

KAUAI ISLAND UTILITY COOPERATIVE

LIHUE, HAWAII

FINANCIAL STATEMENTS WITH ACCOMPANYING INFORMATION

FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

AND

REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

LUBBOCK, TEXAS

KAUAI ISLAND UTILITY COOPERATIVE

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BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

PHONE: (806) 747-3806

FAX: (806) 747-3815

1623 10TH STREET

LUBBOCK, TEXAS 79401-2685

INDEPENDENT AUDITORS' REPORT

Board of Directors
Kauai Island Utility Cooperative
Lihue, Hawaii

We have audited the accompanying balance sheet of Kauai Island Utility Cooperative as of December 31, 2005, and the related statements of income and patronage capital, and cash flows for the year then ended. These financial statements are the responsibility of the cooperative's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Kauai Island Utility Cooperative as of December 31, 2004, were audited by other auditors whose opinion dated February 25, 2005, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audit contained in *Government Auditing Standards*, issued by the Comptroller 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Kauai Island Utility Cooperative, Inc. as of December 31, 2005, and the results of their operations and their cash flows for the year 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 our report dated March 14, 2006, on our consideration of Kauai Island Utility Cooperative's internal control over financial reporting and on our test 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 assessing the results of our audits.

Bolinger, Segars, Gilbert & Moss LLP

Certified Public Accountants

March 14, 2006

KAUAI ISLAND UTILITY COOPERATIVE

Exhibit A

BALANCE SHEET
DECEMBER 31, 2005 AND 2004

ASSETS

	December 31,	
	2005	2004
UTILITY PLANT AT COST		
Electric Plant in Service	\$ 340,772,764	\$ 334,595,149
Electric Plant Acquisition Cost	54,841,934	54,841,934
Construction Work in Progress	4,428,051	3,300,806
	<u>400,042,749</u>	<u>392,737,889</u>
Less: Accumulated Provision for Depreciation and Amortization	161,787,060	150,099,521
	<u>238,255,689</u>	<u>242,638,368</u>
OTHER PROPERTY AND INVESTMENTS		
Non-Utility Plant	766,475	
Investments in Associated Organizations	224,853	100,994
Other Investments	5,953,322	8,449,902
	<u>6,944,650</u>	<u>8,550,896</u>
CURRENT ASSETS		
Cash	4,993,062	3,600,656
Temporary Cash Investments	9,692,634	1,508,476
Accounts and Notes Receivable (Less allowance for uncollectibles of \$147,745 in 2005 and \$93,499 in 2004)	7,073,959	8,144,538
Materials and Supplies	9,678,551	9,045,207
Accrued Unbilled Revenue	7,848,958	6,499,462
Other Current and Accrued Assets	1,049,665	952,874
	<u>40,336,829</u>	<u>29,751,213</u>
DEFERRED CHARGES	<u>6,525,402</u>	<u>5,751,296</u>
	<u>\$ 292,062,570</u>	<u>\$ 286,691,773</u>

EQUITIES AND LIABILITIES

EQUITIES AND MARGINS		
Memberships	\$ 302	\$ 279
Patronage Capital	25,817,712	17,754,491
Unrealized Gain (Loss) on Available-For-Sale Investments	(43,305)	51,222
	<u>25,774,709</u>	<u>17,805,992</u>
LONG -TERM DEBT		
RUS Mortgage Notes Less Current Maturities	191,922,558	198,113,285
FFB Mortgage Notes Less Current Maturities	30,144,000	32,960,000
CFC Mortgage Notes Less Current Maturities	7,240,729	7,632,313
	<u>229,307,287</u>	<u>238,705,598</u>
ACCUMULATED PROVISION FOR PENSION AND BENEFITS		
Postretirement Benefits	3,900,800	4,038,498
	<u>3,900,800</u>	<u>4,038,498</u>
CURRENT LIABILITIES		
Current Maturities of Long-Term Debt	8,506,400	5,825,000
Accounts Payable	5,929,674	4,010,429
Energy Rate Adjustment Clause	1,075,188	180,486
Consumer Deposits	516,266	496,047
Accrued Employee Compensation	621,023	530,119
Accrued Taxes	6,781,161	4,337,312
Other Current and Accrued Liabilities	444,783	707,126
	<u>23,874,495</u>	<u>16,086,519</u>
DEFERRED CREDITS	<u>9,205,279</u>	<u>10,055,166</u>
	<u>\$ 292,062,570</u>	<u>\$ 286,691,773</u>

See accompanying notes to financial statements.

KAUAI ISLAND UTILITY COOPERATIVE

Exhibit B

STATEMENT OF INCOME AND PATRONAGE CAPITAL
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

	Years Ended December 31,				Increase (Decrease)
	2005		2004		
	Amount	%	Amount	%	
OPERATING REVENUES					
Residential	\$ 46,270,326	35.0	\$ 41,852,500	35.2	\$ 4,417,826
Irrigation	437,569	0.3	399,640	0.3	37,929
Commercial and Industrial	82,602,195	62.4	73,324,211	61.7	9,277,984
Public Street and Highway Lighting	1,061,818	0.8	974,405	0.8	87,413
Other Operating Revenues	1,924,919	1.5	2,357,046	2.0	(432,127)
Total Operating Revenues	<u>132,296,827</u>	<u>100.0</u>	<u>118,907,802</u>	<u>100.0</u>	<u>13,389,025</u>
OPERATING EXPENSES					
Power Cost	68,938,018	52.1	55,220,546	46.4	13,717,472
Transmission - Operation	469,069	0.4	351,065	0.3	118,004
Transmission - Maintenance	343,977	0.3	322,838	0.3	21,139
Distribution - Operation	1,144,590	0.9	1,062,267	0.9	82,323
Distribution - Maintenance	1,623,775	1.2	1,756,110	1.5	(132,335)
Customer Accounts	1,849,225	1.4	1,798,833	1.5	50,392
Customer Service and Information	412,968	0.3	359,718	0.3	53,250
Sales	146,201	0.1	109,069	0.1	37,132
Administrative and General	9,486,025	7.2	8,784,875	7.4	701,150
Depreciation and Amortization	16,399,210	12.4	17,021,299	14.3	(622,089)
Taxes	10,843,072	8.2	9,691,003	8.2	1,152,069
Total Operating Expenses	<u>111,656,130</u>	<u>84.5</u>	<u>96,477,623</u>	<u>81.2</u>	<u>15,178,507</u>
OPERATING MARGINS - Before					
Fixed Charges	20,640,697	15.5	22,430,179	18.8	(1,789,482)
FIXED CHARGES					
Interest on Long-Term Debt	<u>10,521,160</u>	<u>8.0</u>	<u>10,189,855</u>	<u>8.6</u>	<u>331,305</u>
OPERATING MARGINS - After					
Fixed Charges	10,119,537	7.5	12,240,324	10.2	(2,120,787)
Capital Credits	<u>73,604</u>	<u>0.1</u>	<u>40,083</u>	<u>0.0</u>	<u>33,521</u>
NET OPERATING MARGINS	<u>10,193,141</u>	<u>7.6</u>	<u>12,280,407</u>	<u>10.2</u>	<u>(2,087,266)</u>
NONOPERATING MARGINS					
Interest Income	1,037,587	0.8	339,421	0.3	698,166
Other Nonoperating Income	<u>(19,838)</u>	<u>0.0</u>	<u>(25,267)</u>	<u>0.0</u>	<u>5,429</u>
	<u>1,017,749</u>	<u>0.8</u>	<u>314,154</u>	<u>0.3</u>	<u>703,595</u>
NET MARGINS	<u>11,210,890</u>	<u>8.4</u>	<u>12,594,561</u>	<u>10.5</u>	<u>\$ (1,383,671)</u>
COMPREHENSIVE INCOME					
Unrealized Gain (Loss) on Available for Sale Securities	<u>(46,160)</u>		<u>51,222</u>		
COMPREHENSIVE INCOME	<u>11,164,730</u>		<u>12,645,783</u>		
Less: Unrealized Gain (Loss) on Available for Sale Securities	<u>46,160</u>		<u>(51,222)</u>		
INCREASE IN PATRONAGE CAPITAL	<u>11,210,890</u>		<u>12,594,561</u>		
PATRONAGE CAPITAL - BEGINNING OF YEAR	<u>17,754,491</u>		<u>6,879,907</u>		
Patronage Capital Retired	<u>(3,147,669)</u>		<u>(1,719,977)</u>		
PATRONAGE CAPITAL - END OF YEAR	<u>\$ 25,817,712</u>		<u>\$ 17,754,491</u>		

