

KOSRAE UTILITIES AUTHORITY

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2004 AND 2003

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Kosrae Utilities Authority:

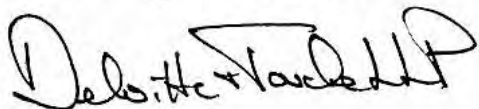
We have audited the accompanying statements of net assets of the Kosrae Utilities Authority, a component unit of the Kosrae State Government, as of September 30, 2004 and 2003, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Kosrae Utilities Authority management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 Kosrae Utilities Authority'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 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements present fairly, in all material respects, the financial position of Kosrae Utilities Authority as of September 30, 2004 and 2003, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management Discussion and Analysis on pages 2-4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. The supplementary information is the responsibility of Kosrae Utilities Authority's management. 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 the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 23, 2005, on our consideration of the Kosrae Utilities Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and 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.



August 23, 2005

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2004

This section of the Kosrae Utilities Authority's (the Authority) annual financial report presents the analysis of the Authority's financial performance during the fiscal year ended September 30, 2004. Please read it in conjunction with the financial statements, which follow this section.

Kosrae Utilities Authority was mandated by law in October 1993 as a semi-agency of the Kosrae State Government to assume the operation and responsibility of providing electric power services to the Island of Kosrae. The Authority is governed by a five (5) member board appointed by the Governor with the advice and consent of the State Legislature for staggered terms of 2 to 4 years. The Authority presently serves 1,586 customers, a 4.5% increase in number of customers from the previous years. The customer base has slightly changed from the previous operating year representing approximately 80% residential, 11% commercial, 6% Kosrae State Government, 2% non-Kosrae State Government and 1% industrial. Energy sales during the current year are 42% to residential customers, 25% to commercial, 21% to Kosrae State Government, 7% to industrial and 5% to non-Kosrae State Government accounts. With little or no economic growth on Kosrae, the energy sales ratio to various customer sectors is expected to continue for the next several years of operation, but should be reviewed annually since any changes in one customer class such as industrial or commercial can have positive or negative effect on future operating revenues.

Fiscal year 2004 was a difficult and challenging year due to serious operating issues facing the operation. These issues encountered were continued decline of the kilowatthours sales, the discontinuation of the U.S. energy grant subsidy, the temporary suspension of the gradual power rate increase schedule by the Authority's Board and the low interest return on investments. The electric revenues from existing power rates and fuel adjustment charges provide for approximately 65% of the total operating expenses with 12% non-operating revenues from OMIP/DOI and Kosrae State Government Compact II Infrastructure funds. The financial challenge is that the electric revenues are inadequate to cover depreciation cost of operation which reinstating of the gradual rate increase schedule will be necessary to make up for the statement loss or resorting to reduction of operating expenses to minimize the shortfall.

The following table summarizes the financial position and results of operations of Kosrae Utilities Authority for 2004 and 2003.

	<u>2004</u>	<u>2003</u>
Assets:		
Current assets	\$ 3,202,708	\$ 3,517,975
Utility plant, net	<u>4,657,656</u>	<u>4,795,884</u>
	<u>\$ 7,860,364</u>	<u>\$ 8,313,859</u>
Liabilities and Net Assets:		
Current liabilities	\$ 87,028	\$ 113,990
Net assets	<u>7,773,336</u>	<u>8,199,869</u>
	<u>\$ 7,860,364</u>	<u>\$ 8,313,859</u>
Revenue, Expenses and Changes in Net Assets		
Operating revenues	\$ 1,143,063	\$ 1,231,302
Operating expenses	<u>1,837,847</u>	<u>1,930,188</u>
Net operating loss	<u>(694,784)</u>	<u>(698,886)</u>
Operating subsidies	223,812	625,978
Interest income	<u>44,439</u>	<u>66,829</u>
Total nonoperating revenue	<u>268,251</u>	<u>692,807</u>
Decrease in net assets	<u>\$ (426,533)</u>	<u>\$ (6,079)</u>

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis
Year Ended September 30, 2004

FINANCIAL HIGHLIGHTS

Operating income generated from electricity sales and related revenue decreases in 2004 by 7% because of the reduction in kilowatthours sold during the year. Residential customers' consumption dropped by 7%, Kosrae State Government by 13%, Non Kosrae State Government by 48% while Industrial and Commercial electricity usage increased by 12% and 4%, respectively. Other electricity related income such as fuel adjustment charge, rental lights, service orders and miscellaneous revenue is down by a total of 5%.

