

KOSRAE UTILITIES AUTHORITY

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2003 AND 2002



INDEPENDENT AUDITORS' REPORT

The Board of Directors
Kosrae Utilities Authority:

We have audited the accompanying balance sheets of the Kosrae Utilities Authority, a component unit of the Kosrae State Government, as of September 30, 2003 and 2002, and the related statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Kosrae Utilities Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

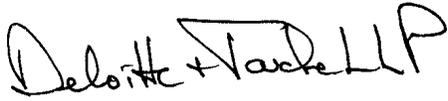
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Kosrae Utilities Authority as of September 30, 2003 and 2002, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 1 to the financial statements, the Authority adopted the provisions of the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, and GASB Statement No. 38, *Certain Financial Statements Note Disclosures*, as of October 1, 2002. The accompanying 2002 financial statements have been restated to reflect the changes required by GASB 34.

The Management Discussion and Analysis on pages 3-5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 23, 2004, on our consideration of the Kosrae Utilities Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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

June 23, 2004

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2003

This section of the Kosrae Utilities Authority's (the Authority) annual financial report presents the analysis of the Authority's financial performance during the fiscal year ended September 30, 2003. Please read it in conjunction with the financial statements, which follows this section.

Kosrae Utilities Authority (KUA) was mandated by law in October 1993 as a semi-agency of the Kosrae State Government to assume the operation and responsibility of providing electric power services to the Island of Kosrae. KUA is governed by five (5) board members appointed by the Governor with the advice and consent of the State Legislature for a staggering term of 2 to 4 years. The Authority presently serves 1,514 customers, a 1.5% increase in number of customers from the previous year. The customer base is comprised of approximately 78% residential, 12% commercial, 7% Kosrae State Government, 2% non-Kosrae State Government and 1% industrial. With the existing customer base composition, the residential energy sales represent approximately 43% of total sales, commercial sales are 22%, Kosrae State Government are 22%, other government sales are 9% and industrial sales are 4% of the total energy sales. With little or no economic activities presently undertaken, these energy sales ratios are expected to continue for the next several years of operation, but should be reviewed annually since any change in one customer class such as industrial or commercial can have positive or negative effect on future operating revenues.

The electric revenues provide for approximately 75% of the total operating expenses with 25% subsidy from the U.S. Compact Energy grants. The Energy grant is discontinued starting in Fiscal Year 2004. The Authority is presently facing a financial challenge to recover the lost subsidy from the U.S. and to control operating expenses. The Authority adopted a gradual rate increase schedule, about 5% to 6% annual increase over the next five year period for gradual cost recovery of operations and has reviewed options to control operating expenses. The Fuel Adjustment charge was also enacted to recover the high cost of fuel. To control and reduce operating expenses, high efficiency engine radiators were installed to reduce engine fuel consumption and overhauling of engines was performed to provide for the maximum operation efficiency of the engines.

The following table summarizes the financial position and results of operations of Kosrae Utilities Authority for 2003 and 2002.

	<u>2003</u>	<u>2002</u>
Assets:		
Current Assets	\$ 3,517,975	\$ 3,263,140
Utility plant, net	<u>4,795,884</u>	<u>4,992,047</u>
	<u>\$ 8,313,859</u>	<u>\$ 8,255,187</u>
Liabilities and Net Assets:		
Current Liabilities	\$ 113,990	\$ 49,239
Net Assets	<u>8,199,869</u>	<u>8,205,948</u>
	<u>\$ 8,313,859</u>	<u>\$ 8,255,187</u>

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2003

	<u>2003</u>	<u>2002</u>
Revenue, Expenses and Changes in Net Assets		
Operating revenues	\$ 1,231,302	\$ 1,255,718
Operating expenses	<u>1,930,188</u>	<u>1,829,416</u>
Net operating loss	<u>(698,886)</u>	<u>(573,698)</u>
Operating subsidies	625,978	526,644
Interest income	<u>66,829</u>	<u>60,768</u>
Total nonoperating revenue	<u>692,807</u>	<u>587,412</u>
(Decrease) Increase in net assets	\$ <u><u>(6,079)</u></u>	\$ <u><u>13,714</u></u>

