

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**

**(A COMPONENT UNIT OF THE FEDERATED STATES
OF MICRONESIA NATIONAL GOVERNMENT)**

**FINANCIAL STATEMENTS, ADDITIONAL
INFORMATION AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2013 AND 2012

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL
GOVERNMENT)**

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Years Ended September 30, 2013 and 2012

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INDEPENDENT AUDITORS' REPORT

Board of Directors
Federated States of Micronesia
Telecommunications Corporation:

Report on the Financial Statements

We have audited the accompanying financial statements of the Federated States of Micronesia (FSM) Telecommunications Corporation (the Corporation), a component unit of the FSM National Government, which comprise the statements of net position as of September 30, 2013 and 2012, and the related statements of revenues, expenses, and changes in net position and cash flows for the years then ended and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that 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 opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Corporation as of September 30, 2013 and 2012, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 7 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. This supplementary information is the responsibility of the Corporation's management. 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.

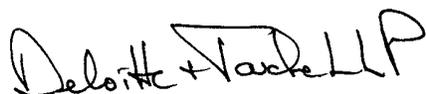
Other Information

Our audits were conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Corporation's basic financial statements. The Other Supplementary Information listed in the accompanying table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The Other Supplementary Information is the responsibility of the Corporation's management and was derived from and relates 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 standard generally accepted in the United States of America. In our opinion, the Other Supplementary Information is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 27, 2013 on our consideration of the Corporation'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 financing reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Corporation's internal control over financial reporting and compliance.



Tamuning, Guam
December 27, 2013

FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL
GOVERNMENT)

Management's Discussion and Analysis
Years Ended September 30, 2013 and 2012

Our discussion and analysis of the Federated States of Micronesia Telecommunications Corporation (FSMTC) financial performance provides an overview of the FSMTC financial activities for the fiscal year then ended September 30, 2013. This discussion has been prepared by FSMTC management to further provide an introduction and understanding of the basic financial statements for the year ended September 30, 2013. Please read it in conjunction with the financial statements and the notes thereto, which follow this discussion and analysis. Fiscal year 2012 and 2011 comparative information has been included, where appropriate.

The FSMTC is a public corporation of the Federated States of Micronesia National Government and is the primary provider of telecommunications services throughout the Federated States of Micronesia (FSM) and to points outside of the FSM. The FSMTC also provides Cable TV in the State of Kosrae, and Digital Broadcast Television (DBTV) to both Yap and Chuuk States. Yap's former Wireless TV broadcasting, which was analog in nature, was replaced by DBTV in FY2012.

The FSMTC is under the governance of an appointed 5-member Board of Directors by the President of the FSM and the Governors of each State, which has oversight over both the FSMTC, Cable TV in Kosrae and DBTV in Yap & Chuuk. The Chief Executive Officer (CEO) is also an ex-officio non-voting member of the Board.

The FSMTC provides telecommunications services which include Plain Old Telephone Services (POTS) to 12,354 active subscribers. Other telecommunications services provided are National and International Overseas Calls, Internet Services, Mobile Cellular Services, Cable Television in the State of Kosrae with 196 active subscribers, DBTV in the State of Chuuk with 256 active subscribers and DBTV in the State of Yap with 208 active subscribers.

The FSMTC relies on calls made to and from outside of the FSM and calls within the FSM, which account for 19.05% of FSMTC's FY2013 operating revenues as compared with 19.85% of FSMTC's FY2012 operating revenues. During FY2013, FSMTC realized a decrease in Call revenue of \$128,520 (or 4.63%) as compared to FY2012. Management believes that the decrease was caused by the increase in internet usage and the increase in ADSL Internet subscribers in FY2013. With the introduction of smart phones and accessibilities to unlimited internet, subscribers were able to utilize such technology to place overseas calls thru the use of applications available in the internet.

Internet Services (Wifi, Dial Up, ADSL & FM Domain) account for 30.26% of FSMTC's FY2013 operating revenues as compared with 28.94% of FSMTC'S FY 2012 operating revenues. During FY2013, FSMTC realized an increase in Internet service revenues of \$158,435 (or 3.91%) as compared to FY2012. More and more customers are moving to unlimited internet service by subscribing to ADSL which contributed to the increase in internet revenue. It is expected that data services will continue to dominate the telecom services in terms of revenue contribution.

Mobile services account for 23.87% of FSMTC's FY2013 operating revenues as compared with 26.80% of FSMTC'S FY2012 operating revenues. During FY2013, FSMTC realized a decrease in mobile service revenues of \$430,629 (or 11.49%) as compared to FY2012. This decrease can be attributed to the continuously increasing usage of smart phones that directly compete with mobile services thru the use of voice and text applications over internet.

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Management's Discussion and Analysis
Years Ended September 30, 2013 and 2012

Statement of Net Position

The statement of net position presents the assets, liabilities, and net position as of the end of the fiscal year. This statement is a point of time financial statement. The purpose of the statement of net position is to present to the readers of the financial statements a fiscal snapshot of the FSMTC. The statement of net position presents end-of-year data concerning assets (current and noncurrent), liabilities (current and noncurrent), and net assets (assets minus liabilities).

From the data presented, readers of the statement of net position are able to determine the assets available to continue the operations of the FSMTC. They also are able to determine how much the FSMTC owes vendors and lending institutions. Finally, the statement of net position provides a picture of the net position (assets minus liabilities), which is a useful indicator of whether the financial position of the FSMTC is improving or deteriorating.

The following summarizes the financial condition and operations of the FSMTC for FY2013, FY2012 and FY2011:

| | <u>2013</u> | <u>2012</u> | <u>2011</u> |
|-------------------------------------|----------------------|----------------------|----------------------|
| Assets: | | | |
| Cash and cash equivalents | \$ 1,198,227 | \$ 1,254,195 | \$ 496,202 |
| TCD's and investments in securities | 1,731,714 | 1,468,405 | 4,739,288 |
| Receivables and prepayments | 1,474,229 | 1,495,375 | 1,098,308 |
| Inventory | <u>784,681</u> | <u>680,442</u> | <u>744,379</u> |
| Total current assets | 5,188,851 | 4,898,417 | 7,078,177 |
| Property, plant and equipment | 43,978,307 | 48,169,976 | 51,469,465 |
| Other non-current assets | <u>3,144,419</u> | <u>3,290,671</u> | <u>3,436,923</u> |
| | <u>\$ 52,311,577</u> | <u>\$ 56,359,064</u> | <u>\$ 61,984,565</u> |
| Liabilities: | | | |
| Current liabilities | \$ 3,032,890 | \$ 3,426,175 | \$ 5,862,955 |
| Non-current liabilities | <u>27,399,546</u> | <u>28,987,140</u> | <u>30,497,987</u> |
| Total liabilities | <u>30,432,436</u> | <u>32,413,315</u> | <u>36,360,942</u> |
| Net Position: | | | |
| Net investment in capital assets | 18,136,421 | 20,962,941 | 22,973,530 |
| Restricted | - | 85,866 | - |
| Unrestricted | <u>3,742,720</u> | <u>2,896,942</u> | <u>2,650,093</u> |
| Total net position | <u>21,879,141</u> | <u>23,945,749</u> | <u>25,623,623</u> |
| | <u>\$ 52,311,577</u> | <u>\$ 56,359,064</u> | <u>\$ 61,984,565</u> |

The total assets of FSMTC decreased compared to prior year. The statements of net position reveal that the decrease in total assets is primarily the result of an increase in depreciation and retirements of ICTV assets in Yap.

