

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

**REPORT ON THE AUDIT OF
FINANCIAL STATEMENTS IN ACCORDANCE
WITH OMB CIRCULAR A-133**

YEAR ENDED SEPTEMBER 30, 2004

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

YEAR ENDED SEPTEMBER 30, 2004

INDEX

	<u>Page No.</u>
INDEPENDENT AUDITORS' REPORT, BASIC FINANCIAL STATEMENTS AND ADDITIONAL INFORMATION	1 - 60
INDEPENDENT AUDITORS' REPORTS ON INTERNAL CONTROL AND ON COMPLIANCE	61 - 92

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Table of Contents
Year Ended September 30, 2004

	<u>Page No.</u>
I. Independent Auditors' Report	1
II. Basic Financial Statements:	
Management's Discussion and Analysis	3
Government-Wide Financial Statements:	
Statement of Net Assets	10
Statement of Activities	11
Governmental Fund Financial Statements:	
Balance Sheet	12
Statement of Revenues, Expenditures, and Changes in Fund Balances (Deficits)	13
Reconciliation of Statement of Revenues, Expenditures and Changes in Fund Balances of Governmental Funds to the Statement of Activities	14
Discretely Presented Component Unit Financial Statements:	
Combining Statement of Net Assets	15
Combining Statement of Revenues, Expenses and Changes in Net Assets	16
Notes to the Basic Financial Statements	17
III. Required Supplementary Information - Other than Management's Discussion and Analysis	37
Schedule of Revenues, Expenditures and Changes in Deficit - Budget and Actual - General Fund	38
Note to Required Supplementary Information - Budgetary Reporting	39
IV. Other Supplementary Information	40
Combining Schedule of Expenditures by Account - Governmental Funds	41
General Fund:	
Statement of Revenues, Expenditures by Function, and Changes in Fund Balance	42
Statement of Revenues, Expenditures by Function, and Changes in Fund Balance (Deficit) – Budget and Actual	44
Nonmajor Governmental Funds:	
Combined Balance Sheet	46
Combined Statement of Revenues, Expenditures by Function, and Changes in Fund Balances	47
Combined Statement of Revenues, Expenditures by Account, and Changes in Fund Balances	48

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Table of Contents, Continued
Year Ended September 30, 2004

	<u>Page No.</u>
IV. Other Supplementary Information, Continued	
Nonmajor Governmental Funds - Special Revenue Funds:	
Combining Balance Sheet	49
Combining Statement of Revenues, Expenditures by Function, and Changes in Fund Balances (Deficit)	51
Combining Statement of Revenues, Expenditures by Account, and Changes in Fund Balances (Deficit)	53
Nonmajor Governmental Funds - Capital Project Funds:	
Combining Balance Sheet	55
Combining Statement of Expenditures by Function, and Changes in Fund Balances (Deficit)	56
Combining Statement of Expenditures by Account, and Changes in Fund Balances (Deficit)	57
Compact Sector Funds:	
Combining Balance Sheet	58
Combining Statement of Expenditures by Function, and Changes in Fund Balances (Deficit)	59
Combining Statement of Expenditures by Account, and Changes in Fund Balances (Deficit)	60
V. Independent Auditors' Reports on Compliance and Internal Control	
Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based Upon the Audit Performed in Accordance with Government Auditing Standards	61
Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards	63
Schedule of Expenditures of Federal Awards	66
Notes to Schedule of Expenditures of Federal Awards	72
Schedule of Programs Selected for Audit in Accordance with OMB Circular A-133	73
Schedule of Findings and Questioned Costs	74
Summary Schedule of Prior Audit Findings and Questioned Costs	92

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

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

YEAR ENDED SEPTEMBER 30, 2004

INDEPENDENT AUDITORS' REPORT

Honorable Rensley A. Sigrah
Governor, State of Kosrae
Federated States of Micronesia:

We have audited the accompanying financial statements of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Kosrae (the State), as of and for the year ended September 30, 2004, which collectively comprise the State's basic financial statements as set forth in Section II of the foregoing table of contents. These financial statements are the responsibility of the management of the State. Our responsibility is to express an opinion on the respective financial statements based on our audit. We did not audit the financial statements of the Micronesia Petroleum Corporation, which represent 32% and 63%, respectively, of the assets and revenues of the State's discretely presented component units. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Micronesia Petroleum Corporation is based solely on the report of the other auditors.

Except as discussed in the following paragraphs, 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 includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

As discussed in Note 2 to the financial statements, the Compact Capital Projects Fund reports its investment in SEMO-Micronesia, Inc., a 50%-owned corporation, at cost. In our opinion, the investment should be adjusted to reflect the Compact Capital Projects Fund's equity in the losses of that corporation to conform with accounting principles generally accepted in the United States of America, which would decrease the investment, decrease fund balance, and change the expenditures of the Compact Capital Projects Fund. Due to the lack of audited financial statements of SEMO-Micronesia, Inc., the amount by which this departure would affect investments, fund balance, and expenditures of the Compact Capital Projects Fund is not reasonably determinable.

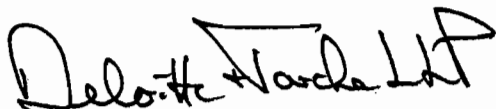
Because of inadequacies in the accounting records, we were unable to determine that advances recorded within the General Fund, the Compact Capital Projects Fund, and the aggregate remaining fund information; that receivables from federal agencies recorded within the Federal Grants Fund; and that loans receivable recorded within the aggregate remaining fund information were fairly stated as of September 30, 2004.

In our opinion, based on our audit and the report of other auditors, except for the effects of the matters discussed in the third, fourth and fifth paragraphs above, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Kosrae as of September 30, 2004, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis, on pages 3 through 9, as well as the Schedule of Revenues, Expenditures, and Changes in Deficit - Budget and Actual - General Fund and notes thereto, on pages 38 and 39, are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the management of the State. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Our audit was conducted for the purpose of forming an opinion on the State's respective financial statements that collectively comprise the State's basic financial statements. The combining and individual fund financial statements, as set forth in Section IV of the foregoing table of contents, which are also the responsibility of the management of the State, are presented for purposes of additional analysis and are not a required part of the basic financial statements of the State. Such additional information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, except for the effects of the matters discussed in the fourth and fifth paragraphs above, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 20, 2006 on our consideration of the State's (Primary Government only) internal control over financial reporting and 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

A handwritten signature in black ink, appearing to read "Delo-H. Tarche" followed by a stylized flourish.

May 29, 2006

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

As management of Kosrae State Government, we offer readers of Kosrae State's financial statements this narrative overview and analysis of the financial activities of for the fiscal year ended September 30, 2004. We encourage readers to read the information presented here in conjunction with additional information that we have furnished in the State's financial statements, which follow this narrative.

FINANCIAL HIGHLIGHTS

- The assets of Kosrae State Government exceeded its liabilities at the close of fiscal year 2004 by \$43,307,814 (*net assets*) compared with net assets, as restated in 2003 of \$46,075,013, which is a decrease of \$2,767,199.
- The government's total net assets decreased by \$2,767,199 in 2004 when compared with 2003, primarily due to a decrease in unrestricted Compact of Free Association unrestricted revenues.
- Total revenues generated for fiscal year 2004 amounted to \$10,171,806 compared with total revenues of \$15,535,614 for fiscal year 2003, which is a decrease of \$5,363,808.
- Total expenditures amounted to \$12,939,005 in 2004 and \$14,874,410 in 2003, which is a decrease of \$1,935,405.

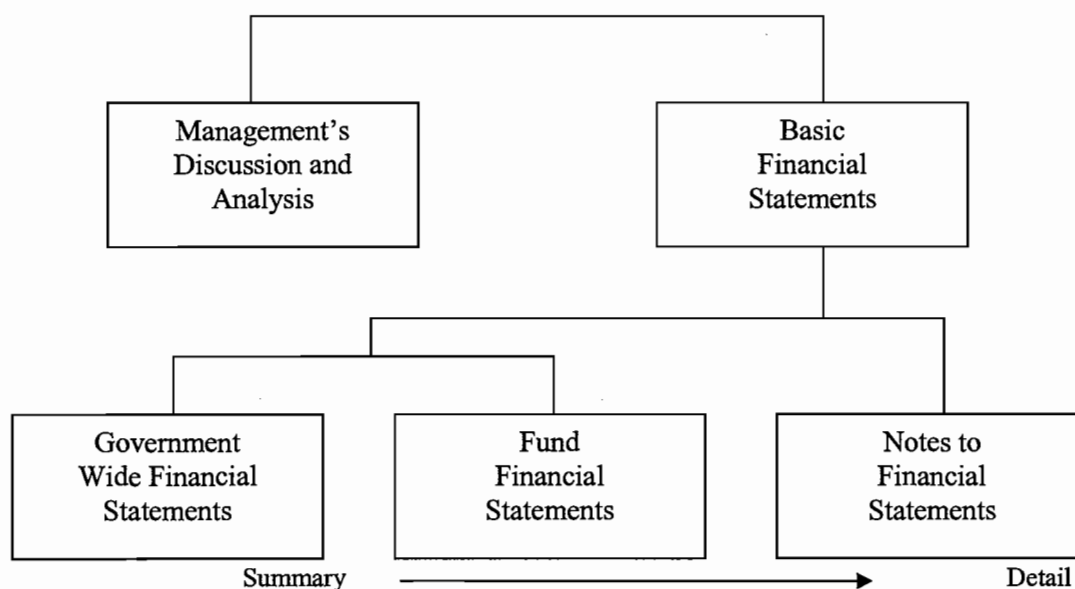
OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis are intended to serve as an introduction to Kosrae State's basic financial statements. The State's basic financial statements consist of three components; 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements (see Figure 1). The basic financial statements present two different views of the State through the use of government-wide statements and fund financial statements. In addition to the basic financial statements, this report contains other supplemental information that will enhance the reader's understanding of the financial condition of Kosrae State. The presentation of this financial report is from top level analysis down to detailed informative disclosures.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

**Figure 1
Required Components of Annual Financial Report**



Basic Financial Statements

The basic financial statements are the Government Wide Financial Statements and Fund Financial Statements which present two different views of the state.

Government Wide Financial Statements

The government wide financial statements are designed to provide the reader a good overview of the State's finances, similar in format to a financial statement in a private-sector business. The government wide statements provide short and long term information about the State's financial status as a whole.

Kosrae State Government's statement of net assets includes all of the government's assets and liabilities. Net assets represent the difference between total assets and total liabilities. Increase and decrease in the net assets is one of the key indicators whether the State's financial position has improved or not.

The statement of activities on the other hand accounts for the State's current year's revenues and expenses regardless of when cash is received or paid.

The government-wide financial statements of the State consist of its governmental activities, which include education, health services, economic development, public works, safety and general administration. Sales taxes, revenue sharing and federal grants are the major sources of these activities. Governmental activities are also financed by Compact grants; however, fiscal year 2003 is the last year of Compact I funding.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

Fund Financial Statements

The fund financial statements provide a more detailed look at the State's most significant activities. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. Kosrae State, like all other states in the Federated States of Micronesia uses fund accounting to ensure and reflect compliance (or non-compliance) with finance-related legal requirements. All of the funds of Kosrae State can be divided into three categories: governmental, proprietary and fiduciary funds.

Governmental funds are used to account for those functions reported as governmental activities in the government-wide financial statements. Most of the State's basic services are accounted for in governmental funds. These funds focus on how assets can readily be converted into cash flow in and out, and what monies are left at year-end that will be available for spending in the next year. Governmental funds are reported using an accounting method called *modified accrual accounting*. This method also has a current financial resources focus. As a result, the governmental fund financial statements give the reader a detailed short-term view that helps him or her determine if there are more or less financial resources available to finance the State's programs. The relationship between government activities (reported in the Statement of Net Assets and the Statement of Activities) and governmental funds is described in a reconciliation that is a part of the fund financial statements.

The State maintains individual governmental funds, which are categorized as major and non-major. The major fund includes the General Fund. The other major funds consist of Federal Grants and Compact CIP.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

PRIMARY GOVERNMENT FINANCIAL ANALYSIS

The following is a summary of the State's net assets as of September 30, 2004 and 2003.

	<u>Governmental Activities</u>	
	<u>2004</u>	<u>2003</u>
Current and other assets	\$ 5,877,466	\$ 8,492,827
Other non-current assets	<u>42,331,142</u>	<u>42,008,290</u>
Total assets	<u>48,208,608</u>	<u>50,501,117</u>
Current liabilities	2,563,297	2,136,900
Other liabilities	<u>2,337,497</u>	<u>2,289,204</u>
Total liabilities	<u>4,900,794</u>	<u>4,426,104</u>
Total net assets	\$ <u>43,307,814</u>	\$ <u>46,075,013</u>

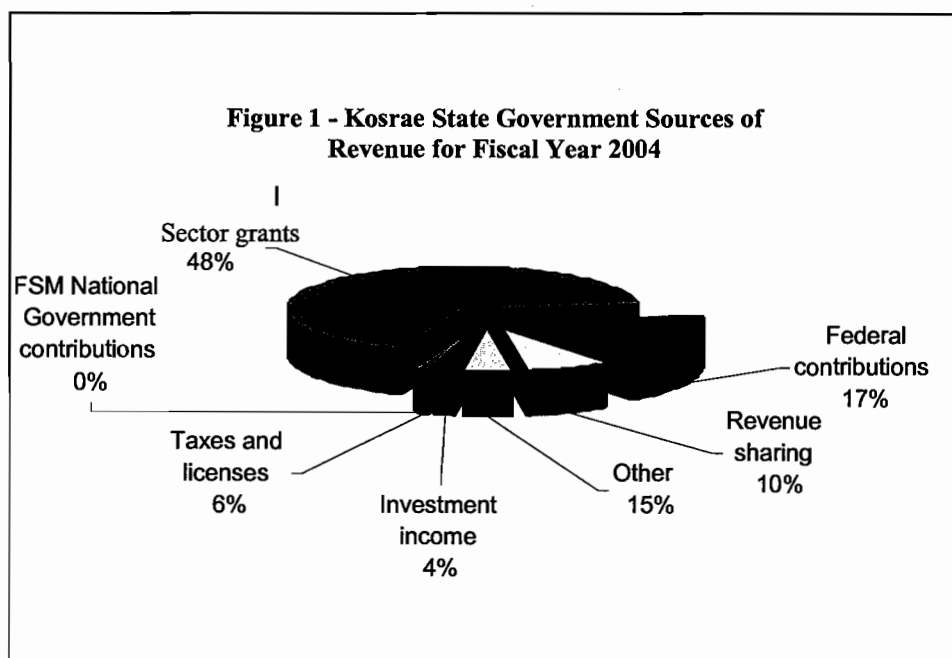
**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

The Summarized Statement of Net Assets of Kosrae State for the fiscal year ended September 30 2004 and 2003 are as follows:

	<u>Governmental Activities</u>	
	<u>2004</u>	<u>2003</u>
Revenues:		
Grants and contributions	\$ 7,405,980	\$ 13,022,511
Charges for services	458,534	538,489
Revenue sharing	1,019,895	1,188,438
Investment earnings	207,516	411,915
Taxes	188,584	197,789
Other	<u>891,297</u>	<u>155,572</u>
Total revenues	<u>10,171,806</u>	<u>15,514,714</u>
Expenses:		
General government	3,809,287	5,002,561
Education	3,299,845	2,665,140
Health services	1,814,569	1,813,547
Capital projects	883,002	1,651,605
Public works	1,931,724	1,497,101
Economic development	-	1,055,077
Public safety	7,280	423,936
Boards and commissions	-	175,991
Community affairs	-	119,452
Other miscellaneous	<u>1,193,298</u>	<u>470,000</u>
Total expenses	<u>12,939,005</u>	<u>14,874,410</u>
Change in net assets	\$ <u>(2,767,199)</u>	\$ <u>640,304</u>

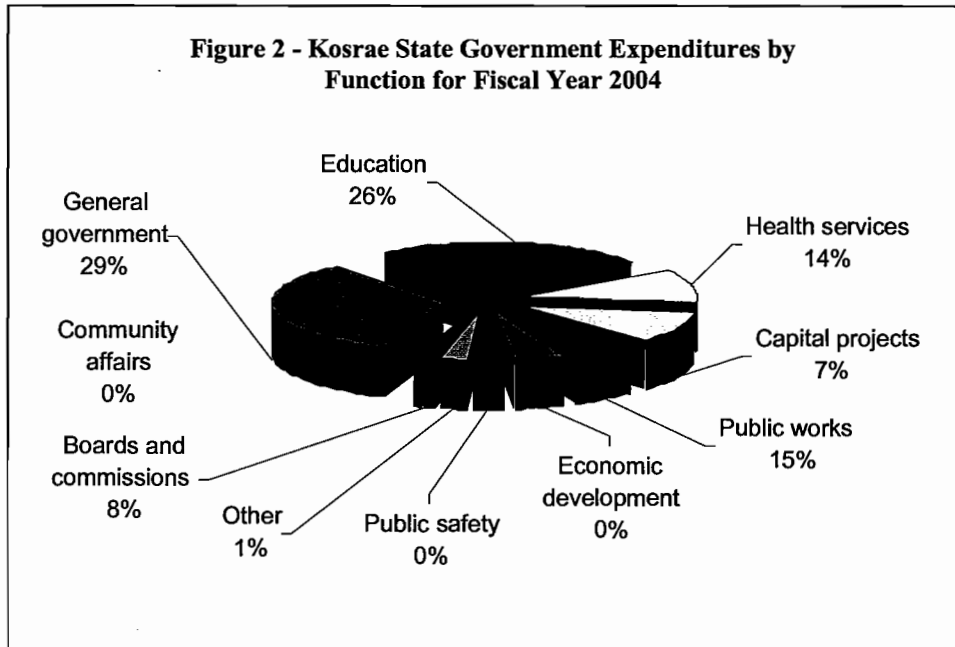
Based on the summarized statement and on Figure 1 presented below, \$6,606,402 (65%) of the State's 2004 revenues came from Sector grants and Federal contributions.



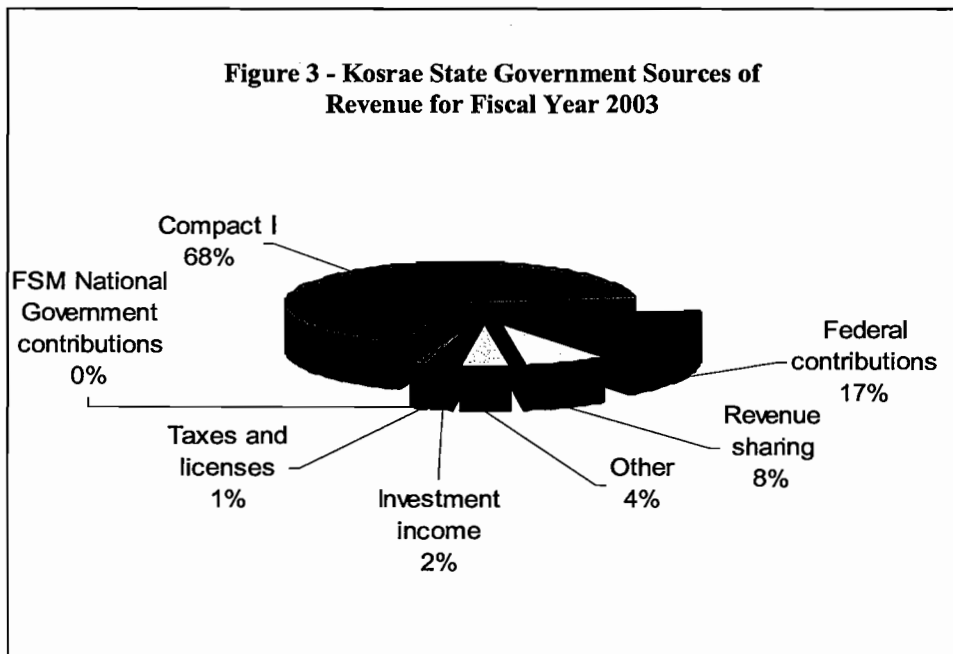
**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

Figure 2 below shows that in 2004, the General Government and Education sector had the highest percentage which is 29% and 26% respectively, of the State's total expenditures.



