KOSRAE UTILITIES AUTHORITY

(A COMPONENT UNIT OF THE STATE OF KOSRAE)

FINANCIAL STATEMENTS AND INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2012 AND 2011

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

Years Ended September 30, 2012 and 2011
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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, 2012 and 2011, 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 referred to in the first paragraph present fairly, in all material respects, the financial position of the Kosrae Utilities Authority as of September 30, 2012 and 2011, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 26, 2013, 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 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 2 to 6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Deloitte + Touche LLP

April 26, 2013

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

Management's Discussion and Analysis
Years Ended September 30, 2012 and 2011

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, 2012. 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-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 staggering terms of 2 to 4 years.

The Authority served 1,903 customers during FY2012. With a slight change in the customer base from the previous operating year, the customer base ratio for FY2012 was approximately 79% residential with energy sales of 39%, 12% commercial with 29% energy sales, 5% Kosrae State Government with 18% energy sales, 3% non-Kosrae State Government with 7% energy sales and 1% industrial with 7% kilowatt-hour (kwh) sales. The total energy sales slightly increased by approximately 7% compared to the previous fiscal year due to increases in industrial sales, commercial sales, and fuel adjustment charge revenue. With slow economic and development activities in the State, the energy sales ratio from various customer sectors are expected to remain constant for the next few years and will be reviewed annually since any changes in customer class can have an effect on future operating revenues.

KUA continued to face challenges during FY2012. These operating issues are the continued revenue shortfalls to adequately cover operating costs and to fund improvements of run-down fixed assets, the fuel inefficiencies of the aging generator units, the deteriorating Power Plant Substation, the increased system loss and the rising cost of fuel, equipment, parts and hardware materials. These continue to be main priorities for the operation and plans of action are focused toward improving these operating issues. The electric revenues from existing power rates and fuel adjustment charges provide for approximately 80% 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 2012:

Assets	2012	2011	2010
Current assets	$ 1,255,215	$ 1,377,031	$ 1,510,683
Utility plant, net	3,436,824	3,728,307	4,118,863
Other non-current assets	252,800	252,800	-
	$ 4,944,839	$ 5,358,138	$ 5,629,546
Liabilities and Net Assets			
Current liabilities	$ 750,726	$ 713,354	$ 583,577
Notes payable, net of current portion	-	-	69,580
	750,726	713,354	653,157
Net Assets:			
Invested in capital assets	3,436,824	3,658,995	3,950,944
Restricted	90,000	90,000	90,000
Unrestricted	667,289	895,789	935,445
Total net assets	4,194,113	4,644,784	4,976,389
	$ 4,944,839	$ 5,358,138	$ 5,629,546

Revenue, Expenses and Changes in Net Assets

	2012	2011	2010
Operating revenues	$ 2,516,176	$ 2,347,648	$ 2,095,856
Operating expenses	3,137,272	2,917,875	2,721,402
Net operating loss	(621,096)	(570,227)	(625,546)
Operating grants	39,152	270,866	-
Interest income and net investment income (loss)	50,876	(32,244)	(3,678)
Total non operating income (loss)	90,028	238,622	(3,678)
Capital contributions	80,397	-	-
Change in net assets	$ (450,671)	$ (331,605)	$ (629,224)

FINANCIAL HIGHLIGHTS

Operating revenues derived from electricity sales are higher by 7% over last year. While revenues from residential and government accounts decreased, industrial sales, commercial sales and fuel adjustment charge (FAC) revenue increased which resulted in an increase of total operating revenue. Kilowatt-hour sales for the period decreased by 2% against last year.

The FAC rate is computed based on the existing fuel prices and fluctuates depending on the fuel purchase price during the period. The FAC rate increased $0.0328/kwh or approximately 70% over last year, from $0.0472/kwh in 2011 to $0.0800/kwh in 2012. The increase in industrial and commercial revenue is due to new establishments' higher electric consumption for the period.

Operating expenses are higher by about 7% compared with last year. The price of fuel continues to rise, from an average purchase price of $4.2147 per gallon in FY 2011 to $4.6158 per gallon in FY 2012, a $0.4011 increase in fuel prices. Fuel consumption went up by around 3%. Maintenance and personnel costs remain consistent compared with the previous year.

