

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2007 AND 2006

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Kosrae Utilities Authority:

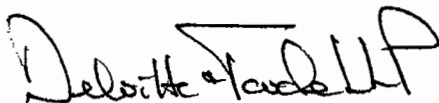
We have audited the accompanying statements of net assets of the Kosrae Utilities Authority, a component unit of the Kosrae State Government, as of September 30, 2007 and 2006, and the related statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Kosrae Utilities Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Kosrae Utilities Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Kosrae Utilities Authority as of September 30, 2007 and 2006, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. The supplementary information is the responsibility of the Kosrae Utilities Authority's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 21, 2008, on our consideration of the Kosrae Utilities Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on 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.



April 21, 2008

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Management Discussion and Analysis
Years Ended September 30, 2007 and 2006

This section of the Kosrae Utilities Authority's (KUA or the Authority) annual financial report presents the analysis of the Authority's financial performance during the fiscal year ended September 30, 2007. Please read it in conjunction with the financial statements, which follows this section.

KUA was mandated by law in October 1993 as a semi-agency of the Kosrae State Government to assume the operation and responsibility of providing electric power services to the Island of Kosrae. KUA is governed by a five (5) member board appointed by the Governor with the advice and consent of the State Legislature for staggered terms of 2 to 4 years. The Authority serves 1,752 customers. With no change in its customer base from the previous operating year, the ratio remains constant at approximately 80% residential, 11% commercial, 5% Kosrae State Government, 3% non-Kosrae State Government and 1% industrial. With little or no economic activities on Kosrae, the energy sales ratio to various customer sectors is expected to continue for the next several years of operation, but should be reviewed annually since any changes in one customer class such as industrial or commercial can have a positive or negative effect on future operating revenues.

In fiscal year 2007, KUA continued to face financial challenges due to various factors affecting the operation. These factors were the continued decline in energy sales to customers, rising fuel costs and freight charges, increasing equipment and spare parts costs, and an inadequate tariff to recover operating costs. Electric revenues from existing power rates and fuel adjustment charges provide for approximately 68% of total operating expenses with 10% non-operating revenues from project funded reimbursements from OMP/DOI and interest earned from investments. Remedial action and measures to alleviate and resolve these financial challenges were aggressively pursued by the staff and the KUA Board of Directors during Fiscal Year 2007.

Management's Discussion and Analysis for the year ended September 30, 2006 is set forth in KUA's report on the audit of financial statements, which is dated May 7, 2007. That Discussion and Analysis explains the major factors impacting the 2006 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmpublicauditor.fm.

The following table summarizes the financial position and results of operations of Kosrae Utilities Authority for 2007 through 2005:

| <u>Assets</u> | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|---------------------------------------|---------------------|---------------------|---------------------|
| Current assets | \$ 2,504,099 | \$ 2,735,548 | \$ 2,978,869 |
| Utility plant, net | 5,103,684 | 5,088,838 | 4,509,386 |
| Other non-current asset | <u>14,358</u> | <u>18,461</u> | <u>-</u> |
| | <u>\$ 7,622,141</u> | <u>\$ 7,842,847</u> | <u>\$ 7,488,255</u> |
| | | | |
| <u>Liabilities and Net Assets</u> | | | |
| Current liabilities | \$ 159,545 | \$ 232,737 | \$ 238,216 |
| Notes payable, net of current portion | <u>360,635</u> | <u>-</u> | <u>-</u> |
| Total liabilities | <u>520,180</u> | <u>232,737</u> | <u>238,216</u> |
| Net assets: | | | |
| Invested in capital assets | 5,103,684 | 5,088,838 | 4,509,386 |
| Restricted | 90,000 | 90,000 | - |
| Unrestricted | <u>1,908,277</u> | <u>2,431,272</u> | <u>2,740,653</u> |
| Total net assets | <u>7,101,961</u> | <u>7,610,110</u> | <u>7,250,039</u> |
| | <u>\$ 7,622,141</u> | <u>\$ 7,842,847</u> | <u>\$ 7,488,255</u> |