See accompanying notes to financial statements.

KAUAI ISLAND UTILITY COOPERATIVE

Exhibit C

STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

	December 31,	
	<u>2005</u>	<u>2004</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Margins	\$ 11,210,890	\$ 12,594,561
Adjustments to Reconcile Net Margins to Net Cash Provided by Operating Activities		
Depreciation and Amortization	16,551,697	17,021,299
Capital Credits	(73,604)	(40,083)
Deferred Charges	(774,106)	(247,075)
Deferred Credits	(849,887)	
Accounts and Notes Receivable	(278,917)	2,165,312
Inventories and Other Current Assets	(730,135)	(5,103,769)
Post Retirement Benefit Obligations	(137,698)	(38,606)
Payables and Accrued Expenses	5,106,577	(570,625)
Net Cash Provided by Operating Activities	<u>30,024,817</u>	<u>25,781,014</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to Utility Plant	(11,930,854)	(9,721,818)
Plant Removal Cost Over Salvage and Other Credits	(238,164)	
Other Property and Investments	1,585,323	(5,459,591)
Net Cash Used in Investing Activities	<u>(10,583,695)</u>	<u>(15,181,409)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on Long-Term Debt to RUS	(5,805,650)	(944,240)
Payments on Long-Term Debt to CFC	(332,185)	(33,284,000)
Advance Payments to RUS	(579,077)	(4,333,218)
Advances on Long-Term Debt to FFB		32,960,000
Memberships	23	22
Retirement of Patronage Capital	(3,147,669)	(1,719,977)
Net Cash Used in Financing Activities	<u>(9,864,558)</u>	<u>(7,321,413)</u>
INCREASE IN CASH AND CASH EQUIVALENTS	9,576,564	3,278,192
CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR	<u>5,109,132</u>	<u>1,830,940</u>
CASH AND CASH EQUIVALENTS - END OF YEAR	<u>\$ 14,685,696</u>	<u>\$ 5,109,132</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash Paid During the Year for:		
Interest on Long-Term Debt	\$ 10,483,180	\$ 9,908,435
Income Taxes	<u>\$ 35,250</u>	<u>\$ 0</u>

See accompanying notes to financial statements.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Kauai Island Utility Cooperative (KIUC or the cooperative) is 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 electricity utility on the island of Kauai, Hawaii. KIUC is the exclusive retail electric service provider for the island of Kauai and provides electric generation, transmission and distribution services to approximately 30,000 members.

On November 1, 2002, the cooperative acquired substantially all of the assets of Kauai Electric (KE), a division of Citizens Communications Company (Citizens). The aggregate purchase price was approximately \$218 million, which includes transaction costs incurred in the acquisition, and was financed by lines of credit from the National Rural Utilities Cooperative Finance Corporation and loans from the U.S. Government. See further discussion of the utility plant assets at Note 3.

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. Membership for all new members is a penny. As of December 31, 2005, there were 30,166 members.

Basis of Accounting

The 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 for Class A and B electric utilities.

Electric Plant, Maintenance, and Depreciation

Electric plant is stated at the original cost of construction, which includes the cost of contracted services, direct labor, materials, and overhead items. Contributions from others toward the construction of electric plant are credited to the applicable plant accounts.

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 other accounts.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

Accounting Policies for Loans and Trade Receivables

In the normal course of business the cooperative recognizes accounts receivable for energy delivered and billed. The cooperative allows 44 days from the date of the bill for payment to be received or the service is disconnected.

The cooperative provides an allowance for doubtful accounts to recognize the portion of receivables considered uncollectible. The allowance is estimated based on .01% of monthly operating revenues. Delinquent accounts are reviewed periodically and charged off.

Inventories

Materials and supplies inventories are valued at average unit cost.

Electric Revenues

The cooperative's headquarters facility is located in Lihue, Hawaii. The service area includes members and non-members located on the island of Kauai. KIUC recognizes revenues based on rates authorized by the HPUC and include revenues applicable to energy consumed in the accounting period but not yet billed to the customers. The cooperative records a receivable for electric revenues as billed on a monthly basis. It is estimated that the cooperative has \$7,848,958 and \$6,499,462 of unbilled revenue as of December 31, 2005 and 2004, respectively. 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. As of December 31, 2005 and 2004, deposits on hand totaled \$516,266 and \$496,047, respectively.

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, undercollected power cost to be billed to consumers in subsequent periods is recognized as a current asset and as an increase of classified operating revenues on the statement of income and patronage capital. Also, to match power cost and related revenues, overcollected power cost to be credited to consumers in subsequent periods is recognized as a current liability and as a reduction of classified operating revenues on the statement of income and patronage capital.

Financial Instruments

The cooperative maintains its temporary cash investments and checking accounts in various financial institutions. The balances are insured by the Federal Deposit Insurance Corporation up to \$100,000. Deposits at times exceeded insured amounts.

Patronage Capital Certificates

Patronage capital from associated organizations is recorded at the stated amount of the certificates.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

Cash and Cash Equivalents

For purposes of the statement of cash flows, the cooperative considers cash and temporary cash investments to be cash equivalents.

Taxes

KIUC is exempt under section 501(c) (12) of the Internal Revenue Code from federal income tax for any year in which at least 85% of its gross income is derived from members but is responsible for income taxes on certain unrelated business income. KIUC is not exempt under Hawaii Revised Statutes from state income taxes. However, operation 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 (PUC Tax) in lieu of general excise taxes and county real property taxes. Also, KIUC is assessed .5% of gross revenues (PUC Fee). For the County of Kauai, Hawaii, KIUC is assessed a 2.5% franchise fee on gross revenues.