Administrative expenses include an amount expended for Ocean Energy Kosrae as contribution for the new joint venture, as well as final payment for the strategic plan/study on the transfer of Kosrae State owned water system to KUA.

A grant was received from US-DOI in a sub-grantee capacity through Kosrae State Government to be used for contracting a consultant to prepare a detailed study and strategic plan on the transfer of responsibility of the Kosrae State-owned water system to KUA referred to as the study on "Water Service Transition Plan". The detailed study was completed this year. Likewise a new grant was received from the United States Department of Agriculture (USDA) for the procurement of two bucket trucks. The grant was for $100,000 with KUA putting up 25% of the total acquisition cost. During the year, KUA drew down $73,900 for this grant and $8,715 came from remaining funds from the pick-up grants particularly used to procure equipment and tools. For more information concerning capital assets, please refer to Note 5 to the financial statements.

KUA is currently selling power at an average of $0.49/kwh and the average cost of producing each kilowatt is computed at $0.61, with a loss of $0.12 for every kwh sold.

The net decrease in current assets is primarily due to the use of funds for operation and maintenance. During the year, a TCD withdrawal of $75,000 was made to support current operations. The TCD is currently earning interest at 0.50% per annum and with a term of one year to mature on August 29, 2013 in Bank of the Federated States of Micronesia (FSM).

Collection of receivables was favorable as the receivable balance generally decreased on all accounts. The increase in short term investments of $ 61,509 represents the net increase of the fair value of investments managed by Morgan Stanley Smith Barney. Investments also increased by $25,000, which represents the initial investment of KUA in the Ocean Energy Kosrae joint venture.

Other non-current assets consists of long-term deposit held by FSMPC as collateral for the purchase of fuel and lubricants. This was received in FY 2011 as a sub-grant from FSM National Government through the Japan Non Project Grant Aid. This enables KUA to obtain a line-of-credit for approximately one month of its fuel and lubricants consumption.

Bank of the FSM approved $200,000 on its line of credit facility to KUA, with interest of 7% per annum. The TCD with the bank was held as collateral for this loan. During the year, KUA drew down $50,000 from the line of credit to be used for operations. The line of credit from Morgan Stanley Smith Barney comprising principal and interest is still unpaid as of the end of the fiscal year. Interest is accrued at 4.50% per annum. For more information concerning KUA's debt, please refer to Notes 6 and 7 to the financial statements.

A study was conducted by KEMA Inc. and sponsored by Pacific Power Association on the existing KUA cost of service and tariff rate. Based on the study, KUA tariff is insufficient to cover the cost of service to customers and an immediate solution is necessary to continue operation. The study shows different scenarios in order to recover the losses; the best solution to arrive at a sound financial performance is a one-time increase of $0.23 per kwh on top of the existing tariff rate. With the tariff rate increase, KUA will be able to sustain the needed operating costs and capital expenditure with a 10% return on capital (ROC).

A public consultation has been conducted and the Board approved a tariff rate increase of $0.06 per kwh sold for residential and commercial accounts and $0.10 for government and industrial customers, effective April 2, 2013. Likewise, the FAC computation was also revised, indicating a decrease in engine and system efficiency from 0.08 to 0.09 gallon consumed per kwh. The new rate is expected to gradually recover losses from operation and help improve the financial condition of KUA.

Plan of Action for 2013

1. Implement the findings and recommendations made by KEMA by second quarter of FY2013 to reduce the financial shortfalls of operation, and implement pressing capital improvements projects to ensure continuity of services to customers. Implement the gradual rate increase in FY2013 as approved by the KUA Board on the existing tariff.

2. Continue to implement specific tasks and projects recommended by the KUA System Loss Reassessment Study to improve and reduce the power system loss for the operation upon the availability of funds.

3. Update the performance benchmarking indicators and data based on FY2012 operating performances. Identify indicators for weaker areas to be improved and create a set of action plans and activities to be implemented with collaboration with the ongoing Pacific Power Association's (PPA) benchmarking program and training funded under the Asian Development Bank (ADB).