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Management Discussion and Analysis
Years Ended September 30, 2007 and 2006

Revenue, Expenses and Changes in Net Assets

| | <u>2007</u> | <u>2006</u> | <u>2005</u> |
|---------------------------------|---------------------|---------------------|---------------------|
| Operating revenues | \$ 1,539,653 | \$ 1,646,297 | \$ 1,459,830 |
| Operating expenses | <u>2,285,478</u> | <u>2,371,646</u> | <u>2,144,252</u> |
| Net operating loss | <u>(745,825)</u> | <u>(725,349)</u> | <u>(684,422)</u> |
| Operating subsidies | 10,016 | 2,143 | 92,637 |
| Interest income | <u>105,612</u> | <u>64,728</u> | <u>68,488</u> |
| Total non operating revenue | 115,628 | 66,871 | 161,125 |
| Capital contributions | <u>122,048</u> | <u>1,018,549</u> | <u>-</u> |
| Change in net assets | (508,149) | 360,071 | (523,297) |
| Net assets at beginning of year | <u>7,610,110</u> | <u>7,250,039</u> | <u>7,773,336</u> |
| Net assets at end of year | \$ <u>7,101,961</u> | \$ <u>7,610,110</u> | \$ <u>7,250,039</u> |

FINANCIAL HIGHLIGHTS

As expected, electricity sales in kilowatt hours continued to decline in 2007 in all power sectors. As such, operating revenues experienced a decrease of about 6%. The fuel adjustment charge rate is recorded at an average of 12.72 cents per kilowatt hour, which is 6% higher than in 2006, but was not able to increase revenue generated during the fiscal year.

Operating revenue is composed of 19% Residential, 14% Kosrae State Government, 3% Non-Kosrae State Government, 5% Industrial, 13% Commercial, 43% Fuel Adjustment Charge and 3% Other operating income.

Operating expenses decreased by approximately 4%. Fuel consumption in gallons was reduced by 11% against usage last year though fuel costs continued to increase from an average usage cost per gallon of \$2.53 in 2006 to \$ 2.61 in 2007. Depreciation of the pole hardening project from Tofol to Utwe started this year.

Operating subsidies and capital contributions are grants received from US-DOI OMIP. In FY 2008, US DOI approved an amount for KUA of \$237,940 as a sub-grantee of Kosrae State Government for the following projects:

1. Major overhaul training for technicians
2. Acquisition of materials and devices for oil spill mitigation
3. Acquisition of specialized tools and equipment
4. Development of termite protection for distribution warehouse
5. Upgrading of power plant control room
6. Upgrading of computer software for GIS.

The projects are expected to be finished no later than March 20, 2010.

The increase in interest income results from higher interest rates from time certificates of deposit when compared with last year and a favorable increase in the market value of KUA's investment portfolio managed by Salomon Smith Barney.

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Management Discussion and Analysis
Years Ended September 30, 2007 and 2006

During Fiscal Year 2007, KUA prepaid an amount of \$324,000 and \$170,000 during the months of February and May 2007 for the purchase of fuel to obtain 135,000 and 68,000 gallons, respectively, at a discounted price. The same arrangement was made in November 2007 where KUA advanced an amount of \$100,000 to Micronesia Petroleum Corporation for 32,895 gallons of diesel fuel. The amount used for the February 2007 payment was primarily from proceeds of a withdrawal of SSB investments.

KUA obtained a \$450,000 loan from Bank of the FSM, initially at a 5.10% interest rate, which is 2.50% over the interest rate on time certificates of deposit collateralizing the debt. The loan was for 5 years. Repayments start on August 25, 2007 at \$8,523 per month including principal and interest. Later this year, the rate was changed to 5.85%. For additional information on KUA's debt, please refer to Note 5 to the financial statements.