FINANCIAL HIGHLIGHTS

Operating revenue generated from electricity sales and related revenues decreases in 2003 as against 2002 by about 2%, which can be attributed to the slight increase of cash power meter hook ups to residential/commercial customers during the year, thus customers were able to conserve power to sustain their current electricity purchase resulting to a lesser consumption. The transfer of some government offices to the new administration building at the later part of the fiscal year also contributed to the decrease in power usage of KSG accounts. Furthermore revenue from service orders as regular meter installation, meter relocation and street lights installation went down this year; likewise also with the miscellaneous revenues representing rental of equipment charge to project. Of the 2003 total revenue, 33% is from Residential Sales; 22% from Kosrae State Government Sales; 20% from Commercial Sales and the remaining 25% comes from Government Non Kosrae State sales, Industrial sales, Fuel adjustment charge, Rental Lights, Service Orders and Miscellaneous Revenues.

Revenue for FY2004 is expected to drop due to the increase in cash power meter hook ups. Non-Kosrae State Government sales is projected to decline in the next fiscal year because of the relocation of the CAT Team. Kosrae State Government is likewise expected to reduce this year, as most of the government support offices were housed in one administration building wherein electricity usage is centralized and consumption is properly and directly monitored.

Operating expenses increased by 5.70% against last year. Depreciation and additional provision for doubtful accounts comprises much of the increase. Production fuel cost average increases this year of \$.04 per gallon constitutes the increment, though the volume of fuel consumption declined by about 1.50%. Salaries and wages, repair and maintenance, and loss on disposal of fixed assets contributed slightly to the increase.

Non-operating revenues arising from operating subsidies and interest income increased by \$ 105,395, which is approximately 18% higher than last year. Operating subsidies constitute grants funded under US-DOI OMIP and the Compact Energy Grant. The Energy Grant is no longer available in the amended Compact effective Fiscal Year 2004. A total grant of \$ 146,250 is approved by OMIP for actual consumption in the next fiscal year.

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2003

Of the Current Assets component, investments were down by 3%. These are investments in time certificate of deposits in Bank of FSM and temporary investments managed by Salomon Smith Barney and Bank of Hawaii. Investments were adjusted to market values at the end of the fiscal year. Gross receivables from electricity sales decreased this year by 11.34%; this was due to the 25% automatic reduction of arrears/delinquent accounts for every purchase of electricity through cash power. Inventories on the other hand increased because of unused materials closed to inventory from completed Pole Hardening Projects, which were lodged temporarily in the work in progress account during the construction period.

Utility plant consists of Production Plant, Distribution Plant and General Plant. Production plant includes the 6 caterpillar generators ranging in size from 560KW to 1.65MW units that supply power on the whole island; and the related equipment and accessories; this represents 52% of the total fixed assets cost. Distribution Plant consists of the distribution system of approximately 41 miles of 13.8kv overhead conductor and underground feeder to the main airport, dock, tank farm and Pacific Tuna Industries fish plant. The distribution feeders originate from the outdoor substation outside the generating plant and serves the island load with three radial feeders that follow coastal roads to the south and north of the plant. Distribution plant comprises 42% of the cost. General Plant is the total of the administration building, vehicles, equipment and fixtures used for administrative purposes and comprises the remaining 6% of the total cost. Various work in process was undertaken during the year and more are expected to be finished in the succeeding fiscal year.

Current liabilities increased by \$ 64,751 due to accrual of payables to suppliers for items received during the year end cut off which were more than last year. Decrease in net assets represents net loss for the period.