4. Implement and install a 200 kwp Solar PV Grid-connected System funded under EU-North-Rep. funding program managed by Secretariat of the Pacific Community (SPC), and a 150 kwp Solar PV grid-connected System provided by Pacific Environment Community (PEC) from the Japanese Government. This will increase approximately 20% of KUA's renewable solar energy into the existing grid-lines which is expected to significantly reduce the diesel fuel required for operations. Install stand-alone Solar PV System to Walung's school and dispensary.

5. Continue to seek start-up capital funds for the installation of the initial phase of 200 kwp capacity WaveSurf Power System. Negotiate with banking institutions and interested investors to lend and invest in the Ocean Energy Kosrae Inc. (OEK) operation. This renewable energy will also contribute to the existing grid-lines that will substantially reduce fossil fuel needed for operation. OEK is targeting to expand capacity to 1.5 Mwp WaveSurf Power Plant to replace most of the present energy load.

6. Continue to control and streamline operating expenses and conduct daily review of cash collection to ensure revenues are properly recorded to prevent attempted fraud and theft. Schedule regular visits and inspection of all Prepayment Meters to ensure proper functioning of meters and registering of kwh used to prevent revenue loss to KUA.

7. Implement projects submitted to JICA and the Government of Japan through the Kosrae State Government and Dept. of Foreign Affairs, FSM National Government for grant assistance to fund a) a new 1.2 Mwp CAT Engine with high-rated fuel efficiency to reduce fuel cost, b) upgrading the Lelu Distribution Power Lines to reduce system loss, c) upgrading the Power Plant Substation due to present deteriorating condition and d) installing a spare feeder to the Airport/Dock commercial area to avoid power services interruptions and major power outages if the existing feeder fails.

8. Upgrade the Suprima Billing Software to change the existing CTS digit version to STS system with increased digit numbers from 16 to 20 digit code to protect power theft and fraud. Re-program all the installed Cash Power Meters to be compatible with the 20 digits STS version. Three hundred Cash Power Meters are expected to be received during FY013. These are funded under the EU grants and managed by SPC. Increasing the number of Cash Power Meter Customers will help improve cash flows and reduce account receivable accounts.

9. Collaborate with Pacific Power Association (PPA), Sustainable Energy Industry Association of the Pacific Island (SEIAPI), International Renewable Energy Agency (IRENA) and Secretariat of the Pacific Communities (SPC) to formulate and provide practical and hands-on training to employees. The training is aimed to improve their skill level and knowledge to perform services and job requests effectively and efficiently. We would also like to prioritize renewable energy system training and maintenance services.

10. Revisit and review existing procedures and policies. Take appropriate measures to improve accountability of inventories, properties and internal control on cash collection and establish a reporting system for capital and maintenance costs. Review and improve maintenance programs to maintain power system facilities and equipment in good working condition.

11. Continue to provide Demand Side Management Programs for customers to use energy efficiently in reducing power consumption as well as to reduce cost to KUA. Implement educational and public awareness programs to improve public relations.

12. Collaborate and work with the Kosrae State Government and the Municipal Government to complete required documents including the MOU in compliance with the ADB Omnibus Water Project for Kosrae for the transfer of Malem and Utwe Water System to KUA and to request RUS/USDA for re-activation of RUS funds for the Lelu/Tofol Water System. Prepare Water Division Budget to justify fund request to ADB for the operation of water functions by KUA.

13. Continue to take active roles in promoting private sector development to improve economic activities in Kosrae to increase disposable income for families and individuals residing in Kosrae.

Contacting the Authority's Financial Management

The Management Discussion and Analysis report is intended to provide information concerning known facts and conditions affecting the Authority's operations. This financial report is designed to provide a general overview of the Authority's finances and to demonstrate KUA's accountability for the funds it receives and expends.

Management's Discussion and Analysis for the year ended September 30, 2011 is set forth in KUA's report on the audit of financial statements which is dated June 6, 2012. That Discussion and Analysis explains in more detail major factors impacting the 2011 financial statements. A copy of that report can be obtained by contacting the addresses noted below.