Residential customers' conservation and the housing of government support offices in one building where usage is regularly monitored contributed much to the decrease of sales in these sectors. Non Kosrae State sales' decline is due to the moving out of the CAT Team in Kosrae. Increase in Industrial sales on the other hand is the result of the higher consumption of FSM Telecom account and the Cable Television accounts.

A gradual increase in tariff over the next five years was initiated in the beginning of FY 2005 to offset the loss of the Compact Energy Grant. This is expected to generate a net increase in sales value but a decline in kilowatthours sold in the next fiscal year.

Operating expenses declined by more than 4% this year. The decrease was attributed to a decrease in the maintenance and administrative expenses. Last year, we increased our provision for bad debts by \$86,227 and none is added this year causing the reduction of administrative expenses account.

Non-operating revenues coming from operating subsidies and interest income is down by 61% this year. The Energy Grant is no longer available in the amended Compact II projects effective this year, hence the big drop. OMIP reimbursement this year amounted to \$153,812; thus a slight fall of 1%. A total OMIP grant of \$98,000 is approved for actual reimbursement in the next fiscal year for training and other projects. Interest earned on time certificates of deposit and investment portfolios was less this year.

Current assets dropped by 9%. Cash available for operation experienced a significant decrease of 38% as such was used to make up for the loss of the Compact energy grant. Investments in time certificates of deposits in Bank of FSM and the investments managed by Salomon Smith Barney and Bank of Hawaii slightly increased because the interest earned rolled over on time certificates of deposit and bonds plus a minimal rise in market value of stock investments occurred during the year. Gross receivables from electricity sales decreased by 55%. Aside from the 25% automatic reduction of arrears on delinquent account for every purchase of electricity through cash power, the management has done their effort in pursuing a higher collection of receivables. Inventories on the other hand decreased by 5% this year.

Utility plant consists of Production Plant, Distribution Plant and General Plant. Production plant includes the 6 caterpillar generators ranging in size from 560KW to 1.65MW units that supply the power on the whole island. Including production vehicles and equipment, this represents 51% of the total fixed assets net book value. Distribution Plant consists of the distribution system of approximately 41 miles of 13.8kv overhead conductor and underground feeder to the main airport, dock, tank farm and Pacific Tuna Industries fish plant. The distribution feeders originate from the outdoor substation outside the generating plant and serve the island load with three radial feeders that follow coastal roads to the south and north of the plant. This comprises 47% of the total cost inclusive of distribution equipment and vehicles. General Plant is composed of the administration building, vehicles, fixtures and equipment. This aggregates 2% of the total cost. Various construction in progress from previous years was completed this period.

KOSRAE UTILITIES AUTHORITY

Management Discussion and Analysis Year Ended September 30, 2004

Current liabilities decreased by \$26,962 due to more pay out of vacation leave balances in addition to the actual vacation availed plus fewer accruals of payables to suppliers for items received at year end. Net assets' change represents the net loss for the period.

Plan of Action for 2005.

