

June 27, 2017

The Board of Directors  
Kosrae State Housing Authority

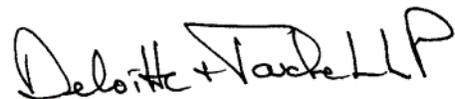
Dear Members of the Board of Directors:

We have performed an audit of the financial statements of Kosrae State Housing Authority (the "Authority" or "KHA"), a component unit of Kosrae State Government, as of and for the year ended September 30, 2016, in accordance with auditing standards generally accepted in the United States of America ("generally accepted auditing standards") and have issued our report thereon dated June 27, 2017.

We have prepared the following comments to assist you in fulfilling your obligation to oversee the financial reporting and disclosure process for which management of the Authority is responsible.

This report is intended solely for the information and use of management, the Board of Directors, others within the Authority and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

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

cc: To Management of Kosrae State Housing Authority

## OUR RESPONSIBILITY UNDER GENERALLY ACCEPTED AUDITING STANDARDS AND GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS

Our responsibility under generally accepted auditing standards and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, have been described in our engagement letter dated March 9, 2017. As described in that letter, the objective of a financial statement audit conducted in accordance with the aforementioned standards is:

- To express an opinion on whether the statement of net position of KHA as of September 30, 2016 and the related statements of revenues, expenses and change in net position and of cash flows for the period then ended (the "financial statements"), are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America ("generally accepted accounting principles") and perform specified procedures on the required supplementary information for the period ended September 30, 2016.
- To report on KHA's internal control over financial reporting and on its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters for the period ended September 30, 2016 based on an audit of financial statements performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*.

Our responsibilities under generally accepted auditing standards include forming and expressing an opinion about whether the financial statements that have been prepared with the oversight of management and the Board of Directors are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The audit of the financial statements does not relieve management or the Board of Directors of their responsibilities.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether caused by fraud or error. In making those risk assessments, we considered internal control over financial reporting relevant to the Authority's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses.

## SIGNIFICANT ACCOUNTING POLICIES

KHA's significant accounting policies are set forth in Note 1 to KHA's 2016 financial statements. During the year ended September 30, 2016, the following pronouncements were adopted by KHA:

- 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.

## SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

- 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.
- 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 these statements did not have a material effect on the 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.

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.

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## **SIGNIFICANT ACCOUNTING POLICIES, CONTINUED**

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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.

We have evaluated the significant qualitative aspects of the Authority's accounting policies, including accounting policies, accounting estimates and financial statement disclosures and concluded that the policies are appropriate, adequately disclosed, and consistently applied by management.

## **ACCOUNTING ESTIMATES**

Accounting estimates are an integral part of the financial statements prepared with the oversight of management and are based on management's current judgments. Those judgments are ordinarily based on knowledge and experience about past and current events and on assumptions about future events. During the year ended September 30, 2016, we are not aware of any significant changes in accounting estimates or in management's judgments relating to such estimates.

## **UNCORRECTED MISSTATEMENTS**

Our audit of the financial statements was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Included in Attachment II as Appendix A is a summary of uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

## **MATERIAL CORRECTED MISSTATEMENTS**

Included in Attachment I is a summary of corrected misstatements which were brought to the attention of management as a result of our audit procedures and were corrected by management during the current period.

**OTHER INFORMATION IN THE ANNUAL REPORTS**

When audited financial statements are included in documents containing other information such as KHA's 2016 Annual Report, we will read such other information and consider whether it, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the financial statements audited by us. In the event that KHA issues an Annual Report or other documentation that includes the audited financial statements, we will read the other information in KHA's 2016 Annual Report and will inquire as to the methods of measurement and presentation of such information. If we note a material inconsistency or if we obtain any knowledge of a material misstatement of fact in the other information, we will discuss this matter with management and, if appropriate, with the Board of Directors.

**DISAGREEMENTS WITH MANAGEMENT**

We have not had any disagreements with management related to matters that are material to the Authority's 2016 financial statements.

**OUR VIEWS ABOUT SIGNIFICANT MATTERS THAT WERE SUBJECT OF CONSULTATION WITH OTHER ACCOUNTANTS**

We are not aware of any consultations that management may have had with other accountants about auditing and accounting matters during 2016.

**SIGNIFICANT FINDINGS OR ISSUES DISCUSSED, OR SUBJECT OF CORRESPONDENCE, WITH MANAGEMENT PRIOR TO OUR ACCEPTANCE**

Throughout the period, routine discussions were held, or were the subject of correspondence with management regarding the application of accounting principles or auditing standards in connection with transactions that have occurred, transactions that are contemplated, or reassessment of current circumstances. In our judgment, such discussions or correspondence were not held in connection with our acceptance as auditors.