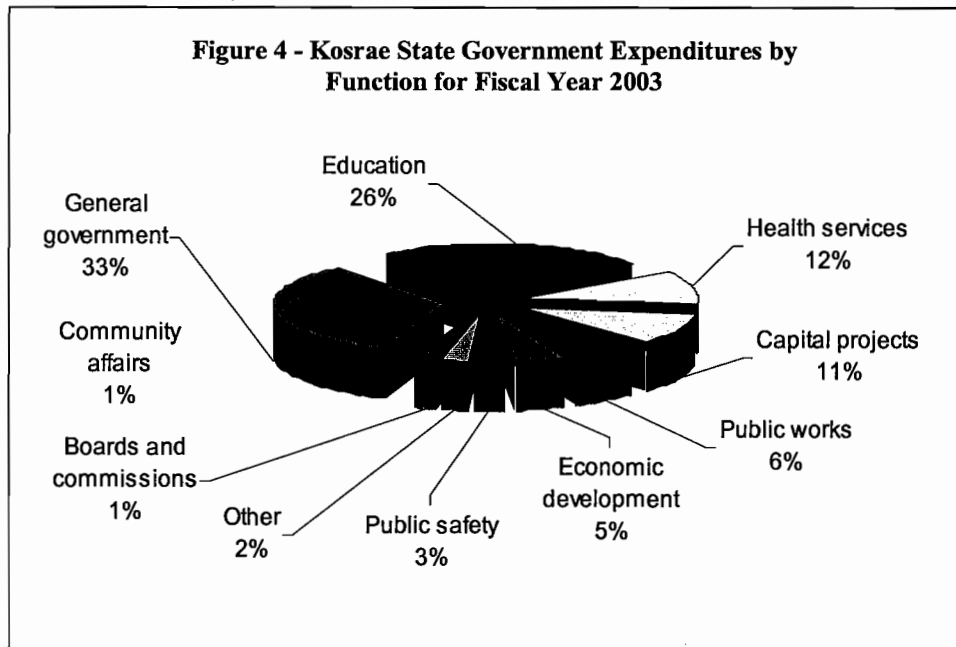
Based on the summarized statement and on Figure 3 presented below, eighty five percent (85%) of the 2003 States revenues came from Compact I and Federal contributions.



**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

Figure 4 below shows that in 2003, General Government and Education sector has the highest percentage, which is 33% and 26% respectively, of the State's total expenditures.



GOVERNMENTAL ACTIVITIES

General Fund

The decrease of \$5,363,808 or 35% of the total revenues compared to prior year was attributed to a decrease in federal contributions due to the implementation of Sector grants. All other revenue categories remained relatively consistent.

The current year's General Government expenditures decreased by \$1,193,274, which is almost 24% based on prior year amount, capital projects decreased by \$768,603, which resulted in a decrease of 47% compared with 2003 levels, health services remained virtually the same and public works expenditures increased by \$434,623 or 29%.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis
September 30, 2004

REQUESTS FOR INFORMATION

This report is designed to provide an overview of the State's finances for those with an interest in this area. Questions concerning any of the information found in this report or requests for additional information should be directed to the Director of Finance and Administration, P.O. BOX 878, Kosrae State, FM 96944.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Statement of Net Assets
September 30, 2004

	Primary Government	Component Units
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 45,953	\$ 362,770
Investments	1,736,366	2,132,936
Receivables, net of allowance for uncollectibles	3,851,466	600,619
Advances	231,924	-
Inventories	11,757	1,364,571
Other current assets	-	12,218
Total current assets	<u>5,877,466</u>	<u>4,473,114</u>
Noncurrent assets:		
Investments	2,446,132	-
Capital assets, net of accumulated depreciation	34,992,105	7,010,920
Due from component units	817	-
Restricted assets:		
Cash and cash equivalents	1,205,869	-
Investments	3,686,219	-
Total noncurrent assets	<u>42,331,142</u>	<u>7,010,920</u>
Total assets	<u>\$ 48,208,608</u>	<u>\$ 11,484,034</u>
<u>LIABILITIES</u>		
Current liabilities:		
Bank overdraft	\$ 438,424	\$ -
Current portion of long-term obligations	3,253	354,350
Accounts payable	812,108	293,624
Other liabilities and accruals	234,675	43,641
Deferred revenue	1,074,837	-
Total current liabilities	<u>2,563,297</u>	<u>691,615</u>
Noncurrent liabilities:		
Noncurrent portion of long-term obligations	2,137,497	1,035,198
Due to primary government	-	62,278
Other noncurrent liabilities	200,000	-
Total noncurrent liabilities	<u>2,337,497</u>	<u>1,097,476</u>
Total liabilities	<u>4,900,794</u>	<u>1,789,091</u>
Contingencies and Commitments		
<u>NET ASSETS</u>		
Invested in capital assets, net of related debt	34,992,105	7,010,920
Restricted for:		
Compact related	5,431,583	-
Future operations	2,300,000	-
Other purposes	2,497,523	-
Unrestricted	(1,913,397)	2,684,023
Total net assets	<u>43,307,814</u>	<u>9,694,943</u>
Total liabilities and net assets	<u>\$ 48,208,608</u>	<u>\$ 11,484,034</u>

See accompanying notes to basic financial statements.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Statement of Activities
Year Ended September 30, 2004

	Program Revenues				Net (Expenses) Revenues and Changes in Net Assets	
	Expenses	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Primary Government	Component Units
<u>Functions/Programs</u>						
Primary government:						
Governmental activities:						
General government	\$ 3,809,287	\$ 269,492	\$ 2,036,517	\$ 35,827	\$ (1,467,451)	\$ -
Land and natural resources	53,595	-	52,791	-	(804)	-
Education	3,299,845	10,378	3,098,747	-	(190,720)	-
Health services	1,814,569	113,037	1,432,226	-	(269,306)	-
Public safety	7,280	-	-	-	(7,280)	-
Public works and transportation	1,931,724	65,627	-	-	(1,866,097)	-
Capital projects	883,002	-	-	172,838	(710,164)	-
Future operations	-	-	500,000	-	500,000	-
Other appropriations	1,139,703	-	77,034	-	(1,062,669)	-
Total primary government	<u>\$ 12,939,005</u>	<u>\$ 458,534</u>	<u>\$ 7,197,315</u>	<u>\$ 208,665</u>	<u>(5,074,491)</u>	<u>-</u>
Component units:						
Kosrae Utilities Authority	\$ 1,837,847	\$ 1,143,063	\$ -	\$ -	-	(694,784)
Micronesia Petroleum Corporation	2,412,653	2,305,591	-	-	-	(107,062)
Total component units	<u>\$ 4,250,500</u>	<u>\$ 3,448,654</u>	<u>\$ -</u>	<u>\$ -</u>	<u>-</u>	<u>(801,846)</u>
General revenues:						
Taxes:						
Revenue sharing					1,019,895	-
Excise taxes					188,584	-
Unrestricted investment earnings					207,516	44,439
Other					891,297	196,324
Total general revenues and transfers					<u>2,307,292</u>	<u>240,763</u>
Change in net assets					<u>(2,767,199)</u>	<u>(561,083)</u>
Net assets at the beginning of the year, as restated					<u>46,075,013</u>	<u>10,256,026</u>
Net assets at the end of the year					<u>\$ 43,307,814</u>	<u>\$ 9,694,943</u>

See accompanying notes to basic financial statements.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Balance Sheet
Governmental Funds
September 30, 2004

	General	Special Revenue U.S Federal Grants	Section 211 Sector Grant	Capital Projects Compact Capital Projects	Permanent Section 215 Compact Trust	Other Governmental Funds	Total
ASSETS							
Cash and cash equivalents	\$ 44,674	\$ -	\$ -	\$ -	\$ -	\$ 1,279	\$ 45,953
Investments	1,099,798	-	-	3,082,700	-	-	4,182,498
Receivables, net:							
Loans	-	-	-	-	-	507,051	507,051
Federal agencies	-	2,152,054	-	-	-	-	2,152,054
CFSM	9,461	-	-	-	-	469,409	478,870
Taxes	401,482	-	-	-	-	-	401,482
Other	207,106	-	35,827	-	-	69,076	312,009
Due from component units	817	-	-	-	-	-	817
Due from other funds	2,349,198	-	509,545	1,332,790	-	1,018,633	5,210,166
Advances	134,216	-	-	-	-	97,708	231,924
Inventories	11,757	-	-	-	-	-	11,757
Restricted assets:							
Cash and cash equivalents	-	-	-	728,264	-	477,605	1,205,869
Investments	-	-	-	-	2,300,000	1,386,219	3,686,219
Total assets	\$ 4,258,509	\$ 2,152,054	\$ 545,372	\$ 5,143,754	\$ 2,300,000	\$ 4,026,980	\$ 18,426,669

LIABILITIES AND FUND BALANCES

Liabilities:							
Bank overdraft	\$ 438,424	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 438,424
Accounts payable	308,678	260,015	49,322	61,247	-	132,846	812,108
Other liabilities and accruals	221,976	4,059	-	-	-	8,640	234,675
Due to other funds	2,860,968	1,790,723	-	-	-	558,475	5,210,166
Deferred revenue	-	97,257	497,160	17,168	-	463,252	1,074,837
Total liabilities	3,830,046	2,152,054	546,482	78,415	-	1,163,213	7,770,210
Fund balances:							
Reserved for:							
Related assets	3,062,897	-	-	2,446,132	2,300,000	1,776,836	9,585,865
Encumbrances	170,183	1,324,784	375,123	1,022,562	-	393,983	3,286,635
Continuing appropriations	212,785	-	-	1,115,244	-	127,970	1,455,999
Unreserved:							
General fund	(3,017,402)	-	-	-	-	-	(3,017,402)
Special revenue funds	-	(1,324,784)	(376,233)	-	-	686,186	(1,014,831)
Capital projects funds	-	-	-	481,401	-	(121,208)	360,193
Total fund balances	428,463	-	(1,110)	5,065,339	2,300,000	2,863,767	10,656,459
Total liabilities and fund balances	\$ 4,258,509	\$ 2,152,054	\$ 545,372	\$ 5,143,754	\$ 2,300,000	\$ 4,026,980	

Amounts reported for governmental activities in the statement of net assets are different because:

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds

34,992,105

Long-term liabilities, including loans payable, are not due and payable in the current period and, therefore, are not reported in the funds. The liabilities include:

Long-term debt payable

(2,140,750)

Claims payable

(200,000)

(2,340,750)

Net assets of governmental activities

\$ 43,307,814

See accompanying notes to basic financial statements.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures, and Changes in Fund Balances (Deficits)
Governmental Funds
Year Ended September 30, 2004

	Special Revenue			Capital Projects	Permanent	Other Governmental Funds	Total
	General	U.S Federal Grants	Section 211 Sector Grant	Compact Capital Projects	Section 215 Compact Trust		
Revenues:							
Compact funding	\$ -	\$ -	\$ 4,860,772	\$ -	\$ -	\$ -	\$ 4,860,772
Investment income	207,516	-	-	149,241	-	49,706	406,463
Federal contributions	-	1,745,630	-	-	-	-	1,745,630
FSM revenue sharing	1,019,895	-	-	-	-	-	1,019,895
State taxes	188,584	-	-	-	-	-	188,584
CFSM grants	-	-	-	-	-	23,597	23,597
Other grants	-	-	-	-	500,000	77,034	577,034
Fees and charges	150,335	-	-	-	-	308,199	458,534
Other	891,297	-	-	-	-	-	891,297
Total revenues	2,457,627	1,745,630	4,860,772	149,241	500,000	458,536	10,171,806
Expenditures:							
Current:							
General government	2,434,141	161,207	1,862,541	-	-	252,662	4,710,551
Land and Nautral Resources	804	52,791	-	-	-	-	53,595
Education	48,487	1,214,123	1,884,624	-	-	26,679	3,173,913
Health	175,107	317,509	1,114,717	-	-	101,001	1,708,334
Public Safety	(120)	-	-	-	-	-	(120)
Office of the Attorney General	(100)	-	-	-	-	-	(100)
Payments to non-governmental agencies	81,955	-	-	-	-	-	81,955
Boards, commissions and other	977,479	-	-	-	-	59,146	1,036,625
Capital projects	-	-	-	859,405	-	23,597	883,002
Total expenditures	3,717,753	1,745,630	4,861,882	859,405	-	463,085	11,647,755
Excess (deficiency) of revenues over (under) expenditures	(1,260,126)	-	(1,110)	(710,164)	500,000	(4,549)	(1,475,949)
Other financing sources (uses):							
Operating transfers in	-	304,147	-	-	1,800,000	292,375	2,396,522
Operating transfers out	(885,282)	-	-	(1,511,240)	-	-	(2,396,522)
Total other financing sources (uses), net	(885,282)	304,147	-	(1,511,240)	1,800,000	292,375	-
Net change in fund balances	(2,145,408)	304,147	(1,110)	(2,221,404)	2,300,000	287,826	(1,475,949)
Fund balances (deficits) at the beginning of the year	2,573,871	(304,147)	-	7,286,743	-	2,575,941	12,132,408
Fund balances (deficits) at the end of the year	\$ 428,463	\$ -	\$ (1,110)	\$ 5,065,339	\$ 2,300,000	\$ 2,863,767	\$ 10,656,459

See accompanying notes to basic financial statements.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Reconciliation of the Statement of Revenues, Expenditure, and Changes in Fund
Balances of Governmental Funds to the Statement of Activities
Year Ended September 30, 2004

Amounts reported for governmental activities in the statement of activities on page 11 are different because:

Net change in fund balances - total governmental funds from page 13	\$ (1,475,949)
---	----------------

Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays exceeded depreciation in the current period	(1,335,616)
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The issuance of long-term debt (e.g. bonds, leases) provides current financial resources to governmental funds, while the repayment of principal of long-term debt consumes the current financial resources of governmental funds. Neither transaction has any effect on net assets. This amount is the net effect of these differences in the treatment of long - term debt and related items	<u>44,366</u>
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Change in net assets of governmental activities as presented on page 11.	\$ <u>(2,467,199)</u>
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**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

**DISCRETELY PRESENTED COMPONENT UNITS
Combining Statement of Net Assets
September 30, 2004**

<u>ASSETS</u>	<u>Kosrae Utilities Authority</u>	<u>Micronesia Petroleum Corporation</u>	<u>Total</u>
Current assets:			
Cash and cash equivalents	\$ 223,933	\$ 138,837	\$ 362,770
Investments	2,101,112	31,824	2,132,936
Receivables, net:			
Federal agencies	30,468	-	30,468
General	180,233	389,918	570,151
Inventories	664,652	699,919	1,364,571
Prepayments	2,310	9,908	12,218
Total current assets	<u>3,202,708</u>	<u>1,270,406</u>	<u>4,473,114</u>
Noncurrent assets:			
Capital assets, net of accumulated depreciation	<u>4,657,656</u>	<u>2,353,264</u>	<u>7,010,920</u>
Total assets	<u>\$ 7,860,364</u>	<u>\$ 3,623,670</u>	<u>\$ 11,484,034</u>
<u>LIABILITIES AND NET ASSETS</u>			
Current liabilities:			
Current portion of long-term debt	\$ -	\$ 354,350	\$ 354,350
Accounts payable	55,078	238,546	293,624
Accrued liabilities	31,950	11,691	43,641
Payable to Kosrae State Government	-	62,278	62,278
Total current liabilities	<u>87,028</u>	<u>666,865</u>	<u>753,893</u>
Noncurrent liabilities:			
Noncurrent portion of long-term debt	-	1,035,198	1,035,198
Total noncurrent liabilities	<u>-</u>	<u>1,035,198</u>	<u>1,035,198</u>
Total liabilities	<u>87,028</u>	<u>1,702,063</u>	<u>1,789,091</u>
Net assets:			
Invested in capital assets, net of related debt	4,657,656	2,353,264	7,010,920
Unrestricted	<u>3,115,680</u>	<u>(431,657)</u>	<u>2,684,023</u>
Total net assets	<u>7,773,336</u>	<u>1,921,607</u>	<u>9,694,943</u>
Total liabilities and net assets	<u>\$ 7,860,364</u>	<u>\$ 3,623,670</u>	<u>\$ 11,484,034</u>

See accompanying notes to financial statements.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

**DISCRETELY PRESENTED COMPONENT UNITS
Combining Statement of Revenues, Expenses, and Changes in Net Assets
Year Ended September 30, 2004**

	Kosrae Utilities Authority	Micronesia Petroleum Corporation	Totals
Operating revenues:			
Charge for services	\$ 1,143,063	\$ 2,305,591	\$ 3,448,654
Operating expenses:			
Cost of goods sold	-	1,952,053	1,952,053
Personnel services	376,936	150,916	527,852
Fuel	752,357	4,811	757,168
Depreciation	538,202	60,732	598,934
Administration and general	118,737	-	118,737
Contractual services	-	39,367	39,367
Repair and maintenance	51,615	4,294	55,909
Taxes	-	78,889	78,889
Travel	-	23,857	23,857
Communications	-	7,373	7,373
Supplies and materials	-	6,823	6,823
Rent	-	5,400	5,400
Utilities	-	4,172	4,172
Others	-	73,966	73,966
Total operating expenses	<u>1,837,847</u>	<u>2,412,653</u>	<u>4,250,500</u>
Operating loss	<u>(694,784)</u>	<u>(107,062)</u>	<u>(801,846)</u>
Nonoperating revenues (expenses):			
Interest income	44,439	-	44,439
Other income (expense)	223,812	53,087	276,899
Interest expense	-	(80,575)	(80,575)
Total nonoperating revenues (expenses), net	<u>268,251</u>	<u>(27,488)</u>	<u>240,763</u>
Net loss	<u>(426,533)</u>	<u>(134,550)</u>	<u>(561,083)</u>
Net assets at beginning of year	<u>8,199,869</u>	<u>2,056,157</u>	<u>10,256,026</u>
Net assets at end of year	<u>\$ 7,773,336</u>	<u>\$ 1,921,607</u>	<u>\$ 9,694,943</u>

See accompanying notes to financial statements.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies

The accompanying financial statements of the State of Kosrae (the State) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Governmental Accounting Standards Board (GASB) is the recognized standard-setting body for establishing governmental accounting and financial reporting principles. The more significant of the State's accounting policies are described below.

A. Reporting Entity

The State is one of the four states that make up the Federated States of Micronesia (FSM), along with the states of Chuuk, Pohnpei and Yap. The State is a constitutional government comprised of three branches: the Legislative Branch, consisting of 14 members elected for a term of four years by qualified voters of their respective election districts; the Executive Branch, headed by the Governor and Lt. Governor who are primarily responsible for executing the laws and administering state government services; and the Judiciary Branch made up of the State Supreme Court, which consists of a Chief Justice and up to four Associate Justices, and other courts that may be created by law.

For financial reporting purposes, the State has included all funds, organizations, agencies, boards, commissions and institutions. The State has also considered all potential component units for which it is financially accountable as well as other entities for which the nature and significance of their relationship with the State are such that exclusion would cause the State's financial statements to be misleading or incomplete. The criteria to be considered in determining financial accountability include whether the State, as the primary government, has appointed a voting majority of an organization's governing body and either has the ability to impose its will on that organization or there is potential for the organization to provide specific financial benefits to or impose specific financial burdens on the State. Financial accountability also exists if an organization is determined to be fiscally dependent on the primary government, although the primary government does not appoint a voting majority of the organization's governing board.

