

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

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

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**YEAR ENDED SEPTEMBER 30, 2006**

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

YEAR ENDED SEPTEMBER 30, 2006

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**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

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

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**YEAR ENDED SEPTEMBER 30, 2006**

## INDEPENDENT AUDITORS' REPORT

Honorable Robert Weilbacher  
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, 2006, 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.

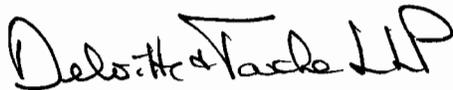
We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and 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 provides a reasonable basis for our opinion.

In our opinion, 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, 2006, 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 40 and 41, 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, 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 June 26, 2007 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 that reads "Deloitte & Touche LLP". The signature is written in a cursive, flowing style.

June 26, 2007

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis  
September 30, 2006

This analysis, prepared by the Department of Administration and Finance, offers readers of the Kosrae State Government's ("Kosrae State") financial statements a narrative overview of the activities of the government for the fiscal year ended September 30, 2006. We encourage readers to consider this information in conjunction with Kosrae State's financial statements, which follow. Fiscal year 2005 comparative information has been included, where appropriate. This analysis is required by the Governmental Accounting Standards Board, (GASB) which provides guidelines on what must be included and excluded from this analysis.

**FINANCIAL HIGHLIGHTS**

- For the fiscal year ended September 30, 2006, Kosrae State's total net assets decreased by \$7.26 million (or 18%) from \$39.62 million in the prior year to \$32.36 million. This decrease is primarily attributable to operating deficits incurred in the General Fund and write-offs of bad debts in the General and Compact Capital Projects Funds.
- During fiscal year 2006, Kosrae State's revenues of \$11.7 million were less than total expenses and special items (\$18.96 million) by \$7.26 million. This deficit primarily was the result of Kosrae State taking bad debt write-offs and other special items of \$4.02 million in fiscal year 2006 pertaining to prior year investments and accounts receivable.
- General Fund budgetary deficits were incurred in fiscal year 2006: budgeted revenues of \$3.36 million exceeded actual collections of \$1.64 million by \$1.72 million (or 51%) as the result of over-estimates of local revenue collections. The expenditure budget also reflected a negative budget variance because of bad-debt write-offs. Total expenditures and special items of \$4.66 million were \$2.08 million greater than budgeted expenditures of \$2.68 million (or 78%); reflecting management's decision to write-off bad debts pertaining to prior year transactions.
- During fiscal year 2006, Kosrae State's general fund balance deficit increased by \$3.22 million (up 819%); growing from \$0.39 million in the prior year to \$3.61 million. The increase primarily reflects both the deficit spending in the general fund as well as management's decision to write-off bad debts incurred in prior years.

**OVERVIEW OF THE FINANCIAL STATEMENTS**

This discussion and analysis is intended to serve as an introduction to Kosrae State's basic financial statements. Kosrae State's basic financial statements comprise three components: 1) governmental-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information in the form of budgetary schedules, which are prepared on the budgetary basis of accounting, and other optional supplementary information, in addition to the basic financial statements themselves, which includes combining statements for governmental funds and component units.

Government-Wide Financial Statements

The government-wide statements report information about Kosrae State as a whole using accounting methods similar to those used by private-sector companies. It provides both long-term and short-term information about the State's financial status.

The statement of net assets includes all the government's assets and liabilities. The difference in the two is called net assets. Over time, increases or decreases in the State's net assets serve as indicator to measure the State's financial position.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis  
September 30, 2006

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

The government-wide financial statements of Kosrae State are divided into two categories:

- Governmental activities -- Most of Kosrae State's basic services are included here, such as education, health, special appropriations, finance, judiciary, and general administration. Compact sector and other federal grants finance most of these activities.
- Component Units -- Kosrae State includes the operating results of the Kosrae Utilities Authority and Micronesia Petroleum Corporation in its report. Although legally separate, these "component units" are important because Kosrae State is financially accountable for them.

Fund Financial Statements

The fund financial statements provide more detailed information about Kosrae State's significant funds. Funds are accounting devices that Kosrae State uses to keep track of specific sources of funding and spending for particular services. The State uses fund accounting to comply with financial and related legal requirements. 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.

Most of Kosrae State's basic services are included in governmental funds, which focus on (1) how cash and other financial assets that can be readily be converted to cash flow in and out and (2) the balances left at year-end that are available for spending. Consequently, the governmental funds statements provide a detailed short-term view that helps you determine whether there are more or fewer financial resources that can be spent in the near future to finance Kosrae State programs. Because this information does not encompass the additional long-term focus of the government-wide statements, we provide additional information at the bottom of the governmental funds statement, or on the subsequent page, that explains and reconciles the relationship (or differences) between them.

The State maintains individual governmental funds, which are categorized as major and non-major. The major funds comprise the general fund, the Compact Sector grants, the Compact Capital Projects fund, and the permanent Compact Trust fund.

**FINANCIAL ANALYSIS OF KOSRAE STATE AS A WHOLE**

Net assets may serve over time as a useful indicator of a government's financial position. At the end of fiscal year 2006, Kosrae State's assets exceeded liabilities by \$32.4 million. However, all these net assets are restricted as to the purposes they can be used for or are invested in capital assets. Kosrae State uses these capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although Kosrae State's investment in capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. The following summary of Kosrae State's net assets as of September 30, 2006, with comparable balances for fiscal year 2005, discloses this relationship:

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis  
September 30, 2006

	<u>2006</u>	<u>2005</u>
Current and other non-capital assets	\$ 8,661,612	\$ 12,769,174
Capital assets	<u>30,385,246</u>	<u>32,416,054</u>
Total Assets	<u>39,046,858</u>	<u>45,185,228</u>
Long-term liabilities	3,235,913	3,226,511
Other liabilities	<u>3,453,438</u>	<u>2,335,810</u>
Total Liabilities	<u>6,689,351</u>	<u>5,562,321</u>
Net Assets		
Invested in capital assets, net of related debt	30,385,246	32,416,054
Restricted	8,824,483	10,327,949
Unrestricted	<u>(6,852,222)</u>	<u>(3,121,096)</u>
Total Net Assets	\$ <u>32,357,507</u>	\$ <u>39,622,907</u>

At the end of fiscal year 2006, Kosrae State's unrestricted assets showed a deficit of \$6.85 million, an increase of \$3.72 million (or 118%) from the prior year. This deficit is the result of having current and long-term commitments that are greater than currently available resources. Specifically, Kosrae State did not include in past annual budgets the full amounts needed to finance its current liabilities to vendors and others or its long-term liabilities arising from Asian Development Bank (ADB) loans and unused employee leave balances. Kosrae State will include these amounts in future years' budgets as funding permits.

Net assets declined by \$7.26 million (or 18%) from the prior year. Key elements are the decrease and the differences from the prior year are shown in the following schedule:

	<u>2006</u>	<u>2005</u>
Revenues:		
Federal contributions	\$ 8,772,236	\$ 8,440,533
Charges for services	399,535	342,410
Revenue sharing	1,216,477	923,297
Unrestricted investment earnings	71,951	237,446
Taxes	157,598	196,360
Other	<u>1,088,035</u>	<u>886,976</u>
Total revenues	<u>11,705,832</u>	<u>11,027,022</u>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

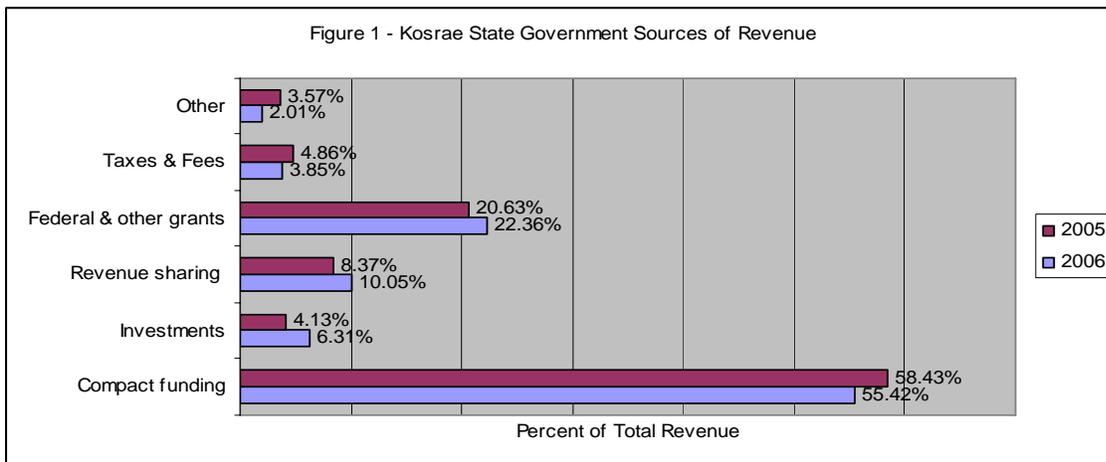
Management's Discussion and Analysis  
September 30, 2006

	<u>2006</u>	<u>2005</u>
Expenses:		
General Government	6,717,127	4,685,687
Education	3,102,602	3,643,613
Health Services	2,191,888	2,288,450
Capital projects	196,909	976,079
Economic development	2,105,967	1,875,843
Land and natural resources	28,870	87,963
Public safety	35,852	9,912
Other miscellaneous	<u>575,747</u>	<u>1,144,382</u>
Total expenses	<u>14,954,962</u>	<u>14,711,929</u>
Special items	<u>(4,016,270)</u>	<u>-</u>
Change in net assets	(7,265,400)	(3,684,907)
Net assets at the beginning of the year	<u>39,622,907</u>	<u>43,307,814</u>
Net assets at the end of the year	\$ <u>32,357,507</u>	\$ <u>39,622,907</u>

Total revenues in fiscal year 2006 of \$11.7 million increased \$0.67 million from the prior year's \$11.03 million (up 16%) primarily due to increases in Compact sector grants, revenue sharing and a discretionary grant of \$0.5 million from the People's Republic of China. In fiscal year 2006, Compact sector grants comprised 57% of all Kosrae State funding sources whereas general fund comprised only 13%.

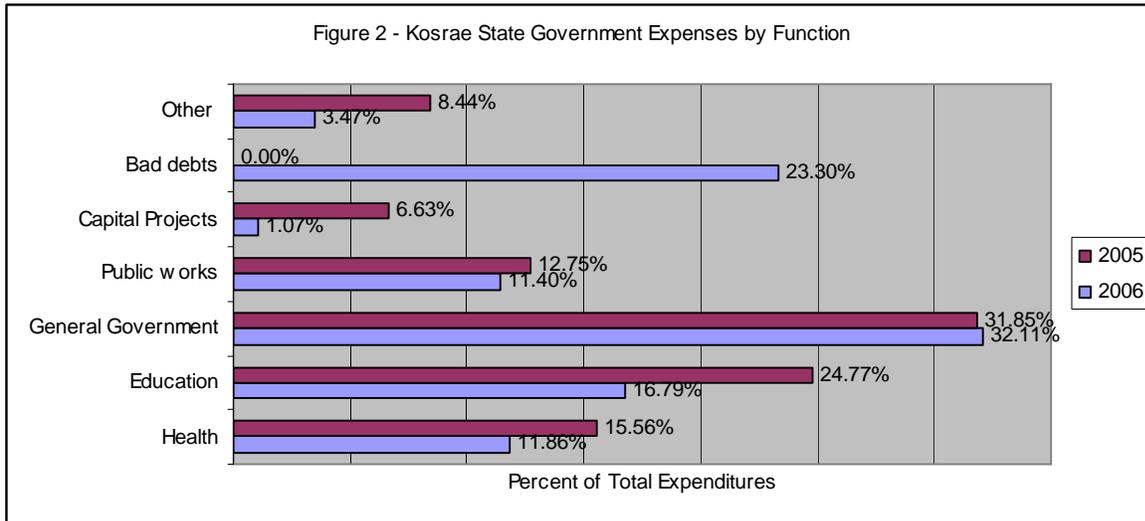
Total expenses and special items of \$18.96 million reflected a \$4.26 million (or 28%) increase from the prior year primarily because of bad debt write-offs. Without these write-offs, operating expenses of \$14.95 million were 1.6% more than in the prior year, primarily due to carrying out activities under certain ADB funded projects.

The following graphs show the major components or revenues and expenditures of governmental funds for the year ended September 30, 2006.



**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis  
September 30, 2006



**FINANCIAL ANALYSIS OF KOSRAE STATE'S FUNDS**

As noted earlier, Kosrae State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. As of the end of fiscal year 2006, Kosrae State's governmental funds reported a combined fund balance of \$5.21 million which represents a \$4.34 million decrease (or 45%) from the \$9.55 million recorded at the end of fiscal 2005. This decrease is attributable to the deficit resulting from expenditures exceeding revenues. Of this total combined fund balance, \$8.27 million is reserved to indicate that it is not available for new spending because it has already been committed: 1) to generate income for future operations or to reflect long-term loan or investment activities (\$6.1 million); 2) to liquidate contracts and purchase orders of the prior period (\$1.41 million); or 3) to fund specific general fund and compact CIP-related activities (\$0.76 million). These reserved fund balances are offset by a combined deficit of \$3.06 million, an decrease of \$0.40 million (or 10%) from fiscal year 2005. The overall decrease in the unreserved fund balance deficit is attributed to management's decision to write-off non-performing assets.

**GENERAL FUND BUDGETARY HIGHLIGHTS**

During the course of the fiscal year, management and elected officials of Kosrae State revised the General Fund budget. The revised budget included a decrease in the authorized expenditure budget of \$0.68 million, from \$3.36 million to \$2.68 million. The primary reason for this downward revision was to reign in expenditures when revenue collections did not match inflated revenue projections. Nevertheless, general fund expenditures and other financing uses exceeded revenues by \$3.2 million. This deficit included the write-down of non-performing accounts receivables and other investments totaling \$2.08 million which had generally proportional decreases in the fund balance reserve for related assets. The unreserved general fund deficit increased \$0.83 million in fiscal year 2006; from \$4.16 million in the prior year, to \$4.99 million.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis  
September 30, 2006

**CAPITAL ASSET AND DEBT ADMINISTRATION**

Capital Assets

Kosrae State's investment in capital assets for the primary government as of September 30, 2006, amounted to \$89.87 million, net of accumulated depreciation of \$59.48 million, leaving a net book value of \$30.39 million. This represents a net decrease of \$2.03 million (or 7 %) from fiscal year 2005. Net fixed assets declined in fiscal year 2006 because new additions lagged depreciation charges as the previous Compact CIP source of capital investment was depleted. Incremental additions were made to buildings and equipment. The table below summarizes Kosrae State's capital assets:

	<u>2006</u>	<u>2005</u>
Buildings	\$ 3,082,832	\$ 3,126,205
Infrastructure	26,698,697	28,655,056
Machinery, equipment, others	<u>603,717</u>	<u>634,793</u>
	\$ <u>30,385,246</u>	\$ <u>32,416,054</u>

Additional information on Kosrae State's capital assets can be found in note 5 to the financial statements.

Long-Term Debt

The following schedule shows Kosrae State's noncurrent liabilities for fiscal year 2006 which is greater than fiscal year 2005's balances due to proceeds received for certain private sector and other ADB development loans:

	<u>2006</u>	<u>2005</u>
ADB Early Retirement Loan and Others	\$ 2,991,777	\$ 2,000,000
Malem Water Supply Loan	136,173	140,750
Other claims	<u>110,000</u>	<u>200,000</u>
Total noncurrent liabilities	\$ <u>3,237,950</u>	\$ <u>2,340,750</u>

Interest and principal payments on ADB loans will commence in fiscal year 2007.

Additional information on Kosrae State's long-term debt obligations can be found in note 6 to the financial statements.

**ECONOMIC FACTORS AND NEXT YEAR'S BUDGET**

In fiscal year 2007 Kosrae State began a process of fiscal reform to rationalize expenditures within available revenues and otherwise put itself in a better financial position. This process was made necessary by depleted cash resources and mounting liabilities.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Management's Discussion and Analysis  
September 30, 2006

A loan of \$1.5 million was received from the FSM national government to pay off short-term liabilities and refund Compact sector funds that had been diverted for other purposes. Moreover, in order to present a true picture of its financial position, Kosrae State management concurred in the write-off of \$4.3 million of non-performing assets to be reflected as of September 30, 2006. Additional steps are planned to reduce personnel paid from local resources. These measures are expected to yield long-term results by making the government leaner and enhancing Kosrae State's reputation with grantor agencies. Kosrae State management is confident that these fiscal reforms will improve the long-term financial viability of the State.