Plan of Action for 2004

1. Take action and implement the gradual rate increases of 5% to 6% annually over the next five years.
2. Reexamine the Budget and streamline expenses to cover the basic needs of the operations.
3. Implement Top End and major Overhaul of the engines to provide the maximum run efficiency and upgrading of engine radiators to reduce engine fuel usage.
4. Aggressively pursue collection of accounts in arrears.
5. Upgrading of Distribution Power Lines to reduce line loss and lost revenues during outages and construct additional power extension lines to increase customer base.
6. Continue to conduct training of employees to improve skill levels and work performance.
7. Improve accountability and relations with government officials and customers.

KOSRAE UTILITIES AUTHORITY

Statements of Net Assets September 30, 2003 and 2002

<u>ASSETS</u>	<u>2003</u>	<u>2002</u>
Current assets:		
Cash, available for operations	\$ 362,552	\$ 347,362
Investments	2,058,838	2,123,452
Accounts receivable, net	383,104	394,193
Receivable-FSM National Government Grant	7,785	7,785
Prepayment	2,964	2,704
Inventories	<u>702,732</u>	<u>387,644</u>
Total current assets	<u>3,517,975</u>	<u>3,263,140</u>
Utility plant:		
Electric plant in service	8,431,754	8,231,836
Construction work in progress	554,122	460,931
Less accumulated depreciation	<u>(4,189,992)</u>	<u>(3,700,720)</u>
Utility plant, net	<u>4,795,884</u>	<u>4,992,047</u>
	<u>\$ 8,313,859</u>	<u>\$ 8,255,187</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Accounts payable	\$ 73,343	\$ 12,406
Accrued taxes and other	16,245	15,584
Accrued annual leave	<u>24,402</u>	<u>21,249</u>
Total liabilities	<u>113,990</u>	<u>49,239</u>
Commitment and contingency		
Net assets:		
Investment in fixed assets	\$ 4,795,884	\$ 4,992,047
Unrestricted	<u>3,403,985</u>	<u>3,213,901</u>
Total net assets	<u>8,199,869</u>	<u>8,205,948</u>
	<u>\$ 8,313,859</u>	<u>\$ 8,255,187</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Statements of Revenues, Expenses, and Changes in Net Assets Years Ended September 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Operating revenues:		
Electricity sales	\$ <u>1,231,302</u>	\$ <u>1,255,718</u>
Operating expenses:		
Production fuel	764,269	741,380
Depreciation	515,905	489,436
Salaries and wages	363,698	350,900
Administrative and general	222,873	195,810
Repair and maintenance	61,802	51,890
Loss on disposal of fixed assets	<u>1,641</u>	<u>-</u>
Total operating expenses	<u>1,930,188</u>	<u>1,829,416</u>
Loss from operations	<u>(698,886)</u>	<u>(573,698)</u>
Nonoperating revenues:		
Operating subsidies	625,978	526,644
Interest income	<u>66,829</u>	<u>60,768</u>
Total nonoperating revenues	<u>692,807</u>	<u>587,412</u>
Change in net assets	(6,079)	13,714
Net assets at beginning of year	<u>8,205,948</u>	<u>8,192,234</u>
Net assets at end of year	<u>\$ <u>8,199,869</u></u>	<u>\$ <u>8,205,948</u></u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Statements of Cash Flows Years Ended September 30, 2003 and 2002