The total liabilities of FSMTC decreased by \$1,980,879 (or 6.11%) compared with prior year. This reduction in total liabilities can be attributed to the repayment of remaining balance for the construction of Chuuk & Yap digital TV, RUS note repayments of \$1,511,401 and payments to various vendors.

The equity of FSMTC was affected by the change in both assets and liabilities and decreased by a net loss from operations of \$2,066,608.

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During FY2013, total cash received from telecommunications services exceeded the amounts paid to vendors and employees for goods and services. This resulted in net cash provided by operating activities of \$3,800,369 as compared with \$3,713,998 in FY2012.

The cash and cash equivalents at the end of FY2013 are \$1,198,227 as compared to \$1,254,195 at the end of the prior year. The net cash provided during FY2013 exceeded net cash used from operations, mainly due to contribution coming from operations.

Statement of Revenues, Expenses and Changes in Net Position

Changes in total net position as presented on the statement of net position are based on the activity presented in the statements of revenues, expenses and changes in net position. The purpose of this statement is to present the revenues received by the FSMTC, both operating and non-operating, and expenses incurred by the FSMTC, operating and non-operating, any other revenues, expenses, gains and losses received or spent by the FSMTC.

Generally speaking, operating revenues are generated from the provision of telecommunications goods and services to various customers. Operating expenses are those expenses incurred to acquire or produce the goods or services provided in return for the operating revenues, and to carry out the mission of the FSMTC. Non-operating revenues are revenues received for which goods or services are not provided. For example, investment income is non-operating because it is earned without providing telecommunications goods or services.

The following table summarizes the financial operations of the FSMTC for the years ended September 30, 2013, 2012 and 2011.

| | <u>2013</u> | <u>2012</u> | <u>2011</u> |
|-------------------------------------|----------------------|----------------------|----------------------|
| Operating revenues | \$ 13,951,541 | \$ 13,986,609 | \$ 13,568,945 |
| Operating expenses | <u>14,695,306</u> | <u>14,794,097</u> | <u>14,617,252</u> |
| Net operating loss | <u>(743,765)</u> | <u>(807,488)</u> | <u>(1,048,307)</u> |
| Interest income and others | 163,157 | 282,748 | 120,340 |
| Interest expense | <u>(1,486,000)</u> | <u>(1,513,134)</u> | <u>(1,518,088)</u> |
| Increase (decrease) in net position | (2,066,608) | (2,037,874) | (2,446,055) |
| Capital grants | - | 360,000 | - |
| Net position at beginning of year | <u>23,945,749</u> | <u>25,623,623</u> | <u>28,069,678</u> |
| Net position at end of year | \$ <u>21,879,141</u> | \$ <u>23,945,749</u> | \$ <u>25,623,623</u> |

Total operating revenue in FY2013 decreased by \$35,068 (or 0.25%) compared to FY2012. The decrease is mainly due to continuous decline in mobile and international revenue. Operating expenses in FY2013 decreased by \$98,791 (or 0.67%) compared to FY2012 operating expenses. This decrease in operating expenses can be attributed to continuing cost control by the Corporation.

The FSMTC investments in property, plant and equipment, net of accumulated depreciation, amounted to \$43,978,307 in FY2013 and \$48,169,976 in FY2012. For additional information concerning capital assets, please refer to note 4 to the accompanying financial statements.

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FSMTC's notes payable with the US Department of Agriculture (Rural Utilities Services) amounted to \$28,986,305 of which \$1,586,759 is classified as the current portion. For additional information concerning the FSMTC's long term debt, please refer to note 7 to the accompanying financial statements.

On November 19, 2008, United States Department of Agriculture Rural Development notified the FSMTC that based on the preliminary review of its "B" loan application, the FSMTC was qualified to borrow an additional amount of \$13,120,000. At September 30, 2013, the FSMTC has drawn-down \$12,136,034 from RUS for the purpose of funding Fiber Optic Cable projects. The loan proceeds were to purchase 8 wavelengths of fiber capacity of two fibers of the Kwajealein Cable System (KCS) as a capital lease for 25 years or an Indefeasible right to use (IRU). The remaining balance of the loan is for electronics, engineering and construction of the undersea facilities between Pohnpei and the KCS network branch.

Economic Outlook

The FSM economy is expected to decline from an estimated growth of 1.4% in FY2013 to an estimated growth of 0.8% for FY 2014. The decline in economic activity is as expected as the FAA and Japan airport development projects wind down. Unless there is an accelerated release of infrastructure grants into the economy, business activities are likely to remain stagnant. Coupled with a stagnant economy, the cost of utility and fuel are eroding the bottom line of FSMTC. FSMTC, in an effort to counteract the effect of higher operating costs, implemented increases in tariffs for its network access, directory assistance and mobile charges. As a result, these areas are seeing increasing revenues. Exactly how much the net effect these measures will realize will be reassessed in the next fiscal year.

There has been no significant stimulus into the economy and none is seen in the near future. The same is contained in a report prepared by the US Graduate School. While there has been a modest increase in economic growth, mostly in the Pohnpei economy, the net effects from other states leave overall growth stagnant.

The Corporation had just completed the Mobile Services expansion in Pohnpei, Chuuk, Yap & Kosrae. Because of the substantial contribution of Mobile Services to revenue, FSMTC is committed to maintaining a more reliable service to the people. On December 14, 2013, the Corporation signed an agreement for the construction of 3G/4G services with ACCLINKS utilizing ZTE equipment. With this expansion, communication connectivity using mobile services within the FSM and to the world will improve. The Corporation has modern, state of the art equipment and tariff rates that we feel are very reasonable compared with other telephone companies in the Pacific Region.

In addition to the mobile services investments, FSMTC also completed its virtualization project which was approved in April 2012. This project ensured a more robust seamless IP network that not only saw a massive reduction in number of physical servers (37 to 7), but also a much more power savings stack of virtual servers (62% less power). Expansion of ADSL Backhaul in all of the States of the FSM is now complete. Because of the huge demand in internet service, management believes that this new infrastructure will contribute to the increase in revenue. The integration of the Fiber Optic Cable in Pohnpei to the FSMTC network services is not possible without the procurement of appropriate equipment and overhaul of existing IP services (VOIP, SIP and Data). The Fiber Optic provisioning in Pohnpei will have little effect on the FSM States of Chuuk, Kosrae, and Yap without significant improvements in domestic satellite connectivity.

