

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT



IPEC



INSIDE PASSAGE ELECTRIC COOPERATIVE

December 31, 2016 and 2015

BLODGETT, MICKELSEN & ADAMSON, P.S.
CERTIFIED PUBLIC ACCOUNTANTS

CONTENTS

	PAGE
INDEPENDENT AUDITOR'S REPORT	1-2
FINANCIAL STATEMENTS	
BALANCE SHEETS	3-4
STATEMENTS OF REVENUES AND MARGINS	5
STATEMENTS OF CHANGES IN EQUITIES AND MARGINS	6
STATEMENTS OF CASH FLOWS	7-8
NOTES TO FINANCIAL STATEMENTS	9-16
RUS AND GOVERNMENT AUDITING STANDARDS REPORTS	17-21

BLODGETT, MICKELSEN & ADAMSON, P.S.

CERTIFIED PUBLIC ACCOUNTANTS
7139 W. DESCHUTES AVE., SUITE 102
KENNEWICK, WA 99336

BRENT R. MICKELSEN, C.P.A.
THOMAS W. BLODGETT, C.P.A.
TRAVIS B. ADAMSON, C.P.A.

TELEPHONE: (509) 735-0379
FACSIMILE: (509) 735-0646

MEMBERS
WASHINGTON STATE SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS
AMERICAN INSTITUTE
OF
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT

Board of Directors
Inside Passage Electric Cooperative, Inc.
Auke Bay, Alaska

We have audited the accompanying financial statements of Inside Passage Electric Cooperative, Inc., which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of revenues and margins, changes in equities and margins, 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.

Auditor's Responsibility

Our responsibility is to express an opinion 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 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 of 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 Inside Passage Electric Cooperative, Inc. as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The financial statements of Inside Passage Electric Cooperative, Inc. for the year ended December 31, 2015 were audited by another auditor who expressed an unmodified opinion on those statements on March 25, 2016.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have issued our report dated March 6, 2017, on our consideration of Inside Passage Electric Cooperative, Inc.'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 Inside Passage Electric Cooperative, Inc.'s internal control over financial reporting and compliance

Blodgett, Mickelsen & Adamson, P.S.

Kennewick, Washington

March 6, 2017

Inside Passage Electric Cooperative, Inc.

BALANCE SHEETS

December 31, 2016 and 2015

ASSETS

	<u>2016</u>	<u>2015</u>
UTILITY PLANT - AT COST (notes 1 and 2)		
Electric plant in service - at cost	\$ 21,264,944	\$ 20,925,867
Construction work in progress	360,855	126,253
	<u>21,625,799</u>	<u>21,052,120</u>
Less accumulated depreciation and amortization	12,108,094	11,659,932
Net electric plant	9,517,705	9,392,188
OTHER ASSETS AND INVESTMENTS - AT COST (notes 1 and 3)		
Investments in associated organizations	1,337,815	1,255,120
Restricted cash:		
Consumer deposits	41,821	45,111
State of Alaska performance guarantees	13,600	13,600
Construction account	-	101
	<u>1,393,236</u>	<u>1,313,932</u>
CURRENT ASSETS (notes 1 and 4)		
Cash and cash equivalents	306,742	711,943
Accounts receivable, less provision for doubtful accounts of \$22,001 in 2016 and \$28,207 in 2015	727,695	398,677
Unbilled revenue	210,743	186,781
Materials and supplies	236,168	250,788
Fuel inventory	223,962	219,579
Prepaid expenses	49,263	51,667
Other current and accrued assets	1,179	1,179
Total current assets	<u>1,755,752</u>	<u>1,820,614</u>
DEFERRED CHARGES (notes 1 and 5)	<u>53,180</u>	<u>63,939</u>
	<u>\$ 12,719,873</u>	<u>\$ 12,590,673</u>

The accompanying notes are an integral part of these statements.

