

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

FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2016 AND 2015

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

Years Ended September 30, 2016 and 2015
Table of Contents

	<u>Page No.</u>
I. INDEPENDENT AUDITORS' REPORT	1
II. MANAGEMENT'S DISCUSSION AND ANALYSIS	3
III. FINANCIAL STATEMENTS	
Statements of Net Position	8
Statements of Revenues, Expenses and Changes in Net Position	9
Statements of Cash Flows	10
Notes to Financial Statements	11
IV. INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS	
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 <i>Government Auditing Standards</i>	23
Summary Schedule of Prior Year Findings and Questioned Costs	25

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" or "KUA"), a component unit of the State of Kosrae, which comprise the statements of net position as of September 30, 2016 and 2015, 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

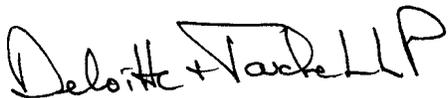
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kosrae Utilities Authority as of September 30, 2016 and 2015, and the results of its operations and its cash flows, for the years then ended in accordance with accounting principles 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 financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the 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 financial statements, and other knowledge we obtained during our audit of the 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 8, 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 8, 2017

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

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, 2016. Please read it in conjunction with the financial statements, which follows this section.

Kosrae Utilities Authority (KUA) was mandated by law in October 1993 as a semi-agency of the Kosrae State Government to assume the operation and responsibility of providing electric power services to the Island of Kosrae. KUA is governed by five (5) board members appointed by the Governor with the advice and consent of the State Legislature for staggered terms of 2 to 4 years.

The Authority served 1,785 customers during FY2016. The customer base remained constant from the previous operating year with customer ratios of approximately 80% residential with energy sales of 39%, 12% commercial with 31% energy sales, 4% Kosrae State Government with 17% energy sales, 3% non-Kosrae State Government with 8% energy sales and 1% industrial with 5% kilowatt-hour sales. The energy sales ratio from the different customer sectors showed slight changes from the previous fiscal year with residential reduced by 3% in energy sales, commercial increased by 5%, State Government reduced by 2%, non-state government reduced by 1% and industrial sales increased by 1%. The trend indicates that more commercial activities took place during FY 2016 compared to FY 2015. These customer base ratios are expected to remain with slight changes for the next few years and will be reviewed annually since any changes to customer class can affect future operating revenues.

KUA has continued to focus on improving operating issues and challenges faced during FY2016. The financial condition has improved significantly to maintain basic needs of the operation and support operating expenditures, but not sufficient to finance major improvements projects needed to meet the targeted state energy goals and objectives. KUA has continued to depend on outside donors to improve run-down fixed assets and essential investments needed for efficiency improvements and to reduce operating cost. The operating challenges and issues during last fiscal year continued to be power system loss, capacity building, aging fixed assets and facilities, inefficiency generator units and equipments and high cost of operation. With the approved grants from the World Bank and the Government of Japan and JICA, the management and staff are optimistic that substantial improvements to alleviate these challenges will be realized after completion of these projects. These grants provide for new gensets, upgrading of power distribution lines and other facilities and trainings to improve system efficiency and reduce operating cost. Proposals for Grid-stability study, expansion of renewable energy sources, re-aligning and relocation of power distribution lines due to erosion and deterioration and replacing of high efficient bulbs and equipment are also prepared to tap EU, GCF, GEF grant funds to improve system efficiency and reduce costs of operation. The State Energy Task Force has revised and updated the State energy action plans to strive toward meeting the targets of achieving at least 30% renewable energy and 50% system efficiency by 2020 as stated under the FSM National Energy Plan and Policy and supported by the State Strategic Development Plan.

