KOSRAE UTILITIES AUTHORITY

(A COMPONENT UNIT OF THE STATE OF KOSRAE)

FINANCIAL STATEMENTS AND INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2010 AND 2009

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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 State of Kosrae, as of September 30, 2010 and 2009, 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, 2010 and 2009, 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 5 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 February 28, 2011, 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.

Deloitte + Touche LLP

February 28, 2011

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

Management's Discussion and Analysis
Years Ended September 30, 2010 and 2009

This section of the Kosrae Utilities Authority's (the Authority) annual financial report presents the analysis of the Authority's financial performance during the fiscal year ended September 30, 2010. Please read it in conjunction with the financial statements, which follows this section.

Kosrae Utilities Authority (KUA) was mandated by law in October 1993 as a semi-autonomous agency of the Kosrae State Government to assume the operation and responsibility of providing electric power services to the Island of Kosrae. KUA is governed by five (5) board members appointed by the Governor with the advice and consent of the State Legislature for staggered terms of 2 to 4 years.

The Authority serves 1,893 customers. With slight change in customer base from the previous operating year, the customer base ratio for FY2010 approximated 78% residential with energy sales of 37%, 13% commercial with 29% energy sales, 5% Kosrae State Government with 19% energy sales, 3% non-Kosrae State Government with 8% energy sales, and 1% industrial with 7% energy sales. The total energy sales slightly increased by approximately 8% compared to the previous fiscal year with the growth attributed to commercial sector activities in the State and steady increases in the number of residential customers. With little economic activities on Kosrae, the energy sales ratio from various customer sectors is expected to remain constant for the next few years and is reviewed annually since any changes of customer class can have an effect on future operating revenues.

KUA continued to face the same challenges experienced in previous years that affect operations. These issues were the continued revenue shortfalls to fund needed capital improvement projects and operations, the running inefficiencies of the generator units and aging substation structure, the increased system loss, and the rising cost of equipments, parts and hardware materials. Electric revenues from existing power rates and fuel adjustment charges provide for approximately 77% of the total operating expenses and the remaining were operating losses.

The following table summarizes the financial position and results of operation of Kosrae Utilities Authority for 2010 through 2008:

Assets	2010	2009	2008
Current assets	$ 1,510,683	$ 1,661,986	$ 1,853,588
Utility plant, net	4,118,863	4,512,088	4,857,830
Other non-current assets	-	-	42,196
	$ 5,629,546	$ 6,174,074	$ 6,753,614
Liabilities and Net Assets			
Current liabilities	$ 583,577	$ 400,521	$ 214,478
Notes payable, net of current portion	69,580	167,940	274,674
Total liabilities	653,157	568,461	489,152
Net Assets:			
Invested in capital assets	3,950,944	4,248,903	4,498,589
Restricted	90,000	90,000	90,000
Unrestricted	935,445	1,266,710	1,675,603
Total net assets	4,976,389	5,605,613	6,264,192
	$ 5,629,546	$ 6,174,074	$ 6,753,614

Revenue, Expenses and Changes in Net Assets

	2010	2009	2008
Operating revenues	$ 2,095,856	$ 1,903,456	$ 1,749,889
Operating expenses	2,721,402	2,592,464	2,548,386
Net operating loss	(625,546)	(689,008)	(798,497)
Operating subsidies	-	8,919	12,277
Interest income and net investment loss	(3,678)	(40,821)	(102,724)
Total Non-operating loss	(3,678)	(31,902)	(90,447)
Capital contributions	-	62,331	51,175
Change in net assets	$ (629,224)	$ (658,579)	$ (837,769)

FINANCIAL HIGHLIGHTS

For the past three years, KUA has experienced continuous increase in sales as a result of our annual gradual increase in tariff rate to recover costs. Volume of kilowatt-hour sold increases by 6% compared with last fiscal year's figure. Residential sales and commercial sales went up by about 10% and 9%, respectively, during the year while other customers' energy sales are within same level with last year's volume.

The Fuel Adjustment Charge (FAC) rate applied to kilowatt-hour sales continued to be negative due to reduction of fuel prices but are not as low as FY 2009. It is projected that the FAC rate will be positive in FY 2011 since fuel purchase prices started to go up hence an addition to FAC revenue, as the cost is added on the kilowatt-hour sold to customers. With no major residential and government projects in progress that would impact on next year's sales, management believes that FY 2011 electric sales will still be the same level as this year.