EQUITIES, MARGINS AND LIABILITIES

	2016	2015
EQUITIES AND MARGINS (note 1)		
Patronage capital	\$ 2,837,371	\$ 2,705,199
Other equities	<u>3,886,177</u>	<u>3,886,177</u>
	<u>6,723,548</u>	<u>6,591,376</u>
 LONG-TERM DEBT, less current maturities (note 6)	 3,201,394	 3,516,378
 COMMITMENTS AND CONTINGENCIES (note 10)	 -	 -
 CURRENT LIABILITIES (notes 1, 6 and 7)		
Accounts payable	231,164	177,389
Consumer deposits	41,821	45,111
Accrued payroll and related liabilities	59,263	62,381
Line of credit	2,000,000	1,600,000
Current maturities of long-term debt	<u>314,989</u>	<u>320,678</u>
Total current liabilities	<u>2,647,237</u>	<u>2,205,559</u>
 DEFERRED CREDITS (notes 1 and 8)	 <u>147,694</u>	 <u>277,360</u>
	 <u>\$ 12,719,873</u>	 <u>\$ 12,590,673</u>

Inside Passage Electric Cooperative, Inc.

STATEMENTS OF REVENUES AND MARGINS

Years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Operating revenues (note 1)	\$ 4,509,001	\$ 4,860,161
Operating expenses		
Purchased power	88,762	80,354
Power production - operation	2,140,848	2,650,381
Power production - maintenance	164,667	271,532
Distribution - operation	167,705	88,157
Distribution - maintenance	63,227	34,584
Consumer accounts	170,454	167,799
Consumer service and information	42,293	30,863
Administrative and general	1,047,401	1,030,130
Depreciation and amortization	455,035	427,665
Taxes	4,682	4,861
Total operating expenses	<u>4,345,074</u>	<u>4,786,326</u>
Net operating margins before fixed charges	163,927	73,835
Fixed charges		
Interest on long-term debt	106,473	114,526
Other	650	550
	<u>107,123</u>	<u>115,076</u>
Net operating margins (loss)	56,804	(41,241)
Non-operating margins		
Patronage capital	94,374	140,596
Interest income	5,189	7,053
Rental (loss) income, net of rental expenses	(24,955)	34,325
Other non-operating income	760	946
	<u>75,368</u>	<u>182,920</u>
NET MARGINS	<u>\$ 132,172</u>	<u>\$ 141,679</u>

The accompanying notes are an integral part of these statements.

Inside Passage Electric Cooperative, Inc.

STATEMENTS OF CHANGES IN EQUITIES AND MARGINS

Years ended December 31, 2016 and 2015

	Patronage Capital			Total
	Other Equities	Operating Margins	Non-Operating Margins	
Balance at December 31, 2014	\$ 3,886,177	\$ 1,227,860	\$ 1,335,660	\$ 6,449,697
Net (loss) margin	-	(41,241)	182,920	141,679
Balance at December 31, 2015	<u>\$ 3,886,177</u>	<u>\$ 1,186,619</u>	<u>\$ 1,518,580</u>	<u>\$ 6,591,376</u>
Net margins	-	56,804	75,368	132,172
Balance at December 31, 2016	<u>\$ 3,886,177</u>	<u>\$ 1,243,423</u>	<u>\$ 1,593,948</u>	<u>\$ 6,723,548</u>

Inside Passage Electric Cooperative, Inc.

STATEMENTS OF CASH FLOWS

Years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net margins	\$ 132,172	\$ 141,679
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	455,035	427,665
Net operating changes in:		
Accounts receivable	(329,018)	77,201
Unbilled revenue	(23,962)	63,502
Materials and supplies	14,620	51,775
Fuel inventory	(4,383)	210,780
Prepaid expenses	2,404	(1,482)
Deferred charges	10,759	(35,939)
Accounts payable	53,775	(210)
Consumer deposits	(3,290)	(35,202)
Accrued payroll and related liabilities	(3,118)	(4,410)
Deferred credits	(128,181)	115,145
	<u>176,813</u>	<u>1,010,504</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES		
CASH FLOWS FROM INVESTING ACTIVITIES		
Net additions to utility plant	(575,164)	(2,219,249)
Book value of property dispositions and plant removal - net	(6,873)	(322,405)
Grants received for construction	-	51,482
Net increase in other assets and investments	(82,695)	(97,246)
	<u>(664,732)</u>	<u>(2,587,418)</u>
NET CASH USED IN INVESTING ACTIVITIES		

	<u>2016</u>	<u>2015</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on long-term debt	\$ (320,673)	\$ (312,620)
Proceeds from borrowings on line of credit	<u>400,000</u>	<u>1,600,000</u>
NET CASH PROVIDED BY FINANCING ACTIVITIES	<u>79,327</u>	<u>1,287,380</u>
Net decrease in cash	(408,592)	(289,534)
Cash and cash equivalents at beginning of year	<u>770,755</u>	<u>1,060,289</u>
Cash and cash equivalents at end of year	<u><u>\$ 362,163</u></u>	<u><u>\$ 770,755</u></u>

Cash paid for interest during the years December 31, 2016 and 2015 amounted to \$106,473 and \$114,526, respectively.