1. Take firm action in effectuating and reinstating the gradual rate increases schedule annually over the next five years to slowly cover depreciation cost.
2. Reexamine the annual Budget and streamline unnecessary operating expenses and seek fuel supply options to reduce fuel cost.
3. Aggressively pursue collection of arrears accounts by more than 25%.
4. Seek and improve investment funds with Salomon Smith Barney, Bank of Hawaii, and FSM Bank on investment schemes option that provide high return on investment with low risk.
5. Continue to provide training opportunities to employees to improve skill level and knowledge to improve work performance and to reduce costs.
6. Improve fuel efficiency of the generator units to reduce fuel usage and reduce cost.
7. Continue to improve distribution power lines to reduce line loss and loss revenues during forced outages and construct power extension lines to remote areas without power to increase customer base.
8. Improve accountability of KUA properties and procurement policies and procedures to reduce cost of materials and loss properties.
9. Improve public relations to government officials and customers.

KOSRAE UTILITIES AUTHORITY

Statements of Net Assets
September 30, 2004 and 2003

<u>ASSETS</u>	<u>2004</u>	<u>2003</u>
Current assets:		
Cash, available for operations	\$ 223,933	\$ 362,552
Investments	2,101,112	2,058,838
Accounts receivable, net	172,448	383,104
Receivable-OMIP	30,468	-
Receivable-FSM National Government Grant	7,785	7,785
Prepayment	2,310	2,964
Inventories	664,652	702,732
Total current assets	<u>3,202,708</u>	<u>3,517,975</u>
Utility plant:		
Electric plant in service	9,117,035	8,431,754
Construction work in progress	268,816	554,122
Less accumulated depreciation	<u>(4,728,195)</u>	<u>(4,189,992)</u>
Utility plant, net	<u>4,657,656</u>	<u>4,795,884</u>
	<u>\$ 7,860,364</u>	<u>\$ 8,313,859</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Accounts payable	\$ 55,078	\$ 73,343
Accrued taxes and other	14,817	16,245
Accrued annual leave	<u>17,133</u>	<u>24,402</u>
Total liabilities	<u>87,028</u>	<u>113,990</u>
Commitments and contingency		
Net assets:		
Investment in capital assets	4,657,656	4,795,884
Unrestricted	<u>3,115,680</u>	<u>3,403,985</u>
Total net assets	<u>7,773,336</u>	<u>8,199,869</u>
	<u>\$ 7,860,364</u>	<u>\$ 8,313,859</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Statements of Revenues, Expenses, and Changes in Net Assets Years Ended September 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Operating revenues:		
Electricity sales	\$ <u>1,143,063</u>	\$ <u>1,231,302</u>
Operating expenses:		
Production fuel	752,357	764,269
Depreciation	538,202	515,905
Salaries and wages	376,936	363,698
Administrative and general	118,737	222,873
Repair and maintenance	51,615	61,802
Loss on disposal of fixed assets	<u>-</u>	<u>1,641</u>
Total operating expenses	<u>1,837,847</u>	<u>1,930,188</u>
Loss from operations	<u>(694,784)</u>	<u>(698,886)</u>
Nonoperating revenues:		
Operating subsidies	223,812	625,978
Interest income	<u>44,439</u>	<u>66,829</u>
Total nonoperating revenues	<u>268,251</u>	<u>692,807</u>
Change in net assets	<u>(426,533)</u>	<u>(6,079)</u>
Net assets at beginning of year	<u>8,199,869</u>	<u>8,205,948</u>
Net assets at end of year	\$ <u><u>7,773,336</u></u>	\$ <u><u>8,199,869</u></u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Statements of Cash Flows Years Ended September 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:		
Cash received from customers	\$ 1,323,251	\$ 1,156,164
Cash paid to suppliers	(902,240)	(1,217,127)
Cash paid to employees	(385,633)	(359,884)
Net cash provided by (used for) operating activities	<u>35,378</u>	<u>(420,847)</u>
Cash flows from investing activities:		
(Increase) reduction in time certificates of deposit	(42,274)	64,613
Interest income	44,439	66,829
Net cash provided by investing activities	<u>2,165</u>	<u>131,442</u>
Cash flows from noncapital financing activities:		
Proceeds from operating grants	223,812	625,978
Net cash provided by noncapital financing activities	<u>223,812</u>	<u>625,978</u>
Cash flows from capital financing activities:		
Purchase of property, plant and equipment	(399,974)	(321,383)
Net cash used for capital financing activities	<u>(399,974)</u>	<u>(321,383)</u>
Net change in cash	(138,619)	15,190
Cash at beginning of year	<u>362,552</u>	<u>347,362</u>
Cash at end of year	\$ <u><u>223,933</u></u>	\$ <u><u>362,552</u></u>
Reconciliation of loss from operations to net cash provided by (used for) operating activities:		
Operating loss	\$ (694,784)	\$ (698,886)
Adjustments to reconcile operating loss to net cash provided by (used for) operating activities:		
Depreciation	538,202	515,905
Bad debt	-	86,227
Loss on disposal of fixed assets	-	1,641
(Increase) decrease in assets:		
Receivables	180,188	(75,138)
Prepayments	654	(260)
Inventories	38,080	(315,088)
Increase (decrease) in liabilities:		
Accounts payable	(18,265)	60,937
Accrued taxes and other liabilities	(8,697)	3,815
Net cash provided by (used for) operating activities	<u>\$ 35,378</u>	<u>\$ (420,847)</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies