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

The following table summarizes the financial position and results of operation of Kosrae Utilities Authority for 2016 through 2014:

<u>Assets</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>
Current assets	\$ 1,570,624	\$ 1,172,126	\$ 1,145,735
Utility plant, net	2,399,065	2,662,830	3,004,143
Other non-current assets	<u>252,800</u>	<u>252,800</u>	<u>302,800</u>
	\$ <u>4,222,489</u>	\$ <u>4,087,756</u>	\$ <u>4,452,678</u>
<u>Liabilities and Net Position</u>			
Current liabilities	\$ <u>233,770</u>	\$ <u>253,139</u>	\$ <u>482,864</u>
Net Position:			
Investment in capital assets	2,399,065	2,662,830	3,004,143
Restricted	90,000	90,000	90,000
Unrestricted	<u>1,499,654</u>	<u>1,081,787</u>	<u>875,671</u>
Total net position	<u>3,988,719</u>	<u>3,834,617</u>	<u>3,969,814</u>
	\$ <u>4,222,489</u>	\$ <u>4,087,756</u>	\$ <u>4,452,678</u>
<u>Revenue, Expenses and Changes</u>			
<u>in Net Position</u>			
	<u>2016</u>	<u>2015</u>	<u>2014</u>
Operating revenues	\$ 2,462,828	\$ 2,485,483	\$ 2,666,039
Operating expenses	<u>2,304,878</u>	<u>2,596,210</u>	<u>2,800,267</u>
Net operating earnings (loss)	<u>157,950</u>	<u>(110,727)</u>	<u>(134,228)</u>
Operating grants	-	1,100	-
Loss on asset impairment	(22,265)	(184,096)	-
Interest income-net and investment income (loss)	<u>18,417</u>	<u>(16,474)</u>	<u>25,084</u>
Total non operating income (loss)	<u>(3,848)</u>	<u>(199,470)</u>	<u>25,084</u>
Capital contributions	-	<u>175,000</u>	<u>22,979</u>
Change in net position	\$ <u>154,102</u>	\$ <u>(135,197)</u>	\$ <u>(86,165)</u>

FINANCIAL HIGHLIGHTS

Operating revenue derived from electricity sales and services for the period decreased by around 1% in comparison to last year's operation but with corresponding increase in the volume of kilowatt sales of approximately 17%. The net reduction was attributed to the negative fuel adjustment charged to the customers while the other sales components increased during the period. The entry of Luen Thai Fishing Ventures makes the Commercial account viably high this fiscal year while Residential, Industrial and Government account sales slightly increased. Service orders include revenues received from the new installation of 3 Phase meters and line rehabilitation/installation of the Tropical Water Bottling Co. project at Pukusrik.

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

With the fuel prices continuing to go down, the fuel adjustment rate used for fuel adjustments became negative, which implies that the price is below the fuel cost included in the base rate. This caused negative fuel adjustments that theoretically reduces KUA's selling price per kilowatt that are charged to the customers. Average fuel adjustment rate applied to kilowatt sales is (\$.0336) as against last year of \$.0393; a reduction of \$.0729 per kilowatt which is approximately a 200% decline of the FAC revenue for this year.

Operating expenses were significantly reduced by about 11% due to the drop in the fuel prices and some expense components that decreased. Fuel price declined from an average of \$3.4337 per gallon in FY 2015 to \$2.7784 in the current year; with a reduction of \$.6553 for every gallon used by the engines. Fuel consumption and fuel generation increased by around 5% and 17% respectively but with the reduced fuel price, fuel expenses incurred is 15% lower compared to last year's expense. Maintenance expense on the other hand is relatively low for this period. Solar power generation for two solar panel grid connected PV contributed 5% of the total power generation.

Kilowatt sales for FY 2016 is 5,320,992 kwh while 4,560,838 kwh for FY 2015; an increase of 760,152 kwh. Average sales price for this year is \$.46 per kwh with approximate production costs of \$.43 per kwh. This results to net operating revenue of around \$.03 per kwh.

Current assets are higher by about 34%, attributed to the increase in cash and temporary investment accounts and minor changes in receivables. Several outstanding receivables were written off as such were deemed uncollectible. Receivables decreased by around 1% with a collection /billing ratio of 97%. Changes in short term investments and time deposits are the interest earned and increase in market value representing the unrealized gains of KUA's investment portfolio as of September 30, 2016.

Utility plant is composed of various fixed assets net of accumulated depreciation. Some fully depreciated fixed assets were retired and written-off during the period with the corresponding deduction on its accumulated depreciation. The decrease on this account is the net change in new acquisition of fixed assets and the depreciation provided for the year. Please see note 5 to the financial statements for detail of utility plant activity during 2016 and 2015.

Other noncurrent assets have not changed. These are the deposit amounts for the fuel purchase contract with FSMPC and investment in Ocean Energy Kosrae (OEK), net of valuation reserve.