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The FSM Telecommunications Corporation (FSMTC) and Palau National Communications Corporation (PNCC) signed a Memorandum of Understanding on August 9, 2012 to act jointly to acquire, deploy, manage, operate and maintain an underwater fiber-optic cable to the State of Yap in the FSM and to Palau. The MOU established a partnership between both companies now known as Caroline Cable Consortium (CCC). FSMTC is working with all stakeholders including Yap State leadership, FSM National Government and international financial organizations such as World Bank and ADB to ensure that Yap State does not miss an opportunity to participate in submarine fiber optic landing.

Most of the telecommunications services provided in other more developed countries are available in the Federated States of Micronesia. These modern telecommunications services should go a long way in assisting the Federated States of Micronesia in its efforts to attract investors and to further develop our island nation. FSMTC will continue to seek improved technologies to better serve its customers and at the same time bring significant operating savings.

Management's Discussion and Analysis for the year ended September 30, 2012 is set forth in FSMTC'S report on the audit of financial statements, which is dated December 31, 2012. That Discussion and Analysis explains the major factors impacting the 2012 financial statements and can be viewed at the Office of the FSM National Public Auditor's website at www.fsmopa.fm

Financial Contact

This financial report is designed to provide all interested users with a general overview of the Federated States of Micronesia Telecommunications Corporation. If you have questions about this report or need additional financial information, please contact John Sohl, President/CEO or Rodelio A. Pulmano, Senior Vice President/CFO at email addresses john.sohl@fsmtc.fm and rodelio.pulmano@fsmtc.fm, respectively, or please write to us at P.O. Box 1210, Kolonia, Pohnpei FM 96941.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Statements of Net Position
September 30, 2013 and 2012

| | 2013 | 2012 |
|---|---------------|---------------|
| <u>ASSETS</u> | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 1,198,227 | \$ 1,254,195 |
| Time certificates of deposit | 276,467 | 176,315 |
| Investment in securities | 1,455,247 | 1,292,090 |
| Accounts receivable, net of an allowance for doubtful accounts of \$1,076,165 and \$1,080,733 in 2013 and 2012, respectively | 589,337 | 569,570 |
| Receivables from carriers | 433,231 | 328,545 |
| Advances to employees | 49,559 | 12,779 |
| Inventory | 784,681 | 680,442 |
| Accrued interest and other accrued earnings | 182,398 | 185,244 |
| Other receivables and prepaid expenses | 219,704 | 399,237 |
| Total current assets | 5,188,851 | 4,898,417 |
| Property, plant and equipment, net | 43,978,307 | 48,169,976 |
| Indefeasible right of use, net | 3,144,419 | 3,290,671 |
| | \$ 52,311,577 | \$ 56,359,064 |
| <u>LIABILITIES AND NET POSITION</u> | | |
| Current liabilities: | | |
| Current maturities of long-term debt | \$ 1,586,759 | \$ 1,510,566 |
| Accounts payable, trade | 233,934 | 447,541 |
| Accounts payable, construction | - | 283,740 |
| Unearned income-debit cards | 137,495 | 170,055 |
| Accrued leave payable | 115,188 | 133,175 |
| Other accrued liabilities | 959,514 | 881,098 |
| Total current liabilities | 3,032,890 | 3,426,175 |
| Long-term debt, net of current portion | 27,399,546 | 28,987,140 |
| Total liabilities | 30,432,436 | 32,413,315 |
| Commitments and contingencies | | |
| Net position: | | |
| Net investment in capital assets | 18,136,421 | 20,962,941 |
| Restricted - expendable | - | 85,866 |
| Unrestricted | 3,742,720 | 2,896,942 |
| Total net position | 21,879,141 | 23,945,749 |
| | \$ 52,311,577 | \$ 56,359,064 |

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA
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Statements of Revenues, Expenses, and Changes in Net Position
Years Ended September 30, 2013 and 2012

| | 2013 | 2012 |
|---|---------------|---------------|
| Operating revenues: | | |
| Internet | \$ 4,206,549 | \$ 4,048,114 |
| Mobile charges | 3,317,897 | 3,748,526 |
| Overseas tolls | 2,648,512 | 2,777,032 |
| Net access | 1,885,607 | 1,759,485 |
| External carriers | 1,626,674 | 1,794,165 |
| ICTV Yap cable charges | 71,664 | 75,563 |
| ICTV Kosrae cable charges | 69,925 | 82,382 |
| ICTV Chuuk cable charges | 68,228 | 105,083 |
| Recovery of bad debts | 67,327 | 96,365 |
| Miscellaneous | 324,024 | 195,787 |
| Discounts | (334,866) | (695,893) |
| Total operating revenues | 13,951,541 | 13,986,609 |
| Operating expenses: | | |
| Corporate operations | 2,595,174 | 2,684,944 |
| Plant operations | 2,063,177 | 1,844,047 |
| Consumer operations | 1,187,439 | 1,265,089 |
| Internet expense | 1,776,888 | 1,736,411 |
| Cable and wire | 1,780,741 | 1,846,922 |
| Earth station | 1,183,432 | 1,173,317 |
| General support | 1,144,595 | 1,097,506 |
| Wireless telephone | 1,529,930 | 1,506,607 |
| Central office | 378,365 | 544,418 |
| Terminal equipment | 449,360 | 583,898 |
| ICTV expense | 606,205 | 510,938 |
| Total operating expenses | 14,695,306 | 14,794,097 |
| Loss from operations | (743,765) | (807,488) |
| Nonoperating revenues (expenses): | | |
| Interest expense | (1,486,000) | (1,513,134) |
| Investment income | 163,157 | 282,748 |
| Total nonoperating revenues (expenses), net | (1,322,843) | (1,230,386) |
| Capital grants | - | 360,000 |
| Change in net position | (2,066,608) | (1,677,874) |
| Total net position at beginning of year | 23,945,749 | 25,623,623 |
| Total net position at end of year | \$ 21,879,141 | \$ 23,945,749 |