Reconciliation of Cash and Cash Equivalents to Balance Sheet:

Cash and cash equivalents	\$ 306,742	\$ 711,943
Restricted cash:		
Consumer deposits	41,821	45,111
State of Alaska performance guarantees	13,600	13,600
Construction account	-	101
	<u>55,421</u>	<u>58,812</u>
	<u><u>\$ 362,163</u></u>	<u><u>\$ 770,755</u></u>

Inside Passage Electric Cooperative, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Inside Passage Electric Cooperative, Inc. (IPEC or the Cooperative) operates an electric utility from offices in Auke Bay, Alaska, which provides services to the southeast Alaska communities of Angoon, Hoonah, Kake, Klukwan, and Chilkat Valley. IPEC operates on a not-for-profit basis and, accordingly, seeks only to generate revenues sufficient to pay operating and maintenance costs, capital expenditures, depreciation, and interest on indebtedness and to provide for the establishment of reasonable margins and reserves.

The accounting records of IPEC conform to the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission as modified for electric borrowers of the Rural Utility Service (RUS). A summary of the Cooperative's significant accounting policies consistently applied in the preparation of the accompanying financial statements follows:

a. Cash and cash equivalents

For purposes of the statement of cash flows, the Cooperative considers all cash on hand, cash in banks and highly liquid instruments that are readily convertible to known amounts of cash and that present an insignificant risk of change in value due to changes in interest rates or other factors to be cash equivalents.

b. Investments in associated organizations

The Cooperative's investments in associated organizations are carried at cost, which approximates fair value, plus patronage capital credits allocated and not retired. Investments are reduced by distributions received.

Investments in associated organizations were not evaluated for impairment because (a) it is not practicable to estimate their fair values due to insufficient information available and (b) management did not identify any events or changes in circumstances that might have a significant adverse effect on the fair value of those investments.

c. Receivables

Accounts receivable are recorded when invoices are issued and are written off as a charge to the allowance for doubtful accounts when they are determined to be uncollectible. The allowance for doubtful accounts is estimated considering the Cooperative's historical losses, review of specific problem accounts, existing economic conditions and the financial stability of its customers. Generally, IPEC considers accounts receivable past due after 31 days.

d. Revenue recognition and unbilled revenue

The Cooperative utilizes cycle billing and records revenue billed based upon monthly meter readings. In addition, the Cooperative recognizes unbilled revenue, revenue from electric power delivered but not yet billed.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

e. Fair value of financial instruments

The fair value of current assets and current liabilities approximates carrying value because of the short-term nature of these items. The Cooperative values all of its investments at cost. Capital credits from associated organizations are not valued until allocated.

f. Materials and supplies

The inventory of materials and supplies is recorded at the lower of average cost or market.

g. Utility plant

Utility plant is stated substantially at original cost. Cost of utility plant includes labor, materials, payments to contractors, transportation and construction equipment use and indirect costs, such as employee benefits and general and administrative expenses, less customers' contributions. The Cooperative requires customers to pay for a majority of the costs associated with extending service to them. The Cooperative's utility plant is understated by the amount of these required customer contributions.

The Cooperative has received more than \$22 million of grant funding since being founded in 2004. The grants were primarily to fund significant long-term assets that are included in the Cooperative's utility plant accounts. The funding was received from both Federal programs and the State of Alaska. The Cooperative's utility plant is understated by the amount of the grant funds received and used for these assets. These assets include hydro projects in Hoonah and Haines; primary line extensions in Hoonah, Angoon, and Klukwan; LED streetlights in Klukwan and Kake; and power plant buildings and generation equipment in Hoonah and Angoon. Many of these assets were completed at zero cost to the Cooperative's membership and therefore the value of these assets at December 31, 2016 and 2015 is \$0. This funding has therefore provided a significant number of assets to Cooperative members at no cost to them. This in turn has reduced the depreciation expense for each year and therefore allows the Cooperative to provide power to their members at lower rates.