Use of Estimates in the Preparation of Financial Statements

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.

Prior Year Reclassifications

For comparative purposes, various 2004 amounts have been reclassified to conform with the 2005 presentation.

2. Assets Pledged

Substantially all assets are pledged as security for the long-term debt to the Rural Utility Services (RUS) and the National Rural Utilities Cooperative Finance Corporation (CFC).

3. Property, Plant, and Equipment

The major classes of plant are as follows at December 31, 2005 and 2004:

	December 31,	
	2005	2004
Production Plant	\$ 123,969,284	\$ 121,818,451
Transmission Plant	65,058,782	64,880,011
Distribution Plant	131,617,636	128,741,637
General Plant	20,127,062	19,155,049
Electric Plant Acquisition Adjustment	54,841,934	54,841,934
Electric Plant in Service	395,614,698	389,437,082
Construction Work in Progress	4,428,051	3,300,807
Total Electric Plant in Service	<u>\$ 400,042,749</u>	<u>\$ 392,737,889</u>

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KAUAI ISLAND UTILITY COOPERATIVE
NOTES TO FINANCIAL STATEMENTS

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

The cooperative provides for depreciation of plant as follows:

Production Plant	1.47-8.08%
Transmission Plant	2.20-6.62%
Distribution Plant	3.35-6.62%
Plant Acquisition Adjustment	4.00%
General Plant	
Structures and Improvements	3.06%
Office Furniture and Equipment	4.03%
Computer Equipment	12.53%
Transportation Equipment	10.00%
Stores Equipment	5.24%
Tools and Shop Equipment	4.68%
Laboratory Equipment	5.22%
Power Operated Equipment	7.41%
Communication Equipment	6.24%
Miscellaneous Equipment	3.05%

During 2004, the cooperative had a depreciation study performed. New depreciation rates were implemented in June 2005. These rates have been approved by the Hawaii Public Utility Commission.

Depreciation for the years ended December 31, 2005 and 2004, was \$16,551,697 and \$17,021,299, respectively.

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KAUAI ISLAND UTILITY COOPERATIVE
NOTES TO FINANCIAL STATEMENTS

4. Investments in Associated Organizations

Investments in associated organizations consisted of the following at December 31, 2005 and 2004:

	December 31,	
	2005	2004
Non-Utility Plant	\$ 766,475	\$ _____
Investments In Associated Organizations		
CFC		
Capital Term Certificates	184,762	82,400
Patronage Capital	39,091	18,594
Membership	1,000	
	224,853	100,994
Other Investments		
CFC Medium Term Notes	4,000,000	4,030,707
CFC Commercial Paper		2,519,898
U.S. Government Agencies	839,655	661,421
U.S. Treasury Obligations	222,434	774,518
Corporate Bonds and Notes	891,233	463,358
	5,953,322	8,449,902
	\$ 6,944,650	\$ 8,550,896

The cooperative has classified its debt securities in accordance with Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities". This statement addresses the accounting and reporting for investments in debt and equity securities that have a readily determinable fair value.

All CFC Medium Term Notes are considered to be held to maturity at December 31, 2005, and are recorded at amortized cost. The Government Agency Securities and Corporate Bonds and Notes are considered to be available-for-sale securities at December 31, 2005, and are recorded at fair market value. Unrealized gains and losses on securities classified as available-for-sale are recognized through a separate equity account.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

Amortized cost and fair value of available-for-sale securities are as follows:

	Amortized Cost	Fair Value	Unrealized Gain (Loss)
December 31, 2005			
U.S. Government Agencies	\$ 856,873	\$ 839,655	\$ (17,218)
U.S. Treasury Obligations	222,506	222,434	(72)
Corporate Bonds and Notes	<u>917,248</u>	<u>891,233</u>	<u>(26,015)</u>
	<u>\$ 1,996,627</u>	<u>\$ 1,953,322</u>	<u>\$ (43,305)</u>
December 31, 2004			
U.S. Government Agencies	\$ 664,153	\$ 661,421	\$ (2,732)
U.S. Treasury Obligations	776,036	774,518	(1,518)
Corporate Bonds and Notes	<u>6,958,491</u>	<u>7,013,963</u>	<u>55,472</u>
	<u>\$ 8,398,680</u>	<u>\$ 8,449,902</u>	<u>\$ 51,222</u>

Annual maturities of available-for-sale investments at December 31, 2005, were as follows:

	Amortized Cost	Fair Value
Less than one year	\$ 475,344	\$ 467,305
After 1 year through 5 years	<u>1,521,283</u>	<u>1,486,017</u>
	<u>\$ 1,996,627</u>	<u>\$ 1,953,322</u>

5. Temporary Investments (at cost)

Temporary cash investments consisted of the following at December 31, 2005 and 2004:

	December 31,	
	2005	2004
CFC Commercial Paper	\$ 1,557,461	\$
CFC Daily Fund	8,075,739	1,508,476
First Hawaiian Bank - Money Market Funds	<u>59,434</u>	<u></u>
	<u>\$ 9,692,634</u>	<u>\$ 1,508,476</u>

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

6. Inventories

Inventories consisted of the following at December 31, 2005 and 2004:

	December 31,	
	2005	2004
Plant Material	\$ 8,688,214	\$ 8,138,408
Fuel	990,337	906,799
	<u>\$ 9,678,551</u>	<u>\$ 9,045,207</u>

7. Deferred Debits

Deferred debits consisted of the following at December 31, 2005 and 2004:

	December 31,	
	2005	2004
Regulatory Asset - Iniki Damage	\$ 4,895,292	\$ 5,187,552
Regulatory Asset - SFAS 106 Transition	482,889	551,877
Regulatory Asset - demand-side management (DSM) and integrated resource plan (IRP)	(308,144)	(568,252)
Preliminary Survey and Investigation	1,326,750	580,119
Other Deferred Debits	128,615	
	<u>\$ 6,525,402</u>	<u>\$ 5,751,296</u>

Financial Accounting Standards Board (FASB) Statement No. 71 allows companies to use, for financial reporting purposes, the same principles used for rate making. The cooperative has elected to apply the provisions of FASB Statement No. 71 to regulatory assets detailed above and to recover, with approval of the HPUC, these costs through future rates over the period specified by the HPUC. The DSM and the IRP are key components of KIUC's energy conservation efforts. To facilitate the purchase of the KE assets, KIUC and Citizens waived their rights to apply for demand side management shareholder incentives available to electricity utilities that meet certain specified energy conservation goals.

8. Return of Capital

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. KIUC is required to obtain the approval of RUS prior to making a distribution equal to 25% of net margins to members. The equities and margins of the cooperative represent 8.79% of the total assets

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

at the balance sheet date. Patronage capital totaling \$3,147,669 and \$1,719,977 was retired during the years ended December 31, 2005 and 2004, respectively, and was approved by RUS.

