

CAROLINE ISLANDS AIR, INC.
**(A COMPONENT UNIT OF THE FSM NATIONAL
GOVERNMENT)**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2012 AND 2011

CAROLINE ISLANDS AIR, INC.
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Years Ended September 30, 2012 and 2011
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INDEPENDENT AUDITORS' REPORT

Board of Directors
Caroline Islands Air, Inc.:

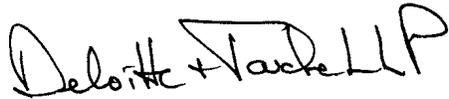
We have audited the accompanying statements of net assets of Caroline Islands Air, Inc. (CIA), a component unit of the FSM National Government, as of September 30, 2012, and the related statements of revenues, expenses and changes in net assets and of cash flows for the year then ended. These financial statements are the responsibility of the CIA's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of CIA as of and for the year ended September 30, 2011 were audited by other auditors whose report, dated June 6, 2012, expressed an unqualified opinion.

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 Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 the Company as of September 30, 2012, and the changes in its net assets and its 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 June 26, 2013, on our consideration of the Company's internal control over financial reporting and on 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 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 to 5 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basis financial statements in an appropriate operational, economic, or historical context. This supplementary information is the responsibility of the Company's management. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

A handwritten signature in black ink that reads "Deloitte + Stark LLP". The signature is written in a cursive, stylized font.

June 26, 2013

CAROLINE ISLANDS AIR, INC.
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Management's Discussion and Analysis
Years Ended September 30, 2012 and 2011

This section of the Caroline Islands Air, Inc. (CIA) annual audit report presents the Management's Discussion and Analysis (MD&A) for the fiscal years ended September 30, 2012 and 2011. MD&A is supplementary information required by the Government Accounting Standards Board Statement 34 (GASB 34) on reporting model. The preparation of MD&A is the responsibility of the management of CIA, and it is designed to help the reader in understanding the accompanying financial statements and notes to the financial statements.

Background

Caroline Islands Air, Inc. is a government owned corporation, created under Public Law No. 10-72 by the Congress of the Federated States of Micronesia (FSM). The main purpose of CIA is to (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" within the meaning of the Federal Program and Services Agreement concluded pursuant to the Compact of Free Association, (6) engage in support activities, included but no limited to, freight terminal and delivery activities and passenger services, and (7) enter into joint ventures with other entities in order to effectuate its operation.

Overview of Fiscal Year 2012

The accounts of CIA are organized as a proprietary fund. Proprietary funds are used by governmental units that are operated in a manner similar to private business enterprises.

For the current year, CIA's operations include regular / charter flight services and cargo.

Fiscal year 2012 revenue sources of CIA operations are from \$186k of passenger airfare, \$124k of charter services, \$50k of baggage fees, \$18k of freight, \$2k of sales of drums and \$22k of non-operating revenues.

Financial Highlights

1. Statement of Net Assets

The statement of Net Assets presents what CIA owns (assets), owes (liabilities) and the net assets (the difference between total assets and total liabilities) at the end of the fiscal year. The "net assets" is one indicator of whether the current financial condition has improved or worsened during the year.

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Management's Discussion and Analysis
Years Ended September 30, 2012 and 2011

Comparative Statements of Net Assets at September 30, 2012, and 2011 are summarized below:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Assets:			
Current Assets	\$ 60,777	\$ 108,230	\$ 157,253
Noncurrent Assets	<u>3,740</u>	<u>4,620</u>	<u>-</u>
Total assets	\$ <u>64,517</u>	\$ <u>112,850</u>	\$ <u>157,253</u>
Liabilities:			
Current Liabilities	\$ <u>13,924</u>	\$ <u>12,985</u>	\$ <u>10,312</u>
Total Liabilities	<u>13,924</u>	<u>12,985</u>	<u>10,312</u>
Net Assets:			
Invested in capital assets, net of related debt	3,740	4,620	-
Unrestricted	<u>46,853</u>	<u>95,245</u>	<u>146,941</u>
Total net assets	<u>50,593</u>	<u>99,865</u>	<u>146,941</u>
	\$ <u>64,517</u>	\$ <u>112,850</u>	\$ <u>157,253</u>

Assets: Total assets of \$65k comprise \$61k or 94% of current assets and \$4k or 6% of capital assets.