The cost of maintenance and repairs, including replacement of minor items of property, is charged to operating expense. The cost for replacement of depreciable property units, as distinguished from minor items, is charged to utility plant. The cost of units of property replaced or retired, including cost of removal less salvage value from the transmission or distribution plants, is charged to accumulated depreciation as prescribed by standard industry practice.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

h. Depreciation

Depreciation rates have been applied on a straight-line basis using the following annual rates:

Production plant	0.12% to 20.00%
Distribution plant	1.52% to 10.27%
General plant	1.74% to 7.70%

i. Recoverability of long-lived assets

The Cooperative reviews its long-lived assets whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable and determines whether an impairment loss should be recognized. No impairment losses have been identified in the financial statements.

j. Asset retirement obligation

Professional accounting standards require entities to record the fair value of a liability for legal obligations associated with an asset retirement in the period in which obligations are incurred. The Cooperative has determined it does not have a material legal obligation to remove long-lived assets, and accordingly has not recognized any asset retirement obligation costs in its financial statements.

k. Capitalization of interest

The Cooperative follows the policy of capitalizing interest as a component of the cost of significant property, plant and equipment constructed for its own use. In 2016, total interest incurred was \$147,280 of which \$40,807 was capitalized. In 2015, total interest incurred was \$137,519 of which \$22,993 was capitalized.

l. Income taxes

The Cooperative is exempt from federal income taxes under section 501(c)(12) of the Internal Revenue Code while functioning for the benefit of its members. The Cooperative had no unrelated business income. The Cooperative adopted Accounting Standards Codification (ASC) 740-10, relating to accounting for uncertain tax positions. The Cooperative does not have any uncertain tax positions. The Cooperative files an exempt organization tax return in the U.S. federal jurisdiction and is no longer subject to examination by taxing authorities before 2013.

m. Credit risk

Financial instruments which could potentially subject the Cooperative to concentrations of credit risk consist principally of temporary cash investments and trade receivables. The Cooperative maintains its cash and cash equivalents with First National Bank Alaska.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

m. Credit risk - continued

The balances are insured by the Federal Deposit Insurance Corporation up to \$250,000. At December 31, 2016 and 2015, there were uninsured balances of \$153,223 and \$653,442, respectively. Concentrations of credit risk with respect to trade receivables are limited due to the number of customers comprising the Cooperative's customer base. However, there is a risk that adverse economic conditions in the Cooperative's service area could impact the Cooperative's ability to collect amounts due from customers.

n. Other equities

Other equities of \$3,886,177 consist of the equity balances transferred at the formation of IPEC and are recorded as donated capital.

o. Deferred charges and credits

Due to regulation of its rates by its Board, the Cooperative is subject to the accounting requirements of the Accounting Standards Codification (ASC) 980, *Regulated Operations*. Accordingly, certain costs and income may be capitalized as a regulatory asset or liability that would otherwise be charged to expense or revenues. Regulatory assets and liabilities are recorded when it is probable that future rates will permit recovery.

p. Regulation

IPEC is subject to economic regulation by the Regulatory Commission of Alaska (RCA). IPEC's base rates, fuel surcharges, and power cost equalization (PCE) amounts are subject to review and approval by the Commission. The PCE is a State subsidy to individual customers and community facilities in rural Alaska locations.

q. Use of estimates

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect certain reported amounts of assets and liabilities, the 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.

r. Reclassifications

Certain prior year balances have been reclassified to conform with the current year's presentation. The reclassifications had no effect on net margins or equity for either period.

s. Subsequent events

The Cooperative has evaluated subsequent events through March 6, 2017, the date the financial statements were available to be issued.