Each blended and discretely presented component unit of the State has a September 30 year-end.

Once financial accountability has been determined for a potential component unit, that component unit is either blended into the primary government or discretely presented from the primary government. Potential component units that do not meet the financial accountability criteria, but where a voting majority of the governing board is appointed by the State, are deemed to be related organizations. The nature and relationship of the State's component units and related organizations are disclosed in the following section.

Blended component units are entities that are legally separate from the State, but are so related to the State that they are, in substance, the same as the State or entities providing services entirely or almost entirely to the State. The State has not identified any entities that should be so blended.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

A. Reporting Entity, Continued

i. Discretely Presented Component Units

Discretely presented component units are entities which are legally separate from the State, but are financially accountable to the State, or whose relationships with the State are such that exclusion would cause the State's basic financial statements to be misleading or incomplete. The component units' column of the basic financial statements includes the financial data of the following major component units:

Kosrae Utilities Authority (KUA): KUA was created by Kosrae State Law (KSL) No. 5-38 and is responsible for operating and maintaining, on a commercially accepted basis, the State's electric power. KUA is governed by a five-member Board of Directors, of which four members are appointed by the Governor subject to the advice and consent of the Legislature, and, ex-officio, the Director of the Department of Public Works.

Micronesia Petroleum Corporation (MPC): MPC was created by KSL No. 6-191 and is responsible for operating and managing the State's fuel storage facilities and to engage in the business of buying and selling petroleum products. MPC is governed by a five-member Board of Directors appointed by the Governor subject to the advice and consent of the Legislature.

Kosrae Port Authority (KPA): KPA was created by KSL No. 7-91 to operate, manage, equip, and maintain all ports of entry and to expand and improve upon services offered at the ports of entry. The official transfer of assets from the State to KPA has yet to occur; therefore, KPA's financial statements are not included in the accompanying financial statements.

The State's component units, departments, and funds that are separately audited issue their own financial statements. These statements may be obtained by directly contacting the various entities or obtaining them directly from the Office of the Public Auditor at the following address.

P.O. Box 727
Tofol, Kosrae, FSM 96944

B. Government-Wide Financial Statements

The Statement of Net Assets and the Statement of Activities report financial information on all of the non-fiduciary activities of the primary government and its component units. For the most part, the effect of interfund activity has been eliminated from these statements except for other charges between the primary government and the discretely presented component units. Elimination of these charges would distort the direct costs and program revenues reported for the various functions concerned.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

B. Government-Wide Financial Statements, Continued

Primary government activities are defined as either governmental or business-type activities. Governmental activities, which normally are supported by taxes, intergovernmental revenues and other non-exchange revenues, are reported separately from business-type activities, which rely to a significant extent on fees charged to external parties for goods or services. As such, business-type activities account for operations similarly to a for-profit business. Likewise, the primary government is reported separately from certain legally separate component units for which the primary government is financially accountable. Discretely presented component unit activities are presented with their business-type focus.

The Statement of Net Assets presents all of the reporting entity's non-fiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- Invested in capital assets, net of related debt consists of capital assets, net of accumulated depreciation and reduced by outstanding balances for bonds, notes and other debt that are attributed to the acquisition, construction or improvement of those assets.
- Restricted net assets result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law.
- Unrestricted net assets consist of net assets, which do not meet the definition of the two preceding categories. Unrestricted net assets often are designated, (for example, internally restricted), to indicate that management does not consider them to be available for general operations.

The government-wide Statement of Net Assets reports \$10,229,106 of restricted net assets, of which \$2,497,523 is restricted by enabling legislation.

The Statement of Activities demonstrates the degree to which the direct expenses of given functions or segments are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function or segment. Program revenues include charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items not meeting the definition of program revenues are, instead, reported as general revenue.

C. Fund Financial Statements

The fund financial statements present a balance sheet and a statement of revenues, expenditures, and changes in fund balances for its major and aggregated non-major funds.

Major individual governmental funds are reported as separate columns in the fund financial statements pursuant to GASB reporting standards, with nonmajor governmental funds being combined into a single column.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

C. Fund Financial Statements, Continued

The State reports its financial position and results of operations in funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

D. Measurement Focus and Basis of Accounting

The government-wide financial statements are reported using the economic resources management focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Governmental fund financial statements account for the general governmental activities of the State and are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as they become susceptible to accrual; generally when they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the State considers revenues to be available if they are collected within 60 days of the end of the current fiscal period.

Significant revenues susceptible to accrual include income and gross revenue taxes, federal grants, federal reimbursements and other reimbursements for use of materials and services. Miscellaneous revenues from other financing sources are recognized when received in cash because they are generally not measurable until actually received. Investment earnings are recorded as earned, since they are both measurable and available. Investments and related investment earnings are recorded at fair value. 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. Expenditures generally are recorded in the period in which the related fund liability is incurred, as under accrual accounting. However, debt service expenditures, as well as expenditures related to compensated absences and claims and judgments, are recorded only when payment is due.

Amounts reported as program revenue include 1) charges to customers or applicants for goods, services, or privileges provided, 2) operating grants and contributions, and 3) capital grants and contributions. Internally dedicated resources are reported as general revenues rather than as program revenues. General revenue is derived from taxation, investment income and other fees that are not allocated to specific programs.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

D. Measurement Focus and Basis of Accounting, Continued

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. All other revenues are reported as nonoperating. Operating expenses includes the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

The State reports the following fund types:

1. Governmental Funds

i. General Fund

This fund is the primary operating fund of the State. It is used to account for all governmental transactions, except those required to be accounted for in another fund.

ii. Special Revenue Funds

These funds account for specific revenue sources that have been aggregated according to enabling legislation to support specific governmental activities.

iii. Capital Projects Funds

These funds account for the acquisition or construction of major State capital facilities financed primarily from loans and federal reimbursements.

iv Permanent Funds

This fund accounts for resources that are legally restricted to the extent that only earnings, and not principal, may be used to support programs for the benefit of the government.

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 - Omnibus*, sets forth minimum criteria (percentage of the assets, liabilities, revenues or expenditures/expenses for either fund category or the governmental and enterprise combined) for the determination of major funds. Major individual governmental funds are reported as separate columns in the fund financial statements. The nonmajor funds are combined in a column in the fund financial statements and detailed in the combining statements. The State reports the following major funds:

U.S. Federal Grants Fund, a Governmental Fund Type - Special Revenue Fund. This fund accounts for all financial transactions of federally assisted funds, which are subgranted to the State, as well as other direct federal grants the State received from the U.S. government.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

D. Measurement Focus and Basis of Accounting, Continued

Section 215 Compact Trust, a Governmental Fund Type – Permanent Fund accounts for the State's contributions to the Trust Fund established in accordance with Section 215 of the Compact of Free Association, as amended, to provide for an additional source of revenue for the government budget that will be needed to substitute for the absence of Compact of Free Association funding.

Compact Capital Projects Fund, a Governmental Fund Type - Capital Projects Fund. This fund accounts for United States Congress appropriations under United States Public Law 99-239, Title 2, Article 1, Section 211(a)(1) and approved by FSM Congress. The aforementioned section requires no less than 40% of the total amounts appropriated by the United States Congress to be applied to the capital account.

Section 211 Sector Grant Fund, a Governmental Fund Type - Special Revenue Fund. This fund accounts for funds received under sector grants pursuant to the amended Compact of Free Association.

E. Reporting Standards

As allowed by GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, the State's proprietary funds follow all GASB pronouncements and those Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement.

F. Cash and Cash Equivalents and Time Certificates of Deposit

The State pools cash resources of its various funds in order to facilitate the management of cash. Unless otherwise required by law, interest income received on pooled cash accrues to the General Fund. Cash and cash equivalents applicable to a particular fund are readily identifiable. Cash and cash equivalents include cash held in demand accounts as well as short-term investments with a maturity date within three months of the date acquired by the State. Deposits maintained in time certificates of deposit with original maturity dates greater than ninety days are separately classified on the statement of net assets/balance sheet.

As of September 30, 2004, the carrying amount of the primary government's total cash and cash equivalents and time certificates of deposit was \$1,251,822 and the corresponding bank balance was \$1,301,396, which is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2003, bank deposits in the amount of \$100,000 were FDIC insured. The State does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

F. Cash and Cash Equivalents and Time Certificates of Deposit, Continued

As of September 30, 2004, the carrying amount of the discretely presented component units' total cash and cash equivalents was \$362,770 and the corresponding bank balance was \$362,770. All cash is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2003, bank deposits in the amount of \$300,000 were FDIC insured. The component units do not require collateralization of their cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

G. Investments

Investments are recorded at fair value. 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. Investments in the equity of companies are carried at cost if less than twenty percent of the companies' total equity, on the equity method if greater than twenty percent and less than fifty percent and on a consolidated basis if greater than fifty percent.

H. Receivables

In general, tax revenue is recognized on the government-wide financial statements when assessed or levied and on the governmental fund financial statements to the extent that it is both measurable and available. Receivables are stated net of estimated allowances for uncollectible accounts. Federal receivables include those funds which are earned, primarily from FSM National Government administered federal grants, which have yet to be reimbursed by the applicable grantor.

Receivables of the primary government are primarily due from businesses and individuals residing in the State. The Republic establishes an allowance for doubtful accounts receivable based on the credit risk of specific customers, historical trends and other information.

I. Prepaid Items

Certain payments made to vendors or persons for services reflect costs applicable to future accounting periods and are recorded as prepaid items in both government-wide and fund financial statements.

J. Interfund Receivables/Payables

During the course of its operations, the State records transactions between individual funds for goods provided or services rendered. Receivables and payables resulting from transactions between funds are classified as "due from other funds" or "due to other funds" on the governmental fund balance sheet.

These balances result from time lag between the dates that 1) interfund goods and services are provided or reimbursable expenditures occur, 2) transactions are recorded in the accounting system, and 3) payments between funds are made, and are scheduled to be collected in the subsequent year.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

K. Inventories

Inventories of materials and supplies are determined by physical count and are valued at the lower of cost (principally average cost) or market.

Inventories of the discretely presented component units are valued at the lower of cost (FIFO) or market

L. Restricted Assets

Certain assets of the primary government are classified as restricted assets because their use is completely restricted through loan agreements or enabling legislation. Specifically, the State has collateralized Asian Development Bank loan proceeds and earnings in the amount of \$1,386,219 for the Kosrae State Early Retirement Scheme. Furthermore, investments recorded in the Compact Trust Fund of \$2,300,000 are restricted in that they are not available to be used in current operations. As of September 30, 2004, cash and cash equivalents and time certificates of deposit of the primary government were restricted for the following uses:

Time certificate of deposit with a local bank as remaining loan proceeds of the \$2,000,000 Early Retirement loan with the Asian Development Bank.	\$ 162,605
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Time certificate of deposit of \$315,000 with a local bank restricted for scholarships for post-secondary students.	315,000
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The State has restricted a time certificate of deposit that collateralizes a bank loan to Micronesia Petroleum Corporation, a component unit. (See Note 6).	412,867
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Time certificate of deposit of \$213,208 and demand deposit account of \$100,730 for the Loan Guarantee Escrow Account established for the sole purpose of loan collateralization made through the USDA Rural Development. The escrow account may be drawn down in the event of a borrower's default on the obligation under the terms of the promissory note and the deed of trust security instrument supporting such note and for which such note is guaranteed by the Kosrae State Housing Authority, the trustee of the Loan Guarantee Escrow Account.	<u>315,397</u>
	\$ <u>1,205,869</u>

M. Capital Assets

Capital assets, which include property, plant, equipment and infrastructure (e.g. roads, bridges, ramps and other similar items), are reported in the governmental activity column of the government-wide financial statements.

Capital assets are recorded at historical cost or estimated historical cost if purchased or constructed. Donated capital assets are recorded at fair market value at the date of donation.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

M. Capital Assets, Continued

All land and non-depreciable land improvements are capitalized, regardless of cost. Singular pieces of machinery and equipment, other than vehicles, that equal or exceed \$50,000 are capitalized. Buildings and infrastructure projects with a cost that equals or exceeds \$100,000 are capitalized. The costs of normal maintenance and repairs that do not add to the value of assets or materially extend asset lives are not capitalized.

All vehicles have been grouped together regardless of cost and depreciated on a composite basis.

Capital assets of the primary government and the component units are depreciated using the straight-line method over their estimated useful lives, with a full year's depreciation charged in the year of acquisition and disposal, regardless of date. Estimated useful lives are as follows:

Buildings	10 - 40 years
Infrastructure - roads, and bridges	5 - 50 years
Machinery, equipment and others	5 - 10 years

N. Interfund/Intrafund Transactions

As a general rule, the effect of interfund activity has been eliminated in the government-wide statements. Exceptions to this rule are: 1) activities between funds reported as governmental activities and funds reported as business-type activities and 2) activities between funds that are reported in different functional categories in either the governmental or business-type activities column. Elimination of these activities would distort the direct costs and program revenues for the functions concerned.

O. Compensated Absences

It is the government's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. There is no liability for unpaid accumulated sick leave since the government does not have a policy to pay any amounts when employees separate from service with the government. All vacation pay is accrued when incurred in the government-wide fund financial statements. A liability for these amounts is reported in governmental funds only if they have matured, for example, as a result of employee resignations and retirements. Annual leave accumulates at the rate of one working day per bi-weekly pay period. All unused annual leave is cancelled at the end of each fiscal year. Accordingly, no liability is recorded for compensated absences in the accompanying statement of net assets.

P. Fund Equity

In the fund financial statements, governmental funds report reservations of fund balance for amounts that are not available for appropriation or are legally restricted by outside parties for use for a specific purpose. Designations of fund balance represent tentative management plans that are subject to change.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

P. Fund Equity, Continued

The unreserved fund balances for the governmental funds represent the amount available for budgeting future operations. The reserve for related assets as of September 30, 2004, is represented by the following assets:

	<u>General</u>	<u>Compact Capital Projects</u>	<u>Compact Trust</u>	<u>Other Governmental Funds</u>	<u>Totals</u>
Investments	\$ 280,509	\$ 2,446,132	\$ -	\$ -	\$ 2,726,641
Receivables:					
Loans	-	-	-	507,051	507,051
Due from other funds	2,782,388	-	-	170,667	2,953,055
Restricted assets:					
Investments	-	-	2,300,000	1,099,118	3,399,118
	<u>\$ 3,062,897</u>	<u>\$ 2,446,132</u>	<u>\$ 2,300,000</u>	<u>\$ 1,776,836</u>	<u>\$ 9,585,865</u>

The reserve for related assets within the General Fund includes the amount of \$280,509 set aside for future repayment of the Early Retirement Program Loan.

Q. Risk Financing

The State is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. It is the policy of the primary government not to purchase commercial insurance for the risks of loss to which it is exposed. Instead, the State management believes it is more economical to manage its risks internally. In the event of claim settlements and judgments, the State reports all of its risk management activities in its General Fund. Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported. The State has not incurred material losses as a result of this policy during the last three years.

R. Restatement of Government – Wide Net Assets

Primary Government

Net assets, as previously reported September 30, 2003	\$ 35,058,832
Understatement of capital assets:	
Buildings	75,040
Infrastructures	12,926,421
Machinery, equipment, others	(422,206)
Accumulated depreciation	<u>(1,542,174)</u>
	11,037,081
Other	<u>(20,900)</u>
Net assets, as restated September 30, 2003	\$ <u>46,075,013</u>

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(1) Summary of Significant Accounting Policies, Continued

S. New Accounting Standards

During fiscal year 2004, the State implemented GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units* (an amendment of GASB Statement 14), which provides additional guidance on GASB Statement No.14, in determining whether an entity should be reported as a component unit based on the nature and significance of its relationship with a primary government. Implementation of this Statement did not have a material effect on the financial statements of the State.

For fiscal year 2005, the State will be implementing GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures* (an amendment of GASB Statement No. 3), which addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest risk, GASB Statement No. 40 requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the State.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this Statement are effective for periods beginning after December 15, 2007. The State does not believe that the implementation of this Statement will have a material effect on its financial statements.

In May 2004, GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section*, an amendment to NCGA Statement 1. GASB Statement No. 44 improves the understandability and usefulness of statistical section information and adds information from the new financial reporting model for state and local governments required by GASB Statement No. 34. The provisions of this Statement are effective for periods beginning after June 15, 2005. The State does not believe the implementation of this Statement will have a material effect on its financial statements.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after December 15, 2008. The State does not believe the implementation of this Statement will have a material effect on its financial statements.

T. 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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures/expenses during the reporting period. Actual results could differ from those estimates.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(2) Investments

The State has invested the majority of its excess Compact Funds in a pooled investment fund which is managed under the control of the Federated Development Authority, an entity comprised of the FSM National Government and its four component states.

The Federated Development Authority has selected investment managers who are given authority to buy and sell securities as follows:

- A. Investment managers may invest in stocks, bonds and cash equivalents. Minimum standards of quality for investments at the time of purchase shall be:

Cash and cash equivalents - The manager may engage in all normally accepted short-term investment practices including, but not limited to U.S. Treasury and Agency securities, bankers acceptances, certificates of deposit, commercial paper and repurchase agreements using any of the foregoing as collateral. The following restrictions apply: (1) Commercial paper must be rated A-1/P-1 or higher by Standard & Poors Corporation and Moody's Investor Services; and (2) Certificates of deposit must be from FDIC insured banks or FSLIC insured savings and loan associations, both of which must have assets in excess of two billion dollars. Deposits in smaller institutions are acceptable, but must not exceed the amount of the insurance, unless collateralized by U.S. Treasury Securities at 102%.

Stocks - A "B" rating by a national rating service. Non-rated stocks, such as banks or insurance companies, must be equal in quality or higher.

Bonds - Confined to issues rated "A" or higher by a national rating service, except in the case of U.S. Treasury or Agency Securities which are not rated.

- B. The equity portfolio shall be diversified among issues and industry classifications. No more than 25% of the equity portfolio may be invested in any single classification, as described by the Standard and Poors 500 Index, unless prior approval is received from the Secretary of Finance.
- C. No investment may be made in a single corporate entity which exceeds 5% of the total assets of the fund at the time of purchase without prior approval of the Secretary of Finance.

GASB Statement No. 3 requires government entities to categorize investments to give an indication of the level of credit risk assumed by the entity at year end. The three categories are described below:

- | | |
|------------|--|
| Category 1 | Insured or registered, or securities held by the State or its agent in the State's name; |
| Category 2 | Uninsured and unregistered, with securities held by the broker's or dealer's trust department or agent in the State's name; or |
| Category 3 | Uninsured and unregistered, with securities held by the broker or dealer, or by its trust department or agent but not in the State's name. |

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(2) Investments, Continued

Investments of the primary government and the discretely presented component units as September 30, 2004, are as follows:

	<u>Categories</u>			<u>Carrying Value</u>
	<u>1</u>	<u>2</u>	<u>3</u>	
<u>Primary Government</u>				
Mixed income	\$ -	\$ 2,678,686	-	\$ 2,678,686
U.S. Government agencies	-	224,162	-	224,162
U.S. Government notes and bonds	-	118,067	-	118,067
Common Stock	<u>2,446,132</u>	<u>-</u>	<u>-</u>	<u>2,446,132</u>
	\$ <u>2,446,132</u>	\$ <u>3,020,915</u>	\$ <u>-</u>	5,467,047
Money market funds				<u>2,401,670</u>
				\$ <u>7,868,717</u>
<u>Discretely Presented Component Units</u>				
Common Stock	\$ <u>-</u>	\$ <u>31,824</u>	\$ <u>-</u>	\$ 31,824
Money market funds				<u>2,101,112</u>
				\$ <u>2,132,936</u>

As of September 30, 2004, the Compact Capital Projects Fund holds 5.4% of the shares of the Bank of the Federated States of Micronesia in the amount of \$500,000, 8.83% of the shares of the Pacific Islands Development Bank in the amount of \$300,000, and 50% of the shares in a joint venture with Semo Co., Ltd, a Korean Company, of Semo-Micronesia, Inc. in the amount of \$1,646,132. As the fair market value of these investments is not readily available, such have been recorded at cost.