KUA withdrew \$100,000 from the existing line of credit at Bank of the FSM on March 2016 to supplement the additional purchase of fuel to expand the inventory level and to avail the decreasing fuel prices. This was fully paid as of September 30, 2016. The same line of credit was renewed in January 2017.

Change in net position represents the net income during the period. JICA-funded projects have started construction and implementation in the 2nd quarter of FY 2017 and are expected to be finished by FY 2018. The World Bank-funded generator is likewise projected to be operational by FY 2018. These projects will help significantly on KUA's engine efficiency and contribute costs savings in maintenance and fuel consumption in the future.

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

Plan of Action for 2017

1. Improve financial records, internal control and procedures, meter readings and technical data and streamline operating expenditures as needed to improve financial position of KUA.
2. Improve Solar PV energy penetration data to support the stability study of the system and for proposed storage system for the expansion of renewable energies into the grid lines. Additional Solar PV System and other renewable energies are under consideration to increase renewable energies into the grid-lines to reduce fuel usage and cost to the operation.
3. Start the construction of the Energy Improvement Projects funded by the Government of Japan (GOJ) and JICA. Projects approved by GOJ are the new power plant with two gensets of 600kwp capacity each, a new substation, the upgrading of the Lelu Power Distribution System and installation of two underground cables at the Airport/Dock areas. These projects will significantly improve power system efficiency and power capacity, reduce system loss and improve services to the island.
4. Prepare to commence the installation of a new genset with 600kwp funded by the World Bank with acquisition of 400 LED street lights and a 250 kwp transformer to replace and supply the Fishing Transshipment Operation at the Dock.
5. Acquire a new Bucket Truck and Auger Truck to support the implementation of the undergoing projects funded by outside donors and to support service request by customers, since the existing heavy equipment is in critical and bad condition.
6. Work with ADB Consultant to prepare a project funding proposal for new power lines to support the state shoreline management plan for new inner roads and for additional Solar PV installation and other renewable energies to be submitted for the Green Climate Funds.
7. Prepare and submit funding request to EU grants for the implementation of the Grid-stability study to ensure stable power services to the island and continue working with Pacifica Energy Inc. for the flywheel storage facility for the existing and additional renewable energies proposed for Kosrae.
8. Plan and implement the new Power Line Extensions for the three municipalities to attract residents to relocate inlands due to coastal erosion and to expand farm productions.
9. Continue collaborating with Pacific Power Association to prepare benchmarking and data based on the FY2016 operating performances to identify weak indicators and areas to be improved and set action plans and activities to be implemented to improve the power system to the island.
10. Prepare and organize the Water Division for the transfer of Utwe Water System after remaining works are completed and transferred terms and conditions are agreed upon between the Kosrae State Government and KUA. Recruit two Water Specialists funded by ADB to manage the Water Operation.
11. Continue to work with Pacific Power Association and other regional organizations to formulate and develop relevant training to improve capacity building to effectively and efficiently perform tasks both on conventional and renewable energy system to minimize cost to the operation.

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

12. Conduct public education on Demand Side Management Programs for customers to use energy efficiently in reducing power consumption as well as reducing cost to KUA.
13. Continue to take active roles in promoting the private sector 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.

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.

