

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

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2014 AND 2013

**KOSRAE UTILITIES AUTHORITY
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Years Ended September 30, 2014 and 2013
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INDEPENDENT AUDITORS' REPORT

The Board of Directors
Kosrae Utilities Authority:

Report on the Financial Statements

We have audited the accompanying financial statements of the Kosrae Utilities Authority (the Authority), a component unit of the State of Kosrae, which comprise the statements of net position as of September 30, 2014 and 2013, and the related statements of revenues, expenses and changes in net position and of cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

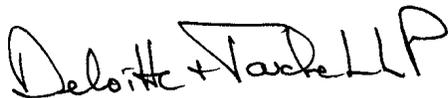
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kosrae Utilities Authority as of September 30, 2014 and 2013, and the results of its operations and its cash flows, for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters – Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 to 7 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 1, 2015, on our consideration of the 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* in considering the Authority's internal control over financial reporting and compliance.

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

June 1, 2015

**KOSRAE UTILITIES AUTHORITY
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Management's Discussion and Analysis
Years Ended September 30, 2014 and 2013

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, 2014. 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 a five-member board appointed by the Governor with the advice and consent of the State Legislature for a staggering term of 2 to 4 years.

The Authority served 1,808 customers during FY2014. The customer base remained constant from the previous operating year with customers ratio of approximately 79% residential with energy sales of 40%, 12% commercial with 28% energy sales, 5% Kosrae State Government with 20% energy sales, 3% non-Kosrae State Government with 6% energy sales and 1% industrial with 6% kilowatt-hour sales. 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 of customer class can have an effect on future operating revenues.

KUA has continued to face challenges and operating issues during FY2014. The financial condition had improved significantly after the tariff increase approved by the KUA Board to fund the basic needs of the operation but remain short to improve run-down fixed assets and essential investments to reduce dependency on fossil fuel and efficiency improvements of the operation. Other challenges are system losses reduction, capacity building, high cost of operation and affordable rates to customers. These continue to be the main priorities for the operation and plan of actions are focused toward improving these operating issues. The electric revenues from existing power rates and fuel adjustment charges provide for approximately 96% 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 2014, 2013 and 2012:

<u>Assets</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Current assets	\$ 1,145,735	\$ 1,081,689	\$ 1,230,215
Utility plant, net	3,004,143	3,258,855	3,436,824
Other non-current assets	<u>302,800</u>	<u>302,800</u>	<u>277,800</u>
	<u>\$ 4,452,678</u>	<u>\$ 4,643,344</u>	<u>\$ 4,944,839</u>
 <u>Liabilities and Net Position</u>			
Current liabilities	\$ <u>482,864</u>	\$ <u>587,365</u>	\$ <u>750,726</u>
 Net Position:			
Net investment in capital assets	3,004,143	3,258,855	3,436,824
Restricted	90,000	90,000	90,000
Unrestricted	<u>875,671</u>	<u>707,124</u>	<u>667,289</u>
Total net position	<u>3,969,814</u>	<u>4,055,979</u>	<u>4,194,113</u>
	<u>\$ 4,452,678</u>	<u>\$ 4,643,344</u>	<u>\$ 4,944,839</u>

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Years Ended September 30, 2014 and 2013

<u>Revenue, Expenses and Changes in Net Position</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Operating revenues	\$ 2,666,039	\$ 2,607,025	\$ 2,516,176
Operating expenses	<u>2,800,267</u>	<u>3,044,287</u>	<u>3,137,272</u>
Loss from operations	<u>(134,228)</u>	<u>(437,262)</u>	<u>(621,096)</u>
Nonoperating grants	-	143,466	39,152
Interest income and net investment income	<u>25,084</u>	<u>21,950</u>	<u>50,876</u>
Total nonoperating revenues, net	<u>25,084</u>	<u>165,416</u>	<u>90,028</u>
Capital contributions	<u>22,979</u>	<u>133,712</u>	<u>80,397</u>
Change in net position	\$ <u>(86,165)</u>	\$ <u>(138,134)</u>	\$ <u>(450,671)</u>

FINANCIAL HIGHLIGHTS

Operating revenue derived from electricity sales increased slightly by about 3%. All power account categories contributed to the increase except industrial sales and service orders where the Authority experienced a slight drop against last year. Tariff increase initiated effective April 2013 is the major factor that attributed to the increase in sales since kilowatt-hour volume of consumption continued to decrease for the three-year period.