9. Patronage Capital

Patronage capital consisted of the following at December 31, 2005 and 2004:

	December 31,	
	<u>2005</u>	<u>2004</u>
Assigned	\$ 19,474,468	\$ 6,879,907
Assignable	<u>11,210,890</u>	<u>12,594,561</u>
	30,685,358	19,474,468
Less: Retired	<u>(4,867,646)</u>	<u>(1,719,977)</u>
	<u>\$ 25,817,712</u>	<u>\$ 17,754,491</u>

10. Mortgage Notes RUS/FFB

Long-term debt due RUS is represented by mortgage notes payable to the United States of America. Following is a summary of long-term debt due RUS and maturing at various times between 2009 and 2027:

	December 31,	
	<u>2005</u>	<u>2004</u>
2.875% Notes	\$ 10,323,596	\$ 10,689,000
2.750% Notes	20,702,995	21,388,000
3.125% Notes	20,738,856	21,393,000
3.750% Notes	31,192,294	32,102,000
4.375% Notes	20,848,169	21,409,000
4.875% Notes	104,443,027	107,074,000
Advance Payments	<u>(10,979,379)</u>	<u>(10,152,715)</u>
	197,269,558	203,902,285
Less: Current Maturities	<u>(5,347,000)</u>	<u>(5,789,000)</u>
	<u>\$ 191,922,558</u>	<u>\$ 198,113,285</u>

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

Principle and interest installments on the above notes are due monthly. As of December 31, 2005, annual maturities of long-term debt due RUS for the next five years are as follows:

2006	\$ 5,347,000
2007	5,566,000
2008	5,793,000
2009	6,031,000
2010	6,278,000

The cooperative has made advance payments with RUS in the amount of \$10,979,379.

Following is a summary of long-term debt due the Federal Financing Bank (FFB):

	December 31,	
	2005	2004
3.137% Notes	\$ 8,240,000	\$ 8,240,000
3.876% Notes	8,240,000	8,240,000
4.305% Notes	<u>16,480,000</u>	<u>16,480,000</u>
	32,960,000	32,960,000
Less: Current Maturities	<u>(2,816,000)</u>	
	<u>\$ 30,144,000</u>	<u>\$ 32,960,000</u>

Principle and interest installments on the above notes are due quarterly. As of December 31, 2005, annual maturities of long-term debt due FFB for the next five years are as follows:

2006	\$ 2,816,000
2007	2,916,000
2008	3,020,000
2009	3,128,000
2010	3,239,000

11. CFC Notes

Following is a summary of long-term notes due CFC as of December 31, 2005 and 2004. These notes mature in 2023:

	December 31,	
	2005	2004
6.25% Note	\$ 7,584,129	\$ 7,916,000
Less: Current Maturities	<u>(343,400)</u>	<u>(283,687)</u>
	<u>\$ 7,240,729</u>	<u>\$ 7,632,313</u>

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KAUAI ISLAND UTILITY COOPERATIVE
NOTES TO FINANCIAL STATEMENTS

Principal and interest installments on the above notes are due quarterly. As of December 31, 2005, the annual maturities of long-term debt due CFC for the next five years is as follows:

2006	\$ 343,400
2007	365,300
2008	388,700
2009	413,600
2010	440,000

12. Line of Credit

The cooperative has a perpetual \$84,000,000 line of credit for short-term financing with CFC at a variable interest rate. At December 31, 2005 and 2004, the cooperative had no outstanding balance on this line of credit.

13. Deferred Credits - Other

Deferred credits consisted of the following at December 31, 2005 and 2004:

	December 31,	
	2005	2004
Customer Advances for Construction	\$ 883,145	\$ 1,324,965
Regulatory Liability - Iniki Amortization	4,895,292	5,187,552
Regulatory Liability - scheduled plant maintenance	3,426,842	3,542,649
	<u>\$ 9,205,279</u>	<u>\$ 10,055,166</u>

As discussed in Note 7, KIUC has elected to apply the provisions of FASB No. 71. As such the regulatory liabilities identified above have been approved for rate recovery by the HPUC and are being amortized and collected over the period specified by the HPUC.

14. Litigation, Commitments, and Contingencies

There is no pending or threatened litigation against the cooperative, which would materially affect the financial position.

As a result of the purchase of KE assets, Citizens assigned to KIUC a diesel fuel supply contract with an international oil refining company that is renewable for 12 month periods unless terminated by KIUC or the supplier. 100 percent of KIUC's diesel 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. Diesel fuel costs for the years ended December 31, 2005 and 2004 approximated \$31,799,313 and \$23,277,410, respectively.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

KIUC has agreements with one union. In December, 2004, the Cooperative negotiated a new contract with the union which was ratified in December, 2004. The agreement expires in December, 2009.

KIUC leases certain office space 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, 2005, the future minimum rental commitment under this lease is approximately as follows:

<u>Year Ending December 31,</u>	
2006	\$ 1,200,000
2007	1,200,000
2008	1,200,000
2009	1,200,000
2010	1,200,000
Thereafter	<u>10,196,000</u>
	<u>\$ 16,196,000</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, 2005 and 2004, were \$1,244,926 and \$1,377,000, respectively.

15. 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 and 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 and security plan equal to the amounts accrued for pension expense. The pension cost for the cooperative for the plan for the years ended December 31, 2005 and 2004, was \$1,115,086 and \$1,559,000, respectively.

The pension cost for the 401(K) Savings Plan was \$217,000 and \$188,000 for the years ended December 31, 2005 and 2004, respectively.

16. Postretirement Benefits

The Kauai Island Utility Cooperative Retiree Welfare Benefit Plan (the "Plan") and its associated trust, the Kauai Island Utility Cooperative Retiree Welfare Benefit Trust (the "Trust") were adopted effective January 1, 2003. The Plan provides certain non-contributory medical, dental, vision and life insurance benefits for retired employees and their beneficiaries and covered dependents. The following table sets forth the reconciliation of the funded status of KIUC's Plan and the amounts recognized in the financial statements as of December 31, 2005 and 2004.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

Assumptions

The weighted-average discount rate used to determine the benefit obligation was 5.75%.

Weighted-average assumptions used to determine net periodic benefit costs for years ended December 31, 2005:

Discount Rate: 6.0%

Expected long-term return on plan assets: 5.57% (The Homestead Short-Term Bond Fund, which is the fund in which all Kauai Island's assets are invested, 10 Year historical return as of December 31, 2004.)

