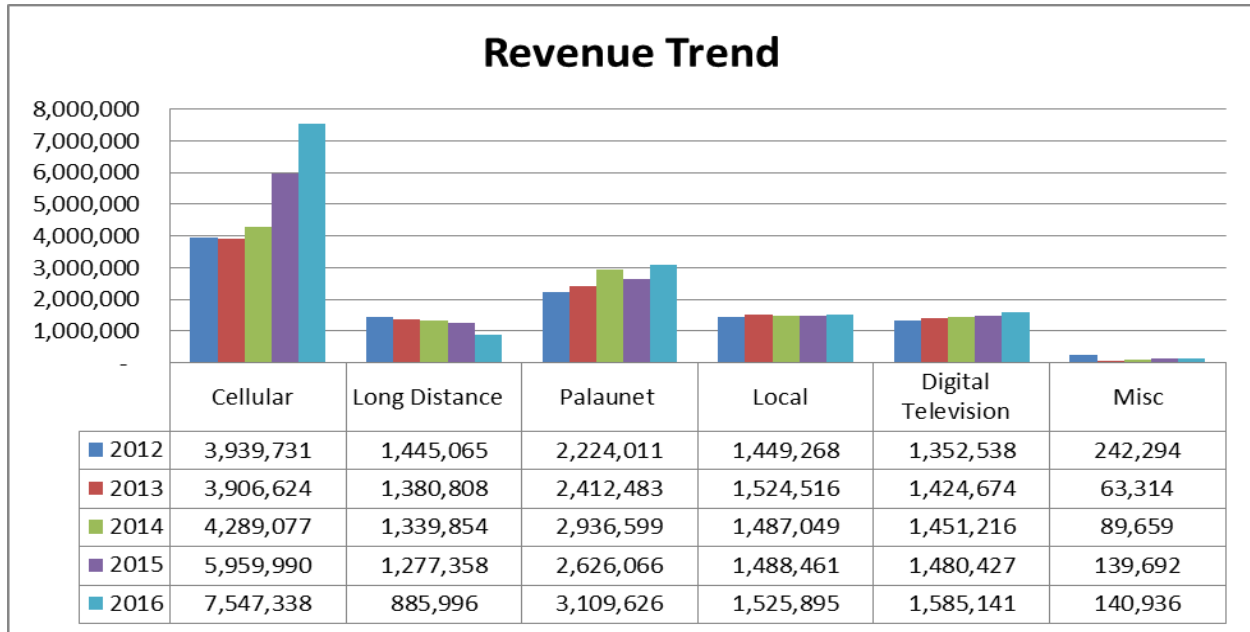


Summarized in the chart above are the major revenue sources. For 2016, the cellular operations contributed 51% of the total operating revenues.

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Management’s Discussion and Analysis
December 31, 2016

The chart below shows the change in revenues by source over the past five years.



SUMMARY OF FINANCIAL RESULTS AND STRATEGIC PLANNING

Summary of Financial Results for 2016

As shown in Table 1. “Statement of Revenues, Expenses and Changes in Net Position”, PNCC’s 2015 revenue increased by 14 % **over** the previous year. The positive change in net position at end of 2016 helps reduce PNCC cumulative deficit from \$9,104,497 in 2015 down to \$5,115,653

- **Telephony:** The revenue for fixed line service has a minimal increase of 2.5%.
- **PalauNet:** The revenue show an increase of 18.4% compared to 2015. This is attributed to customer opting to use the 3G service, Homenet and subscriptions to Palaunet accounts.
- **PalauCel:** GSM mobile revenue maintained strong growth (26.6% for 2016) reflected by the brisk demand for the pre-paid services and introduction of 3G service toward the end of 2015.
- **DTV:** With introduction of live feed for U.S. channels, Digital TV service realized a 7.1% increase in revenue over 2016.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Management's Discussion and Analysis
December 31, 2016

PNCC Strategic Planning Process

The PNCC's 5-year Mid-Term Business Plan (2014-2018), developed with expert assistance of Mr. Akira Maeda in 2013 provides road map for financial sustainability of the corporation. Based on the Business Plan, PNCC implemented 3G platform in 2015 to advance its GSM cellular services. Expansion of 3G service coverage into the whole Babeldaod, Peleliu and Angaur is completed in 2016.

CONTACTING PNCC'S FINANCIAL MANAGEMENT

This financial report is designed to provide a general overview of PNCC's finances and to demonstrate PNCC's transparency and accountability for the money it receives. The Management's Discussion and Analysis for the year ended December 31, 2016 is set forth in the report on the audit of PNCC. The discussion and analysis explains the major factors impacting the 2016 financial statements. If you have questions or need additional information, please contact the Chief Financial Officer at the Palau National Communications Corporation, P.O. Box 99, Koror, Republic of Palau 96940, or e-mail leot@palaunet.com or call 587-9000.

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

FINANCIAL SECTION

For The Years Ended December 31, 2016 and 2015

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

Statements of Net Position
December 31, 2016 and 2015

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES

| | 2016 | 2015 |
|--|---------------|---------------|
| Current assets: | | |
| Cash (Notes 2, 3, 6 and 8) | \$ 3,025,758 | \$ 1,223,089 |
| Receivables: (Notes 2, 6 and 8) | | |
| Trade | 848,403 | 2,279,892 |
| Related party (Note 5) | 685,963 | 887,407 |
| Carriers, net | 192,125 | 34,205 |
| Other receivable | 45,207 | 148,426 |
| Allowance for doubtful accounts (Note 2) | (820,002) | (2,542,212) |
| Total receivables, net | 951,696 | 807,718 |
| Inventories, net (Notes 2 and 6) | 253,259 | 170,310 |
| Deposits | 1,891 | - |
| Prepaid expenses | 23,581 | 12,534 |
| Total current assets | 4,256,185 | 2,213,651 |
| Investments (Notes 2 and 3) | 612,313 | 602,737 |
| Restricted cash and cash equivalents (Notes 2, 3, 6 and 8) | 3,816,336 | 3,816,336 |
| Other noncurrent assets (Note 2) | 51,550 | 51,550 |
| Capital assets, net (Notes 2, 4, 6) | 18,189,738 | 19,040,523 |
| Total assets | 26,926,122 | 25,724,797 |
| Deferred outflows of resources: | | |
| Deferred outflows from pension (Note 2) | 763,471 | 570,684 |
| Total assets and deferred outflows of resources | \$ 27,689,593 | \$ 26,295,481 |

LIABILITIES, DEFERRED INFLOWS OF RESOURCES AND NET POSITION

| | | |
|---|---------------|---------------|
| Current liabilities: | | |
| Current portion of long-term debt (Notes 6 and 8) | \$ 1,776,834 | \$ 1,915,455 |
| Current portion of contract payable (Note 7) | 945,200 | 1,199,800 |
| Accounts payable (Note 8) | 102,182 | 35,939 |
| Payable to carriers, net (Note 8) | 219,389 | 6,875 |
| Accrued expenses (Notes 2 and 8) | 434,482 | 493,259 |
| Unearned revenues (Notes 2 and 8) | 7,797 | 107,621 |
| Customer deposits (Notes 2 and 8) | 590,189 | 600,464 |
| Total current liabilities | 4,076,073 | 4,359,413 |
| Contract payable, net of current portion (Note 7) | - | 945,400 |
| Note payable, net of current portion (Notes 6 and 8) | 20,242,539 | 21,882,079 |
| Net pension liability (Note 2) | 7,015,927 | 7,163,121 |
| Total liabilities | 31,334,539 | 34,350,013 |
| Deferred inflows of resources: | | |
| Deferred inflows from pension (Note 2) | 1,470,707 | 1,049,965 |
| Commitments and contingencies (Note 7) | | |
| Net position (Note 2): | | |
| Net investment in capital assets | (3,829,635) | (4,757,011) |
| Restricted for: | | |
| Debt service and reserve | 3,816,336 | 3,816,336 |
| Unrestricted | (5,102,354) | (8,163,822) |
| Total net position | (5,115,653) | (9,104,497) |
| Total liabilities, deferred inflows of resources and net position | \$ 27,689,593 | \$ 26,295,481 |

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, 2016 and 2015

| | <u>2016</u> | <u>2015</u> |
|--|-----------------------|-----------------------|
| Operating revenues (Note 6): | | |
| Cellular | \$ 7,547,338 | \$ 5,959,990 |
| Palaunet | 3,109,626 | 2,626,066 |
| Digital television | 1,585,141 | 1,480,427 |
| Local | 1,525,895 | 1,488,461 |
| Long distance | 885,996 | 1,277,358 |
| Miscellaneous | 140,936 | 139,692 |
| Provision for doubtful accounts | <u>(109,623)</u> | <u>(53,636)</u> |
| Total net operating revenues | <u>14,685,309</u> | <u>12,918,358</u> |
| Operating expenses: | | |
| Plant specific | | |
| Operations | 3,938,385 | 4,463,780 |
| Depreciation (Note 4) | 2,360,130 | 2,437,603 |
| Corporate office | 1,495,029 | 1,171,082 |
| Customer service | 1,213,678 | 1,232,897 |
| Plant non-specific operations | <u>342,353</u> | <u>310,624</u> |
| Total operating expenses | <u>9,349,575</u> | <u>9,615,986</u> |
| Operating income | <u>5,335,734</u> | <u>3,302,372</u> |
| Nonoperating income (expense): | | |
| Unrealized loss on investments | (434,594) | (19,624) |
| Realized gain on investments | 435,134 | - |
| Interest income | - | 288 |
| Income on investments | 11,486 | 18,533 |
| Gain (loss) on retirement of equipment | (211,155) | - |
| Other income (expense), net | 2,572 | 12,885 |
| Interest expense (Note 6) | <u>(1,150,333)</u> | <u>(867,300)</u> |
| Total nonoperating income (expense), net | <u>(1,346,890)</u> | <u>(855,218)</u> |
| Change in net position | 3,988,844 | 2,447,154 |
| Net position at beginning of year (Note 2) | <u>(9,104,497)</u> | <u>(11,551,651)</u> |
| Net position at end of year | <u>\$ (5,115,653)</u> | <u>\$ (9,104,497)</u> |