Fuel adjustment charge (FAC) applied to kilowatt sales, in addition to the tariff, is higher compared to last year. For FY 2014, the average FAC rate was \$.1168 against last year of \$.0997, an increase of \$.0171 which represents approximately a 17% increase of the FAC revenue this year. FAC rates vary with the actual fuel purchase prices during the year.

KUA is selling electricity at an average rate of \$.60 per kilowatt as against production costs of \$.62; still operating at a loss of \$.02 per kilowatt hour sales.

Operating expenses declined by approximately 8% compared with last year. Fuel consumption and power generation decreased by around 12% and 7%, respectively, resulting in a reduced fuel expense. Fuel price started at \$4.5263 per gallon and ended at \$4.3479 as of September 30, 2014 with few fluctuations within the year. Salaries and wages, repairs and maintenance and administrative expenses had minimal increases as against last year.

Grants received during the year were from North Rep-SPC of \$22,979 representing the cost of a 23" fiberglass motor boat and replacement unit of one offline remote station. The boat is used to monitor the solar project activity in Walung funded by the grantor.

The net increase in current assets can be attributed to the increase in cash and cash equivalents as well as a reduction in KUA's receivable as of the end of the fiscal year. Collection/billing ratio is around 102% this year as against 90% during the previous year, resulting in an increase in cash and a decrease in related receivables.

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The time certificate of deposit (TCD) at Bank of the FSM (BFSM) earns a minimal rate of .50% per annum and is placed for a term of 365 days, maturing on October 6, 2014. The TCD serves as collateral for the line of credit facility with the bank. Likewise, investments managed by Morgan Stanley earned around \$25,398 this year, a 9% increase in market value against last year.

Decrease in value for the utility plant is due to depreciation, net of fixed asset acquisitions. Depreciation expense declined as some fixed assets became fully depreciated in FY 2013. Replacement of unit alternator for Engine# 8, major repairs undertaken on Engine #6 and #8, major repairs on Lelu island's recloser, 23" fiberglass motor boat, 2 units second-hand pick-up truck and cash power replacement unit on one offline station were some of the fixed asset additions during the year.

Other noncurrent assets comprise the deposit amount for the fuel purchase contract and an investment in Ocean's Energy Kosrae (OEK) remained unchanged this fiscal year.

The \$50,000 borrowed against the line of credit with BFSM last January 2013 was fully paid during the year. Accounts payable for fuel to FSM Petroleum Corporation (FSMPC) were reduced by around \$57,225. These contributed to the reduction in current liabilities. The line of credit facility for \$200,000 was renewed in October 2014 for another year with 7% per annum, interest on the drawdown amount payable monthly. The related commitment fee of 1% was also paid upon renewal.

Net loss for this year decreased by about 38%. Management should continue to successfully control expenses and regulate system losses plus exert more effort in finding outside funding for capital expenditures in order to reach a positive result in next year's operation.