	2003	2002
Cash flows from operating activities:		
Cash received from customers	\$ 1,156,164	\$ 1,292,852
Cash paid to suppliers and employees	<u>(1,577,011)</u>	<u>(1,552,910)</u>
Net cash used for operating activities	<u>(420,847)</u>	<u>(260,058)</u>
Cash flows from investing activities:		
Reduction in time certificates of deposit	64,613	155,572
Interest income	<u>66,829</u>	<u>60,768</u>
Net cash provided by investing activities	<u>131,442</u>	<u>216,340</u>
Cash flows from noncapital financing activities:		
Proceeds from operating grants	<u>625,978</u>	<u>526,644</u>
Net cash provided by noncapital financing activities	<u>625,978</u>	<u>526,644</u>
Cash flows from capital financing activities:		
Purchase of property, plant and equipment	<u>(321,383)</u>	<u>(336,115)</u>
Net cash used for capital financing activities	<u>(321,383)</u>	<u>(336,115)</u>
Net change in cash	15,190	146,811
Cash at beginning of year	<u>347,362</u>	<u>200,551</u>
Cash at end of year	<u>\$ 362,552</u>	<u>\$ 347,362</u>
Reconciliation of loss from operations to net cash used for operating activities:		
Operating loss	\$ (698,886)	\$ (573,698)
Adjustments to reconcile operating loss to net cash used for operating activities:		
Depreciation	515,905	489,436
Bad debt	86,227	45,277
Loss on disposal of fixed assets	1,641	-
(Increase) decrease in assets:		
Receivables	(75,138)	37,134
Prepayments	(260)	(2,121)
Inventories	(315,088)	(167,931)
Increase (decrease) in liabilities:		
Accounts payable	60,937	(88,383)
Accrued taxes and other liabilities	<u>3,815</u>	<u>228</u>
Net cash used for operating activities	<u>\$ (420,847)</u>	<u>\$ (260,058)</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2003 and 2002

(1) Summary of Significant Accounting Policies

The accounting policies of Kosrae Utilities Authority (KUA) conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting," requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. KUA has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

For the year ended September 30, 2003, KUA adopted GASB Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB 34) as amended by GASB Statement No. 37 and GASB Statement No. 38 and applied those standards on a retroactive basis. GASB Statement No. 34 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 four net asset categories:

- Invested in capital assets, net of related debt:
Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require KUA to maintain them permanently. For the years ended September 30, 2003 and 2002, KUA does not have nonexpendable net assets.
 - Expendable – Net assets whose use by KUA is subject to externally imposed stipulations that can be fulfilled by actions of KUA pursuant to those stipulations or that expire by the passage of time.
- Unrestricted:
Net assets that are not subject to externally imposed stipulations. Unrestricted net assets 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.

Net Assets: Net assets represent the residual interest in KUA's assets after liabilities are deducted and consist of three sections: invested in capital assets, net of related debt; restricted and unrestricted. Net assets invested in capital assets, net of debt include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation. All other net assets are unrestricted.

Basis of Accounting: All proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of this fund are included on the balance sheet.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2003 and 2002

(1) Summary of Significant Accounting Policies, Continued

The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred. Revenues are recorded as billed to customers on a monthly cycle billing basis. At the end of each month, unbilled revenues are accrued based on the most recent billing cycle.

General: KUA is a component unit of the Government of Kosrae. KUA commenced operations on October 1, 1993, with the assets and liabilities of the Division of Public Utilities of the Kosrae State Department of Public Works transferred as of that date.

Utility Plant: Utility plant assets were transferred from the Division of Public Utilities to KUA as of October 1, 1993 at the estimated net book value in the absence of documents to support cost. At September 30, 2003 and 2002, approximately 18 percent of utility plant transferred to KUA was stated at estimated cost. The net book value of the utility plant assets transferred was \$1,083,053 and \$1,337,179 as of September 30, 2003 and 2002, respectively.

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets (3 - 40 years for plant assets). Depreciation expense for 2003 and 2002 was approximately six percent of the cost of depreciable properties.

Annual and Sick Leave: Earned but unused annual leave is paid to employees upon termination of their employment. Accordingly, KUA accrues these benefits in the period earned. It is the policy of KUA to record the cost of sick leave when leave is actually taken and a liability is actually incurred.

Revenues: Sales of electricity are recorded as billed to customers on a monthly billing cycle basis.

Federal Grants and Subsidies: KUA receives federal grants as a subrecipient from Kosrae State in addition to Kosrae State Legislature appropriated subsidies, FSM National Congress appropriated subsidies, and matching funds for federal programs as required.