Loan proceeds were used for the purchase of a new Caterpillar Engine Model 3512B 1050KW 1200 RPM generator set. The engine became operational starting January 2008. For additional information on KUA's capital assets, please refer to Note 4 to the financial statements.

With the continued increase in fuel prices which affects the fuel adjustment charge, it is projected that the trend in decreasing sales is likely to be experienced. Reserve funds and temporary investments on the other hand will be partially used as collections are not able to pay off existing operational expenses.

Plan of Action for 2008 and Economic Outlook

1. Review the existing tariff rates and make recommendation for adequate rates to cover the cost of operation.
2. Streamline unnecessary expenses to reduce operating costs and continue to work with Micronesia Petroleum Corporation for joint bulk purchases of fuel to reduce fuel costs.
3. Increase installation of Cash Power Customers for power conservation and improve arrears collection and internal cash flows for operations.
4. Seek to improve investment schemes with Salomon Smith Barney and FSM Bank that yield better returns on KUA investments.
5. Provide training opportunities to employees to improve skill level and knowledge to improve work performance and reduce costs.
6. Acquisition of new CAT engine Model 3512B-1200RPM to improve fuel efficiency and to reduce fuel usage and thereby reduce fuel costs.
7. Secure funding from EU to fund the proposed Solar PV grid-connected System for Kosrae to reduce fuel requirements for operations.
8. Improve primary power lines and Power Plant Substation to reduce line loss and lost revenues and extend power lines to remote areas to increase customer base.
9. Improve accountability of KUA properties and procurement policies and procedures to reduce cost of materials and lost properties.
10. Improve public relations with government officials and customers.
11. Seek to develop other alternative Renewable Energy Sources to reduce dependency on diesel fuel.
12. Actively take part in promoting private sector development to improve economic activities in Kosrae to increase the revenue base for KUA operations.

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Statements of Net Assets
September 30, 2007 and 2006

| <u>ASSETS</u> | <u>2007</u> | <u>2006</u> |
|--|---------------------|---------------------|
| Current assets: | | |
| Cash and equivalents | \$ 559,727 | \$ 255,952 |
| Investments | 1,327,718 | 1,575,952 |
| Accounts receivable, net | 153,508 | 203,593 |
| Receivable from other governments | 7,793 | 228,407 |
| Prepayments | 30,120 | 5,300 |
| Inventories (net of an obsolescence allowance of \$96,649 and \$110,440 in 2007 and 2006, respectively) | <u>425,233</u> | <u>466,344</u> |
| Total current assets | <u>2,504,099</u> | <u>2,735,548</u> |
| Utility plant: | | |
| Electric plant in service | 10,761,240 | 10,570,060 |
| Construction work in progress | 472,231 | 165,292 |
| Less accumulated depreciation | <u>(6,129,787)</u> | <u>(5,646,514)</u> |
| Utility plant, net | <u>5,103,684</u> | <u>5,088,838</u> |
| Other asset (net of amortization of \$6,154 and \$2,051 in 2007 and 2006, respectively) | <u>14,358</u> | <u>18,461</u> |
| | <u>\$ 7,622,141</u> | <u>\$ 7,842,847</u> |
| <u>LIABILITIES AND NET ASSETS</u> | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 76,694 | \$ - |
| Accounts payable | 38,504 | 201,340 |
| Accrued annual leave | 17,985 | 16,362 |
| Deferred revenue | 13,402 | - |
| Accrued taxes and other | 12,654 | 15,035 |
| Accrued interest payable | <u>306</u> | <u>-</u> |
| Total current liabilities | 159,545 | 232,737 |
| Long-term debt, net of current portion | <u>360,635</u> | <u>-</u> |
| Total liabilities | <u>520,180</u> | <u>232,737</u> |
| Commitments and contingency | | |
| Net assets: | | |
| Invested in capital assets | 5,103,684 | 5,088,838 |
| Restricted | 90,000 | 90,000 |
| Unrestricted | <u>1,908,277</u> | <u>2,431,272</u> |
| Total net assets | <u>7,101,961</u> | <u>7,610,110</u> |
| | <u>\$ 7,622,141</u> | <u>\$ 7,842,847</u> |

