

**Caroline Islands Air, Inc.**  
Financial Statements and  
Independent Auditor's Reports  
as of and for the Years Ended  
September 30, 2009 and 2008

Fortenberry & Ballard, PC  
Certified Public Accountants

**Caroline Islands Air, Inc.**

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**FORTENBERRY & BALLARD, P.C.**  
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT ON BASIC FINANCIAL STATEMENTS

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

We 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, 2009 and 2008. These financial statements are the responsibility of the Caroline Islands Air, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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. 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 opinions.

In our 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, 2009 and 2008, 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 Caroline Islands Air, Inc. will continue as a going concern. As discussed in Note 7 to the financial statements, the Airline remains dependent on the National Government of the Federated States of Micronesia which evaluates grant requests from the Airline on a year to year basis. This condition raises substantial doubt as to the Airline's ability to continue as a going concern. Management's plans regarding this reliance are described in Note 7. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

In accordance with Government Auditing Standards, we have also issued our report dated December 18, 2009 on our consideration of Caroline Islands Air, Inc.'s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit. Caroline Islands Air, Inc. has not presented a Management's Discussion and Analysis, which is not a required part of the basic financial statements but is supplementary information, required by the Governmental Accounting Standards Board.

*FORTENBERRY & BALLARD, PC*

Fortenberry Ballard, PC  
December 18, 2009

AICPA

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## FINANCIAL STATEMENTS

**Caroline Islands Air, Inc.**  
 Kolonia, Pohnpei  
**Statement of Net Assets**  
 Fiscal Years ended September 30, 2009 and 2008

<u>Assets</u>	<u>2009</u>	<u>2008</u>
Current Assets:		
Cash and Cash Equivalents	\$143,592	\$6,982
Other Receivables	0	118
Total Current Assets	<u>143,592</u>	<u>6,982</u>
Capital Assets:		
Computer and Radio	7,300	7,300
Vehicles	10,000	10,000
Furniture	1,638	1,638
Total Capital Assets	<u>18,938</u>	<u>18,938</u>
Less: Accumulated Depreciation	<u>(18,698)</u>	<u>(17,458)</u>
Net Capital Assets	<u>240</u>	<u>1,480</u>
Total Assets	<u><u>\$143,832</u></u>	<u><u>\$8,462</u></u>
 <u>Liabilities and Net Assets</u>  		
Current Liabilities:		
Accounts Payable	\$12,813	\$1,570
Accrued Payroll Related Liabilities	5,973	2,199
Total Current Liabilities	<u>18,786</u>	<u>3,769</u>
Total Liabilities	<u>18,786</u>	<u>3,769</u>
Net Assets:		
Invested in Capital Assets, Net of Related Debt	240	1,480
Unrestricted	124,806	3,213
Total Net Assets	<u>125,046</u>	<u>4,693</u>
Total Liabilities and Net Assets	<u><u>\$143,832</u></u>	<u><u>\$8,462</u></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, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Operating Revenues:		
Passenger Airfare	\$141,361	\$70,031
Baggage Fees	33,602	41,925
Charter Services	103,900	67,528
Drums	2,676	2,843
Freight	368	5,875
Total Operating Revenue	<u>281,907</u>	<u>188,202</u>
Operating Expenses:		
Salaries and Housing	78,231	72,246
Rent	21,020	17,729
Utilities	3,924	3,184
Ordinary Maintenance & Operations	140,379	22,596
Depreciation	1,240	2,240
Insurance	40,798	17,734
Communication	7,256	10,065
Contract Labor	1,312	0
Taxes	6,231	3,408
Professional Fees	437	1,297
Supplies	2,810	2,372
Bank Service Fees	317	160
Janitorial	97	217
Travel	7,543	8,544
Miscellaneous	51	1,285
Total Operating Expenses	<u>311,646</u>	<u>163,077</u>
Earnings (Loss) from Operations	(29,739.00)	25,125
Nonoperating Revenues (Expenses)		
Service Fees	650	4,700
Grant Subsidies	147,421	0
Contributions	2,000	0
Interest Income	21	13
	<u>120,353</u>	<u>29,838</u>
Net Assets - Beginning	<u>4,693</u>	<u>(25,145)</u>
Net Assets - Ending	<u><u>\$125,046</u></u>	<u><u>\$4,693</u></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, 2009 and 2008