Inventory: Inventories are carried at the lower of cost, using average cost, or market value. An allowance for obsolescence was not provided because management believes that all inventory items are usable.

Cash: For purposes of the balance sheets and statements of cash flows, cash includes cash on hand, cash in bank checking and savings accounts and time certificates of deposit with initial maturities of three months or less. Time certificates of deposit with initial maturities greater than three months are separately classified as investments. Of cash balances at September 30, 2003, \$200,000 is subject to Federal Deposit Insurance Corp. (FDIC) coverage, with the remaining balance exceeding insurable limits. KUA does not require collateralization of its deposits. Therefore, the amounts which exceed FDIC limits are characterized as uncollateralized.

Restricted Investments: As of September 30, 2003, \$1,016,919 (\$1,623,135 in 2002) in time certificates of deposit placed with local banks with annual interest rates ranging from .9% to 3% has been internally reserved for maintenance, capital improvements and work in progress.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2003 and 2002

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards: For fiscal year 2004, KUA will be implementing GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units* and GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)*. For fiscal year 2005, the Authority will be implementing GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. As of the date of the opinion, the Authority has not evaluated the financial statement impact of GASB Statement Nos. 39, 40 and 42.

Management Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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.

(2) Utility Plant

Utility plant consists of the following at September 30, 2003 and 2002:

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2002</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2003</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 4,325,319	\$ 120,833	\$ (73,272)	\$ 4,372,880
Distribution plant	5 to 30 years	3,436,230	131,890	(9,846)	3,558,274
General plant	3 to 20 years	<u>470,287</u>	<u>30,313</u>	<u>-</u>	<u>500,600</u>
Total electric plant in service		8,231,836	283,036	(83,118)	8,431,754
Less accumulated depreciation		<u>(3,700,720)</u>	<u>(515,905)</u>	<u>26,633</u>	<u>(4,189,992)</u>
		4,531,116	(232,869)	(56,485)	4,241,762
<u>Non-depreciable assets:</u>					
Work in progress		<u>460,931</u>	<u>93,191</u>	<u>-</u>	<u>554,122</u>
Electric plant in service, net		\$ <u>4,992,047</u>	\$ <u>(139,678)</u>	\$ <u>(56,485)</u>	\$ <u>4,795,884</u>
	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2001</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2002</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 4,267,093	\$ 58,226	\$ -	\$ 4,325,319
Distribution plant	5 to 30 years	3,332,753	103,477	-	3,436,230
General plant	3 to 20 years	<u>431,390</u>	<u>38,897</u>	<u>-</u>	<u>470,287</u>
Total electric plant in service		8,031,236	200,600	-	8,231,836
Less accumulated depreciation		<u>(3,211,284)</u>	<u>(489,436)</u>	<u>-</u>	<u>(3,700,720)</u>
		4,819,952	(288,836)	-	4,531,116
<u>Non-depreciable assets:</u>					
Work in progress		<u>325,416</u>	<u>135,515</u>	<u>-</u>	<u>460,931</u>
Electric plant in service, net		\$ <u>5,145,368</u>	\$ <u>(153,321)</u>	\$ <u>-</u>	\$ <u>4,992,047</u>

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2003 and 2002

(3) Accounts Receivable

Accounts receivable at September 30, 2003 and 2002, are summarized as follows:

	<u>2003</u>	<u>2002</u>
Residential	\$ 93,826	\$ 107,681
Commercial	156,982	168,432
Government	<u>115,372</u>	<u>136,916</u>
	366,180	413,029
Other	<u>312,160</u>	<u>190,173</u>
	678,340	603,202
Less allowance for doubtful receivables	<u>(295,236)</u>	<u>(209,009)</u>
	\$ <u>383,104</u>	\$ <u>394,193</u>

All of KUA's accounts receivable are with customers and government agencies based in Kosrae.