Operating expenses is higher by 5% compared to last fiscal year. Power generation and fuel consumption increased by about 8%. Fuel price is $3.42/gal at the beginning of the year and closed at $3.621/gal by the end of the year causing an increase in fuel expenses. The reduction in administrative and general expenses was for the various feasibility studies and programs undertaken in previous years.

No grants were received for the period. The proposal submitted to US DOI-OMIP for funding on various capacity building projects is still pending approval. Outstanding projects funded by OMIP, which are due to be finished this fiscal year, are deferred until next year. Progress reports were submitted to the grantor and extension on the date of completion is requested for approval. Grants received from previous years that are pending for implementation are lodged under payable and KUA reserve funds will be used to cover the actual expenses.

Interest rate for the TCD placed in Bank of the FSM is earning at .70% at the start of the year, increased to .80% effective June 2010 and until the end of the fiscal year. The rate was then reduced to .50% in the early part of FY 2011. An amount of $100,000 was withdrawn from the TCD and transferred to Smith Barney for additional investment. Interest rate from savings account with Bank of the FSM and Bank of Guam is still the same as last year. Market value of Salomon Smith Barney investments slightly increased and an unrealized gain was recorded during FY 2010.

Receivables from commercial accounts are down by 14% but Government accounts were higher by about 12%. Total receivables are relatively unchanged. With approximately 80% of KUA customers using prepayment meters, arrears are partially collected upon purchase and we project that receivables will continue to decrease every year. Management is constantly monitoring the receivables under postpaid monthly billings. In FY 2010, KUA also started accepting payments on line.

Finished projects during FY 2010 are the major overhaul of CAT Engine Model 3512 and renovation of office administration building to occupy the whole Reefer Plant. New installation of prepayment meters to customers is also recorded as additions to fixed assets. For additional information concerning capital assets, please refer to note 5 to the accompanying financial statements.

A line of credit facility for $150,000 was availed by KUA in FY 2010 with Salomon Smith Barney to defray the needed operational expenses. Interest is at 4.50% per annum with KUA's investment securities in SSB is collateralized. The existing long-term loan from Bank of the FSM will be fully paid by last quarter of FY 2012. As of FY 2010, the loan balance is $167,919. Interest rate is 2.50% over the TCD rate. This TCD also serves as collateral to the loan. For additional information concerning debt, please refer to note 6 and 7 to the accompanying financial statements.

In as much as tariff rates cannot cover existing production costs, reserve funds and temporary investments will be withdrawn to fund operations and necessary capital expenditures, thus reserve funds are expected to deteriorate every year and operating losses will be experienced in succeeding years.

Management's Discussion and Analysis for the year ended September 30, 2009 is set forth in KUA's report on the audit of financial statements, which is dated April 23, 2010. That Discussion and Analysis explains the major factors impacting the 2009 financial statements and can be viewed at the FSM Office of the National Public Auditors' website at www.fsmopa.fm.

Plan of Action for 2011 and Economic Outlook

1. Complete Full Cost Recovery Plan for KUA and recommend to KUA Board for full rate increases to Government accounts and 10% annual rate increase to other customer sectors to achieve full cost recovery for the operation.

2. Complete KUA system loss reassessment and take actions to improve and reduce system losses by 25% annually.

3. Continue to control unnecessary expenses to reduce operating cost and conduct daily review and monitoring of cash collection to ensure revenues are properly recorded to prevent attempted fraud and theft. Take actions to investigate suspected meters for theft to ensure payments for power usage by customers are properly collected.

4. Continue to increase installation of Cash Power Customers to achieve 85% of the customer base to improve arrears collection and internal cash flow for the operation.

5. Continue to work with the KUA Investment Funds Money Managers to seek investment schemes that yield better returns on KUA investment funds with moderate risks.

6. Provide practical and hands-on training to employees to improve skill level and knowledge to perform services and job request effectively and efficiently to minimize cost.

7. Continue to seek funding to purchase a new CAT engine Model 3512B-1200RBM to improve fuel efficiency and to reduce fuel usage and thereby reducing fuel cost. Implement major overhaul for engine unit #7 (CAT 1.5 MW) to improve running efficiency of the unit.