Current assets: Total current assets of \$61k comprised \$14k or 23% of cash, \$13k or 21% of accounts receivable and \$34k or 56% of inventory.

Noncurrent assets: The noncurrent assets of \$4k comprise the Company's property and equipment, net of accumulated depreciation.

Liabilities: CIA's liabilities of \$14k are all current consisting of accounts payable and accrued liabilities.

2. Summary Statement of Revenues, Expenses and changes in Net Assets

The following table provides information on the financial performance of the current year in terms of revenues and expenses. It presents the operating revenues and expenses and the corresponding net operating results, as well as non-operating revenues and expenses. Below is the comparative summary of the Statement of Revenues, Expenses and Changes in Net Assets for the fiscal years ended September 30, 2012 and 2011.

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating revenue	\$ 380,050	\$ 405,065	\$ 487,414
Operating expenses	<u>(395,741)</u>	<u>(411,062)</u>	<u>(414,585)</u>
Gross (loss) profit	<u>(15,691)</u>	<u>(5,997)</u>	<u>72,829</u>
General and administrative expenses	<u>(55,823)</u>	<u>43,651</u>	<u>51,934</u>
Operating (loss) earnings	(71,514)	(49,648)	20,895
Nonoperating revenues	<u>22,242</u>	<u>2,572</u>	<u>1,000</u>
Change in net assets	(49,272)	(47,076)	21,895
Net assets at beginning of year	<u>99,865</u>	<u>146,941</u>	<u>125,046</u>
Net assets at end of year	\$ <u>50,593</u>	\$ <u>99,865</u>	\$ <u>146,941</u>

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Management's Discussion and Analysis
Years Ended September 30, 2012 and 2011

CIA's operating revenues are from \$186k of passenger airfare, \$124k of charter services, \$50k of baggage fees, \$18k of freight, \$2k of sales of drums and \$22k of non-operating revenues.

3. Summary Statement of Cash Flows

The following table presents information about changes in the cash position using the direct method of reporting sources and uses of cash. The direct method reports all major cash inflows and outflows at gross amounts, differentiating the activities into cash flows arising from operating activities, noncapital financing and capital and related financing.

Below are the summary statements of cash flows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Cash flows from operating activities	\$ (76,569)	\$ (38,895)	\$ (34,371)
Cash flows from noncapital financing activities	22,242	2,572	1,000
Cash flows from capital and related financing activities	<u>-</u>	<u>(5,500)</u>	<u>-</u>
Net change in cash	(54,327)	(41,823)	(33,371)
Cash at beginning of year	<u>68,398</u>	<u>110,221</u>	<u>143,592</u>
Cash at end of year	\$ <u>14,071</u>	\$ <u>68,398</u>	\$ <u>110,221</u>

See accompanying notes to financial statements.

4. Debt and Capital Asset Activities

No significant debt or capital asset activities occurred during the year ended September 30, 2012. For additional information on capital assets, please refer to note 3 to the financial statements.

Management's Discussion and Analysis for the year ended September 30, 2011, is set forth in the report on the audit of financial statements, which is dated June 6, 2012. That Discussion and Analysis explains the major factors impacting the 2011 financial statements and can be viewed at the FSM Office of the National Public Auditors' website at www.fsmopa.fm.

Economic Outlook

CIA continued to face challenges during FY2012. These operating issues are the continued revenue shortfalls to adequately cover operating costs and fuel for the airplanes. CIA temporarily stopped the flight services toward the end of FY2012 while the Company waits for the fuel to be shipped. These continue to be the main priorities for the operation and plan of actions are focused toward improving these operating issues.