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA
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Statements of Cash Flows
Years Ended September 30, 2013 and 2012

| | 2013 | 2012 |
|---|---------------|---------------|
| Cash flows from operating activities: | | |
| Cash received from subscribers, long distance carriers and other customers | \$ 13,479,898 | \$ 13,986,624 |
| Cash paid to suppliers for goods and services | (6,018,253) | (6,678,839) |
| Cash paid to employees | (3,661,276) | (3,593,787) |
| Net cash provided by operating activities | 3,800,369 | 3,713,998 |
| Cash flows from noncapital financing activities: | | |
| Repayment of line of credit facility | - | (2,331,054) |
| Interest paid on line of credit facility | - | (15,473) |
| Net cash used for noncapital financing activities | - | (2,346,527) |
| Cash flows from capital and related financing activities: | | |
| Proceeds from federal grant | - | 360,000 |
| Additions to property, plant and equipment | (758,784) | (1,584,486) |
| Repayments of RUS long-term debt | (1,511,401) | (1,435,152) |
| Interest paid on RUS long-term debt and others | (1,488,676) | (1,503,931) |
| Net cash used for capital and related financing activities | (3,758,861) | (4,163,569) |
| Cash flows from investing activities: | | |
| Net purchases, sales and maturities of investments | (33,398) | (283,208) |
| Withdrawals from investments | - | 3,556,850 |
| Net investment for time deposits | (100,000) | - |
| Interest and dividends received on investment securities and others | 35,922 | 280,449 |
| Net cash provided by investing activities | (97,476) | 3,554,091 |
| Net change in cash and cash equivalents | (55,968) | 757,993 |
| Cash and cash equivalents at beginning of year | 1,254,195 | 496,202 |
| Cash and cash equivalents at end of year | \$ 1,198,227 | \$ 1,254,195 |
| Reconciliation of loss from operations to net cash provided by operating activities: | | |
| Loss from operations | \$ (743,765) | \$ (807,488) |
| Adjustments to reconcile loss from operations to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,812,965 | 4,752,297 |
| (Increase) decrease in assets: | | |
| Accounts receivable | (19,767) | 96,637 |
| Receivable from carriers | (104,686) | (132,897) |
| Advances to employees | (36,780) | (10,169) |
| Inventory | (104,239) | 63,937 |
| Accrued interest and other accrued earnings | 2,846 | (53,666) |
| Other receivables and prepaid expenses | 179,533 | (29,488) |
| Increase (decrease) in liabilities: | | |
| Accounts payable, trade | (213,607) | (412,332) |
| Deferred revenue-debit cards | (32,560) | 89,941 |
| Accrued leave payable | (17,987) | 10,986 |
| Other payables and accrued expenses | 78,416 | 146,240 |
| Net cash provided by operating activities | \$ 3,800,369 | \$ 3,713,998 |

See accompanying notes to financial statements.

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Notes to Financial Statements
September 30, 2013 and 2012

(1) Summary of Significant Accounting Policies

Nature of Operations

The Federated States of Micronesia (FSM) Telecommunications Corporation (the Corporation), a component unit of the FSM National Government, is a local exchange carrier (LEC) and an international exchange carrier providing local telephone service, cellular service, internet access, long distance telecommunication services, and digital wireless TV. The Corporation serves commercial and residential customers in the four States that comprise the FSM - Chuuk, Kosrae, Pohnpei and Yap.

Organization

The Corporation was established as a public corporation under the laws of the Federated States of Micronesia, the purpose of which is to provide telecommunications services, except radio and television broadcasting, throughout the FSM and to points outside the FSM and began its operations in October 1983. The Corporation is governed by a five member Board of Directors. One member is appointed by the President of the FSM with the advice and consent of the FSM Congress. The Governor of each State of the FSM appoints one member of the Board with the advice and consent of the respective State legislatures. The Chief Executive Officer of the Corporation serves as an ex officio member of the Board but has no right to vote.

Basis of Accounting

The Corporation maintains a chart of accounts in accordance with the Uniform System of Accounts for telephone companies of the United States Federal Communications Commission's Rules, and in conformity with accounting principles generally accepted in the United States of America (GAAP). Additionally, the Corporation utilizes the accrual basis of accounting.

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by GASB Statement No.'s 37 and 38, establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following three net position categories:

- Net investment in capital assets - capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- Restricted - net position whose use by the Corporation is subject to externally imposed stipulations that can be fulfilled by actions of the Corporation pursuant to those stipulations or that expire by the passage of time.
- Unrestricted - net position that is not subject to externally imposed stipulations. Unrestricted net position may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

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(1) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents and Time Certificates of Deposit

Cash and cash equivalents include cash on hand, demand deposits, and short-term investments with a maturity date within three months of the date acquired by the Corporation. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified in the statements of net position. Certificate of deposit investment accounts established and set aside for future capital expenditure projects are classified within investment in securities.

Investments

Investments and related investment earnings are reported at fair value using quoted market prices. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Accounts Receivable

Accounts receivable are due from businesses and individuals located within the FSM and are interest free and uncollateralized. Receivables from international carriers are due from entities within the United States and Japan.

Accounts receivable are stated at the amount management expects to collect on outstanding balances. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection effects are written off through a charge to the valuation allowance and a credit to accounts receivable.

Inventory

Materials and supplies are valued at cost, which approximates market, using the first-in-first-out (FIFO) method.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. The Corporation capitalizes buildings, land improvements and equipment that have a cost of \$200 or more and an estimated useful life of at least five years. The cost of maintenance and repairs is charged to operating expenses. Depreciation is calculated on the straight-line method over the estimated useful lives of the respective assets.

Plant Under Construction

Plant under construction represents the accumulated costs of unfinished capital projects. These costs are capitalized as property, plant and equipment upon completion of each project.

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(1) Summary of Significant Accounting Policies, Continued

Indefeasible Right of Use

The Corporation has capitalized the cost of acquisition of the exclusive right to use a specified amount of fiber capacity for a period of time, which is amortized over the length of the term of the capacity agreement on the straight line method.

Valuation of Long-Lived Assets

The Corporation, using its best estimates based on reasonable and supportable assumptions and projections, reviews assets for impairment whenever events or changes in circumstances have indicated that the carrying amount of its assets might not be recoverable. Impaired assets are reported at the lower of cost or fair value. At September 30, 2013 and 2012, no assets had been written down.

Compensated Absences

It is the Corporation's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. No liability is reported for unpaid accumulated sick leave. Vacation pay is accrued when earned.

Income Taxes

Corporate profits are not subject to income tax in the FSM. Instead, the FSM National Government imposes a gross revenue tax (GRT) of 3% on gross revenues earned. The Corporation is subject to GRT; however, the Corporation is specifically exempt from any other taxes in accordance with its enabling legislation for the years ending September 30, 2013 and 2012.

Revenue Recognition and Classification

Billings for local service revenue and basic internet service are rendered monthly in advance. Advance billings are recorded as a liability and are subsequently transferred to income in the period earned. Prepaid card revenues are recorded when the cards are sold.

Long distance network services revenues and usage-sensitive internet service revenues are based on a per-minute charge paid by the end user or other telecommunications service providers. These revenues are billed in arrears, but are recognized in the month that service is provided.

The Corporation records all revenue generated from providing telecommunications services as operating revenue, including local service, long distance, internet, and cellular services.

Non-operating revenues and expenses consist of investment earnings, interest paid on long-term debt, and grant funds received.

Reclassification

Certain reclassifications have been made to the 2012 financial statements to correspond to the 2013 presentation.