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, 2016 and 2015

| | <u>2016</u> | <u>2015</u> |
|--|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Cash received from customers | \$ 14,555,389 | \$ 13,438,060 |
| Cash payments to suppliers for goods and services | (5,519,975) | (5,754,263) |
| Cash payments to employees | <u>(1,398,333)</u> | <u>(1,427,349)</u> |
| Net cash provided by operating activities | <u>7,637,081</u> | <u>6,256,448</u> |
| Cash flows from capital and related financing activities: | | |
| Additions to capital assets | (1,723,202) | (1,124,183) |
| Withdrawals from restricted cash and cash equivalents | - | (91,709) |
| Interest paid | (1,150,333) | (867,300) |
| Repayment of contract payable | (1,200,000) | (1,778,800) |
| Repayment of long-term note payable | <u>(1,778,161)</u> | <u>(1,877,203)</u> |
| Net cash used for capital and related financing activities | <u>(5,851,696)</u> | <u>(5,739,195)</u> |
| Cash flows from investing activities: | | |
| Interest income | 2,572 | 288 |
| Proceeds from sale and maturities of investment securities | 268,032 | 265,286 |
| Income (loss) on investment | 11,486 | 18,533 |
| Purchase of investment securities | <u>(264,806)</u> | <u>(258,372)</u> |
| Net cash provided by investing activities | <u>17,284</u> | <u>25,735</u> |
| Net increase in cash | 1,802,669 | 542,988 |
| Cash at beginning of year | <u>1,223,089</u> | <u>680,101</u> |
| Cash at end of year | <u>\$ 3,025,758</u> | <u>\$ 1,223,089</u> |

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, 2015 and 2014

| | 2016 | 2015 |
|---|--------------|--------------|
| Reconciliation of operating income to net cash provided by operating activities: | | |
| Operating income | \$ 5,335,734 | \$ 3,302,372 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | |
| Depreciation | 2,360,130 | 2,437,603 |
| Provision for doubtful accounts | 109,623 | 53,636 |
| Allowance for uncollectible account write-off | (1,722,210) | (929,387) |
| Other income (expense), net | (2,572) | 12,082 |
| Realized gain on investments | (540) | - |
| Income on investments | (11,486) | - |
| Loss on retirement of equipment | 211,155 | - |
| (Increase) decrease in assets: | | |
| Receivables: | | |
| Trade | 1,320,613 | 995,512 |
| Related party | 201,444 | (39,027) |
| Carriers, net | (157,920) | 390,195 |
| Other receivable | 103,219 | 70,703 |
| Deferred outflows from pension | (192,787) | (112,812) |
| Inventories | (82,949) | 5,097 |
| Deposits | (1,891) | 180,000 |
| Prepaid expenses | (11,047) | 33,183 |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (138,621) | 240,607 |
| Payable to carriers, net | 212,514 | (69,050) |
| Accrued expenses | (58,777) | (180,548) |
| Customer deposits | (10,275) | (97,881) |
| Unearned revenues | (99,824) | (35,837) |
| Deferred inflows from pension | 420,742 | - |
| Net pension liability | (147,194) | - |
| | \$ 7,637,081 | \$ 6,256,448 |
| Net cash provided by operating activities | | |

See accompanying notes to financial statements.

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

Notes to Financial Statements
December 31, 2016 and 2015

(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 proprietary 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.

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

Notes to Financial Statements
December 31, 2016 and 2015

(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 acquisition, construction, or improvement of those assets or related debt should be included in this component of net position. At December 31, 2016 and 2015, PNCC have deferred outflows of resources and deferred inflows of resources that it was included as 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, 2016 and 2015, PNCC have deferred outflows of resources, and deferred inflows of resources that it was included as component of restricted net position.

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

Notes to Financial Statements
December 31, 2016 and 2015

(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, 2016 and 2015, PNCC does not have any 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, 2016 and 2015, PNCC have deferred outflows of resources and deferred inflows of resources that it was included in component of net position.

B. Measurement Focus and Basis of Accounting

Measurement focus 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 proprietary funds. Under the accrual method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred. PNCC uses the accrual basis of accounting.

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

Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

B. Measurement Focus and Basis of Accounting, continued

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's 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 the budget 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.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

D. Budget, continued

The supplementary information in the Management’s Discussion and Analysis in pages 4 to 10 includes PNCC’s analysis of the significant variations and major factors impacting the 2016 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 2015, PNCC implemented the following pronouncements:

In June 2014, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions and GASB Statement No. 71, Pension Transition for contributions Made Subsequent to the Measurement Date – amendment of GASB Statement No. 68*, which revise and establish new financial reporting requirement for most government that provide their employees with pension benefits. The implementation of these statements did have a material effect on the accompanying financial statements resulting in the restatement of PNCC’s 2014 financial statements to reflect the reporting of net pension liabilities and deferred inflows of resources and deferred outflows of resources for a qualified pension plan and recognition of pension expense in accordance with the provisions of GASB Statement No. 68. The implementation of GASB Statement No. 68 results in PNCC reporting deferred inflows of resources of \$657,436 and a net pension liability of \$6,984,966 as of December 31, 2014. PNCC’s net position as of December 31, 2014 and statement of revenues, expenses and changes in net position for the year ended December 31, 2014 have been restated to reflect the required adjustment as follows:

| | As previously <u>Reported</u> | <u>Adjustment</u> | <u>As Restated</u> |
|---------------------------------|----------------------------------|-----------------------|------------------------|
| As of January 1, 2014: | | | |
| Net position | \$ (3,796,437) | \$ (7,755,214) | \$ (11,551,651) |
| For the year ended December 31: | | | |
| Personnel expense | - | - | - |
| Change in net position | - | - | - |
| As of December 31: | | | |
| Deferred outflows from pension | - | - | - |
| Net pension liability | - | (7,163,121) | (7,163,121) |
| Deferred inflows from pension | - | (1,049,965) | (1,049,965) |
| Net position | <u>\$ (3,796,437)</u> | <u>\$ (7,755,214)</u> | <u>\$ (11,551,651)</u> |

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

Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

E. New Accounting Standards, continued

In February, 2015 GASB issued Statement No. 72, *Fair Value Measurement and Application*. This Statement addresses accounting and financial reporting issues related to fair value measurements. This Statement provides guidance for determining a fair value measurement for financial reporting purposes. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. This Statement requires a government to use valuation techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value. This Statement establishes a hierarchy of inputs to valuation techniques used to measure fair value.

This Statement requires additional analysis of fair value if the volume or level of activity for an asset or liability has significantly decreased. It also requires identification of transactions that are not orderly. This Statement requires measurement at acquisition value (an entry price) for donated capital assets, donated works of art, historical treasures, and similar assets and capital assets received in a service concession arrangement. This Statement requires disclosures to be made about fair value measurements, the level of fair value hierarchy, and valuation techniques. It also requires additional disclosures regarding investments in certain entities that calculate net asset value per share (or its equivalent). The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015. Earlier application is encouraged.

In June 2015, GASB issued Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement 68 and Amendments to Certain Provisions of GASB Statement 67 and 68*. This Statement establishes requirements for defined benefit pensions that are not within the scope of Statement No. 68, Accounting and Financial Reporting for Pensions, as well as for the assets accumulated for purposes of providing those pensions. In addition, it establishes requirements for defined contribution pensions that are not within the scope of Statement 68. The requirements of this Statement will improve financial reporting by establishing a single framework for the presentation of information about pensions, which will enhance the comparability of pension-related information reported by employers and nonemployer contributing entities. The provisions in Statement No. 73 are effective for fiscal years beginning after June 15, 2015, with the exception of the provisions that address employers and governmental non-employer contributing entities for pensions that are not within the scope of Statement 68, which are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this Statement will have a material impact on PNCC's financial statements.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

E. New Accounting Standards, continued

In June 2015, GASB Statement No. 74, *Financial Reporting for Postemployment benefits Plans Other Than Pension Plans*. This Statement replaces Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, as amended*, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. It also includes requirements for defined contribution OPEB plans that replace the requirements for those OPEB plans in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, as amended*, Statement 43, and Statement No. 50, *Pension Disclosures*. This Statement also addresses financial reporting requirements for governments whose employees are provided with postemployment benefits other than pensions or OPEB. The provisions in Statement No. 74 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this Statement will have a material impact on PNCC's the financial statements.

In June 2015, GASB issued Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which replaces the requirements of *Statements No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, as amended*, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, for OPEB. Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and provide guidance on reporting by governments that provide OPEB to their employees and for governments that finance OPEB for employees of other governments. The provisions in Statement No. 75 establish new accounting and financial reporting requirements for OPEB plans. This Statement addresses accounting and financial reporting for OPEB that is provided to the employees of state and local governmental employers. This Statement establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures.

For defined benefit OPEB, this Statement identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. Note disclosure and required supplementary information requirements about defined benefit OPEB also are addressed. The provisions in Statements No. 75 are effective for fiscal years beginning after June 15, 2017. Management does not believe that the implementation of this statement will have a material effect on PNCC's financial statements.

In June 2015, GASB issued Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Government*. The objective of this Statement is to identify—in the context of the current governmental financial reporting environment—the hierarchy of generally accepted accounting principles (GAAP).