Plan of Action for 2015

1. Manage and monitor operating revenues and expenditures to ensure that energy sales reflect the new tariff increases and streamline unnecessary operating expenses. Anticipated revenues are expected to cover 95% of the operating cost and continue to monitor expenditures to an achieve balanced budget. Continue to review the financial condition to ensure sustainability of the operation as well as affordability to customers.
2. Completing the installation of 100 kwp Solar PV Grid-connected System funded under EU-North-Rep. funding assistance managed by Secretariat of the Pacific Community (SPC) and solar household lightings to residents at Walung and stand-alone Solar PV System to Walung's school. Completing 200 kwp Solar PV grid-connected System from Pacific Environment Community (PEC), Japan Government. The estimated fuel savings from these projects are at the minimum 10% annually.
3. Completing the Power Plant Efficiency Improvement Project managed by SPREP. This project was awarded to Balance Utility Solution Inc, Australia and the scope of work entails performance testing of power generator units, identification and design of energy efficiency improvements of power generation and development of load optimization model and implementation of feasible energy efficiency improvements in power generation units and load dispatch optimization and conduct capacity building training on technical aspects of the Power Plant operation. Implementation of the efficiency improvements recommendation will ensure to improve engine and components efficiency of the Power Plant.

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4. Pursue and follow up the implementation of the Grid-Stability Study for the power system funded under the North-Rep. EU grant to ensure that it is completed before additional Solar PV energy are penetrated thru the power grid-lines in order to maintain the power grid-stability provided to the island.
5. Collaborate with World Bank Engineering Consultant to prepare engine specifications and preferred engine brand for the new genset from WB grant and the procurement and installation of the new unit (1.25 kwp capacity).
6. Continue working with JICA, Japan Government to conduct re-assessment of the Power System to support grant assistance request submitted for specified projects of the new CAT Engine, 1.2 Mwp with high-rated fuel efficiency to reduce fuel cost, Upgrading of Lelu Distribution Power Lines to reduce system loss, Upgrading of Power Plant Substation due to present deteriorating condition and installing an emergency underground cable feeder to Airport/Dock commercial area to avoid power services interruptions and power outages in case the existing feeder fails.
7. Initiate dialogue and sharing power data information to Indian Energy Pacifica Inc., U.S. for the possibility of micro-grid system installation and the advanced storage facility system (Flywheel Device) to the Power System. This is part of KUA's targeted efforts to improve system efficiency and reduce power cost to customers.
8. Continue to pursue investors to purchase OEK stock and to consider other options to fund the construction and installation of the 1.5 Mwp WaveSurf Power System and negotiate new terms under the Joint Venture Agreement. This project is part of KUA efforts to enhance increased renewable energies which will substantially reduce fossil fuel needs for the operation.
9. Continue to update the performance benchmarking indicators and data based on the FY2014 operating performances and identify weak indicators and areas to be improved and set action plans and activities to be implemented with collaboration with the ongoing Pacific Power Association's (PPA) benchmarking program and trainings funded under the Asian Development Bank (ADB).
10. Collaborate with National Dept. of Transportation & Infrastructure, ADB and Kosrae State Government to ensure that identified issues relating to the ongoing Utwe Water Project Upgrades are corrected and remedial actions are taken before the subject water system is transferred to KUA. These are necessary to ensure that the water system is a working system that is manageable and will not impose unnecessary cost to KUA at the start of the operation. Conduct public awareness to Utwe customers before managing and implementing water rates.
11. Continue to collaborate with Shima Co. Ltd and Association of Micronesia Development, Japan for the survey and construction of a small Hydro System, about (3 to 5 kwp) to supply power to Walung School.
12. Continue to 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 trainings to employees to improve skill level and knowledge to perform services and job request effectively and efficiently to minimize cost with prioritizing renewable energies system training and maintenance services.

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Management's Discussion and Analysis
Years Ended September 30, 2014 and 2013

13. Continue to provide Demand Side Management Programs for customers to use energy efficiently in reducing power consumption as well as to reducing cost to KUA. Implement educational and public awareness programs to improve public relations.
14. Prepare and recruit temporary crew for tree trimming and clearances activities to complete outstanding customers' service orders and perform tree clearances at the primary and secondary lines and other critical areas to prevent power interruption and outages.
15. Continue to take active roles in promoting the private sectors development to spur economic activities in Kosrae to increase disposal incomes to families and individuals residing in Kosrae in order to afford the increasing energy cost.