Health care cost trend rate assumed for next year: 9.0%

Rate to which the cost trend rate is assumed to decline (the ultimate trend rate): 5.0%

Year that the rate reaches the ultimate trend rate: 2014

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

2006	\$ 470,100
2007	481,100
2008	515,100
2009	535,400
2010	541,600
2011-2015	2,778,200

Net periodic postretirement health care costs for the years ended December 31, 2005 and 2004 consisted of the following components:

	December 31,	
	2005	2004
Accumulated Postretirement Benefits Obligation:		
a. Retirees and dependents	\$ 4,467,400	\$ 4,586,900
b. Fully eligible active plan participants	2,031,800	1,869,700
c. Other active plan participants	880,400	762,200
	<u>7,379,600</u>	<u>7,218,800</u>
Less: Plan Assets at Fair Value		
Short Term Bond Fund	<u>2,742,200</u>	<u>2,680,800</u>
Accumulated Obligation in Excess of Plan Assets	4,637,400	4,538,000
Unrecognized net (gain) loss from past experience different from that assumed and from changes in assumptions	<u>(736,600)</u>	<u>(499,502)</u>
	<u>\$ 3,900,800</u>	<u>\$ 4,038,498</u>

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

	December 31,	
	<u>2005</u>	<u>2004</u>
Reconciliation of (accrued) postretirement benefit cost:		
a. (Accrued) postretirement benefit obligation	\$ 4,038,498	\$ 4,077,104
b. SFAS 106 expense	309,800	301,600
c. Contribution to assets		
d. Retiree benefits paid	<u>(447,498)</u>	<u>(340,206)</u>
	<u>\$ 3,900,800</u>	<u>\$ 4,038,498</u>

The plan has been partially funded as of December 31, 2005. The plan assets are held in the KIUC Retiree Welfare Benefit Plan Trust and were invested in the Homestead Funds at December 31, 2005. Subsequent to December 31, 2005, the plan assets were moved to the Central Pacific Bank's Trust Division.

17. Fair Value of Financial Instruments

Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments", requires disclosure of fair value information about financial instruments. Many of the cooperative's financial instruments lack an available market as characterized by a normal exchange between a willing buyer and a willing seller. Accordingly, significant assumptions, estimations, and present value calculations were used for purposes of this disclosure.

The following assumptions were used to estimate fair value of each class of financial instrument for which estimation is practicable.

Patronage Capital from Associated Organization – The right to receive cash is an inherent component of a financial instrument. The cooperative holds no right to receive cash since any payments are at the discretion of the governing body for the associated organizations. As such, Patronage Capital from Associated Organizations is not considered financial instruments.

CFC Capital Term Certificates – It is not practicable to estimate fair value for these financial instruments given the lack of a market and their long holding period.

CFC Medium Term Notes and Commercial Paper – The fair market value for these investments approximate their cost.

Available-for-sale Investments – These investments are recorded at fair market value as reported in footnote number 4.

Cash and Temporary Cash Investments – Carrying value, given the short period to maturity.

KAUAI ISLAND UTILITY COOPERATIVE

NOTES TO FINANCIAL STATEMENTS

Long-Term Debt Fixed Rate – Estimated by computing the present value by individual note to maturity, using currently quoted or offered rates for similar issues of debt. The year-end CFC fixed interest rate for long-term debt repricing every seven years was used in the calculation for all fixed rate long-term debt. These are the only financial instruments of the cooperative that have a difference in Fair Value and Carrying Value. The carrying value of the cooperative's fixed rate debt and the estimated fair value are as follows:

	<u>Carrying Value</u>	<u>Fair Value</u>
December 31, 2005	\$ <u>237,813,687</u>	\$ <u>182,796,851</u>
December 31, 2004	\$ <u>244,530,598</u>	\$ <u>203,343,242</u>

ACCOMPANYING INFORMATION

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

PHONE: (806) 747-3806

FAX: (806) 747-9815

1623 10TH STREET

LUBBOCK, TEXAS 79401-2685

**INDEPENDENT AUDITORS' REPORT
ON ACCOMPANYING INFORMATION**

Our audit of the financial statements presented in the preceding section of this report was made for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying information on pages 20 through 24 also is presented for purposes of additional analysis and is not a required part of the financial statements. The accompanying information, has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

Bolinger, Segars, Gilbert & Moss L.L.P.

Certified Public Accountants

March 14, 2006

ACCOMPANYING INFORMATION

KAUAI ISLAND UTILITY COOPERATIVE

Schedule 1

ELECTRIC PLANT
FOR THE YEAR ENDED DECEMBER 31, 2005

	Balance 1/1/05	Additions	Retirements	Balance 12/31/05
CLASSIFIED ELECTRIC PLANT IN SERVICE				
Production Plant				
Steam Production Plant				
Land and Land Rights	\$ 290,735	\$	\$	\$ 290,735
Structures & Improvements	5,117,123	126,155	530	5,242,748
Boiler Plant Equipment	11,265,960	1,274,569	94,592	12,445,937
Engine Driven Generators	5,556			5,556
Turbogenerators Units	1,715,040	31,368	5,230	1,741,178
Access Electric Equipment	573,850	27,696	4,086	597,460
Miscellaneous Power Plant Equipment	233,573	13,218		246,791
Hydraulic Production Plant				
Reservoirs, Dams & Waterways	207,355			207,355
Water Wheels, Turbines, Generators	384,406			384,406
Fuel Production Plant				
Land and Land Rights	7,486,804			7,486,804
Structures & Improvements	18,210,391			18,210,391
Fuel Holder Producers	3,967,724	82,303		4,050,027
Prime Movers	50,604,493	1,296,005	795,865	51,104,633
Generators	9,294,218	112,538		9,406,756
Accessory Electric Equipment	8,138,145	42,946		8,181,091
Miscellaneous Power Plant Equipment	4,323,078	44,338		4,367,416
Total Production Plant	<u>121,818,451</u>	<u>3,051,136</u>	<u>900,303</u>	<u>123,969,264</u>
Transmission Plant				
Land and Land Rights	576,538			576,538
Structures & Improvements	274,702			274,702
Station Equipment	19,168,151	198,344	177,056	19,189,439
Towers and Fixtures	58,189			58,189
Poles and Fixtures	29,160,924	(440)	69,626	29,090,858
Overhead Conductors & Devices	15,641,507	181,035	53,797	15,768,745
Underground Conduit		5,016		5,016
Underground Conductor		95,295		95,295
Total Transmission Plant	<u>64,880,011</u>	<u>479,250</u>	<u>300,479</u>	<u>65,058,782</u>
Distribution Plant				
Land and Land Rights	276,253	49,266		325,519
Structures & Improvements	311,747			311,747
Station Equipment	7,768,431	1,069,172	155,311	8,682,292
Poles, Towers and Fixtures	34,055,170	24,703	318,205	33,761,668
Overhead Conductors & Devices	32,920,650	1,469,425	592,251	33,797,824
Underground Conduit	4,401,380	785,627	3,092	5,183,915
Underground Conductor & Devices	13,994,532	481,334	334,438	14,141,428
Line Transformers	19,925,835	853,118	640,355	20,138,598
Services	5,065,535	248,636	9,375	5,304,796
Meters	7,234,382	228,684	380,208	7,082,858
Street Lights and Signals	2,787,722	123,497	24,228	2,886,991
Total Distribution Plant	<u>128,741,637</u>	<u>5,333,462</u>	<u>2,457,463</u>	<u>131,617,636</u>
General Plant				
Land and Land Rights	216,685			216,685
Structures & Improvements	9,098,648	310,414	301,427	9,107,635
Office Furniture & Equipment	1,558,109	94,050	125,305	1,526,854
Computer Equipment	2,899,117	906,639	362,597	3,443,159
Transportation Equipment	2,320,102	360,354	140,400	2,540,056
Stores Equipment	155,758	3,512		159,270
Tools and Shop Supplies	944,361	44,925	26,158	963,128
Laboratory Equipment	662,874	62,058		724,932
Power Operated Equipment	212,402	22,599		235,001
Communication Equipment	928,488	89,996		1,016,566
Miscellaneous Equipment	158,505	45,215	9,944	193,776
Total General Plant	<u>19,155,049</u>	<u>1,939,762</u>	<u>967,749</u>	<u>20,127,062</u>
Plant Acquisition Cost	<u>54,841,934</u>			<u>54,841,934</u>
Total Electric Plant in Service	389,437,082	10,803,610	4,625,994	395,614,686
Construction Work in Progress	<u>3,300,807</u>	<u>1,127,244</u>		<u>4,428,051</u>
Total Utility Plant	<u>\$ 392,737,889</u>	<u>\$ 11,930,854</u>	<u>\$ 4,625,994</u>	<u>\$ 400,042,749</u>