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(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards

During fiscal year 2013, the Corporation implemented the following pronouncements:

- GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, which addressed how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 61, *The Financial Reporting Entity: Omnibus*, which improved financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity*, and No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which enhanced the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements issued on or before November 30, 1989, which does not conflict or contradict GASB pronouncements. GASB Statement no. 62 superseded GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which established guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position, and GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. These Statements amend the net asset reporting requirements in Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, and other pronouncements by incorporating deferred outflows of resources and deferred inflows of resources into the definitions of the required components of the residual measure and by renaming that measure as net position, rather than net assets. With the implementation of GASB Statement No. 63 and Statement No. 65, the Statement of Net Assets was renamed the Statement of Net Position. In addition, the Statement of Net Position includes two new classifications separate from assets and liabilities. Amounts reported as deferred outflows of resources are reported in a separate section following assets. Likewise, amounts reported as deferred inflows of resources are reported in a separate section following liabilities.

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(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In April 2012, GASB issued Statement No. 66, *Technical Corrections - 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of the Corporation.

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

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*, which improves accounting and financial reporting for state and local governments' combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. A disposal of government operations can occur through a transfer to another government or a sale. The provisions in Statement 69 are effective for fiscal years beginning after December 15, 2013. Management has not yet determined the effect of implementation of these statements on the financial statements of the Corporation.

In April 2013, GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The provisions in Statement 69 are effective for fiscal years beginning after June 15, 2013. Management has not yet determined the effect of implementation of these statements on the financial statements of the Corporation.

Management Estimates

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

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(2) Investment - Island Cable Television

On December 8, 1998, the Corporation acquired a 50% ownership in Island Cable Television - Pohnpei for \$450,000. The Corporation recorded this investment under the equity method of accounting. Goodwill of \$383,062 resulting from the purchase was being amortized over a period of fifteen (15) years. The remaining goodwill balance of \$325,603 as of September 30, 2002 was written-off.

(3) Deposits and Investments

The deposit and investment policies of the Corporation are governed by the Board of Directors. As such, the Board of Directors is authorized to delegate certain responsibilities to third parties. Investment managers have discretion to purchase, sell, or hold the specific securities to meet the objectives set forth in the investment policy.

Generally, the Corporation can invest in bonds and other indebtedness of the U.S. and in preferred or common stock of any corporation created or existing under the laws of the U.S. or any U.S. state, territory, or commonwealth. Additionally, a maximum of 20% of the total portfolio may be invested in non-U.S. equities.

A. Deposits

Custodial credit risk is the risk that in the event of a bank failure, the Corporation's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution but not in the Corporation's name. The Corporation does not have a deposit policy for custodial credit risk.

As of September 30, 2013 and 2012, the carrying amount of the Corporation's total cash and cash equivalents and time certificates of deposit was \$1,474,694 and \$1,430,510, respectively, and the corresponding bank balances were \$1,537,860 and \$1,287,601, respectively, all of which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2013 and 2012, bank deposits in the amount of \$386,217 and \$770,993, respectively, were FDIC insured. The Corporation does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. The Corporation has not experienced any losses in such accounts and management believes it is not exposed to any significant credit risk on its deposits.

B. Investments

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. With the exception of investments in U.S. government securities, which are explicitly or implicitly guaranteed by the United States government, all other investments must be rated in accordance with the Corporation's investment policy.

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(3) Deposits and Investments, Continued

B. Investments, Continued

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Corporation will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. As of September 30, 2013 and 2012, the Corporation's investments are held in the name of the Corporation and are administered by investment managers subject to Securities Investor Protection Corporation insurance in accordance with the Corporation's investment policy.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Corporation's investment policy states that all fixed income securities shall have a Moody's, Standard & Poor's and/or Fitch's credit rating of no less than "BBB."

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 Corporation. As of September 30, 2013 and 2012, there were no investments in any one issuer that exceeded 5% of total investments.

As of September 30, 2013 and 2012, investments at fair value are as follows:

| | <u>2013</u> | <u>2012</u> |
|-------------------------------------|---------------------|---------------------|
| Fixed income: | | |
| U.S. Treasury obligations | \$ 181,204 | \$ 159,280 |
| U.S. Government agencies | 54,353 | 55,738 |
| Corporate notes | <u>147,347</u> | <u>201,701</u> |
| | 382,904 | 416,719 |
| Other investments: | | |
| Domestic and international equities | 978,474 | 829,140 |
| Money market funds | <u>83,869</u> | <u>36,231</u> |
| | <u>\$ 1,445,247</u> | <u>\$ 1,282,090</u> |

As of September 30, 2013, the Corporation's investments in debt securities were as follows:

| | Moody's Credit Rating | Less Than 1 | Investment Maturities (In Years) | | | Fair Value |
|---------------------------|-----------------------------|------------------|----------------------------------|-------------------|--------------------|-------------------|
| | | | 1 to 5 | 6 to 10 | Greater Than 10 | |
| U.S. Treasury obligations | Aaa/P-1 | \$ 28,609 | \$ 57,907 | \$ 94,688 | \$ - | \$ 181,204 |
| U.S. Government agencies | Aaa/P-1 | - | 54,353 | - | - | 54,353 |
| Corporate notes | A1/P-1 | - | 41,512 | - | - | 41,512 |
| Corporate notes | A2/P-1 | 20,417 | 15,740 | 25,328 | - | 61,485 |
| Corporate notes | A2-/P-1 | - | 27,302 | - | - | 27,302 |
| Corporate notes | Aa3/P-1 | - | - | 17,048 | - | 17,048 |
| | | <u>\$ 49,026</u> | <u>\$ 196,814</u> | <u>\$ 137,064</u> | <u>\$ -</u> | <u>\$ 382,904</u> |

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(3) Deposits and Investments, Continued

B. Investments, Continued

As of September 30, 2012, the Corporation's investments in debt securities were as follows:

| | Moody's Credit Rating | Less Than 1 | Investment Maturities (In Years) | | | Fair Value |
|---------------------------|-----------------------------|-------------------|----------------------------------|------------------|--------------------|-------------------|
| | | | 1 to 5 | 6 to 10 | Greater Than 10 | |
| U.S. Treasury obligations | Aaa/P-1 | \$ 45,711 | \$ 80,299 | \$ 33,270 | \$ - | \$ 159,280 |
| U.S. Government agencies | Aaa/P-1 | 20,870 | 34,868 | - | - | 55,738 |
| Corporate notes | A1/P-1 | 20,905 | 32,513 | 18,688 | - | 72,106 |
| Corporate notes | A2/P-1 | - | 53,380 | 27,461 | - | 80,841 |
| Corporate notes | Aa2/P-1 | 15,629 | - | - | - | 15,629 |
| Corporate notes | Aa3/P-1 | 15,214 | - | 17,911 | - | 33,125 |
| | | <u>\$ 118,329</u> | <u>\$ 201,060</u> | <u>\$ 97,330</u> | <u>\$ -</u> | <u>\$ 416,719</u> |

C. Equity Investment, at Cost

On October 7, 2011, the Corporation invested \$10,000 in Caroline Cable Corporation (CCC). The equity investment in CCC represents 10,000 shares of common stock and a 1/3 ownership interest. The primary purpose of CCC shall be to engage in the commercial enterprise of acquiring, owning, deploying, managing, maintaining, operating, and repairing a new or used underwater fiber-optic cable to the Republic of Palau with a spur running from a branching unit on the main cable to the State of Yap, Federated States of Micronesia.

