



Report of Independent Auditors and
Consolidated Financial Statements with
supplementary information for

Kaua'i Island Utility Cooperative

December 31, 2011 and 2010

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Kaua'i Island Utility Cooperative

We have audited the accompanying consolidated balance sheets of Kaua'i Island Utility Cooperative (the Cooperative) as of December 31, 2011 and 2010 and the related consolidated statements of operations, equities and margins, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Cooperative's management. Our responsibility is to express an opinion on these consolidated 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 audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Cooperative as of December 31, 2011 and 2010 and the consolidated results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated April 20, 2012 on our consideration of the Cooperative's internal control over financial reporting and 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in conjunction with this report in considering the results of our audit.

Moss Adams LLP

Portland, Oregon
April 20, 2012

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**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED BALANCE SHEETS**

ASSETS

	December 31,	
	<u>2011</u>	<u>2010</u>
UTILITY PLANT		
Electric plant in service	\$ 410,001,917	\$ 396,023,652
Electric plant acquisition cost	54,852,453	54,852,453
Accumulated depreciation and amortization	<u>(230,027,434)</u>	<u>(221,234,482)</u>
Net electric plant in service	234,826,936	229,641,623
Construction work in progress	<u>18,406,091</u>	<u>11,789,712</u>
Net utility plant	<u>253,233,027</u>	<u>241,431,335</u>
OTHER PROPERTY AND INVESTMENTS		
Investments in associated organizations	637,759	609,781
Rural economic development loans	<u>555,446</u>	<u>636,961</u>
Total other property and investments	<u>1,193,205</u>	<u>1,246,742</u>
CURRENT ASSETS		
Cash and cash equivalents	3,520,986	5,622,851
Restricted cash and cash equivalents	546,548	463,644
Accounts and notes receivable, less allowance for doubtful accounts of \$454,699 and \$711,029 in 2011 and 2010, respectively	12,164,224	9,269,876
Accrued unbilled revenue	8,058,573	8,167,434
Energy rate adjustment clause	-	424,951
Inventories	14,032,643	14,217,398
Other current and accrued assets	<u>996,266</u>	<u>964,439</u>
Total current assets	<u>39,319,240</u>	<u>39,130,593</u>
DEFERRED DEBITS	<u>5,445,557</u>	<u>6,335,290</u>
Total assets	<u><u>\$ 299,191,029</u></u>	<u><u>\$ 288,143,960</u></u>

**KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED BALANCE SHEETS**

LIABILITIES, EQUITIES AND MARGINS

	December 31,	
	2011	2010
EQUITIES AND MARGINS	\$ 69,347,485	\$ 60,918,555
LONG-TERM DEBT, less current maturities	178,291,187	188,520,589
POST-RETIREMENT BENEFIT OBLIGATION	1,880,500	1,980,600
COMMITMENTS AND CONTINGENCIES (NOTE 11)		
CURRENT LIABILITIES		
Current maturities of long-term debt	9,661,000	9,261,000
Line of credit	8,700,000	-
Accounts payable	7,980,716	7,337,948
Energy rate adjustment clause	540,985	-
Consumer deposits	1,248,210	1,048,833
Accrued employee compensation	2,047,226	2,125,643
Accrued taxes	9,684,268	7,203,240
Other current and accrued liabilities	165,995	119,278
Total current liabilities	40,028,400	27,095,942
DEFERRED CREDITS	9,643,457	9,628,274
Total liabilities, equities and margins	\$ 299,191,029	\$ 288,143,960

KAUA'I ISLAND UTILITY COOPERATIVE

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,				Increase (Decrease)
	2011		2010		
	Amount	%	Amount	%	
OPERATING REVENUES					
Residential	\$ 69,031,915	37.8	\$ 58,599,648	37.8	\$ 10,432,267
Irrigation	33,626	0.0	35,886	0.0	(2,260)
Commercial and industrial	111,772,088	61.2	95,078,517	61.2	16,693,571
Public street and highway lighting	1,573,722	0.9	1,381,050	0.9	192,672
Other operating revenues	168,047	0.1	158,942	0.1	9,105
Total operating revenues	<u>182,579,398</u>	<u>100.0</u>	<u>155,254,043</u>	<u>100.0</u>	<u>27,325,355</u>
OPERATING EXPENSES					
Power cost	113,125,392	62.0	86,812,636	55.9	26,312,756
Transmission – operation	320,984	0.2	398,664	0.3	(77,680)
Transmission – maintenance	724,633	0.4	672,808	0.4	51,825
Distribution – operation	1,202,106	0.7	1,322,158	0.9	(120,052)
Distribution – maintenance	2,852,571	1.6	2,534,584	1.6	317,987
Customer accounts	2,549,349	1.4	2,511,538	1.6	37,811
Customer service and information	612,107	0.3	706,946	0.5	(94,839)
Administrative and general	14,766,674	8.1	14,152,002	9.1	614,672
Depreciation and amortization	13,372,215	7.3	14,595,414	9.4	(1,223,199)
Taxes	15,288,561	8.4	13,047,862	8.4	2,240,699
Other interest expense	130,754	0.1	163,876	0.1	(33,122)
Total operating expenses	<u>164,945,346</u>	<u>90.5</u>	<u>136,918,488</u>	<u>88.2</u>	<u>28,026,858</u>
OPERATING MARGINS, before interest	17,634,052	9.5	18,335,555	11.8	(701,503)
INTEREST ON LONG-TERM DEBT	<u>8,668,886</u>	<u>4.7</u>	<u>9,061,322</u>	<u>5.8</u>	<u>(392,436)</u>
OPERATING MARGINS	<u>8,965,166</u>	<u>4.8</u>	<u>9,274,233</u>	<u>6.0</u>	<u>(309,067)</u>
NONOPERATING MARGINS					
Interest income	552,980	0.3	637,917	0.4	(84,937)
Capital credits	29,665	0.0	40,015	0.0	(10,350)
Other nonoperating income	109,061	0.1	3,957	0.0	105,104
Total nonoperating margins	<u>691,706</u>	<u>0.4</u>	<u>681,889</u>	<u>0.4</u>	<u>9,817</u>
NET MARGINS	9,656,872	<u>5.2</u>	9,956,122	<u>6.4</u>	<u>\$ (299,250)</u>
COMPREHENSIVE INCOME (LOSS)					
Post-retirement benefit obligation gain	<u>(272,100)</u>		<u>150,866</u>		
COMPREHENSIVE INCOME	<u>\$ 9,384,772</u>		<u>\$ 10,106,988</u>		