	<u>2009</u>	<u>2008</u>
<b>Cash flows from operating activities:</b>		
Operating receipts	\$281,907	\$188,203
Cash paid for goods and services	(220,932)	(117,412)
Payment to employees for services	<u>(74,457)</u>	<u>(73,615)</u>
Net provided (used) by operating activities	(13,482)	(2,824)
 <b>Cash flows from noncapital financing activities:</b>		
Grant Subsidies	147,421	0
Service fees	<u>2,650</u>	<u>4,700</u>
Net provided (used) by noncapital financing activities	150,071	4,700
 <b>Cash flows from capital activities:</b>		
Acquisition of capital assets	<u>0</u>	<u>0</u>
Net provided (used) by capital and related financing activities	0	0
 <b>Cash flows from investing activities:</b>		
Interest on Investments	<u>21</u>	<u>13</u>
Net provided (used) by investing activities	21	13
 Net increase/decrease in cash	136,610	1,889
 Cash and cash equivalents, beginning	<u>6,982</u>	<u>5,093</u>
Cash and cash equivalents, ending	<u><u>\$143,592</u></u>	<u><u>\$6,982</u></u>
 <b>Cash flows from operating activities:</b>		
Operating income	(29,739)	25,125
Adjustments to reconcile decrease/increase in net assets to net cash provided by operating activities -		
Depreciation	1,240	2,240
Changes in assets and liabilities:		
Accounts receivable	0	0
Salaries Payable	3,774	(1,368)
Accounts payable	<u>11,243</u>	<u>(28,821)</u>
Total Adjustments	<u>16,257</u>	<u>(27,949)</u>
Net provided (used) by operating activities	<u><u>(\$13,482)</u></u>	<u><u>(\$2,824)</u></u>

The accompanying notes are an integral part of this statement.

**Caroline Islands Air, Inc.**

Notes to the Financial Statements  
September 30, 2009 and 2008

## **Caroline Islands Air, Inc.**

### Notes to the Financial Statements

For the year ended September 30, 2009 and 2008

#### 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 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

## **Caroline Islands Air, Inc.**

### Notes to the Financial Statements

For the year ended September 30, 2009 and 2008

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 collectability 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 includes 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 may be presented. There were no restricted net assets at September 30, 2009 or 2008.

Unrestricted assets may be designated for purposes designated by the Board or Management.

#### 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

## **Caroline Islands Air, Inc.**

### Notes to the Financial Statements

For the year ended September 30, 2009 and 2008

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.

#### J. New Pronouncements

In June 2008, GASB issued Statement No. 53, Accounting and Financial Reporting for Derivative Instruments. This statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CIA.

#### 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, 2009 and 2008 the Airline had cash and savings (book balances) totaling \$143,592 and \$6,982, respectively. These deposits are stated at cost, which approximates market.

These deposits are subjected to custodial credit risk when deposits exceed \$250,000 because they are maintained at financial institutions subject to Federal Deposit Insurance Corporation (FDIC). All of the reported book balances at September 30, 2009 and 2008 were insured.

#### 3) Property and Equipment

## Caroline Islands Air, Inc.

### Notes to the Financial Statements

For the year ended September 30, 2009 and 2008

A summary of property and equipment at September 30, 2008 and 2009 follows:

	<u>10/1/2007</u>	<u>Added</u>	<u>9/30/08</u>	<u>Added</u>	<u>09/30/09</u>
Vehicles	10,000	0	10,000	0	10,000
Equipment	7,300	0	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	18,938	0	18,938	0	18,938
Accumulated depreciation	<u>15,218</u>	<u>2,240</u>	<u>17,458</u>	<u>1,240</u>	<u>18,698</u>
Net Assets	<u>3,720</u>	<u>(2,240)</u>	<u>1,480</u>	<u>(1,240)</u>	<u>240</u>

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 is 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.