(4) Operating Subsidies

Contributions for the years ended September 30, 2003 and 2002 are as follows:

	<u>2003</u>	<u>2002</u>
U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants	\$ 155,978	\$ 56,644
Compact energy grant	<u>470,000</u>	<u>470,000</u>
	\$ <u>625,978</u>	\$ <u>526,644</u>

(5) Commitments

Retained earnings at September 30, 2003 has been appropriated in the amount of \$816,919 for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2004 with a total of \$25,000 being further appropriated on a quarterly basis from retained earnings for this purpose.

(6) Risk Management

KUA carries insurance to cover its potential risks from fire on its building and the contents and full coverage on property damage. KUA is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

The Board of Directors
Kosrae Utilities Authority:

We have audited the financial statements of the Kosrae Utilities Authority (KUA), as of and for the year ended September 30, 2003, and have issued our report thereon dated June 23, 2004. 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.

Compliance

As part of obtaining reasonable assurance about whether KUA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered KUA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended for the information of the Board of Directors and management of KUA and the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than those specified parties.

A handwritten signature in black ink that reads "Deloitte + Touche LLP".

June 23, 2004



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND
INTERNAL CONTROL OVER COMPLIANCE APPLICABLE
TO EACH MAJOR FEDERAL AWARD PROGRAM AND THE
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

The Board of Directors
Kosrae Utilities Authority:

Compliance

We have audited the compliance of the Kosrae Utilities Authority (KUA) with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to its one major federal program for the year ended September 30, 2003. KUA's major federal program is identified in the summary of auditors' results section of the accompanying Schedule of Findings and Questioned Costs (page 17). Compliance with the requirements of laws, regulations, contracts and grants applicable to its one major federal program is the responsibility of KUA's management. Our responsibility is to express an opinion on KUA's compliance based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, Audits of States, Local Governments and Non-Profit Organizations. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about KUA's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on KUA's compliance with those requirements.

In our opinion, KUA complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2003.

Internal Control Over Compliance

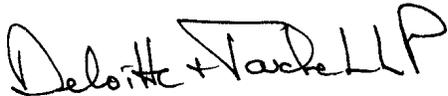
The management of KUA is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered KUA's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of KUA, as of and for the year ended September 30, 2003, and have issued our report thereon dated June 23, 2004. Our audit was performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the financial statements. This schedule is the responsibility of the management of KUA. Such information has been subjected to the auditing procedures applied in our audit of the financial statements and, in our opinion, is fairly stated, in all material respects when considered in relation to the financial statements taken as a whole.

This report is intended for the information of the Board of Directors and management of KUA and the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than those specified parties.

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

June 23, 2004

KOSRAE UTILITIES AUTHORITY

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2003

<u>Grantor/Program Title</u>	<u>CFDA No.</u>	<u>Expenditures for the Year Ended September 30, 2003</u>
<u>U.S. Department of the Interior:</u>		
Office of Territorial and International Affairs:		
<u>Compact of Free Association:</u>		
Energy Program Funds, Section 214(c)	15.875	\$ <u>470,000</u>
<u>Operations and Maintenance Improvements Programs (OMIP)</u>		
OMIP	15.875	\$ <u>155,978</u>

Note: The Compact of Free Association programs are passed through Kosrae State to the Kosrae Utilities Authority. The OMIP grant is received in a direct capacity from the U.S. Department of the Interior. The above schedule has been prepared on the accrual basis of accounting.

KOSRAE UTILITIES AUTHORITY

Schedule of Findings and Questioned Costs
Year Ended September 30, 2003

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were not identified.
3. No instance of noncompliance considered material to the financial statements was disclosed by the audit.
4. Reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were not identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. The Organization's one major program was:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
Compact of Free Association Energy Program Funds, Section 214 (c)	15.875

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. The Organization did qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

Part II - Financial Statement Findings Section

No matters are reportable.

Part III – Federal Award Findings and Questioned Costs Section

No matters are reportable.