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, 2012 and 2011

ASSETS	2012	2011
Utility plant:		
Electric plant in service	$ 11,857,750	$ 11,720,314
Less accumulated depreciation	(8,494,676)	(8,070,563)
	3,363,074	3,649,751
Construction work in progress	73,750	78,556
Net utility plant	3,436,824	3,728,307
Other noncurrent assets:		
Deposit for fuel purchase contract	252,800	252,800
Investment in OEK Inc.	25,000	-
	277,800	252,800
Current assets:		
Cash and cash equivalents	123,584	153,467
Investments	521,800	460,291
Time certificate of deposit - restricted	164,052	238,575
Accounts receivable, net	114,090	158,351
Prepayments	1,684	2,820
Inventories (net of allowance for obsolescence of $146,381 and $142,684 in 2012 and 2011, respectively)	305,005	363,527
Total current assets	1,230,215	1,377,031
Total assets	$ 4,944,839	$ 5,358,138
LIABILITIES AND NET ASSETS		
Current liabilities:		
Current portion of long-term debt	$ -	$ 69,312
Short-term notes payable	216,611	158,747
Accounts payable - fuel	222,069	126,042
Accounts payable - other	92,951	98,198
Federal grants payable	175,000	175,000
Accrued annual leave	13,560	15,889
Deferred revenue	10,268	53,478
Accrued taxes and other	20,267	16,688
Total liabilities	750,726	713,354
Commitments and contingency		
Net assets:		
Invested in capital assets, net of related debt	3,436,824	3,658,995
Restricted	90,000	90,000
Unrestricted	667,289	895,789
Total net assets	4,194,113	4,644,784
	$ 4,944,839	$ 5,358,138

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, 2012 and 2011

	2012	2011
Operating revenues:		
Electricity sales	$ 2,521,582	$ 2,355,343
Less uncollectible accounts	(5,406)	(7,695)
Net operating revenues	2,516,176	2,347,648
Operating expenses:		
Production fuel	2,094,155	1,894,071
Depreciation and amortization	424,113	426,617
Salaries and wages	361,748	369,731
Administrative and general	167,439	144,028
Repairs and maintenance	89,817	83,428
Total operating expenses	3,137,272	2,917,875
Loss from operations	(621,096)	(570,227)
Nonoperating revenues (expenses):		
Interest expense	(11,349)	(10,647)
Interest income	716	1,707
Net change in fair value of investments	61,509	(23,304)
Federal grants	39,152	18,066
Government of Japan grant	-	252,800
Total nonoperating revenues (expenses), net	90,028	238,622
Capital Contributions:		
U.S. Government	80,397	-
Change in net assets	(450,671)	(331,605)
Net assets at beginning of year	4,644,784	4,976,389
Net assets at end of year	$ 4,194,113	$ 4,644,784

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
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Statements of Cash Flows
September 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	$ 2,523,921	$ 2,357,534
Cash paid to suppliers for goods and services	(2,223,539)	(1,964,208)
Cash paid to employees for services	(312,243)	(368,183)
Net cash (used for) provided by operating activities	(11,861)	25,143
Cash flows from investing activities:		
Purchase of investment	(25,000)	-
Withdrawal from time certificate of deposit	75,000	50,000
Interest and dividends received	240	275
Net cash provided by investing activities	50,240	50,275
Cash flows from noncapital financing activities:		
Operating grants received	6,768	50,450
Borrowing under a line of credit facility	50,000	-
Net cash provided by noncapital financing activities	56,768	50,450
Cash flows from capital financing activities:		
Principal payments on long-term debt	(69,312)	(98,607)
Interest paid on long-term debt	(3,485)	(3,580)
Capital contributions received	80,397	-
Capital expenditures for utility plant	(132,630)	(36,061)
Net cash used for capital financing activities	(125,030)	(138,248)
Net change in cash and cash equivalents	(29,883)	(12,380)
Cash and cash equivalents at beginning of year	153,467	165,847
Cash and cash equivalents at end of year	$ 123,584	$ 153,467
Reconciliation of loss from operations to net cash (used for) provided by operating activities:		
Operating loss	$ (621,096)	$ (570,227)
Adjustments to reconcile operating loss to net cash (used for) provided by operating activities:		
Depreciation and amortization	424,113	426,617
Bad debts	5,406	7,695
(Increase) decrease in assets:		
Accounts receivable	41,698	2,297
Prepayments	1,991	161
Inventories	54,825	39,247
Increase (decrease) in liabilities:		
Accounts payable - fuel	96,027	126,042
Accounts payable - other	(5,247)	(4,481)
Accrued annual leave	(2,329)	395
Deferred revenue	(10,826)	(106)
Accrued taxes and other	3,577	(2,497)
Net cash (used for) provided by operating activities	$ (11,861)	$ 25,143