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

E. New Accounting Standards, continued

The “GAAP hierarchy” consists of the sources of accounting principles used to prepare financial statements of state and local governmental entities in conformity with GAAP and the framework for selecting those principles. This Statement reduces the GAAP hierarchy to two categories of authoritative GAAP and addresses the use of authoritative and nonauthoritative literature in the event that the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP. This Statement supersedes Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015, and should be applied retroactively. Earlier application is permitted. Management does not believe that the implementation of this statement will have a material effect on PNCC’s financial statements.

In August 2015, GASB issued Statement No. 77, *Tax Abatement Disclosures*, which requires governments that enter into tax abatement agreements to disclose certain information about the agreements. Although many governments offer tax abatements and provide information to the public about them, they do not always provide the information necessary to assess how tax abatements affect their financial position and results of operations, including their ability to raise resources in the future. This Statement requires disclosure of tax abatement information about (1) a reporting government’s own tax abatement agreements; and (2) those that are entered into by other governments and that reduce the reporting government’s tax revenues. The provisions in Statement No. 77 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material impact on PNCC’s financial statements.

In December 2015, GASB issued Statement No. 78, *Pensions Provided Through Certain Multiple-Employer Defined Benefit Pension Plans*. This Statement addresses an issue regarding the scope and applicability of Statement No. 68, *Accounting and Financial Reporting for Pensions*. This issue is associated with pensions provided through certain multiple-employer defined benefit pension plans and to state or local governmental employers whose employees are provided with such pensions. GASB Statement No. 78 will be effective for fiscal year ending September 30, 2017. Management has not evaluated the impact that the implementation of this statement will have on the PNCC’s financial statements.

In December 2015, GASB issued Statement No. 79, *Certain External Investment Pools and Pool Participants*. This Statement addresses accounting and financial reporting for certain external investment pools and pool participants. GASB Statement No. 79 will be effective for the fiscal year ending September 30, 2017. Management has not evaluated the impact that the implementation of this statement will have on the PNCC’s financial statements.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

E. New Accounting Standards, continued

In January 2016, GASB issued Statement No. 80, *Blending Requirements for Certain Component Units*. The Statement is intended to provide clarity about how certain component units incorporated as not-for-profit corporations should be presented in the financial statements of the primary state or local government. GASB Statement No. 80 will be effective for the fiscal year ending September 30, 2017. Management has not evaluated the impact that the implementation of this statement will have on the PNCC's financial statements.

In March 2016, GASB issued Statement No. 81, *Irrevocable Split-Interest Agreements*. This Statement is to improve accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. GASB Statement No. 81 will be effective for fiscal year ending September 30, 2018. Management has not evaluated the impact that the implementation of this statement will have on the PNCC's financial statements.

In March 2016, GASB issued Statement No. 82, *Pension Issues*. This Statement addresses certain issues that have been raised with respect to Statements No. 67, *Financial Reporting for Pension Plans*, No. 68, *Accounting and Financial Reporting for Pensions*, and No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*. This Statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. GASB Statement No. 82 will be effective for fiscal year ending September 30, 2018. Management has not evaluated the impact that the implementation of this statement will have on the PNCC's financial statements.

In November 2016, GASB issued Statement No. 83, *Certain Asset Retirement Obligations*. This Statement addresses accounting and financial reporting for certain asset retirement obligations. GASB Statement No. 83 will be effective for the fiscal year ending September 30, 2019. Management has not evaluated the impact that the implementation of this statement will have on the PNCC's financial statements.

In January 2017, GASB issued Statement No. 84, *Fiduciary Activities*. This Statement improves guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported. GASB Statement No. 84 will be effective for reporting periods after December 15, 2018. Management has not evaluated the impact that the implementation of this statement will have on the PNCC's financial statements.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

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.

Receivables and Allowance for Doubtful Accounts, Continued

An analysis of the change in allowance for doubtful accounts for the years ended December 31, 2016 and 2015 is as follows:

| | <u>2016</u> | <u>2015</u> |
|----------------------------------|--------------------|---------------------|
| Balance at beginning of the year | \$ 2,542,212 | \$ 3,417,963 |
| Current year provision | 109,623 | 53,636 |
| Account written off | <u>(1,700,139)</u> | <u>(929,387)</u> |
| Balance at end of year | <u>\$ 951,696</u> | <u>\$ 2,542,212</u> |

Inventories

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

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

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, 2016 and 2015, 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, 2016 and 2015 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 than those of this investment policy, will be the governing restriction.
- U.S. and non-U.S. common stocks, ADRs (American Depositary Receipts), convertible bonds, preferred stocks, fixed-income securities, mutual funds and short-term securities are permissible investments.
- No individual security of any issuer, other than that of the United States Government, shall constitute more than 10% (at cost) of any Investment Manager's portfolio.
- Holdings of any issuer shall constitute no more than 5% of the outstanding securities of such issuer.
- Investments in a registered mutual fund managed by the Investment Manager are subject to prior approval of the Board of Directors.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

- 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 manager's stated strategy and style.
- Equity holdings shall be restricted to readily marketable securities of corporations that are actively traded on the major exchanges and over the counter.
- The Investment Managers shall have the discretion to invest a portion of the assets in cash reserves when they deem appropriate. However, the Investment Managers will be evaluated against their peers on the performance of the total funds under their direct management.
- Common stock and preferred stock of any institution or entity created or existing under the laws of the United States of America or any state, district, territory, or District of Columbia, or of any foreign country are permissible investments.

U.S. Fixed Income:

- All fixed income securities (with the exception of U.S. Treasury or Agency securities which are unrated) shall have a Moody's, Standard & Poor's and/or a Fitch's credit quality rating of no less than "BBB".
- No more than 20% of the market value of the portfolio shall be rated less than single "A" quality, unless the Investment Manager has specific written authorization. Total portfolio quality (capitalization weighted) shall maintain an "A" minimum rating.

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.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

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.

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.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Depreciation expense for all capital assets is provided for on the straight-line basis over the following estimated useful lives:

| | <u>Estimated Useful Lives</u> |
|--|-----------------------------------|
| 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, 2016 and 2015.

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 for costs incurred on funds used to construct or acquire property, plant and equipment. The capitalized interest is recorded as part of the asset to which it relates and is amortized over the asset's estimated useful life.

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, 2016 and 2015, refundable deposit was \$51,550 in each year.

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

Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Compensated Absences

Compensated absences are those absences for which employees will be paid, such as annual vacation leave and health (sick) leave. PNCC recognizes all vested vacation leave benefits accrued by its employees when earned. Employees are credited annual leave with pay of 80, 120, and 160 hours per year depending upon their length of service with PNCC. An employee cannot carry over to the following calendar year accumulated annual vacation leave in excess of 80 hours for 5 to 9 years of service, and 120 hours for employees with over 10 years of service. However, a carryover 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, 2016 and 2015 accrued annual leave totaled \$78,845 and \$79,015, respectively, and is included in the Statements of Net Position as a component of accrued expenses. At December 31, 2016 and 2015, all compensated absences are current. For the years ended December 31, 2016 and 2015, annual vacation leave taken totaled \$119,535 and \$92,560, respectively, and is included 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 in which actual traffic minutes were used and processed after the reporting period. At December 31, 2016 and 2015, unearned revenues from prepaid telecom billings were \$7,797 and \$107,621, 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 a refund check is issued for the remainder. Refunds are not automatic; the customer must request a refund. There is no interest paid on customer deposits. At December 31, 2016 and 2015, customer deposits were \$590,189 and \$600,464, respectively.

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

Notes to Financial Statements
December 31, 2016 and 2015

(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, 2016 and 2015, advertising costs totaled \$8,052 and \$3,708, respectively, and are included as a component of customer operations expense reported in the Statements of Revenues, Expenses and Changes in Net Position.

Deferred Outflows of Resources

In addition to assets, the statements of net position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, deferred outflows of resources represents a consumption of net position that applies to a future period and so will not be recognized as an outflow of resources (deduction of net position) until then. PNCC determined the differences between expected and actual experience with regard to economic or demographic factors in the measurement of the total pension liability, pension contributions made subsequent to the measurement date and changes in proportion and difference between PNCC pension contributions and proportionate share of contributions qualify for reporting in this category.

Deferred Inflows of Resources

In additions to liabilities, the statements of net position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, deferred inflows of resources represent acquisition of net position that applies to a future period and so will not be recognized as an inflow of resources (additions to net position) until then. PNCC has determined the difference between projected and actual earnings on pension plan investments qualify for reporting in this category.

Pensions

Pensions are required to be recognized and disclosed using the accrual basis of accounting. PNCC recognizes a net pension liability for the defined benefit pension plan in which it participates, which represents PNCC's proportional share of excess total pension liability over the pension plan assets – actuarially calculated – of a defined benefit, cost sharing multi-employer plan. Changes in the net pension liability during the period are recorded as pension expense, or as deferred inflows of resources or deferred outflows of resources, depending on the nature of the change, in the period incurred.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Pensions, continued

Those changes in net pension liability that are recorded as deferred inflows of resources or as deferred outflows of resources, that arise from changes in actuarial assumptions or other inputs and differences between expected or actual experience, are amortized over the weighted-average remaining service life of all participants in the qualified pension plan and recorded as a component of pension expense beginning with the period in which they are incurred. Projected earnings on qualified pension plan investments are recognized as a component of pension expense. Differences between projected and actual investment earnings are reported as deferred inflows of resources or deferred outflows of resources and amortized as a component of pension expense on a closed basis over a five year period beginning with the period in which the difference occurred,

Retirement Plan and Benefits

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 issues a stand-alone financial report which is available at its office site.