In addition, as of September 30, 2004, the Compact Capital Projects Fund holds 100% of the shares of Pacific Tuna Ventures, Inc. and 50% of the shares in a joint venture with the National Fisheries Corporation of Kosrae Sea Ventures, Inc. These investments are accounted for using the equity method and, accordingly, the carrying values have been reduced to \$0.

(3) Receivables

Receivables as of September 30, 2004, for the primary government's individual major funds and nonmajor funds in the aggregate, including applicable allowances for uncollectible accounts, are as follows:

	<u>General</u>	<u>Federal Grants</u>	<u>Section 211 Sector Grants</u>	<u>Compact Capital</u>	<u>Nonmajor And Other Funds</u>	<u>Totals</u>
Receivables:						
Federal agencies	\$ -	\$ 2,456,955	\$ -	\$ -	\$ 14,599	\$ 2,471,554
Taxes	401,482	-	-	-	-	401,482
Loans	-	-	-	367,500	945,608	1,313,108
CFSM	9,461	-	-	-	499,409	508,870
Other	<u>247,106</u>	<u>-</u>	<u>35,827</u>	<u>-</u>	<u>368,372</u>	<u>651,305</u>
	658,049	2,456,955	35,827	367,500	1,827,988	5,346,319
Less: allowance for uncollectible accounts	<u>(40,000)</u>	<u>(304,901)</u>	<u>-</u>	<u>(367,500)</u>	<u>(782,452)</u>	<u>(1,494,853)</u>
Net receivables	\$ <u>618,049</u>	\$ <u>2,152,054</u>	\$ <u>35,827</u>	\$ <u>-</u>	\$ <u>1,045,536</u>	\$ <u>3,851,466</u>

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(3) Receivables, Continued

Loans receivable of the primary government as of September 30, 2004 are as follows:

Major Governmental Funds

Compact Capital Projects Fund:

Note receivable due from Micronesian Petroleum Corporation, payable in monthly installments of \$2,628, uncollateralized, due February 1, 2009, interest at 1% per annum. This note has been fully provided for in the allowance for uncollectibles. \$ 272,500

Note receivable due from Pacific Tuna Ventures, Inc., payable in monthly installments of \$11,875, uncollateralized, due May 1996, interest at 3% per annum. This note has been fully provided for in the allowance for uncollectibles. 95,000

367,500

Nonmajor Governmental Funds

Loans receivable from post-secondary students issued under a student financial assistance program to qualified Kosraean students, uncollateralized with interest at up to 6% per annum. These loans have been fully provided for in the allowance for uncollectibles. 438,557

Low-income housing loans, details and terms of those loans have not been compiled and such have been provided for in the allowance for uncollectibles. 507,051

945,608

\$ 1,313,108

(4) Interfund Receivables and Payables

Receivables and payables between funds reflected as due to/from other funds in the combined balance sheet at September 30, 2004, are summarized as follows:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Amount</u>
General	U.S. Federal Grants Fund	\$ 1,790,723
General	Nonmajor governmental funds	558,475
Section 211 Sector Grants	General	509,545
Compact Capital Projects	General	1,332,790
Nonmajor governmental funds	General	<u>1,018,633</u>
		<u>\$ 5,210,166</u>

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(5) Fixed Assets

Capital asset activities for the year ended September 30, 2004, are as follows:

Primary Government

	Balance October 1, 2003	Additions	Retirements	Balance September 30, 2004
Governmental activities:				
Buildings	\$ 12,681,719	\$ 569,737	\$ -	\$ 13,251,456
Infrastructure	72,885,749	-	-	72,885,749
Machinery, equipment, others	2,934,457	323,303	-	3,257,760
	<u>88,501,925</u>	<u>893,040</u>	<u>-</u>	<u>89,394,965</u>
Less accumulated depreciation:				
Buildings	(9,514,184)	(243,216)	-	(9,757,400)
Infrastructure	(40,321,648)	(1,804,957)	-	(42,126,605)
Machinery, equipment, others	(2,338,372)	(180,483)	-	(2,518,855)
	<u>(52,174,204)</u>	<u>(2,228,656)</u>	<u>-</u>	<u>(54,402,860)</u>
	<u>\$ 36,327,721</u>	<u>\$ (1,335,616)</u>	<u>\$ -</u>	<u>\$ 34,992,105</u>

During the year ended September 30, 2004, depreciation expense was charged as follows:

General government	\$ 36,142
Education	125,932
Health services	106,235
Public safety	7,500
Economic development	21,123
Public works	1,931,724
	<u>\$ 2,228,656</u>

Discretely Presented Component Units

	Balance October 1, 2003	Additions	Retirements	Balance September 30, 2004
Electrical plant in service	\$ 8,431,754	\$ 687,460	\$ (2,179)	\$ 9,117,035
Bulk plant	2,506,000	-	-	2,506,000
Building and improvements	206,802	544	-	207,346
Land	200,000	-	-	200,000
Machinery and equipment	411,904	5,480	-	417,384
Vehicles	585,074	-	(289,410)	295,664
Furniture and fixtures	61,221	300	-	61,521
	<u>12,402,755</u>	<u>693,784</u>	<u>(291,589)</u>	<u>12,804,950</u>
Less accumulated depreciation	<u>(5,547,085)</u>	<u>(672,639)</u>	<u>156,878</u>	<u>(6,062,846)</u>
	<u>6,855,670</u>	<u>21,145</u>	<u>(134,711)</u>	<u>6,742,104</u>
Construction in progress	<u>554,122</u>	<u>118,901</u>	<u>(404,207)</u>	<u>268,816</u>
	<u>\$ 7,409,792</u>	<u>\$ 140,046</u>	<u>\$ (538,918)</u>	<u>\$ 7,010,920</u>

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(6) Long-Term Obligations

Primary Government

Malem Wastewater System Project (MWSP) Loan:

During the year ended September 30, 1999, the State borrowed \$145,000 from the U.S. Department of Agriculture Rural Utilities Services for the Malem Wastewater System Project, payable in annual installments of \$8,199 commencing September 28, 2001, interest at 4.5% per annum, due September 28, 2041. As of September 30, 2004, the balance payable on this mortgage loan amounted to \$140,750.

Asian Development Bank (ADB) Early Retirement Program Loan:

During the year ended September 30, 1998, the State implemented an Early Retirement Scheme (ERS) in which employees holding certain nonessential positions as identified by the State were retired early with a payout of the equivalent of two-years' wages. This ERS program is funded by a \$2,000,000 loan from the ADB through the FSM National Government, non-interest bearing with a service charge of 1% per annum on the amount of the loan withdrawn from the Loan Account. The activities of the ERS Program are recorded in the Early Retirement Program Fund, a nonmajor governmental fund.

The ADB loan has a grace period of ten years with the first payment due in February 2008 and the last payment in August 2038. However, pursuant to the terms of the Financing Agreement between the State and the FSM National Government, the State is required to deposit into the ERS Trust account held in the name of the State within the FSM National Government investment portfolio, 100% of the outstanding principal balance by September 30, 2002.

Funds for the repayment of the ADB loan are expected to be derived from the annual appropriations for salaries and wages earmarked for the positions abolished under the Early Retirement Scheme. The Financing Agreement requires the State to continue to appropriate salaries for the abolished positions and deposit the appropriate funds into the ERS Trust Account. These funds had not been deposited to the Trust Account as of September 30, 2002. \$2,000,000 identified for future debt service payments is included in the General Fund and the Early Retirement Program Fund reserve for related assets of which \$1,386,219 is actually deposited in an investment account held jointly with the FSM National Government. That investment account is restricted for the repayment of this debt.

Annual debt service requirements to maturity for principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2005	\$ 3,253	\$ 6,264	\$ 9,517
2006	1,688	6,191	7,879
2007	1,764	6,116	7,880
2008	41,844	6,036	47,880
2009	41,927	5,953	47,880
2010 - 2014	211,014	28,385	239,399
2015 - 2019	213,726	25,673	239,399
2020 - 2024	417,105	22,294	439,399
2025 - 2029	421,316	18,083	439,399
2030 - 2034	426,563	12,836	439,399
2035 - 2039	353,010	6,296	359,306
2040	7,540	339	7,879
	<u>\$ 2,140,750</u>	<u>\$ 144,466</u>	<u>\$ 2,285,216</u>

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(6) Long-term Obligations, Continued

Primary Government, Continued

Other long-term liabilities will be liquidated in the future from governmental funds. During the year ended September 30, 2004, the following changes occurred in liabilities reported as part of the primary government's long-term liabilities in the statement of net assets:

	Balance October 1, 2003	Additions	Reductions	Balance September 30, 2004	Due Within One Year
Loans payable:					
ADB loan	\$ 2,000,000	\$ -	\$ -	\$ 2,000,000	\$ -
MWSP loan	140,750	-	-	140,750	3,253
MRP loan	94,366	-	(94,366)	-	-
	<u>2,235,116</u>	<u>-</u>	<u>(94,366)</u>	<u>2,140,750</u>	<u>3,253</u>
Other:					
Claims	150,000	50,000	-	200,000	-
	<u>\$ 2,385,116</u>	<u>\$ 50,000</u>	<u>\$ (94,366)</u>	<u>\$ 2,340,750</u>	<u>\$ 3,253</u>

Discretely Presented Component Units

Micronesia Petroleum Corporation (MPC):

Loan payable to the State, due in monthly installments of \$2,628, uncollateralized, due February 1, 2009, interest at 1% per annum. \$ 272,500

Loan payable to the FSM Development Bank in the original amount of \$500,000 due in monthly installments of \$5,100, with a balloon payment of approximately \$264,000 due at maturity. Interest is at 9%, maturity in September 2008, collateralized by property and inventory of MPC 360,725

Term loan payable to Bank of the FSM, interest at 2.75% greater than TCD rate pledged as collateral by Kosrae State Government, collateralized by a first security interest in essentially all MPC assets and a time certificate of deposit held by Kosrae State Government. 251,099

Loan payable to FSM Development Bank, ten year term, interest at 5%, monthly repayment of \$7,985. 505,224

\$ 1,389,548

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(6) Long-term Obligations, Continued

Discretely Presented Component Units, Continued

Micronesia Petroleum Corporation (MPC), Continued:

Annual debt service requirements to maturity for principal and interest are as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2005	\$ 354,350	\$ 69,066	\$ 423,416
2006	105,516	51,339	156,855
2007	112,038	44,818	156,856
2008	347,017	35,870	382,887
2009	358,594	9,906	368,500
2010 - 2014	<u>112,033</u>	<u>3,668</u>	<u>115,701</u>
	\$ <u>1,389,548</u>	\$ <u>214,677</u>	\$ <u>1,604,225</u>

(7) Contingencies and Commitments

Sick Leave

It is the policy of the State to record expenditures for sick leave when leave is actually taken. Sick leave is compensated time for absence during working hours arising from employee illness or injury. The estimated accumulated amount of unused sick leave as of September 30, 2004 is \$107,777.

Insurance Coverage

The State does not maintain insurance coverage for a significant amount of fixed assets. In the event of a catastrophe, the State may be self-insured to a material extent.

Federal Grants

The State participates in a number of federally assisted grant programs. These programs are subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Cumulative questioned costs of \$413,276 relating to fiscal years 1996 through 2004 have been set forth in the State's Single Audit Report for the year ended September 30, 2004. The ultimate disposition of these questioned costs can be determined only by final action of the respective grantor agencies. Therefore, no provision for any liability that may result upon resolution of this matter has been made in the accompanying financial statements.

Pursuant to Title I, Section 105 of United States Public Law 99-239, the Government of the Federated States of Micronesia (FSM) (which includes the State) is no longer liable for debts to U.S. federal agencies arising prior to the date of the implementation of the Compact of Free Association. This matter has not yet been officially resolved with the U.S. Government.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements
September 30, 2004

(7) Contingencies and Commitments, Continued

Litigation

The State is party to numerous legal proceedings, many of which are normal recurrences in governmental operations. The State's Attorney General is of the opinion that the probable outcome of suits existing at September 30, 2004, is not predictable but could have a material impact on the accompanying financial statements. Such impact has currently been estimated to approximate \$200,000, which has been recorded as a liability in the accompanying statement of net assets.

(8) Individual Deficit Fund Balances

Specific individual funds which had significant individual deficit fund balances as at September 30, 2004, are as follows:

Nonmajor Governmental Funds

Airport Trust Fund	\$ <u>66,429</u>
Scholarship Revolving Fund	\$ <u>23,754</u>

(9) Operating Transfers In/Out

Operating transfers in/out for each major governmental fund and nonmajor governmental funds in the aggregate, for the year ended September 30, 2004, are as follows:

<u>Source</u>	<u>Recipient</u>	<u>Transfers Out</u>	<u>Transfers In</u>
<u>Major Governmental Funds</u>			
General	Compact Trust	\$ 288,760	\$ 288,760
General	U.S. Federal Grants	304,147	304,147
General	Nonmajor governmental funds	292,375	-
Compact Capital Projects	Compact Trust	<u>1,511,240</u>	<u>1,511,240</u>
		<u>2,396,522</u>	<u>2,104,147</u>
<u>Nonmajor Governmental Funds</u>			
Compact Capital Projects	Nonmajor governmental funds	-	<u>292,375</u>
		-	<u>292,375</u>
		\$ <u>2,396,522</u>	\$ <u>2,396,522</u>

Transfers are used to 1) move revenues from the fund that enabling legislation or budget requires to collect them to the fund that enabling legislation or budget requires to expend them, 2) use unrestricted revenues collected in the General Fund to finance various programs accounted for in other funds in accordance with budgetary authorizations, and 3) record reductions in interfund loans for amounts that are not expected to be repaid.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Notes to Financial Statements
September 30, 2004

(9) Operating Transfers In/Out, Continued

During the year ended September 30, 2004, the State made a one-time transfer of \$288,760 and \$1,511,240 from the General Fund and the Compact Capital Projects Fund, respectively, to the Compact Trust Fund representing the establishment of the Trust Fund in accordance with Section 215 of the Compact of Free Association.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

**REQUIRED SUPPLEMENTARY INFORMATION-
OTHER THAN MANAGEMENT'S DISCUSSION AND ANALYSIS**

YEAR ENDED SEPTEMBER 30, 2004

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Schedule of Revenues, Expenditures and Changes in Deficit - Budget and Actual
General Fund
Year Ended September 30, 2004

	Budgeted Amounts		Actual - Budgetary Basis (see Note 1)	Variance
	Original	Final		
Revenues:				
FSM Revenue sharing	\$ 1,345,000	\$ 1,019,895	\$ 1,019,895	\$ -
State taxes	290,000	188,584	188,584	-
Investment income	70,000	207,516	207,516	-
Other	350,000	1,041,632	1,041,632	-
Total revenues	2,055,000	2,457,627	2,457,627	-
Expenditures:				
Current:				
General government	2,170,812	1,813,372	2,434,141	(620,769)
Department of Land and Natural Resources	417,773	-	804	(804)
Department of Education	1,757,192	-	48,487	(48,487)
Department of Health Services	1,073,661	154,000	175,107	(21,107)
Department of Public Safety	-	-	(120)	120
Office of the Attorney-General	412,554	-	(100)	100
Other appropriations	1,606,126	1,098,448	977,479	120,969
Payments to Non-governmental Agencies	124,884	66,000	81,955	(15,955)
Total expenditures	7,563,002	3,131,820	3,717,753	(585,933)
Deficiency of revenues under expenditures	(5,508,002)	(674,193)	(1,260,126)	(585,933)
Other financing uses:				
Operating transfers out	-	-	(885,282)	(885,282)
Net change in unreserved deficit	(5,508,002)	(674,193)	(2,145,408)	(1,471,215)
Other changes in unreserved deficit:				
Decrease in reserve for related assets	-	-	837,505	837,505
Decrease in encumbrances	-	-	148,161	148,161
Unreserved deficit at beginning of the year	(1,857,660)	(1,857,660)	(1,857,660)	-
Unreserved fund deficit at end of the year	\$ (7,365,662)	\$ (2,531,853)	\$ (3,017,402)	\$ (485,549)

See accompanying notes to required supplementary information - budgetary reporting.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Required Supplementary Information – Budgetary Reporting
September 30, 2004

(1) Budgetary Information

The Governor presents to the Kosrae State Legislature, prior to September 30, proposed budget estimates for the fiscal year commencing October 1. The budget estimates include the overall and total proposed expenditures of the State and the means of financing those expenditures. The Kosrae State Legislature reviews and approves these estimates making changes, as it deems appropriate. The Appropriation Committee of the Kosrae State Legislature, during the regular session of the Kosrae State Legislature, holds public hearings at which time Departments and Offices are required to justify their budget estimates. During the regular session of the Kosrae State Legislature, an appropriation bill, as required by the Constitution, is introduced and budget estimates are then legally enacted by the Kosrae State Legislature.

Formal budget integration is employed as a management control device during the year for all funds. The Kosrae State Legislature has the authority to reprogram budgeted estimates in accordance with the Constitution. All annual appropriations lapse at fiscal year end unless otherwise specified by law. Supplemental appropriations may occur throughout the year. Unexpended encumbrances at each fiscal year end are carried forward until they are expended or canceled without further legislative action. The State does not establish budgets for the operations of its other governmental funds.

Accounting principles used in developing data on a budgetary basis differ from those used in preparing the basic financial statements in conformity with GAAP. Amounts included on the Statement of Revenues, Expenditures, and Changes in Deficit - Budget and Actual - General Fund (which are presented on a non-GAAP budgetary basis) are reconciled to unreserved deficit of the Governmental Fund Balance Sheet within the other changes in unreserved deficit section of that statement.

Encumbrance accounting is employed in governmental funds. For budgetary purposes, the encumbrances (i.e., purchase orders, contracts) are considered expenditures when incurred. For GAAP reporting purposes, encumbrances outstanding at year end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be reappropriated and honored during the subsequent fiscal year.