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended September 30, 2007 and 2006

| | <u>2007</u> | <u>2006</u> |
|---------------------------------|---------------------|---------------------|
| Operating revenues: | | |
| Electricity sales | \$ 1,539,653 | \$ 1,646,297 |
| Operating expenses: | | |
| Production fuel | 1,298,004 | 1,416,437 |
| Depreciation and amortization | 487,376 | 459,194 |
| Salaries and wages | 331,895 | 326,692 |
| Administrative and general | 122,554 | 121,567 |
| Repair and maintenance | 45,649 | 47,756 |
| Total operating expenses | <u>2,285,478</u> | <u>2,371,646</u> |
| Loss from operations | <u>(745,825)</u> | <u>(725,349)</u> |
| Nonoperating revenues: | | |
| Interest income | 105,612 | 64,728 |
| Federal Grants - OMIP | 10,016 | 2,143 |
| Total nonoperating revenues | <u>115,628</u> | <u>66,871</u> |
| Capital contributions | <u>122,048</u> | <u>1,018,549</u> |
| Change in net assets | (508,149) | 360,071 |
| Net assets at beginning of year | <u>7,610,110</u> | <u>7,250,039</u> |
| Net assets at end of year | <u>\$ 7,101,961</u> | <u>\$ 7,610,110</u> |

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Statements of Cash Flows
Years Ended September 30, 2007 and 2006

| | <u>2007</u> | <u>2006</u> |
|--|---------------------|--------------------|
| Cash flows from operating activities: | | |
| Cash received from customers | \$ 1,589,349 | \$ 1,624,751 |
| Cash paid to suppliers for goods and services | (1,601,036) | (1,083,753) |
| Cash paid to employees for services | <u>(330,272)</u> | <u>(329,729)</u> |
| Net cash (used for) provided by operating activities | <u>(341,959)</u> | <u>211,269</u> |
| Cash flows from investing activities: | | |
| Proceeds from maturities of investments | 248,234 | 188,387 |
| Increase in other asset | - | (20,512) |
| Interest and investment income | <u>105,612</u> | <u>64,728</u> |
| Net cash provided by investing activities | <u>353,846</u> | <u>232,603</u> |
| Cash flows from noncapital financing activities: | | |
| Proceeds from issuance of long-term debt | 927,350 | 700,000 |
| Principal payments on long-term debt | (490,021) | (900,000) |
| Operating grants received | <u>10,016</u> | <u>2,143</u> |
| Net cash provided by (used for) noncapital financing activities | <u>447,345</u> | <u>(197,857)</u> |
| Cash flows from capital financing activities: | | |
| Capital contributions | 342,662 | 797,935 |
| Additions to utility plant | <u>(498,119)</u> | <u>(1,036,595)</u> |
| Net cash used for capital financing activities | <u>(155,457)</u> | <u>(238,660)</u> |
| Net change in cash and equivalents | 303,775 | 7,355 |
| Cash and equivalents at beginning of year | <u>255,952</u> | <u>248,597</u> |
| Cash and equivalents at end of year | <u>\$ 559,727</u> | <u>\$ 255,952</u> |
| Reconciliation of loss from operations to net cash (used for) provided by operating activities: | | |
| Operating loss | \$ (745,825) | \$ (725,349) |
| Adjustments to reconcile operating loss to net cash (used for) provided by operating activities: | | |
| Depreciation and amortization | 487,376 | 459,194 |
| Inventory obsolescence | (13,791) | 26,783 |
| Bad debt recovery | - | (20,140) |
| (Increase) decrease in assets: | | |
| Receivables | 50,085 | 18,734 |
| Prepayments | (24,820) | 136,773 |
| Inventories | 54,902 | 120,753 |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (162,836) | 197,030 |
| Accrued annual leave | 1,623 | (3,037) |
| Deferred revenue | 13,402 | - |
| Accrued taxes and other liabilities | (2,381) | 1,451 |
| Accrued interest payable | <u>306</u> | <u>(923)</u> |
| Net cash (used for) provided by operating activities | <u>\$ (341,959)</u> | <u>\$ 211,269</u> |