(4) Property, Plant and Equipment

Capital asset activities of the Corporation for the years ended September 30, 2013 and 2012 are as follows:

| | Estimated Useful Lives | Balance October 1, 2012 | Additions | Retirements | Balance September 30, 2013 |
|---------------------------------------|---------------------------|----------------------------|-----------------------|---------------------|-------------------------------|
| General support | 5-35 years | \$ 17,000,113 | \$ 156,521 | \$ (551,384) | \$ 16,605,250 |
| Central office | 20 years | 12,065,328 | 1,746 | - | 12,067,074 |
| Earth station | 20 years | 5,649,401 | 11,076 | (9,094) | 5,651,383 |
| Terminal equipment | 5-20 years | 3,570,176 | 40,321 | - | 3,610,497 |
| Cellular network | 10-20 years | 18,025,738 | 200,873 | - | 18,226,611 |
| Internet equipment | 8 years | 2,633,389 | 408,912 | - | 3,042,301 |
| Pole, cable and wiring | 15-20 years | <u>44,424,242</u> | <u>2,182</u> | <u>(11,031)</u> | <u>44,415,393</u> |
| Total | | 103,368,387 | 821,631 | (571,509) | 103,618,509 |
| Accumulated depreciation | | <u>(55,569,725)</u> | <u>(4,665,711)</u> | <u>571,509</u> | <u>(59,663,927)</u> |
| | | 47,798,662 | (3,844,080) | - | 43,954,582 |
| Plant under construction | | <u>371,314</u> | <u>145,214</u> | <u>(492,803)</u> | <u>23,725</u> |
| Property, plant and equipment, net | | <u>\$ 48,169,976</u> | <u>\$ (3,698,866)</u> | <u>\$ (492,803)</u> | <u>\$ 43,978,307</u> |

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(4) Property, Plant and Equipment, Continued

| | <u>Estimated Useful Lives</u> | <u>Balance October 1, 2011</u> | <u>Additions</u> | <u>Retirements</u> | <u>Balance September 30, 2012</u> |
|---------------------------------------|-----------------------------------|------------------------------------|-----------------------|--------------------|---------------------------------------|
| General support | 5-35 years | \$ 16,459,520 | \$ 540,593 | \$ - | \$ 17,000,113 |
| Central office | 20 years | 11,680,546 | 384,782 | - | 12,065,328 |
| Earth station | 20 years | 5,600,527 | 48,874 | - | 5,649,401 |
| Terminal equipment | 5-20 years | 3,490,160 | 80,016 | - | 3,570,176 |
| Cellular network | 10-20 years | 17,750,622 | 275,116 | - | 18,025,738 |
| Internet equipment | 8 years | 2,098,421 | 534,968 | - | 2,633,389 |
| Pole, cable and Wiring | 15-20 years | <u>44,413,211</u> | <u>11,031</u> | <u>-</u> | <u>44,424,242</u> |
| Total | | 101,493,007 | 1,875,380 | - | 103,368,387 |
| Accumulated depreciation | | <u>(50,963,680)</u> | <u>(4,606,045)</u> | <u>-</u> | <u>(55,569,725)</u> |
| | | 50,529,327 | (2,730,665) | - | 47,798,662 |
| Plant under construction | | <u>940,138</u> | <u>(568,824)</u> | <u>-</u> | <u>371,314</u> |
| Property, plant and equipment, net | | \$ <u>51,469,465</u> | \$ <u>(3,299,489)</u> | \$ <u>-</u> | \$ <u>48,169,976</u> |

(5) Capitalized Interest

Interest is capitalized on all construction-in-progress pursuant to ASC 835-20, *Capitalization of Interest*, provided that the construction period exceeds one year. Interest capitalized on qualifying construction-in-progress was \$0 and \$5,810 during the years ended September 30, 2013 and 2012, respectively.

(6) Indefeasible Right of Use (IRU)

On January 12, 2009, the Corporation entered into an IRU Capital Lease agreement with a third party for the exclusive use of 8 wave lengths of fiber capacity of the two fibers of the Kwajalein Cable System (KCS) which runs between Guam and Kwajalein and which is known as the "HANTRU1 System". Under the terms of the agreement, the Corporation made certain payments of \$3,656,301. The initial term of the agreement is for a period of 10 years commencing on the date the Corporation is initially granted access, and which term is automatically renewable for a further 10 year period and an additional 5 year period thereafter. Prior to the tenth and twentieth anniversary dates, the Corporation has the option to terminate this agreement; however, such is subject to prior approval of the Rural Utilities Services (RUS) of the U.S. Department of Agriculture. The Corporation's policy is to amortize the right of use over the 25 year period. As of September 30, 2013 and 2012, accumulated amortization expense of \$511,882 and \$365,630, respectively, has been recorded.

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(7) Long-term Debt

| | <u>2013</u> | <u>2012</u> |
|---|----------------------|----------------------|
| Loans payable to RUS, with a 35 year term, interest at 5%, collateralized by the Corporation's specific ground leases and essentially all other assets. Pursuant to loan agreements dated August 1, 1990 and March 12, 2009, the Corporation is required to make monthly payments of both principal and interest to RUS. The loans were originally in the amounts of \$32,000,000 and \$12,136,000 and the proceeds were used for capital related purposes. | \$ <u>28,986,305</u> | \$ <u>30,497,706</u> |

Future minimum principal and interest payments on notes payable for subsequent years ending September 30, are as follows:

| <u>Year ending September 30,</u> | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|----------------------------------|----------------------|----------------------|----------------------|
| 2014 | \$ 1,586,759 | \$ 1,413,318 | \$ 3,000,077 |
| 2015 | 1,667,941 | 1,332,136 | 3,000,077 |
| 2016 | 1,752,305 | 1,247,772 | 3,000,077 |
| 2017 | 1,843,782 | 1,156,295 | 3,000,077 |
| 2018 | 1,937,258 | 1,062,819 | 3,000,077 |
| 2019 - 2023 | 11,278,202 | 3,722,182 | 15,000,384 |
| 2024 - 2027 | <u>8,920,058</u> | <u>757,656</u> | <u>9,677,714</u> |
| | <u>\$ 28,986,305</u> | <u>\$ 10,692,178</u> | <u>\$ 39,678,483</u> |

These notes are subject to certain coverage ratio requirements. The Corporation is not in compliance with its ratio requirements as of September 30, 2013. Management is of the opinion that the lender is aware of this matter and will not call the debt. Therefore, the debt is classified per the expected future payouts.