For the year ended September 30, 2004, expenditures of the General Fund exceeded budget at the program area level (i.e., the legal level of budgetary control) as follows:

<u>Program Area</u>	<u>Excess</u>
Department of Administration	\$ 734,235
Department of Education	48,487
Department of Health Services	21,107
USDA Rural Development	15,911

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

OTHER SUPPLEMENTARY INFORMATION

YEAR ENDED SEPTEMBER 30, 2004

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Combining Schedule of Expenditures by Account
Governmental Funds
Year Ended September 30, 2004

		Special Revenue		Capital Projects	Permanent		
		U.S Federal	Section 211	Compact	Section 215	Other	
	General	Grants	Sector Grant	Capital Projects	Compact Trust	Governmental Funds	Total
Expenditures:							
Salaries and wages	\$ 1,620,378	\$ 600,791	\$ 3,757,107	\$ 82,637	\$ -	\$ 120,286	\$ 6,181,199
Grants and subsidies	131,500	-	-	-	-	-	131,500
Contractual services	209,321	437,922	218,808	562,952	-	48,114	1,477,117
Capital outlay	45,174	66,084	33,496	122,328	-	4,483	271,565
Utilities	138,480	17,558	165,526	-	-	13,280	334,844
Travel	331,555	278,718	87,549	7,028	-	4,657	709,507
Supplies and materials	138,153	223,921	170,054	47,998	-	103,508	683,634
Medical supplies	(1,123)	10,575	125,057	-	-	65,604	200,113
Medical referral	3,511	-	-	-	-	8,947	12,458
Scholarship and training	63,111	14,836	126,720	-	-	34,132	238,799
POL	29,524	4,596	17,335	6,048	-	3,295	60,798
Communications	42,868	73,302	33,513	1,168	-	1,814	152,665
Food stuffs	21,699	691	20,748	-	-	84	43,222
Rentals	6,170	2,017	1,460	24,230	-	40	33,917
Principal and interest payments	77,627	-	-	-	-	-	77,627
Repairs and maintenance	1,077	650	624	-	-	-	2,351
Printing and reproduction	4,399	6,021	14,417	149	-	355	25,341
Freight	5,314	108	70	-	-	-	5,492
Other	849,015	7,840	89,398	4,867	-	54,486	1,005,606
	<u>\$ 3,717,753</u>	<u>\$ 1,745,630</u>	<u>\$ 4,861,882</u>	<u>\$ 859,405</u>	<u>\$ -</u>	<u>\$ 463,085</u>	<u>\$ 11,647,755</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSREA
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function, and Changes in Fund Balance
General Fund
Year Ended September 30, 2004
(with comparative totals for the year ended September 30, 2003)

	2004	2003
Revenues:		
Compact funds:		
Current Section 211(a) base grant	\$ -	\$ 2,755,246
Current Section 217 inflation adjustment	-	1,598,043
	-	4,353,289
FSM Revenue sharing	1,019,895	1,188,438
State taxes:		
Sales tax	93,888	165,315
Alcohol and tobacco tax	66,716	-
Licenses and Fees	19,482	20,019
Tax penalties	8,498	12,455
	188,584	197,789
Investment income	207,516	306,589
Other revenues	1,041,632	150,064
Total revenues	2,457,627	6,196,169
Expenditures:		
Current:		
General government:		
Governor and staff	504,362	363,079
Department of Treasury and Administration	786,425	1,026,587
Judiciary Branch	380,622	372,173
Legislative Branch	761,314	723,387
Public Auditor	1,418	116,599
	2,434,141	2,601,825
Department of Land and Natural Resources:		
Office of the Director	804	80,880
Division of Crop Production and Research	-	70,221
Division of Livestock Production and Research	-	39,125
Division of Land Management and Preservation	-	49,083
Division of Surveying and Mapping	-	89,514
	804	328,823
Department of Education:		
Office of the Director	44,941	606,309
Division of Instructional Services	3,550	592,276
Division of Curriculum Development	536	170,066
Facilities Special Services	(540)	115,351
	48,487	1,484,002
Department of Health Services:		
Division of Administration and Health Planning	174,440	312,029
Division of Hospital Services	667	665,131
Division of Administrative Services	-	133,964
Division of Preventative Service	-	71,852
	175,107	1,182,976
Department of Public Safety:		
Division of Police and Security	-	223,284
Division of Law	(120)	102,982
	(120)	326,266
Office of the Attorney-General	(100)	88,870

See Accompanying Independent Auditors' Report.

STATE OF KOSREA
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function, and Changes in Fund Balance, Continued
General Fund
Year Ended September 30, 2004
(with comparative totals for the year ended September 30, 2003)

	2004	2003
Expenditures, continued:		
Current, continued:		
Boards, Commissions and Other:		
Transportation and Infrastructure	474,305	424,366
Community Affairs	137,365	119,452
Scholarship Board	99,027	20,669
Kosrae Utility Authority	70,000	-
Broadcast Authority	78,027	65,287
Economic Development Authority	60,336	322,397
Sports Operation	35,074	46,147
KSA Conservation and Safety Organization	10,000	-
KCAP Operations - legislative	5,000	32,000
Kosrae State Election Commission	4,442	-
Kosrae Port Authority	2,189	69,675
Parole Board	1,182	502
EPIC Conference	816	114,921
Municipal Election	-	6,000
Other	-	6,276
Development Review Commission	(284)	90,035
	<u>977,479</u>	<u>1,317,727</u>
Payments to Non-governmental Agencies:		
Micronesian Legal Services Corporation	30,000	38,000
USDA Rural Development	51,911	85,377
Kosrea Visitors Bureau	44	42,332
	<u>81,955</u>	<u>165,709</u>
Total expenditures	<u>3,717,753</u>	<u>7,496,198</u>
Deficiency of revenues under expenditures	<u>(1,260,126)</u>	<u>(1,300,029)</u>
Other financing uses:		
Operating transfers out:		
U.S. Federal Grants Fund	(596,522)	-
Section 215 Compact Trust Fund	(288,760)	-
	<u>(885,282)</u>	<u>-</u>
Net change in fund balance	(2,145,408)	(1,300,029)
Fund balance at the beginning of the year	<u>2,573,871</u>	<u>3,873,900</u>
Fund balance at the end of the year	<u>\$ 428,463</u>	<u>\$ 2,573,871</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function and Changes in Fund Balance (Deficit)
Budget and Actual - General Fund
Year Ended September 30, 2004

	Budgeted Amounts		Actual Amounts	Variance
	Original	Final		
Revenues:				
FSM Revenue sharing:	\$ 1,345,000	\$ 1,019,895	\$ 1,019,895	\$ -
State taxes:				
Sales tax	200,000	93,888	93,888	-
Alcohol and tobacco tax	65,000	66,716	66,716	-
Licenses and Fees	18,000	19,482	19,482	-
Tax penalties	7,000	8,498	8,498	-
	<u>290,000</u>	<u>188,584</u>	<u>188,584</u>	<u>-</u>
Investment income	70,000	207,516	207,516	-
Other revenues	350,000	1,041,632	1,041,632	-
Total revenues	<u>2,055,000</u>	<u>2,457,627</u>	<u>2,457,627</u>	<u>-</u>
Expenditures:				
Current:				
General government:				
Governor and staff	275,102	511,703	504,362	7,341
Department of Treasury and Administration	538,633	52,190	786,425	(734,235)
Judiciary Branch	400,559	404,940	380,622	24,318
Legislative Branch	851,839	844,539	761,314	83,225
Public Auditor	104,679	-	1,418	(1,418)
	<u>2,170,812</u>	<u>1,813,372</u>	<u>2,434,141</u>	<u>(620,769)</u>
Department of Land and Natural Resources:				
Office of the Director	417,773	-	804	(804)
	<u>417,773</u>	<u>-</u>	<u>804</u>	<u>(804)</u>
Department of Education:				
Office of the Director	1,757,192	-	44,941	(44,941)
Division of Instructional Services	-	-	3,550	(3,550)
Division of Curriculum Development	-	-	536	(536)
Facilities Special Services	-	-	(540)	540
	<u>1,757,192</u>	<u>-</u>	<u>48,487</u>	<u>(48,487)</u>
Department of Health Services:				
Division of Administration and Health Planning	1,073,661	154,000	174,440	(20,440)
Division of Hospital Services	-	-	667	(667)
	<u>1,073,661</u>	<u>154,000</u>	<u>175,107</u>	<u>(21,107)</u>
Department of Public Safety:				
Division of Law	-	-	(120)	120
	<u>-</u>	<u>-</u>	<u>(120)</u>	<u>120</u>
Office of the Attorney-General	412,554	-	(100)	100

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function and Changes in Fund Balance (Deficit), Continued
Budget and Actual - General Fund
Year Ended September 30, 2004

	Budgeted Amounts		Actual Amounts	Variance
	Original	Final		
Expenditures, continued:				
Current, continued:				
Boards, Commissions and Other:				
Transportation and Infrastructure	601,281	601,281	474,305	126,976
Community Affairs	148,166	139,307	137,365	1,942
Scholarship Board	154,479	90,231	99,027	(8,796)
Kosrae Utility Authority	70,000	70,000	70,000	-
Broadcast Authority	75,673	75,673	78,027	(2,354)
Economic Development Authority	213,401	56,606	60,336	(3,730)
Sports Operation	-	43,483	35,074	8,409
KSA Conservation and Safety Organization	-	10,000	10,000	-
KCAP Operations - legislative	-	5,000	5,000	-
Kosrae State Election Commission	-	5,000	4,442	558
Kosrae Port Authority	216,944	-	2,189	(2,189)
Parole Board	1,300	1,300	1,182	118
EPIC Conference	-	-	816	(816)
Other	124,882	-	-	-
Development Review Commission	-	567	(284)	851
	<u>1,606,126</u>	<u>1,098,448</u>	<u>977,479</u>	<u>120,969</u>
Payments to Non-governmental Agencies:				
Micronesian Legal Services Corporation	30,000	30,000	30,000	-
USDA Rural Development	52,000	36,000	51,911	(15,911)
Kosrea Visitors Bureau	42,884	-	44	(44)
	<u>124,884</u>	<u>66,000</u>	<u>81,955</u>	<u>(15,955)</u>
Total expenditures	<u>7,563,002</u>	<u>3,131,820</u>	<u>3,717,753</u>	<u>(585,933)</u>
Deficiency of revenues under expenditures	<u>(5,508,002)</u>	<u>(674,193)</u>	<u>(1,260,126)</u>	<u>(585,933)</u>
Other financing uses:				
Operating transfers out				
U.S. Federal Grants Fund	-	-	(596,522)	(596,522)
Section 215 Compact Trust Fund	-	-	(288,760)	(288,760)
	<u>-</u>	<u>-</u>	<u>(885,282)</u>	<u>(885,282)</u>
Net change in unreserved deficit	<u>(5,508,002)</u>	<u>(674,193)</u>	<u>(2,145,408)</u>	<u>(1,471,215)</u>
Other changes in unreserved deficit:				
Decrease in reserve for related assets	-	-	837,505	837,505
Decrease in encumbrances	-	-	148,161	148,161
Unreserved deficit at the beginning of the year	<u>(1,857,660)</u>	<u>(1,857,660)</u>	<u>(1,857,660)</u>	<u>-</u>
Unreserved fund balance (deficit) at the end of the year	<u>\$ (7,365,662)</u>	<u>\$ (2,531,853)</u>	<u>\$ (3,017,402)</u>	<u>\$ (485,549)</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Combined Balance Sheet
Nonmajor Governmental Funds
September 30, 2004

	Other Special Revenue	Other Capital Projects	Total
<u>ASSETS</u>			
Cash and equivalents	\$ 1,279	\$ -	\$ 1,279
Receivables:			
CFSM	-	469,409	469,409
Other	44,599	-	44,599
General	24,477	-	24,477
Advances	87,461	10,247	97,708
Loans receivable	507,051		507,051
Due from other funds	1,018,633	-	1,018,633
Restricted assets:			
Cash and equivalents	477,605	-	477,605
Investments	1,386,219	-	1,386,219
Total assets	<u>\$ 3,547,324</u>	<u>\$ 479,656</u>	<u>\$ 4,026,980</u>
<u>LIABILITIES AND FUND BALANCES</u>			
Liabilities:			
Accounts payable	\$ 133,785	\$ (939)	\$ 132,846
Other liabilities and accruals	3,088	5,552	8,640
Due to other funds	83,432	475,043	558,475
Deferred Revenue	463,252	-	463,252
Total liabilities	<u>683,557</u>	<u>479,656</u>	<u>1,163,213</u>
Fund balances:			
Reserved for:			
Related assets	1,776,836	-	1,776,836
Encumbrances	294,975	99,008	393,983
Continuing appropriations	105,770	22,200	127,970
Unreserved:			
Special revenue funds	686,186	-	686,186
Capital projects funds	-	(121,208)	(121,208)
Total fund balances	<u>2,863,767</u>	<u>-</u>	<u>2,863,767</u>
Total liabilities and fund balances	<u>\$ 3,547,324</u>	<u>\$ 479,656</u>	<u>\$ 4,026,980</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Combined Statement of Revenues, Expenditures by Function,
and Changes in Fund Balances (Deficits)
Nonmajor Governmental Funds
Year Ended September 30, 2004

	Other Special Revenue	Other Capital Projects	Total
Revenues:			
Investment income	\$ 49,706	\$ -	\$ 49,706
CFSM grants	-	23,597	23,597
Fees and charges	308,199	-	308,199
Other grants	77,034	-	77,034
Other	-	-	-
Total revenues	<u>434,939</u>	<u>23,597</u>	<u>458,536</u>
Expenditures by function:			
Current:			
General government	252,662	-	252,662
Education	26,679	-	26,679
Health services	101,001	-	101,001
Resources and development	35	-	35
Boards, Commissions, others	59,111	-	59,111
Capital projects	-	23,597	23,597
Total expenditures	<u>439,488</u>	<u>23,597</u>	<u>463,085</u>
Excess of revenues over expenditures	(4,549)	-	(4,549)
Other financing sources:			
Operating transfer in	<u>242,451</u>	<u>49,924</u>	<u>292,375</u>
Net change in fund balances	<u>237,902</u>	<u>49,924</u>	<u>287,826</u>
Fund balances (deficits) at the beginning of the year	<u>2,625,865</u>	<u>(49,924)</u>	<u>2,575,941</u>
Fund balances at the end of the year	<u>\$ 2,863,767</u>	<u>\$ -</u>	<u>\$ 2,863,767</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Combined Statement of Revenues, Expenditures by Account,
and Changes in Fund Balances (Deficits)
Nonmajor Governmental Funds
Year Ended September 30, 2004

	Other Special Revenue	Other Capital Projects	Total
Revenues:			
Investment income	\$ 49,706	\$ -	\$ 49,706
CFSM grants	-	23,597	23,597
Fees and charges	308,199	-	308,199
Other grants	77,034	-	77,034
Other	-	-	-
Total revenues	<u>434,939</u>	<u>23,597</u>	<u>458,536</u>
Expenditures by account:			
Salaries and wages	112,286	8,000	120,286
Contractual services	48,114	-	48,114
Capital outlay	4,483	-	4,483
Utilities	6,776	6,504	13,280
Travel	1,518	3,139	4,657
Supplies and materials	100,024	3,484	103,508
Medical supplies	65,604	-	65,604
Medical referral	8,947	-	8,947
Scholarship and training	34,132	-	34,132
POL	2,173	1,122	3,295
Communications	466	1,348	1,814
Food stuffs	84	-	84
Rentals	40	-	40
Printing and reproduction	355	-	355
Other	54,486	-	54,486
	<u>439,488</u>	<u>23,597</u>	<u>463,085</u>
Excess of revenues over expenditures	(4,549)	-	(4,549)
Other financing sources:			
Operating transfer in	242,451	49,924	292,375
Net change in fund balances	237,902	49,924	287,826
Fund balances (deficits) at the beginning of the year	2,625,865	(49,924)	2,575,941
Fund balances at the end of the year	<u>\$ 2,863,767</u>	<u>\$ -</u>	<u>\$ 2,863,767</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
SPECIAL REVENUE FUNDS

Combining Balance Sheet
September 30, 2004

	Compact Special Block 211(b)	Compact Health & Medical 216(a)(2)	Compact Scholarship 216(a)(3)	Compact Energy Block Grant 214	Compact Special Development 212(b)	Foreign Assistance	Airport Revolving	Agriculture Revolving	Fisherman	Production Loan
ASSETS										
Cash and equivalents	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 407	\$ -	\$ -
Receivables, net:										
Other governments	-	-	-	-	-	14,599	-	-	-	-
General, net	-	-	-	-	-	-	2,020	18,743	-	-
Advances	-	78,636	-	-	-	-	-	8,825	-	-
Loans Receivable	-	-	-	-	-	-	-	-	-	-
Due from other funds	129,304	149,601	2,692	153	49,015	48,248	-	-	69	1,495
Restricted:										
Cash and equivalents	-	-	-	-	-	-	-	-	-	-
Investments	-	-	-	-	-	-	-	-	-	-
Total assets	\$ 129,304	\$ 228,237	\$ 2,692	\$ 153	\$ 49,015	\$ 62,847	\$ 2,020	\$ 27,975	\$ 69	\$ 1,495
LIABILITIES AND FUND BALANCES (DEFICITS)										
Liabilities:										
Accounts payable	\$ 13,153	\$ 3,638	\$ 2,692	\$ 153	\$ 20,355	\$ 4,784	\$ 1,925	\$ -	\$ -	\$ -
Other liabilities and accruals	3,166	-	-	-	-	(78)	-	-	-	-
Due to other funds	-	-	-	-	-	66,524	-	-	-	-
Deferred Revenue	-	-	-	-	-	63,252	-	-	-	-
Total liabilities	16,319	3,638	2,692	153	20,355	67,958	68,449	-	-	-
Fund balances (deficits):										
Reserved for:										
Related assets	-	-	-	-	-	-	-	-	-	-
Encumbrances	-	6,370	373	-	4,670	1,494	1,938	-	-	-
Continuing appropriations	-	-	373	-	105,397	-	-	-	-	-
Unreserved (deficit)	112,985	218,229	(746)	-	(81,407)	(6,605)	(68,367)	27,975	69	1,495
Total fund balances (deficits)	112,985	224,599	-	-	28,660	(5,111)	(66,429)	27,975	69	1,495
Total liabilities and fund balances (deficits)	\$ 129,304	\$ 228,237	\$ 2,692	\$ 153	\$ 49,015	\$ 62,847	\$ 2,020	\$ 27,975	\$ 69	\$ 1,495

See Accompanying Independent Auditors' Report.