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Notes to Financial Statements
September 30, 2007 and 2006

(1) Organization

The Kosrae Utilities Authority (KUA), a component unit of the Kosrae State Government (KSG), was created under KSG State Law 5-38 for the purpose of generating and transmitting electricity. Effective October 1, 1993, all assets and liabilities were transferred from KSG's Public Works Department to KUA. The principal market for the generation and transmission of electricity are government agencies, businesses and residential customers located in the State of Kosrae. KUA has adopted the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC).

KUA is governed by a five-member Board of Directors appointed by the Governor of KSG with the consent of the KSG Legislature.

KUA's financial statements are incorporated into the financial statements of KSG as a component unit.

(2) Summary of Significant Accounting Policies

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

KUA considers utility revenues and costs that are directly related to utility operations to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

GASB issued Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Note Disclosures*. These statements establish financial reporting standards for governmental entities which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements.

To conform to the requirements of GASB 34, net assets are presented in the following categories:

- Investment in capital assets; capital assets, net of accumulated depreciation and related debt, plus construction or improvement of those assets.

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Notes to Financial Statements
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

- Restricted:
 - Nonexpendable - Net assets subject to externally imposed stipulations that require KUA to maintain them permanently. For the years ended September 30, 2007 and 2006, KUA does not have nonexpendable restricted net assets.
 - Expendable - Net assets whose use by KUA is subject to externally imposed stipulations that can be fulfilled by actions of KUA pursuant to those stipulations or that expire by the passage of time. As of September 30, 2007 and 2006, KUA recorded restricted expendable net assets of \$90,000 representing appropriations received from the FSM National Government for the power extension project to Walung, which has yet to commence.
- Unrestricted; net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets. The accrual basis of accounting is utilized by proprietary funds. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Cash and Equivalents

Custodial credit risk is the risk that in the event of a bank failure, deposits may not be returned to KUA. 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. KUA does not have a deposit policy for custodial credit risk.

For purposes of the statements of net assets and of cash flows, cash and equivalents is defined as cash on hand, cash held in demand accounts, and time certificates of deposit with initial maturities of three months or less. Time certificates of deposit with initial maturities greater than three months are separately classified as investments. Bank balances were subject to Federal Deposit Insurance Corporation (FDIC) insurance coverage in the amount of \$200,000 as at September 30, 2007 and 2006, with the remaining balances exceeding insurable limits. KUA does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk.

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

Investments

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.

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 KUA or its agent in KUA'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 KUA's name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in KUA'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, 2007 and 2006, investments at fair value comprise the following:

| | <u>2007</u> | <u>2006</u> |
|------------------------------|---------------------|---------------------|
| Time certificates of deposit | \$ 660,987 | \$ 644,123 |
| Money market funds | 247,490 | 373,224 |
| Common stock | <u>419,241</u> | <u>558,605</u> |
| | <u>\$ 1,327,718</u> | <u>\$ 1,575,952</u> |

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, KUA will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. KUA's investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in KUA's name by KUA's custodial financial institutions at September 30, 2007 and 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 KUA. As of September 30, 2007 and 2006, there was no concentration of credit risk for KUA's investments.

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

Investments, Continued

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. KUA 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.

Restricted Investments

As of September 30, 2007 and 2006, time certificates of deposit (TCD) in the amounts of \$660,987 and \$644,123, respectively, placed with local banks with annual interest rates of 3.35% in 2007 and 1.5% to 2.6% in 2006 has been internally reserved for maintenance, capital improvements and work in progress. As of September 30, 2007, the time certificate of deposit amounting to \$660,987 is pledged as collateral of KUA's loan in the same institution.