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED STATEMENTS OF EQUITIES AND MARGINS

	Years Ended December 31,	
	<u>2011</u>	<u>2010</u>
Memberships		
Balance at January 1,	\$ 409	\$ 391
Additions	<u>19</u>	<u>18</u>
Balance at December 31,	<u>428</u>	<u>409</u>
Patronage capital		
Balance at January 1,	59,755,656	51,316,308
Transfer of net margins	9,656,872	9,956,122
Retirement of capital credits, net	<u>(1,028,712)</u>	<u>(1,516,774)</u>
Balance at December 31,	<u>68,383,816</u>	<u>59,755,656</u>
Other equity		
Balance at January 1,	120,990	61,044
Additions	<u>72,851</u>	<u>59,946</u>
Balance at December 31,	<u>193,841</u>	<u>120,990</u>
Post-retirement benefit obligation gain (loss)		
Balance at January 1,	1,041,500	890,634
Gain (loss)	<u>(272,100)</u>	<u>150,866</u>
Balance at December 31,	<u>769,400</u>	<u>1,041,500</u>
Total equities and margins	<u><u>\$ 69,347,485</u></u>	<u><u>\$ 60,918,555</u></u>

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net margins	\$ 9,656,872	\$ 9,956,122
Adjustments to reconcile net margins to net cash from operating activities		
Depreciation and amortization	13,727,445	14,914,143
Capital credits allocated	(29,665)	(40,015)
Change in assets and liabilities		
Accounts and notes receivable and unbilled revenue	(2,785,487)	209,757
Energy rate adjustment clause	965,936	52,011
Inventories and other current and accrued assets	152,928	(655,464)
Deferred debits	889,733	(445,760)
Post-retirement benefit obligation	(372,200)	(252,100)
Accounts payable, consumer deposits and accrued expenses	3,291,473	2,112,563
Deferred credits	15,183	(752,028)
Net cash from operating activities	<u>25,512,218</u>	<u>25,099,229</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to utility plant, net	(25,529,137)	(14,604,969)
Rural economic development loans	81,515	46,950
Other property and investments	1,687	7,807
Net cash from investing activities	<u>(25,445,935)</u>	<u>(14,550,212)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on long-term debt	(9,829,402)	(3,914,521)
Net activity on line of credit	8,700,000	(2,000,000)
Memberships	19	18
Other equity	72,851	59,946
Retirement of patronage capital	(1,028,712)	(1,516,774)
Net cash from financing activities	<u>(2,085,244)</u>	<u>(7,371,331)</u>
CHANGE IN CASH AND CASH EQUIVALENTS	(2,018,961)	3,177,686
CASH AND CASH EQUIVALENTS, beginning of year	<u>6,086,495</u>	<u>2,908,809</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 4,067,534</u>	<u>\$ 6,086,495</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for		
Interest on long-term debt	<u>\$ 8,668,886</u>	<u>\$ 9,061,322</u>
Income taxes	<u>\$ 5,012</u>	<u>\$ 4,114</u>

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Nature of Organization and Operations

Kaua'i Island Utility Cooperative (KIUC or the Cooperative), a not-for-profit cooperative association pursuant to the provisions of Chapter 421C of the Hawaii Revised Statutes, was formed to purchase and operate the electric utility on the island of Kaua'i, Hawaii. KIUC is the exclusive retail electric service provider for the island of Kaua'i and provides electric generation, transmission and distribution services to approximately 36,000 customers. The Cooperative's headquarters facility is located in Lihue, Hawaii.

On November 1, 2002, the Cooperative acquired substantially all of the assets of Kaua'i Electric (KE), a division of Citizens Communications Company (Citizens). The aggregate purchase price was approximately \$218 million, which included transaction costs incurred in the acquisition, and was financed by lines of credit from the National Rural Utilities Cooperative Finance Corporation (CFC) and loans from the U.S. government.

On October 10, 2011, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions One LLC (KRS One). KRS One is a Delaware limited liability company that has elected to be treated as a corporation for federal tax purposes. KRS One was created to construct, own, and operate a photovoltaic (PV) facility for the purpose of selling the renewable energy produced by the PV facility to the Cooperative for use in the Cooperative's operations.

The accompanying consolidated financial statements reflect the financial position and results of operations for the Cooperative and its wholly owned subsidiary KRS One. See Note 2 principles of consolidation for further discussion on consolidation.

Note 2 – Summary of Significant Accounting Policies

Principles of consolidation – The consolidated financial statements include the accounts of the Cooperative and its wholly owned subsidiary, KRS One. The consolidation of the Cooperative and KRS One eliminated all inter-company transactions and balances. See supplemental information for details on the elimination of inter-company transactions and balances.

Basis of accounting and presentation – The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as applied to regulated enterprises, which conform to policies prescribed or permitted by the Hawaii Public Utilities Commission (HPUC) and the United States Department of Agriculture, Rural Utilities Service (RUS).

The accounting records of the Cooperative are maintained in accordance with the Uniform System of Accounts as prescribed by the Federal Energy Regulatory Commission (FERC) for Class A and B electric utilities.

