

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

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEAR ENDED SEPTEMBER 30, 2016

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

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INDEPENDENT AUDITORS' REPORT

Board of Directors
Kosrae State Housing Authority:

Report on the Financial Statements

We have audited the accompanying financial statements of the Kosrae State Housing Authority (the "Authority"), a component unit of the State of Kosrae, which comprise the statement of net position as of September 30, 2016, and the related statements of revenues, expenses and change in net position and of cash flows for the year 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 audit. 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. 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 qualified audit opinion.

Basis for Qualified Opinion

Because of the inadequacy of accounting records, documentary evidence available to us was limited as the Authority has been unable to identify the propriety of approximately \$60,000 of amounts that form part of loans receivable. The impact of this matter is uncertain.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the statement of net position as of September 30, 2016, and the related statements of revenues, expenses and change in net position and of cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

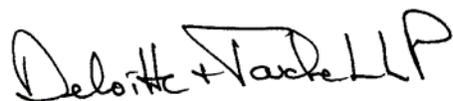
Other Matters

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 4 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 27, 2017, 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.



June 27, 2017

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

Management's Discussion and Analysis
September 30, 2016

This analysis prepared by Kosrae State Housing Authority (the Authority) offers readers of the Authority's financial statements a narrative overview of its activities for the year ended September 30, 2016. This analysis is required by the Government Accounting Standards Board (GASB), which provides guidelines on what must be included and excluded from the analysis.

The Statement of Net Position and Statement of Revenues, Expenses and Changes in Net Position provide an indication of the Authority's financial condition. The Authority's net position reflects the difference between assets and liabilities. An increase in net position over time typically indicates an improvement in the Authority's financial condition.

The following summarizes the financial position and results of operations of Kosrae Housing Authority as of and for the year ended September 30, 2016.

Summary Statement of Net Position:

Assets:

Current assets	\$ 585,456
Restricted time certificates of deposit	200,000
Property and equipment, net	<u>3,197</u>
Total assets	\$ <u>788,653</u>

Liabilities and Net position:

Current liabilities	\$ 57,281
Due to primary government, net of current portion	<u>46,296</u>
Total liabilities	<u>103,577</u>

Net position:

Net investment in capital assets	3,197
Unrestricted	<u>681,879</u>
Total net position	<u>685,076</u>
Total liabilities and net position	\$ <u>788,653</u>

Summary Statement of Revenues, Expenses and Change in Net Position:

Investment and fees on loans	\$ 100,713
Provision for loan losses	<u>(80,557)</u>
Net operating revenues	<u>20,156</u>
Operating expenses	<u>147,266</u>
Operating loss	<u>(127,110)</u>
Nonoperating revenues	<u>812,186</u>
Change in net position	685,076
Net position at beginning of period	<u>-</u>
Net position at the end of period	\$ <u>685,076</u>

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

Management's Discussion and Analysis
September 30, 2016

Financial Highlights

The Authority's assets as of September 30, 2016 are comprised of the net amount of its cash, loans receivable, net of an allowance, restricted certificates of deposit and property and equipment, net of accumulated depreciation. During the year ended September 30, 2016, the Authority received operating subsidies from Kosrae State Government and the FSM National Government.

The Authority's liabilities as of September 30, 2016 are comprised of accrued liabilities, accounts payable, and the due to primary government.

Operating revenues consist of interest and fees on loans.

Operating expenses consist of salaries (54%), travel and transportation (21%), contractual services (6%) and others (19%) such as supplies and materials, meetings, utilities and communication expenses.

The \$1.3 million allowance for doubtful loans was carried over from Kosrae State Government as far as loan classification is concerned. It is a carry-over figure from prior year audits. KHA will incorporate the loan classification into its revenues so that such may possibly be removed or dropped.

Capital Assets and Debt Administration

For additional information concerning capital assets, please refer to Note 4 to the financial statements.

The Authority has not engaged in debt financing.

Economic factors and Next Year's Budget

The Kosrae Housing Authority continuously experiences economic and financial challenges as it relies heavily on interest and fees on loans. Expenditures, on the other hand, are expected to increase given changed program structure and need. The Authority has developed a Strategic Development Plan (SDP) to counter the challenges including the need to expand its revenue streams through loan diversification other than housing loans as well as increasing lending toward off-island clients.