A summary of changes in long-term liabilities for the years ended September 30, 2013 and 2012 are as follows:

| | <u>Balance</u> <u>October 1, 2012</u> | <u>Increases</u> | <u>Decreases</u> | <u>Balance</u> <u>September 30, 2013</u> | <u>Due Within</u> <u>one Year</u> |
|--|--|-------------------|-----------------------|---|--------------------------------------|
| Notes payable: Rural Utilities Service | \$ <u>30,497,706</u> | \$ <u> -</u> | \$ <u>(1,511,401)</u> | <u>\$28,986,305</u> | <u>\$1,586,759</u> |
| | <u>Balance</u> <u>October 1, 2011</u> | <u>Increases</u> | <u>Decreases</u> | <u>Balance</u> <u>September 30, 2012</u> | <u>Due Within</u> <u>one Year</u> |
| Notes payable: Rural Utilities Service | \$ <u>31,932,858</u> | \$ <u> -</u> | \$ <u>(1,435,152)</u> | <u>\$30,497,706</u> | <u>\$1,510,566</u> |

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(8) Commitments and Contingencies

Leases

The Corporation has fourteen operating leases as of September 30, 2013. Six are residential real estate leases for contract employees, which have a term of one or two years. Three represent thirty-year leases for satellite stations of Yap, Pohnpei, and Kosrae. Three are for land sites for state offices with 25-35 year terms beginning in 1988 for Pohnpei and Yap and 1990 for Kosrae. Two are for land site lease for the previous central office and for the southeast remote switch on Pohnpei; both for 15 year terms beginning in 1994. The Corporation has also entered into various circuit leases expiring through 2016.

The approximate future minimum annual lease payments payable by the Corporation are as follows:

| <u>Year ending September 30;</u> | <u>Total</u> |
|----------------------------------|---------------------|
| 2014 | \$ 2,113,191 |
| 2015 | 1,210,969 |
| 2016 | 30,407 |
| 2017 | 9,816 |
| 2018 | 8,101 |
| 2019 - 2023 | 19,364 |
| 2024 - 2027 | <u>5,292</u> |
| | <u>\$ 3,397,140</u> |

Operation, Management and Repair (OM&R) Agreement

On March 2, 2009, the Corporation, along with the Marshall Islands National Telecommunications Authority (MINTA), entered into an OM&R agreement with a third party for the purpose of operating, maintaining, and repairing the “Micronesian Addition”, which is a subset of the HANTRU1 System. The term of the agreement coincides with the term of the IRU Capital Lease agreement wherein the Corporation and MINTA are required to each make monthly payments of \$6,400 less certain service credits, and which are subject to inflationary adjustments and an annual incremental increase of 3%.

Self Insurance

The Corporation purchases insurance to cover risks associated with its buildings and equipment (\$20,409,779 of coverage) and vehicles (up to \$1,000,000 of coverage per vehicle per incident). Additionally, the Corporation purchases fidelity insurance coverage for selected employees (total coverage of \$2,454,000) and workmen’s compensation insurance (coverage of up to \$100,000 per employee). The Corporation also purchases general liability insurance in connection with operations (up to \$1,000,000 per occurrence). There have been no significant reductions in coverage, and there have been no settlements in excess of insurance coverage for the past three years. The Corporation does not purchase insurance for its Outside Plant. As most of these items are underground, the Corporation is of the opinion that losses from such, if any, will be minimal. Therefore, the Corporation is self insured for Outside Plant and all other risks not encompassed in the forgoing. Management is of the opinion that no material losses have resulted from this practice.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**
(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Notes to Financial Statements
September 30, 2013 and 2012

(8) Commitments and Contingencies, Continued

Construction and Other Commitments

During the year ended September 30, 2013, the Corporation entered into various contracts for construction and expansion of its facilities and services. Approximately \$1,805,879 is outstanding under these contracts as of September 30, 2013.

The Corporation entered into a \$4 million contract with Acclinks Communications, Inc. for a Third Generation (3G) Mobile Network Partnership Agreement signed on September 12, 2013.

External Carriers

External carriers located in other countries are subject to oversight policies from their respective regulatory agencies. Currently, U.S. regulatory agencies are contemplating a reduction of the tariff rate used by the Corporation for settlement with certain U.S. carriers. The ultimate outcome of this matter and the related impact on the Corporation cannot be predicted at this time.

Litigation

In the ordinary course of business, claims have been filed against the Corporation. Management does not believe that the plaintiffs will prevail and the ultimate outcome is currently not determinable. Therefore, no provision has been recorded in the accompanying financial statements for losses, if any, that may result.

(9) Related Party Transactions

The Corporation's services are provided to its affiliates at the same rates as are charged to third parties. The Corporation is a component unit of the FSM National Government. As of September 30, 2013 and 2012, receivables from the FSM National Government amounted to \$33,439 and \$35,491, respectively.

(10) Retirement Plan

The Corporation's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees received from the FSM Social Security System. The Plan is a contributory plan in which the Corporation contributes 10 percent of the participant's annual salary, and the participant contributes 3 or more percent from his or her annual salary. Participation is optional. The Corporation's controller is the designated Plan administrator. Contributions to the Plan during the years ended September 30, 2013 and 2012 were \$377,768 and \$359,323, respectively. Management is of the opinion that the plan does not represent an asset or liability of the Corporation. At September 30, 2013 and 2012, plan assets were \$4,463,870 and \$4,348,568, respectively.

**FEDERATED STATES OF MICRONESIA
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Schedule of Operating Expenses
Years Ended September 30, 2013 and 2012

| | <u>2013</u> | <u>2012</u> |
|-------------------------------|----------------------|----------------------|
| Depreciation and amortization | \$ 4,812,965 | \$ 4,752,297 |
| Salaries and wages | 3,616,549 | 3,627,418 |
| Circuit lease | 2,107,537 | 2,208,335 |
| Utilities | 1,378,967 | 1,320,032 |
| Repairs and maintenance | 628,424 | 489,000 |
| Cost of sales | 328,254 | 419,076 |
| Taxes | 362,164 | 384,001 |
| Travel | 261,634 | 240,824 |
| Petroleum and lubricants | 157,641 | 205,308 |
| Rental expenses | 138,025 | 187,270 |
| Communications | 121,390 | 154,472 |
| Contractual services | 144,411 | 141,715 |
| Supplies | 130,738 | 113,991 |
| ICTV affiliated | 127,773 | 104,393 |
| Training | 12,055 | 83,641 |
| Insurance | 79,239 | 73,888 |
| Freight | 44,906 | 51,009 |
| Professional fees | 45,546 | 38,011 |
| Publications and printing | 26,430 | 37,748 |
| Representation | 19,104 | 34,339 |
| Advertising | 12,875 | 20,418 |
| Land lease | 32,132 | 28,503 |
| Miscellaneous | 106,547 | 78,408 |
| | <u>\$ 14,695,306</u> | <u>\$ 14,794,097</u> |

See Accompanying Independent Auditors' Report.