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Regulatory accounting – Due to regulation of its rates by the HPUC, the Cooperative follows regulatory accounting requirements. Regulatory accounting requirements recognize that the ratemaking process can result in differences in the application of generally accepted accounting principles between regulated and non-regulated businesses. Such differences generally involve the accounting period in which various transactions enter into the determination of net margins. Accordingly, certain costs and income may be capitalized as a regulatory asset or liability that would otherwise be charged to expense or revenues. Regulatory assets and liabilities are recorded when it is probable that future rates will permit recovery and are approved by the HPUC (see Notes 6 and 10). Such balances are amortized over the period specified by the HPUC.

In accordance with an HPUC Decision & Order, KIUC is allowed recovery of depreciation expense not realized due to the early retirement of an electric plant destroyed in hurricane Iniki. In 1996, the HPUC approved \$7,598,760 as the total amount of Iniki deferred depreciation with an amortization period of 26 years. The annual amortization amount is \$292,260 ending in 2022. The Iniki regulatory asset is amortized to depreciation expense and the offsetting Iniki regulatory liability is amortized to accumulated depreciation.

Membership – In accordance with KIUC's bylaws, all electricity users can elect whether or not to become a member. Each member is entitled to one vote regardless of billing amounts.

Patronage capital – Net margins are assigned to individual Cooperative members' capital credit accounts based upon their pro rata use of total Cooperative electricity provided for the year (see Note 7). Capital credits are returned to members in accordance with the Cooperative's policies. Under the provisions of the mortgage agreements, until the equities and margins equal or exceed 30% of the total assets of the Cooperative, the return to patrons of capital contributed by them is limited generally to 25% of the patronage capital or margins received by the Cooperative in the prior calendar year. The equities and margins of the Cooperative represent 23.18% and 21.14% of the total assets at December 31, 2011 and 2010, respectively. Under the provisions of the 2010 HPUC approved rate case, subject to the loan agreements, KIUC is required to return patronage capital for amounts exceeding a 2.00 TIER in a given year.

Electric plant, acquisition cost, depreciation, and maintenance – Electric plant is stated at the original cost of construction, which includes the cost of contracted services, direct labor and materials, and overhead items (see Note 3). Contributions from others toward the construction of electric plant are credited to the applicable plant accounts.

In accordance with RUS accounting regulations, electric plant acquisition cost represents the difference between the purchase price for the acquisition of KE's assets and the carrying value of those assets. This amount is being amortized over the remaining useful life of the assets acquired which was originally estimated to be 25 years.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Provision has been made for depreciation of electric plant at a straight-line composite rate of approximately 2.9% per annum. A depreciation study was conducted in March 2009 and was approved by the HPUC in 2010. The effective date of the new depreciation rates was June 1, 2010. Depreciation for the years ended December 31, 2011 and 2010 was \$13,727,445 and \$14,914,143, respectively, of which \$13,372,215 and \$14,595,414 was charged to depreciation and amortization expense and \$355,230 and \$318,729 was allocated to other accounts, respectively.

When property which represents a retirement unit is replaced or removed, the average cost of such property as determined from the continuing property records is credited to electric plant and such cost, together with cost of removal less salvage, is charged to the accumulated provision for depreciation.

Maintenance and repairs, including the renewal of minor items of plant not comprising a retirement unit, are charged to the appropriate maintenance accounts, except that repairs of transportation and service equipment are charged to clearing accounts and redistributed to operating expense and capital accounts.

Management assesses impairment and the existence of asset retirement obligations annually and as circumstances warrant.

Investments in associated organizations – Investments in associated organizations are carried at cost (see Note 4), which approximates fair value, plus capital credits allocated and not retired.

Rural economic development loans – The Cooperative has received Rural Economic Development Grants (RED Grant) from the USDA Rural Development (USDA RD) Office in order to provide loans to promote sustainable rural economic development and job creation projects. KIUC is required to match 20% of the RED Grant award. The RED Grant is awarded to KIUC, who in turn loans the funds to the eligible project applicant at 0% interest for a term of up to ten years. When the loan recipient repays the loan, the loan funds are retained and placed into the Revolving Loan Fund (RLF) and then reused to fund new loans to additional projects (RLF Loans). The RLF Loans are made in accordance with the USDA RD approved Revolving Loan Fund Plan Loan Policies and Procedures Manual. Both the RED Grant loans and the RLF loans are stated at cost (see Note 4).

Cash equivalents – The Cooperative considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Restricted cash – Cash restricted for rural economic development loans.

Accounts and notes receivable – Accounts and notes receivable are recorded when invoices are issued and are written off when they are determined to be uncollectible. The allowance for doubtful accounts is estimated considering the Cooperative's historical losses, review of specific problem accounts, existing economic conditions and the financial stability of its customers, currently 0.1% of monthly operating revenues. Generally, the Cooperative considers accounts receivable past due after 44 days.

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Inventories – Materials and supplies inventories consist primarily of items for construction and maintenance of electric plant and are valued at average unit cost. Fuel inventories consist of naphtha and diesel fuel for the generation units and are valued at lower of cost or current market (see Note 5).

Accrued vacation – The Cooperative accrues accumulated unpaid vacation as the obligation is incurred. Compensated absences are included in “accrued employee compensation.”

Customer advances for construction – Customer advances for construction represent advances for construction jobs that the customer requested, such as line extensions. The customer advance is held in a deferred credit account until the requirements have been met, at which time the advance, or applicable proportion of the advance, is refunded. If the requirements are not met within a five year time period, the advance is forfeited by the customer and credited to electric plant.

Overhaul accounting – In accordance with an HPUC Decision & Order, KIUC accrues for overhaul costs on the generation equipment by charging a proportion of the estimated cost of the overhaul, over the period covered by the overhaul cycle, to maintenance expense. The overhaul cycle for the individual generation units vary based on the type of unit and hours of use. For most generation units, the typical overhaul cycle is every two to five years. When the overhaul occurs, the actual costs are charged against the overhaul deferred credit (regulatory liability – scheduled plant maintenance), with any leftover being charged to maintenance expense (see Note 10).