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, 2013 is set forth in KUA's report on the audit of financial statements which is dated June 14, 2014. That Discussion and Analysis explains in more detail major factors impacting the 2013 financial statements. A copy of that report can be obtained by contacting the address 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 obtained from Finance Division with the permission of the General Manager at P.O. Box KUA, Kosrae, FM 96944.

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Statements of Net Position
September 30, 2014 and 2013

<u>ASSETS</u>	<u>2014</u>	<u>2013</u>
Utility plant:		
Electric plant in service	\$ 12,197,362	\$ 11,918,737
Less accumulated depreciation	<u>(9,263,284)</u>	<u>(8,888,257)</u>
	2,934,078	3,030,480
Construction work-in-progress	<u>70,065</u>	<u>228,375</u>
Net utility plant	<u>3,004,143</u>	<u>3,258,855</u>
Other noncurrent assets:		
Deposit for fuel purchase contract	252,800	252,800
Investment in OEK Inc.	<u>50,000</u>	<u>50,000</u>
	<u>302,800</u>	<u>302,800</u>
Current assets:		
Cash and cash equivalents	277,246	178,957
Investments	308,842	283,444
Time certificate of deposit - restricted	165,764	164,937
Accounts receivable, net	146,781	193,199
Prepayments	3,205	4,332
Inventories (net of allowance for obsolescence of \$197,727 and \$157,882 in 2014 and 2013, respectively)	<u>243,897</u>	<u>256,820</u>
Total current assets	<u>1,145,735</u>	<u>1,081,689</u>
Total assets	<u>\$ 4,452,678</u>	<u>\$ 4,643,344</u>
<u>LIABILITIES AND NET POSITION</u>		
Current liabilities:		
Short-term notes payable	\$ -	\$ 50,000
Accounts payable - fuel	178,806	236,031
Accounts payable - other	84,454	85,426
Federal grants payable	175,000	175,000
Accrued annual leave	10,696	9,741
Unearned revenue	15,206	14,148
Accrued taxes and other	<u>18,702</u>	<u>17,019</u>
Total liabilities	<u>482,864</u>	<u>587,365</u>
Commitments and contingency		
Net position:		
Net investment in capital assets	3,004,143	3,258,855
Restricted	90,000	90,000
Unrestricted	<u>875,671</u>	<u>707,124</u>
Total net position	<u>3,969,814</u>	<u>4,055,979</u>
	<u>\$ 4,452,678</u>	<u>\$ 4,643,344</u>

See accompanying notes to financial statements.

KOSRAE UTILITIES AUTHORITY
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Statements of Revenues, Expenses, and Changes in Net Position
Years Ended September 30, 2014 and 2013

	<u>2014</u>	<u>2013</u>
Operating revenues:		
Electricity sales	\$ 2,712,101	\$ 2,636,046
Less provisions for uncollectible accounts	<u>(46,062)</u>	<u>(29,021)</u>
Net operating revenues	<u>2,666,039</u>	<u>2,607,025</u>
Operating expenses:		
Production fuel	1,858,866	2,122,395
Salaries and wages	377,500	348,046
Depreciation and amortization	375,027	393,913
Administrative and general	138,456	131,279
Repairs and maintenance	<u>50,418</u>	<u>48,654</u>
Total operating expenses	<u>2,800,267</u>	<u>3,044,287</u>
Loss from operations	<u>(134,228)</u>	<u>(437,262)</u>
Nonoperating revenues (expenses):		
Interest expense	(1,460)	(9,477)
Interest income	1,146	1,161
Net change in fair value of investments	25,398	29,934
Gain on disposal of capital asset	-	332
Government of Japan grant	<u>-</u>	<u>143,466</u>
Total nonoperating revenues, net	<u>25,084</u>	<u>165,416</u>
Capital contributions:		
U.S. Government and others	<u>22,979</u>	<u>133,712</u>
Change in net position	<u>(86,165)</u>	<u>(138,134)</u>
Net position at beginning of year	<u>4,055,979</u>	<u>4,194,113</u>
Net position at end of year	\$ <u><u>3,969,814</u></u>	\$ <u><u>4,055,979</u></u>

See accompanying notes to financial statements.