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

Statements of Net Position
September 30, 2016 and 2015

<u>ASSETS</u>	<u>2016</u>	<u>2015</u>
Utility plant:		
Electric plant in service	\$ 10,625,223	\$ 10,837,861
Less accumulated depreciation	<u>(8,295,463)</u>	<u>(8,242,003)</u>
	2,329,760	2,595,858
Construction work-in-progress	<u>69,305</u>	<u>66,972</u>
Net utility plant	<u>2,399,065</u>	<u>2,662,830</u>
Other noncurrent assets:		
Deposit for fuel purchase contract	<u>252,800</u>	<u>252,800</u>
Current assets:		
Cash and cash equivalents	706,892	322,096
Investments	319,287	298,588
Time certificate of deposit	166,225	166,121
Accounts receivable, net	164,760	166,279
Prepayments	15,015	1,981
Inventories (net of allowance for obsolescence of \$192,034 and \$196,151 in 2016 and 2015, respectively)	<u>198,445</u>	<u>217,061</u>
Total current assets	<u>1,570,624</u>	<u>1,172,126</u>
Total assets	<u>\$ 4,222,489</u>	<u>\$ 4,087,756</u>
<u>LIABILITIES AND NET POSITION</u>		
Current liabilities:		
Short-term notes payable	\$ -	\$ 61
Accounts payable - fuel	81,351	125,236
Accounts payable - other	83,151	84,123
Accrued annual leave	8,183	11,132
Unearned revenue	28,361	12,111
Accrued taxes and other	<u>32,724</u>	<u>20,476</u>
Total liabilities	<u>233,770</u>	<u>253,139</u>
Commitments and contingency		
Net position:		
Net investment in capital assets	2,399,065	2,662,830
Restricted	90,000	90,000
Unrestricted	<u>1,499,654</u>	<u>1,081,787</u>
Total net position	<u>3,988,719</u>	<u>3,834,617</u>
	<u>\$ 4,222,489</u>	<u>\$ 4,087,756</u>

See accompanying notes to financial statements.

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

Statements of Revenues, Expenses, and Changes in Net Position
Years Ended September 30, 2016 and 2015

	2016	2015
Operating revenues:		
Electricity sales	\$ 2,456,882	\$ 2,468,946
Recovery of uncollectible accounts	5,946	16,537
Net operating revenues	2,462,828	2,485,483
Operating expenses:		
Production fuel	1,267,662	1,487,923
Salaries and wages	461,045	423,127
Depreciation and amortization	328,475	368,256
Administrative and general	171,893	165,337
Repairs and maintenance	75,803	151,567
Total operating expenses	2,304,878	2,596,210
Earnings (loss) from operations	157,950	(110,727)
Nonoperating revenues (expenses):		
Loss on asset impairment	(22,265)	(184,096)
Interest expense	(3,536)	(7,027)
Interest income	1,254	807
Net change in fair value of investments	20,699	(10,254)
Grant from U.S. Government	-	1,100
Total nonoperating expenses, net	(3,848)	(199,470)
Capital contributions:		
U.S. Government and others	-	175,000
Change in net position	154,102	(135,197)
Net position at beginning of year	3,834,617	3,969,814
Net position at end of year	\$ 3,988,719	\$ 3,834,617

See accompanying notes to financial statements.

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

Statements of Cash Flows
Years Ended September 30, 2016 and 2015

	2016	2015
Cash flows from operating activities:		
Cash received from customers	\$ 2,436,748	\$ 2,462,890
Cash paid to suppliers for goods and services	(1,607,228)	(1,829,967)
Cash paid to employees for services	(393,199)	(421,618)
Net cash provided by operating activities	436,321	211,305
Cash flows from investing activities:		
Interest and dividends received on investments and others	1,150	450
Cash flows from noncapital financing activities:		
Contribution received from U.S. Government	-	1,100
Net borrowing under (payment on) a line of credit facility	(61)	61
Interest paid on a line of credit facility	(3,536)	(7,027)
Net cash used in noncapital financing activities	(3,597)	(5,866)
Cash flows from capital financing activities:		
Capital expenditures for utility plant	(49,078)	(161,039)
Net cash used in capital financing activities	(49,078)	(161,039)
Net change in cash and cash equivalents	384,796	44,850
Cash and cash equivalents at beginning of year	322,096	277,246
Cash and cash equivalents at end of year	\$ 706,892	\$ 322,096
Reconciliation of earnings (loss) from operations to net cash provided by operating activities:		
Earnings (loss) from operations	\$ 157,950	\$ (110,727)
Adjustments to reconcile earnings (loss) from operations to net cash provided by operating activities:		
Depreciation and amortization	328,475	368,256
Recovery of uncollectible accounts	(5,946)	(16,537)
(Increase) decrease in assets:		
Accounts receivable	3,608	(2,961)
Prepayments	(11,097)	1,224
Inventories	(17,361)	26,836
Increase (decrease) in liabilities:		
Accounts payable - fuel	(43,885)	(53,570)
Accounts payable - other	(972)	(331)
Accrued annual leave	(2,949)	436
Unearned revenue	16,250	(3,095)
Accrued taxes and other	12,248	1,774
Net cash provided by operating activities	\$ 436,321	\$ 211,305
Supplemental information of noncash financing activities:		
Decommissioned Engine # 7:		
Capital assets	\$ 89,061	\$ 1,523,633
Accumulated depreciation	(66,796)	(1,389,537)
Impairment loss	(22,265)	(134,096)
	\$ -	\$ -
Investment valuation reserve:		
Investment in OEK, Inc.	\$ -	\$ 50,000
Impairment loss	-	(50,000)
	\$ -	\$ -
Redesignation of U.S. Federal grant:		
Federal grants payable	\$ -	\$ (175,000)
Capital contributions	-	175,000
	\$ -	\$ -