Receivables

All receivables are due from government agencies, businesses and individuals located within the State of Kosrae and are interest free and uncollateralized. The allowance for uncollectible accounts is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense.

Inventory

Materials and fuel inventory are substantially carried at the lower of cost (weighted average) or market.

Utility Plant

Utility plant assets were transferred from KSG's Public Works Department at estimated net book value in the absence of documents to support cost. As of September 30, 2007 and 2006, approximately 18 percent of utility plant transferred to KUA was stated at estimated net book value. The net book value of the utility plant assets transferred was \$426,173 and \$547,801 as of September 30, 2007 and 2006, respectively. KUA capitalizes individual items that have a cost in excess of \$1,000 and an estimated useful life of more than one year. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefits accrue to employees. Unused annual leave is paid to employees upon termination of their employment. No liability is recorded for nonvesting accumulating rights to receive sick benefits.

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Notes to Financial Statements
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

Taxes

Corporate profits are not subject to income tax in the Federated States of Micronesia (FSM). The FSM National Government imposes a gross receipts tax of 3% on revenues. KUA is specifically exempt from this tax. In addition, KUA is exempt from any taxes or assessments on any of its property, operations or activities imposed by KSG or local governments.

Revenues

Sales of electricity are recorded as billed to customers on a monthly billing cycle basis. At the end of each month, unbilled revenues are accrued based on the most recent cycle billing. Unbilled receivables at September 30, 2007 and 2006 are \$79,163 and \$86,332, respectively.

Federal Grants and Subsidies

During the years ended September 30, 2007 and 2006, KUA was the recipient of federal funds from the U.S. Department of the Interior in a direct recipient capacity. In addition, during the year ended September 30, 2006, KUA was the recipient of federal funds from KSG in a subrecipient capacity, KSG Legislature appropriated subsidies, FSM National Congress appropriated subsidies, and matching funds for federal programs as required.

Estimates

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

Reclassifications

Certain reclassifications have been made to the 2006 financial statements in order to conform with the 2007 presentation.

New Accounting Standards

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, 2006.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition and display of other postemployment benefit expenses and related liabilities, note disclosures, and, if applicable, required supplementary information in the reports of the state and local employers. The provisions of this Statement are effective for periods beginning after December 15, 2007.

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. GASB Statement No. 48 establishes uniform financial reporting for these types of revenues. The provisions of this Statement are effective for periods beginning after December 15, 2006.

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The provisions of this Statement are effective for periods beginning after December 15, 2007.

In May 2007, GASB issued Statement No. 50, *Pension Disclosures an amendment of GASB Statements No. 25 and 27*. GASB Statement No. 50 more closely aligns the financial reporting requirements for pensions with those for other post-employment benefits. The provisions of this Statement are effective for periods beginning after June 15, 2007.

In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this Statement are effective for periods beginning after June 15, 2009.

Management does not believe that the implementation of these Statements will have a material effect on the financial statements of KUA.

(3) Accounts Receivable

Accounts receivable at September 30, 2007 and 2006, are summarized as follows:

| | <u>2007</u> | <u>2006</u> |
|---|-------------------|-------------------|
| Utility: | | |
| Residential | \$ 33,555 | \$ 48,349 |
| Commercial | 122,019 | 129,692 |
| Government | <u>65,147</u> | <u>67,374</u> |
| | 220,721 | 245,415 |
| Other | <u>138,018</u> | <u>149,618</u> |
| | 358,739 | 395,033 |
| Less allowance for doubtful receivables | <u>(205,231)</u> | <u>(191,440)</u> |
| | <u>\$ 153,508</u> | <u>\$ 203,593</u> |

KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)