**CONTACTING KOSRAE STATE'S FINANCIAL MANAGEMENT**

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors, a general overview of Kosrae State's finances to demonstrate its accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Director, Administration and Finance; P.O. Box 878; Kosrae, FM, 96944.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Statement of Net Assets  
September 30, 2006

	Primary Government	Component Units
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 44,227	\$ 344,739
Investments	1,731,642	1,607,776
Receivables, net of allowance for uncollectibles	1,319,198	683,107
Due from primary government	-	220,614
Advances	360,598	6,533
Inventories	20,582	1,407,181
Other current assets	-	18,461
Total current assets	3,476,247	4,288,411
Noncurrent assets:		
Capital assets, net of accumulated depreciation	30,385,246	7,266,931
Restricted assets:		
Cash and cash equivalents	649,478	-
Time certificates of deposit	458,639	-
Investments	4,077,248	-
Total noncurrent assets	35,570,611	7,266,931
Total assets	\$ 39,046,858	\$ 11,555,342
<u>LIABILITIES</u>		
Current liabilities:		
Current portion of long-term obligations	\$ 2,037	\$ 576,637
Bank overdraft	322,286	-
Accounts payable	1,268,021	501,800
Other liabilities and accruals	40,946	42,430
Due to component units	5,651	-
Due to primary government	-	62,278
Deferred revenue	1,814,497	-
Total current liabilities	3,453,438	1,183,145
Noncurrent liabilities:		
Noncurrent portion of long-term obligations	3,125,913	951,865
Other noncurrent liabilities	110,000	-
Total noncurrent liabilities	3,235,913	951,865
Total liabilities	6,689,351	2,135,010
Contingencies		
<u>NET ASSETS</u>		
Invested in capital assets, net of related debt	30,385,246	7,266,931
Restricted for:		
Nonexpendable:		
Future operations	2,537,525	-
Expendable:		
Compact related	2,927,554	-
Other purposes	3,359,404	90,000
Unrestricted	(6,852,222)	2,063,401
Total net assets	32,357,507	9,420,332
Total liabilities and net assets	\$ 39,046,858	\$ 11,555,342

See accompanying notes to basic financial statements.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Statement of Activities  
Year Ended September 30, 2006

Functions/Programs	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
<b>Primary government:</b>						
<b>Governmental activities:</b>						
General government	\$ 6,717,127	\$ 399,535	\$ 4,569,810	\$ 3,023	\$ (1,744,759)	\$ -
Land and natural resources	28,870	-	28,510	-	(360)	-
Education	3,102,602	-	2,953,280	-	(149,322)	-
Health services	2,191,888	-	1,951,170	-	(240,718)	-
Public safety	35,852	-	-	-	(35,852)	-
Economic development	2,105,967	-	-	-	(2,105,967)	-
Municipal governments	-	-	-	-	-	-
Future operations	-	-	71,131	94,577	165,708	-
Capital projects	196,909	-	81,820	-	(115,089)	-
Other appropriations	575,747	-	-	-	(575,747)	-
<b>Total primary government</b>	<b>\$ 14,954,962</b>	<b>\$ 399,535</b>	<b>\$ 9,655,721</b>	<b>\$ 97,600</b>	<b>(4,802,106)</b>	<b>-</b>
<b>Component units:</b>						
Kosrae Utilities Authority	\$ 2,371,646	\$ 1,646,297	\$ -	\$ -	-	(725,349)
Micronesian Petroleum Corporation	3,920,997	4,030,074	-	-	-	109,077
<b>Total component units</b>	<b>\$ 6,292,643</b>	<b>\$ 5,676,371</b>	<b>\$ -</b>	<b>\$ -</b>	<b>-</b>	<b>(616,272)</b>
<b>General revenues:</b>						
<b>Taxes:</b>						
Revenue sharing					1,216,477	-
Excise taxes					157,598	-
Unrestricted investment earnings					71,951	-
Other					106,950	1,021,805
<b>Total general revenues and transfers</b>					<b>1,552,976</b>	<b>1,021,805</b>
<b>Special items:</b>						
Write down of investments					(1,732,000)	-
Bad debts					(2,284,270)	-
<b>Total special items</b>					<b>(4,016,270)</b>	<b>-</b>
Change in net assets					(7,265,400)	1,021,805
Net assets at the beginning of the year					39,622,907	9,014,799
<b>Net assets at the end of the year</b>					<b>\$ 32,357,507</b>	<b>\$ 10,036,604</b>

See accompanying notes to basic financial statements.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Balance Sheet  
Governmental Funds  
September 30, 2006

	Special Revenue			Capital Projects	Permanent	Other	Total
	General	U.S Federal Grants	Compact Sector Grants	Compact Capital Projects	Compact Trust	Governmental Funds	
<b>ASSETS</b>							
Cash and cash equivalents	\$ 41,348	\$ 1,600	\$ -	\$ -	\$ -	\$ 1,279	\$ 44,227
Equity in internal investment pool	140,617	-	-	591,025	-	-	731,642
Investments	200,000	-	-	800,000	-	-	1,000,000
Receivables, net:							
Loans	270,000	-	-	-	-	68,215	338,215
Federal agencies	-	452,724	333,365	-	-	-	786,089
CFSM	11,314	-	-	-	-	26,230	37,544
Other	133,342	-	-	-	-	24,008	157,350
Due from other funds	201,958	-	1,924,464	487,061	-	1,665,117	4,278,600
Advances	233,181	106,700	-	20,742	-	(25)	360,598
Inventories	11,757	-	-	-	-	8,825	20,582
Restricted assets:							
Cash and cash equivalents	-	-	-	138,114	-	511,364	649,478
Time certificates of deposit	-	-	-	419,256	-	39,383	458,639
Investments	-	-	-	-	2,537,525	1,539,723	4,077,248
Total assets	<u>\$ 1,243,517</u>	<u>\$ 561,024</u>	<u>\$ 2,257,829</u>	<u>\$ 2,456,198</u>	<u>\$ 2,537,525</u>	<u>\$ 3,884,119</u>	<u>\$ 12,940,212</u>
<b>LIABILITIES AND FUND BALANCES</b>							
<b>Liabilities:</b>							
Bank overdraft	\$ 322,286	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 322,286
Accounts payable	414,261	252,867	528,933	11,760	-	60,200	1,268,021
Other liabilities and accruals	37,063	4,059	-	-	-	(176)	40,946
Due to other funds	4,076,642	172,985	-	-	-	28,973	4,278,600
Due to component unit	5,651	-	-	-	-	-	5,651
Deferred revenue	-	118,514	1,535,496	-	-	160,487	1,814,497
Total liabilities	<u>4,855,903</u>	<u>548,425</u>	<u>2,064,429</u>	<u>11,760</u>	<u>-</u>	<u>249,484</u>	<u>7,730,001</u>
<b>Fund balances:</b>							
Reserved for:							
Related assets	812,157	-	-	800,000	2,537,525	1,948,542	6,098,224
Encumbrances	60,935	137,988	811,722	171,722	-	230,036	1,412,403
Continuing appropriations	501,303	-	-	81,661	-	179,001	761,965
Unreserved:							
General fund	(4,787,904)	-	-	-	-	-	(4,787,904)
Special revenue funds	-	(125,389)	(618,322)	-	-	1,288,840	545,129
Capital projects funds	-	-	-	1,391,055	-	(11,784)	1,379,271
Total fund balances	<u>(3,413,509)</u>	<u>12,599</u>	<u>193,400</u>	<u>2,444,438</u>	<u>2,537,525</u>	<u>3,634,635</u>	<u>5,409,088</u>
Total liabilities and fund balances	<u>\$ 1,442,394</u>	<u>\$ 561,024</u>	<u>\$ 2,257,829</u>	<u>\$ 2,456,198</u>	<u>\$ 2,537,525</u>	<u>\$ 3,884,119</u>	
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							
							30,385,246
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							(3,127,950)
Claims payable							(110,000)
							<u>(3,237,950)</u>
Net assets of governmental activities							<u>\$ 32,556,384</u>

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, 2006

	Special Revenue			Capital Projects	Permanent	Other Governmental Funds	Total
	General	U.S Federal Grants	Compact Sector Grants	Compact Capital Projects	Compact Trust		
<b>Revenues:</b>							
Compact funding	\$ -	\$ -	\$ 6,709,120	\$ -	\$ -	\$ -	\$ 6,709,120
Investment income	71,951	16	-	15,732	165,708	110,358	363,765
Federal contributions	-	2,063,116	-	-	-	-	2,063,116
FSM revenue sharing	1,216,477	-	-	-	-	-	1,216,477
State taxes	157,598	-	-	-	-	-	157,598
CFSM grants	-	-	-	-	-	28,352	28,352
Fees and charges	91,414	-	-	-	-	308,121	399,535
Other grants	-	10,720	-	-	-	604,442	615,162
Other	106,950	-	-	37,736	-	8,021	152,707
<b>Total revenues</b>	<b>1,644,390</b>	<b>2,073,852</b>	<b>6,709,120</b>	<b>53,468</b>	<b>165,708</b>	<b>1,059,294</b>	<b>11,705,832</b>
<b>Expenditures:</b>							
<b>Current:</b>							
General government	1,641,435	824,746	3,025,266	-	-	1,262,168	6,753,615
Land and natural resources	360	28,510	-	-	-	-	28,870
Education	953	899,438	2,053,842	-	-	(3)	2,954,230
Health services	-	321,158	1,630,012	-	-	121,420	2,072,590
Public safety	-	-	-	-	-	28,352	28,352
Payments to non-governmental agencies	108,667	-	-	-	-	-	108,667
Boards, commissions and other	629,269	-	-	-	-	246,229	875,498
Capital projects	-	-	-	196,909	-	-	196,909
<b>Total expenditures</b>	<b>2,380,684</b>	<b>2,073,852</b>	<b>6,709,120</b>	<b>196,909</b>	<b>-</b>	<b>1,658,166</b>	<b>13,018,731</b>
Excess (deficiency) of revenues over (under expenditures)	(736,294)	-	-	(143,441)	165,708	(598,872)	(1,312,899)
<b>Other financing sources (uses):</b>							
Proceeds from long term debt	-	-	-	-	-	991,777	991,777
Operating transfers in	-	-	-	-	-	198,877	198,877
Operating transfers out	(198,877)	-	-	-	-	-	(198,877)
<b>Total other financing sources (uses), net</b>	<b>(198,877)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,190,654</b>	<b>991,777</b>
<b>Special items (expenses):</b>							
Write down of investments	-	-	-	(1,732,000)	-	-	(1,732,000)
Bad debts	(2,284,270)	-	-	-	-	-	(2,284,270)
<b>Total special items</b>	<b>(2,284,270)</b>	<b>-</b>	<b>-</b>	<b>(1,732,000)</b>	<b>-</b>	<b>-</b>	<b>(4,016,270)</b>
<b>Net change in fund balances (deficits)</b>	<b>(3,020,564)</b>	<b>-</b>	<b>-</b>	<b>(1,875,441)</b>	<b>165,708</b>	<b>591,782</b>	<b>(4,138,515)</b>
Fund balances (deficits) at the beginning of the year	(392,945)	12,599	193,400	4,319,879	2,371,817	3,042,853	9,547,603
<b>Fund balances (deficits) at the end of the year</b>	<b>\$ (3,413,509)</b>	<b>\$ 12,599</b>	<b>\$ 193,400</b>	<b>\$ 2,444,438</b>	<b>\$ 2,537,525</b>	<b>\$ 3,634,635</b>	<b>\$ 5,409,088</b>

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, 2006

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

Net change in fund balances - total governmental funds from page 13	\$ (4,337,392)
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 or are less than depreciation in the current period	(1,936,231)
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>(991,777)</u>
Change in net assets of governmental activities as presented on page 11.	\$ <u>(7,265,400)</u>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

DISCRETELY PRESENTED COMPONENT UNITS  
Combining Statement of Net Assets  
September 30, 2006

<u>ASSETS</u>	Kosrae Utilities Authority	Micronesia Petroleum Corporation	Total
Current assets:			
Cash and cash equivalents	\$ 255,952	\$ 88,787	\$ 344,739
Investments	1,575,952	31,824	1,607,776
Receivables, net:			
Federal agencies	7,793	-	7,793
General	203,593	471,721	675,314
Due from primary government	220,614	-	220,614
Inventories	466,344	940,837	1,407,181
Prepayments	5,300	1,233	6,533
Other	18,461	-	18,461
Total current assets	<u>2,754,009</u>	<u>1,534,402</u>	<u>4,288,411</u>
Noncurrent assets:			
Capital assets, net of accumulated depreciation	5,088,838	2,178,093	7,266,931
Total assets	<u>\$ 7,842,847</u>	<u>\$ 3,712,495</u>	<u>\$ 11,555,342</u>
<u>LIABILITIES AND NET ASSETS</u>			
Current liabilities:			
Current portion of long-term debt	\$ -	\$ 576,637	\$ 576,637
Accounts payable	201,340	300,460	501,800
Accrued liabilities	31,397	11,033	42,430
Due to primary government	-	62,278	62,278
Total current liabilities	<u>232,737</u>	<u>950,408</u>	<u>1,183,145</u>
Noncurrent liabilities:			
Noncurrent portion of long-term debt	-	951,865	951,865
Total noncurrent liabilities	<u>-</u>	<u>951,865</u>	<u>951,865</u>
Total liabilities	<u>232,737</u>	<u>1,902,273</u>	<u>2,135,010</u>
Net assets:			
Invested in capital assets, net of related debt	5,088,838	2,178,093	7,266,931
Temporary restricted	90,000	-	90,000
Unrestricted	2,431,272	(367,871)	2,063,401
Total net assets	<u>7,610,110</u>	<u>1,810,222</u>	<u>9,420,332</u>
Total liabilities and net assets	<u>\$ 7,842,847</u>	<u>\$ 3,712,495</u>	<u>\$ 11,555,342</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, 2006

	Kosrae Utilities Authority	Micronesia Petroleum Corporation	Totals
Operating revenues:			
Charge for services	\$ 1,646,297	\$ 4,030,074	\$ 5,676,371
Operating expenses:			
Cost of goods sold	-	3,522,294	3,522,294
Fuel	1,416,437	6,771	1,423,208
Depreciation	459,194	44,012	503,206
Personnel services	326,692	130,899	457,591
Taxes	-	128,209	128,209
Administration and general	121,567	-	121,567
Repair and maintenance	47,756	6,629	54,385
Professional fees	-	26,000	26,000
Travel and entertainment	-	12,354	12,354
Bank service charges	-	8,470	8,470
Utilities	-	7,757	7,757
Rent	-	6,311	6,311
Supplies and materials	-	5,400	5,400
Insurance	-	4,557	4,557
Communications	-	4,276	4,276
Others	-	7,058	7,058
Total operating expenses	<u>2,371,646</u>	<u>3,920,997</u>	<u>6,292,643</u>
Operating (loss) income	<u>(725,349)</u>	<u>109,077</u>	<u>(616,272)</u>
Nonoperating revenues (expenses):			
Interest income	64,728	-	64,728
Other income (expense)	-	1,644	1,644
Federal grants	2,143	-	2,143
Interest expense	-	(65,259)	(65,259)
Total nonoperating revenues (expenses), net	<u>66,871</u>	<u>(63,615)</u>	<u>3,256</u>
Capital contributions	<u>1,018,549</u>	<u>-</u>	<u>1,018,549</u>
Change in net assets	360,071	45,462	405,533
Net assets at beginning of year	<u>7,250,039</u>	<u>1,764,760</u>	<u>9,014,799</u>
Net assets at end of year	<u>\$ 7,610,110</u>	<u>\$ 1,810,222</u>	<u>\$ 9,420,332</u>

See accompanying notes to financial statements.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(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, 2006

(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.

**Micronesian 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, 2006

(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 - nonexpendable consists of permanent funds in which donors or other outside sources have stipulated that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may either be expended or added to the principal.
- Restricted net assets - expendable consists of resources in which the State is legally or contractually obligated to spend resources in accordance with restrictions 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 \$8,824,483 of restricted net assets, of which \$3,359,404 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.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(1) Summary of Significant Accounting Policies, Continued

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.

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, 2006

(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:

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(1) Summary of Significant Accounting Policies, Continued

D. Measurement Focus and Basis of Accounting, Continued

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.

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 Compact Sector Grants 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, 2006, the carrying amount of the primary government's total cash and cash equivalents and time certificates of deposit was \$1,152,344 and the corresponding bank balance was \$1,163,568, which is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006, bank deposits in the amount of \$132,313 were FDIC insured. The State does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Therefore, these deposits are exposed to custodial credit risk.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(1) Summary of Significant Accounting Policies, Continued

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

As of September 30, 2006, the carrying amount of the discretely presented component units' total cash and cash equivalents was \$344,739, which approximates the corresponding bank balance amount. All cash is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2006, 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. Therefore, these deposits are exposed to custodial credit risk.

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 State 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, 2006

(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

As of September 30, 2006, cash and cash equivalents and time certificates of deposit of the primary government were restricted for the following uses:

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 \$1,539,723 for the Kosrae State Early Retirement Scheme. Furthermore, investments recorded in the Compact Trust Fund of \$2,537,525 are restricted in that they are not available to be used in current operations. As of September 30, 2006, cash and cash equivalents and time certificates of deposit of the primary government were restricted for the following uses:

A demand deposit account with a local bank as remaining loan proceeds of the \$2,000,000 Early Retirement loan with the Asian Development Bank.	\$ 169,937
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Time certificate of deposit of \$39,383 and demand deposit of \$341,427 with a local bank restricted for scholarships for post-secondary students.	380,810
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The State has restricted a time certificate of deposit that collateralizes a bank loan to Micronesian Petroleum Corporation, a component unit. (See Note 6)	219,256
---	---------

Time certificate of deposit of \$200,000 and demand deposit account of \$138,114 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>338,114</u>
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\$ 1,108,117

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, 2006

(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 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, 2006

(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, 2006, is represented by the following assets:

	<u>General</u>	U.S. Federal <u>Grants</u>	Section 211 <u>Sector Grant</u>	Compact Capital <u>Projects</u>	Section 215 Compact <u>Trust</u>	Other Governmental <u>Funds</u>	<u>Totals</u>
Investments	\$ 119,673	\$ -	\$ -	\$ 800,000	\$ -	\$ -	\$ 919,673
Receivables:							
General	374,204	-	-	-	-	-	374,204
Loans	246,000	-	-	-	-	68,215	314,215
Federal agencies	33,204	-	-	-	-	-	33,204
Due from other funds	39,076	-	-	-	-	170,667	209,742
Restricted assets:							
Cash and cash equivalents	-	-	-	-	-	169,937	169,937
Investments	-	-	-	-	<u>2,537,525</u>	<u>1,539,723</u>	<u>4,077,248</u>
	<u>\$ 812,157</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 800,000</u>	<u>\$ 2,537,525</u>	<u>\$ 1,948,542</u>	<u>\$6,098,224</u>

The reserve for related assets within the General Fund includes the amount of \$119,673 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. However, no material losses have been sustained from this practice in the last three years.

R. New Accounting Standards

During fiscal year 2006, the State implemented the following pronouncements:

- GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which establishes standards for impairment of capital assets when service utility has declined significantly and unexpectedly.
- GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation (an amendment to GASB Statement No. 34)*, which requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(1) Organization and Summary of Significant Accounting Policies, Continued

R. New Accounting Standards, Continued

- GASB Statement No. 47, *Accounting for Termination Benefits*, which establishes guidance for state and local governmental employers on accounting and financial reporting for termination of benefits.
- GASB Technical Bulletin No. 2004-2, *Recognition of Pension and Other Postemployment Benefit Expenditures/Expense and Liabilities by Cost-Sharing Employers*, which clarifies the requirements of GASB Statement Nos. 27 and 45 for recognition of pension and other postemployment benefit expenditures/expense and liabilities by cost-sharing employers.

The implementation of these pronouncements did not have a material impact on the accompanying 2006 financial statements.

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. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the State.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other post employment 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. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the State.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*. GASB Statement No. 48 establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. The Statement also includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. The provisions of this Statement are effective for periods beginning after December 15, 2006. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the State.

S. 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, 2006

(1) Summary of Significant Accounting Policies, Continued

T. Deferred Revenue

In the government-wide financial statements, deferred revenue is recognized when cash, receivables or other assets are recorded prior to their being earned. In the governmental fund financial statements deferred revenue represents monies received or revenues accrued which have not been earned or do not meet the "available" criterion for revenue recognition under the modified accrual basis of accounting. The deferred revenue in the governmental fund types has primarily resulted as federal funds are received in advance of eligible expenditures.

(2) Deposits and Investments

GASB Statement No. 40 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 rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

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. 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. Investment income originating from the pool accrues to the General Fund.

The deposit and investment policies of the State are governed by State legislation. The Treasurer is responsible for ensuring that deposits of the General Fund are maintained in commercial checking or savings accounts of any financial institution whose assets are at least \$1 billion and whose deposits are subject to Federal Deposit Insurance Corporation (FDIC) insurance. The Governor is responsible for the investment of any monies of the State that are deemed not necessary for immediate use.

The Federated Development Authority has selected investment managers who are given authority to buy and sell securities. These investment managers may invest in stocks, bonds and cash equivalents, for which minimum standards of quality of such investments at the time of purchase shall be as follows:

- i. Cash equivalents - the investment manager may engage in all normally accepted short-term investment practices including, but not limited to U.S. Treasury and government 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 \$2 billion. Deposits in smaller institutions are acceptable, but must not exceed the amount of the insurance, unless collateralized by U.S. Treasury obligations at 102%.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(2) Deposits and Investments, Continued

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

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.

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.

A. Deposits

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

Category 1 Deposits that are federally insured or collateralized with securities held by the State or its agent in the State's name;

Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the State's name; or

Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the State's name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the State's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The State does not have a deposit policy for custodial credit risk.