Post-retirement benefits – KIUC sponsors a Retiree Welfare Benefit Plan (the Plan). The Cooperative accounts for the Plan by reporting the current economic status (the overfunded or underfunded status) of the Plan in the balance sheet and measuring the plan assets and plan obligations as of the balance sheet date (see Note 13).

Taxes – The Cooperative is exempt from federal income taxes under the provisions of Section 501(c)(12) of the Internal Revenue Code, except to the extent of unrelated business income, if any. Effective January 1, 2009, the Cooperative adopted Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740-10, relating to accounting for uncertain tax positions. As of December 31, 2011 and 2010, the Cooperative does not have any uncertain tax positions. The Cooperative files an exempt organization tax return in the U.S. federal jurisdiction and is no longer subject to examination by taxing authorities before 2008.

KIUC is not exempt under Hawaii Revised Statutes from state income taxes; however, margins that are allocated within a specific time period are considered a deduction for state income tax purposes. For the State of Hawaii, KIUC is assessed a 5.885% of gross revenues PSC Tax in lieu of general excise taxes and county real property taxes. Also, KIUC is assessed a 0.5% of gross revenues PUC Fee. For the County of Kaua'i, Hawaii, KIUC is assessed a 2.5% franchise fee on gross revenues.

Electric revenues and unbilled revenue – KIUC recognizes revenues based on rates (tariffs) authorized by the HPUC including unbilled revenue, revenue from electric power delivered but not yet billed to the customers.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

The Cooperative's tariffs for electric service include energy rate adjustment clauses under which billings to customers are adjusted to reflect changes in the cost of fuel. In order to match power costs and related revenues, under-collected or over-collected power costs to be billed or credited to consumers in subsequent periods is recognized as a current asset or current liability and as an increase or decrease of classified operating revenues on the statement of operations.

Cushion of credit – RUS established a Cushion of Credit Payment Program, whereby borrowers may make advance payments on their RUS and FFB notes. These advance payments earn interest at the rate of 5.0% per annum. The advance payments, plus any accrued interest, can only be used for the payment of principal and interest on the notes. The Cooperative's participation in the Cushion of Credit Payment Program totaled approximately \$10.7 million and \$10.2 million at December 31, 2011 and 2010, respectively, and is recorded as a reduction of RUS long-term debt on the consolidated balance sheets.

Environmental matters – KIUC is subject to federal, state and local environmental laws. These laws regulate the discharge of materials into the environment and may require KIUC to mitigate the effects of a release of a hazardous substance. Environmental matters are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. In general, costs related to environmental matters are charged to expense. Environmental costs are capitalized if the costs increase the value of the property and/or prevent or mitigate contamination from future operations. Although the level of future expenditures for environmental matters is difficult to determine, it is management's opinion that such costs when determined will not have a material adverse effect on KIUC's financial condition. Accordingly, no provision has been included in the accompanying consolidated financial statements.

Concentration of credit risk – Financial instruments that are exposed to concentrations of credit risk consist primarily of cash, including other investments, and receivables.

The Cooperative maintains its cash in deposit accounts in various financial institutions and its other investments in highly rated securities. At times these balances exceed federally insured limits.

Credit is extended to customers generally without collateral requirements; however, the Cooperative requires a deposit from some members upon connection, which is applied to unpaid bills and fees in the event of default. The deposit accrues interest annually and is returned along with accrued interest periodically. In addition, formal shut-off procedures are in place.

Use of estimates – The preparation of consolidated 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates include the allowance for doubtful accounts, unbilled revenue, overhaul deferrals, the post-retirement benefit obligation and depreciation of electric plant. Actual results could differ from those estimates.

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Summary of Significant Accounting Policies (continued)

Subsequent events – The Cooperative has evaluated subsequent events through April 20, 2012, the date the consolidated financial statements were available to be issued (see Note 14).

Note 3 – Electric Plant in Service

The major classes of electric plant in service are as follows at December 31:

	<u>2011</u>	<u>2010</u>
Production plant	\$ 146,919,566	\$ 143,560,793
Transmission plant	73,635,610	72,593,896
Distribution plant	162,518,492	153,022,034
General plant	<u>26,928,249</u>	<u>26,846,929</u>
Total electric plant in service	<u><u>\$ 410,001,917</u></u>	<u><u>\$ 396,023,652</u></u>

Note 4 – Other Property and Investments

Other property and investments consisted of the following at December 31:

	<u>2011</u>	<u>2010</u>
Investments in associated organizations (CFC)		
Capital term certificates, interest from 0% to 7.5% maturing through 2044 or consistent with the related debt (see Note 8)	\$ 502,716	\$ 488,775
Patronage capital	130,819	119,122
Membership/other	<u>4,224</u>	<u>1,884</u>
	<u><u>\$ 637,759</u></u>	<u><u>\$ 609,781</u></u>
Rural economic development loans		
National Tropical Botanical Gardens	\$ 237,500	\$ 271,875
Island School	253,125	290,625
Hale Opio	<u>64,821</u>	<u>74,461</u>
	<u>555,446</u>	<u>636,961</u>
Total other property and investments	<u><u>\$ 1,193,205</u></u>	<u><u>\$ 1,246,742</u></u>

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 – Inventories

Inventories consisted of the following at December 31:

	<u>2011</u>	<u>2010</u>
Materials and supplies	\$ 12,370,029	\$ 12,794,598
Fuel	<u>1,662,614</u>	<u>1,422,800</u>
Total inventories	<u><u>\$ 14,032,643</u></u>	<u><u>\$ 14,217,398</u></u>

