

**Caroline Islands Air, Inc.**  
Financial Statements and  
Independent Auditor's Reports  
as of and for the Years Ended  
September 30, 2011 and 2010

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

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

We have audited the accompanying statements of net assets of the Caroline Islands Air, Inc., a component unit of the Federated States of Micronesia, as of and for the years ended September 30, 2011 and 2010, and the related statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. 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.

Except as discussed in the following paragraph, 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the internal control over financial reporting. Accordingly, we express no such opinion. 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.

As discussed in Note 3 to the financial statements there was incomplete documentation to substantiate the valuation of three aircraft recorded as \$540,000 along with associated accumulated depreciation of \$162,000. Accounting principles generally accepted in the United States of America require that capital assets be recorded at historical cost or if donated at the fair market value on the date of donation. The amount by which an adjustment, if any, would affect assets and net assets is not reasonable determinable.

In our opinion, except for the effects of any adjustment to historical cost for the aircraft as discussed in the previous paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the Caroline Islands Air, Inc. at September 30, 2011 and 2010, and the results of its operations, changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated March 9, 2011 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

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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

March 9, 2012

## FINANCIAL STATEMENTS

**Caroline Islands Air, Inc.**  
 Kolonia, Pohnpei  
**Statement of Net Assets**  
 Fiscal Years ended September 30, 2011 and 2010

Assets

	<u>2011</u>	<u>2010</u>
Current Assets:		
Cash and Cash Equivalents	\$68,398	\$110,221
Receivables	11,947	16,268
Inventory	27,885	30,764
Total Current Assets	<u>108,230</u>	<u>157,253</u>
Capital Assets:		
Aircraft	540,000	0
Vehicles	15,500	10,000
Equipment	7,300	7,300
Furniture	1,638	1,638
Total Capital Assets	<u>564,438</u>	<u>18,938</u>
Less: Accumulated Depreciation	<u>(181,818)</u>	<u>(18,938)</u>
Net Capital Assets	<u>382,620</u>	<u>0</u>
Total Assets	<u><u>\$490,850</u></u>	<u><u>\$157,253</u></u>

Liabilities and Net Assets

Current Liabilities:		
Accounts Payable	\$4,359	\$7,208
Accrued Payroll Related Liabilities	8,626	3,104
Total Current Liabilities	<u>12,985</u>	<u>10,312</u>
Total Liabilities	<u>12,985</u>	<u>10,312</u>
Net Assets:		
Invested in Capital Assets	382,620	0
Unrestricted	95,245	146,941
Total Net Assets	<u>477,865</u>	<u>146,941</u>
Total Liabilities and Net Assets	<u><u>\$490,850</u></u>	<u><u>\$157,253</u></u>

The accompanying notes are an integral part of this statement.

**Caroline Islands Air, Inc.**

Exhibit B

Kolonia, Pohnpei

**Statement of Revenue, Expenses and Change in Net Assets**

Fiscal Years ended September 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Operating Revenues:		
Passenger Airfare	\$183,787	\$238,597
Baggage Fees	69,305	78,985
Charter Services	141,384	168,242
Drums	4,274	1,590
Freight	6,315	0
Total Operating Revenue	<u>405,065</u>	<u>487,414</u>
Cost of Operating Revenues:		
Salaries and Housing	105,646	107,876
Rent	12,790	12,334
Maintenance & Operations	252,626	262,053
Depreciation	17,080	0
Taxes	9,238	7,841
Insurance	29,882	24,481
Total Cost of Operating Revenue	<u>427,262</u>	<u>414,585</u>
Gross Profit	<u>(22,197)</u>	<u>72,829</u>
General and Administrative Expenses:		
Salaries	13,817	13,817
Utilities	6,200	4,695
Repairs	33	2,851
Depreciation	0	240
Communication	8,004	14,406
Contract Labor	3,424	1,465
Professional Fees	1,938	313
Supplies	3,611	3,719
Bank Service Fees	1,330	2,082
Janitorial	142	168
Travel	5,113	8,128
Miscellaneous	39	50
Total Operating Expenses	<u>43,651</u>	<u>51,934</u>
Earnings (Loss) from Operations	(65,848)	20,895
Nonoperating Revenues (Expenses)		
Service Fees	1,072	1,000
Grant Subsidies	0	0
Sales of Avgas	1,500	0
Net Income	<u>(63,276)</u>	<u>21,895</u>
Net Assets - Beginning	146,941	125,046
Prior Period Adjustment	394,200	0
Net Assets - Ending	<u>\$477,865</u>	<u>\$146,941</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, 2011 and 2010