**KOSRAE UTILITIES AUTHORITY
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Statements of Cash Flows
Years Ended September 30, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Cash received from customers	\$ 2,717,987	\$ 2,514,140
Cash paid to suppliers for goods and services	(2,094,677)	(2,092,481)
Cash paid to employees for services	(376,544)	(351,866)
Net cash provided by operating activities	246,766	69,793
Cash flows from investing activities:		
Addition to equity investment	-	(25,000)
Net purchases, sales and maturities of investments	-	(29,934)
Withdrawal from investment	-	267,406
Interest and dividends received on investments and others	23,298	31,095
Net cash provided by investing activities	23,298	243,567
Cash flows from noncapital financing activities:		
Borrowing under a line of credit facility	-	50,000
Payment on a line of credit facility	(50,000)	(200,000)
Interest paid on a line of credit facility	(1,460)	(26,088)
Net cash used in noncapital financing activities	(51,460)	(176,088)
Cash flows from capital financing activities:		
Capital contributions received	22,979	133,712
Capital expenditures for utility plant	(143,294)	(216,055)
Proceeds from sale of capital asset	-	444
Net cash used in capital financing activities	(120,315)	(81,899)
Net change in cash and cash equivalents	98,289	55,373
Cash and cash equivalents at beginning of year	178,957	123,584
Cash and cash equivalents at end of year	\$ 277,246	\$ 178,957
Reconciliation of loss from operations to net cash provided by operating activities:		
Loss from operations	\$ (134,228)	\$ (437,262)
Adjustments to reconcile loss from operations to net cash provided by operating activities:		
Depreciation and amortization	375,027	393,913
Provisions for uncollectible accounts	46,062	29,021
(Increase) decrease in assets:		
Accounts receivable	41,447	(96,376)
Prepayments	(119)	(2,901)
Inventories	(26,922)	180,150
Increase (decrease) in liabilities:		
Accounts payable - fuel	(57,225)	13,962
Accounts payable - other	(972)	(7,525)
Accrued annual leave	955	(3,819)
Unearned revenue	1,058	3,880
Accrued taxes and other	1,683	(3,250)
Net cash provided by operating activities	\$ 246,766	\$ 69,793

Supplemental information of noncash financing activities:

During the year ended September 30, 2013, KUA received \$143,466 of fuel from the Government of Japan.

See accompanying notes to financial statements.

**KOSRAE UTILITIES AUTHORITY
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Notes to Financial Statements
September 30, 2014 and 2013

(1) Organization

The Kosrae Utilities Authority (the “Authority” or “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.

KUA adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – Management’s Discussion and Analysis for State and Local Governments*. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into four net position categories:

- *Net Investment in Capital Assets* – include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt, net of debt service reserves.
- *Restricted Nonexpendable* – net position subject to externally imposed stipulations that require the Authority to maintain them permanently.
- *Restricted Expendable* – net position whose use by the Authority is subject to externally imposed stipulations that can be fulfilled by actions of the Authority pursuant to those stipulations or that expire by the passage of time.
- *Unrestricted* – net position that is not subject to externally imposed stipulations. Unrestricted net position 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.

As of September 30, 2014 and 2013, KUA recorded restricted expendable net position of \$90,000 representing appropriations received from the FSM National Government for the power extension project to Walung, which has yet to commence.

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Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

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 position. Proprietary fund operating statements present increases and decreases in net position. 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.

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, 2014 and 2013, such plant assets are fully depreciated. KUA capitalizes individual items that have an estimated useful life of more than one year regardless of costs. Depreciation is calculated on the straight-line method over the estimated useful lives of the respective assets.

Investment in OEK, Inc.