Note 6 – Deferred Debits

Deferred debits consisted of the following at December 31:

	<u>2011</u>	<u>2010</u>
Regulatory asset – Iniki damage	\$ 3,141,732	\$ 3,433,992
Regulatory asset – post-retirement transition	68,961	137,949
Regulatory asset – demand-side management (DSM) and integrated resource plan (IRP)	(20,226)	(51,933)
Regulatory asset – rate case	-	859,500
Preliminary survey and investigation	1,924,008	1,419,628
Other deferred debits	<u>331,082</u>	<u>536,154</u>
Total deferred debits	<u><u>\$ 5,445,557</u></u>	<u><u>\$ 6,335,290</u></u>

Note 7 – Patronage Capital

Patronage capital consisted of the following at December 31:

	<u>2011</u>	<u>2010</u>
Assigned	\$ 76,752,727	\$ 66,796,605
Assignable	<u>9,656,872</u>	<u>9,956,122</u>
	86,409,599	76,752,727
Less: Retired	<u>(18,025,783)</u>	<u>(16,997,071)</u>
Total patronage capital	<u><u>\$ 68,383,816</u></u>	<u><u>\$ 59,755,656</u></u>

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 – Long-Term Debt

The Cooperative has long-term debt due to Rural Utilities Services (RUS), National Rural Utilities Cooperative Finance Corporation (CFC) and the Federal Financing Bank (FFB). Substantially all assets of the Cooperative are pledged as security for the long-term debt and the notes are subject to certain covenants.

Following is a summary of long-term debt at December 31:

	2011	2010
Fixed and variable notes payable due to RUS in monthly installments of principal and interest with rates ranging from 3.125% to 4.875%, maturing October 31, 2027.	\$ 168,614,673	\$ 175,908,136
Fixed and variable notes payable due to FFB in quarterly installments of principal and interest with rates ranging from 2.712% to 4.305%, maturing December 31, 2023.	24,629,796	26,221,746
Fixed note payable due to CFC in quarterly installments of principal and interest at a rate of 3.108%, maturing September 30, 2023.	5,431,715	5,806,223
RUS/FFB advance payments (cushion of credit)	(10,723,997)	(10,154,516)
Total long-term debt	187,952,187	197,781,589
Less current maturities	(9,661,000)	(9,261,000)
Long-term debt, less current maturities	\$ 178,291,187	\$ 188,520,589

Maturities of long-term debt for the next five years and thereafter are as follows:

2012	\$ 9,661,000
2013	10,065,172
2014	15,369,838
2015	10,479,426
2016	10,923,772
Thereafter	131,452,979
	\$ 187,952,187

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 – Long-Term Debt (continued)

The carrying value for variable rate debt is considered fair value due to the frequency of repricing. The fair market value of the Cooperative's fixed rate long-term debt is determined using currently quoted or offered rates for similar issues.

	Carrying Value	Fair Value
	<u> </u>	<u> </u>
December 31, 2011	\$ 198,676,184	\$ 129,187,782
December 31, 2010	\$ 207,936,104	\$ 112,874,144

Note 9 – Line of Credit

The Cooperative has a perpetual \$60,000,000 disaster line of credit, a perpetual \$5,000,000 line of credit for short-term financing, and a 3-year \$20,000,000 line of credit for construction financing with CFC all at a variable interest rate. The lines are secured by substantially all Cooperative assets and subject to termination provisions and certain covenants. The total balance outstanding was \$8,700,000 at December 31, 2011. There was no balance outstanding at December 31, 2010.

Note 10 – Deferred Credits

Deferred credits consisted of the following:

	2011	2010
	<u> </u>	<u> </u>
Rural economic development grant	\$ 921,927	\$ 920,539
Customer advances for construction	3,466,422	3,664,968
Regulatory liability – Iniki	3,141,732	3,433,992
Regulatory liability – Scheduled plant maintenance	2,113,376	1,608,775
	<u>\$ 9,643,457</u>	<u>\$ 9,628,274</u>

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11 – Litigation, Commitments, and Contingencies

Litigation – In March 2007, the Cooperative was notified by the Environment and Natural Resources Division of the U.S. Department of Justice that it was the target of an investigation into the taking of migratory birds. This investigation was conducted by the U.S. Fish and Wildlife Service in conjunction with the U.S. Department of Justice with the cooperation of the U.S. Attorney's office for the District of Hawaii. This suit was settled in December 2010 with the Cooperative paying a \$40,000 fine, making a \$225,000 donation and agreeing to approximately \$11 million in future mitigation efforts.

In the normal course of business, the Cooperative is a party to claims and matters of litigation. The ultimate outcome of these matters cannot presently be determined; however, in the opinion of management of the Cooperative, the resolution of these matters will not have a material adverse effect on the Cooperative's financial position, results of operations or liquidity.

Fuel contract – As a result of the purchase of KE assets, Citizens assigned to KIUC a fuel supply contract with an international oil refining company that is renewable for 12-month periods unless terminated by KIUC or the supplier; 99.1% of KIUC's fuel is obtained through this supply contract. The price is adjusted monthly to equal a published price, as defined, plus other defined costs such as terminal and freight costs. Fuel costs under this contract for the years ended December 31, 2011 and 2010 were \$89,769,233 and \$68,115,764, respectively. The contract was renegotiated and signed December 2011, with an effective date of April 1, 2012.

Power supply – Most of KIUC's power is generated using diesel and naphtha generating units. In addition, KIUC maintains various power supply agreements to purchase power from hydroelectric and photovoltaic projects. The terms of the agreements vary and include termination provisions.

In 2011, the Cooperative installed a 41kW roof solar photovoltaic system on its Port Allen maintenance shop roof. In addition, the Cooperative installed 16 utility pole mount solar photovoltaic panels which generate a total of 3 kW.