KAUAI ISLAND UTILITY COOPERATIVE

Schedule 2

**ACCUMULATED PROVISION FOR DEPRECIATION
FOR THE YEAR ENDED DECEMBER 31, 2005**

	Balance 1/1/05	Depreciation Accruals	Retirements	Adjustment	Balance 12/31/05
Production Plant	\$ 51,652,450	\$ 5,153,898	\$ 896,400	\$ (31,201)	\$ 55,878,747
Transmission Plant	28,666,812	2,308,468	356,575	(67,385)	30,551,320
Distribution Plant	53,973,093	5,465,371	2,449,417	(1,272,150)	55,716,897
General Plant	10,478,686	1,138,022	774,220	(187,719)	10,654,769
Iniki Deferred Depreciation	1,753,560	292,260			2,045,820
Plant Acquisition Amortization	<u>4,752,968</u>	<u>2,193,678</u>			<u>6,946,646</u>
Total Electric Plant in Service	151,277,569	16,551,697	4,476,612	(1,558,455)	161,794,199
Accumulated Net Loss	(1,137,163)		421,292	1,558,455	0
Retirement Work in Progress	<u>(40,885)</u>		<u>(33,746)</u>		<u>(7,139)</u>
Total Utility Plant	<u>\$ 150,099,521</u>	<u>\$ 16,551,697</u>	<u>\$ 4,864,158</u>	<u>\$ 0</u>	<u>\$ 161,787,060</u>

(1)

(2)

- (1) Charged to Depreciation Expense
Charged to Clearing and Other Accounts

\$ 16,321,594
230,103

Total Depreciation

\$ 16,551,697

- (2) Cost of Units Retired
Cost of Removal Less Salvage

\$ 4,625,994
238,164

Loss Due to Retirement

\$ 4,864,158

KAUAI ISLAND UTILITY COOPERATIVE

Schedule 3

OTHER PROPERTY AND INVESTMENTS
DECEMBER 31, 2005 AND 2004

	December 31,	
	2005	2004
NON-UTILITY PROPERTY	\$ 766,475	\$
INVESTMENTS IN ASSOCIATED ORGANIZATIONS		
Memberships		
National Rural Utilities Cooperative Finance Corporation	1,000	
	<u>1,000</u>	<u>0</u>
Patronage Capital		
National Rural Utilities Cooperative Finance Corporation	39,091	18,594
	<u>39,091</u>	<u>18,594</u>
Capital Term Certificates		
National Rural Utilities Cooperative Finance Corporation	184,762	82,400
	<u>184,762</u>	<u>82,400</u>
Other Investments		
National Rural Utilities Cooperative Finance Corporation		
Medium Term Notes	4,000,000	4,030,707
Commercial Paper		2,519,898
U.S. Government Securities	839,655	661,421
U.S. Treasury Obligations	222,434	774,518
Corporate Bonds and Notes	891,233	463,358
	<u>5,953,322</u>	<u>8,449,902</u>
Total Investments in Associated Organizations	\$ <u>6,944,650</u>	\$ <u>8,550,896</u>
Temporary Cash Investments		
National Rural Utilities Cooperative Finance Corporation		
Commercial Paper	\$ 1,557,461	\$
Daily Funds	8,075,739	1,508,476
First Hawaiian Bank - Money Market Funds	59,434	
	<u>9,692,634</u>	<u>1,508,476</u>

KAUAI ISLAND UTILITY COOPERATIVE

Schedule 4

PATRONAGE CAPITAL
DECEMBER 31, 2005

<u>Year</u>	<u>Assignable</u>	<u>Assigned</u>	<u>Retired</u>	<u>Balance</u>
2002	\$	\$ 573,778	\$ 143,361	\$ 430,417
2003		6,306,129	1,575,602	4,730,527
2004		12,594,561	3,148,683	9,445,878
2005	<u>11,210,890</u>			<u>11,210,890</u>
	<u>\$ 11,210,890</u>	<u>\$ 19,474,468</u>	<u>\$ 4,867,646</u>	<u>\$ 25,817,712</u>

KAUAI ISLAND UTILITY COOPERATIVE

Schedule 5

RUS, FFB, AND CFC MORTGAGE NOTES
DECEMBER 31, 2005

RUS Mortgage Notes

Note Number	Date of Note	Interest Rate - %	Principal Amount	Amount Unadvanced	Principal Payments	Net Obligation
1B010	11-01-02	2.875	\$ 10,750,000	\$	\$ 426,404	\$ 10,323,596
1B011	11-01-02	2.750	21,500,000		797,005	20,702,995
1B012	11-01-02	3.125	21,500,000		761,144	20,738,856
1B013	11-01-02	3.750	32,250,000		1,057,706	31,192,294
1B014	11-01-02	4.375	21,500,000		651,831	20,848,169
1B015	11-01-02	4.875	107,500,000		3,056,973	104,443,027
	Advance Payments					(10,979,379)
Total RUS			<u>\$ 215,000,000</u>	<u>\$ 0</u>	<u>\$ 6,751,063</u>	<u>\$ 197,269,558</u>

FFB Mortgage Notes

F0010	10-19-04	3.137	\$ 8,240,000	\$	\$	\$ 8,240,000
F0015	10-19-04	3.876	8,240,000			8,240,000
F0020	10-19-04	4.305	16,480,000			16,480,000
Total FFB			<u>\$ 16,480,000</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 32,960,000</u>

CFC Mortgage Notes

9005	12-17-03	6.250	\$ 8,240,000	\$	\$ 655,871	\$ 7,584,129
Total CFC			<u>\$ 8,240,000</u>	<u>\$ 0</u>	<u>\$ 655,871</u>	<u>\$ 7,584,129</u>

Net obligations include \$5,347,000 due RUS, \$2,816,000 due FFB and \$343,400 due CFC payable within one year and classified as current liabilities on the balance sheet.