Inside Passage Electric Cooperative, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 2 – ELECTRIC PLANT IN SERVICE

Electric plant in service consisted of the following at December 31:

	<u>2016</u>	<u>2015</u>
Production	\$ 5,451,298	\$ 5,216,063
Distribution	13,197,530	13,204,665
General plant	<u>2,616,116</u>	<u>2,505,139</u>
	<u>\$ 21,264,944</u>	<u>\$ 20,925,867</u>

NOTE 3 – INVESTMENTS IN ASSOCIATED ORGANIZATIONS

Investments in associated organizations consisted of the following as of December 31:

	<u>2016</u>	<u>2015</u>
Alaska Rural Electric Cooperative Association (ARECA) Insurance Exchange patronage capital credits	\$ 1,213,414	\$ 1,134,270
National Rural Utilities Cooperative Finance Corporation (CFC):		
Membership	1,000	1,000
Capital term certificates, interest bearing, 3 to 5 percent	93,543	93,543
Patronage capital certificates	18,389	16,621
National Information Solutions Cooperative (NISC) patronage capital	<u>11,469</u>	<u>9,686</u>
	<u>\$ 1,337,815</u>	<u>\$ 1,255,120</u>

NOTE 4 – ACCOUNTS RECEIVABLE

Accounts receivable consisted of the following at December 31:

	<u>2016</u>	<u>2015</u>
Consumer accounts	\$ 330,031	\$ 276,437
Power cost equalization (PCE)	387,235	121,624
Contract services	<u>24,908</u>	<u>28,823</u>
Total accounts receivable	749,696	426,884
Allowance for doubtful accounts	<u>(22,001)</u>	<u>(28,207)</u>
	<u>\$ 727,695</u>	<u>\$ 398,677</u>

Inside Passage Electric Cooperative, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 5 – DEFERRED CHARGES

Deferred charges consisted of the following as of December 31:

	<u>2016</u>	<u>2015</u>
Community based rates study	<u>\$ 53,180</u>	<u>\$ 63,939</u>

These costs are being amortized to expense over a period of five years. Amortization expense for the years ended December 31, 2016 and 2015 was \$14,731 and \$0, respectively.

NOTE 6 – LONG-TERM DEBT

Long-term debt consisted of the following at December 31:

	<u>2016</u>	<u>2015</u>
Mortgages payable to the United States of America (Rural Utilities Service), payable in quarterly installments of \$106,787, including interest at either 2% or 5%, maturing at various dates through June 2029	\$ 3,516,383	\$ 3,837,056
Less current maturities	<u>(314,989)</u>	<u>(320,678)</u>
	<u>\$ 3,201,394</u>	<u>\$ 3,516,378</u>

The aggregate long-term debt maturing over the next five years is approximately as follows: 2017 - \$314,989; 2018 - \$309,984; 2019 - \$277,677; 2020 - \$270,855; 2021 - \$278,570 and succeeding years of \$2,064,308. The mortgage notes are subject to various covenants and requirements detailed in the loan documents. All assets of the Cooperative are pledged as collateral on these notes.

NOTE 7 – LINE OF CREDIT

The Cooperative has a \$3,000,000 perpetual line of credit with National Rural Utilities Cooperative Finance Corporation (CFC). Provisions on the line of credit require repayment in full within 360 days of the advance. Interest is accrued and payable quarterly. The interest rate is determined and set by CFC each month. At December 31, 2016 and 2015, the outstanding balance due on the line of credit was \$2,000,000 and \$1,600,000, respectively.

Inside Passage Electric Cooperative, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 8 – DEFERRED CREDITS

Deferred credits consisted of the following at December 31:

	<u>2016</u>	<u>2015</u>
Special equipment costs	\$ 49,900	\$ 58,300
Customer advances for construction	440	1,925
Cost of power adjustment	<u>97,354</u>	<u>217,135</u>
	<u>\$ 147,694</u>	<u>\$ 277,360</u>

NOTE 9 – EMPLOYEE BENEFIT PLANS

Retirement Security Plan

The Retirement Security Plan (RS Plan), sponsored by the National Rural Electric Cooperative Association (NRECA), is a defined benefit pension plan qualified under Section 401 and tax-exempt under Section 501(a) of the Internal Revenue Code. It is considered a multi-employer plan under the accounting standards. The plan sponsor's Employer Identification Number is 53-0116145 and the Plan Number is 333.

A unique characteristic of a multi-employer plan compared to a single employer plan is that all plan assets are available to pay benefits of any plan participant. Separate asset accounts are not maintained for participating employers. This means that assets contributed by one employer may be used to provide benefits to employees of other participating employers.

The Cooperative's contributions to the RS Plan in 2016 and in 2015 represented less than 5 percent of the total contributions made to the plan by all participating employers. The Cooperative made contributions to the plan of \$321,033 in 2016 and \$246,125 in 2015. There have been no significant changes that affect the comparability of 2016 and 2015 contributions.