In 2011, the Cooperative created a wholly owned subsidiary, KIUC Renewable Solutions One LLC (KRS One). KRS One is developing a 12 MW solar photovoltaic facility with an integrated Battery Energy Storage System and associated interconnection facilities on a 55 acre parcel of land leased from the State of Hawaii, Department of Hawaiian Home Lands located in Anahola, Kauai, Hawaii. The output of the project is expected to provide 12 MW of peak power for the electric system on Kauai, an amount that represents about 5% of total energy consumption and would power approximately 4,000 homes. The solar project is being built for KRS One under an Engineering Procurement and Construction contract with REC Solar, Inc. and is expected to be placed in service in the summer of 2013. This project is estimated to have a 25 year life.

In 2011, the Cooperative signed an agreement with McBryde Sugar Company, Limited, to purchase power from its proposed 6 MW solar photovoltaic facility, which is planned to be constructed in 2012 / 2013. This contract has a term of 20 years.

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11 – Litigation, Commitments, and Contingencies (continued)

In 2011, the Cooperative signed an agreement with MP2 Hawaii Solar I, LLC, to purchase power from its proposed 300kW photovoltaic facility, which is planned to be constructed in 2012 / 2013. This contract has a term of 20 years.

Union contract – KIUC has an agreement with one union. In December 2010, the Cooperative negotiated a new contract with the union. As of December 31, 2011, 60% of the positions and 62% of the employees were covered by the union contract. The agreement expires in December 2015.

Operating lease – KIUC leases their headquarters under a non-cancelable operating lease which expires in 2020 and contains options to extend the term up to an additional 25 years. The lease also includes an option to purchase the landlord's interest, as defined, in the year 2025. As of December 31, 2011, the future minimum rental commitment under this lease is as follows:

2012	\$ 1,077,000
2013	1,077,000
2014	1,077,000
2015	1,077,000
2016	1,020,000
Thereafter	<u>4,080,000</u>
	<u>\$ 9,408,000</u>

In addition to the amounts above, the Cooperative is responsible for common area maintenance costs, real property taxes and other reimbursable operating expenses. Rent expense for the years ended December 31, 2011 and 2010 was \$1,310,312 and \$1,402,512, respectively.

Note 12 – Pension Benefits

Substantially all employees of the Cooperative participate in the National Rural Electric Cooperative Association (NRECA) Retirement & Security Program (a defined benefit plan) and the 401(k) Savings Plan (a defined contribution plan). The plans are qualified as tax exempt under the Internal Revenue Code. In these multi-employer plans, which are available to all NRECA member cooperatives, the accumulated benefits and plan assets are not determined or allocated separately by the individual employer.

The Cooperative makes monthly contributions to the Retirement & Security Plan equal to the amounts accrued for pension expense. In response to impacts from the economic crisis, there was an increase in the required contribution rate in 2010. The pension cost for the Cooperative for the years ended December 31, 2011 and 2010 was \$2,761,775 and \$2,686,922, respectively.

The pension cost for the 401(k) Savings Plan was \$471,586 and \$488,334 for the years ended December 31, 2011 and 2010, respectively.

KAUA'I ISLAND UTILITY COOPERATIVE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 – Post-Retirement Benefits

The KIUC Retiree Welfare Benefit Plan (the Plan) and its associated trust, the KIUC Retiree Welfare Benefit Trust (the Trust), were adopted effective January 1, 2003. The Plan provides certain non-contributory medical (which includes a dollar cap, for which retirees pay back KIUC for amounts exceeding the cap), dental, vision and life insurance benefits for retired employees, their beneficiaries and covered dependents.

Benefits are paid on behalf of retirees and are a function of medical insurance costs and number of retirees. Benefits paid for the years ended December 31, 2011 and 2010 were \$332,403 and \$303,849, respectively.

The measurement date for the current valuation is December 31, 2011.

Assumptions:

The actuarial cost method used for the valuation is the projected unit credit cost method.

Weighted-average assumptions used to determine the net periodic benefit cost for year ended December 31, 2011:

- Discount rate: 6.0%
- Expected long-term return on plan assets: 2.65% (based on the five-year performance of the funds, weighted by market value as of December 31, 2010)
- Health care cost trend rate assumed for next year: 7.5%
- Rate to which the cost trend rate is assumed to decline (the ultimate trend rate): 5.0% in 2017

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 – Post-Retirement Benefits (continued)

	<u>2011</u>	<u>2010</u>
I) Net post-retirement benefit cost		
Service cost	\$ -	\$ -
Interest cost	291,200	297,500
Expected return on plan assets	(86,800)	(66,800)
Amortization of actuarial gain	<u>(171,900)</u>	<u>(88,800)</u>
Net post-retirement benefit cost	<u>\$ 32,500</u>	<u>\$ 141,900</u>
II) Accumulated post-retirement benefit obligation (APBO)		
APBO balance at the beginning of year	\$ (5,256,800)	\$ (5,353,300)
Other	(258,601)	(125,922)
Net post-retirement benefit cost	(32,500)	(141,900)
Benefits paid	<u>404,601</u>	<u>364,322</u>
Net post-retirement benefit obligation at year-end	<u>\$ (5,143,300)</u>	<u>\$ (5,256,800)</u>
III) Reconciliation of funded status		
APBO	\$ (5,143,300)	\$ (5,256,800)
Assets funded	<u>3,262,800</u>	<u>3,276,200</u>
Accrued post-retirement benefit cost	<u>\$ (1,880,500)</u>	<u>\$ (1,980,600)</u>
IV) Accumulated other comprehensive (gain) loss		
Unrecognized prior service cost	\$ (1,041,500)	\$ (890,634)
Other comprehensive loss (gain)	<u>272,100</u>	<u>(150,866)</u>
Accumulated other comprehensive gain	<u>\$ (769,400)</u>	<u>\$ (1,041,500)</u>

The following benefit payments, which reflect expected future service as appropriate, are expected to be paid:

2012	\$ 402,800
2013	417,600
2014	423,300
2015	397,700
2016	381,800
2017 – 2021	1,831,900

The Plan has been partially funded as of December 31, 2011. The Plan assets are held in the Trust and are invested in the Central Pacific Bank's Trust Division at December 31, 2011.