Supplemental information of noncash operating financing activities:

During the year ended September 30, 2011, KUA received a sub-grant of $252,800 from the FSM National Government through an increase in long-term deposit for its fuel purchase line with FSM Petroleum Corporation, a component unit of the FSM National Government.

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, equity is 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, 2012 and 2011, 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, 2012 and 2011, 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, 2012 and 2011, time certificates of deposit of $164,052 and $238,575, respectively, are deposited with a local bank with annual interest rates of 0.50% in 2012 and 0.25% in 2011 and have been internally reserved for maintenance, capital improvements and work in progress. As of September 30, 2012, the time certificate of deposit of $164,052 is pledged as collateral for KUA's line of credit facility 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 93% and 7% of the net inventory value, respectively, as of September 30, 2012, and 90% and 10%, respectively, as of September 30, 2011.

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, 2012 and 2011, approximately 0.2% and 1%, 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 $5,609 and $33,450 as of September 30, 2012 and 2011, respectively. KUA capitalizes individual items that have 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 leave 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, 2012 and 2011 are $84,296 and $98,653, respectively.

Federal Grants and Subsidies

The Authority receives federal grants either as a direct recipient or as a subrecipient from the Kosrae State Government.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards

During fiscal year 2012, the Authority implemented the following pronouncements:

- GASB 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 the frequency and timing of measurements for actuarial valuations first used to report funded status information in OPEB plan financial statements. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.

- GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions* (an amendment of GASB Statement No. 53), which will improve financial reporting by state and local governments by clarifying the circumstances in which hedge accounting continues to be applied when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.

In December 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, which addresses how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Authority.

In December 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus*, which is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity*, and No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this statement are effective for periods beginning after June 15, 2012. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Authority.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Authority.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In July 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which establishes guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The provisions of this statement are effective for periods beginning after December 15, 2011. Management has not yet determined the effect of implementation of this statement on the financial statements of the Authority.

In April 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of the Authority.

In April 2012, GASB issued Statement No. 66, *Technical Corrections - 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of the Authority.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans, and Statement No. 68, *Accounting and Financial Reporting for Pensions*, which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of these statements on the financial statements of the Authority.

(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.

(3) Deposits and Investments, Continued

A. Deposits

As of September 30, 2012 and 2011, cash and cash equivalents were $123,584 and $392,042, respectively, and the corresponding bank balances were $116,033 and $404,164, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2012 and 2011, bank deposits in the amount of $116,033 and $404,164, 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

As of September 30, 2012 and 2011, investments at fair value comprise the following:

	2012	2011
Fixed income securities:		
U.S. Treasury obligations	$ 84,217	$ -
U.S. Government agencies	45,725	-
Corporate notes	78,297	-
	208,239	-
Other Investments:		
Common equities	299,949	235,577
Money market funds	13,612	224,714
	313,561	460,291
	$ 521,800	$ 460,291

As of September 30, 2012, the Authority's fixed income securities had the following maturities:

		Fair Value	1 to 5 Years	6 to 10 Years
U.S. Treasury obligations	AAA	$ 84,217	$ 65,081	$ 19,136
U.S. Government agencies obligations	AAA	45,725	45,725	-
Corporate Notes	A1	13,689	13,689	-
Corporate Notes	A2	26,019	6,264	19,755
Corporate Notes	A3	13,169	-	13,169
Corporate Notes	BAA2	25,420	6,403	19,017
		$ 208,239	$ 137,162	$ 71,077

(3) Deposits and Investments, Continued

B. Investments, Continued

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, 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, 2012 and 2011.

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, 2012 and 2011, 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.