Notes to Financial Statements
September 30, 2007 and 2006

(4) Utility Plant

Capital asset activity for the years ended September 30, 2007 and 2006, was as follows:

| | <u>Estimated Useful Lives</u> | <u>Balance at October 1, 2006</u> | <u>Transfers and Additions</u> | <u>Transfers and Deletions</u> | <u>Balance at September 30, 2007</u> |
|---------------------------------|---------------------------------------|---|--|--|--|
| <u>Depreciable assets:</u> | | | | | |
| Production plant | 5 to 40 years | \$ 4,703,253 | \$ 925 | \$ - | \$ 4,704,178 |
| Distribution plant | 5 to 30 years | 5,350,116 | 142,413 | - | 5,492,529 |
| General plant | 3 to 20 years | <u>516,691</u> | <u>47,842</u> | <u>-</u> | <u>564,533</u> |
| Total electric plant in service | | 10,570,060 | 191,180 | - | 10,761,240 |
| Less accumulated depreciation | | <u>(5,646,514)</u> | <u>(483,273)</u> | <u>-</u> | <u>(6,129,787)</u> |
| | | 4,923,546 | (292,093) | - | 4,631,453 |
| <u>Non-depreciable assets:</u> | | | | | |
| Construction work-in-progress | | <u>165,292</u> | <u>390,160</u> | <u>(83,221)</u> | <u>472,231</u> |
| Electric plant in service, net | | \$ <u>5,088,838</u> | \$ <u>98,067</u> | \$ <u>(83,221)</u> | \$ <u>5,103,684</u> |
| | <u>Estimated Useful Lives</u> | <u>Balance at October 1, 2005</u> | <u>Transfers and Additions</u> | <u>Transfers and Deletions</u> | <u>Balance at September 30, 2006</u> |
| <u>Depreciable assets:</u> | | | | | |
| Production plant | 5 to 40 years | \$ 4,588,519 | \$ 114,734 | \$ - | \$ 4,703,253 |
| Distribution plant | 5 to 30 years | 4,394,191 | 955,925 | - | 5,350,116 |
| General plant | 3 to 20 years | <u>511,491</u> | <u>5,200</u> | <u>-</u> | <u>516,691</u> |
| Total electric plant in service | | 9,494,201 | 1,075,859 | - | 10,570,060 |
| Less accumulated depreciation | | <u>(5,189,371)</u> | <u>(457,143)</u> | <u>-</u> | <u>(5,646,514)</u> |
| | | 4,304,830 | 618,716 | - | 4,923,546 |
| <u>Non-depreciable assets:</u> | | | | | |
| Construction work-in-progress | | <u>204,556</u> | <u>1,033,216</u> | <u>(1,072,480)</u> | <u>165,292</u> |
| Electric plant in service, net | | \$ <u>4,509,386</u> | \$ <u>1,651,932</u> | \$ <u>(1,072,480)</u> | \$ <u>5,088,838</u> |

(5) Long-Term Debt

Long-term debt at September 30, 2007 and 2006, is as follows:

| | <u>2007</u> | <u>2006</u> |
|---|-------------------|-------------|
| Term loan payable to bank, interest at 2.50% greater than TCD rate pledged as collateral, monthly repayment of \$8,523, collateralized by a first security interest in a time certificate of deposit of \$660,987 held by KUA. Interest rate effective as of September 30, 2007 ranges from 5.10% to 5.85%. | \$ 437,329 | \$ - |
| Less current portion | <u>(76,694)</u> | <u>-</u> |
| Long-term debt, net of current portion | \$ <u>360,635</u> | \$ <u>-</u> |

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements
September 30, 2007 and 2006

(5) Long-term Debt, Continued

During the year ended September 30, 2006, KUA drew down on a bank line of credit of \$500,000 (line expiring August 19, 2007), interest at a TCD rate plus 2.5%, and collateralized by a TCD of \$644,123.