The Fund provides retirement, security and other benefits to employees, and their spouses and dependents, of the Republic of Palau State Governments and Republic of Palau agencies, funds and public corporations, which are paid monthly and are two percent of each member's average monthly salary. Normal benefits are the credited total service up to a maximum of thirty years total service. Generally, benefits vest after three years of credited service. Members, who retire at or after age 60, or with 30 years of vesting service, are entitled to retirement benefits. On April 30, 2013, RPPL 9-2 eliminated the mandatory service retirement after thirty years of service. After December 31, 2013, no employee shall be entitled to pension benefits until reaching the age of sixty.

In accordance with the directives of RPPL 5-7, which provides that "no person who retires after October 1, 1997, may receive benefits un the Plan unless he or she has contributed to the Plan for at least five years or has made an actuarially equivalent lump sum contributions". In accordance with RPPL 9-2, members who retire after April 30, 2013 must not receive benefits greater than thirty thousand dollars per year. Further, the amount of benefits that a member receives should not be recalculated if the members is re-employed after the member begins receiving benefits under the Fund. Additionally, a member should not receive benefits during the time the member is re-employed subsequent to retirement.

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

Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Retirement Plan and Benefits, continued

Republic of Palau Public Law 2-26 is the authority under which benefit provisions and contributions rates are established. Member contribution rates are established by Republic of Palau Public Law 2-26 at six percent (6%) of total payroll and are deducted from the member's dollar for dollar by the employer. Under the provisions of the Republic of Palau Public Law 2-26, the Fund's Board of Trustees adopted a Trust Fund Operation 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.

Actuarial Assumptions

The Fund utilizes the actuarial cost method termed "level aggregate cost method" with actuarial assumptions used to compute the pension benefit obligation. The following is the statement of actuarial assumptions as of September 30, 2015, for the same measurement date, using the following assumptions:

| | | |
|----------------------------|---|---|
| Actuarial Cost Method | : | Normal costs are calculated under the entry age normal method |
| Investment Income | : | 7.5% per year, net of investment expenses |
| Expenses | : | \$300,000 each year |
| Inflation: | | 3% |
| Salary Increase | : | 3% per year |
| Mortality | : | RP 2000 Combined Healthy Mortality Table, set forward ten years for all members except disability recipients, where the total table is set forward ten years |
| Termination of Employment: | | 5% per year prior to age 35; none after age 35 |

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Retirement Plan and Benefits, continued

| Disabled | : | PBGC Mortality Table for Disabled Persons Receiving Social Security | | | | | | | | | | | | | | | | | | |
|--|-------------------|---|------------|-------------------|----|-------|----|-------|----|-------|----|-------|----|-------|----|-------|----|-------|----|-------|
| | | <table border="0"> <thead> <tr> <th style="text-align: left;"><u>Age</u></th> <th style="text-align: left;"><u>Disability</u></th> </tr> </thead> <tbody> <tr> <td>25</td> <td>0.21%</td> </tr> <tr> <td>30</td> <td>0.18%</td> </tr> <tr> <td>35</td> <td>0.25%</td> </tr> <tr> <td>40</td> <td>0.35%</td> </tr> <tr> <td>45</td> <td>0.50%</td> </tr> <tr> <td>50</td> <td>0.76%</td> </tr> <tr> <td>55</td> <td>1.43%</td> </tr> <tr> <td>60</td> <td>2.12%</td> </tr> </tbody> </table> | <u>Age</u> | <u>Disability</u> | 25 | 0.21% | 30 | 0.18% | 35 | 0.25% | 40 | 0.35% | 45 | 0.50% | 50 | 0.76% | 55 | 1.43% | 60 | 2.12% |
| <u>Age</u> | <u>Disability</u> | | | | | | | | | | | | | | | | | | | |
| 25 | 0.21% | | | | | | | | | | | | | | | | | | | |
| 30 | 0.18% | | | | | | | | | | | | | | | | | | | |
| 35 | 0.25% | | | | | | | | | | | | | | | | | | | |
| 40 | 0.35% | | | | | | | | | | | | | | | | | | | |
| 45 | 0.50% | | | | | | | | | | | | | | | | | | | |
| 50 | 0.76% | | | | | | | | | | | | | | | | | | | |
| 55 | 1.43% | | | | | | | | | | | | | | | | | | | |
| 60 | 2.12% | | | | | | | | | | | | | | | | | | | |
| Retirement Age | : | 100% at age 60 | | | | | | | | | | | | | | | | | | |
| Form of payment | : | Single: Straight life annuity; Married; 100% joint and survivor | | | | | | | | | | | | | | | | | | |
| Duty vs Non-Duty related Disability | : | 100% Duty related | | | | | | | | | | | | | | | | | | |
| Pre-retirement Beneficiary Benefit Members | : | Present value of accrued benefit earned by the member. 80% of the workers are assumed to be married and males are assumed to be 3 years older than their spouses | | | | | | | | | | | | | | | | | | |
| Post Retirement Survivor's Benefit | : | 100% of the benefit the retiree was receiving prior death. 80% of active workers are assumed to be married when they retire. Males are assumed to be 3 years older than their spouses | | | | | | | | | | | | | | | | | | |

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 affects 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.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Retirement Plan and Benefits, continued

Based on the actuarial valuation of the Fund as of October 1, 2014, the actuarial valuation determined the unfunded pension benefit obligation as follows:

Accrued liability as of October 1, 2015 for:

| | |
|---|-----------------------|
| Active participants | \$ 82,099,216 |
| Inactive participants with vested deferred benefits | 3,323,468 |
| Participants in pay status | <u>61,865,857</u> |
| Total accrued liability | 147,288,541 |
| Market value of assets | <u>(34,261,206)</u> |
| Unfunded accrued liability | \$ <u>113,027,335</u> |
| | |
| Funded ratio (ratio of assets to liabilities) | 23.3% |

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.

Deferred Outflows and Inflows of Resources

As of September 30, 2016, PNCC reported total deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

| | <u>2016</u> | | <u>2015</u> | |
|---|--------------------------------------|-------------------------------------|--------------------------------------|-------------------------------------|
| | Deferred Outflows of Resources | Deferred Inflows of Resources | Deferred Outflows of Resources | Deferred Inflows of Resources |
| Differences between expected and actual experience | \$ 62,032 | \$ - | \$ 457,872 | \$ - |
| Net difference between projected and actual earnings on pension plan investment | 570,384 | 1,049,965 | - | 1,049,965 |
| PNCC contributions subsequent to the measurement date | - | - | 112,812 | - |
| Changes in portion and difference between the Authority contribution and proportionate shares of contributions | <u>131,055</u> | <u>420,742</u> | <u>-</u> | <u>-</u> |
| Total | <u>\$ 763,471</u> | <u>\$ 1,470,707</u> | <u>\$ 570,684</u> | <u>\$ 1,049,965</u> |

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Medical and Life Insurance Benefit

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

In October 2010, in compliance with the requirements of RPPL 8-14, PNCC began withholding from its employees 2.5% of gross earnings each pay period, with a matching employer share (a 5% combined contribution) for remittance to the ROP Social Security Administration that administers the Medical Savings Fund and Palau Health Insurance. For the years ended December 31, 2016, 2015 and 2014, PNCC’s employer’s share paid to the Social Security Administration was for these costs was \$108,266, \$88,325 and \$87,393, respectively, and is included as a component of payroll burden in the Schedule of Functional Expenses.

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, 2016 and 2015. Therefore, the PNCC’S net position represents the residual interest in PNCC’s assets after liabilities. At December 31, 2016 and 2015, PNCC’s net position is negative, meaning that total liabilities exceeded total assets.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(2) Summary of Significant Accounting Policies, continued

F. Assets, Liabilities and Net Position, continued

Net Position, continued

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, 2016 and 2015, PNCC had a deficit net position totaling \$5,115,653 and \$9,104,497, respectively. When program expenses are incurred, where 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 PNCC or by 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 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, 2016 and 2015, the carrying amount of PNCC's cash balances was \$3,025,758 and \$1,223,089, respectively. The corresponding bank balances as of December 31, 2016 and 2015 were \$2,919,791 and \$1,303,129, respectively. From these deposits, \$573,720 and \$603,036, respectively, were subject to coverage by the Federal Deposit Insurance Corporation (FDIC) with the remaining balance exceeding insurable limits. PNCC does not require collateralization of bank accounts, and therefore, deposits in excess of FDIC insurance coverage are uncollateralized.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(3) Deposits and Investments Risk, continued

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 PNCC or by its agent in 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 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 PNCC's name.

Fair Value Measurement of the Investments

Investment and related investment earnings are reported at fair value using quoted market prices. Fair value is the price that would be received to sell an asset or liability (i.e. the exit price) in an orderly transaction between market participants at the date as of which the fair value of an asset or liability is determined.