B. Investments

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

Category 1 Investments that are insured or registered, or securities held by the State or its agent in the State's name;

Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the State's name; or

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(2) Deposits and Investments, Continued

B. Investments

Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the State's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of September 30, 2006, the State's investments at fair value are as follows:

Fixed income securities:	
Domestic fixed income	\$ <u>491,212</u>
Other investments:	
Domestic equities	2,647,165
Money market funds	104,118
Cash management account	<u>2,566,395</u>
	<u>5,317,678</u>
	\$ <u>5,808,890</u>

As of September 30, 2006, the State's fixed income securities, including their Moody's Investors Service credit ratings, had the following maturities:

	Credit Ratings	Investment Maturities (In Years)				Fair Value
		Less Than 1	1 to 5	6 to 10	Greater Than 10	
U.S. government obligations	Aaa	\$ 494	\$ 27,446	\$ 35,057	\$ 45,140	\$108,127
U.S. government agency obligations	Aaa	14,312	68,068	8,015	173,698	264,093
Corporate notes and bonds	Aaa	-	18,345	-	4,550	22,895
Corporate notes and bonds	Aa1	-	5,939	975	-	6,914
Corporate notes and bonds	Aa2	-	-	2,338	-	2,338
Corporate notes and bonds	Aa3	-	1,964	2,001	-	3,965
Corporate notes and bonds	A1	-	-	980	9,153	10,133
Corporate notes and bonds	A2	-	11,409	17,781	5,277	34,467
Corporate notes and bonds	A3	-	4,243	-	981	5,224
Corporate notes and bonds	Baa1	-	2,791	5,247	-	8,038
Corporate notes and bonds	Baa2	-	-	2,189	-	2,189
Corporate notes and bonds	Baa3	-	-	-	619	619
Corporate notes and bonds	Not rated	<u>1,003</u>	<u>5,990</u>	<u>995</u>	<u>14,222</u>	<u>22,210</u>
		<u>\$15,809</u>	<u>\$146,195</u>	<u>\$75,568</u>	<u>\$253,640</u>	<u>\$491,212</u>

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

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(2) Deposits and Investments, Continued

B. Investments, Continued

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the State will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The State's investments are held and administered by trustees. Based on negotiated trust and custody contracts, all of these investments were held in the State's name by the State's custodial financial institutions at September 30, 2006.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the State. As of September 30, 2006, the State did not hold an investment in any one issuer that represented more than 5% of the State's total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The State does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

As of September 30, 2006, 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, 5.7% of the shares of the Pacific Islands Development Bank in the amount of \$300,000, and 50% of the shares in a joint venture. As the fair market value of these investments is not readily available, such have been recorded at cost.

As of September 30, 2006, the Compact Capital Projects Fund wrote off its investment in a joint venture with Semo Co., Ltd, a Korean Company, of Semo-Micronesia, Inc. in the amount of \$1,732,000.

In addition, as of September 30, 2006, 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.

As of September 30, 2006, the General Fund holds 5.7% of the shares of the Pacific Island Development Bank in the amount of \$300,000. As the fair market value of this investment is not readily available, such has been recorded at cost.

Discretely Presented Component Units

As of September 30, 2006, investments at fair value comprise the following:

Time certificates of deposit	\$ 644,123
Common stock	590,429
Money market funds	<u>373,224</u>
	\$ <u>1,607,776</u>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(3) Receivables

Receivables as of September 30, 2006, 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.S. Federal <u>Grants</u>	Section 211 Sector <u>Grants</u>	Compact Capital <u>Projects</u>	Section 215 Compact <u>Trust</u>	Other Governmental <u>Funds</u>	<u>Total</u>
Receivables:							
Federal agencies	\$ -	\$ 1,874,308	\$ 342,759	\$ -	\$ -	\$ 173,144	\$ 2,390,211
Taxes	177,038	-	-	-	-	-	177,038
Loans	270,000	-	-	367,500	-	1,802,851	2,440,351
CFSM	-	972,877	-	-	-	445,812	1,418,689
Other	<u>28,414</u>	<u>34,899</u>	<u>35,827</u>	<u>-</u>	<u>-</u>	<u>386,646</u>	<u>485,786</u>
Less: Allowance for uncollectible accounts	<u>(60,796)</u>	<u>(2,429,360)</u>	<u>(45,221)</u>	<u>(367,500)</u>	<u>-</u>	<u>(2,690,000)</u>	<u>(5,592,877)</u>
Net receivables	<u>\$ 414,656</u>	<u>\$ 452,724</u>	<u>\$ 333,365</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 118,453</u>	<u>\$ 1,319,198</u>

Loans receivable of the primary government as of September 30, 2006 are as follows:

Major Governmental Funds

General Fund:

Note receivable due from Micronesian Petroleum Corporation, payable in monthly installments of \$2,000, uncollateralized, due June 1, 2005, interest at 1% per annum. \$ 270,000

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

Less: Allowance for uncollectibles 367,500  
(367,500)

\$ -

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(3) Receivables, Continued

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.	<u>1,364,294</u>
	1,802,851
	<u>(1,734,636)</u>
	<u>\$ 68,215</u>

(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, 2006, are summarized as follows:

Receivable Fund	Payable Fund	Amount
Section 211 Sector Grant	General	\$ 1,924,464
Compact Capital Projects	General	487,061
Nonmajor governmental funds	General	1,665,117
General	U.S. Federal Grants	172,985
General	Nonmajor governmental funds	<u>28,973</u>
		<u>\$ 4,278,600</u>

(5) Fixed Assets

Capital asset activities for the year ended September 30, 2006, are as follows:

Primary Government

	Balance September 30, 2005	Additions	Retirements	Balance September 30, 2006
Governmental activities:				
Buildings	\$ 13,251,456	\$ 253,518	\$ -	\$ 13,504,974
Infrastructure	72,885,749	-	-	72,885,749
Machinery, equipment, others	<u>3,324,510</u>	<u>154,900</u>	<u>-</u>	<u>3,479,410</u>
	<u>89,461,715</u>	<u>408,418</u>	<u>-</u>	<u>89,870,133</u>
Less accumulated depreciation:				
Buildings	(10,125,251)	(296,892)	-	(10,422,142)
Infrastructure	(44,230,693)	(1,956,359)	-	(46,187,052)
Machinery, equipment, others	<u>(2,689,717)</u>	<u>(185,975)</u>	<u>-</u>	<u>(2,875,693)</u>
	<u>(57,045,661)</u>	<u>(2,439,226)</u>	<u>-</u>	<u>(59,484,887)</u>
	<u>\$ 32,416,054</u>	<u>\$ (2,030,808)</u>	<u>\$ -</u>	<u>\$ 30,385,246</u>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(5) Fixed Assets, Continued

Primary Government, Continued

During the year ended September 30, 2006, depreciation expense was charged as follows:

General government	\$ 58,089
Education	148,372
Health services	119,298
Public safety	7,500
Economic development	1,870,219
Other appropriations	<u>235,748</u>
	<b>\$ 2,439,226</b>

Discretely Presented Component Units

	Balance September 30, 2005	Additions	Retirements	Balance September 30, 2006
Electrical plant in service	\$ 9,494,201	\$ 1,075,859	\$ -	\$10,570,060
Bulk plant	2,506,000	-	-	2,506,000
Building and improvements	207,346	-	-	207,346
Land	200,000	-	-	200,000
Machinery and equipment	445,191	2,849	(276)	447,764
Vehicles	295,664	15,000	-	310,664
Furniture and fixtures	<u>61,521</u>	<u>-</u>	<u>(2,915)</u>	<u>58,606</u>
	13,209,923	1,093,708	(3,191)	14,300,440
Less accumulated depreciation	<u>(6,626,857)</u>	<u>(574,958)</u>	<u>3,014</u>	<u>(7,198,801)</u>
	6,583,066	518,750	-	7,101,639
Construction in progress	<u>204,556</u>	<u>1,033,216</u>	<u>(1,072,480)</u>	<u>165,292</u>
	<b><u>\$ 6,787,622</u></b>	<b><u>\$ 1,551,966</u></b>	<b><u>\$ (1,072,657)</u></b>	<b><u>\$ 7,266,931</u></b>

(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, 2006, the balance payable on this mortgage loan amounted to \$136,173.

Asian Development Bank (ADB) Early Retirement Program Loan and Other ADB Debt:

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.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(6) Long-Term Obligations, Continued

Primary Government, Continued

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 \$1,539,723 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.

During the year ended September 30, 2003, the State entered into an agreement with the Federated States of Micronesia National Government (FSM) to borrow a portion of the proceeds of the FSM Program Loan with ADB (Loan Number 1873 (SF) and Loan Number 1874 FSM (SF)), for the purpose of promoting private sector development in Yap, with interest at 1 to 1½%. As of September 20, 2006, total drawdowns received were \$991,777. The principal payments shall be made in 32 equal semi-annual payments with the first payment due on May 15, 2011 and the last payment on November 15, 2026.

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>
2007	\$ 2,037	\$ 6,116	\$ 8,153
2008	41,844	6,036	47,880
2009	41,927	5,953	47,880
2010	42,013	5,866	47,879
2011	54,070	66,998	121,068
2012 – 2016	514,553	90,786	605,339
2017 – 2021	700,987	64,355	765,342
2022 – 2026	769,967	35,373	805,340
2027 – 2031	423,277	16,122	439,399
2032 - 2036	428,917	10,391	439,308
2037 - 2041	<u>108,358</u>	<u>3,160</u>	<u>111,518</u>
	<u>\$ 3,127,950</u>	<u>\$ 311,156</u>	<u>\$ 3,439,106</u>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(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, 2006, the following changes occurred in liabilities reported as part of the primary government's long-term liabilities in the statement of net assets:

	Balance September <u>30, 2005</u>	<u>Additions</u>	<u>Reductions</u>	Balance September <u>30, 2006</u>	Due Within <u>One Year</u>
Loans payable:					
ADB loans	\$ 2,000,000	\$ 991,777	\$ -	\$ 2,991,777	\$ -
MWSP loan	<u>140,750</u>	<u>-</u>	<u>(4,577)</u>	<u>136,173</u>	<u>2,037</u>
	<u>2,140,750</u>	<u>991,777</u>	<u>(4,577)</u>	<u>3,127,950</u>	<u>2,037</u>
Other:					
Claims	<u>200,000</u>	<u>-</u>	<u>(90,000)</u>	<u>110,000</u>	<u>-</u>
	<u>\$ 2,340,750</u>	<u>\$ 991,777</u>	<u>\$ (94,577)</u>	<u>\$ 3,237,950</u>	<u>\$ 2,037</u>

Discretely Presented Component Units

Micronesia Petroleum Corporation (MPC):

Loan payable to Kosrae State Government, in the original amount of \$300,000, due in monthly installments of \$2,628, interest at 1%, maturing on February 1, 2009. \$ 272,500

Loan payable to Kosrae State Government in the original amount of \$300,000 due in monthly installments of \$2,000. Commencing June 1, 2008, installments shall be increased to \$4,000 per month, interest at 1%. 272,106

Loan payable to 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 the property and inventory of the Company. 298,777

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. Interest rate effective as of September 30, 2006 and 2005 are 5.25% and 6.92%, respectively. 144,641

Loan payable to FSM Development Bank, ten year term, maturing on July 18, 2010, interest at 5%, monthly repayment of \$7,958, collateralized by MPC's accounts receivable and inventory. 356,538

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(6) Long-Term Obligations, Continued

Discretely Presented Component Units, Continued

Micronesia Petroleum Corporation (MPC): Continued

Loan payable to FSM Development Bank, two year term, maturing on July 31, 2008, interest at 9%, monthly repayment of \$9,136, collateralized by interest in essentially all MPC assets.	<u>183,940</u>
Total debt	1,528,502
Less current portion	<u>(576,637)</u>
Long-term debt, net of current portion	\$ <u>951,865</u>

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>
2007	\$ 576,637	\$ 71,586	\$ 648,223
2008	549,213	48,462	597,675
2009	131,577	11,919	143,496
2010	136,318	7,178	143,496
2011	68,645	2,219	70,864
2012 – 2013	<u>66,112</u>	<u>849</u>	<u>66,961</u>
	<u>\$ 1,528,502</u>	<u>\$ 142,213</u>	<u>\$ 1,670,715</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, 2006 is \$222,277.

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.

**STATE OF KOSRAE**  
**FEDERATED STATES OF MICRONESIA**

Notes to Financial Statements  
September 30, 2006

(7) Contingencies and Commitments, Continued

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 \$1,506,567 relating to fiscal years 1996 through 2006 have been set forth in the State's Single Audit Report for the year ended September 30, 2006. 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.

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, 2006, is not predictable but could have a material impact on the accompanying financial statements. Such impact has currently been estimated to approximate \$110,000, 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, 2006, are as follows:

General Fund	\$ <u>3,612,386</u>
Compact Special Development Fund 212 (b)	\$ <u>39,076</u>
Airport Revolving Fund	\$ <u>10,766</u>

(9) Subsequent Events and General Fund Financial Position

As of September 30, 2006, the State's General Fund has an unreserved deficit of approximately \$5 million. A loan agreement was executed with the FSM National Government on April 5, 2007 in the amount of \$1.5 million. The loan is interest free and has a grace period of two years. In return, the FSM National Government has recommended a freeze in hiring, stoppage of nearly all travel by government workers, a reduction in working hours, the imposition of higher tax rates, the creation of a rainy day fund, allocation of funds to only revenue generating programs and activities, and the enforcement of balanced annual budgets. To finance the State's deficit, Compact Sector grant cash was utilized and this loan allowed repayment to the affected grant account as well as the liquidation of certain other State liabilities. Additionally, the State is actively reviewing cost containment matters including the potential lay-off of personnel funded through the general fund and the redesignation of certain Compact Capital account funds as current. State management is of the opinion that these efforts will result in a reduction of the stated deficit.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

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

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**YEAR ENDED SEPTEMBER 30, 2006**

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Schedule of Revenues, Expenditures and Changes in Fund Balance - Budget and Actual  
General Fund  
Year Ended September 30, 2006

	Budgeted Amounts		Actual - Budgetary Basis (see Note 1)	Variance with Final Budget -
	Original	Final		
<b>Revenues:</b>				
FSM Revenue sharing	\$ 2,133,146	\$ 2,133,146	\$ 1,216,477	\$ (916,669)
State taxes	-	-	157,598	157,598
Investment income	-	-	71,951	71,951
Other	1,228,564	1,228,564	198,364	(1,030,200)
Total revenues	<u>3,361,710</u>	<u>3,361,710</u>	<u>1,644,390</u>	<u>(1,717,320)</u>
<b>Expenditures:</b>				
<b>Current:</b>				
General government	1,569,342	1,618,492	1,641,435	(22,943)
Department of Land and Natural Resources	33,800	-	360	(360)
Department of Education	617,289	-	953	(953)
Department of Health Services	384,123	-	-	-
Department of Public Safety	20,000	-	-	-
Office of the Attorney-General	-	324,331	-	324,331
Other appropriations	707,206	633,926	629,269	4,657
Payments to Non-governmental Agencies	29,900	102,466	108,667	(6,201)
Total expenditures	<u>3,361,660</u>	<u>2,679,215</u>	<u>2,380,684</u>	<u>298,531</u>
Excess (deficiency) of revenues over (under) expenditures	<u>50</u>	<u>682,495</u>	<u>(736,294)</u>	<u>(1,418,789)</u>
<b>Other financing uses:</b>				
Operating transfers out	-	-	(198,877)	(198,877)
<b>Special items:</b>				
Bad debt	-	-	(2,284,270)	(2,284,270)
Net change in unreserved fund balance	50	682,495	(3,219,441)	(3,901,936)
<b>Other changes in unreserved fund balance:</b>				
Decrease in reserve for related assets	-	-	2,309,016	2,309,016
Decrease in encumbrances	-	-	26,096	26,096
Decrease in reserve for continuing appropriations	-	-	52,784	52,784
Unreserved fund balance (deficit) at the beginning of the year	<u>(4,155,236)</u>	<u>(4,155,236)</u>	<u>(4,155,236)</u>	<u>-</u>
Unreserved fund balance (deficit) at the end of the year	<u>\$ (4,155,186)</u>	<u>\$ (3,472,741)</u>	<u>\$ (4,986,781)</u>	<u>\$ (1,514,040)</u>

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, 2006

(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, 2006, 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>
Governor and staff	\$ 34,098
Department of Treasury and Administration	\$ 193,567
Judiciary Branch	\$ 3,078
Department of Land and Natural Resource	\$ 360
Department of Education	\$ 953
Commerce and Industry	\$ 61,187
Scholarship Board	\$ 49,306
Broadcast Authority	\$ 236
Sports Operation	\$ 683
USDA Rural Development	\$ 6,201

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

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**OTHER SUPPLEMENTARY INFORMATION**

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**YEAR ENDED SEPTEMBER 30, 2006**

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Combining Schedule of Expenditures by Account  
Governmental Funds  
Year Ended September 30, 2006

	General	Special Revenue		Capital	Permanent	Other Governmental Funds	Total
		U.S Federal Grants	Section 211 Sector Grant	Projects Compact Capital Projects	Section 215 Compact Trust		
Expenditures:							
Salaries and wages	\$ 1,454,030	\$ 632,464	\$ 3,698,841	\$ 5,047	\$ -	\$ 226,768	\$ 6,017,150
Contractual services	121,914	981,875	994,962	155,800	-	114,782	2,369,333
Capital outlay	29,645	22,821	392,242	9,538	-	66,927	521,173
Utilities	81,707	8,273	211,325	-	-	12,967	314,272
Travel	212,267	187,103	280,976	-	-	24,663	705,009
Supplies and materials	42,656	183,466	416,026	26,516	-	86,821	755,485
Medical supplies	-	773	163,003	-	-	18,385	182,161
Medical referral	-	-	37,288	-	-	-	37,288
Scholarship	-	-	178,926	-	-	369	179,295
POL	106,544	8,020	38,877	-	-	13,321	166,762
Communications	39,560	16,852	56,052	-	-	1,786	114,250
Food stuffs	15,332	1,486	26,188	-	-	539	43,545
Rentals	2,897	6,227	506	-	-	-	9,630
Repairs and maintenance	1,105	448	2,421	-	-	743	4,717
Printing and reproduction	3,693	11,562	19,167	-	-	517	34,939
Leased housing/land	25,031	450	80,023	-	-	-	105,504
Training	5,045	6,938	46,390	-	-	-	58,373
Contributions	102,500	-	53,131	-	-	-	155,631
Other	136,758	5,094	12,776	8	-	1,089,578	1,244,214
	<u>\$ 2,380,684</u>	<u>\$ 2,073,852</u>	<u>\$ 6,709,120</u>	<u>\$ 196,909</u>	<u>\$ -</u>	<u>\$ 1,658,166</u>	<u>\$ 13,018,731</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function, and Changes in Fund Balances  
General Fund  
Year Ended September 30, 2006  
(with comparative totals for the year ended September 30, 2005)