The Authority through its loan classifications has seen promising decline in loan defaults and has exceeded its lending and collection targets in the first year. As outlined in its SDP, the Authority's performance is linked against 3 outcome measures using FY15 as the baseline: (i) loan making to grow 2% each year; (ii) loan collection to increase 5% each year; and (iii) delinquency to drop to a single digit at 10% or less in 3 years.

Contacting the Authority's Financial Management

This financial report is designed to provide our customers, creditors, and other interested parties a general overview of Kosrae State Housing Authority's finances. If you have questions about this report or need additional financial information, contact the Executive Director, Kosrae State Housing Authority P.O. Box 533 Tofol, Lelu, Kosrae, FM 96944.

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

Statement of Net Position
September 30, 2016

ASSETS

Current assets:	
Cash	\$ 69,940
Loans receivable, net	<u>515,516</u>
Total current assets	585,456
Restricted time certificates of deposit	200,000
Property and equipment, net	<u>3,197</u>
	<u>\$ 788,653</u>

LIABILITIES AND NET POSITION

Current liabilities:	
Accrued liabilities	\$ 6,612
Accounts payable	669
Due to primary government, current portion	<u>50,000</u>
Total current liabilities	57,281
Due to primary government, net of current portion	<u>46,296</u>
Total liabilities	<u>103,577</u>
Commitments and contingencies	
Net position:	
Net investment in capital assets	3,197
Restricted	<u>681,879</u>
Total net position	<u>685,076</u>
	<u>\$ 788,653</u>

See accompanying notes to financial statements.

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

Statement of Revenues, Expenses and Changes in Net Position
Year Ended September 30, 2016

Operating revenues:	
Interest and fees on loans	\$ 100,713
Provision for loan losses	<u>(80,557)</u>
Net operating revenues	<u>20,156</u>
Operating expenses:	
Salaries	79,044
Travel and transportation	31,512
Contractual services	8,918
Supplies and materials	8,602
Meetings	4,445
Utilities	3,200
Communication	2,973
Food	2,143
Fuel	2,098
Repairs and maintenance	1,899
Depreciation	799
Miscellaneous	<u>1,633</u>
Total operating expenses	<u>147,266</u>
Operating loss	(127,110)
Nonoperating revenues:	
Operating grant from Kosrae State Government	797,529
Operating grant from FSM National Government	<u>14,657</u>
Total nonoperating revenues	<u>812,186</u>
Change in net position	685,076
Net position at beginning of period	<u>-</u>
Net position at end of period	<u>\$ 685,076</u>

See accompanying notes to financial statements.

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

Statement of Cash Flows
Year Ended September 30, 2016

Cash flows from operating activities:	
Cash received from customers	\$ 100,713
Cash paid to suppliers for goods and services	(66,754)
Cash paid to employees	<u>(72,432)</u>
Net cash used in operating activities	<u>(38,473)</u>
Cash flows from noncapital financing activities:	
Operating subsidy from Kosrae State Government	84,142
Operating subsidy from FSM National Government	14,657
Repayment to Kosrae State Government	<u>(60,000)</u>
Net cash provided by noncapital financing activities	<u>38,799</u>
Cash flows from capital and related financing activities:	
Acquisition of fixed assets	<u>(3,996)</u>
Cash flows from investing activities:	
Loan originations and principal collections, net	<u>73,610</u>
Net change in cash	69,940
Cash at beginning of year	<u>-</u>
Cash at end of year	<u>\$ 69,940</u>
Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	\$ (127,110)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Provision for loan losses	80,557
Depreciation	799
Increase in accrued liabilities	6,612
Increase in accounts payable	<u>669</u>
Net cash used in operating activities	<u>\$ (38,473)</u>

Supplemental information on a noncash activity:

During the year ended September 30, 2016, the Authority received \$200,000 and \$513,387 which substantially consisted of restricted time certificates of deposit and the net loan portfolio, respectively, previously carried in the books of Kosrae State Government.

See accompanying notes to financial statements.

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

Notes to Financial Statements
September 30, 2016

(1) Organization and Summary of Significant Accounting Policies

Organization

The Kosrae State Housing Authority (the "Authority" or "KHA") was established in October 2015 by Kosrae State Public Law 10-113. The purpose of the Authority is to manage and invest funds of Kosrae Home Improvement Program and other funds of the Authority and to lend money to qualified Kosraeans who wish to build and maintain residential homes in Kosrae.