C. Investment in OEK, Inc.

In FY 2012, KUA invested $25,000 in a joint-venture, Ocean Energy Kosrae, Inc. (OEK). 1000 shares has been issued by OEK – 500 to KUA and 500 to Ocean Energy Industries, Inc. (OEI). The purpose of OEK is to be an Independent Power Producer based on OEI's WaveSurfer power generating facilities in the waters around Kosrae in order to significantly reduce the energy generation cost. The Board of KUA has committed to invest another $25,000 in FY 2013 to fund the first phase of the project. The joint-venture was recognized in KUA's financial statements using the cost method due to the uncertainty of obtaining future funds for the project. Travel expense of $15,918 related to OEK was included in KUA's administration and general expense in the year ended September 30, 2012.

(4) Accounts Receivable

Accounts receivable at September 30, 2012 and 2011, are summarized as follows:

	2012	2011
Utility:		
Residential	$ 39,796	$ 43,240
Commercial	128,864	146,645
Government	55,275	67,788
Fuel adjustment charge	11,377	21,472
	235,312	279,145
Receivable from other governments	7,785	7,785
Other	71,948	69,813
	315,045	356,743
Less allowance for doubtful accounts	(200,955)	(198,392)
	$ 114,090	$ 158,351

(5) Utility Plant

Capital asset activity for the years ended September 30, 2012 and 2011, was as follows:

	Estimated Useful Lives	Balance at October 1, 2011	Transfers and Additions	Transfers and Deletions	Balance at September 30, 2012
Depreciable assets:					
Production plant	5 to 40 years	$ 5,187,615	$ 6,775	$ -	$ 5,194,390
Distribution plant	5 to 30 years	5,806,380	121,185	-	5,927,565
General plant	3 to 20 years	726,319	9,476	-	735,795
Total electric plant in service		11,720,314	137,436	-	11,857,750
Less accumulated depreciation		(8,070,563)	(424,113)	-	(8,494,676)
		3,649,751	(286,677)	-	3,363,074
Non-depreciable assets:					
Construction work-in-progress		78,556	1,655	(6,461)	73,750
Electric plant in service, net		$ 3,728,307	$ (285,022)	$ (6,461)	$ 3,436,824

	Estimated Useful Lives	Balance at October 1, 2010	Transfers and Additions	Transfers and Deletions	Balance at September 30, 2011
Depreciable assets:					
Production plant	5 to 40 years	$ 5,187,615	$ -	$ -	$ 5,187,615
Distribution plant	5 to 30 years	5,769,063	37,317	-	5,806,380
General plant	3 to 20 years	718,499	7,820	-	726,319
Total electric plant in service		11,675,177	45,137	-	11,720,314
Less accumulated depreciation		(7,643,946)	(426,617)	-	(8,070,563)
		4,031,231	(381,480)	-	3,649,751
Non-depreciable assets:					
Construction work-in-progress		87,632	20,038	(29,114)	78,556
Electric plant in service, net		$ 4,118,863	$ (361,442)	$ (29,114)	$ 3,728,307

(6) Long-Term Debt

Long-term debt at September 30, 2012 and 2011, is as follows:

	2012	2011
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, 2011 range from 3.3% to 3.0%. The proceeds of the loan were used to fund the acquisition of a new 1.2 MW generator.	$ -	$ 69,312
Less current portion	-	(69,312)
Long-term debt, net of current portion	$ -	$ -

Interest expense of $3,485 and $3,580 was charged for the years-ended September 30, 2012 and 2011, respectively.

(6) Long-Term Debt, Continued

Changes in long-term liabilities during the years ended September 30, 2012 and 2011, are as follows:

2012					
	Balance October 1, 2011	Additions	Reductions	Balance September 30, 2012	Balance due in One Year
Term loan	$ 69,312	$ -	$ (69,312)	$ -	$ -

2011					
	Balance October 1, 2010	Additions	Reductions	Balance September 30, 2011	Balance due in One Year
Term loan	$ 167,919	$ -	$ (98,607)	$ 69,312	$ 69,312

(7) Short-term Borrowing

A schedule of KUA's short-term borrowing as of September 30, 2012 and 2011, is as follows:

	2012	2011
Line of credit facility of $200,000, withdrawn $50,000, interest at 7.0% per annum, collateralized by certain eligible investment securities and existing and future business accounts receivable. The line of credit will expire on July 26, 2013 and repayment will be due at that time.	$ 50,240	$ -
Line of credit facility of $150,000, interest at 4.5% per annum, collateralized by certain eligible investment securities.	166,371	158,747
	$ 216,611	$ 158,747

The balances of $16,611 and $8,747 represent related interest payable as of September 30, 2012 and 2011, respectively. Interest expense of $7,863 and $7,067 was charged for the years-ended September 30, 2012 and 2011, respectively.