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

KUA has adopted GASB Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB 34) as amended by GASB Statement No. 37 and GASB Statement No. 38. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following four net asset categories:

- Invested in capital assets, net of related debt:
Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- Restricted:
 - Nonexpendable – Net assets subject to externally imposed stipulations that require KUA to maintain them permanently. For the years ended September 30, 2004 and 2003, KUA does not have nonexpendable restricted net assets.
 - Expendable – Net assets whose use by KUA is subject to externally imposed stipulations that can be fulfilled by actions of KUA pursuant to those stipulations or that expire by the passage of time.
- Unrestricted:
Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

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

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

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

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

Utility Plant: Utility plant assets were transferred from the Division of Public Utilities to KUA as of October 1, 1993 at the estimated net book value in the absence of documents to support cost. At September 30, 2004 and 2003, approximately 18 percent of utility plant transferred to KUA was stated at estimated cost. The net book value of the utility plant assets transferred was \$850,602 and \$1,083,053 as of September 30, 2004 and 2003, respectively. KUA capitalizes individual items that have a cost in excess of \$1,000 and an estimated useful life of more than one year.

Depreciation: Depreciation is computed using the straight-line method over the estimated useful lives of the assets (3 - 40 years for plant assets). Depreciation expense for 2004 and 2003 was approximately six percent of the cost of depreciable properties.

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

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

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

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

Cash: For purposes of the statements of net assets and of cash flows, cash includes cash on hand, cash in bank checking and savings accounts and time certificates of deposit with initial maturities of three months or less. Time certificates of deposit with initial maturities greater than three months are separately classified as investments. Of cash balances at September 30, 2004, \$200,000 is subject to Federal Deposit Insurance Corp. (FDIC) coverage, with the remaining balance exceeding insurable limits. KUA does not require collateralization of its deposits. Therefore, the amounts which exceed FDIC limits are characterized as uncollateralized.

Restricted Investments: As of September 30, 2004, \$1,025,869 (\$1,016,919 in 2003) in time certificates of deposit placed with local banks with annual interest rates ranging from .9% to 3% has been internally reserved for maintenance, capital improvements and work in progress.

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

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2004 and 2003

(1) Summary of Significant Accounting Policies, Continued

Management Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Utility Plant

Utility plant consists of the following at September 30, 2004 and 2003:

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2003</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2004</u>
Depreciable assets:					
Production plant	5 to 40 years	\$ 4,372,880	\$ 210,491	\$ -	\$ 4,583,371
Distribution plant	5 to 30 years	3,558,274	470,055	(2,179)	4,026,150
General plant	3 to 20 years	<u>500,600</u>	<u>6,914</u>	<u>-</u>	<u>507,514</u>
Total electric plant in service		8,431,754	687,460	(2,179)	9,117,035
Less accumulated depreciation		<u>(4,189,992)</u>	<u>(538,203)</u>	<u>-</u>	<u>(4,728,195)</u>
		4,241,762	149,257	(2,179)	4,388,840
Non-depreciable assets:					
Work in progress		<u>554,122</u>	<u>118,901</u>	<u>(404,207)</u>	<u>268,816</u>
Electric plant in service, net		\$ <u>4,795,884</u>	\$ <u>268,158</u>	\$ <u>(406,386)</u>	\$ <u>4,657,656</u>
	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2002</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2003</u>
Depreciable assets:					
Production plant	5 to 40 years	\$ 4,325,319	\$ 120,833	\$ (73,272)	\$ 4,372,880
Distribution plant	5 to 30 years	3,436,230	131,890	(9,846)	3,558,274
General plant	3 to 20 years	<u>470,287</u>	<u>30,313</u>	<u>-</u>	<u>500,600</u>
Total electric plant in service		8,231,836	283,036	(83,118)	8,431,754
Less accumulated depreciation		<u>(3,700,720)</u>	<u>(515,905)</u>	<u>26,633</u>	<u>(4,189,992)</u>
		4,531,116	(232,869)	(56,485)	4,241,762
Non-depreciable assets:					
Work in progress		<u>460,931</u>	<u>93,191</u>	<u>-</u>	<u>554,122</u>
Electric plant in service, net		\$ <u>4,992,047</u>	\$ <u>(139,678)</u>	\$ <u>(56,485)</u>	\$ <u>4,795,884</u>

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2004 and 2003

(3) Accounts Receivable

Accounts receivable at September 30, 2004 and 2003, are summarized as follows:

	<u>2004</u>	<u>2003</u>
Residential	\$ 73,004	\$ 93,826
Commercial	137,203	156,982
Government	<u>157,709</u>	<u>115,372</u>
	367,916	366,180
Other	<u>99,768</u>	<u>312,160</u>
	467,684	678,340
Less allowance for doubtful receivables	<u>(295,236)</u>	<u>(295,236)</u>
	\$ <u>172,448</u>	\$ <u>383,104</u>

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

(4) Operating Subsidies

Contributions for the years ended September 30, 2004 and 2003 are as follows:

	<u>2004</u>	<u>2003</u>
U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants	\$ 153,812	\$ 155,978
Kosrae State Government	70,000	-
Compact energy grant	<u>-</u>	<u>470,000</u>
	\$ <u>223,812</u>	\$ <u>625,978</u>

(5) Commitments

Net assets at September 30, 2004 has been appropriated in the amount of \$916,919 for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2005 with a total of \$25,000 being further appropriated on a quarterly basis from net assets for this purpose.

(6) Risk Management

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

(7) Retirement Plan

In 2004, KUA initiated a retirement plan covering all employees with at least one year of service. Vesting occurs upon plan entry. Employee contributions can be from 1% to 15% of earnings with a 50% match by KUA. During the year ended September 30, 2004, KUA incurred an expense of \$2,452 for such match.

KOSRAE UTILITIES AUTHORITY

Notes to Financial Statements
September 30, 2004 and 2003

(8) Related Parties

KUA is affiliated with Kosrae State and its component units. All production fuel is purchased from a Kosrae State component unit. All KUA services to Kosrae State and its component units are provided on the same basis as provided to unrelated parties.

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

The Board of Directors
Kosrae Utilities Authority:

We have audited the financial statements of the Kosrae Utilities Authority (KUA), as of and for the year ended September 30, 2004, and have issued our report thereon dated August 23, 2005. 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

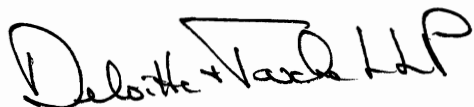
In planning and performing our audit, we considered KUA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect KUA's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

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 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, we noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KUA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

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

A handwritten signature in black ink, appearing to read "Deloitte + Touche LLP", with a stylized flourish at the end.

August 23, 2005