The PNCC, categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the assets. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs. PNCC has the following fair value measurements:

| | 12/31/16 | Fair Value Measurement Using | | |
|--|-------------------|------------------------------|-------------------|-------------|
| | | Level 1 | Level 2 | Level 3 |
| Investments by fair value level | | | | |
| Fixed income securities: | | | | |
| Corporate bonds | \$ 72,383 | \$ - | \$ 72,383 | \$ - |
| U.S. Treasury securities | 74,355 | 74,355 | - | - |
| Federal agencies | 31,333 | - | 31,333.0 | - |
| Equity securities: | | | | |
| U.S. equities | 292,406 | 292,406 | - | - |
| Non-U.S. equities | 59,728 | 59,728 | - | - |
| Total investments by fair value level | \$ 530,205 | \$ 426,489 | \$ 103,716 | \$ - |
| Investments measured at net asset value (NAV): | | | | |
| Exchange-traded funds | \$ 7,601 | | | |
| Investments measured at cost based measure: | | | | |
| Money market funds | \$ 74,507 | | | |
| | | | | |
| | | | | |
| Investments by fair value level | 12/31/15 | | | |
| Fixed income securities: | | | | |
| Corporate bonds | \$ 63,271 | \$ - | \$ 63,271 | \$ - |
| U.S. Treasury securities | 54,163 | 54,163 | - | - |
| Federal agencies | 25,125 | - | 25,125.0 | - |
| Equity securities: | | | | |
| U.S. equities | 348,255 | 348,255 | - | - |
| Non-U.S. equities | 62,358 | 62,358 | - | - |
| Total investments by fair value level | \$ 553,172 | \$ 464,776 | \$ 88,396 | \$ - |
| Investments measured at net asset value (NAV): | | | | |
| Exchange-traded funds | \$ - | | | |
| Investments measured at cost based measure: | | | | |
| Money market funds | \$ 49,565 | | | |

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(3) Deposits and Investments Risk, continued

Investments, continued

Restricted Cash and Cash Equivalents

PNCC's restricted cash and cash equivalents 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 to 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 a market value of \$3,816,336 as of December 31, 2015, are placed in short-term money market mutual funds held by the Bank of New York Mellon, an FDIC insured financial institution. Although the money market mutual fund is not insured by the FDIC, this mutual fund portfolio consists of US Treasury bills and obligations guaranteed by the US Department of the Treasury as well as repurchase agreements which are fully collateralized by such obligation. This mutual fund has a weighted average maturity of 45 days and is rated AAAM by Standard and Poor's and AAA-mf by Moody's. At December 31, 2016, the restricted cash and cash equivalents amounting \$3,816,336 was returned by New York Mellon to PNCC and deposited to FDIC insured financial institution.

PNCC's Emergency Reserve Fund (the Fund) has been invested with Morgan Stanley Smith Barney, which holds the investments in PNCC's name. 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 of time, should a distribution need arise. At December 31, 2015, the PNCC's Board of Directors selected Raymond James as the new investment consultant. The selection was go through procurement process.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(3) Deposits and Investments Risk, continued

Investments, continued

At December 31, 2016 and 2015, PNCC's investment portfolios at fair value are as follows:

| | 2016 | | | 2015 | | |
|---------------------------|-------------|-------------|-------------------|-------------|-------------|-------------------|
| | Allocation | | Market Value | Allocation | | Market Value |
| | Actual | Policy | | Actual | Policy | |
| Fixed income securities: | | | | | | |
| Corporate Bonds | | | \$ 72,383 | | | \$ 63,271 |
| U.S. Treasury | | | 74,355 | | | 54,163 |
| Federal agencies | | | <u>31,333</u> | | | <u>25,125</u> |
| Total fixed income | 29% | 29% | 178,071 | 24% | 30% | 142,559 |
| Equity securities: | | | | | | |
| U.S. equities | 48% | 43% | 292,406 | 58% | 50% | 348,255 |
| Non-U.S. equities | 10% | 16% | <u>59,728</u> | 10% | 10% | <u>62,358</u> |
| Total equity securities | | | 352,134 | | | 410,613 |
| Exchange-traded funds | 1% | 1% | 7,601 | | | |
| Cash and cash equivalents | <u>12%</u> | <u>11%</u> | <u>74,507</u> | <u>8%</u> | <u>10%</u> | <u>49,565</u> |
| Total investments | <u>100%</u> | <u>100%</u> | \$ <u>612,313</u> | <u>100%</u> | <u>100%</u> | \$ <u>602,737</u> |

At December 31, 2016 and 2015, PNCC's fixed income securities had the following ratings and maturities:

| As of December 31, 2016 | | | | | | | |
|-------------------------|-------------------|----------------------------------|------------------|------------------|------------------|--------|--------------------|
| Investment type | Fair Value | Investment maturities (in years) | | | | Rating | |
| | | Less than 1 | 1-5 | 6-10 | More than 10 | Moody | Standard & Poor |
| Corporate bonds | \$ 6,067 | \$ - | \$ - | \$ 6,067 | \$ - | BAA1 | BBB+ |
| Corporate bonds | 4,723 | - | - | 4,723 | - | A2 | A |
| Corporate bonds | 5,920 | - | - | 5,920 | - | BAA1 | BBB+ |
| Corporate bonds | 4,801 | - | - | 4,801 | - | BAA2 | BBB |
| Corporate bonds | 5,064 | - | - | 5,064 | - | BAA3 | BBB |
| Corporate bonds | 6,293 | - | - | 6,293 | - | A1 | AA- |
| Corporate bonds | 4,384 | - | 4,384 | - | - | A3 | BBB+ |
| Corporate bonds | 4,913 | - | - | 4,913 | - | A3 | A- |
| Corporate bonds | 5,149 | - | - | 5,149 | - | A3 | A |
| Corporate bonds | 4,978 | - | - | 4,978 | - | A3 | BBB |
| Corporate bonds | 5,986 | - | - | 5,986 | - | A3 | A- |
| Corporate bonds | 2,044 | - | - | - | 2,044 | A3 | A |
| Corporate bonds | 5,900 | - | - | 5,900 | - | BAA2 | BBB |
| Corporate bonds | 6,163 | - | - | 6,163 | - | A2 | A |
| Federal agencies | 31,333 | - | 31,333 | - | - | AAA | AA+ |
| U.S. Treasury | 29,666 | - | - | - | 29,666 | AAA | No rating |
| U.S. Treasury | 13,818 | - | - | 13,818 | - | AAA | No rating |
| U.S. Treasury | <u>30,871</u> | <u>-</u> | <u>30,871</u> | <u>-</u> | <u>-</u> | AAA | No rating |
| Total | <u>\$ 178,073</u> | <u>\$ -</u> | <u>\$ 66,588</u> | <u>\$ 79,775</u> | <u>\$ 31,710</u> | | |

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(3) Deposits and Investments Risk, continued

Investments, continued

| | | As of December 31, 2015 | | | | Rating | |
|------------------------|--------------------------|---|-------------------------|-------------------------|-------------------------|--------------|----------------------------|
| <u>Investment type</u> | <u>Fair Value</u> | <u>Investment maturities (in years)</u> | | | | <u>Moody</u> | <u>Standard & Poor</u> |
| | | <u>Less than</u> | <u>1-5</u> | <u>6-10</u> | <u>More than</u> | | |
| | | <u>1</u> | | | <u>10</u> | | |
| Corporate bonds | \$ 4,084 | \$ - | \$ - | \$ 4,084 | \$ - | BAA1 | BBB+ |
| Corporate bonds | 2,874 | - | - | 2,874 | - | BAA3 | BBB |
| Corporate bonds | 3,926 | - | - | 3,926 | - | A2 | A |
| Corporate bonds | 3,801 | - | - | 3,801 | - | A3 | A- |
| Corporate bonds | 4,774 | - | - | 4,774 | - | BAA3 | BBB |
| Corporate bonds | 3,480 | - | - | 3,480 | - | BAA3 | BBB- |
| Corporate bonds | 4,894 | - | - | - | 4,894 | A1 | AA+ |
| Corporate bonds | 4,097 | - | - | 4,097 | - | A3 | A- |
| Corporate bonds | 4,423 | - | - | 4,423 | - | A3 | BBB+ |
| Corporate bonds | 3,995 | - | 3,995 | - | - | A3 | A- |
| Corporate bonds | 4,767 | - | - | 4,767 | - | A3 | BBB+ |
| Corporate bonds | 3,972 | - | - | 3,972 | - | A3 | A- |
| Corporate bonds | 4,059 | - | - | - | 4,059 | A2 | A |
| Corporate bonds | 2,998 | - | - | 2,998 | - | BA1 | BB+ |
| Corporate bonds | 4,121 | - | - | 4,121 | - | A2 | A |
| Corporate bonds | 3,006 | - | - | 3,006 | - | A2 | A |
| Federal agencies | 25,125 | - | 25,125 | - | - | AAA | AA+ |
| U.S. Treasury | 13,628 | - | - | - | 13,628 | AAA | No rating |
| U.S. Treasury | 15,692 | - | - | 15,692 | - | AAA | No rating |
| U.S. Treasury | 24,843 | - | - | 24,843 | - | AAA | No rating |
| Total | <u>\$ 142,559</u> | <u>\$ -</u> | <u>\$ 29,120</u> | <u>\$ 90,858</u> | <u>\$ 22,581</u> | | |

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

Notes to Financial Statements
December 31, 2016 and 2015

(4) Capital Assets

Summarized below are PNCC's capital assets for the years ended December 31, 2016 and 2015.

| | Balance at December 31, 2015 | Additions | Transfers/ Retirements | Balance at December 31, 2016 |
|---|------------------------------------|---------------------|---------------------------|------------------------------------|
| Regulated capital assets | | | | |
| Cables and transmission lines | \$ 27,094,700 | \$ 103,957 | \$ - | \$ 27,198,657 |
| Transmission equipment | 9,743,265 | - | - | 9,743,265 |
| Buildings | 8,857,170 | 9,105 | - | 8,866,275 |
| Central office equipment | 4,054,431 | 535 | - | 4,054,966 |
| General support equipment | 2,293,517 | 60,902 | (32,178) | 2,322,241 |
| Customer premises wiring and equipment | 1,353,084 | 80,740 | - | 1,433,824 |
| Vehicles | 666,733 | 50,005 | (103,779) | 612,959 |
| Furniture and fixtures | 34,013 | - | - | 34,013 |
| Regulated capital assets, at cost | 54,096,913 | 305,244 | (135,957) | 54,266,200 |
| Accumulated depreciation | (42,807,961) | (1,293,522) | 135,957 | (43,965,526) |
| Regulated capital assets, at net book value | 11,288,952 | (988,278) | - | 10,300,674 |
| Non-regulated capital assets | | | | |
| Cable television | 3,130,535 | 340,165 | (402,049) | 3,068,651 |
| Cellular | 10,026,733 | 157,108 | - | 10,183,841 |
| Palaunet | 1,298,523 | 122,574 | - | 1,421,097 |
| Non-regulated capital assets, at cost | 14,455,791 | 619,847 | (402,049) | 14,673,589 |
| Accumulated depreciation | (6,889,951) | (1,280,465) | 402,049 | (7,768,367) |
| Non-regulated capital assets, at net book value | 7,565,840 | (660,618) | - | 6,905,222 |
| Construction in progress | 185,731 | 798,111 | - | 983,842 |
| Total | \$ 19,040,523 | \$ (850,785) | \$ - | \$ 18,189,738 |

