

Caroline Islands Air, Inc.

Financial Statements and
Independent Auditor's Reports
as of and for the Years Ended
September 30, 2006 and 2007

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Caroline Islands Air, Inc.
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J.E. FORTENBERRY, III, P.C.
CERTIFIED PUBLIC ACCOUNTANT

INDEPENDENT AUDITOR'S REPORT ON BASIC FINANCIAL STATEMENTS

Board of Directors
Caroline Islands Air, Inc.
Pohnpei, Micronesia

I have audited the accompanying financial statements of the Caroline Islands Air, Inc., a component unit of the Federated States of Micronesia, as of and for the years ended September 30, 2006 and 2007. These financial statements are the responsibility of the Caroline Islands Air, Inc.'s management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that I 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. I believe that my audit provides a reasonable basis for my opinions.

In my opinion the financial statements referred to above present fairly, in all material respects, the financial position of the Caroline Islands Air, Inc. at September 30, 2006 and 2007, and the 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.

The accompanying financial statements have been prepared assuming that the Caroline Islands Air, Inc. will continue as a going concern. As discussed in Note 6 to the financial statements, the Airline does not possess a reliable means of transportation to obtain aviation gasoline. This condition raises substantial doubt about its ability to continue as a going concern. Management's plans regarding this matter also are described in Note 6. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

In accordance with Government Auditing Standards, I have also issued my report dated November 27, 2007 on my consideration of the Caroline Islands Air, Inc.'s internal control over financial reporting and my 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 my 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 my audit.



J.E. Fortenberry, III, PC
November 27, 2007

Certified Public Accountant

Caroline Islands Air, Inc.
 Kolonia, Pohnpei
Statement of Net Assets
 September 30

Assets

	<u>2006</u>	<u>2007</u>
Current Assets:		
Cash and Cash Equivalents	<u>\$26,122</u>	<u>\$5,093</u>
Total Current Assets	26,122	5,093
Property and Equipment:		
Vehicles	10,000	10,000
Furniture & Equipment	<u>8,938</u>	<u>8,938</u>
Total Capital Assets	18,938	18,938
Less: Accumulated Depreciation	<u>(12,178)</u>	<u>(15,218)</u>
Net Capital Assets	<u>6,760</u>	<u>3,720</u>
Total Assets	<u>\$32,882</u>	<u>\$8,813</u>

Liabilities and Net Assets

Current Liabilities:		
Accounts Payable	\$20,084	30,391
Accrued Payroll Related Liabilities	<u>2,696</u>	<u>3,568</u>
Total Current Liabilities	22,780	33,959
Total Liabilities	<u>22,780</u>	<u>33,959</u>
Net Assets:		
Invested in Capital Assets, Net of Related Debt	\$6,760	3,720
Unrestricted	<u>3,342</u>	<u>(28,866)</u>
Total Net Assets	<u>\$10,103</u>	<u>(\$25,145)</u>

The accompanying notes are an integral part of this statement.

Caroline Islands Air, Inc.
 Kolonia, Pohnpei
Statement of Revenue, Expenses and Change in Net Assets
 Fiscal Years ended September 30, 2006 and 2007

	<u>2006</u>	<u>2007</u>
Operating Revenues:		
Passenger Airfare	\$131,696	\$105,138
Baggage Fees	20,569	44,922
Charter Services	56,774	43,390
Drums	7,822	2,201
Freight	<u>380</u>	<u>533</u>
Total Operating Revenue	217,241	196,184
Operating Expenses:		
Salaries and Benefits	86,086	100,985
Rent	11,737	10,079
Utilities	10,054	7,621
Ordinary Maintenance & Operations	183,305	92,192
Depreciation	4,371	3,040
Insurance	23,588	25,912
Communication	1,318	0
Taxes	1,252	4,668
Administrative Repairs	577	0
Supplies	3,859	3,082
Professional Fees	0	1,131
Travel	6,721	4,868
Miscellaneous	<u>616</u>	<u>442</u>
Total Operating Expenses	333,484	254,020
Earnings (Loss) from Operations	(116,243)	(57,836)
Nonoperating Revenues (Expenses)		
Government Appropriations	109,337	22,573
Interest Income	<u>99</u>	<u>13</u>
	<u>(6,807)</u>	<u>(35,250)</u>
Net Assets - Beginning	<u>16,910</u>	<u>10,103</u>
Net Assets - Ending	<u>\$10,103</u>	<u>(\$25,145)</u>