COMPLIANCE AND INTERNAL CONTROL SECTION

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

PHONE: (806) 747-3806

FAX: (806) 747-3815

1623 10TH STREET

LUBBOCK, TEXAS 79401-2685

**LETTER TO BOARD OF DIRECTORS REGARDING RUS, 7 CFR, PART 1773,
POLICIES CONCERNING AUDITS OF RUS BORROWERS**

Board of Directors
Kauai Island Utility Cooperative
Lihue, Hawaii

We have audited the financial statements of Kauai Island Utility Cooperative for the year ended December 31, 2005, and have issued our report thereon dated March 14, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and 7 CFR Part 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of Kauai Island Utility Cooperative for the year ended December 31, 2005, we considered its internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting that we consider to be material weaknesses.

7 CFR Part 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR Part 1773.33(e)(1), related party transactions, depreciation rates, a schedule of deferred debits and credits, and a schedule of investments, upon which we express an opinion. In addition, our audit of the financial statements also included the procedures specified in 7 CFR Part 1773.38 -.45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports (other than our independent auditors' report and our independent auditors' report on compliance and on internal control over financial reporting, both dated March 14, 2006) or summary of recommendations related to our audit have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR Part 1773.33 are presented below.

COMMENTS ON CERTAIN SPECIFIC ASPECTS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted no matters regarding Kauai Island Utility Cooperative's internal control over financial reporting and its operation that we consider to be a material weakness as previously defined with respect to:

- the accounting procedures and records;
- the process for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts; and
- the materials control.

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS

At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others for the year ended December 31, 2005, of Kauai Island Utility Cooperative:
 - Obtained and read a borrower-prepared schedule of new written contracts entered into during the year for the operation or maintenance of its property, or for the use of its property by others, as defined in §1773.33(e)(1)(i).
 - Reviewed Board of Director minutes to ascertain whether board-approved written contracts are included in the borrower-prepared schedule.
 - Noted the existence of written RUS and CFC approval of each contract listed by the borrower.
- Procedure performed with respect to the requirement to submit RUS Form 7 to the RUS:
 - Agreed amounts reported in Form 7 to Kauai Island Utility Cooperative's records.

The results of our tests indicate that, with respect to the items tested, Kauai Island Utility Cooperative complied, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has obtained written approval of the RUS to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others, as defined in §1773.33(e)(1)(i); and
- The borrower has submitted its Form 7 to the RUS and the Form 7, Financial and Statistical Report, as of December 31, 2005, represented by the borrower as having been submitted to RUS is in agreement with Kauai Island Utility Cooperative's audited records in all material respects.

COMMENTS ON OTHER ADDITIONAL MATTERS

In connection with our audit of the financial statements of Kauai Island Utility Cooperative, nothing came to our attention that caused us to believe that Kauai Island Utility Cooperative failed to comply with respect to:

- The reconciliation of continuing property records to the controlling general ledger plant accounts addressed at 7 CFR Part 1773.33(c)(1);
- The clearing of construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR Part 1773.33(c)(2);
- The retirement of plant addressed at 7 CFR Parts 1773.33(c)(3) and (4);
- Approval of the sale, lease, or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR 1773.33 (c)(5);
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standards No. 57, *Related Party Transactions*, for the year ended December 31, 2005, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR Part 1773.33(f);
- The depreciation rates addressed at 7 CFR Part 1773.33(g);
- The detailed schedule of deferred debits and deferred credits; and
- The detailed schedule of investments.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of deferred debits and deferred credits required by 7 CFR Part 1773.33(h) provided below are presented for purposes of additional analysis and are not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Deferred debits consist of the following:

Regulatory Asset - Iniki Damage	\$ 4,895,292
Regulatory Asset - SFAS 106 Transition	482,889
Regulatory Asset - demand-side management (DSM) and integrated resource plan (IRP)	(308,144)
Preliminary Survey and Investigation	1,326,750
Other Deferred Debits	<u>128,615</u>
	<u>\$ 6,525,402</u>

Deferred credits consist of:

Customer Advances for Construction	\$	883,145
Regulatory Liability - Iniki Amortization		4,895,292
Regulatory Liability - scheduled plant maintenance		<u>3,426,842</u>
	\$	<u>9,205,279</u>

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 used and should not be used by anyone other than these specified parties.

Balinger, Segars, Gilbert & Moss LLP

Certified Public Accountants

March 14, 2006

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

PHONE: (806) 747-3806

FAX: (806) 747-3815

1023 10TH STREET

LUBBOCK, TEXAS 79401-2685

**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**

Board of Directors
Kauai Island Utility Cooperative
Lihue, Hawaii

We have audited the financial statements of Kauai Island Utility Cooperative as of and for the year ended December 31, 2005, and have issued our report thereon dated March 14, 2006. 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, we considered Kauai Island Utility Cooperative's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Kauai Island Utility Cooperative's 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 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 that are required to be reported under *Government Auditing Standards*.

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

Bolinger, Segars, Gilbert & Moss LLP

Certified Public Accountants

March 14, 2006

BOLINGER, SEGARS, GILBERT & MOSS, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

PHONE: (806) 747-3806

FAX: (806) 747-3815

1625 10TH STREET

LUBBOCK, TEXAS 79401-2685

March 14, 2006

Board of Directors
Kauai Island Utility Cooperative
Lihue, Hawaii

As part of our responsibility in the conduct of the audit for the period ended December 31, 2005, we are required to determine that certain matters related to the conduct of the audit are communicated to those who have responsibility for oversight of the financial reporting process. It is our understanding that the oversight of the financial reporting process is your responsibility, and as such, this communication is directed to you.

Auditors' Responsibility Under U. S. Generally Accepted Auditing Standards

As stated in our engagement letter dated December 20, 2005, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement and are fairly presented in accordance with U. S. generally accepted accounting principles. Because an audit is designed to provide reasonable, but not absolute, assurance and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us. As part of our audit, we considered the internal control of the Kauai Island Utility Cooperative. Such considerations were solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

Significant Accounting Policies

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the organization are described in Note 1 to the financial statements. No new accounting policies were adopted, and the application of existing policies was not changed during the audit period. We noted no transactions entered into by the organization during the audit period that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates can be particularly

sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. We feel these estimates are reasonable for the audit period.

Audit Adjustments

For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the organization's financial reporting process (that is, cause future financial statements to be materially misstated). Attached to this letter are the adjustments made as a part of this audit. These adjustments are considered to be significant to the financial reporting process, either individually or in the aggregate.

Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the organization's financial statements and report does not extend beyond the financial information identified in the report. In addition, we have no obligation to perform any procedures to corroborate other information contained in these documents. We have read the other information noting that nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditor's report. No such disagreements arose during the course of our audit.

Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the organization's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine whether the consultant has all the relevant facts. To our knowledge, management has not consulted with other accountants about auditing and accounting matters.

Issues Discussed Prior to Retention of Independent Auditors

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the organization's auditors. However, these discussions occurred in the normal course of our professional relationship, and our responses were not a condition to our retention.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties with management in performing and completing our audit.