See accompanying notes to financial statements.

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

Notes to Financial Statements
September 30, 2016 and 2015

(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 discretely presented 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 such 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, 2016 and 2015, 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.

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

Notes to Financial Statements
September 30, 2016 and 2015

(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 costs. As of September 30, 2016 and 2015, 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 the 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. During the year ended September 30, 2015, the Authority recognized an impairment loss of \$50,000 associated with this investment.

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.

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

Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

Investments

Investments and related investment earnings are reported at fair value using quoted market prices. Fair value is the price that would be received to sell an asset or paid to transfer a liability (i.e. the exit price) in an orderly transaction between market participants at the date as of which the fair value of an asset or liability is determined.

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 79% and 21% of the net inventory value, respectively, as of September 30, 2016, and 85% and 15%, respectively, as of September 30, 2015.

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, 2016 and 2015 are \$89,329 and \$80,807, 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, 2016 and 2015

(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, 2016, KUA 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 required additional disclosures to be made about fair value measurements, the level of fair value hierarchy, and valuation techniques.
- 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*, 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.

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

Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

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.

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.

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

Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

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.

(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, 2016 and 2015, cash and cash equivalents and time certificates of deposit were \$873,117 and \$488,217, respectively, and the corresponding bank balances were \$904,529 and \$484,227, respectively, which are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2016 and 2015, bank deposits in the amount of \$298,696 and \$306,333, 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.

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

Notes to Financial Statements
September 30, 2016 and 2015

(3) Deposits and Investments, Continued

B. Investments

As of September 30, 2016 and 2015, investments at fair value comprise the following:

	<u>2016</u>	<u>2015</u>
Fixed income securities:		
U.S. Treasury obligations	\$ 46,244	\$ 45,300
U.S. Government agencies	25,235	24,186
Corporate notes	<u>39,887</u>	<u>36,375</u>
	<u>111,366</u>	<u>105,861</u>
Other Investments:		
Common equities	201,920	171,708
Money market funds	<u>6,001</u>	<u>21,019</u>
	<u>207,921</u>	<u>192,727</u>
	\$ <u>319,287</u>	\$ <u>298,588</u>

As of September 30, 2016, 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	\$ 46,244	\$ 37,890	\$ 8,354
U.S. Government agencies	AAA	25,235	25,235	-
Corporate notes	A1	3,255	-	3,255
Corporate notes	A2	3,312	-	3,312
Corporate notes	A3	16,924	3,269	13,655
Corporate notes	BAA1	6,309	-	6,309
Corporate notes	BAA2	4,025	-	4,025
Corporate notes	BAA3	3,182	3,182	-
Corporate notes	BA3	<u>2,880</u>	<u>-</u>	<u>2,880</u>
		\$ <u>111,366</u>	\$ <u>69,576</u>	\$ <u>41,790</u>

As of September 30, 2015, 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	\$ 45,300	\$ 36,996	\$ 8,304
U.S. Government agencies	AAA	24,186	24,186	-
Corporate notes	A1	3,176	-	3,176
Corporate notes	A2	3,361	-	3,361
Corporate notes	A3	12,473	6,577	5,896
Corporate notes	BAA1	6,074	-	6,074
Corporate notes	BAA2	3,659	3,659	-
Corporate notes	BAA3	<u>7,632</u>	<u>2,706</u>	<u>4,926</u>
		\$ <u>105,861</u>	\$ <u>74,124</u>	\$ <u>31,737</u>

KUA categorizes its fair value measurements within the fair value hierarchy established by GASB Statement No.72. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