Investment in OEK, Inc. represents 50% interest in in joint-venture, Ocean Energy Kosrae, Inc. (OEK) with the remaining 50% held by 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 energy generation cost. The joint-venture was recognized in the accompanying financial statements using the cost method due to the uncertainty of obtaining future funds for the project.

Cash and Cash Equivalents and Time Certificates of Deposit

Cash and cash equivalents include cash on hand and cash held in demand deposit accounts. Deposits maintained in time certificates of deposit accounts with original maturity dates greater than three months are separately classified.

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.

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Notes to Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

Restricted Assets

As of September 30, 2014 and 2013, time certificates of deposit of \$165,764 and \$164,937, respectively, are deposited with a local bank with annual interest rates of 0.50% in 2014 and 2013 and have been collateralized for the line of credit.

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. Bad debts are written off against the allowance on the specific identification method.

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 90% and 10% of the net inventory value, respectively, as of September 30, 2014, and 97% and 3%, respectively, as of September 30, 2013.

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, 2014 and 2013 are \$95,793 and \$118,584, respectively. Cash power revenue is recognized as revenue upon point of sale; the estimated unearned portion is determined at year end and recorded as unearned revenue in the accompanying statements of net position.

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

Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

Operating and Non-Operating Revenues and Expenses

Operating revenues and expenses generally result directly from the operation and maintenance of the Authority. Non-operating revenues and expenses result from capital and financing activities, costs and related recoveries from natural disasters, and certain other non-recurring income and costs.

Grants and Subsidies

The Authority receives grants from the U.S. Government or other foreign governments or entities either as a direct recipient or as a subrecipient from the Kosrae State Government or the FSM National Government.

New Accounting Standards

During the year ended September 30, 2014, the Authority implemented the following pronouncements:

- GASB 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 implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The implementation of this statement did not have a material effect on the accompanying financial statements.

In June 2012, GASB issued 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 68 are effective for fiscal years beginning after June 15, 2014. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Authority.

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*, which improves accounting and financial reporting for state and local governments' combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. A disposal of government operations can occur through a transfer to another government or a sale. The provisions in Statement 69 are effective for fiscal years beginning after December 15, 2013. Management has not yet determined the effect of implementation of this statement on the financial statements of the Authority.

**KOSRAE UTILITIES AUTHORITY
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Notes to Financial Statements
September 30, 2014 and 2013

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In November 2013, GASB issued Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date - an amendment of GASB Statement No. 68*, which addresses an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The issue relates to amounts associated with contributions, if any, made by a state or local government employer or nonemployer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability. The provisions in Statement 71 are effective for fiscal years beginning after June 15, 2014. Management does not believe that the implementation of this statement will have a material effect 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.

A. Deposits

As of September 30, 2014 and 2013, cash and cash equivalents and time certificates of deposit were \$443,010 and \$343,894, respectively, and the corresponding bank balances were \$437,900 and \$339,698, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2014 and 2013, bank deposits in the amount of \$258,531 and \$265,043, 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.

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Notes to Financial Statements
September 30, 2014 and 2013

(3) Deposits and Investments, Continued

B. Investments

As of September 30, 2014 and 2013, investments at fair value comprise the following:

	<u>2014</u>	<u>2013</u>
Fixed income securities:		
U.S. Treasury obligations	\$ 39,631	\$ 39,518
U.S. Government agencies	24,061	24,480
Corporate notes	<u>41,947</u>	<u>41,955</u>
	<u>105,639</u>	<u>105,953</u>
Other Investments:		
Common equities	188,550	166,641
Money market funds	<u>14,653</u>	<u>10,850</u>
	<u>203,203</u>	<u>177,491</u>
	\$ <u>308,842</u>	\$ <u>283,444</u>

As of September 30, 2014, the Authority's fixed income securities consist of the following:

		<u>Fair Value</u>	<u>1 to 5 Years</u>	<u>6 to 10 Years</u>
U.S. Treasury obligations	AAA	\$ 39,631	\$ 26,072	\$ 13,559
U.S. Government agencies	AAA	24,061	-	24,061
Corporate notes	A1	3,306	3,306	-
Corporate notes	A2	3,354	-	3,354
Corporate notes	A3	9,227	-	9,227
Corporate notes	A3(-)	2,982	-	2,982
Corporate notes	BAA1	6,560	6,560	-
Corporate notes	BAA2	7,094	3,800	3,294
Corporate notes	BAA3	<u>9,424</u>	-	<u>9,424</u>
		\$ <u>105,639</u>	\$ <u>39,738</u>	\$ <u>65,901</u>

As of September 30, 2013, the Authority's fixed income securities consist of the following:

		<u>Fair Value</u>	<u>1 to 5 Years</u>	<u>6 to 10 Years</u>
U.S. Treasury obligations	AAA	\$ 39,518	\$ 27,939	\$ 11,579
U.S. Government agencies	AAA	24,480	24,480	-
Corporate notes	A1	3,395	3,395	-
Corporate notes	A2	2,982	-	2,982
Corporate notes	A2(-)	6,527	-	6,527
Corporate notes	A3	2,871	-	2,871
Corporate notes	A3(-)	6,913	6,913	-
Corporate notes	BAA1	6,917	6,917	-
Corporate notes	BAA2	6,606	-	6,606
Corporate notes	BAA3	<u>5,744</u>	-	<u>5,744</u>
		\$ <u>105,953</u>	\$ <u>69,644</u>	\$ <u>36,309</u>

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

Notes to Financial Statements
September 30, 2014 and 2013

(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, 2014 and 2013.

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, 2014 and 2013, 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, 2014 and 2013, are summarized as follows:

	<u>2014</u>	<u>2013</u>
Utility:		
Residential	\$ 44,445	\$ 46,417
Commercial	125,587	148,916
Government	67,480	101,210
Fuel adjustment charge	<u>18,793</u>	<u>28,158</u>
	256,305	324,701
Receivable from other governments	7,785	7,785
Other	<u>91,162</u>	<u>78,935</u>
	355,252	411,421
Less allowance for doubtful accounts	<u>(208,471)</u>	<u>(218,222)</u>
	\$ <u>146,781</u>	\$ <u>193,199</u>

**KOSRAE UTILITIES AUTHORITY
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Notes to Financial Statements
September 30, 2014 and 2013

(5) Utility Plant

Capital asset activity for the years ended September 30, 2014 and 2013, is as follows:

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2013</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2014</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 5,196,353	\$ 148,176	\$ -	\$ 5,344,529
Distribution plant	5 to 30 years	5,980,400	99,640	-	6,080,040
General plant	3 to 20 years	<u>741,984</u>	<u>30,809</u>	<u>-</u>	<u>772,793</u>
Total electric plant in service		11,918,737	278,625	-	12,197,362
Less accumulated depreciation		<u>(8,888,257)</u>	<u>(375,027)</u>	<u>-</u>	<u>(9,263,284)</u>
		3,030,480	(96,402)	-	2,934,078
<u>Non-depreciable assets:</u>					
Construction work-in-progress		<u>228,375</u>	<u>17,995</u>	<u>(176,305)</u>	<u>70,065</u>
Electric plant in service, net		\$ <u>3,258,855</u>	\$ <u>(78,407)</u>	\$ <u>(176,305)</u>	\$ <u>3,004,143</u>
	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2012</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2013</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 5,194,390	\$ 1,963	\$ -	\$ 5,196,353
Distribution plant	5 to 30 years	5,927,565	52,835	-	5,980,400
General plant	3 to 20 years	<u>735,795</u>	<u>6,632</u>	<u>(443)</u>	<u>741,984</u>
Total electric plant in service		11,857,750	61,430	(443)	11,918,737
Less accumulated depreciation		<u>(8,494,676)</u>	<u>(393,913)</u>	<u>332</u>	<u>(8,888,257)</u>
		3,363,074	(332,483)	(111)	3,030,480
<u>Non-depreciable assets:</u>					
Construction work-in-progress		<u>73,750</u>	<u>200,194</u>	<u>(45,569)</u>	<u>228,375</u>
Electric plan in service, net		\$ <u>3,436,824</u>	\$ <u>(132,289)</u>	\$ <u>(45,680)</u>	\$ <u>3,258,855</u>