8. Install additional Solar PV Grid-connected System from EDF-10 –EU grants funding to increase alternative energy sources into the grid-lines and reduce fuel requirements at the Power Plant.

9. Continue to seek funding to upgrade the Power Plant Substation to prevent major power problems and blackouts to the island and to reduce system loss and revenue losses.

10. Work with Ocean Energy Industries Co., (OEI), Chicago, Illinois to form the Joint Venture for the establishment and installation of the WaveSurf System Technology on Kosrae to increase renewable energy sources into the grid-lines to supply power to the island and thus reducing dependency of imported fuel.

11. Continue to take measures to improve accountability of inventories, properties and establish better reporting system for capital and maintenance costs. .

12. Conduct Demand Side Management Programs for customers to use energy efficiently to benefit customers in reducing power consumption as well as benefiting KUA to provide services with less cost. Implement educational and public awareness programs to improve public relations.

13. Continue to take active role in promoting the private sector development to improve economic activities in Kosrae and to increase the revenue base for the KUA operation.

Contacting the Authority's Financial Management

This financial report is designed to provide our customers, creditors, Board of Directors and other interested parties with the general overview of KUA's financial activities. Questions or additional financial information can be asked or obtained from Finance Division with the permission of the General Manager at P.O. Box KUA, Kosrae, FM 96944.

KOSRAE UTILITIES AUTHORITY
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Statements of Net Assets
September 30, 2010 and 2009

ASSETS	2010	2009
Utility plant:		
Electric plant in service	$ 11,675,177	$ 11,431,873
Less accumulated depreciation	(7,643,946)	(7,135,849)
	4,031,231	4,296,024
Construction work in progress	87,632	216,064
Net utility plant	4,118,863	4,512,088
Current assets:		
Cash and cash equivalents	165,847	280,972
Investments	483,595	432,520
Time certificate of deposit - restricted	287,042	383,979
Accounts receivable, net	168,444	169,257
Prepayments	2,981	43,785
Inventories (net of allowance for obsolescence of $140,966 and $136,540 in 2010 and 2009, respectively)	402,774	351,473
Total current assets	1,510,683	1,661,986
Total assets	$ 5,629,546	$ 6,174,074
LIABILITIES AND NET ASSETS		
Long-term debt, net of current portion	$ 69,580	$ 167,940
Current liabilities:		
Current portion of long-term debt	98,339	95,245
Short-term note payable	151,680	-
Accounts payable	102,679	86,555
Federal grants payable	175,000	-
Accrued annual leave	15,494	14,835
Deferred revenue	21,200	185,557
Accrued taxes and other	19,185	18,329
Total current liabilities	583,577	400,521
Total liabilities	653,157	568,461
Commitments and contingency		
Net assets:		
Invested in capital assets, net of related debt	3,950,944	4,248,903
Restricted	90,000	90,000
Unrestricted	935,445	1,266,710
Total net assets	4,976,389	5,605,613
	$ 5,629,546	$ 6,174,074

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
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Statements of Revenues, Expenses, and Changes in Net Assets
Years Ended September 30, 2010 and 2009

	2010	2009
Operating revenues:		
Electricity sales	$ 2,090,698	$ 1,906,200
Less uncollectible accounts	5,158	(2,744)
Net operating revenue	2,095,856	1,903,456
Operating expenses:		
Production fuel	1,645,181	1,440,804
Depreciation and amortization	508,097	510,828
Salaries and wages	367,945	345,571
Administrative and general	145,742	194,921
Repairs and maintenance	54,437	55,241
Other operating expenses	-	45,099
Total operating expenses	2,721,402	2,592,464
Loss from operations	(625,546)	(689,008)
Nonoperating revenues (expenses):		
Interest expense	(8,664)	(6,052)
Interest income	3,911	3,770
Net change in fair value of investments	1,075	(38,539)
Federal grants - OMIP	-	8,919
Total nonoperating revenues (expenses), net	(3,678)	(31,902)
Capital contributions:		
U.S. government	-	62,331
Change in net assets	(629,224)	(658,579)
Net assets at beginning of year	5,605,613	6,264,192
Net assets at end of year	$ 4,976,389	$ 5,605,613