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

Notes to Financial Statements
September 30, 2016 and 2015

(3) Deposits and Investments, Continued

B. Investments, Continued

KUA has the following recurring fair value measurements as of September 30, 2016 and 2015:

	September 30, <u>2016</u>	Fair Value Measurements Using		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments by fair value level:				
Fixed income:				
U.S. Treasury obligations	\$ 46,244	\$ -	\$ 46,244	\$ -
U.S. Government Agencies	25,235	-	25,235	-
Corporate notes	<u>39,887</u>	<u>-</u>	<u>39,887</u>	<u>-</u>
	\$ <u>111,366</u>	\$ <u>-</u>	\$ <u>111,366</u>	\$ <u>-</u>
Equity securities:				
U.S. equities	\$ 201,920	\$ 201,920	\$ -	\$ -
Total investments at fair value	<u>313,286</u>	<u>201,920</u>	<u>111,366</u>	<u>-</u>
Investments measured at amortized cost:				
Money market funds	<u>6,001</u>			
	\$ <u>319,287</u>			

	September 30, <u>2015</u>	Fair Value Measurements Using		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investments by fair value level:				
Fixed income:				
U.S. Treasury obligations	\$ 45,300	\$ -	\$ 45,300	\$ -
U.S. Government Agencies	24,186	-	24,186	-
Corporate notes	<u>36,375</u>	<u>-</u>	<u>36,375</u>	<u>-</u>
	\$ <u>105,861</u>	\$ <u>-</u>	\$ <u>105,861</u>	\$ <u>-</u>
Equity securities:				
U.S. equities	\$ 171,708	\$ 171,708	\$ -	\$ -
Total investments at fair value	<u>277,569</u>	<u>171,708</u>	<u>105,861</u>	<u>-</u>
Investments measured at amortized cost:				
Money market funds	<u>21,019</u>			
	\$ <u>298,588</u>			

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, 2016 and 2015.

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, 2016 and 2015, there was no concentration of credit risk for KUA's investments.

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

Notes to Financial Statements
September 30, 2016 and 2015

(3) Deposits and Investments, Continued

B. Investments, Continued

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, 2016 and 2015, are summarized as follows:

	<u>2016</u>	<u>2015</u>
Utility:		
Residential	\$ 34,796	\$ 39,335
Commercial	62,404	130,130
Government	61,895	73,192
Fuel adjustment charge	<u>(5,960)</u>	<u>2,042</u>
	153,135	244,699
Other	<u>61,353</u>	<u>77,043</u>
	214,488	321,742
Less allowance for doubtful accounts	<u>(49,728)</u>	<u>(155,463)</u>
	<u>\$ 164,760</u>	<u>\$ 166,279</u>

(5) Utility Plant

Capital asset activity for the years ended September 30, 2016 and 2015, is as follows:

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2015</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2016</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 4,092,743	\$ 10,685	\$ (229,896)	\$ 3,873,532
Distribution plant	5 to 30 years	6,146,418	61,424	-	6,207,842
General plant	3 to 20 years	<u>598,700</u>	<u>12,533</u>	<u>(67,384)</u>	<u>543,849</u>
Total electric plant in service		10,837,861	84,642	(297,280)	10,625,223
Less accumulated depreciation		<u>(8,242,003)</u>	<u>(328,475)</u>	<u>275,015</u>	<u>(8,295,463)</u>
		2,595,858	(243,833)	(22,265)	2,329,760
<u>Non-depreciable assets:</u>					
Construction work-in-progress		<u>66,972</u>	<u>18,474</u>	<u>(16,141)</u>	<u>69,305</u>
Electric plant in service, net		\$ <u>2,662,830</u>	\$ <u>(225,359)</u>	\$ <u>(38,406)</u>	\$ <u>2,399,065</u>