The accompanying notes are an integral part of this statement.

Caroline Islands Air, Inc.
 Kolonia, Pohnpei
Statement of Cash Flows
 Fiscal Years ended September 30, 2006 and 2007

	<u>2006</u>	<u>2007</u>
Cash flows from operating activities:		
Operating receipts	\$217,241	\$196,184
Cash paid for goods and services	(244,171)	(138,814)
Payment to employees for services	<u>(86,086)</u>	<u>(100,985)</u>
Net provided (used) by operating activities	(113,016)	(43,615)
Cash flows from noncapital financing activities:		
Appropriated grants	<u>109,337</u>	<u>22,573</u>
Net provided (used) by noncapital financing activities	109,337	22,573
Cash flows from capital activities:		
Acquisition of capital assets	(8,200)	0
Proceeds from capital grants	<u>0</u>	<u>0</u>
Net provided (used) by capital and related financing activities	(8,200)	0
Cash flows from investing activities:		
Interest on Investments	<u>99</u>	<u>13</u>
Net provided (used) by investing activities	99	13
Net increase/decrease in cash	(11,780)	(21,029)
Cash and cash equivalents, beginning	<u>37,902</u>	<u>26,122</u>
Cash and cash equivalents, ending	<u><u>\$26,122</u></u>	<u><u>\$5,093</u></u>
Cash flows from operating activities:		
Increase in Net Assets Before Depreciation	(2,436)	(32,210)
Adjustments to reconcile decrease/increase in net assets to net cash provided by operating activities -		
Interest on Investments	(\$99)	(\$13)
Operating grants	(109,337)	(22,571)
Changes in assets and liabilities:		
Accounts payable	<u>(1,144)</u>	<u>11,179</u>
Total Adjustments	<u>(110,580)</u>	<u>(11,405)</u>
Net cash used in operating activities	<u><u>(\$113,016)</u></u>	<u><u>(\$43,615)</u></u>

The accompanying notes are an integral part of this statement.

Caroline Islands Air, Inc.

Notes to the Financial Statements

For the year ended September 30, 2006 and 2007

(1) Summary of Significant Accounting Policies.

A. Nature of Organization and Operations.

Caroline Islands Air, Inc. (CIA) is a public corporation established under the laws of the Federated States of Micronesia (FSM). On December 27, 1997, Public Law No. 10-72 established the public corporation to manage the operation and maintenance of the aircraft already purchased, as well as any other aircraft that may subsequently be purchased to operate out of Pohnpei State in the FSM. CIA is managed by a Board of Directors composed of 5 members: the Secretary of the FSM Department of Transportation, Communication and Infrastructure, or his designee; one member from Chuuk, one member from Kosrae, one member from Yap, one member from Pohnpei and the chief executive officer of CIA.

The public corporation is charged by the Congress of the Federated States of Micronesia with the following duties:

- 1) provide air transportation service throughout the Nation;
- 2) contract with domestic and foreign persons and corporations for the provisions of aircraft and services;
- 3) operate domestic air transportation;
- 4) train citizens in professions related to aeronautics;
- 5) act as a "Freely Associated State Air Carrier" with in the meaning of the Federal Program and Services Agreement concluded pursuant to the Compact of Free Association;
- 6) engage in support activities, included but not limited to, freight terminal and delivery activities and passenger services;
- 7) enter into joint ventures with other entities in order to effectuate its operations.