The affairs of the Authority are managed by a five-member Board of Directors, consisting of representatives of the Kosrae State Government appointed by the Governor to four-year terms. Daily operation of the Authority is delegated to an executive director, who is also appointed by the Governor and serves at the pleasure of the Board.

The Authority's financial statements are incorporated into the financial statements of the Kosrae State Government as a component unit.

Basis of Accounting

The accounting policies of the Authority conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds.

GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments: Omnibus*, and modified by Statement No. 38, *Certain Financial Statement Note Disclosures*, establishes 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.

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 statement 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 method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. The Authority considers interest income and costs that are directly related to lending operations to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

Net Position

Net position represents the residual interest in the Authority's assets after liabilities are deducted and consist of three sections: net investment in capital assets; restricted and unrestricted. Net position classified as net investment in capital assets, include capital assets, restricted and unrestricted, net of accumulated depreciation and reduced by outstanding debt, net of debt service reserve. Net position are reported as restricted when constraints are imposed by third parties or enabling legislation. The Authority's restricted assets are expendable, and are restricted for loan programs.

**KOSRAE STATE HOUSING AUTHORITY
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Notes to Financial Statements
September 30, 2016

(1) Organization and Summary of Significant Accounting Policies, Continued

Management Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses.

Cash

Custodial credit risk is the risk that in the event of a bank failure, the Authority's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The Authority does not have a deposit policy for custodial credit risk.

For the purposes of the statements of net position and of cash flows, cash is defined as cash in checking accounts, savings accounts and cash on hand. As of September 30, 2016, the carrying amount of the Authority's total cash and time certificates of deposit was \$269,940, and the corresponding bank balance was \$284,587 which is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2016, \$258,490 in total bank deposits were FDIC insured.

Property and Equipment

Property and equipment are stated at cost. Depreciation of property and equipment is calculated using the straight-line method over the estimated useful lives of the respective assets, which range from one to five years. The Authority capitalizes all fixed assets, irrespective of value, that have estimated useful lives of more than one year.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefit accrues to employees. No liability is recorded for nonvesting accumulating rights to receive sick leave pay benefits. The related sick leave pay expense is recorded when the benefit is actually taken.

**KOSRAE STATE HOUSING AUTHORITY
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Notes to Financial Statements
September 30, 2016

(1) Organization and Summary of Significant Accounting Policies, Continued

New Accounting Standards

During the year ended September 30, 2016, KHA implemented the following pronouncements:

- GASB Statement No. 72, *Fair Value Measurement and Application*, which addresses accounting and financial reporting issues related to fair value measurements and requires entities to expand their fair value disclosures by determining major categories of debt and equity securities within the fair value hierarchy on the basis of the nature and risk of the investment. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which eliminates two of the four categories of authoritative GAAP that exist under the existing hierarchy prescribed by Statement No. 55. The two categories that will remain under the new standard are (1) GASB Statements and (2) GASB technical bulletins and implementation guides in addition to AICPA guidance that the GASB clears. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*, which, addresses for certain external investment pools and their participants the accounting and financial reporting implications that result from changes in the regulatory provisions referenced by previous accounting and financial reporting standards. Those provisions were based on the Investment Company Act of 1940, Rule 2a7. Rule 2a7 contains the Securities and Exchange Commission's regulations that apply to money market funds and were significantly amended in 2014. The implementation of this statement did not have a material effect on the accompanying financial statements.

In June 2015, GASB issued Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement No. 68, and Amendments to Certain Provisions of GASB Statements No. 67 and No. 68*, which aligns the reporting requirements for pensions and pension plans not covered in GASB Statements No. 67 and No. 68 with the reporting requirements in Statement No. 68. The provisions in Statement No. 73 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In June 2015, GASB issued Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which replaces Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, and addresses financial reporting requirements for governments whose employees are provided with postemployment benefits other than pensions (other postemployment benefits or OPEB). The provisions in Statement No. 74 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

**KOSRAE STATE HOUSING AUTHORITY
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Notes to Financial Statements
September 30, 2016