	<u>2011</u>	<u>2010</u>
<b>Cash flows from operating activities:</b>		
Operating receipts	\$412,265	\$440,382
Cash paid for goods and services	(331,697)	(353,060)
Payment to employees for services	<u>(119,463)</u>	<u>(121,693)</u>
Net provided (used) by operating activities	(38,895)	(34,371)
<b>Cash flows from noncapital financing activities:</b>		
Sales of Avgas	1,500	0
Service fees	<u>1,072</u>	<u>1,000</u>
Net provided (used) by noncapital financing activities	2,572	1,000
<b>Cash flows from noncapital financing activities:</b>		
Acquisition of Capital Assets	<u>(5,500)</u>	<u>0</u>
Net provided (used) by noncapital financing activities	(5,500)	0
<b>Cash flows from investing activities:</b>		
Interest on Investments	<u>0</u>	<u>0</u>
Net provided (used) by investing activities	0	0
Net increase/decrease in cash	(41,823)	(33,371)
Cash and cash equivalents, beginning	110,221	143,592
Cash and cash equivalents, ending	<u><u>\$68,398</u></u>	<u><u>\$110,221</u></u>
<b>Cash flows from operating activities:</b>		
Operating income	(65,848)	20,895
Adjustments to reconcile decrease/increase in net assets to net cash provided by operating activities -		
Depreciation	17,080	240
Changes in assets and liabilities:		
Receivables	4,321	(16,268)
Inventory	2,879	(30,764)
Payroll Related Payables	5,522	(2,869)
Accounts payable	<u>(2,849)</u>	<u>(5,605)</u>
Total Adjustments	<u>26,953</u>	<u>(55,266)</u>
Net provided (used) by operating activities	<u><u>(\$38,895)</u></u>	<u><u>(\$34,371)</u></u>

The accompanying notes are an integral part of this statement.

**Caroline Islands Air, Inc.**

Notes to the Financial Statements  
September 30, 2011 and 2010

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

Notes to the Financial Statements

For the year ended September 30, 2011 and 2010

### **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 Accounting, the Airline has elected to apply all applicable Financial Accounting

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

### Notes to the Financial Statements

For the year ended September 30, 2011 and 2010

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.

Revenues derived from air transportation are accounted for as operating revenues and all revenues which do not meet that definition are accounted for as non operating revenues.

#### 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 uncollectable 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. Inventory

Inventory consists of Avgas fuel in drums. These drums are valued at the lower of cost or market using the first-in, first-out method.

#### F. 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, 2011 or 2010.

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

#### G. 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 H.

## Caroline Islands Air, Inc.

### Notes to the Financial Statements

For the year ended September 30, 2011 and 2010

#### H. 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:

Aircraft	30 years
Vehicles	5 years
Furniture and equipment	5 years

#### I. 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.

#### J. 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.

#### K. Lease

Caroline Islands Air maintains a one year lease for a hangar at Dekehtik Island, Nett, Pohnpei State for \$713.04 per month.

#### L. New Pronouncements

Governmental Accounting Standards Board (GASB) has issued GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The implementation of this statement did not have a material effect on the financial statements of CIA.

GASB has issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The implementation of this statement did not have a material effect on the financial statements of CIA.

GASB has issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to

## Caroline Islands Air, Inc.

### Notes to the Financial Statements

For the year ended September 30, 2011 and 2010

manage specific risks or make investments - in their financial statements. The implementation of this statement did not have a material effect on the financial statements of CIA.

GASB has issued Statement No. 58, Accounting and Financial Reporting for Chapter 9 Bankruptcies. This statement establishes accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. The requirements of this Statement are effective for periods beginning after June 15, 2010. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CIA.

GASB has issued Statement No. 59, *Financial Instruments Omnibus*. The Statement updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The implementation of this statement did not 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, 2011 and 2010 the Airline had cash totaling \$68,391 and \$110,221, 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, 2011 and 2010 were insured. Caroline Islands Airline does not have a formal deposit or investment policy.