CAROLINE ISLANDS AIR, INC.
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Statements of Net Assets
September 30, 2012 and 2011

<u>ASSETS</u>	<u>2012</u>	<u>2011</u>
Current assets:		
Cash	\$ 14,071	\$ 68,398
Trade receivables	12,886	11,947
Inventory	<u>33,820</u>	<u>27,885</u>
Total current assets	60,777	108,230
Property and equipment, net	<u>3,740</u>	<u>4,620</u>
	<u>\$ 64,517</u>	<u>\$ 112,850</u>
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Accounts payable	\$ 8,832	\$ 4,359
Accrued liabilities and others	<u>5,092</u>	<u>8,626</u>
Total liabilities	<u>13,924</u>	<u>12,985</u>
Contingencies		
Net assets:		
Invested in capital assets, net of related debt	3,740	4,620
Unrestricted	<u>46,853</u>	<u>95,245</u>
Total net assets	<u>50,593</u>	<u>99,865</u>
	<u>\$ 64,517</u>	<u>\$ 112,850</u>

See accompanying notes to financial statements.

CAROLINE ISLANDS AIR, INC.
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Statements of Revenue, Expenses, and Changes in Net Assets
Years Ended September 30, 2012 and 2011

	2012	2011
Operating revenue:		
Passenger airfare	\$ 185,547	\$ 183,787
Charter services	123,970	141,384
Baggage fees	49,778	69,305
Freight	18,610	6,315
Drums	2,145	4,274
Total operating revenue	380,050	405,065
Operating expenses:		
Maintenance and operation	252,445	252,626
Salaries and housing	105,728	105,646
Insurance	17,700	29,882
Rent	11,859	12,790
Taxes	7,129	9,238
Depreciation	880	880
Total cost of operating revenue	395,741	411,062
Gross loss	(15,691)	(5,997)
General and administrative expenses:		
Communications	26,849	8,004
Utilities	8,100	6,200
Travel	6,488	5,113
Supplies	4,980	3,611
Bank service fees	3,125	1,330
Contract labor	2,961	3,424
Janitorial	462	142
Professional fees	219	1,938
Repairs and maintenance	-	33
Miscellaneous	2,639	39
Total operating expenses	55,823	43,651
Operating loss	(71,514)	(49,648)
Nonoperating expenses:		
Sales of Avgas	19,109	1,500
Service fees	3,133	1,072
Change in net assets	(49,272)	(47,076)
Net assets at beginning of year	99,865	146,941
Net assets at end of year	\$ 50,593	\$ 99,865

See accompanying notes to financial statements.

CAROLINE ISLANDS AIR, INC.
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Statements of Cash Flows
Years Ended September 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Cash received from customers	\$ 373,176	\$ 412,265
Cash paid to suppliers for goods and services	(344,017)	(331,697)
Cash paid to employees for services	(105,728)	(119,463)
Net cash used in operating activities	(76,569)	(38,895)
Cash flows from noncapital financing activities:		
Sales of Avgas	19,109	1,500
Service fees	3,133	1,072
Net cash provided by noncapital financing activities	22,242	2,572
Cash flows from capital and related financing activities:		
Acquisition of capital assets	-	(5,500)
Net change in cash	(54,327)	(41,823)
Cash at beginning of year	68,398	110,221
Cash at end of year	\$ 14,071	\$ 68,398
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	\$ (71,514)	\$ (49,648)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation	880	880
(Increase) decrease in assets:		
Trade receivables	(939)	4,321
Inventory	(5,935)	2,879
Increase in liabilities:		
Accounts payable	(3,534)	5,522
Accrued liabilities and others	4,473	(2,849)
Net cash used in operating activities	\$ (76,569)	\$ (38,895)

See accompanying notes to financial statements.