**OTHER SIGNIFICANT FINDINGS OR ISSUES ARISING FROM THE AUDIT DISCUSSED, OR SUBJECT OF CORRESPONDENCE, WITH MANAGEMENT**

Throughout the period, routine discussions were held, or were the subject of correspondence, with management. In our judgment, such discussions or correspondence did not involve significant findings or issues requiring communication to the Board of Directors.

**SIGNIFICANT DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT**

In our judgment, we received the full cooperation of the Authority's management and staff and had unrestricted access to the Authority's senior management in the performance of our audit.

**MANAGEMENT'S REPRESENTATIONS**

We have made specific inquiries of the Authority's management about the representations embodied in the financial statements. Additionally, we have requested that management provide to us the written representations the Authority is required to provide to its independent auditors under generally accepted auditing standards. We have attached to this letter, as Attachment II, a copy of the representation letter we obtained from management.

## **MODIFICATIONS TO OUR 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 significant unsubstantiated amounts that form part of loans receivable, net position, and related interest revenues. The Authority has not adequately recorded loan transactions in the loan portfolio. Accounting principles generally accepted in the United States of America require that transactions that have occurred be recorded. The amount by which this departure would affect loans receivable, allowance for loan losses, net position, and the related interest revenues of the Authority is not reasonably determinable. Our opinion is modified with respect to this matter.

## **CONTROL-RELATED MATTERS**

We have identified, and included in Attachment III, certain deficiencies related to the Authority's internal control over financial reporting as of September 30, 2016 that we wish to bring to your attention.

The definition of a control deficiency is also set forth in Attachment III.

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

\* \* \* \* \*

## Journal Entries - AJE

#	Name	Debit	Credit
<b>1 AJE Various on Beginning Balances and Preliminary TB</b>			
1111	BOG-Operation	2,614.22	
1112	BFSM-Disbursement Account	1,495.78	
1113	BFSM-Savings	54,608.03	
1114	BFSM-Escrow Savings	6,325.62	
1115	BOG-Savings	4,896.38	
1116	BFSM-Escrow TCD	200,000.00	
1120	Loans Receivable		28,589.99
1121	Allow D/A		1,275,514.21
1130	Fixed Assets	3,996.00	
1131	Accumulated Depreciation		799.20
2130	Due to State		96,296.12
3110	Fund Balance Surplus	1,331,024.07	
3120	FB Reserved	443,606.37	
3130	FB Restricted	62,167.13	
2131	Due to from other fund	210.00	
4110	Interest Income	8,096.28	
4410	Transfer from KSG		797,529.00
4420	Subsidy from CFMS		14,657.44
5110	Salaries		4,173.07
5112	Life Ins		1,202.22
5113	Payroll Taxes	6,744.24	
5120	Travel & Transportation	27,373.08	
5130	Communication	273.93	
5140	Food	75.70	
5160	Office Supplies	3,081.31	
5170	POL	366.15	
5190	Repair & Maintenance	698.85	
5210	Utilities	800.00	
5220	Gen Contractual Srvcs	2,460.00	
5230	Training		4,474.00
5240	Meeting Allowance	505.00	
5260	Bank Charges	572.76	
5270	Depreciation	799.20	
5310	Provision for Loan Losses	80,556.58	
1140	Loan Receivable (USDA Loans)	80,556.58	
1141	Allow D/A (USDA Loans)		80,556.58
1122	Loans Receivable Reconciliation		20,111.43
		<u>2,323,903.26</u>	<u>2,323,903.26</u>

Preliminary Adjustments per TB and  
PY KSG Report

<b>2 AJE Accrued Payroll</b>			
5110	Salaries	2,366.95	
2120	Payroll Accrual		2,366.95
		<u>2,366.95</u>	<u>2,366.95</u>
	Recalculated accrued payroll		
<b>3 AJE Unrecorded Liabilities</b>			
5170	POL	38.00	
5130	Communication	631.27	
2110	Accounts Payable		669.27
		<u>669.27</u>	<u>669.27</u>
	Unrecorded liabilities		
<b>4 AJE USDA Loans</b>			
4210	Rural Development Loans	82,430.20	
4211	Loan Repayment		82,430.20
		<u>82,430.20</u>	<u>82,430.20</u>
	USDA Loans recorded in revenue and expense accounts		

We have reviewed the audit adjustments summarized above and agreed that they should be recorded in the general ledger as of September 30, 2016. These adjusting journal entries are the results of errors and not results of fraud, irregularities, or illegal acts.