	2006	2005
<b>Revenues:</b>		
Compact funds:		
Current Section 211(a) base grant	\$ -	\$ 9,269
	-	9,269
FSM Revenue sharing	1,216,477	923,297
State taxes:		
Sales tax	55,026	96,204
Alcohol and tobacco tax	50,388	75,747
Licenses and Fees	52,184	15,818
Tax penalties	-	8,591
	157,598	196,360
Investment income	71,951	237,446
Other revenues	198,364	390,276
Total revenues	1,644,390	1,756,648
<b>Expenditures:</b>		
Current:		
General government:		
Governor and staff	490,254	465,399
Department of Treasury and Administration	34,806	-
Judiciary Branch	355,471	383,857
Legislative Branch	760,904	809,923
	1,641,435	1,659,179
Department of Land and Natural Resources:		
Office of the Director	360	30
	360	30
Department of Education:		
Office of the Director	953	1,656
	953	1,656
Department of Health Services:		
Division of Administration and Health Planning	-	45,093
	-	45,093
Department of Public Safety:		
Division of Law	-	2,412
	-	2,412
Boards, Commissions and Other:		
Transportation and Infrastructure	356,682	460,022
Community Affairs	122,294	-
Scholarship Board	16,256	-
Commerce and Industry	67,405	-
Broadcast Authority	65,189	-
Sports Operation	683	-
Parole Board	760	-
Other	-	157,338
	629,269	617,360
Payments to Non-governmental Agencies:		
Micronesia Legal Services Corporation	30,000	-
USDA Rural Development	78,667	252,326
	108,667	252,326

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Statement of Revenues, Expenditures by Function, and Changes in Fund Balance, Continued  
General Fund  
Year Ended September 30, 2006  
(with comparative totals for the year ended September 30, 2005)

	2006	2005
Expenditures, continued:		
Current, continued:		
Bad debts	2,284,270	-
Total expenditures	4,664,954	2,578,056
Excess (deficiency) of revenues over (under) expenditures	(3,020,564)	(821,408)
Other financing uses:		
Operating transfers out:		
Airport Revolving Fund	(116,040)	-
Scholarship Revolving Fund	(82,837)	-
	(198,877)	-
Net change in fund balance	(3,219,441)	(821,408)
Fund balance at the beginning of the year	(392,945)	428,463
Fund balance at the end of the year	\$ (3,612,386)	\$ (392,945)

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, 2006

	Budgeted Amounts		Actual Amounts	Variance
	Original	Final		
Revenues:				
FSM Revenue sharing:	\$ 2,133,146	\$ 2,133,146	\$ 1,216,477	\$ (916,669)
State taxes:				
Sales tax	-	-	55,026	55,026
Alcohol and tobacco tax	-	-	50,388	50,388
Licences and fees	-	-	52,184	52,184
Tax penalties	-	-	-	-
	-	-	157,598	157,598
Investment income	-	-	71,951	71,951
Other revenues	1,228,564	1,228,564	198,364	(1,030,200)
Total revenues	3,361,710	3,361,710	1,644,390	(1,717,320)
Expenditures:				
Current:				
General government:				
Governor and staff	382,006	456,156	490,254	(34,098)
Department of Treasury and Administration	48,000	48,000	34,806	13,194
Judiciary Branch	377,393	352,393	355,471	(3,078)
Legislative Branch	761,943	761,943	760,904	1,039
	1,569,342	1,618,492	1,641,435	(22,943)
Department of Land and Natural Resources:				
Office of the Director	33,800	-	360	(360)
	33,800	-	360	(360)
Department of Education:				
Office of the Director	617,289	-	953	(953)
	617,289	-	953	(953)
Department of Health Services:				
Division of Administration and Health Planning	384,123	-	-	-
	384,123	-	-	-
Department of Public Safety:				
Division of Law	20,000	-	-	-
	20,000	-	-	-
Office of the Attorney-General	-	324,331	-	324,331
Boards, Commissions and Other:				
Transportation and Infrastructure	288,276	364,299	356,682	7,617
Commerce and Industry	61,107	61,107	67,405	(6,298)
Community Affairs	131,868	123,868	122,294	1,574
Scholarship Board	18,470	18,099	16,256	1,843
Broadcast Authority	64,953	64,953	65,189	(236)
Sports Operation	-	-	683	(683)
Parole Board	1,600	1,600	760	840
Kosrae Port Authority	140,932	-	-	-
Other	-	-	-	-
	707,206	633,926	629,269	4,657
Payments to Non-governmental Agencies:				
Micronesia Legal Services Corporation	-	30,000	30,000	-
USDA Rural Development	29,900	72,466	78,667	(6,201)
	29,900	102,466	108,667	(6,201)
Total expenditures	3,361,660	2,679,215	2,380,684	298,531
Excess (deficiency) of revenues over (under) expenditures	50	682,495	(736,294)	(1,418,789)

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, 2006

	Budgeted Amounts		Actual Amounts	Variance
	Original	Final		
Other financing uses:				
Operating transfers out				
Airport Revolving Fund	-	-	(116,040)	(116,040)
Scholarship Revolving Fund	-	-	(82,837)	(82,837)
	-	-	(198,877)	(198,877)
Special items (expense):				
Bad debts	-	-	(2,284,270)	(2,284,270)
Net change in unreserved fund balance (deficit)	50	682,495	(3,219,441)	(3,901,936)
Other changes in unreserved fund balance (deficit):				
Decrease in reserve for related assets	-	-	2,309,016	2,309,016
Decrease in encumbrances	-	-	26,096	26,096
Change in reserve for continuing appropriations	-	-	52,784	52,784
Unreserved deficit at the beginning of the year	(4,155,236)	(4,155,236)	(4,155,236)	-
Unreserved fund balance (deficit) at the end of the year	<u>\$ (4,155,186)</u>	<u>\$ (3,472,741)</u>	<u>\$ (4,986,781)</u>	<u>\$ (1,514,040)</u>

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

Combined Balance Sheet  
Nonmajor Governmental Funds  
September 30, 2006

	<u>Other Special Revenue</u>	<u>Other Capital Projects</u>	<u>Total</u>
<b><u>ASSETS</u></b>			
Cash and equivalents	\$ 1,279	\$ -	\$ 1,279
Receivables:			
CFSM	-	26,230	26,230
Other	24,008	-	24,008
Advances	(25)	-	(25)
Inventory	8,825	-	8,825
Loans receivable	68,215	-	68,215
Due from other funds	1,665,117	-	1,665,117
Restricted assets:			
Cash and cash equivalents and TCDs	511,364	-	511,364
Time certificates of deposit	39,383	-	39,383
Investments	1,539,723	-	1,539,723
Total assets	<u>\$ 3,857,889</u>	<u>\$ 26,230</u>	<u>\$ 3,884,119</u>
<b><u>LIABILITIES AND FUND BALANCES</u></b>			
Liabilities:			
Accounts payable	\$ 59,900	\$ 300	\$ 60,200
Other liabilities and accruals	(77)	(99)	(176)
Due to other funds	2,977	25,996	28,973
Deferred revenue	160,454	33	160,487
Total liabilities	<u>223,254</u>	<u>26,230</u>	<u>249,484</u>
Fund balances:			
Reserved for:			
Related assets	1,948,542	-	1,948,542
Encumbrances	226,050	3,986	230,036
Continuing appropriations	171,203	7,798	179,001
Unreserved:			
Special revenue funds	1,288,840	-	1,288,840
Capital projects funds	-	(11,784)	(11,784)
Total fund balances	<u>3,634,635</u>	<u>-</u>	<u>3,634,635</u>
Total liabilities and fund balances	<u>\$ 3,857,889</u>	<u>\$ 26,230</u>	<u>\$ 3,884,119</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  
Nonmajor Governmental Funds  
Year Ended September 30, 2006

	Other Special Revenue	Other Capital Projects	Total
Revenues:			
Investment income	\$ 110,358	\$ -	\$ 110,358
Fees and charges	308,121	-	308,121
CFSM grants	-	28,352	28,352
Other grants	604,442	-	604,442
Other	8,021	-	8,021
	<u>1,030,942</u>	<u>28,352</u>	<u>1,059,294</u>
Total revenues			
Expenditures by function:			
Current:			
General government	1,262,168	-	1,262,168
Education	(3)	-	(3)
Health services	121,420	-	121,420
Public safety	-	28,352	28,352
Boards, commissions and other	246,229	-	246,229
	<u>1,629,814</u>	<u>28,352</u>	<u>1,658,166</u>
Total expenditures			
Excess of revenues over expenditures	<u>(598,872)</u>	<u>-</u>	<u>(598,872)</u>
Other financing sources:			
Proceeds from long term debt	991,777	-	991,777
Operating transfers in	198,877	-	198,877
	<u>1,190,654</u>	<u>-</u>	<u>1,190,654</u>
Totaling other financing sources			
Net change in fund balances	591,782	-	591,782
Fund balances at the beginning of the year	<u>3,042,853</u>	<u>-</u>	<u>3,042,853</u>
Fund balances at the end of the year	<u>\$ 3,634,635</u>	<u>\$ -</u>	<u>\$ 3,634,635</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  
Nonmajor Governmental Funds  
Year Ended September 30, 2006

	Other Special Revenue	Other Capital Projects	Total
<b>Revenues:</b>			
Investment income	\$ 110,358	\$ -	\$ 110,358
Fees and charges	308,121	-	308,121
CFSM grants	-	28,352	28,352
Other grants	604,442	-	604,442
Other	8,021	-	8,021
	<u>1,030,942</u>	<u>28,352</u>	<u>1,059,294</u>
<b>Total revenues</b>			
<b>Expenditures by account:</b>			
Salaries and wages	208,768	18,000	226,768
Contractual services	114,782	-	114,782
Capital outlay	66,927	-	66,927
Utilities	12,967	-	12,967
Travel	24,663	-	24,663
Supplies and materials	77,096	9,725	86,821
Medical supplies	18,385	-	18,385
Scholarship	369	-	369
POL	13,321	-	13,321
Communications	1,786	-	1,786
Food stuffs	-	539	539
Repairs and maintenance	655	88	743
Printing and reproduction	517	-	517
Other	1,089,578	-	1,089,578
	<u>1,629,814</u>	<u>28,352</u>	<u>1,658,166</u>
<b>Total expenditures</b>			
Excess of revenues over expenditures	<u>(598,872)</u>	<u>-</u>	<u>(598,872)</u>
<b>Other financing sources:</b>			
Proceeds from long term debt	991,777	-	991,777
Operating transfers in	198,877	-	198,877
	<u>1,190,654</u>	<u>-</u>	<u>1,190,654</u>
<b>Totaling other financing sources</b>			
Net change in fund balances	591,782	-	591,782
Fund balances at the beginning of the year	<u>3,042,853</u>	<u>-</u>	<u>3,042,853</u>
Fund balances at the end of the year	<u>\$ 3,634,635</u>	<u>\$ -</u>	<u>\$ 3,634,635</u>

See Accompanying Independent Auditors' Report.

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

Combining Balance Sheet  
September 30, 2006

	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
<b>ASSETS</b>										
Cash and equivalents	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 407	\$ -	\$ -
Receivables, net:										
General, net	-	-	-	-	-	-	1,508	-	-	-
Advances	-	-	-	-	-	-	(25)	-	-	-
Inventory	-	-	-	-	-	-	-	8,825	-	-
Loans receivable	-	-	-	-	-	-	-	-	-	-
Due from other funds	112,988	177,593	3,348	153	8,884	477,122	-	-	-	1,495
Restricted:										
Cash and equivalents	-	-	-	-	-	-	-	-	-	-
Time certificates of deposit	-	-	-	-	-	-	-	-	-	-
Investments	-	-	-	-	-	-	-	-	-	-
Total assets	\$ 112,988	\$ 177,593	\$ 3,348	\$ 153	\$ 8,884	\$ 477,122	\$ 1,483	\$ 9,232	\$ -	\$ 1,495
<b>LIABILITIES AND FUND BALANCES (DEFICITS)</b>										
Liabilities:										
Accounts payable	\$ -	\$ 865	\$ 3,348	\$ 153	\$ 4	\$ 6,506	\$ 12,249	\$ -	\$ -	\$ -
Other liabilities and accruals	-	-	-	-	-	(77)	-	-	-	-
Due to other funds	-	-	-	-	-	-	-	-	-	-
Deferred revenue	-	-	-	-	-	160,454	-	-	-	-
Total liabilities	-	865	3,348	153	4	166,883	12,249	-	-	-
Fund balances (deficits):										
Reserved for:										
Related assets	-	-	-	-	-	-	-	-	-	-
Encumbrances	-	6,370	373	-	17,845	52,831	4,780	-	-	-
Continuing appropriations	-	-	-	-	42,886	128,317	-	-	-	-
Unreserved (deficit)	112,988	170,358	(373)	-	(51,851)	129,091	(15,546)	9,232	-	1,495
Total fund balances (deficits)	112,988	176,728	-	-	8,880	310,239	(10,766)	9,232	-	1,495
Total liabilities and fund balances (deficits)	\$ 112,988	\$ 177,593	\$ 3,348	\$ 153	\$ 8,884	\$ 477,122	\$ 1,483	\$ 9,232	\$ -	\$ 1,495

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS  
SPECIAL REVENUE FUNDS

Combining Balance Sheet, Continued  
September 30, 2006

	Scholarship Revolving Loan	Housing Revolving	Aluminum Recycling	Tourism Revolving	Health Care	Sports Council	ADB Loan Programs	Broadcast Authority	Gifford Scholarship	Total
<b>ASSETS</b>										
Cash and equivalents	\$ -	\$ -	\$ -	\$ 872	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,279
Receivables, net:										
General, net	-	-	-	-	22,500	-	-	-	-	24,008
Advances	-	-	-	-	-	-	-	-	-	(25)
Inventory	-	-	-	-	-	-	-	-	-	8,825
Loans receivable	-	68,215	-	-	-	-	-	-	-	68,215
Due from other funds	-	301,678	206,405	-	197,539	502	170,667	6,743	-	1,665,117
Restricted:										
Cash and equivalents	-	-	-	-	-	-	169,937	-	341,427	511,364
Time certificates of deposit	-	-	-	-	-	-	-	39,383	-	39,383
Investments	-	-	-	-	-	-	1,539,723	-	-	1,539,723
Total assets	\$ -	\$ 369,893	\$ 206,405	\$ 872	\$ 220,039	\$ 502	\$ 1,880,327	\$ 6,743	\$ 380,810	\$ 3,857,889
<b>LIABILITIES AND FUND BALANCES (DEFICITS)</b>										
Liabilities:										
Accounts payable	\$ -	\$ 7,904	\$ -	\$ -	\$ 28,790	\$ -	\$ -	\$ 81	\$ -	\$ 59,900
Other liabilities and accruals	-	-	-	-	-	-	-	-	-	(77)
Due to other funds	-	-	-	-	-	-	-	-	2,977	2,977
Deferred revenue	-	-	-	-	-	-	-	-	-	160,454
Total liabilities	-	7,904	-	-	28,790	-	-	81	2,977	223,254
Fund balances (deficits):										
Reserved for:										
Related assets	-	68,215	-	-	-	-	1,880,327	-	-	1,948,542
Encumbrances	-	135,070	-	-	8,781	-	-	-	-	226,050
Continuing appropriations	-	-	-	-	-	-	-	-	-	171,203
Unreserved (deficit)	-	158,704	206,405	872	182,468	502	-	6,662	377,833	1,288,840
Total fund balances (deficits)	-	361,989	206,405	872	191,249	502	1,880,327	6,662	377,833	3,634,635
Total liabilities and fund balances (deficits)	\$ -	\$ 369,893	\$ 206,405	\$ 872	\$ 220,039	\$ 502	\$ 1,880,327	\$ 6,743	\$ 380,810	\$ 3,857,889

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, 2006

	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:										
Investment income	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Fees and charges	-	-	-	-	-	-	110,292	-	-	-
Other grants	-	-	-	-	-	604,442	-	-	-	-
Other	-	-	-	-	-	-	1,050	-	-	-
Total revenues	-	-	-	-	-	604,442	111,342	-	-	-
Expenditures by function:										
Current:										
General government	-	-	-	-	-	46,103	144,780	18,743	69	-
Education	(3)	-	-	-	-	17,870	-	-	-	-
Health services	-	47,956	-	-	-	228,812	-	-	-	-
Boards, commissions and other	-	-	-	-	-	-	-	-	-	-
Total expenditures	(3)	47,956	-	-	-	292,785	144,780	18,743	69	-
Excess of revenues over expenditure	3	(47,956)	-	-	-	311,657	(33,438)	(18,743)	(69)	-
Other financing sources:										
Proceeds from long term debt	-	-	-	-	-	-	116,040	-	-	-
Operating transfers in	-	-	-	-	-	-	116,040	-	-	-
Total other financing sources	-	-	-	-	-	-	116,040	-	-	-
Net change in fund balances (deficits)	3	(47,956)	-	-	-	311,657	(18,743)	(18,743)	(69)	-
Fund balances (deficits) at the beginning of the year	112,985	224,684	-	-	8,880	(1,418)	(93,368)	27,975	69	1,495
Fund balances (deficits) at the end of the year	\$ 112,988	\$ 176,728	\$ -	\$ -	\$ 8,880	\$ 310,239	\$ (10,766)	\$ 9,232	\$ -	\$ 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 Function,  
and Changes in Fund Balances (Deficits), Continued  
Year Ended September 30, 2006

	Scholarship Revolving Loan	Housing Revolving	Aluminum Recycling	Tourism Revolving	Health Care	Sports Council	ADB Loan Programs	Broadcast Authority	Gifford Scholarship	Total
Revenues:										
Investment income	\$ -	\$ 64,417	\$ -	\$ -	\$ -	\$ -	\$ 42,918	\$ -	\$ 3,023	\$ 110,358
Fees and charges	-	-	70,268	-	127,561	-	-	-	-	308,121
Other grants	-	-	-	-	-	-	-	-	-	604,442
Other	2,883	-	-	-	395	-	-	3,693	-	8,021
Total revenues	<u>2,883</u>	<u>64,417</u>	<u>70,268</u>	<u>-</u>	<u>127,956</u>	<u>-</u>	<u>42,918</u>	<u>3,693</u>	<u>3,023</u>	<u>1,030,942</u>
Expenditures by function:										
Current:										
General government	-	460,696	-	-	-	-	591,777	-	-	1,262,168
Education	-	-	-	-	-	-	-	-	-	(3)
Health services	-	-	-	-	55,594	-	-	-	-	121,420
Boards, commissions and other	369	15,174	-	-	-	-	-	1,874	-	246,229
Total expenditures	<u>369</u>	<u>475,870</u>	<u>-</u>	<u>-</u>	<u>55,594</u>	<u>-</u>	<u>591,777</u>	<u>1,874</u>	<u>-</u>	<u>1,629,814</u>
Excess of revenues over expenditure	2,514	(411,453)	70,268	-	72,362	-	(548,859)	1,819	3,023	(598,872)
Other financing sources:										
Proceeds from long term debt	-	-	-	-	-	-	991,777	-	-	991,777
Operating transfers in	82,837	-	-	-	-	-	-	-	-	198,877
Total other financing sources	<u>82,837</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>991,777</u>	<u>-</u>	<u>-</u>	<u>1,190,654</u>
Net change in fund balances (deficits)	85,351	(411,453)	70,268	-	72,362	-	442,918	1,819	3,023	591,782
Fund balances (deficits) at the beginning of the year	(85,351)	773,442	136,137	872	118,887	502	1,437,409	4,843	374,810	3,042,853
Fund balances (deficits) at the end of the year	\$ -	\$ 361,989	\$ 206,405	\$ 872	\$ 191,249	\$ 502	\$ 1,880,327	\$ 6,662	\$ 377,833	\$ 3,634,635