## 3) Property and Equipment

A summary of property and equipment at September 30, 2010 and 2011 follows:

	<u>10/1/2009</u>	<u>Added</u>	<u>9/30/10</u>	<u>Added</u>	<u>09/30/11</u>
Aircraft	0	0	0	540,000	540,000
Vehicles	10,000	0	10,000	5,500	15,500
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	545,500	564,438
Accumulated depreciation	<u>(18,698)</u>	<u>(240)</u>	<u>(18,938)</u>	<u>(162,880)</u>	<u>(181,818)</u>
Net Assets	<u>240</u>	<u>(240)</u>	<u>0</u>	<u>(382,620)</u>	<u>(382,620)</u>

During the fiscal year ended September 30, 2011 Caroline Islands Air, Inc. substantiated ownership of three aircraft by evidence of Certificates of Registration of a 1979 Britten Norman Islander, a 1960 Beech Queenair, and a 1971 Britten Norman Islander previously thought to be

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

### Notes to the Financial Statements

For the year ended September 30, 2011 and 2010

owned by Federated States of Micronesia National Government. (See Note 8) However the historical cost of these three aircraft has not been substantiated therefore an estimate based on insurance valuations for current replacement cost has been used to record the aircraft.

#### **4) Risk Management**

Caroline Islands Airline purchases insurance to cover accidental damage or loss to aircraft hulls. 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.

	Accounts	Allowance
	Receivable	for
<u>Year</u>	<u>Receivable</u>	<u>Doubtful</u>
		<u>Accounts</u>
2011	14,947	3,000
2010	41,540	25,272

#### **6) Other Post Employment Benefits Payable**

Other Post Employment Benefits Payable at September 30, 2011 includes relocation costs estimated at \$4,500 for the relocation of employees back to the state of recruitment. This cost was estimated based on current passage and freight ticket charges and represents a contractual obligation on the part of CIA.

#### **7) Partial Year Operation**

During the fiscal year ended September 30, 2010 Caroline Islands Air, Inc. operated only a partial year.

#### **8) Prior Period Adjustment**

During the fiscal year ended September 30, 2011 Caroline Islands Air, Inc. substantiated ownership of three aircraft by evidence of Certificates of Registration three aircraft, a 1979 Britten Norman Islander, a 1960 Beech Queenair, and a 1971 Britten Norman Islander previously thought to be owned by Federated States of Micronesia National Government. (See Note 3) The aircraft were booked for \$180,000 each along with their accompanying

**Caroline Islands Air, Inc.**

Notes to the Financial Statements

For the year ended September 30, 2011 and 2010

accumulated depreciation from September 4, 2001, the date ownership was established in the amount of \$145,800. The adjustment to Net Assets on the Statement of Revenue, Expenses and Change in Net Assets was \$394,200.

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 Caroline Islands Air, Inc. as of and for the years ended September 30, 2011 and 2010, and have issued our report thereon dated March 9, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Corporation's internal control over financial reporting as a basis for designing our 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.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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

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 or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned

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costs as item 2011-1.

We noted certain matters that we reported to management of Caroline Islands Air, Inc. in a separate letter dated March 9, 2012.

Caroline Islands Air, Inc.'s response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit Caroline Islands Air, Inc.'s response and, accordingly, we express no opinion on it.

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.

*FORTENBERRY & BALLARD, PC*

Fortenberry & Ballard, PC  
March 9, 2012

## FINDINGS AND CORRECTIVE ACTION PLAN

**Caroline Islands Air, Inc.**  
Schedule of Findings and Questioned Costs  
For the Years Ended September 30, 2011 and 2010

Section 1: Summary Schedule of Auditor's Results:

Financial Statements:

1. Type of auditor's report issued on the financial statements: Qualified.
2. Material noncompliance relating to the financial statements? No.
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

Significant deficiency:

Finding 2011-1

Condition: Financial statements were not available during quarterly board meetings.

Criteria: Public Law 10-72, Section 5 charges the Board of Directors to "exercise corporate powers for Pohnpei operations". To fulfill this responsibility financial statements are a necessary planning and policy tool.

Cause: Financial statements were not completed in time for the quarterly board meetings.

Effect: Directors did not have CIA financial statements with which to base policy decisions.

Recommendation: Current financial reports for board directors should be presented at each board meeting.

Response: The Finance Officer will present current financial statements at board meetings.

Responsible Party: Yirwor Tretnoff.