	<u>Accounts</u>	<u>Allowance for</u>
<u>Year</u>	<u>Receivable</u>	<u>Doubtful</u>
		<u>Accounts</u>
2009	30,382	30,382
2008	28,402	28,401

#### 6) Other Post Employment Benefits Payable

Other Post Employment Benefits Payable at September 30, 2009 includes relocation costs estimated at \$4,500 for the relocation of employees back to the state of recruitment. This cost was estimated based on

## **Caroline Islands Air, Inc.**

### Notes to the Financial Statements

For the year ended September 30, 2009 and 2008

current passage and freight ticket charges and represents a contractual obligation on the part of CIA.

#### 7) Going Concern Disclosure

Caroline Islands Air, Inc. remains dependent on the National Government of the Federated States of Micronesia which evaluates grant requests to cover shortfalls in revenue of the Airline on a year to year basis. This condition raises substantial doubt as to the Airline's ability to continue as a going concern. The Board and Management are vigorously pursuing a solution to this National Government dependence with both short term and long term planning. However, to date the Airline has not proved sustainable.

#### 8) National Government Grants

Because of the above referenced viability in Note 7, CIA in fact did operate only partial years during both the September 30, 2009 and 2008 fiscal periods. During the fiscal year ended September 30, 2009 Congress approved a budget of \$246,000 of which Department of Finance and Administration records show that \$147,420.60 was expended for CIA operational costs.

While Caroline Islands Air, Inc.'s financial statements reflect \$147,420.60 grant revenue and the related expenses reported by Department of Finance and Administration, the airline disagrees with the amount (\$147,420.60) of these expenses reported by the department. Whereas Department of Finance and Administration confirms expenditures of \$147,420.60 during the year ended September 30, 2009 on behalf of the airline, Caroline Islands Air, Inc. believes those expenditures were \$236,075. Because the airline has no supporting documentation of the perceived additional grant resources paid directly by the Department, only confirmed grant amounts are included in the financial statements of this audit report. At the date of this report the consequence, if any, of this unresolved variance between entities is not known.

#### 9) Contingency

Caroline Islands Air, Inc. does not hold title to the aircraft used for operations. Such property is held in the name of the FSM National Government. Caroline Islands Air, Inc. is not charged a fee for use of this property.

**FORTENBERRY & BALLARD, P.C.**  
CERTIFIED PUBLIC ACCOUNTANTS

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

We have audited the financial statements of the Caroline Islands Air, Inc. as of and for the years ended September 30, 2009 and 2008, and have issued our report thereon dated December 18, 2009. 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 the Corporation's internal control over financial reporting as a basis for designing my auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Corporation's internal control over financial reporting.

Our 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, we identified deficiencies in internal control over financial reporting that we 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. We consider the deficiencies described in the accompanying schedule of findings and questioned costs (findings 2008-1 and 2009-1) 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.

Our 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, we believe the significant deficiencies above are not material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation'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 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 finding 2008-1.

This report is intended solely for the information and use of the President, Congress, 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.

*FORTENBERRY & BALLARD, PC*

Fortenberry & Ballard, PC  
December 18, 2009

FINDINGS, CORRECTIVE ACTION PLAN AND AUDIT FOLLOW-UP

**Caroline Islands Air, Inc.**  
Schedule of Findings and Questioned Costs  
For the Years Ended September 30, 2009 and 2008

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 2008-1

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: No monitoring was in place with which to notice that this report was late.

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 report for 2008 was not submitted because CIA was waiting for the response from the National Government on the 2006 budget before CIA could proceed.

Responsible Party: Kiyoshi Phillip

Finding 2009-1

Condition: Accruals in several account balances were not booked.

Criteria: CIA uses the accrual basis of accounting which requires that expenses be recognized when incurred.

Cause: Quickbooks training is needed for accruals and other non-cash entries such as depreciation and the use of journal entries.

Effect: Financial statements have been incomplete during operations and would have understated expenditures for the fiscal years audited in the Annual Report to the President and Congress had it not been corrected in the audit process.

Recommendation: We recommend monitoring of account balances on a quarterly basis using a written monitoring plan.

Response: These accounts will be monitored for completion.

Responsible Party: Alex Tretnoff

**Caroline Islands Air, Inc.**  
Status of Prior Year Findings

Finding:

Status:

2007-1	corrected
2007-2	corrected
2007-3	not corrected in 2008, not yet due in 2009
2007-4	corrected
2007-5	corrected