  
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 Steven L. George, Executive Director

  
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 Isao Mike, CFO



# KOSRAE HOUSING AUTHORITY

KOSRAE STATE GOVERNMENT  
P.O. Box 553  
TOFOL, KOSRAE STATE, FM 96944  
TELEPHONE: 370-2068

June 27, 2017

Deloitte & Touche  
P.O. Box 753  
Kolonias, Pohnpei 96941

We are providing this letter in connection with your audit of the statements of net position of the Kosrae Housing Authority (the Authority), a component unit of Kosrae State Government, as of September 30, 2016 and the related statements of revenues, expenses and changes in net position and of cash flows for the period then ended, and the related notes to the financial statements, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the Authority in conformity with accounting principles generally accepted in the United States of America (GAAP).

We confirm that we are responsible for the following:

- a. The fair presentation in the basic financial statements of the Authority's net position, and the related statements of revenues, expenses and changes in net position, and cash flows in conformity with accounting principles generally accepted in the United States of America, except for your report modification with respect to \$60,000 of loans, the impact of which is not currently determinable.
- b. 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
  - To prevent and detect fraud
- c. The review and approval of the financial statements and related notes and acknowledge your role in the preparation of this information. Specifically, we acknowledge that your role in the preparation of the financial statements was a matter of convenience rather than one of necessity. We have reviewed the financial statement preparation assistance provided by you and acknowledge that the financial statements are prepared in accordance with GAAP. Our review was based on the use of the financial statement disclosure checklist for stand-alone business-type activities obtained from the Government Finance Officers Association.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes

it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audits.

1. The basic financial statements referred to above are fairly presented in conformity with GAAP. In addition:
  - a. The financial statements include all component units as well as joint ventures with an equity interest, and properly disclose all other joint ventures and other related organizations.
  - b. Net position components (invested in capital assets net of related debt, restricted and unrestricted) are properly classified and approved.
  - c. Deposits and investment securities are properly classified in the category of custodial credit risk.
  - d. Required supplementary information is measured and presented within prescribed guidelines.
  - e. Applicable laws and regulations are followed in adopting, approving, and amending budgets.
  - f. Capital assets are properly capitalized, reported and depreciated.
2. The Authority has provided to you all relevant information and access as agreed in the terms of the audit engagement letter.
3. The Authority has made available to you:
  - a. All minutes of the meetings of the Board of Directors or summaries of actions of recent meetings for which minutes have not yet been prepared.
  - b. All financial records and related data for all financial transactions of the Authority and for all funds administered by the Authority. The records, books, and accounts, as provided to you, record the financial and fiscal operations of all funds administered by the Authority and provide the audit trail to be used in a review of accountability. Information presented in financial reports is supported by the books and records from which the financial statements have been prepared.
  - c. Contracts and grant agreements (including amendments, if any) and any other correspondence that has taken place with federal agencies.
4. There have been no:
  - a. Action taken by the Authority's management that contravenes the provisions of federal and Federated States of Micronesia (FSM) laws and regulations or of contracts and grants applicable to the Authority and for all funds administered by the Authority.
  - b. Communication from other regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices or other matters that could have a material effect on the financial statements.

5. We believe the effects of any uncorrected financial statement misstatements aggregated by you during the current audit engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole for each opinion unit. A summary of such uncorrected misstatements has been attached as Appendix A.
6. The Authority has not performed a formal risk assessment, including the assessment of the risk that the financial statements may be materially misstated as a result of fraud. However, management has made available to you their understanding about the risks of fraud in the Authority and do not believe that the financial statements are materially misstated as a result of fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the Authority involving:
  - (a) Management
  - (b) Employees who have significant roles in internal control over financial reporting
  - (c) Others, where the fraud could have a material effect on the financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the Authority received in communications from employees, former employees, analysts, regulators, or others.
9. There are no unasserted claims or assessments that legal counsel has advised us are probable of assertion and must be disclosed in accordance with GASB Codification of Governmental Accounting and Financial Reporting Standards ("GASB Codification") Section C50, *Claims and Judgments*.
10. We are responsible for compliance with local and state laws, rules and regulations, including compliance with the provisions of grants and contracts relating to the Authority's operations. We are responsible for establishing and maintaining the components of internal control relating to our activities in order to achieve the objectives of providing reliable financial reports, effective and efficient operations, and compliance with laws and regulations. The Authority is responsible for maintaining accounting and administrative control over revenues, obligations, expenditures, assets, and liabilities.
11. There are no reportable conditions, including significant deficiencies and material weaknesses, in the design or operation of internal control that could adversely affect the Authority's ability to initiate, record, process, and report financial information.
12. Management has identified and disclosed to you all laws and regulations that have a direct and material effect on the determination of financial statement amounts.
13. Significant assumptions used by us in making accounting estimates are reasonable.

Except where otherwise stated below, matters less than \$3,000 collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the financial statements.