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
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Statements of Cash Flows
Years Ended September 30, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Cash received from customers	$ 2,107,280	$ 1,904,701
Cash paid to suppliers for goods and services	(1,841,183)	(1,602,462)
Cash paid to employees for services	(364,862)	(343,749)
Net cash used for operating activities	(98,765)	(41,510)
Cash flows from investing activities:		
Net purchases, sales and maturities of investments	(53,156)	(5,237)
Withdrawal from investment accounts	-	100,000
Withdrawal from time certificate of deposit	100,000	200,000
Interest and dividends received	4,036	5,952
Net cash provided by investing activities	50,880	300,715
Cash flows from noncapital financing activities:		
Operating grants received	-	183,919
Borrowing under a line of credit facility	150,000	-
Net cash provided by noncapital financing activities	150,000	183,919
Cash flows from capital financing activities:		
Principal payments on long-term debt	(95,266)	(96,056)
Interest paid on long-term debt	(7,102)	(6,222)
Capital contributions received	-	62,331
Capital expenditures for utility plant	(114,872)	(165,086)
Net cash used for capital financing activities	(217,240)	(205,033)
Net change in cash and cash equivalents	(115,125)	238,091
Cash and cash equivalents at beginning of year	280,972	42,881
Cash and cash equivalents at end of year	$ 165,847	$ 280,972
Reconciliation of loss from operations to net cash used for operating activities:		
Operating loss	$ (625,546)	$ (689,008)
Adjustments to reconcile operating loss to net cash used for operating activities:		
Depreciation and amortization	508,097	510,828
Bad debts	(5,158)	2,744
(Increase) decrease in assets:		
Accounts receivable	5,939	687
Prepayments	40,804	(34,472)
Inventories	(51,301)	125,250
Other assets	-	42,196
Increase (decrease) in liabilities:		
Accounts payable	16,124	(4,471)
Accrued annual leave	659	1,552
Deferred revenue	10,643	(2,186)
Accrued taxes and other	974	5,370
Net cash used for operating activities	$ (98,765)	$ (41,510)

See accompanying notes to financial statements.

(1) Organization

The Kosrae Utilities Authority (KUA), a component unit of the State of Kosrae (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.

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by GASB Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and modified by GASB Statement No. 38, *Certain Financial Statement Note Disclosures,* 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 Statement No. 34, retained earnings are presented in the following net asset categories:

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

- Restricted:

  - Nonexpendable - Net assets subject to externally imposed stipulations that require KUA to maintain them permanently. For the years ended September 30, 2010 and 2009, KUA does not have nonexpendable restricted net assets.

(2) Summary of Significant Accounting Policies, Continued

- 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, 2010 and 2009, 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.

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.

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. 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.

Cash and Cash Equivalents and Time Certificates of Deposit

Cash and cash equivalents include cash on hand and cash held in demand deposits. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified on the statements of net assets within investments.

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.

Restricted Assets

As of September 30, 2010 and 2009, time certificates of deposit of $287,042 and $383,979, respectively, are deposited with local banks with annual interest rates of 0.80% in 2010 and 0.70% in 2009 and have been internally reserved for maintenance, capital improvements and work in progress. As of September 30, 2010, the time certificate of deposit of $287,042 is pledged as collateral for KUA's loan with the same institution.

(2) Summary of Significant Accounting Policies, Continued

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 or market. First-in first-out costing method is used for materials and the average method for fuel, which approximate 94% and 6% of the net inventory value, respectively, as of September 30, 2010, and 95% and 5%, respectively, as of September 30, 2009.

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, 2010 and 2009, approximately 2% and 4%, respectively, of utility plant transferred to KUA was stated at estimated net book value. The net book value of the utility plant assets transferred was $61,291 and $182,917 as of September 30, 2010 and 2009, 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 respective 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.

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, 2010 and 2009 are $90,862 and $78,935, respectively.

Federal Grants and Subsidies

During the year ended September 30, 2009, KUA was the recipient of federal funds from the U.S. Department of the Interior in a direct recipient capacity.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards

During fiscal year 2010, KUA implemented the following pronouncements:

- GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which addresses whether and when intangible assets should be considered capital assets for financial reporting purposes.

- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements.

- GASB Technical Bulletin No. 2008-1, *Determining the Annual Required Contribution Adjustment for Postemployment Benefits*, which clarifies the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers,* and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* for calculating the annual required contribution (ARC) adjustment.

- GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, which provides guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code, and establishes requirements for recognizing and measuring the effects of the bankruptcy process on assets and liabilities, and for classifying changes in those items and related costs.

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

In March 2009, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of KUA.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method are effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of KUA.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of KUA.

(3) 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 deposit and investment policies of KUA are governed by the Board of Directors. As such, the Board of Directors is authorized to delegate certain responsibilities to third parties. Investment managers have discretion to purchase, sell, or hold the specific securities to meet the objectives set forth in the investment policy.

Generally, KUA can invest in bonds and other indebtedness of the U.S. and in preferred or common stock of any corporation created or existing under the laws of the U.S. or any U.S. state, territory, or commonwealth. Additionally, a maximum of 25% of the total portfolio may be invested in non-U.S. equities per the revised investment policy adopted in February 2010.

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 KUA or its agent in KUA'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 KUA'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 KUA'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, KUA'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. KUA does not have a deposit policy for custodial credit risk.

(3) Deposits and Investments, Continued

A. Deposits, Continued

As of September 30, 2010 and 2009, cash and cash equivalents and time certificates of deposit were $452,889 and $664,951, respectively, and the corresponding bank balances were $505,305 and $661,094, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2010 and 2009, bank deposits in the amount of $300,734 and $250,000 respectively are FDIC insured. 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.

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 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, 2010 and 2009, investments at fair value comprise the following:

	2010	2009
Money market funds	$ 226,877	$ 259,180
Common stock	256,718	173,340
	$ 483,595	$ 432,520

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, 2010 and 2009.

(3) Deposits and Investments, Continued

B. Investments, Continued

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, 2010 and 2009, there was no concentration of credit risk for KUA's investments.

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.

(4) Accounts Receivable

Accounts receivable at September 30, 2010 and 2009, are summarized as follows:

	2010	2009
Utility:		
Residential	$ 43,547	$ 42,765
Commercial	143,685	167,307
Government	101,795	90,695
Fuel adjustment charge	(1,130)	(9,018)
	287,897	291,749
Receivable from other governments	7,785	7,785
Other	71,308	69,914
	366,990	369,448
Less allowance for doubtful accounts	(198,546)	(200,191)
	$ 168,444	$ 169,257

(5) Utility Plant

Capital asset activity for the years ended September 30, 2010 and 2009, was as follows:

	Estimated Useful Lives	Balance at October 1, 2009	Transfers and Additions	Transfers and Deletions	Balance at September 30, 2010
Depreciable assets:					
Production plant	5 to 40 years	$ 5,124,386	$ 63,229	$ -	$ 5,187,615
Distribution plant	5 to 30 years	5,681,272	87,791	-	5,769,063
General plant	3 to 20 years	626,215	92,284	-	718,499
Total electric plant in service		11,431,873	243,304	-	11,675,177
Less accumulated depreciation		(7,135,849)	(508,097)	-	(7,643,946)
		4,296,024	(264,793)	-	4,031,231
Non-depreciable assets:					
Construction work-in-progress		216,064	74,540	(202,972)	87,632
Electric plant in service, net		$ 4,512,088	$ (190,253)	$ (202,972)	$ 4,118,863

(5) Utility Plant, Continued

	Estimated Useful Lives	Balance at October 1, 2008	Transfers and Additions	Transfers and Deletions	Balance at September 30, 2009
Depreciable assets:					
Production plant	5 to 40 years	$ 5,122,241	$ 2,145	$ -	$ 5,124,386
Distribution plant	5 to 30 years	5,593,459	87,813	-	5,681,272
General plant	3 to 20 years	572,505	53,710	-	626,215
Total electric plant in service		11,288,205	143,668	-	11,431,873
Less accumulated depreciation		(6,625,021)	(510,828)	-	(7,135,849)
		4,663,184	(367,160)	-	4,296,024
Non-depreciable assets:					
Construction work-in-progress		194,646	111,340	(89,922)	216,064
Electric plant in service, net		$ 4,857,830	$ (255,820)	$ (89,922)	$ 4,512,088

(6) Long-Term Debt

Long-term debt at September 30, 2010 and 2009, is as follows:

	2010	2009
Term loan payable to bank, interest at 2.5% per annum above the TCD rate pledged as collateral, monthly repayment of $8,523, collateralized by a first security interest in a TCD. Interest rates effective as of September 30, 2010 and 2009 range from 3.2% to 3.3%. The proceeds of the loan were used to fund the acquisition of a new 1.2 MW generator.	$ 167,919	$ 263,185
Less current portion	(98,339)	(95,245)
Long-term debt, net of current portion	$ 69,580	$ 167,940

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

Year	Principal	Interest	Total
2011	$ 98,339	$ 3,939	$ 102,278
2012	69,580	868	70,448
	$ 167,919	$ 4,807	$ 172,726

Changes in long-term liabilities during the years ended September 30, 2010 and 2009, are as follows:

	2010				
	Balance October 1, 2009	Additions	Reductions	Balance September 30, 2010	Balance due in One Year
Term loan	$ 263,185	$ -	$ (95,266)	$ 167,919	$ 98,339

(6) Long-Term Debt, Continued

	2009				
	Balance October 1, 2008	Additions	Reductions	Balance September 30, 2009	Balance due in One Year
Term loan	$ 359,241	$ -	$ (96,056)	$ 263,185	$ 95,245

(7) Short-term Borrowing

A schedule of KUA's short-term borrowing as of September 30, 2010 and 2009, is as follows:

	2010	2009
Line of credit facility of $150,000, interest at 4.5% per annum, collateralized by certain eligible investment securities.	$ 151,680	$ -

During the year ended September 30, 2010, KUA drew down $150,000 against the line. Proceeds from the line were used to fund operations. The above balance includes $1,680 of related interest.

(8) Contributions

Contributions for the years ended September 30, 2010 and 2009 are as follows:

	2010	2009
Capital Related:		
U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants	$ -	$ 62,331
Noncapital Related:		
U.S. Department of the Interior operations and maintenance improvement program (OMIP) grants	-	8,919
	$ -	$ 71,250

(9) Significant Customers

KUA purchased all fuel from one supplier in 2010 and 2009.

(10) Commitments

Net assets at September 30, 2010 and 2009 have been appropriated in the amounts of $1,516,919 and $1,416,919, respectively, for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2011 with a total of $25,000 being further appropriated on a quarterly basis from net assets for this purpose.

(11) 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.

(12) Retirement Plan

KUA administers a retirement plan (the 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. KUA's controller is the designated Plan administrator. Contributions to the Plan during the years ended September 30, 2010 and 2009 were $5,827 and $5,722, respectively. Management is of the opinion that the Plan does not represent an asset or liability of KUA. For the years ended September 30, 2010 and 2009, Plan assets were $148,061 and $135,116 respectively, with the corresponding cash balances of $112,388 and $114,761 respectively.

(13) Related Parties

KUA is a component unit of 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 or from FSM Petroleum Corporation, a component unit of the FSM National Government. All KUA services to KSG and its component units are provided on the same basis as provided to unrelated parties.

(14) Contingency

KUA participates in a number of U.S. Department of the Interior grant programs and other various federally assisted grants. These programs are subject to financial and compliance audits to ascertain if Federal laws and guidelines have been followed. Cumulative questioned costs of $109,706 relating to fiscal year 2010 and prior have been set forth in KUA's Single Audit Report for the year ended September 30, 2010. 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.

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS 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, 2010, and have issued our report thereon dated February 28, 2011. 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 *deficiency in internal control* 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 *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

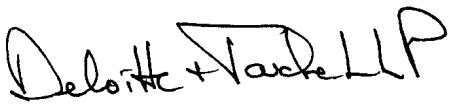
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies or material weaknesses. We did not identify 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 instance of noncompliance and other matters that are required to be reported under *Government Auditing Standards.*

We noted certain matters that we reported to management of KUA in a separate letter dated February 28, 2011.

This report is intended for the information and use of the Board of Directors, 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.



February 28, 2011

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

Summary Schedule of Prior Year Findings
Year Ended September 30, 2010

The following is a summary of unresolved questioned costs of Kosrae Utilities Authority as of September 30, 2010:

	Questioned Costs Set Forth in Prior Audit Reports	Questioned Costs Resolved in Fiscal Year 2010	Questioned Costs at September 30, 2010
Unresolved Questioned Costs FY 2008	$ 44,172	$ -	$ 44,172
Unresolved Questioned Costs FY 2009	65,534	-	65,534
	$ 109,706	$ -	$ 109,706