(6) Short-term Borrowing

At September 30, 2013, short-term notes payable of \$50,000 was outstanding against a \$200,000 line of credit, bearing interest at 7.0% per annum, with interest payable monthly and principal balance due upon maturity. The line is collateralized by certain eligible investment securities and existing and future business accounts receivable. The line expired in July 2014 and was subsequently renewed in October 2014 for another year.

(7) Significant Suppliers

KUA purchased virtually all fuel from one supplier in the fiscal years ended September 30, 2014 and 2013.

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Notes to Financial Statements
September 30, 2014 and 2013

(8) Contributions

Contributions for the years ended September 30, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Capital Related:		
FSM Congress	\$ -	\$ 40,000
North Rep – SPC	<u>22,979</u>	<u>93,712</u>
	\$ <u>22,979</u>	\$ <u>133,712</u>
Noncapital Related:		
Government of Japan	\$ <u>-</u>	\$ <u>143,466</u>

(9) Commitments

Net position at September 30, 2014 and 2013 have been appropriated in the amounts of \$1,916,919 and \$1,816,919, respectively, for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2015 with a total of \$25,000 being further appropriated on a quarterly basis from net position for this purpose.

(10) 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.

(11) 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, 2014 and 2013 were \$2,297 and \$2,045, respectively. Management is of the opinion that the Plan does not represent an asset or liability of KUA. For the years ended September 30, 2014 and 2013, Plan assets were \$51,211 and \$45,606, respectively, with corresponding cash balances of \$49,167 and \$41,369, respectively.

**KOSRAE UTILITIES AUTHORITY
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Notes to Financial Statements
September 30, 2014 and 2013

(12) 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.

Travel expense of \$633 and \$1,721 related to OEK was included in KUA's administration and general expense in the years ended September 30, 2014 and 2013, respectively.

(13) Contingency

KUA has invested \$50,000 in a joint venture business that constructs and installs a 1.5 Mwp WaveSurf Power System in the waters off Kosrae Island. The project has stopped due to lack of working capital, and the joint venture is in negotiations with an investor who is interested in acquiring a majority of the equity stock of the joint venture. KUA has not assessed whether its investment has impaired, and has not recorded a valuation reserve.

(14) Subsequent Events

KUA renewed its line of credit facility on October 13, 2014. It withdrew \$100,000 in October 2014 and \$50,000 in February 2015.

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, in accordance with the 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, the financial statements of the Authority, which comprise the statement of net position as September 30, 2014, and the related statements of revenues, expenses and changes in net position and of cash flows for the year then ended and the related notes to the financial statements, and have issued our report thereon dated June 1, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Authority's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control.

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 a 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. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

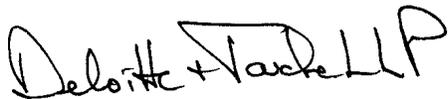
Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

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

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

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

June 1, 2015

**KOSRAE UTILITIES AUTHORITY
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Summary Schedule of Prior Year Findings and Questioned Costs
Year Ended September 30, 2014

The following is a summary of unresolved questioned costs of Kosrae Utilities Authority as of September 30, 2014:

	<u>Questioned Costs Set Forth in Prior Audit Reports</u>	<u>Questioned Costs Resolved in Fiscal Year 2014</u>	<u>Questioned Costs at September 30, 2014</u>
Unresolved Questioned Costs FY 2009	\$ 65,534	-	\$ 65,534