B. Enterprise Fund Accounting.

The Airline is organized, operated and financed in a manner similar to a private business enterprise, where (a) the intent of the governing body is that the cost (expense, including depreciation) of providing services on a continuing basis be financed or recovered primarily through user charges, or (b) where the governing body has decided the periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

C. Basis of Accounting.

The financial statements of the Caroline Islands Air, Inc. have been prepared in conformity with accounting principles generally accepted in the United States of America and, as a governmental entity provides certain disclosures required by the Governmental Accounting Standard Board (GASB). The GASB is the

Caroline Islands Air, Inc.

Notes to the Financial Statements

For the year ended September 30, 2006 and 2007

accepted standard-setting body for establishing governmental accounting and financial reporting principles.

Pursuant to Governmental Accounting Standard Board (GASB) Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, the Airline has elected to apply all applicable Financial Accounting Standard Board (FASB) pronouncements issued on or before November 30, 1989 in preparing financial statements and related disclosures unless those pronouncements conflict or contradict Governmental Accounting Standard Board (GASB) pronouncements.

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. The Enterprise Fund is accounted for on a flow of economic resources measurement focus and a determination of net income and capital maintenance. With this measurement focus, all assets and all liabilities associated with the operation of this fund are included on the balance sheet. The Enterprise Fund uses the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized at the time liabilities are incurred, regardless of the timing of the related cash flows.

D. Receivables

The Airline's accounts receivable are with businesses and individuals that relate to passenger and freight tickets. The allowance for un-collectible accounts is stated at an amount which management believes will be adequate to absorb possible losses on receivables that may become un-collectable based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for bad debts charged to expense.

E. Net Asset Categories

Resources are classified into the following net assets categories:

Invested in capital assets, net of related debt whereas capital assets, net of accumulated depreciation and outstanding principal balances of debt attributed to the acquisition, construction or improvement of those assets.

Restricted, either Nonexpendable where net assets subject to externally imposed stipulations require permanent maintenance or Expendable where external stipulations exist which may be fulfilled by the Airline. There was no restricted net assets at September 30, 2006 or 2007.

Unrestricted, in which case assets may be designated for purposes designated by the Committee, or Management.

Caroline Islands Air, Inc.

Notes to the Financial Statements

For the year ended September 30, 2006 and 2007

F. Use of Estimates.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. In the case of Caroline Islands Air, Inc. depreciation was used with the estimates as described in note G.

G. Capital Assets and Depreciation

Property and equipment are recorded at cost and depreciated using the straight-line method over the estimated useful life of the assets. The Airline has a policy in place which requires the capitalization of all asset purchases of \$1,000 or greater and with a useful life of five years or more.

Depreciation of all exhaustible capital assets used by enterprise funds is charged as an expense against operations; and accumulated depreciation is reported on the balance sheet. Depreciation has been provided over the estimated useful lives using the straight-line method. The estimated useful lives are as follows:

Vehicles	5 years
Furniture and equipment	5 years

H. Compensated Absences

Accumulated leave for contracted employees is recorded as an expense as the benefit is used by the employees. No liability is recorded for non-vesting accumulating rights to receive sick pay benefits. The related sick pay expense is recorded when the benefit is actually taken.

I. Cash Equivalents.

Cash includes amounts in demand deposits and interest bearing demand deposits. Cash equivalents include amounts in time deposits having a maturity of three month or less when purchased.

(2) Cash and Certificates of Deposit

The Airline may deposit funds within a fiscal agent bank organized under the laws of the Federated States of Micronesia. At September 30, 2006 and 2007 the Airline had cash and savings (book balances) totaling \$26,122 and \$5,093, respectively. These deposits are stated at cost, which approximates market.

Caroline Islands Air, Inc.