CAROLINE ISLANDS AIR, INC.
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Notes to Financial Statements
September 30, 2012 and 2011

(1) Organization

Caroline Islands Air, Inc. (CIA or the Company) is a component unit of the Federated States of Micronesia (FSM) National Government (FSMNG). CIA was created under Public Law 10-72, as passed by the FSM Congress and which was signed into law on December 27, 1997, for the purpose of providing the following services:

- Provide air transportation service throughout the Nation;
- Contract with domestic and foreign persons and corporations for the provisions of aircraft and services;
- Operate domestic air transportation;
- Train citizens in professions related to aeronautics;
- Act as a “Freely Associated State Air Carrier” within the meaning of the Federal Program and Services Agreement concluded pursuant to the Compact of Free Association;
- Engage in support activities, included but not limited to, freight terminal and delivery activities and passenger services;
- Enter into joint ventures with other entities in order to effectuate its operation.

CIA is governed by a six-member Board of Directors appointed as follows:

- 1 member appointed by the President with the advice and consent of the FSM Congress to represent the FSMNG.
- 4 State representatives appointed by the President with the advice and consent of the FSM Congress upon the recommendation to the President by the Governor of the pertinent State.
- The Chief Executive Officer of CIA as ex officio but without rights to vote.

CIA’s financial statements are incorporated into the financial statements of the FSM National Government as a component unit.

(2) Summary of Significant Accounting Policies

The accounting policies of CIA conform to accounting principles generally accepted in the United States of America as applicable to governmental entities, specifically proprietary funds. Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. FSMPC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

GASB Statement No. 34, *Basic Financial Statements - and Management’s Discussion and Analysis - for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements - Management’s Discussion and Analysis - for State and Local Governments: Omnibus*, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, establish standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following three net asset categories:

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Notes to Financial Statements
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

- Invested in capital assets, net of related debt: capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.
- Restricted: Nonexpendable - Net assets subject to externally imposed stipulations that require the Company to maintain them permanently. As of September 30, 2012 and 2011, the Company does not have nonexpendable restricted net assets. Expendable - Net assets whose use by the Company is subject to externally imposed stipulations that can be fulfilled by actions of the Company pursuant to those stipulations or that expire with the passage of time.
- Unrestricted: Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Operating and Non-Operating Revenue and Expenses

Operating revenues and expenses generally result directly from the operation and maintenance of the Company. Non-operating revenues and expenses result from capital and related financing activities as well as certain other non-recurring income and expense items.

Cash

Custodial credit risk is the risk that in the event of a bank failure, CIA's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. CIA does not have a deposit policy for custodial credit risk.

As of September 30, 2012 and 2011, the carrying amounts of CIA's total cash was \$11,892 and \$68,391, respectively, and the corresponding bank balances were \$11,892 and \$68,391, respectively, which were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2012 and 2011, all bank deposits were FDIC insured. Balances in excess of FDIC insurance are not collateralized.

Accounts Receivable

CIA'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.

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Notes to Financial Statements
September 30, 2012 and 2011

(2) Summary of Significant Accounting Policies, Continued

Inventory

CIA's inventory consists of Avgas fuel in drums. Inventory is substantially carried at the lower of cost (first-in, first-out) or market.

Property, Plant and Equipment

CIA capitalizes individual items with estimated useful lives of more than five years and the purchase cost of more than \$1,000. Depreciation of property and equipment is calculated using the straight-line method over the estimated useful lives of the assets. Estimated useful lives of property and equipment are as follows:

Motor vehicle	5 years
Equipment	5 years
Furniture and fixtures	5 years

Risk Management

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

New Accounting Standards

During the year ended September 30, 2012, CIA implemented the following pronouncements:

GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to the frequency and timing of measurements for actuarial valuations first used to report funded status information in OPEB plan financial statements. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.

GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions (an amendment of GASB Statement No. 53)*, which will improve financial reporting by state and local governments by clarifying the circumstances in which hedge accounting continues to be applied when a swap counterparty, or a swap counterparty's credit support provider, is replaced. The implementation of this pronouncement did not have a material effect on the accompanying financial statements.

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Notes to Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In December 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, which addresses how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CIA.