(7) Short-term Borrowing, Continued

Changes in short-term borrowing during the years ended September 30, 2012 and 2011, are as follows:

2012					
	Balance October 1, 2011	Additions	Reductions	Balance September 30, 2012	Balance due in One Year
LOC $200,000	$ -	$ 50,240	$ -	$ 50,240	$ 50,240
LOC $150,000	158,747	7,624	-	166,371	166,371
	$158,747	$ 57,864	$ -	$216,611	$216,611

2011					
	Balance October 1, 2011	Additions	Reductions	Balance September 30, 2012	Balance due in One Year
LOC $150,000	$151,680	$ 7,067	$ -	$158,747	$158,747

(8) Contributions

Contributions for the years ended September 30, 2012 and 2011 are as follows:

	2012	2011
Capital Related:		
U.S. Department of Agriculture	$ 80,397	$ -
Noncapital Related:		
U.S. Department of Agriculture	$ 2,218	$ -
U.S. Department of the Interior – Water project	$ 36,934	$ 18,066

(9) Significant Suppliers

KUA purchased all fuel from one supplier in 2012 and 2011.

(10) Commitments

Net assets at September 30, 2012 and 2011 have been appropriated in the amounts of $1,716,919 and $1,616,919, respectively, for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2012 with a total of $25,000 being further appropriated on a quarterly basis from net assets for this purpose.

In September 2011, KUA entered into a twenty-five year agreement to acquire power from a provider who is planning to construct a related plant. The agreement documents the agreed prices for energy output, among other matters. As discussed in Note 3C above, KUA paid $25,000 for a 50% interest in this entity and is committed to invest another $25,000 in FY 2013. This entity has not commenced activity as of September 30, 2012.

(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 also pays for workers' compensation to cover for wage replacement, medical benefits to employees injured in the course of employment. 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, 2012 and 2011 were $1,426 and $3,710 respectively. Management is of the opinion that the Plan does not represent an asset or liability of KUA. For the years ended September 30, 2012 and 2011, Plan assets were $39,125 and $30,863, respectively, with the corresponding cash balances of $37,420 and $30,474, 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 FSM Petroleum Corporation (FSMPC), a component unit of the FSM National Government (FSMNG). All KUA services to KSG and its component units are provided on the same basis as provided to unrelated parties.

A long-term deposit in the amount of $252,800, through a sub-grant from the FSMNG, is held by FSMPC as collateral for fuel and lubricant purchases.

(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 $65,534 relating to prior fiscal years have been set forth in KUA's Single Audit Report for the year ended September 30, 2012. 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, 2012, and have issued our report thereon dated April 26, 2013. 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

Management of KUA is responsible for establishing and maintaining effective 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 and correct 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 over financial reporting 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 April 26, 2013.

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.

Deloitte + Touche LLP

April 26, 2013

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

Summary Schedule of Prior Year Findings and Questioned Costs
Year Ended September 30, 2012

The following is a summary of unresolved questioned costs of Kosrae Utilities Authority as of September 30, 2012:

	Questioned Costs Set Forth in Prior Audit Reports	Questioned Costs Resolved in Fiscal Year 2012	Questioned Costs at September 30, 2012
Unresolved Questioned Costs FY 2008	$ 44,172	$ 44,172 (1)	$ -
Unresolved Questioned Costs FY 2009	65,534	-	65,534
	$ 109,706	$ 44,172	$ 65,534

(1) Questioned costs resolved during fiscal year 2012 are a result of KUA exercising the two-year rule per OMB Circular A-133 Section .315(b)(4).