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, 2006

	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:										
Investment income	-	-	-	-	-	-	-	-	-	-
Fees and charges	-	-	-	-	-	-	110,292	-	-	-
Other grants	-	-	-	-	-	604,442	-	-	-	-
Other	-	-	-	-	-	-	1,050	-	-	-
Total revenues	-	-	-	-	-	604,442	111,342	-	-	-
Expenditures by account:										
Salaries and wages	-	-	-	-	-	113,073	95,695	-	-	-
Contractual services	-	47,096	-	-	-	53,507	14,179	-	-	-
Capital outlay	-	860	-	-	-	55,192	-	-	-	-
Utilities	-	-	-	-	-	-	12,967	-	-	-
Travel	-	-	-	-	-	8,467	1,022	-	-	-
Supplies and materials	-	-	-	-	-	35,301	14,335	-	-	-
Medical supplies	-	-	-	-	-	-	-	-	-	-
Scholarship	-	-	-	-	-	-	-	-	-	-
POL	-	-	-	-	-	9,335	3,986	-	-	-
Communications	-	-	-	-	-	44	1,451	-	-	-
Repairs and maintenance	-	-	-	-	-	-	655	-	-	-
Printing and reproduction	-	-	-	-	-	27	490	-	-	-
Other	(3)	-	-	-	-	17,839	-	18,743	69	-
Total expenditures	(3)	47,956	-	-	-	292,785	144,780	18,743	69	-
Excess of revenues over expenditure	3	(47,956)	-	-	-	311,657	(33,438)	(18,743)	(69)	-
Other financing sources:										
Proceeds from long term debt	-	-	-	-	-	-	-	-	-	-
Operating transfers in	-	-	-	-	-	-	116,040	-	-	-
Total other financing sources	-	-	-	-	-	-	116,040	-	-	-
Net change in fund balances	3	(47,956)	-	-	-	311,657	82,602	(18,743)	(69)	-
Fund balances (deficits) at the beginning of the year	112,985	224,684	-	-	8,880	(1,418)	(93,368)	27,975	69	1,495
Fund balances (deficits) at the end of the year	\$ 112,988	\$ 176,728	\$ -	\$ -	\$ 8,880	\$ 310,239	\$ (10,766)	\$ 9,232	\$ -	\$ 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, 2006

	Scholarship Revolving Loan	Housing Revolving	Aluminum Recycling	Tourism Revolving	Health Care	Sports Council	ADB Loan Programs	Broadcast Authority	Gifford Scholarship	Total
Revenues:										
Investment income	\$ -	\$ 64,417	\$ -	\$ -	\$ -	\$ -	\$ 42,918	\$ -	\$ 3,023	\$ 110,358
Fees and charges	-	-	70,268	-	127,561	-	-	-	-	308,121
Other grants	-	-	-	-	-	-	-	-	-	604,442
Other	2,883	-	-	-	395	-	-	3,693	-	8,021
Total revenues	2,883	64,417	70,268	-	127,956	-	42,918	3,693	3,023	1,030,942
Expenditures by account:										
Salaries and wages	-	-	-	-	-	-	-	-	-	208,768
Contractual services	-	-	-	-	-	-	-	-	-	114,782
Capital outlay	-	-	-	-	10,000	-	-	875	-	66,927
Utilities	-	-	-	-	-	-	-	-	-	12,967
Travel	-	15,174	-	-	-	-	-	-	-	24,663
Supplies and materials	-	-	-	-	26,752	-	-	708	-	77,096
Medical supplies	-	-	-	-	18,385	-	-	-	-	18,385
Scholarship	369	-	-	-	-	-	-	-	-	369
POL	-	-	-	-	-	-	-	-	-	13,321
Communications	-	-	-	-	-	-	-	-	-	1,786
Repairs and maintenance	-	-	-	-	-	-	-	291	-	655
Printing and reproduction	-	-	-	-	-	-	-	-	-	517
Other	-	460,696	-	-	457	-	591,777	-	-	1,089,578
Total expenditures	369	475,870	-	-	55,594	-	591,777	1,874	-	1,629,814
Excess of revenues over expenditure	2,514	(411,453)	70,268	-	72,362	-	(548,859)	1,819	3,023	(598,872)
Other financing sources:										
Proceeds from long term debt	-	-	-	-	-	-	991,777	-	-	991,777
Operating transfers in	82,837	-	-	-	-	-	-	-	-	198,877
Total other financing sources	82,837	-	-	-	-	-	991,777	-	-	1,190,654
Net change in fund balances	85,351	(411,453)	70,268	-	72,362	-	442,918	1,819	3,023	591,782
Fund balances (deficits) at the beginning of the year	(85,351)	773,442	136,137	872	118,887	502	1,437,409	4,843	374,810	3,042,853
Fund balances (deficits) at the end of the year	\$ -	\$ 361,989	\$ 206,405	\$ 872	\$ 191,249	\$ 502	\$ 1,880,327	\$ 6,662	\$ 377,833	\$ 3,634,635

See Accompanying Independent Auditors' Report.

STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA

NONMAJOR GOVERNMENTAL FUNDS  
CAPITAL PROJECTS FUNDS

Combining Balance Sheet  
September 30, 2006

	TTG Capital Projects	CFSM Projects Fund	Total
<u>ASSETS</u>			
Receivables, net:			
CFSM	\$ -	\$ 26,230	\$ 26,230
	\$ -	\$ 26,230	\$ 26,230
 <u>LIABILITIES AND FUND BALANCES</u>			
Liabilities:			
Accounts payable	\$ -	\$ 300	\$ 300
Accrued payroll and others	(99)	-	(99)
Deferred revenue	-	33	33
Due to other funds	99	25,897	25,996
Total liabilities	-	26,230	26,230
Fund balances:			
Reserved for:			
Encumbrances	-	3,986	3,986
Continuing appropriations	-	7,798	7,798
Unreserved	-	(11,784)	(11,784)
Total fund balances	-	-	-
Total liabilities and fund balances	\$ -	\$ 26,230	\$ 26,230

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  
Year Ended September 30, 2006

	TTG Capital Projects	CFSM Projects Fund	Total
Revenues:			
CFSM grants	\$ -	\$ 28,352	\$ 28,352
	-	28,352	28,352
Expenditures by function:			
Public safety	-	28,352	28,352
Total expenditures	-	28,352	28,352
Net change in fund balances	-	-	-
Fund balances at the beginning of the year	-	-	-
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  
Year Ended September 30, 2006

	TTG Capital Projects	CFSM Projects Fund	Total
Revenues:			
CFSM grants	\$ -	\$ 28,352	\$ 28,352
	-	28,352	28,352
Expenditures by account:			
Bad debt expense	-	-	-
Salaries and wages	-	18,000	18,000
Supplies and materials	-	9,725	9,725
Food stuffs	-	539	539
Repairs and maintenance	-	88	88
Total expenditures	-	28,352	28,352
Net change in fund balances (deficits)	-	-	-
Fund balances (deficit) at the beginning of the year	-	-	-
Fund balances (deficit) 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, 2006

	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	Section 211(a)(7) Supplemental Ed	Total
<u>ASSETS</u>								
Receivables, net:								
Federal agencies	\$ -	\$ 47,500	\$ 180,815	\$ -	\$ -	\$ 105,050	\$ -	\$ 333,365
Due from other funds	368,190	659,414	95,784	304,650	41,703	-	454,723	1,924,464
	<u>\$ 368,190</u>	<u>\$ 706,914</u>	<u>\$ 276,599</u>	<u>\$ 304,650</u>	<u>\$ 41,703</u>	<u>\$ 105,050</u>	<u>\$ 454,723</u>	<u>\$ 2,257,829</u>
<u>LIABILITIES AND FUND BALANCES</u>								
Liabilities:								
Accounts payable	\$ 70,572	\$ 189,352	\$ 21,272	\$ 120,648	\$ 4,209	\$ 105,050	\$ 17,830	\$ 528,933
Deferred revenue	297,618	365,320	230,098	168,073	37,494	-	436,893	1,535,496
Total liabilities	<u>368,190</u>	<u>554,672</u>	<u>251,370</u>	<u>288,721</u>	<u>41,703</u>	<u>105,050</u>	<u>454,723</u>	<u>2,064,429</u>
Fund balances:								
Reserved for:								
Encumbrances	232,262	151,944	133,771	58,218	8,651	-	226,876	811,722
Unreserved special revenue funds	(232,262)	298	(108,542)	(42,289)	(8,651)	-	(226,876)	(618,322)
Total fund balances	<u>-</u>	<u>152,242</u>	<u>25,229</u>	<u>15,929</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>193,400</u>
Total liabilities and fund balances	<u>\$ 368,190</u>	<u>\$ 706,914</u>	<u>\$ 276,599</u>	<u>\$ 304,650</u>	<u>\$ 41,703</u>	<u>\$ 105,050</u>	<u>\$ 454,723</u>	<u>\$ 2,257,829</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, 2006

	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	Supplement Education Grant	Total
Revenues:								
Compact funding	\$ 2,053,842	\$ 1,630,012	\$ 759,955	\$ 1,157,955	\$ 288,990	\$ 105,050	\$ 713,316	\$ 6,709,120
	<u>2,053,842</u>	<u>1,630,012</u>	<u>759,955</u>	<u>1,157,955</u>	<u>288,990</u>	<u>105,050</u>	<u>713,316</u>	<u>6,709,120</u>
Expenditures by function:								
Current:								
General government	-	-	759,955	1,157,955	288,990	105,050	713,316	3,025,266
Education	2,053,842	-	-	-	-	-	-	2,053,842
Health services	-	1,630,012	-	-	-	-	-	1,630,012
Total expenditures	<u>2,053,842</u>	<u>1,630,012</u>	<u>759,955</u>	<u>1,157,955</u>	<u>288,990</u>	<u>105,050</u>	<u>713,316</u>	<u>6,709,120</u>
Net change in fund balances	-	-	-	-	-	-	-	-
Fund balances at the beginning of the year	-	152,242	25,229	15,929	-	-	-	193,400
Fund balances at the end of the year	<u>\$ -</u>	<u>\$ 152,242</u>	<u>\$ 25,229</u>	<u>\$ 15,929</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 193,400</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, 2006

	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	Section 211(a)(7) Supplemental Ed	Total
Revenues:								
Compact funding	\$ 2,053,842	\$ 1,630,012	\$ 759,955	\$ 1,157,955	\$ 288,990	\$ 105,050	\$ 713,316	\$ 6,709,120
	<u>2,053,842</u>	<u>1,630,012</u>	<u>759,955</u>	<u>1,157,955</u>	<u>288,990</u>	<u>105,050</u>	<u>713,316</u>	<u>6,709,120</u>
Expenditures by account:								
Salaries and wages	1,555,894	722,314	324,356	734,233	240,320	-	121,724	3,698,841
Contractual services	33,800	336,780	270,249	90,449	5,399	105,050	153,235	994,962
Supplies and materials	81,044	95,738	99,405	53,738	6,763	-	79,338	416,026
Capital outlay	149,477	31,758	8,369	20,740	-	-	181,898	392,242
Travel	3,269	89,702	10,121	80,599	6,558	-	90,727	280,976
Utilities	72,018	91,662	19,537	20,981	7,127	-	-	211,325
Scholarship	117,250	-	-	-	100	-	61,576	178,926
Communications	842	6,030	14,403	17,363	4,683	-	12,731	56,052
Contributions	-	-	-	53,131	-	-	-	53,131
POL	10,073	5,101	4,337	10,327	5,640	-	3,399	38,877
Medical referral	-	37,288	-	-	-	-	-	37,288
Food stuffs	135	22,576	19	2,308	150	-	1,000	26,188
Printing and reproduction	1,075	12,050	2,068	2,723	1,121	-	130	19,167
Repairs and maintenance	-	250	890	488	617	-	176	2,421
Rentals	-	19	73	414	-	-	-	506
Medical supplies	-	163,003	-	-	-	-	-	163,003
Leased housing/land	28,814	10,022	2,730	29,797	8,660	-	-	80,023
Training	-	-	3,323	39,439	1,172	-	2,456	46,390
Other	151	5,719	75	1,225	680	-	4,926	12,776
Total expenditures	<u>2,053,842</u>	<u>1,630,012</u>	<u>759,955</u>	<u>1,157,955</u>	<u>288,990</u>	<u>105,050</u>	<u>713,316</u>	<u>6,709,120</u>
Net change in fund balances	-	-	-	-	-	-	-	-
Fund balances at the beginning of the year	-	152,242	25,229	15,929	-	-	-	193,400
Fund balances at the end of the year	<u>\$ -</u>	<u>\$ 152,242</u>	<u>\$ 25,229</u>	<u>\$ 15,929</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 193,400</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 Robert Weilbacher  
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, 2006, and have issued our report thereon dated June 26, 2007. 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 operation 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 76 through 109) as items 2006-09 through 2006-16.

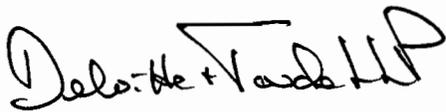
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being 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 2006-09, 2006-12, 2006-13 and 2006-15 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*.

We noted certain matters that we reported to management of the State of Kosrae in a separate letter dated June 26, 2007.

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 "Deloitte + Touche LLP". The signature is stylized and cursive.

June 26, 2007

**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 Robert Weilbacher  
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, 2006. 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 76 through 109). 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 2006-01 through 2006-08 in the accompanying Schedule of Findings and Questioned Costs, the State of Kosrae did not comply with requirements regarding procurement and suspension and debarment, allowable costs/cost principles, special tests and provisions, cash management, equipment and real property management, and period of availability that are applicable to its CFDA# 15.875, Economic, Social and Political Development of the Territories (Compact Sector Grants) CFDA# 84.027; Special Education – Grants to States; and CFDA# 97.039 Hazard Mitigation Grants as described in the Federal Award Findings and Questioned Cost 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, 2006.

The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying Schedule of Findings and Questioned Costs in items 2006-01, 2006-02, 2006-03, 2006-5 and 2006-07.

#### 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.

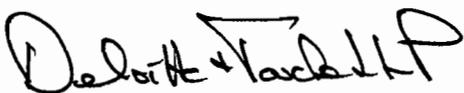
We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance 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 2006-01 through 2006-08.

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, 2006, and have issued our report thereon dated June 26, 2007. 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 67 through 73) 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, 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.



June 26, 2007

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Summary Schedule of Expenditures of Federal Awards, by Grantor  
Year Ended September 30, 2006

Agency/Program	Expenditures
U.S. Department of Agriculture	\$ 83,546
U.S. Department of the Interior	7,007,086
U.S. Department of Labor	70,099
U.S. Department of Homeland Security	716,608
U.S. Department of Education	814,521
U.S. Department of Health and Human Services	331,880
	331,880
GRAND TOTAL	\$ <u><u>9,023,740</u></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	84.256
Vocational Education - National Programs	84.051

Reconciliation to the basic financial statements:

U.S. Federal Grants Fund (page 13)	\$ 2,073,852
Section 211 Compact Sector Grant (page 13)	6,709,120
Compact Capital Projects Fund (page 13)	196,909
Compact Other Grants Fund (page 53)	47,956
Less amounts of non-federal awards included herein	(4,097)
	(4,097)
	\$ <u><u>9,023,740</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  
Year Ended September 30, 2006

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF AGRICULTURE		
Cooperative Forestry Assistance	10.664	\$ 20,906
Rural Self-Help Housing Technical Assistance	10.420	8,342
Rural Housing Preservation Grants	10.433	8,341
Forestry Research	10.652	45,957
Community Facilities Loans and Grants	10.766	-
U.S. DEPARTMENT OF AGRICULTURE TOTAL		<u>\$ 83,546</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, 2006

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF THE INTERIOR		
Economic, Social and Political Development of the Territories:	15.875	
Compact Section 211(A) Capital Account		\$ 196,909
Compact Health and Medical 216(a)(2)		47,956
Compact II Capacity Building Sector		1,157,955
Compact II Education Sector		2,053,842
Compact II Environment Sector		288,990
Compact II Health Sector		1,630,012
Compact II Private Sector		759,955
Compact II Infrastructure Sector		105,050
Supplemental Education Grant Sector		713,316
Technical Assistance:		
Road Maintenance Equipment		2,214
Historic Preservation Fund Grants-in-Aid	10.904	<u>50,887</u>
U.S. DEPARTMENT OF THE INTERIOR TOTAL		<u>\$ 7,007,086</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, 2006

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF LABOR		
WIA Administration	17.255	\$ 7,024
WIA Adult Program	17.258	9,737
WIA Youth Activities	17.259	4,672
WIA Dislocated Worker	17.260	<u>48,666</u>
U.S. DEPARTMENT OF LABOR TOTAL		<u>\$ 70,099</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, 2006

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF HOMELAND SECURITY		
Hazard Mitigation Grant	83.548	\$ <u>716,608</u>
U.S. DEPARTMENT OF HOMELAND SECURITY		\$ <u><u>716,608</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, 2006

<u>Agency/Program</u>	<u>CFDA#</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF EDUCATION		
Special Education - Grants to States	84.027	\$ 636,671
Freely Associated States - Educational Grant Program	84.256A	127,620
Vocation Education - National Programs	84.051	<u>50,230</u>
U.S. DEPARTMENT OF EDUCATION TOTAL		<u>\$ 814,521</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, 2006

Agency/Program	CFDA#	Expenditures
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES		
Maternal and Child Health Federal Consolidated Programs	93.110	\$ 18,096
CDC Project Grants and Cooperative Agreements for Tuberculosis		
Control Programs	93.116	21,041
Family Planning - Services	93.217	41,140
Immunization Grants	93.268	41,241
HIV Prevention Activities-Health Department Based	93.940	6,604
Epidemiologic Research Studies of Acquired Immunodeficiency Syndrome (AIDS) and Human Immunodeficiency Virus (HIV) Infection in Selected Population Groups	93.943	2,989
Block Grants for Prevention and Treatment of Substance Abuse	93.959	73,108
Cooperative Agreements for State-Based Diabetes Control Programs and Evaluation of Surveillance Systems	93.988	11,870
National Bioterrorism Hospital Preparedness Program	93.889	21,590
Preventive Health and Health Services Block Grant	93.991	8,592
Maternal and Child Health Services Block Grant to the States	93.994	62,208
Centers for Disease Control and Prevention-Investigations and Technical Assistance	93.283	12,680
Cancer Prevention and Control Program	93 Unknown	10,721
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES TOTAL		\$ <u>331,880</u>
GRAND TOTAL		\$ <u>9,023,740</u>

Note: The grant is received through the University of Hawaii and the grant number is U55/CCU923887.02.

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, 2006

(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
- U.S. Department of Homeland Security

(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."

C. CFDA #15.875

CFDA #15.875 represents the Office of Insular Affairs (OIA), U. S. Department of the Interior. Funding from this source is subject to varying rules and regulations since OIA administers the Compact of Free Association, which is a treaty, and is not a federal program. The Compact is comprised of various funded programs, each with separate compliance requirements. To maximize audit coverage of OIA funding, the OIG has recommended that programs administered under CFDA #15.875 be grouped by like compliance requirements and such groupings be separately evaluated as major programs.