**FEDERATED STATES OF MICRONESIA
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(A COMPONENT UNIT OF THE FEDERATED STATES OF MICRONESIA NATIONAL GOVERNMENT)

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2013

U.S. Department of Agriculture

Rural Utilities Service Loan Funding:

| Approved Purposes | Loan Proceeds Approved as of September 30, 2013 | Loan Proceeds Received During FY 2013 | Total Disbursements on Contracts During FY 2013 |
|---------------------|--|---|---|
| F/A 1 | \$ 411,584 | \$ - | \$ - |
| Work Orders | 422,905 | - | - |
| CT. A-4 | 90,688 | - | - |
| CT. A-5 | 1,191,004 | - | - |
| CT. A-6 | 650,676 | - | - |
| CT. A-7 | 3,108,615 | - | - |
| CT. A-8 | 3,500,000 | - | - |
| CT. A-9 | 1,108,149 | - | - |
| CT. A-10 | 636,505 | - | - |
| CT. A-11 | 1,193,317 | - | - |
| CT. A-12 | 1,422,800 | - | - |
| CT. A-13 | 19,440,795 | - | - |
| CT. A-14X | 1,988,002 | - | - |
| CT. B-15 | 8,206,857 | - | - |
| CT. B-16E | 274,500 | - | - |
| CT. A-1E | 275,625 | - | - |
| CT. A-2E | 4,008,263 | - | - |
| CT. A-3A | 304,109 | - | - |
| Operating Equipment | 387,263 | - | - |
| Pre-Loan | 55,000 | - | - |
| IRU Capital Lease | 3,656,301 | - | - |
| Interest Income | - | - | - |
| | <u>\$ 52,332,958</u> | <u>\$ -</u> | <u>\$ -</u> |

U.S. Department of the Interior

Compact Sector funds received during FY12
(CFDA #15.875)

\$ 85,866

See Accompanying Independent Auditors' Report.

INDEPENDENT AUDITORS' 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

Board of Directors
Federated States of Micronesia
Telecommunications 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 Federated States of Micronesia (FSM) Telecommunications Corporation (the Corporation), which comprise the statement of net position as of September 30, 2013, and the related statements of revenues, expenses, and changes in net position and of cash flows for the year then ended and the related notes to the financial statements, and have issued our report thereon dated December 27, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Corporation'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 opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Corporation'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.

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 as item 2013-001 to be material weaknesses.

Compliance and Other Matters

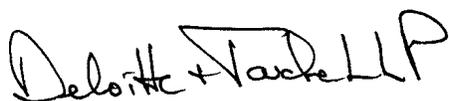
As part of obtaining reasonable assurance about whether the Corporation's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material 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 of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Responses as item 2013-002.

The Corporation's Response to Findings

The Corporation's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. The Corporation's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the 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.

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is written in a cursive, stylized font.

Tamuning, Guam
December 27, 2013

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**

Schedule of Findings and Responses
Year Ended September 30, 2013

Bank Reconciliations

Finding No. 2013-001

Criteria: Adequate internal control policies necessitate the bank reconciliation process to provide accurate and reliable information.

Condition:

- A. Per scrutiny of the September 2013 bank reconciliations, we noted variances between the adjusted balances and the general ledger. The below summarizes the noted variances:

| <u>Bank Account</u> | <u>General Ledger Balance</u> | <u>Bank Reconciliation Balance</u> | <u>Difference</u> |
|------------------------|---------------------------------------|--|-------------------|
| Retirement Fund | \$ 120,949 | \$ 120,946 | \$ 3 |
| Payroll Checking - Yap | 10,810 | 9,246 | 1,564 |

- B. \$108,083 in the Merchandise for Sale Fund account was a bank reconciling item which resulted from variances between recorded transactions and actual bank deposits. Per further investigation, the reconciling item was invalid and was subsequently reversed.
- C. Per scrutiny of incidental revenues, we noted transactions involving adjustments to Collection Fund accounts at year-end arising from bank reconciliations.

Cause: It appears that the cause of the condition is inadequate review of bank reconciliations.

Effect: The effect of the condition is late identification of bank reconciling items which may influence the reliability of the financial information.

Recommendation: We recommend improvement of the timely preparation and review of bank reconciliations.

Auditee Response and Corrective Action Plan:

- A. Bank reconciliation reports will be submitted on or before the end of the following month, without exception. Since bank statements are all available on line, there is no reason why this report will be delayed.
- B. One of the main reasons why this report is delayed is due to reporting issues with the existing Accounting Software, ACCPAC and the Billing Software, AVABILL. The GL extracts from AVABILL TO ACCPAC requires further reconciliation. This will be corrected as soon as the upgrade on AVABILL be completed this coming fiscal year 2014.

**FEDERATED STATES OF MICRONESIA
TELECOMMUNICATIONS CORPORATION**

Schedule of Findings and Responses, Continued
Year Ended September 30, 2013

Loan Noncompliance

Finding No. 2013-002

Criteria: Section 5.12, *TIER Requirement*, of the RUS Loan Agreements states the required TIER rate that is to be maintained. Such provision has also been stated under the preliminary review of “B” Loan letter dated November 19, 2008 requiring at least 1.5 commencing December 31, 2012.

Condition: Per examination of RUS Form 479 ending December 31, 2012, submitted by the Corporation on February 7, 2013, the TIER rate reported was -0.42, which is less than the criteria.

Cause: The cause of the above condition is net losses incurred as of December 31, 2012, the RUS loan reporting period, which resulted in a negative TIER rate.

Effect: The effect of the above condition is noncompliance with the criteria.

Recommendation: We recommend compliance with the criteria.

Auditee Response and Corrective Action Plan: Management is fully aware of the situation as to non compliance to the TIER required by RUS, due to the fact that the Corporation has been experiencing major losses since 2007.

We have requested RUS a Loan Payment break and utilize the fund for other projects that could contribute to increase in revenue like the 3G/4G system.

As a requirement, a 5 year plan has to be submitted to RUS projection the plan of action to bring the TIER to the required number, which is 1.5. The current financial condition of the Corporation is the main reason why the TIER number is impossible to achieve unless more capital is infused into the Corporation. As of December 10, 2013, the Corporation had signed a contract with ACCLINKS to provide 3G System in the FSM with arranged financing requirement affordable by the Corporation. Management is optimistic that this new service will contribute to the recovery of losses that is being experienced over the past 6 years. Hoping that the TIER will at least increase if not the required number is actually achieved.