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

Notes to Financial Statements
December 31, 2016 and 2015

(4) Capital Assets, continued

| | Balance at December 31, 2014 | Additions | Transfers/ Retirements | Balance at December 31, 2015 |
|---|------------------------------------|----------------|---------------------------|------------------------------------|
| Regulated capital assets | | | | |
| Cables and transmission lines | \$ 26,949,562 | \$ 145,138 | \$ - | \$ 27,094,700 |
| Transmission equipment | 9,723,765 | 19,500 | - | 9,743,265 |
| Buildings | 8,857,170 | - | - | 8,857,170 |
| Central office equipment | 4,027,010 | 27,421 | - | 4,054,431 |
| General support equipment | 2,262,780 | 30,737 | - | 2,293,517 |
| Customer premises wiring and equipment | 1,321,298 | 31,786 | - | 1,353,084 |
| Vehicles | 701,853 | 17,840 | (52,960) | 666,733 |
| Furniture and fixtures | 34,013 | - | - | 34,013 |
| Regulated capital assets, at cost | 53,877,451 | 272,422 | (52,960) | 54,096,913 |
| Accumulated depreciation | (41,424,764) | (1,436,157) | 52,960 | (42,807,961) |
| Regulated capital assets, at net book value | 12,452,687 | (1,163,735) | - | 11,288,952 |
| Non-regulated capital assets | | | | |
| Cable television | 3,075,697 | 104,715 | (49,877) | 3,130,535 |
| Cellular | 5,219,000 | - | 4,807,733 | 10,026,733 |
| Palaunet | 1,155,722 | 142,801 | - | 1,298,523 |
| Non-regulated capital assets, at cost | 9,450,419 | 247,516 | 4,757,856 | 14,455,791 |
| Accumulated depreciation | (5,948,898) | (990,930) | 49,877 | (6,889,951) |
| Non-regulated capital assets, at net book value | 3,501,521 | (743,414) | 4,807,733 | 7,565,840 |
| Construction in progress | 4,831,744 | - | (4,646,013) | 185,731 |
| Total | \$ 20,785,952 | \$ (1,907,149) | \$ 161,720 | \$ 19,040,523 |

Depreciation expense for the years ended December 31, 2016 and 2015 was \$2,360,130 and \$2,437,603, respectively, and is reported in the Statements of Revenues, Expenses and Changes in Net Position.

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

Notes to Financial Statements
December 31, 2016 and 2015

(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, 2016 and 2015, amounts due from the Republic of Palau and its component units totaled \$685,963 and \$887,407, respectively.

(6) Long-term debt

Long-term debt as of December 31, 2016 and 2015 are summarized below:

| | <u>2016</u> | <u>2015</u> |
|---|----------------------|----------------------|
| 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 asset and a pledge of its revenues | \$ 21,577,580 | \$ 22,841,700 |
| Note payable to Chunghwa Telecom Company, due in monthly installments of \$34,087, non-interest bearing (net of unamortized discount of \$21,857 and \$25,706 at December 31, 2016 and 2015, respectively), due in July 2017, collateralized by earth station and ground common equipment | 275,228 | 662,281 |
| Note payable to National Information Solutions Cooperative (NISC), non-interest bearing, payable in monthly installments of \$10,482 from January 2013 through March 2013, and thereafter \$13,325 monthly, due October 2017 (net of unamortized discount of \$9,858 and \$12,509 as of December 31, 2016 and 2015, respectively), uncollateralized | <u>166,899</u> | <u>293,553</u> |
| | 22,019,707 | 23,797,534 |
| Less current portion | <u>1,777,168</u> | <u>1,915,455</u> |
| Long-term debt, net of current portion | <u>\$ 20,242,539</u> | <u>\$ 21,882,079</u> |

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

Notes to Financial Statements
December 31, 2016 and 2015

(6) Long-term debt, continued

RUS Mortgage Note

The original RUS note of \$39,143,000 approved in 1992 was unconditionally guaranteed by ROP and 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, 2016 and 2015.

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

| <u>Years ending December 31,</u> | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|--------------------------------------|----------------------|---------------------|----------------------|
| 2017 | \$ 1,335,041 | \$ 971,131 | \$ 2,306,172 |
| 2018 | 1,397,625 | 908,547 | 2,306,172 |
| 2019 | 1,463,143 | 843,029 | 2,306,172 |
| 2020 | 1,531,732 | 774,439 | 2,306,171 |
| 2021 | 1,603,537 | 702,635 | 2,306,172 |
| 2022-2026 | 9,218,246 | 2,312,246 | 11,530,492 |
| 2027-2029 | <u>5,028,256</u> | <u>345,502</u> | <u>5,373,758</u> |
| | <u>\$ 21,577,580</u> | <u>\$ 6,857,529</u> | <u>\$ 28,435,109</u> |

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, totaling \$3,067,830, payable monthly in ninety (90) installments of \$34,087 including interest, starting in January 2010 through July 2017. 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, 2016, the future note payments to CHT with a present value of note was \$275,228 with discount amortization of \$3,849 in 2017. 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.

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

Notes to Financial Statements
December 31, 2016 and 2015

(6) Long-term debt, continued

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

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, 2016 and 2015, bandwidth fees paid to CHT under this ESLA agreement totaled \$168,000 in each year and are included as a component of plant specific operations expense reported in the Statements of Revenues, Expenses and Changes in Net Position.

New billing and customer care information technology system

In August 2012, PNCC entered into a note agreement 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 amounting 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 at \$13,325 monthly from April 2013 through October 2017. 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, 2016, the future note payments to NISC with a present value of note was \$166,899 with discount amortization of \$2,651 in 2017

The operational commitments of PNCC related to the NISC's technical support performance during the terms of the notes totaled \$103,845, payable monthly at \$540 commencing from January 2013 to October 2017, plus a \$14,289 annual payment for five years from 2013 through 2017. For the years ended December 31, 2016 and 2015, amounts paid to NISC for technical support under the agreement totaled \$14,513 and \$22,133, respectively, and are 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, 2016, the remaining commitments chargeable to operations are included in Note 7.

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

Notes to Financial Statements
December 31, 2016 and 2015

(6) Long-term debt, continued

At December 31, 2016 and 2015, the changes in the long-term liabilities are as follows:

| | Balance January 1, <u>2015</u> | <u>Additions</u> | <u>Reductions</u> | Balance December 31, <u>2016</u> | <u>Current</u> | <u>Noncurrent</u> |
|--|--------------------------------------|------------------|---------------------|--|---------------------|----------------------|
| Rural Utilities Services | \$ 22,841,700 | \$ - | \$ 1,264,120 | \$ 21,577,580 | \$ 1,335,041 | \$ 20,242,539 |
| Chunghwa Telecom Company, net of discount | 662,281 | - | 387,053 | 275,228 | 275,228 | - |
| National Information Solutions Cooperative, net of discount | <u>293,553</u> | <u>-</u> | <u>126,654</u> | <u>166,899</u> | <u>166,899</u> | <u>-</u> |
| | <u>\$ 23,797,534</u> | <u>\$ -</u> | <u>\$ 1,777,827</u> | <u>\$ 22,019,707</u> | <u>\$ 1,777,168</u> | <u>\$ 20,242,539</u> |

| | Balance January 1, <u>2014</u> | <u>Additions</u> | <u>Reductions</u> | Balance December 31, <u>2015</u> | <u>Current</u> | <u>Noncurrent</u> |
|--|--------------------------------------|------------------|---------------------|--|---------------------|----------------------|
| Rural Utilities Services | \$ 25,438,349 | \$ - | \$ 2,596,649 | \$ 22,841,700 | \$ 1,378,133 | \$ 21,463,567 |
| Chunghwa Telecom Company, net of discount | 1,341,769 | - | 679,488 | 662,281 | 387,187 | 275,094 |
| National Information Solutions Cooperative, net of discount | <u>563,202</u> | <u>-</u> | <u>269,649</u> | <u>293,553</u> | <u>150,135</u> | <u>143,418</u> |
| | <u>\$ 27,343,320</u> | <u>\$ -</u> | <u>\$ 3,545,786</u> | <u>\$ 23,797,534</u> | <u>\$ 1,915,455</u> | <u>\$ 21,882,079</u> |

Interest expense paid in 2016 and 2015 amounted to \$1,150,333 and \$867,300, respectively.

(7) Contract Payable

PNCC entered into a Third Generation (3G) Mobile Network Agreement on April 2, 2014. Under this agreement, PNCC agreed to purchase a turnkey complete 3G network for Palau for a total of \$4,360,000. The contract calls for a down payments of \$218,000 within two weeks of signing, another \$218,000 on or before September 30, 2014 and \$697,600 on or before January 31, 2015. The remaining balance is to be paid at \$83,000 per month from February 2015 to July 2015 and then at \$100,000 per month until the balance is paid off. Interest will be applied to the unpaid balance at the rate of 2.4% per annum for the first 12 months from February 2015 to January 2016 and then at the rate of 4.8% per annum until the balance is paid off.

PALAU NATIONAL COMMUNICATIONS CORPORATION
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Notes to Financial Statements
December 31, 2016 and 2015

(7) Contract Payable, continued

As of December 31, 2014 PNCC had paid \$436,000 to the vendor under this contract. The system was completed and activated on January 10, 2015. Since the system was substantially complete as of December 31, 2014 the entire system cost has been capitalized as construction in progress and the remaining unpaid balance of \$3,924,000 has been recognized as a liability. At December 31, 2016, the future payments under this contract was \$945,200 in 2017.