STATE OF POHNPEI
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
SPECIAL REVENUE FUNDS

Combining Balance Sheet, Continued
September 30, 2004

	Scholarship Revolving Loan	Housing Revolving	Aluminum Recycling	Tourism Revolving	Health Care	Sports Council	Early Retirement Program	Broadcast Authority	Gifford Scholarship	Total
ASSETS										
Investments	\$ -	\$ -	\$ -	872	\$ -	-	\$ -	\$ -	-	\$ 1,279
Receivables, net:										
Other governments	-	-	-	-	30,000	-	-	-	-	44,599
General, net	-	-	-	-	3,714	-	-	-	-	24,477
Advances	-	-	-	-	-	-	-	-	-	87,461
Loans Receivable	-	507,051	-	-	-	-	-	-	-	507,051
Due from other funds	-	277,696	53,527	-	132,725	582	170,667	2,859	-	1,018,633
Restricted:										
Cash and equivalents	-	-	-	-	-	-	162,605	-	315,000	477,605
Investments	-	-	-	-	-	-	1,386,219	-	-	1,386,219
Total assets	\$ -	\$ 784,747	\$ 53,527	\$ 872	\$ 166,439	\$ 582	\$ 1,719,491	\$ 2,859	\$ 315,000	\$ 3,547,324
LIABILITIES AND FUND BALANCES (DEFICITS)										
Liabilities:										
Accounts payable	\$ 9,823	\$ 55,096	\$ -	\$ -	\$ 22,166	\$ -	\$ -	\$ -	\$ -	\$ 133,785
Other liabilities and accruals	-	-	-	-	-	-	-	-	-	3,088
Due to other funds	13,931	-	-	-	-	-	-	-	2,977	83,432
Deferred Revenue	-	-	-	-	-	-	400,000	-	-	463,252
Total liabilities	23,754	55,096	-	-	22,166	-	400,000	-	2,977	683,557
Fund balances (deficits):										
Reserved for:										
Related assets	-	507,051	-	-	-	-	1,269,785	-	-	1,776,836
Encumbrances	-	224,508	-	-	53,304	409	-	1,909	-	294,975
Continuing appropriations	-	-	-	-	-	-	-	-	-	105,770
Unreserved (deficit)	(23,754)	(1,908)	53,527	872	90,969	173	49,706	950	312,023	686,186
Total fund balances (deficits)	(23,754)	729,651	53,527	872	144,273	582	1,319,491	2,859	312,023	2,863,767
Total liabilities and fund balances (deficits)	\$ -	\$ 784,747	\$ 53,527	\$ 872	\$ 166,439	\$ 582	\$ 1,719,491	\$ 2,859	\$ 315,000	\$ 3,547,324

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
SPECIAL REVENUE FUNDS

Combining Statement of Revenues, Expenditures By Function,
and Changes in Fund Balances (Deficits)
Year Ended September 30, 2004

	Compact Special Block 211(b)	Compact Health & Medical 216(a)(2)	Compact Scholarship 216(a)(3)	Compact Energy Block Grant 214	Compact Special Development 212(b)	Foreign Assistance	Airport Revolving	Agriculture Revolving	Fisherman	Production Loan
Revenues:										
Compact funding	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Investment income	-	-	-	-	-	-	-	-	-	-
Fees and charges	-	-	-	-	-	-	65,627	-	-	-
Other grants	-	-	-	-	-	20,900	-	-	-	-
Other	-	-	-	-	-	-	-	-	-	-
Total revenues	-	-	-	-	-	20,900	65,627	-	-	-
Expenditures by function:										
Current:										
General government	-	-	-	-	38,793	3,717	132,056	-	-	-
Education	(7,453)	-	-	-	-	-	-	-	-	-
Health services	-	(1,560)	-	-	-	1,359	-	-	-	-
Resources and development	-	-	-	-	-	35	-	-	-	-
Boards, commissions and other	-	-	-	-	-	-	-	-	-	-
Total expenditures	(7,453)	(1,560)	-	-	38,793	5,111	132,056	-	-	-
Excess (deficiency) of revenues over (under) expenditures	7,453	1,560	-	-	(38,793)	15,789	(66,429)	-	-	-
Other financing sources (uses):										
Operating transfer in (out)	-	-	34,193	7,453	-	169,296	18,230	-	-	-
Net change in fund balances (deficits)	7,453	1,560	34,193	7,453	(38,793)	185,085	(48,199)	-	-	-
Fund balances (deficits) at the beginning of the year	105,532	223,039	(34,193)	(7,453)	67,453	(190,196)	(18,230)	27,975	69	1,495
Fund balances (deficits) at the end of the year	\$ 112,985	\$ 224,599	\$ -	\$ -	\$ 28,660	\$ (5,111)	\$ (66,429)	\$ 27,975	\$ 69	\$ 1,495

See Accompanying Independent Auditors' Report.

STATE OF POHNPEI
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
SPECIAL REVENUE FUNDS

Combining Statement of Revenues, Expenditures By Function,
and Changes in Fund Balances (Deficits), Continued
Year Ended September 30, 2004

	Scholarship Revolving Loan	Housing Revolving	Aluminum Recycling	Tourism Revolving	Health Care	Sports Council	Early Retirement Program	Broadcast Authority	Gifford Scholarship	Total
Revenues:										
Compact funding	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Investment income	-	-	-	-	-	-	49,706	-	-	49,706
Fees and charges	10,378	38,381	76,096	-	113,037	111	-	4,569	-	308,199
Other grants	-	-	-	-	-	-	-	-	56,134	77,034
Other	-	-	-	-	-	-	-	-	-	-
Total revenues	10,378	38,381	76,096	-	113,037	111	49,706	4,569	56,134	434,939
Expenditures by function:										
Current:										
General government	-	-	75,000	-	-	298	-	2,798	-	252,662
Education	34,132	-	-	-	-	-	-	-	-	26,679
Health services	-	-	-	-	101,202	-	-	-	-	101,001
Resources and development	-	-	-	-	-	-	-	-	-	35
Boards, commissions and other	-	-	-	-	-	-	-	-	59,111	59,111
Total expenditures	34,132	-	75,000	-	101,202	298	-	2,798	59,111	439,488
Excess (deficiency) of revenues over (under) expenditures	(23,754)	38,381	1,096	-	11,835	(187)	49,706	1,771	(2,977)	(4,549)
Other financing sources (uses):										
Operating transfer in (out)	13,279	-	-	-	-	-	-	-	-	242,451
Net change in fund balances (deficits)	(10,475)	38,381	1,096	-	11,835	(187)	49,706	1,771	(2,977)	237,902
Fund balances (deficits) at the beginning of the year	(13,279)	691,270	52,431	872	132,438	769	1,269,785	1,088	315,000	2,625,865
Fund balances (deficits) at the end of the year	\$ (23,754)	\$ 729,651	\$ 53,527	\$ 872	\$ 144,273	\$ 582	\$ 1,319,491	\$ 2,859	\$ 312,023	\$ 2,863,767

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
SPECIAL REVENUE FUNDS

Combining Statement of Revenues, Expenditures By Account,
and Changes in Fund Balances (Deficits)
Year Ended September 30, 2004

	Compact Special Block 211(b)	Compact Health & Medical 216(a)(2)	Compact Scholarship 216(a)(3)	Compact Energy Block Grant 214	Compact Special Development 212(b)	Foreign Assistance	Airport Revolving	Agriculture Revolving	Fisherman	Production Loan
Revenues:										
Compact funding	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Investment income	-	-	-	-	-	-	-	-	-	-
Fees and charges	-	-	-	-	-	-	65,627	-	-	-
Other grants	-	-	-	-	-	20,900	-	-	-	-
Other	-	-	-	-	-	-	-	-	-	-
Total revenues	-	-	-	-	-	20,900	65,627	-	-	-
Expenditures by account:										
Salaries and wages	-	-	-	-	-	-	112,286	-	-	-
Contractual services	-	-	-	-	36,217	100	7,865	-	-	-
Capital outlay	-	-	-	-	-	2,883	-	-	-	-
Utilities	-	-	-	-	-	-	5,964	-	-	-
Travel	-	-	-	-	180	-	1,338	-	-	-
Supplies and materials	-	-	-	-	124	1,569	1,735	-	-	-
Medical supplies	-	-	-	-	-	-	-	-	-	-
Medical referral	-	-	-	-	(174)	-	-	-	-	-
Scholarship and training	-	-	-	-	(554)	-	2,408	-	-	-
POL	-	-	-	-	-	319	-	-	-	-
Communications	-	-	-	-	-	200	-	-	-	-
Food stuffs	-	-	-	-	-	-	-	-	-	-
Rentals	-	-	-	-	-	40	-	-	-	-
Printing and reproduction	-	-	-	-	-	-	-	-	-	-
Other	(7,453)	(1,560)	-	-	3,000	-	460	-	-	-
	(7,453)	(1,560)	-	-	38,793	5,111	132,056	-	-	-
Excess (deficiency) of revenues over (under) expenditures	7,453	1,560	-	-	(38,793)	15,789	(66,429)	-	-	-
Other financing sources (uses):										
Operating transfer in (out)	-	-	34,193	7,453	-	169,296	18,230	-	-	-
Net change in fund balances (deficits)	7,453	1,560	34,193	7,453	(38,793)	185,085	(48,199)	-	-	-
Fund balances (deficits) at the beginning of the year	105,532	223,039	(34,193)	(7,453)	67,453	(190,196)	(18,230)	27,975	69	1,495
Fund balances (deficits) at the end of the year	\$ 112,985	\$ 224,599	\$ -	\$ -	\$ 28,660	\$ (5,111)	\$ (66,429)	\$ 27,975	\$ 69	\$ 1,495

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA
NONMAJOR GOVERNMENTAL FUNDS
SPECIAL REVENUE FUNDS

Combining Statement of Revenues, Expenditures By Account,
and Changes in Fund Balances (Deficits), Continued
Year Ended September 30, 2004

	Scholarship Revolving Loan	Housing Revolving	Aluminum Recycling	Tourism Revolving	Health Care	Sports Council	Early Retirement Program	Broadcast Authority	Gifford Scholarship	Total
Revenues:										
Compact funding	\$ -	\$ -	\$ -	\$ -	\$ -	-	-	\$ -	-	\$ -
Investment income	-	-	-	-	-	-	49,706	-	-	49,706
Fees and charges	10,378	38,381	76,096	-	113,037	111	-	4,569	-	308,199
Other grants	-	-	-	-	-	-	-	-	56,134	77,034
Other	-	-	-	-	-	-	-	-	-	-
Total revenues	10,378	38,381	76,096	-	113,037	111	49,706	4,569	56,134	434,939
Expenditures by account:										
Salaries and wages	-	-	-	-	-	-	-	-	-	112,286
Contractual services	-	-	-	-	3,932	-	-	-	-	48,114
Capital outlay	-	-	-	-	-	-	-	1,600	-	4,483
Utilities	-	-	-	-	812	-	-	-	-	6,776
Travel	-	-	-	-	-	-	-	-	-	1,518
Supplies and materials	-	-	75,000	-	20,184	298	-	1,114	-	100,024
Medical supplies	-	-	-	-	65,604	-	-	-	-	65,604
Medical referral	-	-	-	-	9,121	-	-	-	-	8,947
Scholarship and training	34,132	-	-	-	-	-	-	-	-	34,132
POL	-	-	-	-	-	-	-	-	-	2,173
Communications	-	-	-	-	266	-	-	-	-	466
Food stuffs	-	-	-	-	-	-	-	84	-	84
Rentals	-	-	-	-	-	-	-	-	-	40
Printing and reproduction	-	-	-	-	355	-	-	-	-	355
Other	-	-	-	-	928	-	-	-	-	466
Total expenditures	34,132	-	75,000	-	101,202	298	-	2,798	59,111	54,486
Excess (deficiency) of revenues over (under) expenditures	(23,754)	38,381	1,096	-	11,835	(187)	49,706	1,771	(2,977)	(4,549)
Other financing sources (uses):										
Operating transfer in (out)	13,279	-	-	-	-	-	-	-	-	242,451
Net change in fund balances (deficits)	(10,475)	38,381	1,096	-	11,835	(187)	49,706	1,771	(2,977)	237,902
Fund balances (deficits) at the beginning of the year	(13,279)	691,270	52,431	872	132,438	769	1,269,785	1,088	315,000	2,625,865
Fund balances (deficits) at the end of the year	\$ (23,754)	\$ 729,651	\$ 53,527	\$ 872	\$ 144,273	\$ 582	\$ 1,319,491	\$ 2,859	\$ 312,023	\$ 2,863,767

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA
NONMAJOR GOVERNMENTAL FUNDS
CAPITAL PROJECTS FUNDS

Combining Balance Sheet
September 30, 2004

	TTG Capital Projects	CFSM Projects Fund	Total
<u>ASSETS</u>			
Receivables, net:			
CFSM	\$ -	\$ 469,409	\$ 469,409
Advances	10,247	-	10,247
	<u>\$ 10,247</u>	<u>\$ 469,409</u>	<u>\$ 479,656</u>
 <u>LIABILITIES AND FUND BALANCES (DEFICITS)</u>			
Liabilities:			
Accounts payable	\$ (3,287)	\$ 2,348	\$ (939)
Accrued payroll and others	5,552	-	\$ 5,552
Due to other funds	7,982	467,061	475,043
Total liabilities	<u>10,247</u>	<u>469,409</u>	<u>479,656</u>
Fund balances (deficits):			
Reserved for:			
Encumbrances	-	99,008	99,008
Continuing appropriations	-	22,200	22,200
Unreserved	<u>-</u>	<u>(121,208)</u>	<u>(121,208)</u>
Total fund balances	<u>-</u>	<u>-</u>	<u>-</u>
Total liabilities and fund balances	<u>\$ 10,247</u>	<u>\$ 469,409</u>	<u>\$ 479,656</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
CAPITAL PROJECTS FUNDS

Combining Statement of Expenditures by Function,
and Changes in Fund Balances (Deficit)
Year Ended September 30, 2004

	TTG Capital Projects	CFSM Projects Fund	Total
Revenues:			
CFSM grants	\$ -	\$ 23,597	\$ 23,597
	-	23,597	23,597
Expenditures by function:			
Capital projects	-	23,597	23,597
Total expenditures	-	23,597	23,597
Excess of revenues over expenditures	-	-	-
Other financing sources:			
Operating transfer in	-	49,924	49,924
Net change in fund balances (deficits)	-	49,924	49,924
Fund balances (deficit) at the beginning of the year	-	(49,924)	(49,924)
Fund balances at the end of the year	\$ -	\$ -	\$ -

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS
CAPITAL PROJECTS FUNDS

Combining Statement of Expenditures by Account,
and Changes in Fund Balances (Deficit)
Year Ended September 30, 2004

	TTG Capital Projects	CFSM Projects Fund	Total
Revenues:			
CFSM grants	\$ -	\$ 23,597	\$ 23,597
	-	23,597	23,597
Expenditures by account:			
Salaries and wages	-	8,000	8,000
Utilities	-	6,504	6,504
Travel	-	3,139	3,139
Supplies and materials	-	3,484	3,484
POL	-	1,122	1,122
Communications	-	1,348	1,348
Total expenditures	-	23,597	23,597
Excess of revenues over expenditures	-	-	-
Other financing sources:			
Operating transfer in	-	49,924	49,924
Net change in fund balances (deficits)	-	49,924	49,924
Fund balances (deficit) at the beginning of the year	-	(49,924)	(49,924)
Fund balances at the end of the year	\$ -	\$ -	\$ -

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

SECTION 211 COMPACT SECTOR FUNDS

Combining Balance Sheet
September 30, 2004

	Section 211(a)(1) Education Sector	Section 211(a)(2) Health Sector	Section 211(a)(3) Private Sector Development	Section 211(a)(4) Capacity Building	Section 211(a)(5) Environment	Section 211(a)(6) Infrastructure	Total
ASSETS							
Receivables, net:							
Other	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 35,827	\$ 35,827
Due from other funds	9,193	214,250	291,504	9,013	14,791	-	538,751
Advances	-	-	-	-	-	-	-
	<u>\$ 9,193</u>	<u>\$ 214,250</u>	<u>\$ 291,504</u>	<u>\$ 9,013</u>	<u>\$ 14,791</u>	<u>\$ 35,827</u>	<u>\$ 574,578</u>
LIABILITIES AND FUND BALANCES							
Liabilities:							
Accounts payable	\$ 9,978	\$ 2,307	\$ 17,275	\$ 9,336	\$ 3,805	\$ 6,621	\$ 49,322
Due to other funds	-	-	-	-	-	29,206	29,206
Deferred revenue	-	211,945	274,229	-	10,986	-	497,160
Total liabilities	<u>9,978</u>	<u>214,252</u>	<u>291,504</u>	<u>9,336</u>	<u>14,791</u>	<u>35,827</u>	<u>575,688</u>
Fund balances (deficits):							
Reserved for:							
Encumbrances	10,143	229,899	82,376	33,455	2,715	16,535	375,123
Unreserved	(10,928)	(229,901)	(82,376)	(33,778)	(2,715)	(16,535)	(376,233)
Total fund balances (deficits)	<u>(785)</u>	<u>(2)</u>	<u>-</u>	<u>(323)</u>	<u>-</u>	<u>-</u>	<u>(1,110)</u>
Total liabilities and fund balances	<u>\$ 9,193</u>	<u>\$ 214,250</u>	<u>\$ 291,504</u>	<u>\$ 9,013</u>	<u>\$ 14,791</u>	<u>\$ 35,827</u>	<u>\$ 574,578</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

SECTION 211 COMPACT SECTOR FUNDS

Combining Statement of Expenditures by Account,
and Changes in Fund Balances (Deficit)
Year Ended September 30, 2004

	Section 211(a)(1) Education Sector	Section 211(a)(2) Health Sector	Section 211(a)(3) Private Sector Development	Section 211(a)(4) Capacity Building	Section 211(a)(5) Environment	Section 211(a)(6) Infrastructure	Total
Revenues:							
Compact funding	\$ 1,883,839	\$ 1,114,715	\$ 557,444	\$ 977,413	\$ 291,534	\$ 35,827	\$ 4,860,772
	<u>1,883,839</u>	<u>1,114,715</u>	<u>557,444</u>	<u>977,413</u>	<u>291,534</u>	<u>35,827</u>	<u>4,860,772</u>
Expenditures by function:							
Current:							
General government	-	-	557,444	977,736	291,534	35,827	1,862,541
Education	1,884,624	-	-	-	-	-	1,884,624
Health services	-	1,114,717	-	-	-	-	1,114,717
Total expenditures	<u>1,884,624</u>	<u>1,114,717</u>	<u>557,444</u>	<u>977,736</u>	<u>291,534</u>	<u>35,827</u>	<u>4,861,882</u>
Net change in fund balances	(785)	(2)	-	(323)	-	-	(1,110)
Fund balances at the beginning of the year	-	-	-	-	-	-	-
Fund balances (deficits) at the end of the year	<u>\$ (785)</u>	<u>\$ (2)</u>	<u>\$ -</u>	<u>\$ (323)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (1,110)</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

SECTION 211 COMPACT SECTOR FUNDS

Combining Statement of Expenditures by Account,
and Changes in Fund Balances (Deficit)
Year Ended September 30, 2004

	Section 211(a)(1) Education Sector	Section 211(a)(2) Health Sector	Section 211(a)(3) Private Sector Development	Section 211(a)(4) Capacity Building	Section 211(a)(5) Environment	Section 211(a)(6) Infrastructure	Total
Revenues:							
Compact funding	\$ 1,883,839	\$ 1,114,715	\$ 557,444	\$ 977,413	\$ 291,534	\$ 35,827	\$ 4,860,772
	<u>1,883,839</u>	<u>1,114,715</u>	<u>557,444</u>	<u>977,413</u>	<u>291,534</u>	<u>35,827</u>	<u>4,860,772</u>
Expenditures by account:							
Salaries and wages	1,600,179	739,479	377,994	776,332	261,715	1,408	3,757,107
Contractual services	28,000	120,746	33,320	34,049	1,277	1,416	218,808
Utilities	54,957	60,000	9,803	17,050	1,923	21,793	165,526
Supplies and materials	35,650	3,700	106,461	17,507	3,820	2,916	170,054
POL	2,737	1,719	4,095	5,195	3,589	-	17,335
Medical supplies	-	125,057	-	-	-	-	125,057
Scholarship and training	126,661	-	59	-	-	-	126,720
Capital outlay	6,000	24,996	-	2,500	-	-	33,496
Travel	-	9,989	9,259	62,127	6,174	-	87,549
Communications	2,858	5,400	5,163	15,447	3,181	1,464	33,513
Repairs and maintenance	-	-	110	432	82	-	624
Printing and reproduction	2,264	1,896	3,682	6,417	158	-	14,417
Freight	-	70	-	-	-	-	70
Rentals	-	-	1,425	-	-	35	1,460
Food stuffs	378	15,495	192	4,683	-	-	20,748
Leased housing/land	24,690	6,170	5,881	30,319	7,065	6,595	80,720
Training	-	-	-	4,763	1,550	-	6,313
Other	250	-	-	915	1,000	200	2,365
Total expenditures	<u>1,884,624</u>	<u>1,114,717</u>	<u>557,444</u>	<u>977,736</u>	<u>291,534</u>	<u>35,827</u>	<u>4,861,882</u>
Net change in fund balances	(785)	(2)	-	(323)	-	-	(1,110)
Fund balances at the beginning of the year	-	-	-	-	-	-	-
Fund balances (deficits) at the end of the year	<u>\$ (785)</u>	<u>\$ (2)</u>	<u>\$ -</u>	<u>\$ (323)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (1,110)</u>

See Accompanying Independent Auditors' Report.