14. Except as listed in Appendix A, there are no transactions that have not been properly

recorded in the accounting records underlying the financial statements.

15. The Authority has no plans or intentions that may affect the carrying value or classification of assets and liabilities.
16. Regarding related parties:
  - a. We have disclosed to you the identity of the Authority's related parties and all the related party relationships and transactions of which we are aware.
  - b. To the extent applicable, related parties and all the related-party relationships and transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees (written or oral) have been appropriately identified, properly accounted for, and disclosed in the financial statements.
17. In preparing the financial statements in conformity with GAAP, management uses estimates. All estimates have been disclosed in the financial statements for which known information available prior to the issuance of the financial statements indicates that both of the following criteria are met:
  - a. It is reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events
  - b. The effect of the change would be material to the financial statements.

We are not aware of any estimates at September 30, 2016 that may change and that the effect of the change would be material to the financial statements.
18. There are no:
  - a. Instances of identified or suspected noncompliance with laws and regulations whose effects should be considered when preparing the financial statements
  - b. Known actual or possible litigation and claims whose effects should be considered when preparing the financial statements that have not been disclosed to you and accounted for and disclosed in accordance with GAAP
  - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by GASB Codification Section C50, Claims and Judgments.
19. Regarding required supplementary information:
  - a. We confirm that we are responsible for the required supplementary information.
  - b. The required supplementary information is measured and presented in accordance with GASB Codification Section 2200, *Comprehensive Annual Financial Report*
  - c. The methods of measurement and presentation of the supplementary information have not changed from those used in the prior period.
20. The Authority has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.

21. The Authority has complied with all aspects of contractual agreements that may affect the financial statements.
22. No corporation or agency of the Federal Government, the FSM National Government or Košrae State Government has reported a material instance of noncompliance to us.
23. During the period ended September 30, 2016, the Authority 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.
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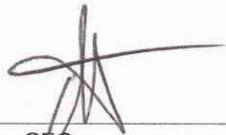
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24. The Authority does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. The Authority has not experienced any losses on such accounts and management believes it is not exposed to any significant credit risk on its deposits.
25. We believe that all expenditures that have been deferred to future periods are recoverable.

26. No events have occurred after September 30, 2016, but before June 27, 2017, the date the financial statements were available to be issued that require consideration as adjustments to or disclosures in the financial statements.



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Steven L. George, Executive Director

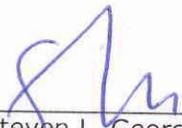


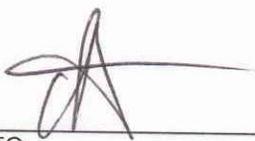
\_\_\_\_\_  
Isao Mike, CEO

**Uncorrected Misstatement - PAJE**

<b>Name</b>	<b>Debit</b>	<b>Credit</b>
<b>1 PAJE Unrecorded accrued interest income</b>		
Accrued interest income	3,866.00	
Interst income		3,866.00
	<u>3,866.00</u>	<u>3,866.00</u>
Unrecorded accrued interest		

We have reviewed the uncorrected misstatements summarized above. These misstatements are the results of errors and not results of fraud, irregularities, or illegal acts.

  
\_\_\_\_\_  
Steven L. George, Executive Director

  
\_\_\_\_\_  
Isao Mike, CFO

**SECTION I – DEFICIENCIES**

We identified, and have included below, deficiencies involving the Authority's internal control over financial reporting as of September 30, 2016 that we wish to bring to your attention:

**1. Bookkeeping**

Comment: There were numerous audit adjustments which impacted a significant number of accounts. Many of the adjustments relate to the lack of formal accounting procedures.

Recommendation: We recommend that management record all journal entries, such as cash, loan disbursements and collections, accounts receivable and payable and expenses. Procedures should be formalized to require periodic bookkeeping.

**2. Cash**

Comment: Cash was not recorded in the preliminary general ledger.

Recommendation: We recommend that management acquire adequate accounting assistance and formalize bookkeeping procedures.

**3. Deposits**

Comment: There were numerous loan collections which were not timely deposited. Several collections had not been deposited as of test date. KHA's Manual of Administration requires daily deposit of cash collections.

Recommendation: We recommend that management implement requirements for daily deposit of cash collections.

**4. Unrecorded Subsidies**

Comment: Subsidies from FSM National Government were not recorded in the preliminary general ledger.

Recommendation: We recommend that management record and monitor subsidies and related expenses.

**SECTION II – DEFINITION**

The definition of a deficiency is as follows:

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

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

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

**Management's Responsibility**

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

**Objectives of Internal Control over Financial Reporting**

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

**Inherent Limitations of Internal Control over Financial Reporting**

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