(3) Component Units

The Kosrae Utilities Authority (KUA), a component unit - proprietary fund of the State of Kosrae separately satisfies the requirements of OMB Circular A-133.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Programs Selected for  
Audit In Accordance With OMB Circular A-133  
Year Ended September 30, 2006

<u>Grantor Program Title</u>	<u>CFDA No.</u>	<u>2006 Fiscal Year Expenditures</u>
<u>Major Programs</u>		
<u>U.S. Dept. of the Interior</u>		
Compact of Free Association: Compact Sector Grants	15.875	6,709,120
<u>U.S. Department of Education</u>		
Special Education – Grants to States	84.027	636,671
<u>U.S. Department of Homeland Security</u>		
Hazard Mitigation Grant	97.039/83.548	<u>716,608</u>
Total U.S. Federal program expenditures selected		\$ <u>8,062,399</u>
Total U.S. Federal program expenditures		\$ <u>9,023,740</u>
% of total U.S. Federal Program expenditures covered by Major Programs		<u>89</u> %

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2006

**Part I - Summary of Auditors' Results**

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were 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 –Sector Grants	15.875
U.S. Department of Education – Special Education-Grants to States	84.027
U.S. Department of Homeland Security – Hazard Mitigation Grant	97.039

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.

**Part II - Financial Statement Findings Section**

<u>Reference Number</u>	<u>Findings</u>	<u>Questioned Costs</u>
2006-09	Cash	\$ -
2006-10	Payroll	\$ -
2006-11	Representation Fund	\$ -
2006-12	Accounts Receivable	\$ -
2006-13	Travel Advance	\$ -
2006-14	Encumbrances	\$ -
2006-15	Equity Investments	\$ -
2006-16	Unauthorized disbursement	\$ -

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

**Part III - Federal Award Findings and Questioned Cost Section**

<u>Reference Number</u>	<u>CFDA#</u>	<u>Findings</u>	<u>Questioned Costs</u>
2006-01	15.875	Procurement	\$ 302,531
	84.027	Procurement	\$ 8,085
	15.875	Procurement	\$ 121,703
	10.652	Procurement	\$ 8,898
	84.256	Procurement	\$ 22,550
	10.433	Procurement	\$ 2,284
	93.283	Procurement	\$ 2,000
2006-02	15.875	Allowable Costs/Cost Principles	\$ 21,636
	15.875	Allowable Costs/Cost Principles	\$ -
	84.256	Allowable Costs/Cost Principles	\$ 29,175
	10.652	Allowable Costs/Cost Principles	\$ -
	10.766	Allowable Costs/Cost Principles	\$ -
	10.664	Allowable Costs/Cost Principles	\$ 2,500
	15.875	Allowable Costs/Cost Principles	\$ 2,129
	84.994	Allowable Costs/Cost Principles	\$ 11,267
2006-03	15.875	Allowable Costs/Cost Principles	\$ -
	93.994	Allowable Costs/Cost Principles	\$ -
	17.260	Allowable Costs/Cost Principles	\$ -
2006-04	15.875	Contract Provisions	\$ -
	97.039	Contract Provisions	\$ -
2006-05	84.027	Cash Management	Undeterminable
	97.039	Cash Management	Undeterminable
	84.256	Cash Management	Undeterminable
2006-06	15.875	Fixed Asset Maintenance	\$ -
2006-07	15.875	Allowable Costs/Cost Principles	\$ 6,068
	17.260	Allowable Costs/Cost Principles	\$ 1,138
2006-08	15.875	Period of Availability	\$ 152,550

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2006-01
CFDA:	15.875
Grant:	CSG-FSM-2006-CAP, CSG-FSM-2005-EDU, CSG-FSM-2006-INF, CSG-FSM-2006-ENV, CSG-FSM-2006-PSD, CSG-FSM-2006-HLT
Grantor Agency:	U.S. Department of the Interior
Area:	Procurement
Questioned Cost:	\$302,531
CFDA:	84.027
Grant:	H027B030002-05
Grantor Agency:	U.S. Department of Education – Special Education
Area:	Procurement
Questioned Costs:	\$8,085
CFDA:	15.875
Grant:	CSG FSM 2005 INF
Grantor Agency:	U.S. Department of the Interior – Compact CIP
Area:	Procurement
Questioned Costs:	\$121,703
CFDA:	10.652
Grant:	FSM 94, Amd 1
Agency:	U.S. Department of Agriculture – Forestry Research
Area:	Procurement
Questioned Costs:	\$8,898
CFDA:	84.256
Grant:	S256A030009-04
Grantor Agency:	U.S. Department of Education - Freely Associated States-Education Grant Program
Area:	Procurement
Questioned Costs:	\$22,550
CFDA:	10.433
Grant:	64 05 20457
Grantor Agency:	U.S. Department of Agriculture - Rural Housing Preservation Grants
Area:	Procurement
Questioned Costs:	\$2,284
CFDA:	93.283
Grant:	U90 CCU921821-04
Grantor Agency:	U.S. Department of Health Human Services - Centers for Disease Control and Prevention-Investigations and Technical Assistance
Area:	Procurement
Questioned Costs:	\$2,000

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-01, Continued

Condition:

1. CFDA# 15.875 Compact Sector Grants: For eleven of 64 (17.2%) non-payroll expenditures (\$275,540 of the aggregate amount of \$1,086,436 tested), there was insufficient documentation to support competitive procurement requirements.

	<u>FORG</u>	<u>CCELED</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	731210	KC225A	8110	\$ 7,388	600303601	T0615401	20503
2	741062	KC412A	8110	2,907	600245101	T0612601	20019
3	771415	KB122A	8110	4,591	600590501	DOE	23100
4	741062	KC450B	8101	2,435	600583801	T0632102	23029
5	771415	KB123A	8210	71,800	600420501	P6009301	21756
6	721413	KA116A	8210	50,000	600065201	L5173201	18957
7	721413	KC116A	8210	50,000	600300801	L6040201	20536
8	721413	KC116A	8210	45,202	600554901	L6162701	22815
9	771415	KB121A	8303	156	600301401	L6088401	20534
10	721411	KC120A	8313	8,755	600517401	L6076901	22811
11	761107	KA641J	8405	<u>32,306</u>	600128401	C5010301	18994
				<u>\$275,540</u>			

- a. Under Kosrae State Government Financial Management Regulations (FMR), open bidding-free and open competitive bidding by sealed bids is required for purchases \$25,000 or above. For item 5, purchase order number P6005201 totaling \$71,800 was procured only by price quotations. Since the State's procurement procedure is more stringent than the Compact's procedure, the State may utilize its own procurement procedures. Thus, as competitive procurement appears to be adequately documented, the amount of \$71,800 will not be questioned although this amount was expended in noncompliance with State procurement regulations.
- b. For items 6 to 8, expenditures are partial payments of school furniture and fixtures with a total bid price of \$390,326. Procurement documents indicate that the vendor was not the lowest bidder. The lowest bidder totaled \$146,333. However, the awarded vendor was justified to have been the only bidder to offer free 3 years of spare parts for the furniture, which appears to be inadequate due to the major difference in bid price and a lack of documentation concerning negotiation with the lower bidder concerning this matter. We therefore question the difference between the lowest bidder and the vendor awarded totaling \$243,993 (\$390,326-\$146,333).

Total	\$ 275,540
Less item 5	(71,800)
Less items 6-8	(145,202)
Plus (see b above)	<u>243,993</u>
Total questioned costs:	\$ <u>302,531</u>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-01, Continued

Condition, Continued:

2. CFDA# 84.027 Special Education: For two of thirty-seven (5.4%) non-payroll expenditures (\$8,085 of the aggregate amount of \$179,019 tested), there was insufficient documentation to support competitive procurement requirements.

	<u>FORG</u>	<u>CCLD</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>	<u>CK AMOUNT</u>
1	301410	KA5091	8210	\$4,980	600115701	P5001501	19492	\$4,980
2	301410	KA6091	8308	<u>3,105</u>	600246102	L6071002	20534	6,131
				<u>\$8,085</u>				

3. CFDA# 15.875 Compact CIP: For twelve of 33 (36.4%) non-payroll expenditures (\$121,703 of the aggregate amount of \$194,187 tested), there was insufficient documentation to support competitive procurement requirements.

	<u>FORG</u>	<u>CCLD</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO</u>
1	601310	K03006	8303	\$ 5,250	600095801	C3016008	20509
2	601310	K03006	8303	2,100	600283801	C3016008	21844
3	601310	K03006	8303	1,050	600292901	C3016008	21844
4	601310	K03006	8419	2,625	600394401	C3012404	21844
5	601310	K03006	8419	7,665	600239201	C3016005	21844
6	601310	K03006	8419	8,409	600492401	C3016005	22793
7	601061	6982	8405	25,834	600068701	C4005203	20509
8	601061	6982	8405	21,006	600221302	C4005203	20509
9	601061	6982	8405	19,000	600221303	C4005204	20509
10	601061	6982	8405	5,640	600492402	C4005204	22793
11	601310	K0140	8405	20,974	600083801	C0042201	18619
12	601310	K03006	8405	<u>2,150</u>	600221301	C4005202	20509
				<u>\$121,703</u>			

4. CFDA# 10.652 Forestry Research: For three of 55 (5%) non-payroll expenditures tested (\$50,893 of the aggregate amount of \$325,145 tested), there was insufficient documentation to support competitive procurement requirements.

	<u>CFDA#</u>	<u>FORG</u>	<u>CCLD</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>	<u>CK AMOUNT</u>
1	10.652	371101	KH1559	8210	\$41,995	600122201	P5017601	25124	\$42,045
2	10.652	371101	KH1559	8110	4,449	600057701	T06049	18336	9,317
3	10.652	371101	KH1559	8110	<u>4,449</u>	600057801	TO6050	18336	9,317
					<u>\$50,893</u>				

Total Procurement Questioned Cost:	\$ 50,893
Less: Item no. 1 (See below)	(41,995)
<b>Total</b>	<b>\$ <u>8,898</u></b>

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-01, Continued

Condition, Continued:

Under Kosrae State Government Financial Management Regulations (FMR) open bidding-free and open competitive bidding by sealed bids is required for purchases \$25,000 or above. For item one, purchase order number P5017601 totaling \$41,995 was procured only by price quotations. Since the State's procurement procedure is more stringent than the Federal Government's procedures, the State may utilize its procurement procedures. As competitive procurement appears to be adequately documented, no questioned costs result from this finding, although noncompliance with State procurement regulations occurred. An audit adjustment has been proposed to record this expenditure as an advance, as equipment was not received in the current fiscal year.

5. CFDA# 84.256 Freely Associated States-Education Grant Program: For one of 55 (1%) non-payroll expenditures (\$22,550 of the aggregate amount of \$325,145 tested), there was insufficient documentation to support competitive procurement requirements.

<u>CFDA#</u>	<u>FORG</u>	<u>CCELED</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	CK <u>NO.</u>	CK. <u>AMOUNT</u>
84.256	461410	5910	8405	\$22,550	600333601	C4002501	21855	\$22,550

6. CFDA# 10.433 Rural Housing Preservation Grants: For one of 55 (1%) non-payroll expenditures (\$2,284 of the aggregate amount of \$325,145 tested), there was insufficient documentation to support competitive procurement requirements.

<u>CFDA#</u>	<u>FORG</u>	<u>CCELED</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	CK <u>NO.</u>	CK. <u>AMOUNT</u>
10.433	371101	KH0300	8210	\$ 2,284	60032780	P40167	20988	\$2,284

7. CFDA# 93.283 Centers for Disease Control and Prevention-Investigations and Technical Assistance: For one of 55 (1%) non-payroll expenditure (\$2,000 of the aggregate amount of \$325,145 tested), there was insufficient documentation to support competitive procurement requirements.

<u>CFDA#</u>	<u>FORG</u>	<u>CCELED</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	CK <u>NO.</u>	CK. <u>AMOUNT</u>
92.283	411210	KV0612	8308	\$ 2,000	600610801	L6191301	23885	\$12,295

Cause: There appears to be a lack of controls over ensuring that competition remains open among vendors and a lack of control in the maintenance and storage of relevant financial and programmatic documentation.

Effect: Noncompliance and questioned costs result from this condition due to insufficient competitive procurement documentation.

Prior Year Status: The above condition is reiterative of conditions identified in the prior year Single Audit report for Compact Sector Grant number CSG-FSM-2006.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-01, Continued

Recommendation: We recommend that Kosrae State Government comply with U.S. Federal program requirements and strengthen its internal controls to ensure that adequate competitive procurement documentation is on file.

We recommend that the State establish an account with a travel agency on island or off-island, to assist in meeting competitive procurement concerns for travel extending to areas served by multiple airlines.

Auditee Response and Corrective Action Plan:

1. Management concurs that the items pertaining to off-island travel where Continental was the vendor were not subject to open competition among vendors. Continental is the only carrier who serves Kosrae and no travel agent is available on island. We believe that special condition warrants sole sourcing itineraries with Continental. Kosrae will continue to adhere to its travel regulations which do not require competitive procurement of off-island airfares.

As noted in the audit finding, the purchase of computers for \$71,800 was supported by price quotations but not sealed bidding. This exception was made to the State's procurement procedure in the interest of expediting the purchase and the lowest quotation was selected.

Payments to DJ Store for the purchase of school furniture and fixtures was made after bids were received from several vendors. As noted, the low bid was not selected. The rationale was the parts warranty offered by the vendor. In the future, the Department of Education will be required to offer better documentation to justify the award of a bid to a vendor who is not the lowest vendor.

Payments to Kosrae Printing were sole-sourced because that is the only printing company on the island and the urgency of obtaining specialized printing materials for the Department of Education necessitated performing this job on-island vs. the delays that would result from shipping off-island. Moreover, this establishment has the templates for recurring printing needs and can quickly meet DOE'S needs.

The contractual payment of \$32,306 to YH & CC SHELL was for construction of the Mangrove Crab Hatchery. Although this project was competitively bid, documents were not available to support the submissions of the other contractors. Management will ensure that all bid documents are retained for audit perusal in the future.

2. The payment to Hans Micronesia was sole-source procurement for a boat for the Special Education Program. At the time the boat was needed, no other vendor on island had one in supply and Kosrae DOE bought locally to avoid incurring prohibitive freight costs from purchasing a boat off-island.

Payments to Kosrae Printing were sole-sourced because that is the only printing company on the island and the urgency of obtaining specialized printing materials for the Department of Education necessitated performing this job on-island vs. the delays that would result from shipping off-island. Moreover, this establishment has the templates for recurring printing needs and can quickly meet DOE'S needs.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-01, Continued

Auditee Response and Corrective Action Plan, Continued:

3. The road paving project was sole-sourced to Black Micro because they were the only contractor on-island that had the necessary manpower and equipment to undertake the job. The project was sole sourced after a study by the Director DPW indicated that Kosrae State would save a considerable amount by not having to pay an off-island contractor for mobilization. This project utilized Compact CIP funds which by the time of construction were available for the discretionary use of Kosrae State government.
4. Management concurs that the items pertaining to off-island travel where Continental was the vendor were not subject to open competition among vendors. Continental is the only carrier who serves Kosrae and no travel agent is available on island. We believe that special condition warrants sole sourcing itineraries with Continental. Kosrae will continue to adhere to its travel regulations which do not require competitive procurement of off-island airfares.
5. This finding pertains to a payment to purchase and print a book on Kosrae's history from the books author, Eldon Buck. Mr. Buck's lifetime involvement with Kosrae and specialized knowledge of aspects of its history justify the non-competitive procurement of this book. There are no other Kosrae history books available.
6. There were competitive quotes for this purchase, and the low quote was selected. The purchase was for a #37765 SOLO FIELD MAPPING. There's a Price Competition form submitted for this purchase. The Vendors in the PC Form are:
  1. Forestry & Suppliers -\$4,495.00
  2. Kaya Naksawa -Out of Stock
  3. Mac Warehouse -\$6,000.00

Only the quote for Forestry & Suppliers was submitted to the Supply Office.

7. Payments to Kosrae Printing were sole-sourced because that is the only printing company on the island and the urgency of obtaining specialized printing materials for the Health department necessitated performing this job on-island vs. the delays that would result from shipping off-island.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2006-02
CFDA:	15.875
Grant:	CSG-FSM-2006-CAP, CSG-FSM-2005-EDU, CSG-FSM-2006-INF, CSG-FSM-2006-ENV, CSG-FSM-2006-PSD, CSG-FSM-2006-HLT
Grantor Agency:	U.S. Department of the Interior - Compact Sector Grant
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$21,636
CFDA:	15.875
Grant:	CSG FSM 2005 INF
Grantor Agency:	U.S. Department of the Interior - Compact CIP
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$0
CFDA:	84.256
Grant:	S256A030009-04
Grantor Agency:	U.S. Department of Education - Freely Associated States-Education Grant Program
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$29,175
CFDA:	10.652
Grant:	FSM 94, Amd 1
Grantor Agency:	U.S. Department of Agriculture – Forestry Research
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$0
CFDA:	10.766
Grant:	62-008-000224507
Grantor Agency:	U.S. Department of Agriculture - Community Facilities Loans and Grants
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$0
CFDA:	10.664
Grant:	06 DG 11052021-363
Grantor Agency:	U.S. Department of Agriculture - Cooperative Forestry Assistance
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$2,500
CFDA:	15.875
Grant:	OMIP KOS 2004-1
Grantor Agency:	U.S. Department of the Interior - Economic, Social and Political Development of the Territories-Technical Assistance: Road Maintenance Equipment
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$2,129

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-02, Continued  
CFDA: 84.994  
Grant: V048B020001  
Grantor Agency: U.S. Department of Education - Vocational Education – National Program  
Area: Allowable Costs/Cost Principles  
Questioned Costs: \$11,267

Criteria: Expenditures should be necessary and reasonable for program needs and should be in accordance with the program needs. Furthermore, expenditures should be recorded in the appropriate period underlying the receipt of applicable goods or services.

Condition:

1. CFDA# 15.875 Compact Sector Grant (74): Under purchase order number L5204301, an amount of \$15,548 was paid for matching funds for police vehicle acquisitions. As of March 2007, the vehicles have not been received but the amount was recorded as an expenditure in fiscal year 2006.
2. CFDA# 15.875 Compact Sector Grant (73): Under purchase order number P6008315, an amount of \$5,308 was paid for medical supplies. The supplies were received in February 2007; however this amount was expended in the 2006 financial statements.
3. CFDA# 15.875 Compact Sector Grant (77): Under purchase order number P6009301, an amount of \$71,800 was paid for 40 computer systems. Only ten computer systems were received in FY2006; the other computers amounting to \$53,850 were received on October 25, 2006. However the total amount of \$71,800 was expended in the 2006 financial statements.

(This expenditure has already been considered at finding no. 1.)

4. CFDA# 15.875 Compact Sector Grant (73): Under travel authorization number T0534701, three travel days amounting to \$780 of per diem were not in accordance with the authorized travel. Travel was extended on Hawaii for an additional seven days for an unauthorized meeting. No support was provided to substantiate this travel deviation.
5. CFDA# 15.875 Compact CIP (60): Under purchase order number P40143, an amount of \$10,071 was paid for Trial King Tilt Trailer). The equipment was received on December 4, 2006; however this amount was expended in the 2006 financial statements.