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

Honorable Rensley A. Sigrah
Governor, State of Kosrae
Federated States of Micronesia:

We have audited the financial statements of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Kosrae as of and for the year ended September 30, 2004, and have issued our report thereon dated May 29, 2006, which report was qualified due to our inability to: 1) examine evidence regarding the investments of the Compact Capital Projects Fund in SEMO-Micronesia, Inc.; and 2) assure ourselves as to the propriety of advances receivable of the General Fund, the Compact Capital Projects Fund, and the aggregate remaining fund information; receivables from federal agencies of the Federal Grants Fund; and loans receivable of the aggregate remaining fund information. Except as discussed in the preceding sentence, 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.

Internal Control Over Financial Reporting

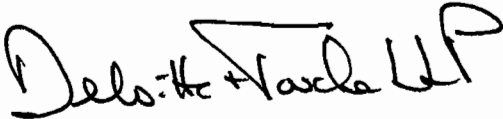
In planning and performing our audit, we considered the State of Kosrae's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect the State of Kosrae's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs (pages 74 through 91) as items 2004-10 through 2004-18.

A material weakness is a reportable 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 caused by error or fraud 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items 2004-14 and 2004-15 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Kosrae's financial statements are free of 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the management of the State of Kosrae, federal awarding agencies, pass-through entities, and the cognizant audit and other federal agencies, and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink, appearing to read "Delo:the + Naele LP". The signature is stylized with a large, looped initial "D" and a long horizontal line extending to the right.

May 29, 2006

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

Honorable Rensley A. Sigrah
Governor, State of Kosrae
Federated States of Micronesia:

Compliance

We have audited the compliance of the State of Kosrae 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 each of its major federal programs for the year ended September 30, 2004. The State of Kosrae's major federal programs are identified in the summary of auditors' results section of the accompanying Schedule of Findings and Questioned Costs (pages 74 through 91). Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the State of Kosrae's management. Our responsibility is to express an opinion on the State of Kosrae's compliance based on our audit.

We conducted our audit of compliance 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 the State of Kosrae'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 the State of Kosrae's compliance with those requirements.

As described in items 2004-01 through 2004-09 in the accompanying Schedule of Findings and Questioned Costs, the State of Kosrae did not comply with requirements regarding allowable costs/cost principles, period of availability, procurement, reporting, and cash management that are applicable to its Freely Associated States-Education Grant Program (CFDA 84.256), Special Education-Grants to States (CFDA 84.027) and U.S. Department of the Interior Compact Sector Grants (CFDA 15.875) described in the Federal Award Findings and Questioned Costs Section of the accompanying Schedule of Findings and Questioned Costs. Compliance with such requirements is necessary, in our opinion, for the State of Kosrae to comply with the requirements applicable to those programs.

In our opinion, except for the noncompliance described in the preceding paragraph, the State of Kosrae complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2004.

Internal Control Over Compliance

The management of the State of Kosrae is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the State of Kosrae'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 the internal control over compliance in accordance with OMB Circular A-133.

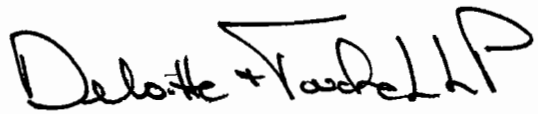
We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the State of Kosrae's ability to administer a major federal program in accordance with applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as items 2004-01 through 2004-09.

A material weakness is a reportable 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 the applicable requirements of laws, regulations, contracts, and grants caused by error or fraud 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. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. We believe that the reportable conditions described above are material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Kosrae as of and for the year ended September 30, 2004, and have issued our report thereon dated May 29, 2006, which report was qualified due to our inability to: 1) examine evidence regarding the investments of the Compact Capital Projects Fund in SEMO-Micronesia, Inc.; and 2) assure ourselves as to the propriety of advances receivable of the General Fund, the Compact Capital Projects Fund, and the aggregate remaining fund information; receivables from federal agencies of the Federal Grants Fund; and loans receivable of the aggregate remaining fund information. Our audit was performed for the purpose of forming an opinion on the financial statements that collectively comprise the State of Kosrae's basic financial statements. The accompanying schedule of expenditures of federal awards (pages 66 through 71) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of the State of Kosrae. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had the propriety of receivables from federal agencies of the Federal Grants Fund been determinable, is fairly stated, in all material respects when considered in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the management of the State of Kosrae, federal awarding agencies, pass-through entities, and the cognizant audit and other federal agencies, and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Deloitte + Tocher LLP". The signature is stylized, with the "D" being large and the "LLP" being written in a cursive-like font.

May 29, 2006

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Summary Schedule of Expenditures of Federal Awards, by Grantor
Year Ended September 30, 2004

Agency/Program	CFDA#	Expenditures
U.S. Department of Agriculture		\$ 109,112
U.S. Department of the Interior		5,849,657
U.S. Department of Labor		108,264
U.S. Department of Education		1,175,906
U.S. Department of Health and Human Services		239,220
 GRAND TOTAL		 \$ <u>7,482,159</u>

Note: All awards are received in a subgrantee capacity through the FSM National Government, except for the following, which are received directly from the grantor agencies:

U.S. Department of Agriculture:	
Housing Preservation Grant	10.433
U.S. Department of Education:	
Freely Associated States-Education Grant Program	84.256A
Twenty-First Century Community Learning Center	84.287
Vocational Education Improvement Program	84.994

Reconciliation to the basic financial statements:

U.S. Federal Grants Fund	\$ 1,745,630
Section 211 Compact Sector Grant	4,861,882
Compact Capital Projects Fund	859,405
Section 211 (b) Compact Special Block Grant	(7,453)
Compact Special Development 212 (b)	38,793
Section 216 (b) (2) Health and Medical	(1,560)
Less amounts included in the federal grants fund that are non-U.S. awards	<u>(14,538)</u>
	 \$ <u>7,482,159</u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2004

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF AGRICULTURE		
Cooperative Forestry Assistance	10.664	\$ 29,904
Forestry Supplemental	10.664	9,833
Natural Resources Management	10.652	581
Housing Preservation Grant	10.433	56,320
KIRMA Research/Capacity Building for Statistical Activities	10.652	<u>12,474</u>
U.S. DEPARTMENT OF AGRICULTURE TOTAL		<u>\$ 109,112</u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2004

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF THE INTERIOR		
Economic, Social and Political Development of the Territories and the Freely Associated States:	15.875	
Compact Section 211(A) Capital Improvement Projects		\$ 854,538
Compact Health and Medical Grants		(1,560)
Compact Special Development		38,793
Compact Special Block Grants		(7,453)
Compact II Capacity Building Sector		977,736
Compact II Education Sector		1,884,624
Compact II Environment Sector		291,534
Compact II Health Sector		1,114,717
Compact II Infrastructure Sector		35,827
Compact II Private Sector		557,444
Technical Assistance:		
Hospital Renovation		78,289
Historic Preservation	15.904	<u>25,168</u>
U.S. DEPARTMENT OF THE INTERIOR TOTAL		\$ <u>5,849,657</u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2004

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF LABOR		
School to Work	17.249	\$ 28,917
WIA Administration	17.255	8,863
WIA Adult Program	17.258	41,582
WIA Youth Activities	17.259	18,978
WIA Dislocated Workers	17.260	<u>9,924</u>
U.S. DEPARTMENT OF LABOR TOTAL		\$ <u><u>108,264</u></u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2004

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF EDUCATION		
Special Education - Grants to States	84.027	\$ 470,073
Freely Associated States - Education Grant Program	84.256A	539,638
Twenty-First Century Community Learning Center	84.287	75,076
Vocational Education Improvement Program	84.994	<u>91,119</u>
U.S. DEPARTMENT OF EDUCATION TOTAL		<u>\$ 1,175,906</u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Expenditures of Federal Awards, Continued
Year Ended September 30, 2004

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES		
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	\$ 9,226
Family Planning - Services	93.217	28,267
Immunization Grants	93.268	20,863
HIV Prevention Activities-Health Department Based	93.940	9,722
Block Grants for Prevention and Treatment of Substance Abuse (Prevention and Treatment (SAPT) Block Grant)	93.959	71,538
Cooperative Agreements for State-Based Diabetes Control Programs and Evaluation of Surveillance Systems	93.988	17,020
Public Health Preparation/Bioterrorism	93.283	15,164
Maternal and Child Health Services Block Grant to the States	93.994	54,490
Tobacco Prevention	93.283	12,930
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES TOTAL		\$ <u>239,220</u>
GRAND TOTAL		\$ <u>7,482,159</u>

See accompanying notes to schedule of expenditures of federal awards.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Notes to Schedule of Expenditures of Federal Awards
Year Ended September 30, 2004

(1) Scope of Review

The Kosrae State Government is a governmental entity governed by its own Constitution. All significant operations of the State are included in the scope of the OMB Circular A-133 audit (the "Single Audit"). The U.S. Department of the Interior has been designated as the State's cognizant agency for the Single Audit.

A. Programs Subject to Single Audit

- U.S. Department of Agriculture
- U.S. Department of Education
- U.S. Department of Health and Human Services
- U.S. Department of the Interior
- U.S. Department of Labor

(2) Summary of Significant Accounting Policies

A. Basis of Accounting

For purposes of this report, certain accounting procedures were followed which help illustrate the expenditures of the individual programs. All expenses and capital outlays are reported as expenditures on the accrual basis of accounting.

B. Reporting Entity

The Kosrae State Government, for purpose of the general purpose financial statements, includes all of the funds of the primary government as defined by Governmental Accounting Standards Board (GASB) Statement 14, "The Financial Reporting Entity."

(3) Component Units

The Kosrae Utilities Authority, a component unit - proprietary fund of the State of Kosrae separately satisfies the requirements of OMB Circular A-133. The Kosrae Utilities Authority's Schedule of Expenditures of Federal Awards is as follows:

<u>Grantor Agency/Program</u>	<u>CFDA#</u>	Fiscal Year 2004 <u>Expenditures</u>
U.S. Department of the Interior: Operations and Maintenance Improvement Programs (OMIP)	15.875	<u>153,812</u>
Total		\$ <u>153,812</u>

The Compact of Free Association programs are received from the State of Kosrae in a subrecipient capacity. The aforementioned audit did not specify the existence of any questioned costs pertinent to the above expenditures. Funds passed through to the Kosrae Utilities Authority are included within the Schedule of Expenditures of Federal Awards of Kosrae State.

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

Schedule of Programs Selected for
Audit In Accordance With OMB Circular A-133
Year Ended September 30, 2004

<u>Grantor</u> <u>Program Title</u>	<u>CFDA No.</u>	2004 <u>Fiscal Year</u> <u>Expenditures</u>
<u>Major Programs</u>		
<u>U.S. Department of the Interior</u>		
Compact of Free Association:		
Compact II Sector Grants	15.875	\$ 4,861,882
Compact Section 211(A) Capital	15.875	854,538
<u>U.S. Department of Education</u>		
Special Education – Grants to States	84.027	470,073
Freely Associated States - Education Grant Program	84.256	<u>539,638</u>
Total U.S. Federal program expenditures selected		\$ <u>6,726,131</u>
Total U.S. Federal program expenditures		\$ <u>7,482,159</u>
% of total U.S. Federal Program expenditures covered by Major Programs		<u>90%</u>

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs
Year Ended September 30, 2004

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the financial statements expressed a qualified opinion due to our inability to: 1) examine evidence regarding the investments of the Compact Capital Projects Fund in SEMO-Micronesia, Inc.; and 2) assure ourselves as to the propriety of advances receivable of the General Fund, the Compact Capital Projects Fund, and the aggregate remaining fund information; receivables from federal agencies of the Federal Grants Fund; and loans receivable of the aggregate remaining fund information.
2. Reportable conditions in internal control over financial reporting were identified, several of which are considered to be material weaknesses.
3. No instances of noncompliance considered material to the financial statements were disclosed by the audit.
4. Reportable conditions in internal control over compliance with requirements applicable to major federal award programs were identified, all of which are considered to be material weaknesses.
5. The independent auditors' report on compliance with requirements applicable to major federal award programs expressed a qualified opinion.
6. The audit disclosed findings required to be reported by OMB Circular A-133.
7. The State's major programs were:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
U.S. Department of the Interior –	
Compact of Free Association –Capital Account	15.875
Compact of Free Association –Sector Grants	15.875
U.S. Department of Education –	
Special Education – Grants to States	84.027
Freely Associated States - Education Grant Program	84.256

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 State did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Part II - Financial Statement Findings Section

<u>Reference Number</u>	<u>Findings</u>	<u>Questioned Costs</u>
2004-10	FY04 Appropriation Law	\$ -
2004-11	Time Certificates of Deposit	\$ -
2004-12	Accounts Payable	\$ -
2004-13	Due From Other Governements	\$ -
2004-14	Housing Renovation Loan Receivables	\$ -
2004-15	Equity Investments	\$ -
2004-16	Clearing Account	\$ -
2004-17	Timely Deposit of Cash Collections	\$ -
2004-18	Budgetary Expenditures	\$ -

Part III - Federal Award Findings and Questioned Cost Section

<u>Reference Number</u>	<u>CFDA #</u>	<u>Findings</u>	<u>Questioned Costs</u>
2004-01	15.875	Allowable Costs/Cost Principles and Procurement – Compact II Sector Grants	\$ 38,373
2004-02	15.875	Period of Availability-Compact II Sector Grants	\$ 80,202
2004-03	15.875	Reporting- Compact II Sector Grants	\$ -
2004-04	15.875	Allowable Costs/Cost Principles-Compact II Sector Grants	\$ 9,034
2004-05	84.027	Cash Management - SEPIIE	Undeterminable
2004-06	84.027	Allowable Costs/Cost Principles-SEPIIE	\$ 10,124
2004-07	84.256	Cash Management -TFASEG	Undeterminable
2004-08	84.256	Allowable Costs/Cost Principles and Procurement – FASEG	\$ 68,387
2004-09	84.256	Period of Availability-TFASEG	\$ 31,525

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-01
CFDA No.: 15.875
Grant: Section 211 Education Sector, Health Sector, Capacity Building Sector Grants
Grantor Agency: U.S. Department of the Interior, Office of Insular Affairs
Area: Allowable Costs/Cost Principles and Procurement
Questioned Costs: \$38,373

Criteria: Expenditures should be necessary and reasonable for program needs and should be in accordance with the program. Also, sufficient records should be maintained to detail the significant history of a procurement, including a rationale for vendor selection. Furthermore, financial and programmatic records should be maintained on file for at least 3 years.

Condition: For one of 12 (8%) expenditures tested (\$8,550 out of the aggregate population of \$103,238), there were no procurement documents on file or no justification of the procurement selection.

Check No	Payee	APV #	APV Amt	Fund	Org	Cost Center
10530	Bank of the Fsm	400376450	\$25,767	73	1211	KA220A

For two of 12 (17%) expenditures tested (\$18,006 out of the aggregate population of \$103,238), there was no invoice on file.

Check No	Payee	APV #	APV Amt	Fund	Org	Cost Center
9901	Kosrae Utility Authority	400326501	\$ 6,654	72	1410	KA100A
10380	Kosrae Utility Authority	400391201	5,952	72	1410	KA100A
		TOTAL	\$12,606			

Cause: There appears to be a lack of internal controls over ensuring compliance with the applicable allowable costs/cost principles and procurement requirements, and questioned costs result.

Effect: The Kosrae State Government appears to be in noncompliance with the applicable allowable costs/cost principles and procurement requirements, and questioned costs result.

Recommendation: The Kosrae State Government should comply with Compact II grant requirements.

Auditee Response and Corrective Action Plan: We agree with the findings, the Kosrae State Government will comply with the recommendation.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-02
CFDA No.: 15.875
Grant: Section 211 Education Sector, Health Sector, Capacity Building Sector Grants
Grantor Agency: U.S. Department of the Interior, Office of Insular Affairs
Area: Period of Availability
Questioned Costs: \$80,202

Criteria: Expenditures should be recorded in the appropriate period.

Condition: For ten of 12 (83%) expenditures tested (\$101,358 out of the aggregate population of \$103,238), the underlying receipt of goods or services occurred in fiscal year 2003 or earlier but these costs were charged to the fiscal year 2004 grant awards.

Check No	Payee	APV #	APV Amt	Fund	Org	Cost Center
11778	KOSRAE UTILITY AUTHORITY	400550501	\$ 13,364	72	1410	KA100A
9901	KOSRAE UTILITY AUTHORITY	400326501	6,654	72	1410	KA100A
10380	KOSRAE UTILITY AUTHORITY	400391201	5,952	72	1410	KA100A
10380	KOSRAE UTILITY AUTHORITY	400391101	15,000	73	1410	KA100A
10937	KOSRAE UTILITY AUTHORITY	400445701	15,000	73	1213	KA200B
11420	KOSRAE UTILITY AUTHORITY	400498601	2,838	74	1610	KA435A
11618	COM-FSM NATIONAL CAMPUS	400528401	20,000	76	1102	KA631H
11746	COM-FSM NATIONAL CAMPUS	400528502	14,000	76	1102	KA631H
		Subtotal	92,808			
LESS: Amounts previously Questioned in 2004-01						
9901	KOSRAE UTILITY AUTHORITY	400326501	(6,654)	72	1410	KA100A
10380	KOSRAE UTILITY AUTHORITY	400391201	(5,952)	72	1410	KA100A
		TOTAL	<u>\$ 80,202</u>			

Cause: There appears to be a control deficiency over ensuring that expenditures are recorded in the appropriate period.

Effect: Expenditures may be misstated in both FY 2003 and FY 2004, and the Kosrae State Government appears to be in noncompliance with the program requirements, and questioned costs result.

Recommendation: The Kosrae State Government should ensure that expenditures are correctly accounted for in relation to the fiscal year they relate and should comply with Compact II requirements.

Auditee Response and Corrective Action Plan: We agree with the finding that the expenditures were not recorded in the proper period.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2004-03
CFDA No.:	15.875
Grant:	Section 211 Infrastructure Sector Grant
Grantor Agency:	U.S. Department of the Interior, Office of Insular Affairs
Area:	Reporting
Questioned Costs:	\$0

Criteria: Financial Status Reports (FSRs) should be accurate and submitted in accordance with grant terms and conditions.

Condition: The FSR for Compact Infrastructure Sector Fund 68 was not submitted. Furthermore, FSR expenditures reported were less than detailed expenditures recorded for the fiscal year.

Cause: There appears to be a lack of internal controls over the preparation and accuracy of federal financial reports.

Effect: The Kosrae State Government appears to be in noncompliance with reporting requirements.

Recommendation: The Kosrae State Government should comply with the Compact Sector Grant requirements.

Auditee Response and Corrective Action Plan: Kosrae State Government did not receive any fund for Compact II Sector Fund 68 which is the infrastructure Sector. The Audit condition has been corrected. The Administrator of Division of Finance & Budget will be responsible for compliance.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-04
CFDA No.: 15.875
Grant: Section 211 Health Sector, Capacity Building Sector and Private Sector Grants
Grantor Agency: U.S. Department of the Interior, Office of Insular Affairs
Area: Allowable Costs/Cost Principles
Questioned Costs: \$9,034

Criteria: Expenditures should be necessary and reasonable for program needs and should be in accordance with program objectives. Furthermore, financial and programmatic records should be maintained on file for at least 3 years.

Condition: For 2 of 34 (6%) items tested, there was no timesheet on file to verify hours.

FUND	Check #	PP#	PPE	Empl #	Gross Pay	Deduction	Net Pay
73	30790	13	6/12/2004	78406	\$2,304	\$428	\$1,876
76	29556	11		18526	<u>608</u>	\$577	\$ 31
					<u>\$2,912</u>		

For 4 of 34 (12%) items tested, there was no personnel action form on file to verify the applicable pay rate.