KAUA'I ISLAND UTILITY COOPERATIVE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 – Post-Retirement Benefits (continued)

The Plan assets are managed by a trustee and are authorized to be held in various equity and fixed income investments and cash equivalents. The trustee is not allowed to invest in real estate or any other investment other than those noted in the investment policy. The investing strategy is long-term with a focus on moderate volatility and moderate growth investments. All investments at December 31, 2011 and 2010 were level one investments as outlined in the fair value hierarchy as they have quoted prices in active markets for identical assets. The following table shows the investment allocation for Plan assets.

	2011		2010	
Cash and other accrued income	\$ 3,677	0%	\$ 5,143	0%
Mutual funds	1,405,881	43%	3,123,567	95%
Bonds	194,760	6%	147,821	5%
Fixed Income	958,844	29%	-	0%
Equities	699,658	22%	-	0%
Due to brokers	(20)	0%	(331)	0%
	\$ 3,262,800		\$ 3,276,200	

Note 14 – Subsequent Event

RUS FFB C8 Note – On September 24, 2010, The Rural Utilities Service (RUS) approved a loan guarantee commitment for the Cooperative in the amount of \$109,968,000 to finance system extensions and additions. Under this commitment, RUS will guarantee a loan of \$109,968,000 to the Cooperative from the Federal Financing Bank (FFB). As required by Hawaii Revised Statutes (HRS) §269, all financing and security arrangements by the Cooperative must be approved by the Hawaii Public Utility Commission (HPUC). On August 25, 2011, the HPUC issued their Decision and Order approving the Cooperative to enter into the financing and security arrangements with RUS for purpose of securing a loan in the amount of \$41,968,000. The remaining \$68,000,000 of the RUS loan guarantee commitment will be documented as a separate loan at a later date. On March 9, 2012, the fully executed and recorded RUS and FFB loan documents for the \$41,968,000 loan were submitted to RUS and CFC for finalization of the loan closing process.

KAUA'I ISLAND UTILITY COOPERATIVE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 14 – Subsequent Event (continued)

Member complaint filed with the U.S. District Court – On March 16, 2012, a member filed a complaint with the U.S. District Court in Honolulu requesting an injunction to prevent KIUC from moving forward with its rollout of smart meters. The complaint filed against KIUC asks the court to stop KIUC's installation of smart meters, require KIUC to use an "opt-in" system for future installations of smart meters, and have all KIUC members subsidize the expense associated with maintaining two separate metering systems. The cooperative had already informed the members, prior to the filing of the complaint, that it will indefinitely defer installation of smart meters for the small number of members who are opposed to the technology and submit a formal request. Under the deferred installation plan, each member will receive two weeks' notice prior to installation, and will be given clear instructions for notifying KIUC if they would like to defer. KIUC will take time to assess the situation with the few who defer and determine the most appropriate long-term solution without delaying the efficiency and cost control benefits of this technology to the majority of members. The smart meters to be deployed by KIUC will transmit data to the cooperative using encryption technology. KIUC will use the information to more efficiently manage its system, troubleshoot problems, and help members manage their electricity usage. The complaint, which closely mirrors a similar action filed against the city of Naperville, Ill., cites security and privacy concerns as the basis for its claims. KIUC intends to promptly and vigorously defend against this action, and is advised by counsel that as the complaint is presently drafted it is likely subject to dismissal for failure to state a legally cognizable claim against KIUC. KIUC intends to immediately challenge the complaint on this basis.

SUPPLEMENTAL INFORMATION

REPORT OF INDEPENDENT AUDITORS ON SUPPLEMENTARY INFORMATION

Board of Directors
Kaua'i Island Utility Cooperative

Our report on our audits of the consolidated financial statements of Kaua'i Island Utility Cooperative (the Cooperative) as of and for the years ended December 31, 2011 and 2010 appears on page 1. Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The additional supplementary information is also not a required part of the basic financial statements, but is supplemental information presented for the purposes of additional analysis. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

Moss Adams LLP

Portland, Oregon
April 20, 2012

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KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING BALANCE SHEETS
DECEMBER 31, 2011

	KIUC	KRS One	Eliminations	KIUC Consolidated
UTILITY PLANT				
Electric plant in service	\$ 410,001,917	\$ -	\$ -	\$ 410,001,917
Electric plant acquisition cost	54,852,453	-	-	54,852,453
Accumulated depreciation and amortization	<u>(230,027,434)</u>	<u>-</u>	<u>-</u>	<u>(230,027,434)</u>
Net electric plant in service	234,826,936	-	-	234,826,936
Construction work in progress	<u>13,452,399</u>	<u>4,953,692</u>	<u>-</u>	<u>18,406,091</u>
Net utility plant	<u>248,279,335</u>	<u>4,953,692</u>	<u>-</u>	<u>253,233,027</u>
OTHER PROPERTY AND INVESTMENTS				
Investments in subsidiary companies	5,593,493	-	(5,593,493)	-
Investments in associated organizations	637,759	-	-	637,759
Rural economic development loans	<u>555,446</u>	<u>-</u>	<u>-</u>	<u>555,446</u>
Total other property and investments	<u>6,786,698</u>	<u>-</u>	<u>(5,593,493)</u>	<u>1,193,205</u>
CURRENT ASSETS				
Cash and cash equivalents	2,881,185	639,801	-	3,520,986
Restricted cash and cash equivalents	546,548	-	-	546,548
Accounts and notes receivable, less allowance for doubtful accounts of \$454,699 and \$711,029 in 2011 and 2010, respectively	12,164,224	-	-	12,164,224
Accrued unbilled revenue	8,058,573	-	-	8,058,573
Energy rate adjustment clause	-	-	-	-
Inventories	14,032,643	-	-	14,032,643
Other current and accrued assets	<u>996,266</u>	<u>-</u>	<u>-</u>	<u>996,266</u>
Total current assets	<u>38,679,439</u>	<u>639,801</u>	<u>-</u>	<u>39,319,240</u>
DEFERRED DEBITS				
	<u>5,445,557</u>	<u>-</u>	<u>-</u>	<u>5,445,557</u>
Total assets	<u>\$ 299,191,029</u>	<u>5,593,493</u>	<u>(5,593,493)</u>	<u>299,191,029</u>