For the RS Plan, a "zone status" determination is not required, and therefore not determined, under the Pension Protection Act (PPA) of 2006. In addition, the accumulated benefit obligations and plan assets are not determined or allocated separately by individual employer. In total, the Retirement Security Plan was over 80 percent funded on January 1, 2016 and over 80 percent funded at January 1, 2015 based on the PPA funding target and PPA actuarial value of assets on those dates.

Because the provisions of the PPA do not apply to the RS Plan, funding improvement plans and surcharges are not applicable. Future contribution requirements are determined each year as part of the actuarial valuation of the plan and may change as a result of plan experience.

Inside Passage Electric Cooperative, Inc.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2016 and 2015

NOTE 9 – EMPLOYEE BENEFIT PLANS - continued

401(k) Plan

The Cooperative also participates in a 401(k) plan that is available to all employees. Employees may contribute to the plan on a payroll deduction basis. Beginning in 2011, the Cooperative began matching 100% of the first 3% of employee contributions and up to an additional 50% of the next 2% of employee contributions. Contributions made during 2016 and 2015 were \$27,226 and \$31,237, respectively.

NOTE 10 – CONTINGENCIES AND COMMITMENTS

The Cooperative is party to various claims, for and against its interest, which are either covered by insurance or which management believes will not have a material effect to its financial position.

RUS AND GOVERNMENT AUDITING STANDARDS REPORTS

BLODGETT, MICKELSEN & ADAMSON, P.S.

CERTIFIED PUBLIC ACCOUNTANTS
7139 W. DESCHUTES AVE., SUITE 102
KENNEWICK, WA 99336

BRENT R. MICKELSEN, C.P.A.
THOMAS W. BLODGETT, C.P.A.
TRAVIS B. ADAMSON, C.P.A.

TELEPHONE: (509) 735-0379
FACSIMILE: (509) 735-0646

MEMBERS
WASHINGTON STATE SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS
AMERICAN INSTITUTE
OF
CERTIFIED PUBLIC ACCOUNTANTS

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

Board of Directors
Inside Passage Electric Cooperative, Inc.
Auke Bay, Alaska

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 Inside Passage Electric Cooperative, Inc. (the Cooperative), which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of revenue and margins, changes in equities and margins, and cash flows for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated March 6, 2017. In accordance with *Government Auditing Standards*, we have also issued our report dated March 6, 2017, on our consideration of the Cooperative'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. No reports other than the reports referred to above and our schedule of findings and recommendations 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 the Cooperative 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*, §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 the Cooperative's noncompliance with the 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, we noted no matters regarding the Cooperative's accounting and records to indicate that the Cooperative 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 if the contract covers all or substantially all of the electric 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 (See RUS Bulletin 183-1, Depreciation Rates and Procedures);
- 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.

This report is intended solely for the information and use of the board of directors, management, and the RUS 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.

Blodgett, Mickelsen & Adamson, P.S.

Kennewick, Washington

March 6, 2017

BLODGETT, MICKELSEN & ADAMSON, P.S.

CERTIFIED PUBLIC ACCOUNTANTS
7139 W. DESCHUTES AVE., SUITE 102
KENNEWICK, WA 99336

BRENT R. MICKELSEN, C.P.A.
THOMAS W. BLODGETT, C.P.A.
TRAVIS B. ADAMSON, C.P.A.

TELEPHONE: (509) 735-0379
FACSIMILE: (509) 735-0646

MEMBERS
WASHINGTON STATE SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS
AMERICAN INSTITUTE
OF
CERTIFIED PUBLIC ACCOUNTANTS

**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***

Board of Directors
Inside Passage Electric Cooperative, Inc.
Auke Bay, Alaska

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Inside Passage Electric Cooperative, Inc. (a nonprofit organization) (the Cooperative), which comprise the balance sheets as of December 31, 2016, and the related statements of revenues and margins, changes in equities and margins, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 6, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Inside Passage Electric Cooperative, Inc.'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 Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative's internal control.

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 Cooperative's financial statements will not be prevented, or detected and corrected on a timely basis. *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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Inside Passage Electric Cooperative, Inc.'s financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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 Cooperative'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 Cooperative's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Blodgett, Mickelsen & Adamson, P.S.

Kennewick, Washington

March 6, 2017