Changes in long-term debt during the years ended September 30, 2007 and 2006, are as follows:

| | <u>2007</u> | | | <u>Balance September 30, 2007</u> | <u>Balance due in One Year</u> |
|-----------|--|-------------------|---------------------|---|------------------------------------|
| | <u>Balance October 1, 2006</u> | <u>Additions</u> | <u>Reductions</u> | | |
| Term loan | \$ <u>-</u> | \$ <u>927,350</u> | \$ <u>(490,021)</u> | \$ <u>437,329</u> | \$ <u>76,694</u> |
| | <u>2006</u> | | | | |
| | <u>Balance October 1, 2005</u> | <u>Additions</u> | <u>Reductions</u> | <u>Balance September 30, 2006</u> | <u>Balance due in One Year</u> |
| Term loan | \$ <u>200,000</u> | \$ <u>700,000</u> | \$ <u>(900,000)</u> | \$ <u>-</u> | \$ <u>-</u> |

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

| <u>Year</u> | <u>Principal</u> | <u>Interest</u> | <u>Total</u> |
|-------------|-------------------|------------------|-------------------|
| 2008 | \$ 76,694 | \$ 25,584 | \$ 102,278 |
| 2009 | 81,181 | 21,097 | 102,278 |
| 2010 | 85,930 | 16,348 | 102,278 |
| 2011 | 90,956 | 11,322 | 102,278 |
| 2012 | <u>102,568</u> | <u>5,999</u> | <u>108,567</u> |
| | \$ <u>437,329</u> | \$ <u>80,350</u> | \$ <u>517,679</u> |

(6) Contributions

Contributions for the years ended September 30, 2007 and 2006 are as follows:

| | <u>2007</u> | <u>2006</u> |
|--|-------------------|---------------------|
| Capital Related: | | |
| U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants | \$ 122,048 | \$ 84,548 |
| Kosrae State Government | | 147,250 |
| FSM National Government | - | 90,000 |
| U.S. Department of Homeland Security-FEMA Hazard Mitigation Grant Program | - | <u>696,751</u> |
| | <u>122,048</u> | <u>1,018,549</u> |
| Noncapital Related: | | |
| U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants | <u>10,016</u> | <u>2,143</u> |
| | \$ <u>132,064</u> | \$ <u>1,020,692</u> |

**KOSRAE UTILITIES AUTHORITY
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements
September 30, 2007 and 2006

(7) Commitments

Net assets at September 30, 2007 have been appropriated in the amount of \$1,016,919 for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2008 with a total of \$25,000 being further appropriated on a quarterly basis from net assets for this purpose.

(8) Risk Management

KUA 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. KUA has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed to from fire on its building and the contents and full coverage on property damage. KUA is substantially self-insured for all other risks. Settled claims from these risks have not exceeded commercial insurance coverage for the past three years.

(9) Retirement Plan

KUA administers a retirement plan covering all employees with at least one year of service that is modeled after a U.S. defined contribution plan. Vesting occurs upon plan entry. Employee contributions can be made from 1% to 15% of earnings with a 50% match by KUA up to 5% of employee compensation. During the years ended September 30, 2007 and 2006, KUA incurred an expense of \$6,285 and \$5,735, respectively, for matching contributions.

(10) Related Parties

KUA is wholly-owned by KSG and is therefore affiliated with all KSG-owned and affiliated entities. All production fuel is purchased from Micronesian Petroleum Corporation, a component unit of KSG. All KUA services to KSG and its component units are provided on the same basis as provided to unrelated parties.

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

The Board of Directors
Kosrae Utilities Authority:

We have audited the financial statements of the Kosrae Utilities Authority (KUA), as of and for the year ended September 30, 2007, and have issued our report thereon dated April 21, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered KUA's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of KUA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of KUA's internal control over financial reporting.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

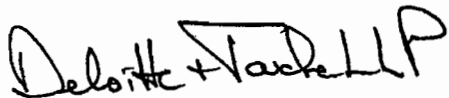
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

We noted other matters that we reported to management of KUA in a separate letter dated April 21, 2008.

This report is intended for the information of the Board of Directors and management of Kosrae Utilities Authority, federal awarding agencies, pass-through entities, the cognizant audit and other federal agencies, and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties.

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

April 21, 2008