FUND	Check #	PP#	PPE	Empl #	Gross Pay	Deduction	Net Pay
73	32810	16	7/24/2004	29422	\$1,077	\$449	\$ 628
73	33513	17	8/07/2004	800610	2,015	\$ 250	\$1,764
73	34159	18	8/21/2004	33210	872	\$ 639	\$ 234
73	35531	20	9/18/2004	58250	<u>924</u>	\$ 571	\$ 353
					<u>\$4,888</u>		

For 3 of 34 (9%) items selected, employee timesheet hours were less than 80 hours and holiday hours were paid at double the regular rate.

FUND	Check #	PP#	PPE	Empl #	Gross Pay	Deduction	Net Pay
74	29482	11	05/15/04	24057	\$ 446	\$287	\$159
74	34256	18	08/21/04	43961	406	\$235	\$171
74	35612	20	09/18/04	29492	<u>382</u>	\$180	\$202
					<u>\$1,234</u>		

Cause: There appears to be a lack of controls exercised over record keeping and documentation to ensure that payroll transactions are substantiated by timesheets and personnel action forms and that expenditures meet program requirements.

Effect: The Kosrae State Government appears to be in noncompliance with the allowable costs/cost principles requirements. A questioned cost exists. Although the known questioned cost is less than \$10,000, the projected questioned cost exceeds the threshold.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2004-04, Continued
CFDA No.:	15.875
Grant:	Section 211 Health Sector, Capacity Building Sector and Private Sector Grants
Grantor Agency:	U.S. Department of the Interior, Office of Insular Affairs
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$9,034

Recommendation: The Kosrae State Government should ensure that all current Personnel Action Forms and timesheets are filed within individual employee files to substantiate expenditures.

Auditee Response and Corrective Action Plan: We agree to this finding. All employee files are being reviewed for proper wage documentation. Unsupported compensation will be reviewed with appropriate Department Director for obtaining of proper wage documentation. The Payroll Officer will substantiate wage rates with proper documentation prior to processing new payroll compensation. On a monthly basis, the Finance Administrator will spot check payroll records to insure compliance. The Payroll Officer will be responsible for procedural compliance.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-05
CFDA No.: 84.027
Grant: Special Education – Grants to States
Grant No.: H027B030002-04
Grantor Agency: U.S. Department of Education
Area: Cash Management
Questioned Costs: Undeterminable

Criteria: In accordance with applicable cash management requirements, the time elapsed between the receipt of Federal funds and the clearing of the applicable check should be minimized.

Condition: The Kosrae State Government could not provide documented details of expenditure drawdowns per GAPS for the program.

Cause: There appears to be a lack of internal controls over cash management.

Effect: The Kosrae State Government appears to be in noncompliance with applicable cash management requirements. Due to lack of information available and provided by the grantee, the amount of questioned costs, if any, resulting from this condition is undeterminable.

Prior Year Status: The inability of the State to support cash management requirements was reported as a finding in the State's 2003 Single Audit report.

Recommendation: The Kosrae State Government should establish internal controls over cash management and should match applicable drawdowns with checks issued.

Auditee Response and Corrective Action Plan: Kosrae State Government (KSG) do agree with this finding. KSG has implemented in fiscal year 2006 internal control over cash management requirements.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-06
CFDA No.: 84.027
Grant: Special Education – Grants to States
Grant No.: H027B030002-04
Grantor Agency: U.S. Department of Education
Area: Allowable Costs/Cost Principles
Questioned Costs: \$10,124

Criteria: Expenditures should meet program objectives.

Condition: For four of 12 (33%) transactions tested (\$35,268 out of the aggregate population tested of \$88,767), there was no information demonstrating the relevancy of the charges to the program.

Org #	Check No	Payee	APV #	APV Amt
301410	12230	F.S.M. TELECOMM. CORP.	400566005	\$ 2,974
301410	8916	F.S.M. TELECOMM. CORP.	400163902	2,664
301410	7822	F.S.M. TELECOMM. CORP.	400028706	2,317
301410	11943	F.S.M. TELECOMM. CORP.	400551901	<u>2,169</u>
		TOTAL		<u>\$10,124</u>

Cause: There appears to be a control deficiency over ensuring that expenditures meet program objectives.

Effect: Expenditures have been misstated, and the Kosrae State Government appears to be in noncompliance with the allowable costs/cost principles requirements, and questioned costs result.

Recommendation: The Kosrae State Government should ensure that expenses are correctly accounted for and comply with allowable costs/cost principles requirements.

Auditee Response and Corrective Action Plan: We agree to this finding. The Kosrae DOE Special Education will ensure that a logging system is in place and that expenses are correctly accounted for in relation to the fiscal year they relate to and comply with the condition specified in the criteria.

The charges are all relevant to the program as justified by program personnel. Please verify the questioned costs.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-07
CFDA No.: 84.256
Grant: Freely Associated States - Education Grant Program
Grant No.: S256A030009-04
Grantor Agency: U.S. Department of Education
Area: Cash Management
Questioned Costs: Undeterminable

Criteria: In accordance with applicable cash management requirements, the time elapsed between the receipt of Federal funds and the applicable check clearance through the bank should be minimized.

Condition: The Kosrae State Government could not provide documented details of expenditure drawdowns per GAPS for the program.

Cause: There appears to be a lack of internal controls over cash management.

Effect: The Kosrae State Government appears to be in noncompliance with applicable cash management requirements. Due to lack of information available and provided by the grantee, the amount of questioned costs, if any, resulting from this condition is undeterminable.

Recommendation: The Kosrae State Government should establish internal controls over cash management.

Auditee Response and Corrective Action Plan: We agree to this finding. Kosrae State Government will ensure establishment of internal control over cash management requirement. Administrator of Division of Finance & Budget will be responsible to make sure procedures are followed. The Director of Administration & Finance will conduct monthly review to ensure full compliance.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-08
CFDA No.: 84.256
Grant: Freely Associated States - Education Grant Program
Grant No.: S256A030009-04
Grantor Agency: U.S. Department of Education
Area: Allowable Costs/Cost Principles and Procurement
Questioned Costs: \$68,387

Criteria: Expenditures should be necessary and reasonable for the program needs and should be in accordance with the program objectives. Also, sufficient records should be maintained to detail the significant history of a procurement, including selection of contract type, contractor selection or rejection, and the basis for the contract price. Furthermore, financial and programmatic records should be maintained on file for at least 3 years.

Condition: For four of 21 (19%) expenditures tested (\$43,187 of the aggregate population tested of \$204,029), either the basis of the phone bill allocation to the program was not substantiated, or in the case of check number 10537, there was no documentation concerning the relevancy of the expenditure to the program.

Org #	Cost Center	Check No	Payee	APV #	APV Amt
461410	5910	7300	FSMTC	400006301	\$21,962
461410	5911	10750	FSMTC	400394001	7,689
461410	5910	12230	FSMTC	400598001	7,436
461410	5910	10537	TAKEO S. LIKIAKSA	400405901	<u>6,100</u>
			TOTAL		<u>\$43,187</u>

For four of 21 (19%) expenditures tested (\$25,200 of the aggregate population tested of \$204,029), there were no procurement documents on file supporting the basis of competitive procurement.

Org #	Cost Center	Check No	Payee	APV #	APV Amt
461410	5910	7188	CASSEY FREDDY	400005701	\$ 7,680
461410	5910	9730	DAVID ROTH	400082201	7,000
461410	5910	7204	BARNABAS PALSIS	400005901	5,760
461410	5910	7194	BERNIS NENA	400006101	<u>4,760</u>
			TOTAL		<u>\$25,200</u>

Cause: There appears to be a lack of internal controls over ensuring compliance with the applicable allowable costs/cost principles and procurement requirements.

Effect: The Kosrae State Government appears to be in noncompliance with the applicable allowable costs/cost principles and procurement requirements, and questioned costs result.

Recommendation: The Kosrae State Government should comply with the criteria.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2004-08, Continued
CFDA No.:	84.256
Grant:	Freely Associated States - Education Grant Program
Grant No.:	S256A030009-04
Grantor Agency:	U.S. Department of Education
Area:	Allowable Costs/Cost Principles and Procurement
Questioned Costs:	\$68,387

Auditee Response and Corrective Action Plan: The FASEG Program does have a communication budget that supplements communications and internet connectivity for the Kosrae State Education System. This Plan is inclusive of all communications and internet service expenditures from all seven centers, including Kosrae High School, as well as the Department of Education central office. Although each learning center does have its own communications and internet service budget, the FASEG program serves as a supplemental fund for such services, as authorized by the Project Grantor.

The FASEG Program also serves as a supplemental funding source for all special and extra curricular activities coordinated by the Kosrae State Department of Education. Check number 10537 was issued to and dispersed Mr. Likiaksa for that very reason, as a supplemental source of funding for school field day commencement activities for all six learning centers.

Prior to the initiation of the GATE Program, there had been a series of workshops and training sessions to prepare qualified teachers to design and deliver and advanced curriculum for the GATE Program. In the end, there were approximately thirty (30) teachers who had successfully completed the training phase, and assigned to deliver the advance instructional program for the students attending the GATE Program throughout the Kosrae State Public School System.

One Teacher from each school was designated to coordinate each site to oversee implementation of the Program and report on all progress and setbacks that might be encountered at each site. Some of those site coordinators are as follows, Cassey Freddy, Barnabus Palsis, & Bernis Nena.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2004-09
CFDA No.: 84.256
Grant: Freely Associated States - Education Grant Program
Grant No.: S256A030009-04
Grantor Agency: U.S. Department of Education
Area: Period of Availability
Questioned Costs: \$31,525

Criteria: Expenditures should be recorded in the appropriate period.

Condition: For four of 12 (33%) expenditures tested (\$71,687 of the aggregate population tested of \$204,029), the following services were provided in FY03 and the period of availability had expired prior to payment.

Org #	Cost Center	Check No	Payee	APV #	APV Amt
461410	5910	7307	DOTTY KELLY	400016801	\$31,525
461410	5910	7300	FSMTC	400006301	21,962
461410	5910	7188	CASSEY FREDDY	400005701	7,680
461410	5910	7204	BARNABAS PALSIS	400005901	5,760
461410	5910	7194	BERNIS NENA	400006101	<u>4,760</u>
					<u>\$71,687</u>

Cause: There appears to be a control deficiency over ensuring that expenditures are recorded in the appropriate period.

Effect: Expenditures may be misstated and the Kosrae State Government appears to be in noncompliance with period of availability requirements.

Questioned costs	\$ 71,687
Less: Amounts previously questioned at 2004-08	
Check #7300	(21,962)
Check #7188	(7,680)
Check #7204	(5,760)
Check #7194	<u>(4,760)</u>

Questioned costs presented at this finding \$ 31,525

Recommendation: The Kosrae State Government should ensure that expenditures are correctly accounted for and are not charged to expired funds.

Auditee Response and Corrective Action Plan: We agree with this finding, however it should be noted that the reason for the delayed posting is due to the time lapsed between grant period. The approval process for the FASEG Program extension was delayed several months at the end of the FY'03. Kosrae State will ensure that expenses are correctly accounted for in relation to the fiscal year they relate to.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Financial Statements Findings Section

Finding No: 2004-10
Area: Appropriation Law

Criteria: Kosrae State Government should only employ the maximum number of employees as stipulated by the Appropriation Law.

Condition:

Department	Budget Act	Payroll ledger	Diff
Education	223	239	(16)
Health Services	77	83	(6)

Cause: We noted that the payroll registers include contractors as employees. When the balances per the Payroll Register are compared to the Budget Act appropriation, two Departments are found to be in excess of the maximum allowed levels.

Effect: If contractors are hired using Sector Grants, then this would be an illegal activity. If they are hired using local funds, and if the State is withholding taxes, then the hirees are employees, not contractors.

Recommendation: We recommend that the Kosrae State Government adheres to budget restraints, and hires only the maximum level of employees as stipulated in the Appropriation Law.

Auditee Response and Corrective Action Plan: We agree to this finding. The excesses in the payroll register are due to the inclusion of special contracts (personnel) in the payroll system. The Department of Administration & Finance will ensure that contracts (personnel) are not processed through the payroll system. An overall review of the payroll system (register) will be done immediately to determine the course of action to be taken.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Financial Statements Findings Section, Continued

Finding No.: 2004-11

Area: Time Certificates of Deposit

Criteria: Kosrae State should maintain a subsidiary ledger to support any purchase, redemption or earnings of each time certificate of deposit during the year.

Condition: We were not able to verify movement of \$94,000 in time certificates of deposit during the year, resulting in a liability as of September 30, 2004.

Cause: The cause of this condition is that Kosrae State Government did not reconcile movement of each time certificate of deposit during the year.

Effect: The effect of this condition is a potential misstatement of the financial statements.

Recommendation: We recommend that Kosrae State maintain a subsidiary ledger of all time certificates of deposit so that movements can be tracked and balances are reconciled properly.

Auditee Response and Corrective Action Plan: We agree with this finding. Monthly reconciliation of all time certificates of deposits are reconciled properly.

Finding No.: 2004-12

Area: Accounts Payable

Criteria: Kosrae State should ensure that the accounts payable subsidiary ledger contain valid unpaid invoices.

Condition: Our review of the accounts payable subsidiary ledger revealed that the liquidation for certain travel authorization claims is recorded in fund 10, while the corresponding payables are still outstanding in other funds as of September 30, 2004.

Cause: The cause of this condition is that the accounts payable subsidiary ledgers are not reviewed on a periodic basis.

Effect: Due to the design of the accounts payable software, corrections could not be made retroactively, and therefore, corrections were made in fiscal year 2006.

Recommendation: We recommend that Kosrae State ensures that paid TA claims are cleared from the accounts payable subsidiary ledger, and such ledger is reconciled on a periodic basis.

Auditee Response and Corrective Action Plan: We agree with the finding. The Chief Accountant will review the accounts payable account monthly to insure reconciliation. The account payable staff will be responsible for compliance. Monthly reconciliation of accounts payable is a requirement that was implemented in fiscal year 2006.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

**Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004**

Financial Statements Findings Section, Continued

Finding No.: 2004-13
Area: Due From Other Governments

Criteria: Due From Other Governments should be fairly stated at the end of each fiscal year.

Condition: Due From Other Governments has not been adjusted for uncollectible receivables.

Cause: The cause of this condition is that the necessary allowance for doubtful accounts has not been performed.

Effect: There is no effect of this condition on the financial statements by fund type as these receivable balances are already included as a reserve for related assets in the fund balance.

Recommendation: We recommend that the Department of Administration ensures that due From Other Governments is properly valued at the end of each fiscal year.

Auditee Response and Corrective Action Plan: We agree with the finding. Again in fiscal year 2006 periodic reconciliation of due from other governments is also a requirement that was implemented in fiscal year 2006.

Finding No.: 2004-14
Area: Housing Renovation Loan Receivables

Criteria: The general ledger should reconcile with the subsidiary ledger.

Condition: The detailed schedule of loans receivable for the Expendable Trust Fund did not agree with the general ledger. The subsidiary ledger balance was greater than the general ledger balance by \$323,561.

Cause: The cause of this condition is that necessary reconciliations have not been performed.

Effect: The effect of this condition is a potential misstatement of the financial statements.

Prior Year Status: This condition was reported as a finding in the Single Audit of Kosrae State Government for fiscal years 1999, 2000, 2001, 2002 and 2003.

Recommendation: We recommend that the Department of Administration ensures that loans receivable are reconciled at the end of each fiscal year.

Auditee Response and Corrective Action Plan: We agree with the finding, however, with the joint effort by Department of Administration & Finance, and Department of Commerce & Industry, Housing Renovation Program will correct this finding in fiscal year 2006.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Financial Statements Findings Section, Continued

Finding No.: 2004-15
Area: Equity Investments

Criteria: Kosrae State Government should ensure that audited financial statements are furnished by all investees of Kosrae State Government at the end of each fiscal year.

Condition: Unaudited financial statements were submitted for KSVI and SEMO in support of Kosrae State equity investments. No financial statements for Pacific Tuna Industries were furnished in support of Kosrae State equity investments.

Cause: The cause of this condition is the lack of financial statements by investees.

Effect: The effect of this condition is a misstatement of the financial statements.

Prior Year Status: The above condition was reported as a finding in the Single Audit of Kosrae State Government for fiscal years 1999, 2000, 2001, 2002 and 2003.

Recommendation: We recommend that the Department of Administration ensures that audited financial statements are furnished by its material investees at the end of each fiscal year.

Auditee Response and Corrective Action Plan: We agree with the finding. Kosrae State Government will ensure that audited financial statements are furnished by its material investees at the end of each fiscal year.

Finding No.: 2004-16
Area: Clearing Account

Criteria: A functioning system of internal control requires all activities in any clearing accounts be transferred to the proper general ledger account.

Condition: Account 10-820, "Clearing Account" Payable, had a \$54,000 balance as of September 30, 2004. Management was not able to determine the appropriate accounts in which to record these receipts.

Cause: The cause of this condition is that management failed to transfer all activities of the clearing account to the proper accounts.

Effect: The effect of this condition is a potential misstatement of the financial statements.

Prior Year Status: The above condition was reported as a finding in the Single Audit of Kosrae State Government for fiscal year 2002.

Recommendation: We recommend that management ensures all general ledger accounts are reconciled on a monthly basis.

Auditee Response and Corrective Action Plan: We agree with the finding. Kosrae State Government will comply with the recommendation.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued
Year Ended September 30, 2004

Financial Statements Findings Section, Continued

Finding No.: 2004-17
Area: Timely Deposit of Cash Collections

Criteria: Cash collected at Treasury should be deposited in a timely manner to safeguard assets.

Condition: Of 25 samples tested, thirteen instances indicated that cash collections were not deposited in a timely manner.

Cause: The cause of this finding is that Kosrae State did not comply with the criteria.

Effect: The effect of this condition is a potential loss of cash.

Prior Year Status: The above condition was reported as a finding in the Single Audit of Kosrae State Government for fiscal years 2000, 2001, 2002 and 2003.

Recommendation: We recommend that Kosrae State Finance comply with the criteria.

Auditee Response and Corrective Action Plan: We agree with the finding. Kosrae State Finance will comply with the criteria.

Finding No.: 2004-18
Area: Budgetary Expenditures

Criteria: Management should ensure that expenditures incurred do not exceed amounts authorized by law.

Condition: The following expenditure accounts exceeded the authorized budget.

<u>Department</u>	<u>Budget</u>	<u>Actual</u>	<u>Variance</u>
Department of Administration	\$ 52,190	\$786,425	\$ 734,235
Department of Education	\$ -	\$ 48,487	\$ 48,487
Department of Health Services	\$154,000	\$175,107	\$ 21,107
USDA Rural Development	\$ 36,000	\$ 51,911	\$ 15,911

Cause: The cause of this condition is lack of management review of budgetary account balances.

Effect: The effect of this condition is potential noncompliance with State law.

Recommendation: We recommend that management ensures that expenditures are incurred within authorized budgetary levels.

Auditee Response and Corrective Action Plan: We agree with the finding. Kosrae State Finance will comply with the criteria.

**STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA**

**Unresolved Prior Years' Findings and Questioned Costs
Year Ended September 30, 2004**

The following is a summary of unresolved questioned costs of the State of Kosrae as of September 30, 2004:

	Questioned Costs Set Forth in Prior Audit Report <u>2003</u>	Questioned Costs Resolved in Fiscal Year <u>2004</u>	Questioned Costs at <u>September 30, 2004</u>
Unresolved Questioned Costs FY 2002	\$ 72,138	\$ -	\$ 72,138
Unresolved Questioned Costs FY 2003	103,493	-	103,493
Unresolved Questioned Costs FY 2004	<u>-</u>	<u>-</u>	<u>237,645</u>
	\$ <u>175,631</u>	\$ <u>-</u>	\$ <u>413,276</u>

The prior year status of findings is contained in the accompanying Schedule of Findings and Questioned Costs.