In December 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus*, which is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity*, and No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this statement are effective for periods beginning after June 15, 2012. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CIA.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which is intended to enhance the usefulness of its Codification by incorporating guidance that previously could only be found in certain Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA) pronouncements. The provisions of this statement are effective for periods beginning after December 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of CIA.

In July 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, which establishes guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The provisions of this statement are effective for periods beginning after December 15, 2011. Management has not yet determined the effect of implementation of this statement on the financial statements of CIA.

In April 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of CIA.

In April 2012, GASB issued Statement No. 66, *Technical Corrections - 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implementation of this statement on the financial statements of CIA.

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Notes to Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans, and Statement No. 68, *Accounting and Financial Reporting for Pensions*, which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of these statements on the financial statements of CIA.

Management Estimates

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.

(3) Property, Plant and Equipment

Capital asset activities for the year ended September 30, 2012 are as follows:

	Balance at October <u>1, 2011</u>	Transfers and <u>Additions</u>	Transfers and <u>Deletions</u>	Balance at September <u>30, 2012</u>
Motor vehicles	\$ 15,500	\$ -	\$ -	\$ 15,500
Equipment	7,300	-	-	7,300
Furniture and fixtures	<u>1,638</u>	<u>-</u>	<u>-</u>	<u>1,638</u>
	24,438	-	-	24,438
Less accumulated depreciation	<u>(19,818)</u>	<u>(880)</u>	<u>-</u>	<u>(20,698)</u>
	<u>\$ 4,620</u>	<u>\$ (880)</u>	<u>\$ -</u>	<u>\$ 3,740</u>

Capital asset activities for the year ended September 30, 2011 are as follows:

	Balance at October <u>1, 2010</u>	Transfers and <u>Additions</u>	Transfers and <u>Deletions</u>	Balance at September <u>30, 2011</u>
Motor vehicles	\$ 10,000	\$ 5,500	\$ -	\$ 15,500
Equipment	7,300	-	-	7,300
Furniture and fixtures	<u>1,638</u>	<u>-</u>	<u>-</u>	<u>1,638</u>
	18,938	5,500	-	24,438
Less accumulated depreciation	<u>(18,938)</u>	<u>(880)</u>	<u>-</u>	<u>(19,818)</u>
	<u>\$ -</u>	<u>\$ 4,620</u>	<u>-</u>	<u>\$ 4,620</u>

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Notes to Financial Statements
September 30, 2012 and 2011

(4) Commitments

Leases

CIA leases a hangar underlying its operations from the Pohnpei Port Authority, a component unit of the State of Pohnpei. CIA is to pay \$8,556 per year and the lease expires in July 2013.

The approximate future minimum lease payments are as follows:

<u>Year Ending</u> <u>September 30,</u>	
2013	\$ 7,130

(5) Related Party Transactions

CIA is a component unit of the FSM National Government. As of September 30, 2012 and 2011, revenue from the FSM National Government amounted to \$20,340 and \$19,562, respectively.

Additionally, CIA utilizes an airplane owned by the FSM National Government at no cost.

**INDEPENDENT AUDITORS' 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
Caroline Islands Air, Inc.:

We have audited the financial statements of net assets of Caroline Islands Air, Inc. (the Company), as of and for the year ended September 30, 2012, and have issued our report thereon dated June 26, 2013. 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

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Company'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 Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company'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 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.

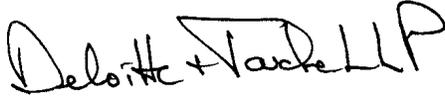
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. 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 Company'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 or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Company in a separate letter dated June 26, 2013.

This report is intended for the information and use of the Board of Directors, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Deloitte + Stach LLP". The signature is written in a cursive, slightly stylized font.

June 26, 2013

CAROLINE ISLANDS AIR, INC.
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Unresolved Prior Year Findings
Year Ended September 30, 2011

There were no unresolved audit findings from the prior year audits of the Company.