(1) Organization and Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2015, GASB issued Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which replaces the requirements of Statements No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, and provides guidance on reporting by governments that provide OPEB to their employees and for governments that finance OPEB for employees of other governments. The provisions in Statement No. 75 are effective for fiscal years beginning after June 15, 2017. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In August 2015, GASB issued Statement No. 77, *Tax Abatement Disclosures*, which requires governments that enter into tax abatement agreements to disclose certain information about the agreements. The provisions in Statement No. 77 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In December 2015, GASB issued Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*, which addresses a practice issue regarding the scope and applicability of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The provisions in Statement No. 78 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In January 2016, GASB issued Statement No. 80, *Blending Requirements for Certain Component Units - an amendment of GASB Statement No. 14*, which improves financial reporting by clarifying the financial statement presentation requirements for certain component units. The provisions in Statement No. 80 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In March 2016, GASB issued Statement No. 81, *Irrevocable Split-Interest Agreements*, which improves accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. The provisions in Statement No. 81 are effective for fiscal years beginning after December 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In March 2016, GASB issued Statement No. 82, *Pension Issues - an amendment of GASB Statements No. 67, No. 68, and No. 73*, which addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The provisions in Statement No. 82 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

**KOSRAE STATE HOUSING AUTHORITY
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Notes to Financial Statements
September 30, 2016

(2) Due To Primary Government

The Authority received \$96,296 of cash from the Kosrae State Government (KSG). Per agreement with KSG, this amount will be repaid in the amount of \$50,000 in 2017 and \$49,296 in 2018. This balance is noninterest bearing.

(3) Loans Receivable

The Authority's loan portfolio is comprised of Kosrae Home Improvement Program and USDA Rural Development ("USDA RD") loans.

During the year ended September 30, 2016, the State of Kosrae transferred \$80,557 of defaulted USDA Rural Development (RD) loans to the Authority. The Authority guarantees USDA RD loans and bears responsibility for collection. The Authority has pledged an escrow account in support of USDA RD loans. As of September 30, 2016, \$200,000 of time certificates of deposit and approximately \$6,000 cash has been so pledged. Per the USDA RD agreement with the State, \$300,000 is to be so pledged. In the event of default, the Authority could be exposed to an amount in excess of the escrow account balance, which is presently indeterminable.

Loans are stated at face value, net of an allowance for loan losses. The allowance represents an amount which, in management's judgment, will be adequate to absorb possible losses on existing loans that may become uncollectible. Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of loans. The allowance for loan losses are reported based on certain assumptions pertaining to the Authority's periodic review and evaluation of the loan portfolio, which is subject to change. Due to uncertainties inherent in the estimations and assumptions process, it is at least reasonably possible that changes in the estimates and assumptions in the near term would be material to the financial statements. A summary of loans receivable as of September 30, 2016, is presented below:

Kosrae Home Improvement Program loans	\$ 1,880,019
USDA Rural Development loans	<u>80,557</u>
	1,960,576
Less allowance for loan losses	<u>(1,445,060)</u>
Loans receivable, net	\$ <u>515,516</u>

There were no loan recoveries or write-offs recorded during the year ended September 30, 2016.

(4) Property and Equipment

Capital asset activity for the year ended September 30, 2016 is as follows:

Depreciable:	Estimated <u>Useful Life</u>	Balance at October <u>1, 2015</u>	Additions and <u>Transfers</u>	Deletions and <u>Transfers</u>	Balance at September <u>30, 2016</u>
Office equipment	1-5 years	\$ _____	\$ <u>3,996</u>	\$ _____	\$ <u>3,996</u>
		-	3,996	-	3,996
Less accumulated depreciation		_____	<u>(799)</u>	_____	<u>(799)</u>
		\$ _____	\$ <u>3,197</u>	\$ _____	\$ <u>3,197</u>

**KOSRAE STATE HOUSING AUTHORITY
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Notes to Financial Statements
September 30, 2016

(5) Commitments and Contingencies

Loan Commitments

The Authority has loan commitments aggregating \$323,290 as of September 30, 2016. The loan commitments represent undisbursed balances of approved loans for housing projects.

Risk Management

The Authority does not purchase insurance to cover risks associated with potential losses. Management is of the opinion that no material losses during the year ended September 30, 2016 have resulted from this practice.

(6) Related Parties

The Authority became a component unit of the State of Kosrae in October 2015 and \$513,387 of the prior fund balance of the Home Improvement Program Revolving Fund and restricted time certificates deposits of \$200,000 were transferred from Kosrae State Government (KSG) to the Authority.

The Authority is not allowed to lend money to its employees or their immediate relatives pursuant to Kosrae State Public Law 10-113. As of September 30, 2016, the Authority has \$126,467 of loans receivable from employee family members, who are eligible to file loan applications.