(8) 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:

| <u>Years ending December 31,</u> | |
|----------------------------------|----------------------------|
| 2017 | \$ 1,200,000 |
| 2018 | <u>1,900,000</u> |
| | \$ <u><u>3,100,000</u></u> |

At December 31, 2014, 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, 2014. 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, \$697,600 of outstanding purchase commitments are not reported in the financial statements for the year ended December 31, 2014. At December 31, 2015, PNCC received the goods and services associated for these cost was \$2,103,775, and is included as a component of outside services in the Schedule of Functional Expenses.

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.

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

Notes to Financial Statements
December 31, 2016 and 2015

(8) Commitments and Contingencies, continued

Risk Management, continued

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.

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

PNCC's policy is 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, 2016 and 2015 is \$1,029,943 and \$1,026,587 respectively.

(9) 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, 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, unearned revenues, and the current portion of long-term debt approximate their fair values based on their short-term nature. The recorded value of customer deposits approximates 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 the related unamortized discount is estimated by discounting the future cash flow using the PNCC'S current borrowing rate for similar types and maturities of debt.

(10) Reclassifications

Certain amounts presented in 2015 have been reclassified to conform to the 2016 financial statement presentation. These reclassifications did not affect the change in net position or the total net position.

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

Notes to Financial Statements
December 31, 2016 and 2015

(11) Subsequent Events

PNCC has evaluated subsequent events through June 9, 2017, the date the financial statements were available to be issued. Subsequently, PNCC entered into a contract on March 22, 2017. Under this agreement, PNCC agreed to purchase parts and software to build 23 full site power antenna for Third Generation (3G) and Fourth Generation (4G) Mobile Networks. PNCC agreed to purchase a turnkey complete 4G network for Palau for a total of \$2,650,000. The contract calls for a first payment of \$500,000 within 30 days after contract signing, \$300,000 within 30 days after the first payment and \$168,750 per month for the next eight months after the second payment. The remaining \$500,000 will be paid on or before the one year anniversary of the service launch date. Interest will be applied to the unpaid balance at the rate of 2% per month. This project is part of PNCC's modernization plans.

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

SUPPLEMENTARY SCHEDULES

Year Ended December 31, 2016

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, 2016

| | Budget | | | Actual | Variance |
|---|---------------------|-------------|---------------------|---------------------|----------------------------|
| | Original | Revisions | Final | | Favorable (Unfavorable) |
| Operating revenues: | | | | | |
| Cellular | \$ 6,456,621 | \$ - | \$ 6,456,621 | \$ 7,547,338 | \$ 1,090,717 |
| Palaunet | 2,967,747 | - | 2,967,747 | 3,109,626 | 141,879 |
| Digital television | 1,515,832 | - | 1,515,832 | 1,585,141 | 69,309 |
| Local | 1,561,374 | - | 1,561,374 | 1,525,895 | (35,479) |
| Long distance | 1,385,656 | - | 1,385,656 | 885,996 | (499,660) |
| Miscellaneous | 94,121 | - | 94,121 | 140,936 | 46,815 |
| Provision for doubtful accounts | (262,067) | - | (262,067) | (109,623) | 152,444 |
| Total operating revenues | 13,719,284 | - | 13,719,284 | 14,685,309 | 966,025 |
| Operating expenses: | | | | | |
| Plant specific operations | 3,681,191 | - | 3,681,191 | 3,938,385 | (257,194) |
| Depreciation | 2,725,740 | - | 2,725,740 | 2,360,130 | 365,610 |
| Customer service operations | 1,445,185 | - | 1,445,185 | 1,495,029 | (49,844) |
| Corporate operations | 1,046,884 | - | 1,046,884 | 1,213,678 | (166,794) |
| Plant non-specific operations | 342,684 | - | 342,684 | 342,353 | 331 |
| Total operating expenses | 9,241,684 | - | 9,241,684 | 9,349,575 | (107,891) |
| Operating income (loss) | 4,477,600 | - | 4,477,600 | 5,335,734 | 858,134 |
| Nonoperating income (expenses): | | | | | |
| Interest expense | (1,433,267) | - | (1,433,267) | (1,150,333) | 282,934 |
| Unrealized loss on investment | - | - | - | (434,594) | (434,594) |
| Realized gain on investment | - | - | - | 435,134 | 435,134 |
| Income on investment | 10,016 | - | 10,016 | 11,486 | 1,470 |
| Gain (loss) on retirement of equipment | 18,000 | - | 18,000 | (211,155) | (229,155) |
| Interest and other income | 10,208 | - | 10,208 | 2,574 | (7,634) |
| Total nonoperating expenses, net | (1,395,043) | - | (1,395,043) | (1,346,888) | 48,155 |
| Change in net position | \$ 3,082,557 | \$ - | \$ 3,082,557 | \$ 3,988,846 | \$ 906,289 |

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, 2016
(With Comparative Totals for 2015)

| | Plant Specific | | | | Plant non-specific operations | Total Operating Expenses | | |
|------------------------|---------------------|---------------------|---------------------|-----------------------|-------------------------------------|-----------------------------|---------------------|---------------------|
| | Depreciation | Operation | Corporate | Customer Relations | | Total | 2016 | 2015 |
| Outside services | \$ - | \$ 2,213,605 | \$ 76,641 | \$ 765,711 | \$ 3,055,957 | \$ 516 | \$ 3,056,473 | \$ 3,813,859 |
| Depreciation | 2,360,130 | - | - | - | 2,360,130 | - | 2,360,130 | 2,437,603 |
| Salaries and wages | - | 75,655 | 758,079 | 402,946 | 1,236,680 | 161,652 | 1,398,332 | 1,634,457 |
| Others | - | 419,208 | 449,334 | 1,867 | 870,409 | 80,573 | 950,982 | 186,746 |
| Utilities | - | 640,901 | - | - | 640,901 | - | 640,901 | 650,261 |
| Materials and supplies | - | 254,323 | 34,783 | 11,071 | 300,177 | 98,677 | 398,854 | 92,375 |
| Clearance | - | 354,235 | - | - | 354,235 | 2,774 | 357,009 | 47,230 |
| Training | - | 1,435 | 89,956 | 4,226 | 95,617 | 3,309 | 98,926 | 133,528 |
| Fuel | - | 52,815 | 242 | 339 | 53,396 | 14,096 | 67,492 | 108,136 |
| Insurance | - | - | 60,724 | - | 60,724 | - | 60,724 | 59,098 |
| Postage | - | - | 20,755 | - | 20,755 | - | 20,755 | 22,615 |
| Legal fees | - | - | 13,276 | - | 13,276 | - | 13,276 | 18,523 |
| Board fees | - | - | 10,373 | - | 10,373 | - | 10,373 | 7,882 |
| Rent | - | 320 | - | - | 320 | - | 320 | |
| Inventory obsolescence | - | - | - | - | - | - | - | 8,964 |
| Payroll burden | - | (74,112) | (19,134) | 27,518 | (65,728) | (19,244) | (84,972) | 394,709 |
| | <u>\$ 2,360,130</u> | <u>\$ 3,938,385</u> | <u>\$ 1,495,029</u> | <u>\$ 1,213,678</u> | <u>\$ 9,007,222</u> | <u>\$ 342,353</u> | <u>\$ 9,349,575</u> | <u>\$ 9,615,986</u> |

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, 2016
(With Comparative Totals for 2015)