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING BALANCE SHEETS
DECEMBER 31, 2011

	KIUC	KRS One	Eliminations	KIUC Consolidated
EQUITIES AND MARGINS	\$ 69,347,485	\$ (31,560)	\$ 31,560	\$ 69,347,485
LONG-TERM DEBT, less current maturities	178,291,187	5,618,493	(5,618,493)	178,291,187
POST-RETIREMENT BENEFIT OBLIGATION	1,880,500	-	-	1,880,500
COMMITMENTS AND CONTINGENCIES (NOTE 11)				
CURRENT LIABILITIES				
Current maturities of long-term debt	9,661,000	-	-	9,661,000
Line of credit	8,700,000	-	-	8,700,000
Accounts payable	7,980,716	-	-	7,980,716
Energy rate adjustment clause	540,985	-	-	540,985
Consumer deposits	1,248,210	-	-	1,248,210
Accrued employee compensation	2,047,226	-	-	2,047,226
Accrued taxes	9,684,268	-	-	9,684,268
Other current and accrued liabilities	165,995	6,560	(6,560)	165,995
Total current liabilities	40,028,400	6,560	(6,560)	40,028,400
DEFERRED CREDITS	9,643,457	-	-	9,643,457
Total liabilities and equities	\$ 299,191,029	\$ 5,593,493	\$ (5,593,493)	\$ 299,191,029

KAUA'I ISLAND UTILITY COOPERATIVE
CONSOLIDATING STATEMENT OF OPERATIONS
YEAR ENDED DECEMBER 31, 2011

	KIUC	KRS One	Eliminations	KIUC Consolidated
OPERATING REVENUES				
Residential	\$ 69,031,915	\$ -	\$ -	\$ 69,031,915
Irrigation	33,626	-	-	33,626
Commercial and industrial	111,772,088	-	-	111,772,088
Public street and highway lighting	1,573,722	-	-	1,573,722
Other operating revenues	168,047	-	-	168,047
Total operating revenues	<u>182,579,398</u>	<u>-</u>	<u>-</u>	<u>182,579,398</u>
OPERATING EXPENSES				
Power cost	113,100,392	25,000	-	113,125,392
Transmission – operation	320,984	-	-	320,984
Transmission – maintenance	724,633	-	-	724,633
Distribution – operation	1,202,106	-	-	1,202,106
Distribution – maintenance	2,852,571	-	-	2,852,571
Customer accounts	2,549,349	-	-	2,549,349
Customer service and information	612,107	-	-	612,107
Administrative and general	14,766,674	-	-	14,766,674
Depreciation and amortization	13,372,215	-	-	13,372,215
Taxes	15,288,561	-	-	15,288,561
Other interest expense	130,754	6,560	(6,560)	130,754
Total operating expenses	<u>164,920,346</u>	<u>31,560</u>	<u>(6,560)</u>	<u>164,945,346</u>
OPERATING MARGINS, before interest	17,659,052	(31,560)	6,560	17,634,052
INTEREST ON LONG-TERM DEBT	<u>8,668,886</u>	<u>-</u>	<u>-</u>	<u>8,668,886</u>
OPERATING MARGINS	<u>8,990,166</u>	<u>(31,560)</u>	<u>6,560</u>	<u>8,965,166</u>
NONOPERATING MARGINS				
Interest income	559,540	-	(6,560)	552,980
Capital credits	29,665	-	-	29,665
Other nonoperating income	77,501	-	31,560	109,061
Total nonoperating margins	<u>666,706</u>	<u>-</u>	<u>25,000</u>	<u>691,706</u>
NET MARGINS	9,656,872	(31,560)	31,560	9,656,872
COMPREHENSIVE INCOME				
Post-retirement benefit obligation gain	<u>(272,100)</u>	<u>-</u>	<u>-</u>	<u>(272,100)</u>
COMPREHENSIVE INCOME	<u>\$ 9,384,772</u>	<u>\$ (31,560)</u>	<u>\$ 31,560</u>	<u>\$ 9,384,772</u>

REPORT REQUIRED BY GOVERNMENT AUDITING STANDARDS

REPORT OF INDEPENDENT AUDITORS 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*

To the Board of Directors
Kaua'i Island Utility Cooperative

We have audited the consolidated financial statements of Kaua'i Island Utility Cooperative (the Cooperative) as of and for the year ended December 31, 2011 and have issued our report thereon dated April 20, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit of the consolidated financial statements of the Cooperative as of and for the year ended December 31, 2011, in accordance with auditing standards generally accepted in the United States of America, we considered the Cooperative's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Cooperative's internal control. Accordingly, we do not express an opinion on the effectiveness of the Cooperative'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 consolidated financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

**REPORT OF INDEPENDENT AUDITORS 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*
(continued)**

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Cooperative's consolidated financial statements are free of 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 consolidated 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*.

We noted certain matters that we reported to the Cooperative's Board of Directors and management in a presentation.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service and supplemental lenders and is not intended to be and should not be used by anyone other than these specified parties.

Moss Adams LLP

Portland, Oregon
April 20, 2012