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

Notes to Financial Statements
September 30, 2016 and 2015

(5) Utility Plant, Continued

	<u>Estimated Useful Lives</u>	<u>Balance at October 1, 2014</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at September 30, 2015</u>
<u>Depreciable assets:</u>					
Production plant	5 to 40 years	\$ 5,344,529	\$ 90,182	\$(1,341,968)	\$ 4,092,743
Distribution plant	5 to 30 years	6,080,040	66,378	-	6,146,418
General plant	3 to 20 years	<u>772,793</u>	<u>7,572</u>	<u>(181,665)</u>	<u>598,700</u>
Total electric plant in service		12,197,362	164,132	(1,523,633)	10,837,861
Less accumulated depreciation		<u>(9,263,284)</u>	<u>(368,256)</u>	<u>1,389,537</u>	<u>(8,242,003)</u>
		2,934,078	(204,124)	(134,096)	2,595,858
<u>Non-depreciable assets:</u>					
Construction work-in-progress		<u>70,065</u>	<u>124,411</u>	<u>(127,504)</u>	<u>66,972</u>
Electric plant in service, net		\$ <u>3,004,143</u>	\$ <u>(79,713)</u>	\$ <u>(261,600)</u>	\$ <u>2,662,830</u>

In 2015, Engine #7 was decommissioned due to unavailability of repair parts. The asset cost and accumulated depreciation have been written-off as of September 30, 2015, resulting in an impairment loss of \$134,096.

(6) Short-Term Borrowings

In the normal course of operations, KUA obtains short-term borrowings primarily for the purpose of funding the purchase of fuel. As of September 30, 2016 and 2015, KUA has a bank credit line amounting to \$200,000 bearing interest at 7.0% per annum, with interest payable monthly and principal balance due upon maturity, which is collateralized by certain eligible investment securities and existing and future business accounts receivable.

Short-term borrowings drawn down and repaid during the years ended September 31, 2016 and 2015 are as follows:

	<u>Outstanding October 1, 2015</u>	<u>Increase</u>	<u>Decrease</u>	<u>Outstanding September 30, 2016</u>
<u>2016</u>				
Bank line of credit	\$ <u>61</u>	\$ <u>100,000</u>	\$ <u>(100,061)</u>	\$ <u>-</u>
	<u>Outstanding October 1, 2014</u>	<u>Increase</u>	<u>Decrease</u>	<u>Outstanding September 30, 2015</u>
<u>2015</u>				
Bank line of credit	\$ <u>-</u>	\$ <u>150,000</u>	\$ <u>(149,939)</u>	\$ <u>61</u>

(7) Significant Suppliers

KUA purchased virtually all fuel from one supplier during the years ended September 30, 2016 and 2015.

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

Notes to Financial Statements
September 30, 2016 and 2015

(8) Contributions

Contributions for the years ended September 30, 2016 and 2015 are as follows:

	<u>2016</u>	<u>2015</u>
Capital Related:		
U.S. Government	\$ -	\$ 175,000
North Rep – SPC	<u>-</u>	<u>-</u>
	<u>\$ -</u>	<u>\$ 175,000</u>
Noncapital Related:		
U.S. Government	<u>\$ -</u>	<u>\$ 1,100</u>

(9) Commitments

Net position at September 30, 2016 and 2015 has been appropriated in the amounts of \$2,116,919 and \$2,016,919, respectively, for repair and maintenance and capital improvement projects. This process will continue in fiscal year 2017 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, 2016 and 2015 were \$3,428 and \$2,576, respectively. Management is of the opinion that the Plan does not represent an asset or liability of KUA. For the years ended September 30, 2016 and 2015, Plan assets were \$65,770 and \$54,629, respectively, with corresponding cash balances of \$61,195 and \$54,425, respectively.

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

Notes to Financial Statements
September 30, 2016 and 2015

(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.

As of September 30, 2016 and 2015, KUA has payables in the amount of \$71,760 to Kosrae State Government, which represents the cost of fuel purchased from Micronesia Petroleum Corporation, a component unit that closed down in 2009.

(13) Impairment Loss

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. As a result of existing conditions, KUA recorded a \$50,000 impairment loss associated with this investment.

(14) Subsequent Events

KUA withdrew \$100,000 from the existing line of credit facility in November 2016.

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, 2016, 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 8, 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.

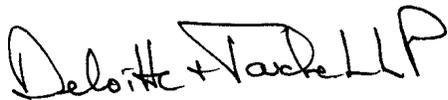
Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not 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 + Touche LLP". The signature is written in a cursive, flowing style.

June 8, 2017

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

Summary Schedule of Prior Year Findings and Questioned Costs
Year Ended September 30, 2016

There are no prior year findings or unresolved questioned costs of Kosrae Utilities Authority as of September 30, 2016.