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June 10, 2015

Alik S. Isaac
Director of Department of Administration and Finance
Kosrae State Government:

Dear Director Isaac:

In planning and performing our audit of the financial statements of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Kosrae (the State) as of and for the year ended September 30, 2014 (on which we have issued our report dated June 10, 2015), 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, we considered the State's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to the State's internal control over financial reporting and other matters as of September 30, 2014 that we wish to bring to your attention.

We have also issued a separate report to the Governor, Honorable Lyndon Jackson, also dated June 10, 2015, on our consideration of the State'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 definition of a deficiency is also set forth in the attached Appendix I.

A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with this report.

This report is intended solely for the information and use of the management of the State and the Office of the FSM National Public Auditor and is not intended to be and should not be used by anyone other than these specified parties. However, this report is also a matter of public record.

We will be pleased to discuss the attached comments with you and, if desired, to assist you in implementing any of the suggestions.

We wish to thank the staff and management of the State for their cooperation and assistance during the course of this engagement.

Very truly yours,

Deloitte + Tatchell LLP

SECTION I – OTHER MATTERS

We identified, and have included below, other matters involving the State's internal control over financial reporting as of September 30, 2014 that we wish to bring to your attention:

1. Controls over Housing Loans

Condition: Controls over housing loans indicated control deficiencies in the following areas:

- Several loans reflected negative outstanding balances;
- The loan portfolio maintained by the Kosrae Housing Authority was not reconciled to the State's general ledger;
- Several loan agreements and promissory notes were not on file; and
- The allowance for uncollectible loan receivable accounts was not assessed at year end.

Recommendation: We recommend that:

- Outstanding loans per the loan portfolio be confirmed with borrowers;
- The loan portfolio be reconciled to the general ledger;
- A check list of necessary documents be utilized for filing; and
- Year end assessments of uncollectible balances be performed.

2. Lack of Audited Financial Statements of Investee

Condition: The equity investment in Kosrae Industrial Development Corporation (KIDCO) has been recorded at a nil value; however, management has not obtained audited KIDCO financial statements.

Recommendation: We recommend that management obtain audited financial statements from the investee.

SECTION II – DEFINITION

The definition of a deficiency is as follows:

A *deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, INTERNAL CONTROL OVER FINANCIAL REPORTING

The following comments concerning management's responsibility for internal control over financial reporting and the objectives and inherent limitations of internal control over financial reporting are adapted from auditing standards generally accepted in the United States of America.

Management's Responsibility

The State's management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

Objectives of Internal Control over Financial Reporting

Internal control over financial reporting is a process affected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

Inherent Limitations of Internal Control over Financial Reporting

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.