Notes to the Financial Statements

For the year ended September 30, 2006 and 2007

These deposits are subjected to custodial credit risk when deposits exceed \$100,000 because they are maintained at financial institutions subject to Federal Deposit Insurance Corporation (FDIC). All of the reported book balances at September 30, 2006 and 2007 were insured.

(3) Property and Equipment

A summary of property and equipment at September 30, 2006 and 2007 follows:

	10.1.2005	added	9.30.2006	added	9.30.2007
Vehicles	3,000	7,000	10,000	0	10,000
Equipment	6,100	1,200	7,300	0	7,300
Furniture	<u>1,638</u>	<u>0</u>	<u>1,638</u>	<u>0</u>	<u>1,638</u>
Total	10,738	8,200	18,938	0	18,938
Accumulated Depreciation	7,807	4,371	12,178	3,040	15,218
Net Assets	2,931		6,760		3,720

Public Law 10-72 Section 3 paragraph 4 allows Caroline Islands Air, Inc. to operate aircraft owned by the Federated States of Micronesia. The Airline operates three aircraft, a 1979 Britten Norman Islander, a 1960 Beech Queenair, and a 1971 Britten Norman Islander. The law specifies that CIA should operate these aircraft only with a valid lease. However, no lease agreement could be found between the FSM and CIA.

(4) Risk Management

Caroline Islands Airline purchases insurance to cover accidental damage or loss to aircraft owned by the Federated States of Micronesia. Additionally liability insurance is obtained against the Airline's legal liability to third parties and passengers for accidental bodily injury and accidental damage to property including cargo, freight, and mail. Caroline Islands Airline is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

(5) Receivables

The Airline's accounts receivable are with businesses and governments that relate to passenger, cargo and charter charges. The allowance for uncollectible accounts is stated at an amount which management believes will be adequate to absorb losses that may become uncollectible. The allowance is established through a provision for bad debts expense and netted with the accounts receivable for reporting purposes.

Caroline Islands Air, Inc.

Notes to the Financial Statements

For the year ended September 30, 2006 and 2007

	Accounts Receivable	Allowance for Doubtful Accounts
2006	\$30,034	\$30,034
2007	28,402	28,402

(6) Going Concern Disclosure

The aircraft operated by Caroline Islands Air, Inc. use aviation gasoline shipped in 55 gallon drums. PM&O Lines was a major provider of freight for this fuel until 2005. Since that time freight costs have escalated which has added to worldwide rising petroleum costs. This escalation has caused flight cancellations and cost overruns. On March of 2007 the Airline received appropriations from the Federated States of Micronesia in order to continue to operate after five years of self sufficiency. This appears to have been a short term solution. Unless dependable affordable shipping is obtained the airline will be unable to operate.

Management is faced with either finding other means of shipping or replacing government owned aircraft, discussed in Note 3, with at least one aircraft capable of using the jet fuel utilized by a neighboring Continental fleet. The second option would be complicated because the longer runways needed for jet aircraft are not available.

The following is a schedule of sampled costs depicting aviation gasoline costs together with the freight costs over the last four years when freight was available:

Fiscal Year	Drum Cost
2004	\$217
2005	265
2006	295
2007	355
As of report date	380

J.E. FORTENBERRY, III, P.C.
CERTIFIED PUBLIC ACCOUNTANT

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT
OF THE FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS

Board of Directors
Caroline Islands Air, Inc.
Pohnpei, Micronesia

I have audited the financial statements of the Caroline Islands Air, Inc. as of and for the years ended September 30, 2006 and 2007, and have issued my report thereon dated November 27, 2007. I conducted my 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 my audit, I considered the Corporation's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing my opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, I do not express an opinion on the effectiveness of the Corporation's internal control over financial reporting.

My consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, I identified deficiencies in internal control over financial reporting that I consider to be significant deficiencies.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. I consider the deficiency described in the accompanying schedule of findings and questioned costs (Finding 2007-1) to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Corporation's internal control.

My consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses, however, I believe the significant deficiency above is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, I 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

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provisions was not an objective of my audit and, accordingly, I do not express such an opinion. The results of my test disclosed instances of noncompliance that are required to be reported under Government Auditing Standards and which are described in the accompanying schedule of findings and questioned costs as findings 2007-2, 2007-3, 2007-4 and 2007-5.

This report is intended solely for the information and use of the legislature, board and management, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.



J.E. Fortenberry, III, PC
November 27, 2007

Certified Public Accountant

Caroline Islands Air, Inc.
Schedule of Findings and Questioned Costs
For the Years Ended September 30, 2006 and 2007

Section 1: Summary Schedule of Auditor's Results:

Financial Statements:

1. Type of auditor's report issued on the financial statements: Unqualified.
2. Material noncompliance relating to the financial statements? Yes.
3. Internal control over financial reporting:
 - a. Material weakness(es) identified? No.
 - b. Significant deficiency(ies) identified that are not considered to be material weaknesses? Yes.

Section 2: Findings Relating to the Financial Statements

Finding 2007-1

Condition: Internal controls were missing for both recording and reporting of transactions.

Criteria: The new pronouncement of SAS 112 requires the reporting of internal control deficiencies.

Cause: Due to the size of the Airline personnel were not available for recommended control practices such as segregation of duties or rotation of responsibilities.

Effect: Non-cash transactions such as directly paid vendor appropriations or depreciation were not recorded on the books.

Recommendation: Services such as bank reconciliations, quarterly financial statement review and quarterly tax reporting should be contracted through an outside accountant and then reviewed by the budget and finance officer and the chief executive officer.

Response: The Board and Management are considering the cost and benefits of contracting these services.

Responsible Party: Alex Tretnoff

Finding 2007-2

Condition: Minutes were not approved or signed by the Board of Directors.

Criteria: Public Law 10-72 Section 17 requires the Secretary-Treasurer or another board member in his absence record minutes of all meetings.

Cause: unknown

Effect: Board directives or budgets could not be communicated or disputed.

Recommendation: At each board meeting the previous meeting minutes should be reviewed, accepted by vote if accurate, and signed by the President and Secretary-Treasurer.

Response: These minutes have in fact already begun being signed in fiscal year 2007.

Responsible Party: Marion Henry

Finding 2007-3

Condition: The Annual Report to the President and Congress was late.

Criteria: Public Law 10-72 Section 23 paragraph 2 requires the Board to present an annual report to the President and Congress within ninety (90) days after the fiscal year.

Cause: unknown

Effect: The President and Congress did not have sufficient timely information.

Recommendation: The annual report should be given the highest priority in order to keep the President and Congress informed of the Airline position and activities.

Response: The reports for 2004, 2005, 2006 have already been submitted and 2007 will be forthcoming.
Responsible Party: Lukner Weilbacher

Finding 2007-4

Condition: In past years an audit of Caroline Airlines, Inc. was not performed.

Criteria: Public Law 10-72 Section 23 paragraph 3 requires an audit of the Airline every year.

Cause: unknown

Effect: Management, the Board, the Congress and the President could have an additional tool for oversight.

Recommendation: The Board should contract with an independent audit firm or the National Public Auditor to have this duty discharged annually.

Response: This will be remedied.

Responsible Party: Lukner Weilbacher

Finding 2007-5

Condition: Documentation that required quarterly board meetings occurred was not available.

Criteria: Public Law 10-72 Section 12 requires that in addition to "special" meetings "regular" meetings be held no less than once every three (3) months.

Cause: A quorum was not always available for the quarterly meetings.

Effect: Airline business could be late or inefficiently conducted.

Recommendation: If board members miss three (3) consecutive meetings they should be relieved from duties and replaced pursuant to Public Law 10-72 Section 10 by the remaining board members.

Response: The Board will monitor this situation to comply with Section 12 of PL 10-72.

Responsible Party: Lukner Weilbacher