| | | | | | Total Operating Expenses By Division | |
|------------------------|---------------------|---------------------|---------------------|-----------------------|---|---------------------|
| | Depreciation | Operation | Corporate | Customer Relations | 2016 | 2015 |
| Telephony | | | | | | |
| Depreciation | \$ 1,293,004 | \$ - | \$ - | \$ - | \$ 1,293,004 | \$ 1,442,891 |
| Salaries and wages | - | 75,656 | 758,079 | 402,946 | 1,236,681 | 1,208,614 |
| Others | - | 406,026 | 407,334 | 1,728 | 815,088 | 108,604 |
| Utilities | - | 640,901 | - | - | 640,901 | 650,261 |
| Outside services | - | 350,197 | 76,641 | 14,847 | 441,685 | 609,162 |
| Clearance | - | 247,735 | - | - | 247,735 | 31,206 |
| Materials and supplies | - | 96,804 | 34,783 | 11,071 | 142,658 | 80,582 |
| Training | - | 1,199 | 89,959 | 4,225 | 95,383 | 129,960 |
| Insurance | - | - | 60,724 | - | 60,724 | 59,098 |
| Fuel | - | 52,814 | 242 | 339 | 53,395 | 93,106 |
| Postage | - | - | 20,755 | - | 20,755 | 22,615 |
| Legal fees | - | - | 13,276 | - | 13,276 | 18,523 |
| Board fees | - | - | 10,373 | - | 10,373 | 7,882 |
| Rent | - | 320 | - | - | 320 | - |
| Inventory obsolescence | - | - | - | - | - | 8,964 |
| Payroll burden | - | (72,993) | (19,134) | 27,518 | (64,609) | 253,009 |
| Allocation | - | - | (210,168) | (64,695) | (274,863) | (394,112) |
| | <u>1,293,004</u> | <u>1,798,659</u> | <u>1,242,864</u> | <u>397,979</u> | <u>4,732,506</u> | <u>4,330,365</u> |
| Cellular | | | | | | |
| Depreciation | 809,910 | - | - | - | 809,910 | 763,119 |
| Outside services | - | 156,965 | - | - | 156,965 | 206,442 |
| Allocation | - | - | 70,056 | 24,030 | 94,086 | 135,674 |
| Others | - | 5,457 | 42,000 | - | 47,457 | 56,200 |
| Clearance | - | 36,253 | - | - | 36,253 | - |
| Materials and supplies | - | 2,130 | - | - | 2,130 | 99 |
| Salaries and wages | - | - | - | - | - | 30,313 |
| Payroll burden | - | - | - | - | - | 9,201 |
| Utilities | - | - | - | - | - | - |
| Training | - | - | (3) | - | (3) | - |
| Fuel | - | - | - | - | - | - |
| | <u>809,910</u> | <u>200,805</u> | <u>112,053</u> | <u>24,030</u> | <u>1,146,798</u> | <u>1,201,048</u> |
| Palaunet | | | | | | |
| Outside services | - | 1,706,443 | - | - | 1,706,443 | 2,103,775 |
| Depreciation | 110,122 | - | - | - | 110,122 | 99,163 |
| Allocation | - | - | 42,034 | 20,333 | 62,367 | 91,671 |
| Others | - | 6,767 | - | - | 6,767 | 3,390 |
| Materials and supplies | - | 2,205 | - | - | 2,205 | 8,572 |
| Training | - | 236 | - | - | 236 | 3,941 |
| Salaries and wages | - | - | - | - | - | 58,410 |
| Payroll burden | - | (319) | - | - | (319) | 16,273 |
| Clearance | - | - | - | - | - | 2,418 |
| | <u>110,122</u> | <u>1,715,332</u> | <u>42,034</u> | <u>20,333</u> | <u>1,887,821</u> | <u>2,387,613</u> |
| Digital TV | | | | | | |
| Outside services | - | - | - | 750,864 | 750,864 | 892,893 |
| Materials and supplies | - | 153,184 | - | - | 153,184 | 733 |
| Depreciation | 147,094 | - | - | - | 147,094 | 132,430 |
| Allocation | - | - | 98,078 | 20,333 | 118,411 | 166,843 |
| Clearance | - | 70,247 | - | - | 70,247 | 10,591 |
| Others | - | 958 | - | 139 | 1,097 | 617 |
| Salaries and wages | - | - | - | - | - | 130,012 |
| Payroll burden | - | (800) | - | - | (800) | 52,217 |
| Utilities | - | - | - | - | - | - |
| | <u>147,094</u> | <u>223,589</u> | <u>98,078</u> | <u>771,336</u> | <u>1,240,097</u> | <u>1,386,336</u> |
| | <u>\$ 2,360,130</u> | <u>\$ 3,938,385</u> | <u>\$ 1,495,029</u> | <u>\$ 1,213,678</u> | <u>\$ 9,007,222</u> | <u>\$ 9,305,362</u> |

See Accompanying Independent Auditor's Report.

Required Supplemental Information (Unaudited)
Schedule of Proportionate Share of the Net Pension Liability
Last 10 Fiscal Years*

| | 2015 | 2014 |
|---|----------------|-------------|
| Civil Service Pension Trust Fund (Plan) total net pension liability | \$ 215,546,176 | 204,281,232 |
| PNCC proportionate share of the net pension liability | 7,015,927 | 7,163,121 |
| PNCC proportionate share of the net pension liability | \$ 3.255% | 3.506% |
| PNCC's covered-employee payroll** | \$ 1,578,557 | 1,648,460 |
| PNCC's proportionate share of the net pension liability as a percentage of its covered employee payroll | 444.45% | 434.53% |
| Plan Fiduciary net position as a percentage of the total pension liability | | |

* This data is presented for those years for which information is available.

** Covered-employee payroll data from the actuarial valuation date with a one-year lag.

See Accompanying Independent Auditors' Report.

Palau National Communications Corporation
(A Component Unit of the Republic of Palau)

Required Supplemental Information (Unaudited)
Schedule of Pension Contributions
Last 10 Fiscal Years*

| | <u>2015</u> | <u>2014</u> |
|---|---------------------|------------------|
| Actuarially determined contribution | \$ 354,787 | 372,513 |
| Contribution in relation to the actuarially determined contribution | <u>94,083</u> | <u>97,071</u> |
| Contribution (excess) deficiency | \$ <u>260,704</u> | <u>275,442</u> |
| PNCC's covered-employee payroll** | \$ <u>1,578,557</u> | <u>1,648,460</u> |
| PNCC's proportionate share of the net pension liability | 5.96% | 5.89% |

* This data is presented for those years for which information is available.

** Covered-employee payroll data from the actuarial valuation date with a one-year lag.

See Accompanying Independent Auditors' 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, 2016

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

To the Board of Directors
Palau National Communications Corporation

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Palau National Communications Corporation (PNCC), a component unit of the Republic of Palau, as of and for the year ended December 31, 2016, and the related notes to the financial statements, which collectively comprise PNCC's basic financial statements and have issued our report thereon dated June 9, 2017.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we 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, we do not express an opinion on the effectiveness of PNCC's internal control.

Our 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, we identified certain deficiencies in internal control that we 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. We consider the deficiencies described in the accompanying schedule of findings and responses and consider findings 2016-01 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. We consider Finding 2016-02 described in the accompany schedule of findings and responses 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, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances no 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 our 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, we 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.



BURGER COMER MAGLIARI

Koror, Republic of Palau
June 9, 2017

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

Schedule of Findings and Responses
Year Ended December 31, 2016

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

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

Schedule of Findings and Responses
Year Ended December 31, 2016

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

CURRENT YEAR FINDINGS:

Finding No.: 2016-01

Area : 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 \$590,189 representing numerous inactive customer deposits over 10 years old, and whose deposits can be applied to the customer's unpaid balance. As noted in prior year Finding No. 2015-01, accounts receivable that are potential for write-off approximate \$2.5 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 11 years.

Prior Year Status:

The lack of internal control and a formalized accounts receivable collection policy over customer deposits was cited as finding in the audit in 2013 through 2016 audits of PNCC.

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

Schedule of Findings and Responses
Year Ended December 31, 2016

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 2016-01, continued

Area : 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. In January 2017, PNCC implemented the formal procedure by effectively reviewing the customer's deposit account on a monthly basis in relation to account receivable and the allowance for doubtful accounts balances. This will be subject for valuation for the effectiveness of procedures in 2017.

Auditee Response and Corrective Action Plan:

PNCC agrees with this finding and after thorough reconciliation, customer deposits will be applied to outstanding customer account balances in accordance with PNCC's Accounts Receivable Write-off policy. The CFO will ensure procedures are adhered to. Beginning 2017, the Company will keep observing the effectiveness of implemented procedures.

This is a finding is a repeat and unresolved.

Finding No.: 2016-02

**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.

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

Schedule of Findings and Responses
Year Ended December 31, 2016

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 2016-02, continued

**Area : Unearned revenues from prepaid long distance sales and prepaid
airtime**

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, 2014, 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 2016.

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 international 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.

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

Schedule of Findings and Responses
Year Ended December 31, 2016

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 2016-02, 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.

This is a finding is a repeat and unresolved.

PRIOR YEAR FINDINGS:

Finding No.: 2015-01

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 uncollectable accounts for 2013 was calculated and determined in March 2014 totaling \$249,587 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:

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

Schedule of Findings and Responses
Year Ended December 31, 2016

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 2015-01, continued
Area : Allowance for Doubtful Accounts

| | As of December 31, | | | | | |
|----------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
| Balance, beginning of year | \$ 3,417,963 | \$ 4,214,265 | \$ 4,083,262 | \$ 3,503,641 | \$ 3,195,114 | \$ 3,195,114 |
| Current year provisions | 53,636 | 249,587 | 274,923 | 778,427 | 308,527 | - |
| Written-off | (929,387) | (1,045,889) | (143,920) | (198,806) | - | - |
| Balance, end of year | <u>\$ 2,542,212</u> | <u>\$ 3,417,963</u> | <u>\$ 4,214,265</u> | <u>\$ 4,083,262</u> | <u>\$ 3,503,641</u> | <u>\$ 3,195,114</u> |

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:

Uncollectable old accounts estimated at \$2.5 million or 73% 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.

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. We 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.

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

Schedule of Findings and Responses
Year Ended December 31, 2016

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No.: 2015-01, continued

Area : Allowance for Doubtful Accounts

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.

Prior Year Status:

Corrective action has been taken. In March 2016, the Company formally implemented the collection procedure over control of account receivable, monthly evaluation of past due balances was regularly evaluated in any relation with account receivable. Set up an appropriate amount of allowance to cover for any bad debts. Written-off on account that it was truly identified uncollectible and removed from the books. This procedures will continue observed passing through and it was subject for periodic evaluation. This finding is considered resolved.

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**

Year Ended December 31, 2016

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

To the Board of Directors
Palau National Communications Corporation:

We 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, 2016, 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 our report thereon dated June 9, 2017. In accordance with Government Auditing Standards, we have also issued our report dated June 9, 2017, on our consideration of PNCC's internal control over financial reporting on our 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 our separate letter regarding recommendations concerning certain matters related to internal control, also dated June 9, 2017 related to our audit, have been furnished to management.

In connection with our audit, nothing came to our attention that caused us 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, our audit was not directed primarily toward obtaining knowledge of noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our 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 our audit, as except of the comments noted below, we 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;
- 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.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. At December 31, 2016, PNCC had no investments in subsidiary and affiliated companies that needed to be accounted for on either the cost or equity basis in accordance with the requirement of 7 CFR Part 1733.33(i).

* * * * *

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



BURGER COMER MAGLIARI

Koror, Republic of Palau

June 9, 2017

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

Unresolved Prior Year Comments
Year Ended December 31, 2016

STATUS OF PRIOR YEAR FINDINGS RESULTS

The status of unresolved prior year findings are disclose within the Schedule of Findings and Responses section of this report on page 57 through 63.