(No questioned costs result from this finding as an audit adjustment was proposed to recognize the advance.

6. CFDA# 84.256 Freely Associated States-Education Grant Program: For nine of 55 (16%) non-payroll expenditures (\$59,034 of the aggregate amount of \$325,145 tested), the expenditures were recorded in fiscal year 2006, but underlying goods and/or services were received prior to fiscal year 2006, in 2007, or have not yet been received.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

FindingNo.: 2006-02, Continued

Condition, Continued:

	<u>CFDA</u>	<u>FORG</u>	<u>CCL</u>	<u>CCDESC.</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	84.256	461410	5910	FY2004 TFASEG	\$22,550	600333601	C4002501	21855
2	84.256	461410	5911	FY05 TFASEG	4,905	600369001	P5010601	21300
3	84.256	461410	5911	FY05 TFASEG	4,905	600369201	P5010301	21300
4	84.256	461410	5911	FY05 TFASEG	4,871	600369301	P5010201	21300
5	84.256	461410	5911	FY05 TFASEG	4,646	600369501	P5010001	21300
6	84.256	461410	5911	FY05 TFASEG	4,646	600369601	P5010101	21300
7	84.256	461410	5911	FY05 TFASEG	3,098	600368601	P5009801	21300
8	84.256	461410	5911	FY05 TFASEG	2,104	600368801	P5010701	21300
9	84.256	461410	5911	FY05 TFASEG	<u>7,309</u>	600112401	P6002601	18867
					<u>\$59,034</u>			

Item 1 relates to equipment purchases not received at fiscal year end. No questioned costs result from this finding due to an audit adjustment proposed to recognize an advance.

Item 9 relates to repayment of FY 2002 Single Audit Finding No. 2002-04 to U.S. Department of Education. No questioned cost results from this finding as the grantee subsequently transferred the expense to the general fund.

Total Questioned Cost	\$ 59,034
Less Item 1	(22,550)
Less Item 9	<u>(7,309)</u>
	<u>\$ 29,175</u>

7. CFDA# 10.652 Forestry Research: For two of 55 (3%) non-payroll expenditures (\$53,755 of the aggregate amount of \$325,145 tested), the expenditures relate to equipment purchases, which were not received at fiscal year end. No questioned costs result due to an audit adjustment being proposed to recognize the expenditure as an advance.

	<u>CFDA</u>	<u>FORG</u>	<u>CCL</u>	<u>CCDESC.</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	10.652	371101	KH1559	KOSRAE LANDS/SURVEY MODERNIZA.	\$41,995	600122201	P5017601	25124
2	10.652	371101	KH1559	KOSRAE LANDS/SURVEY MODERNIZA.	\$11,760	600127201	P5019001	25166

8. CFDA# 10.766 - Community Facilities Loans and Grants: For one of 55 (1%) non-payroll expenditure (\$28,468 of the aggregate amount of \$325,145 tested), the transaction was for an equipment purchase that was not received at fiscal year end. This is not questioned due to an audit adjustment being proposed to recognize this transaction as an advance.

	<u>CFDA</u>	<u>FORG</u>	<u>CCL</u>	<u>CCDESC.</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
10.766	461612	OAG601		POLICE VEHICLE ACQUISITION	<u>\$28,468</u>	600292001	P6006901	20826

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-02, Continued

Condition, Continued:

9. CFDA# 10.664 Cooperative Forestry Assistance: For one of 55 (1%) non-payroll expenditures (\$2,500 of the aggregate amount of \$325,145 tested), the expenditure was recorded in fiscal year 2006, but the underlying goods and/or services were not received.

<u>CFDA</u>	<u>FORG</u>	<u>CLED</u>	<u>CCDESC.</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
10.664	341840	KE1502	URBAN & COMMUNITY FORESTRY	<u>\$2,500</u>	600683001	P6017201	23887

10. CFDA# 15.875 Economic, Social and Political Development of the Territories-Technical Assistance, Road Maintenance Equipment: For two of 55 (3%) non-payroll expenditures (\$13,520 of the aggregate amount of \$325,145 tested), the expenditures were recorded in fiscal year 2006, but the underlying goods and/or services were not received.

	<u>CFDA</u>	<u>FORG</u>	<u>CLED</u>	<u>CCDESC.</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	15.875	371310	KH4001	ROAD MAINTENANCE EQUIPMENT	\$11,391	600101201	P4014301	18960
2	15.875	371310	KH4001	ROAD MAINTENANCE EQUIPMENT	<u>2,129</u>	600486302	P6011402	22825
					<u>\$13,520</u>			

Item 1 will not be questioned due to an audit adjustment being proposed to recognize an advance.

Total Questioned Cost	\$ 13,520
Less Item 1	<u>(11,391)</u>
	<u>\$ 2,129</u>

11. CFDA# 84.051 Vocational Education – National Programs: For two of 55 (3%) non-payroll expenditures (\$11,267 of the aggregate amount of \$325,145 tested), expenditures were recorded in fiscal year 2006, but the underlying goods and/or services were received in fiscal year 2005 or have not been received yet.

	<u>CFDA</u>	<u>FORG</u>	<u>CLED</u>	<u>CCDESC.</u>	<u>AMOUNT</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	84.994	461410	3973	FY05 KVEIP	\$ 9,059	600126902	C5008902	19047
2	84.994	461410	3973	FY05 KVEIP	<u>2,208</u>	600125401	P5009101	21123
					<u>\$11,267</u>			

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

Effect: Expenditures appear to be misstated, and noncompliance with allowable costs/costs principles results from the condition.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-02, Continued

Prior Year Status: The above conditions are reiterative of conditions identified in the prior year audit of Kosrae State Government.

Recommendation: We recommend that the State record expenditures when goods or services have been received or incurred. If disbursements have been advanced for these costs, they should be recorded as prepaid or advance payments.

We recommend that the State obtain approval from the grantor if goods or services are not anticipated to be received or incurred within 90 days after the period of availability. If such is not obtained, questioned costs may result in the following fiscal year.

The State has received verbal communication from the Office of Insular Affairs that indicated that such prepaid expenses may be classified in each respective Compact Sector balance sheet and therefore, such classification appears to be authorized.

Auditee Response and Corrective Action Plan:

1. We agree with the finding and recommendation. These questioned costs pertain to the recording of grant expenditures as expenses when advance to vendors were made but where the goods or services were received in a different, usually subsequent, fiscal year. DOF management in FY -07 has reinforced with its staff the correct recording of advance payments. This procedure requires recording the advance in a general ledger account, keeping the encumbrance open until the goods or services are received, and upon receipt transferring the amount from the general ledger to the correct expenditure account in the department's sub-ledger and liquidation of the expenditure. We note that as part of the sector grant closure process, DOF management routinely communicates with the FSNING and OIA about advances for which the goods are not received within the grant period.
2. We agree with the finding and recommendation. These questioned costs pertain to the recording of grant expenditures as expenses when advance to vendors were made but where the goods or services were received in a different, usually subsequent, fiscal year. We note that the applicable advances were all for FASEG program purposes and since the FASEG grant is a multi-yr grant that ended in FY-06, there are no adverse affects from recording the expenditures in the wrong accounting period.
3. We agree with the finding and recommendation. The questioned cost pertains to the purchase of conservation posters from Pohnpei Arts and Crafts; the items were received on October 20, 2006.
4. We agree with the finding and recommendation. The questioned costs pertains to the additional freight costs for a Trail Kind 30-ton tilt-top trailer. The trailer was received on December 7, 2006.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2006-03
CFDA:	15.875
Grant:	CSG-FSM-2006-CAP, CSG-FSM-2005-EDU, CSG-FSM-2006-INF, CSG-FSM-2006-ENV, CSG-FSM-2006-PSD, CSG-FSM-2006-HLT
Grantor Agency:	U.S. Department of the Interior - Compact Sector Grant
Program Name:	Allowable Costs/Cost Principles
Questioned Costs:	\$0
CFDA #:	93.994
Grant #:	B04MC04266,
Grantor Agency:	Department of Health and Human Services - Maternal Child Health Services Block Grant to the States
Area:	Allowable Costs/Cost Principles
Questioned Costs:	\$0
CFDA #:	17.260
Grant #:	AA-13838-04-50
Agency:	U.S. Department of Labor - WIA Dislocated Workers
Program Name:	Allowable Costs/Cost Principles
Questioned Costs:	\$0

Criteria: Contractors should not be entitled to government share benefits.

Condition:

1. CFDA# 15.875 Compact Sector Grants: JV6M0055 was recorded to transfer salaries expense to contractual expense. Total salaries transferred aggregate to \$86,200 of which \$7,317 is for employee benefits. This transfer relates to individuals hired under contract, who appear to be treated as employees, since the State bears responsibility for all withholdings and deducts taxes from the contractor payments at individual tax rates. As a result, these contractors actually appear to be employees. Hence, the basis of the transfer appears to be inappropriate.
2. CFDA# 93.994 Maternal Child Health Services Block Grant to the States: JV6M0073 was recorded to transfer salaries expense to contractual expense. Total salaries transferred aggregate to \$4,265.
3. CFDA# 17.260 WIA Dislocated Workers: JV6M0095 was recorded to transfer salaries expense to contractual expense. Total salaries transferred aggregate \$3,453.

The above transfers for items two and three relate to doctors and WIA individuals hired under contract, who appear to be treated as employees. Since the State bears responsibility for all withholdings and deducts taxes from the contractor payments at individual tax rates, these contractors actually appear to be employees. Hence, the basis of the transfer appears to be inappropriate.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-03, Continued

Cause: The State does not appear to be aware of the difference between a contractor and an employee.

Effect: Potential unallowable costs result from this condition as contractors should not be entitled to government benefits and the government should not withhold individual taxes from contractors.

No questioned costs result from this finding as the issue is the appropriation classification of these expenditures.

Prior Year Status: The above conditions are reiterative of conditions identified in the prior year audit of Kosrae State Government.

Recommendation: We recommend that the State reexamine the distinction between a contractor and an employee and ensure that employee salaries are appropriately classified in the financial statements.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The long-standing practice of transferring personnel expenditures to contractual services expenditures is the result of a previous legal opinion from the Kosrae Attorney General authorizing this practice for those contract employees not paid under the grade-step tables pertaining to many public service system employees. This matter will be resubmitted to the Attorney General in FY-07 for an updated opinion.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2006-04
CFDA:	15.875
Grant:	CSG-FSM-2006-CAP, CSG-FSM-2005-EDU, CSG-FSM-2006-INF, CSG-FSM-2006-ENV, CSG-FSM-2006-PSD, CSG-FSM-2006-HLT
Grantor Agency:	U.S. Department of the Interior - Compact Sector Grant
Area:	Contract Provisions
Questioned Costs:	\$0
CFDA:	97.039
Grant:	FEMA-1427-DR-FM/HMGP #13
Agency:	U.S. Department of Homeland Security - Hazard Mitigation
Program Name:	Contract Provisions
Questioned Costs:	\$0

Criteria: For all contracts the following provisions should be included as applicable:

- (i) For contracts in excess of \$100,000, administrative, contractual, or legal remedies in instances where contractors violate or breach contract terms, and the provision of such sanctions and penalties as appropriate;
- (ii) For contracts in excess of \$100,000, termination for cause and for convenience by the Grantee or Sub-Grantee including the manner by which it will be effected and the basis for settlement;
- (iii) Compliance with the local statutes regarding kickbacks and corrupt practices;
- (iv) Access by the Government of the Federated States of Micronesia and its Sub-Grantees, the Government of the United States, or any of their duly authorized representatives to any books, documents, papers, and records of the contractor which are directly pertinent to that specific contract for the purpose of making audit, examination, excerpts, and transcriptions;
- (v) Retention of all required records for three years after Grantees or Sub-Grantees make final payments and all other pending matters are closed; and
- (vi) Compliance with all applicable standards, orders, or requirements issued under local environmental laws.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-04, Continued

Condition:

1. For nine of 64 (14.1%) non-payroll expenditures tested (\$162,290 of the aggregate amount of \$1,086,436 tested), Fiscal Procedures contract provisions (iii) to (vi) were not noted in the contract.

	<u>FORG</u>	<u>CCELED</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>VENDOR</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	761107	KA641J	8405	\$ 32,306	YH & CC SHELL	600128401	C5010301	18994
2	731210	KA200A	8405	30,000	MEDPHARM	600121501	C5010501	19057
3	721415	KB121A	8405	28,851	ISLAND CAFE	600028801	C6000301	18127
4	721415	KB121A	8405	28,851	ISLAND CAFE	600185301	C6000301	19525
5	721415	KB121A	8405	14,426	ISLAND CAFE	600423901	C6000301	21814
6	721415	KB121A	8405	12,728	IONE S. SIBA	600028901	C6000201	18124
7	721415	KB121A	8405	12,728	IONE S. SIBA	600211401	C6000201	19744
8	741063	KC422A	8431	1,200	WILLIAM O. TO	600027101	NOV	18108
9	741063	KC422A	8431	<u>1,200</u>	SEMEON T. SIG	600416201	JUN-AUG	21683
				<u>\$162,290</u>				

2. For three out of four (75%) non-payroll expenditures tested (\$696,751 of the aggregate amount of \$697,454 tested), Fiscal Procedures contract provisions (iii) and (v) were not noted in the contract.

	<u>FORG</u>	<u>CCELED</u>	<u>ACCT</u>	<u>AMOUNT</u>	<u>VENDOR</u>	<u>DESC.01</u>	<u>DESC.03</u>	<u>CK NO.</u>
1	441010	KX7401	8405	\$ 73,364	KOSRAE UTILIT	600443301	C6000101	24542
2	441010	KX7401	8405	286,743	KOSRAE UTILIT	600079401	C6000101	19180
3	441010	KX7401	8405	<u>336,644</u>	KOSRAE UTILIT	600168901	C6000101	21218
				<u>\$696,751</u>				

Cause: There appears to be lack of internal control in ensuring that Fiscal Procedures Agreement contract provisions are included as applicable in the contract.

Effect: The Kosrae State Government appears to be in noncompliance with Compact Sector program objective.

The conditions sited are the provisions of the contract and not the amount and therefore no questioned costs result from this finding.

Recommendation: We recommend that the State strengthen its control in ensuring that Fiscal Procedures Agreement contract provisions requirements are included as applicable in the contract.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The Department of Finance will refer this matter to the Kosrae Attorney General in May, 2007 to ensure that all future contracts encumbered under sector grant funds are in compliance with the Fiscal Procedures Agreement.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-05

CFDA: 84.027  
Grant #: H027B0300002-05  
Grantor Agency: U.S. Department of Education - Special Education  
Area: Cash Management  
Questioned Cost: Undeterminable

CFDA#: 97.039  
Grant #: FEMA 1427 DR FM/HMGP #13  
Grantor Agency: U.S. Department of Homeland Security - Hazard Mitigation Grant  
Area: Cash Management  
Questioned Cost: Undeterminable

CFDA: 84.256  
Grant #: S256A30009-04  
Grantor Agency: U.S. Department of Education - Freely Associated State-Education Grant Program  
Program: Cash Management  
Questioned Cost: 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 the 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 above condition is reiterative of conditions identified in the prior year audit of Kosrae State Government.

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: We agree with the finding and recommendation. Because of cash flow problems in fiscal year 2006, Kosrae was late in making payments to many vendors. In 2007 the FSM National Government Finance Office began processing transactions for all Kosrae U.S. Federal Grant transactions. This will ensure that minimal time elapses between receipt of Federal funds and the clearing of the actual checks.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.:	2006-06
CFDA:	15.875
Grant:	Compact Sector Grants
Grantor Agency:	U.S. Department of the Interior - Maintenance of Fixed Assets
Area:	Fixed Asset Maintenance
Questioned Cost:	\$0

Criteria: Management should periodically review asset maintenance activities, to ensure compliance with program objectives and requirements.

Condition: No procedures are in place to ensure that fixed assets are periodically reviewed for asset maintenance.

Cause: There appears to be a weakness in internal controls over ensuring that fixed assets are periodically maintained.

Effect: The expected life of the fixed asset may be shortened.

Recommendation: We recommend that the State strengthen internal controls to ensure that there are periodic reviews to ensure that asset maintenance activities are monitored and performed.

Auditee Response and Corrective Action Plan: We do not agree with the finding which pertains to new school buses purchased by DOE. The Kosrae DOE, as do other major government departments, has comprehensive written maintenance plans for its capital assets, including vehicle maintenance, which have been followed. Moreover, the assets are in good working condition. Management will review the documentation of these maintenance servicing to ensure a sufficient audit trail exists to evidence such.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-07

CFDA #: 15.875  
Grant #: CSG-FSM-2006-CAP, CSG-FSM-2005-EDU, CSG-FSM-2006-INF, CSG-FSM-2006-ENV, CSG-FSM-2006-PSD, CSG-FSM-2006-HLT

Grantor Agency: U.S. Department of the Interior - Compact Sector Grant  
Area: Allowable Costs/Cost Principles  
Questioned Costs: \$6,068

CFDA #: 17.260  
Grantor Agency: U.S. Department of Labor - WIA Dislocated Workers  
Program Name: Allowable Costs/Cost Principles  
Questioned Costs: \$1,138

Criteria:

1. Payroll disbursements should be recorded to the account presented in the employee personnel action form.
2. Sixty-four regular work hours should be consistent for all employees, unless otherwise authorized by the grantor agency.

Condition:

1. CFDA 15.875 and 17.260: One (4%) of twenty five employees tested, employee 58322, the salary was charged to an inaccurate account. The personnel action form indicated that payroll expenditures were to be charged to the Compact Education Sector Grant; however, salary of \$1,138 and \$6,068 was charged to the WIA Dislocated Workers program and the Compact Supplemental Education Grant, respectively.
2. CFDA 15.875 Compact Sector Grants: Eight (10%) of eighty-four employees tested were paid 80 regular work hours despite Government general fund employees only being allowed to work 64 hours. Questioned costs for this finding are undeterminable as we have not been provided sufficient information to estimate the related amount. The employees are listed below.

	<u>Fund</u>	<u>Org</u>	<u>Employee no.</u>
1	72	1410	23055
2	73	1211	29422
3	73	1211	42252
4	73	1211	800610
5	74	1611	803440
6	74	1611	803616
7	76	1101	30633
8	76	1510	17281

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-07, Continued

Cause: There appear to be weak internal controls over ensuring that payroll disbursements are charged to the proper accounts.

Regular hours for all employees should be consistent for all government employees.

Effect: Payroll expenditures may be misstated in the individual fund accounts and abuse of federal funds may be presented for employees paid eighty regular work hours. These matters are reportable as the projected questioned costs exceed the threshold.

Recommendation: We recommend that the State of Kosrae strengthen internal controls to ensure that payroll disbursements are recorded to the proper account and any changes are properly documented and filed in the personnel files.

Employees funded under the federal grants fund paid at eighty regular work hours per pay period should be approved by the grantor as the State has regulated only sixty-four regular work hours per pay period.

Auditee Response and Corrective Action Plan: We agree that accounts charged for payroll disbursements should be consistent with that indicated on the personnel action form. It is standard procedure in the payroll division of the finance office to document account changes with properly approved personnel action forms. The instances noted were oversights. Since both the WIA dislocated workers and SEG programs involve substantial education components it is common to utilize the same pool of candidates to perform services under the respective grants.