This information is intended solely for the use of those with the oversight responsibility over the financial reporting process, including the audit committee, Board of Directors and management, and is not intended to be and should not be used by anyone other than these specified parties. If you should have any questions or wish to discuss any of the items referred to above in further detail, please do not hesitate to contact our office.

Balinger, Segars, Gilbert & Moss LLP

Certified Public Accountants

Client: **40277 - Kauai Island Utility Cooperative**
 Engagement: **2005 KIUC**
 Trial Balance: **017 - Annual Trial Balance - 2 Year**
 Workpaper: **Adjusting Journal Entries Report**

Account	Description	W/P Ref	Debit	Credit
Adjusting Journal Entries JE # 1				
To record client entries to clean up accounts.				
1420.001	Deferred Paymen		348.34	
1650.000	PrepaidExp-Rent		2,835.00	
1651.000	Prepaid Exp-Ins		0.33	
1841.610	Transportation Clearing		295.60	
1841.610	Transportation Clearing		10,866.00	
1842.004	Clearing Account		3,384.00	
1842.004	Clearing Account		5,885.37	
1842.004	Clearing Account		30,533.00	
2000.000	Membership		0.40	
2371.000	Int Acd Cus Dep		2,855.98	
9310.450	Rents-Gen Exp		1,904.29	
1440.000	AR-Allow Uncoll			0.40
1440.000	AR-Allow Uncoll			348.34
1650.000	PrepaidExp-Rent			1,904.29
1650.000	PrepaidExp-Rent			30,533.00
1651.000	Prepaid Exp-Ins			295.60
1651.000	Prepaid Exp-Ins			2,835.00
1651.000	Prepaid Exp-Ins			3,384.00
1651.000	Prepaid Exp-Ins			5,885.37
1651.000	Prepaid Exp-Ins			10,866.00
4311.931	Int Ex-Cust Dep			2,855.98
9240.000	Prop Ins Exp			0.33
Total			58,908.31	58,908.31

Adjusting Journal Entries JE # 2

To correct unrealized gain/loss equity account.

2150.001	Unreal Gain/Los		48,366.79	
4190.910	Interest & Div			48,366.79
Total			48,366.79	48,366.79

Adjusting Journal Entries JE # 3

To spread amounts recorded in clearing accounts and correcting of fas 106 balance to updated actuarial calculation.

2283.001	FAS 106		290,698.00	
1070.000	CWIP			24,096.57
1072.000	A&G-Sal & Wages			39,905.12
1073.000	CWIP-Spc Equip			656.04
1841.610	Transportation Clearing			11,161.60
1842.004	Clearing Account			39,802.37
5000.100	Opr Supv-S&W			8,040.91
5020.100	Stm Exp-S&W			6,720.43
5100.100	Mt Supv&Eng-Sal			742.85
5460.100	Opr Supv-S&W			6,905.81
5480.100	Gen Exp-S&W			16,792.19
5490.000	Misc OthrPwr Ex			3,678.65
5510.100	Mt Supv&Eng-Sal			18.69
5530.000	Mnt of GnElc Pl			18,838.63
5560.100	Sys Ctrl&Ld-S&W			19.03
5600.100	Sys Ctrl&Ld-S&W			63.34
5620.100	Stn Exp-Salarie			474.10
5660.100	Msc Trans-S&W			3,600.59
5700.100	Mt Stn Eq-S&W			2,499.30
5710.100	Mt of OH-Sal&Wg			5.31
5800.100	Opr Supv-S&W			63.17
5820.100	Stn Exp-Sal&Wgs			1,052.46

5830.100	OH Line Ex-S&W		461.63
5840.100	UG Line Ex-S&W		187.27
5860.100	Mtr Ex-Sal & Wg		6,725.62
5880.100	Misc Dist-S&W		5,904.83
5900.100	Mt Supv-S&W		51.20
5920.100	Mt Stn Eq-Sal		4,444.76
5930.000	Mnt of OH Lines		11,477.98
5940.100	Mt UG-Salaries		3,787.09
5960.100	Mt SL&Sig-Sal		503.03
9010.100	CS Acc-Sal & Wg		49.01
9020.100	CS Ac-Mtr Rd SW		6,357.54
9030.100	CS Rec-Sal&Wgs		15,724.70
9070.100	CS & info-S&W		3,581.73
9100.100	Misc CS&Inf-S&W		12.27
9200.100	A&G - Sal & Wgs		45,941.71
9350.100	Mt Gen Pt-S&W		350.47
Total		290,698.00	290,698.00

Adjusting Journal Entries JE # 4

To correct recording of revenue refund distributed in 2005.

4400.000	Residential Rev	355,016.68	
4420.000	Commercial Rev	146,932.19	
4421.000	Commercial Rev	130,869.70	
4430.000	Large Power Rev	121,590.91	
4431.000	Large Power Rev	237,182.32	
4440.000	Public St Lt Re	8,030.86	
2010.000	Patron Capital		999,622.66
Total		999,622.66	999,622.66

Adjusting Journal Entries JE # 5

To adjust plant to eliminate the negative overhead spread in 2005 for Joint Pole billings

3550.000	Poles and Fixtu	20,891.41	
3640.000	Poles, Towers,	173,676.50	
3110.000	Structures and		4,896.40
3120.000	Boiler Plant Eq		22,404.44
3150.000	Accessory Elect		1,165.00
3430.000	Prime Movers		49,073.09
3460.000	Miscellaneous P		234.13
3530.000	Station Equipme		6,500.02
3600.000	Land and Land R		1,062.83
3620.000	Station Equipme		32,757.41
3650.000	Overhead Conduc		12,931.62
3660.000	Underground Con		42,900.02
3670.000	Underground Con		8,487.33
3680.000	Line Transforme		4,580.04
3690.000	Services		2,722.01
3700.000	Meters		364.72
3730.000	Street Lighting		4,688.85
Total		194,567.91	194,567.91

Adjusting Journal Entries JE # 6

To correct equity accounts to detail.

9300.000	General Expense	1,903.69	
2010.000	Patron Capital		969.80
2380.001	Pat Cap Payable		933.89
Total		1,903.69	1,903.69

Adjusting Journal Entries JE # 7

To record membership fee to CFC.

1232.300	Other Investments in Associated Organizations	1,000.00	
4191.910	Inv Inc Asso Co		1,000.00
Total		1,000.00	1,000.00

Adjusting Journal Entries JE # 8

To correct PSC Tax accrual.

2363.000	PUC Tax Accrued	110,801.00	
4080.790	Other/Misc Tax		110,801.00
Total		<u><u>110,801.00</u></u>	<u><u>110,801.00</u></u>

Adjusting Journal Entries JE # 9

to reduce accrued taxes.

2362.000	Franchise Taxes	24,990.57	
2363.000	PUC Tax Accrued	58,827.79	
2364.000	Public Util Fee	4,998.11	
4080.790	Other/Misc Tax		58,827.79
4081.790	Franchise Taxes		24,990.57
9280.770	Reg Exp-PUC Fee		4,998.11
Total		<u><u>88,816.47</u></u>	<u><u>88,816.47</u></u>