The Authority utilizes various KSG capital assets at no cost in its operations. KSG is to transfer title of these capital assets to the Authority but this transfer has not yet occurred.

(7) Due To Primary Government

	Balance October 1, <u>2015</u>	<u>Additions</u>	<u>Reductions</u>	Balance September 30, <u>2016</u>	Due Within <u>One Year</u>
Due to primary government	\$ <u>-</u>	\$ <u>156,296</u>	\$ <u>(60,000)</u>	\$ <u>96,296</u>	\$ <u>50,000</u>
	\$ <u>-</u>	\$ <u>156,296</u>	\$ <u>(60,000)</u>	\$ <u>96,296</u>	\$ <u>50,000</u>

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 State Housing 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 Kosrae State Housing Authority (the "Authority"), which comprise the statement of net position as September 30, 2016, and the related statements of revenues, expenses and change 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 27, 2017.

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 and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did identify certain deficiencies in internal control, described in the accompanying Schedule of Findings and Responses that we consider to be material weaknesses as items 2016-001 and 2016-002.

Compliance and Other Matters

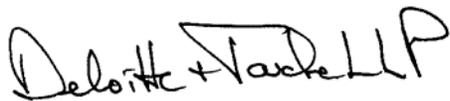
As part of obtaining reasonable assurance about whether the Authority's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material 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*.

The Authority's Responses to Findings

The Authority's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. The Authority's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

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, stylized font.

June 27, 2017

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

Schedule of Findings and Responses
Year Ended September 30, 2016

Finding No. 2016-001 – Loan Receivable

Criteria: The Authority should maintain an adequate system of accounting and be able to reconcile its general ledger with subsidiary ledgers.

Condition: Because of inadequacies in the accounting records, detailed records regarding loans and allowance for loan losses were not substantiated by underlying supporting documentation evidencing the validity of loans. The Authority did not utilize accounting or loan software and did not maintain an adequate system of accounting.

Cause: The cause of this condition is primarily due to inadequate accounting assistance, the absence of closing procedures and review and the lack of adequate filing and document maintenance systems.

Effect: The effect of this condition is an inability to substantiate certain financial statement balances, financial statement transactions and compliance with laws and regulations.

Recommendation: The Authority should acquire adequate accounting assistance, should prepare monthly financial statements that are supported by its books and records, and should maintain an adequate filing and retention system and must be able to demonstrate compliance with laws and regulations.

Auditee Response and Corrective Action Plan: This finding is similar to that of 2015-001 and in prior years having to do with accuracy of loan portfolio records. Since housing was established in early 1990s, financial system was operated manually but then in 2010 program was advanced to using excel program designed for loan agreement. Such has been the case until KHA was formed and implemented in FY2016.

As response to FY2015 Audit Findings, KHA had proposed and implemented corrective action plan for audit by procurement of a new loan software in April 2017. The loan software has been procured and properly set up and configured with necessary staff training. This project however is still under implementation due largely on the need to import historical data into the new system. Further, HKA board has agreed to implement the 2nd part of the financial systems upgrade to acquire a new accounting software, such project will be implemented in August 2017 hence would remove the discrepancies cited in audit. It is important to note that due to funding constraints, KHA was not able to accomplish FY2015 corrective action plans in FY2016 though fortunate to be accomplished in FY2017 with funding support from FSM Congress.

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

Schedule of Findings and Responses
Year Ended September 30, 2016

Finding No. 2016-002 – Capital Assets

Criteria: The Authority should be able to support ownership and carrying value of capital assets acquired from the Kosrae State Government (KSG).

Condition: The Authority assumed maintenance responsibility for a building, vehicles and other capital assets during the period ended September 30, 2016; however, KSG has yet to transfer legal title to the Authority.

Cause: The cause of this condition is primarily due to lack of control over acquisition and transfer of capital assets.

Effect: The effect of this condition is that capital assets have not yet been transferred.

Recommendation: The Authority should enter into a formal agreement to transfer ownership of the capital assets.

Auditee Response and Corrective Action Plan: This finding is new, however, KHA does not have the exclusive authority and responsibility. This is a shared responsibility with the State and in fact, the State has the sole control whether or not to release the title of capital assets to KHA as required by State Law 10-113. Nevertheless, KHA Board and management would continue to work with the State for the eventual capital asset transfer.