It is not the case that all employees are only allowed 64 hours per pay period. This policy only pertains to non-exempt public service system employees. For employees who are exempt from these employment terms, the individual contractual terms apply. Department directors, doctors and other expatriate professionals are those who commonly are paid 80 hours per pay period. For the instances cited in the finding, employee numbers 23055, 30633 and 17281 are department directors. Employees 29422, 42252 and 800610 are doctors employed at the hospital. Employees 803440 and 803616 are expatriate attorneys. All these employees are entitled to be paid 80 hours per pay period.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.: 2006-08  
CFDA: 15.875  
Grant : CSG-FSM-2006-INF, CSG-FSM-2005-EDU  
Grantor Agency: U.S. Department of the Interior - Compact Sector Grant  
Area: Period of Availability  
Questioned Costs: \$152,550

Criteria: Expenditures should be necessary and reasonable for program needs and should be in accordance with the program needs. Furthermore, expenditures should be recorded in the appropriate period underlying the receipt of applicable goods or services.

Condition:

1. CFDA# 15.875 Compact Infrastructure Sector Grant (68): Through review of subsequent disbursements, two checks were recorded as an expenditure in fiscal year 2007 however services rendered were in fiscal year 2006. Contract number C60001 totaling \$105,050 was paid with two disbursements issued in fiscal year 2007 (check numbers 25470 and 24942) for \$39,325 and \$65,725, respectively. Due to the materiality of the disbursement, an audit adjustment was proposed to recognize the expenditure in the current year and therefore these items have been included as a questioned cost since they were paid outside the period of availability.
2. CFDA# 15.875 Compact Education Sector Grant (73): Per review of subsequent disbursements, check number 25206 totaling \$47,500 for contract C60107, was disbursed and recorded as an expenditure in fiscal year 2007; however, payment was for services incurred in fiscal year 2006. Due to the materiality of the disbursement, an audit adjustment was proposed to recognize the expenditures in 2006 and therefore has been included as a questioned cost since they were paid outside the period of availability.

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

Effect: Expenditures appear to be misstated, and noncompliance with allowable costs/costs principles results from the condition.

Prior Year Status: The above conditions are reiterative of conditions identified in the prior year audit of Kosrae State Government.

Recommendation: We recommend that the State record expenditures when goods or services have been received or incurred. If disbursements have been advanced for these costs, they should be recorded as prepaid or advance payments.

We recommend that the State obtain approval from the grantor if goods or services are not anticipated to be received or incurred within 90 days after the period of availability. If such is not obtained, questioned costs may result in the following fiscal year.

The State has received verbal communication from the Office of Insular Affairs that indicated that such prepaid expenses may be classified in each respective Compact Sector Balance sheet and therefore, such classification appears to be authorized.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Federal Findings and Questioned Costs Section, Continued

Finding No.:           2006-08, Continued

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In fiscal year 2007 management corrected its accounts to record expenditures in the proper period. An advance to vendor account is initially charged for prepaid expenses; subsequent vouchering to the expenditure account will occur only when the goods or services are received. As noted in the finding, the individual sector funds are being used to record these advances. This will assist the finance office in timely reconciliation of outstanding advances.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section

Finding No.: 2006-09  
Area: Cash

Criteria:

1. Outstanding checks listed on the bank reconciliations should be regularly reviewed to establish stale dated items.
2. Bank reconciliations should be performed in a timely manner.
3. Manual checks issued should be recorded.
4. Cash collections should be identified and timely recorded.
5. Cash should be deposited on a timely basis.

Condition:

1. Stale dated checks from 12/03/02-09/30/05 amounting to \$52,911 are included as reconciling items on the general fund bank reconciliation. Outstanding checks should be reviewed on a consistent basis and be adjusted for any amounts greater than one year.
2. Bank reconciliations were not provided for the Kosrae Farmer's Exchange and the Kosrae Visitor's Bureau checking accounts with September 30, 2006 bank balances of \$31,670 and \$643, respectively.
3. Two manual checks were issued to replace check number 19902 totaling \$107,700. Check number 19902 still remains outstanding after the disbursement of the replacement checks were issued.
4. Manual check no's 23702 and 23701 for \$57,700 and \$5,146, respectively, were dated prior to September 30, 2006 and were not included in the bank reconciliation as reconciling items as of 09/30/06.
5. Manual checks 23702 and 20175 totaling \$107,700 were not recorded with an offset account.
6. The following cash receipts totaling \$814,008 did not indicate the reason or basis for the payment and therefore, we could not ensure that the revenue category was appropriate.

<u>Receipt#</u>	<u>Amount</u>	<u>Receipt#</u>	<u>Amount</u>	<u>Receipt#</u>	<u>Amount</u>	<u>Receipt#</u>	<u>Amount</u>
71617	\$124,696	73089	\$18,775	71509	\$6,689	71110	\$ 15,000
71509	65,726	71279	16,604	71509	6,185	71320	15,000
72069	55,198	71509	14,689	71509	5,913	71354	3,701
73089	53,039	72349	12,838	72463	5,678	71075	3,240
71328	43,040	71509	9,862	72348	5,103	71143	2,874
72349	32,583	72829	9,356	71092	4,767	71842	2,570
72463	28,625	72463	8,025	72348	4,552	70884	2,505
71809	26,418	73089	7,789	72350	4,536	71988	123,757
72463	26,231	72635	7,288	71091	4,453		-
73089	25,585	72635	6,740	72613	4,378		-

TOTAL: \$814,008

7. For two (4%) of fifty-two samples tested for Other Governmental Funds, cash was not deposited in a timely basis.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-09, Continued  
Area: Cash

Condition, Continued:

8. Of 52 samples, one sample showed a cash receipt dated on April 30, 2006 (Sunday) and deposited four days later (Thursday). Upon inquiry, it was revealed that the cash receipt was actually made on Wednesday (May 3, 2006), but the preparer predated the cash receipt so that the issuance could fall in April instead of May.
9. Two (4%) of fifty-nine cash receipts tested, totaling \$640,996, were improperly classified to the wrong revenue account.

Cause: There appear to be weak internal controls over ensuring that outstanding checks are reconciled and reviewed and that bank reconciliations are performed in a timely manner.

Manual checks are not properly accounted for.

Cash collections are not classified at the time of deposit since the basis for the collection may not be known.

There appears to be a weakness in internal control over cash collections and ensuring that the recordation of receipts is reflected against the correct revenue or receivable account.

Effect: A misstatement in cash and income may result. Misuse of cash may also be present leading to fraud or theft.

Recommendation: We recommend that the outstanding checks be properly reconciled and reviewed. Management should review the outstanding checklist for possible stale dated checks on a quarterly basis. Amounts outstanding for greater than one year should be adjusted and voided.

Bank reconciliations should be performed on a timely basis to avoid abuse and fraudulent transactions.

Manual checks should be controlled to ensure that all are accounted for.

Cash receipts should evidence the payment basis and the account code annotated should be reviewed to ensure that the appropriate general ledger posting occurred.

The State should ensure that all cash collections are deposited and recorded in a timely manner and are credited to the correct account.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. In fiscal year 2007, outstanding checks older than one year were written off. Likewise, bank reconciliations are now performed immediately upon receipt of the bank statements. The accountant responsible for these reconciliations has been instructed to properly book all reconciling items each month, including those related to manual checks. The Kosrae Farmer's exchange and the Kosrae Visitor's Bureau will be requested to provide bank reconciliations to the Finance Office for these two decentralized accounts. Prior instances of late deposits reflected holding checks from the FSMNG for federal grant reimbursements until the detail was received.

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Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-09, Continued  
Area: Cash

Auditee Response and Corrective Action Plan, Continued:

These deposits are now directly wired to the Kosrae State government bank account. Finally, upon the implementation of a new FMIS system in July, 2007, the Finance office will automate its cash receipt and bank reconciliation processing. This will ensure that adequate descriptions and revenue codes are documented on the cash receipt form as well as eliminate errors in the bank reconciliation process.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-10  
Area: Payroll

Criteria:

1. Salary compensation should be supported by underlying timesheet or timecards.
2. All deductions from employees should be authorized by the employee via an authorized allotment form, enrollment form, or memo.

Condition:

1. Employee numbers 801136, 802251, 802874 were exempted by the Department and/or Governor from utilizing timecards. However, the employees are not exempted from overtime.
2. Allotment authorizations are not documented.

Cause:

1. There appears to be a lack of control in the maintenance and storage of relevant financial documentation.
2. Payroll deductions are not properly documented.

Effect:

1. Time charges may be misstated.
2. Unauthorized payroll deductions could result.

Recommendation:

1. We recommend that the State utilize timecards for employees who are not exempted from overtime.
2. We recommend that the Government ensure that payroll allotments are authorized and documented.

Auditee Response and Corrective Action Plan: We agree with the finding but do not agree with the recommendation. The finding refers to the payment of overtime to Doctors who are exempted from the public service system but are entitled to overtime per the terms of their contracts. These employees do not utilize timecards and the system in place by the hospital timekeeper is felt adequate to properly record the applicable hours.

No allotments are entered into the payroll system without an allotment deduction form approved by the employee. Because of the high volume of the allotment forms, many do not get filed correctly and management feels this is the reason for the audit exceptions. Moreover, all allotment deductions are noted on an employees' check stub so the risk of improper deductions is relatively small.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-11  
Area: Misuse of Representation Fund

Criteria: The representation fund is to be used for reimbursement of expenses incurred while performing official duties for certain State officials.

Condition: Reference #600169901 totaling \$2,000 was reimbursed for automobile repair and medical expenditures that appear to be personal in nature.

Cause: There appears to be a weakness in internal controls over ensuring that the representation fund is used solely for reimbursement of expenses incurred while performing official duties and not for personal expenditures.

Effect: A potential violation of the objective of the fund can result from this finding.

Recommendation: We recommend that the State ensure that reimbursements are approved for those expenditures incurred while performing official duties and not include personal expenditures.

Auditee Response and Corrective Action Plan: We agree with the finding and representation. The finding pertains to a reimbursement to a Senator in the Kosrae State Legislature who utilized his reimbursement fund for personal, non-official purposes. The use of these funds is approved by KSL's own rules and procedures which allow for this type of use even though it is not for official purposes.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-12  
Area: Accounts Receivable

Criteria: Accounts receivable should be collected in a timely manner and be supported by subsidiary ledgers.

Condition:

1. The following receivables totaling \$3,346,435 have been outstanding for in excess of one year and have not been assessed as to their collectibility.

<u>Fund</u>	<u>Acct</u>	<u>Amount</u>	<u>Fund</u>	<u>Acct</u>	<u>Amount</u>	<u>Fund</u>	<u>Acct</u>	<u>Amount</u>	
10	200	\$ 107,915	44	280	\$ 9,689	30	262	\$ 866,567	
10	202	1,077	46	283	246,895	32	262	61,742	
10	280	9,461	46	284	161,632	33	262	20,568	
10	297	270,000	46	285	37,268	33	302	20,496	
10	820	(54,227)	46	286	(123,059)	34	262	5,624	
11	280	419,582	46	287	34,302	41	262	149,627	
30	280	255,435	47	262	14,599	44	262	14,239	
32	280	33,874	85	207	1,508	46	262	28,617	
33	302	20,496	91	250	11,335	68	262	9,394	
34	280	10,853	AGR	210	18,743	68	250	35,827	
37	280	117,243	46	280	202	82	298	<u>528,911</u>	
							TOTAL		<u>\$3,346,435</u>

2. Accounts receivable subsidiary ledgers were not provided or did not agree with the general ledger.

Cause: There appears to be a lack of reconciliation between subsidiary ledgers and the general ledger and non-timely collection of accounts receivable.

Effect: There may be a potential misstatement of the financial statements if subsidiary ledgers are not reconciled with the general ledger, and uncollected receivables affect the availability of cash.

Recommendation: Subsidiary ledgers should be routinely reconciled with the general ledger. In addition, standard collection efforts should be initiated.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Management agreed to write-off \$2.58 million of dormant accounts receivable balances as of September 30, 2006. Most of these balances pertain to dormant accounts that were over five years old and were distorting the financial position of the state. Accounts receivable balances are now monitored extremely closely, cash collections persistently pursued, and adjustments made on a timely basis.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-13  
Area: Travel Advances

Criteria: Travel advances should be cleared in a timely manner.

Condition: Travel advances totaling \$125,279 appear to have been outstanding over a year, representing 90% of total travel advances.

Cause: There appear to be weak internal controls over ensuring that travel is cleared in a timely manner.

Effect: Cash flows may be negatively impacted.

Prior Year Status: This finding is reiterative of conditions identified in the prior year audit of Kosrae State Government.

Recommendation: We recommend that the State enforce a collection policy for travel advances.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. As part of its account review prior the 2007 FMIS implementation management has agreed to write-off old outstanding travel advances totaling \$115,000. Moreover, the State is now actively enforcing a filing policy for outstanding travel advances and making payroll deductions from those employees who do not file on a timely basis.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-14  
Area: Encumbrances

Criteria:

1. All encumbrances recorded or amended should be supported by documentation to track the entry and to facilitate the review process.
2. Encumbrances should be periodically reviewed to ensure their continuing validity.

Condition:

1. Thirteen (18%) of seventy-four encumbrances tested were dated FY 2002 and prior:

<u>Purchase Order</u>	<u>Fund / Org</u>	<u>CC</u>	<u>Acct</u>	<u>Vendor</u>	<u>Name</u>	<u>PO Amount</u>	<u>PO Paid</u>	<u>Remaining Balance</u>
C23922	601510	6822	8405	1052	NENA S. NENA CONTINENTAL	\$4,336.95	\$ -	\$4,336.95
T02360	261210	2499	8111	2974	MICRONESIA	5,902.00	-	5,902.00
C24091	828201		8303	1943	CLARA S. ASHER	2,084.50	-	2,084.50
C24629	828201		8405	4229	ARNON L. TIMOTHY	5,251.45	2,486.45	2,765.00
C00173	828201		8405	1058	YOSIWO P. GEORGE	5,000.00	2,216.35	2,783.65
C24940	828201		8405	6067	CARL R. ALOKOA	2,893.92	-	2,893.92
C24924	828201		8405	5983	ANITA K. OBET	3,515.02	-	3,515.02
C24049	601510	6822	8405	936	GODWIN JOEL	2,196.65	-	2,196.65
T00146	101611		8110	5382	ANDREW BLUM	3,775.40	509.00	3,266.40
TOO150	301410	KA9090	8110	2521	ARTHUR F. ALBERT	3,370.00	-	3,370.00
T00869	601060	K0148	8110	1052	NENA S. NENA	1,427.72	-	1,427.72
T00009	111010	120115	8110	2620	ROPINA D. ALOKA	2,082.00	-	2,082.00
T00240	291010	2826	8110	3705	SIMPSON K. ABRAHAM	3,844.80	1,738.80	2,106.00

2. For eight (11%) of seventy-four encumbrances tested, the supporting document does not agree to the purchase order, contract or travel advance total.

<u>Purchase Order</u>	<u>Fund / Org</u>	<u>CC</u>	<u>Acct</u>	<u>Vendor</u>	<u>Name</u>	<u>PO Amount</u>	<u>PO Paid</u>	<u>Remaining Balance</u>
T00146	101611		8110	5382	ANDREW BLUM	\$ 3,775.00	\$ 509.00	\$ 3,266.00
TOO150	301410	KA9090	8110	2521	ARTHUR F. ALBERT	3,370.00	-	3,370.00
C30160	601310	K03006	8001	6927	DEPT. OF PUBLIC WORKS KOSRAE WHITE SAND & CO.	15,919.00	-	15,919.00
C00422	601310	K0140	8405	5576	SIMPSON K. ABRAHAM	578,621.00	513,140.00	65,481.00
T00240	291010	2826	8110	3705	SIMPSON K. ABRAHAM	3,845.00	1,739.00	2,106.00
C50091	828201		8405	1318	ALIKSA B. ALIKSA	16,000.00	11,582.00	4,418.00
C00261	828201		8405	3462	CARON N. SIGRAH	18,688.85	14,537.80	4,151.05

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-14, Continued  
Area: Encumbrances

Cause: There are weak internal controls over ensuring that encumbrances are well supported and are accurately reported in the system.

Effect: A potential misstatement of the fund level financial statements could result from this condition.

Recommendation: Encumbrances should be periodically reviewed and reconciled to underlying support.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. As part of its 2007 FMIS implementation, the Finance office has done a comprehensive review of all encumbrances, and cancelled those no longer valid. About 90% of these pertained to inactive encumbrances in the housing revolving fund or for old T.A.s Henceforth, the finance office will ensure inactive encumbrances are cancelled.

The instances cited wherein the amounts in the FOCUS system did not agree with the supporting documents reflect a system problem whereby manual adjustments incorrectly reduced the original P.O. amount rather than as a separate addition or reduction of the original amount. Hence, the applicable balances were understated. The new FMIS software to be implemented in July 2007 will properly account for adjustments to or partial liquidations of open encumbrances.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-15  
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 not 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 is reiterative of conditions identified in the prior year audits of Kosrae State Government for fiscal years, 1999-2005.

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 but note that both KSV I and SEMO are essentially defunct corporations so there is no likelihood that financial statements can be obtained from either. In fiscal year 2006, management wrote-down its \$1.732 million SEMO investment. The joint investment with NFC, Kosrae Sea Ventures, is accounted for using the equity method and consequently has a \$0 carrying value.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2006

Financial Statements Findings Section, Continued

Finding No.: 2006-16  
Area: Unauthorized Disbursement

Criteria: Payees on checks and supporting documentation should match.

Condition: Of 48 samples selected, disbursement reference number 600017801 was not paid to the correct payee. The State did not provide any supporting document to authorize this change.

Cause: There appears to be a weakness in internal controls over ensuring that disbursements are paid to the correct vendor or payee.

Effect: Weakness with this control may allow fraudulent activity and abuse to occur.

Recommendation: We recommend that Kosrae State Government strengthen internal controls to prevent unauthorized disbursements.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The example pertained to a processing error in Finance, whereby a State pension payment was incorrectly made to an individual with the same first name as the intended payee. The check was given to the correct individual and was honored by the bank even though it had an incorrect payee name. Finance found out about its error after the fact and subsequently made the correction. It is standard finance office policy to match checks with supporting documents.

**STATE OF KOSRAE  
FEDERATED STATES OF MICRONESIA**

Unresolved Prior Years' Findings and Questioned Costs  
Year Ended September 30, 2006

The following is a summary of unresolved questioned costs of the State of Kosrae as of September 30, 2006:

	Questioned Costs Set Forth in Prior Audit Report <u>2005</u>	Questioned Costs Resolved in Fiscal Year <u>2006</u>	<u>Questioned Costs at September 30, 2006</u>
Unresolved Questioned Costs FY 2002	\$ 72,138	\$ -	\$ 72,138
Unresolved Questioned Costs FY 2003	103,493	63,682	39,811
Unresolved Questioned Costs FY 2004	237,645	-	237,645
Unresolved Questioned Costs FY 2005	462,459	-	462,459
Questioned Costs FY 2006	<u>-</u>	<u>-</u>	<u>694,514</u>
	<u>\$ 875,735</u>	<u>\$ 63,682</u>	<u>\$ 1,506,567</u>

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