

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

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2016 AND 2015

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

Years Ended September 30, 2016 and 2015
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INDEPENDENT AUDITORS' REPORT

Board of Directors
Caroline Islands Air, Inc.:

Report on the Financial Statements

We have audited the accompanying financial statements of Caroline Islands Air, Inc., a component unit of the Federated States of Micronesia National Government, which comprise the statements of net position as of September 30, 2016 and 2015, and the related statements of revenues, expenses and changes in net position and of cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Caroline Islands Air, Inc. as of September 30, 2016 and 2015, and the changes in its financial position and its cash flows, for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

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 financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. 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 financial statements, and other knowledge we obtained during our audit of the 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated February 14, 2017 on our consideration of Caroline Islands Air, Inc.'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* in considering Caroline Islands Air, Inc.'s internal control over financial reporting and compliance.

Deloitte & Touche LLP

February 14, 2017

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

Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

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, 2016 and 2015. MD&A is supplementary information required by the Governmental Accounting Standards Board Statement No. 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 2016

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 2016 revenue sources of CIA operations are from \$250k of passenger airfare, \$354k of charter services, \$50k of baggage fees, and \$20k of freight and others.

Financial Highlights

1. Summary Statements of Net Position

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

Comparative Statements of Net Position at September 30, 2016, 2015 and 2014 are summarized below:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Assets:			
Current Assets	\$ 524,663	\$ 298,331	\$ 224,716
Capital Assets	<u>4,055</u>	<u>10,136</u>	<u>10,136</u>
Total Assets	\$ <u>528,718</u>	\$ <u>308,467</u>	\$ <u>234,852</u>
Liabilities:			
Current Liabilities	\$ <u>15,785</u>	\$ <u>11,057</u>	\$ <u>14,768</u>
Total Liabilities	<u>15,785</u>	<u>11,057</u>	<u>14,768</u>

CAROLINE ISLANDS AIR, INC.
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Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

Comparative Statements of Net Position at September 30, 2016, 2015 and 2014 are summarized below, continued:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Net Position:			
Net investment in capital assets	4,055	10,136	10,136
Unrestricted	<u>508,878</u>	<u>287,274</u>	<u>209,948</u>
Total Net Position	<u>512,933</u>	<u>297,410</u>	<u>220,084</u>
	\$ <u>528,718</u>	\$ <u>308,467</u>	\$ <u>234,852</u>

Assets: Total assets of \$529k comprise \$525k or 99% of current assets and \$4k or 1% of capital assets.

Current assets: Total current assets of \$525k comprised \$395k or 75% of cash, \$67k or 13% of inventory, \$53k or 10% of trade receivables, net of an allowance, and \$9k or 2% of prepaid expense.

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

Liabilities: CIA's liabilities of \$16k are all current consisting of accounts payable and accrued liabilities.

2. Summary Statements of Revenues, Expenses and Changes in Net Position

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 Statements of Revenues, Expenses and Changes in Net Position for the fiscal years ended September 30, 2016, 2015 and 2014.

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Operating revenues	\$ 674,069	\$ 432,754	\$ 430,312
Operating costs	<u>(527,139)</u>	<u>(330,447)</u>	<u>(365,184)</u>
Gross profit	146,930	102,307	65,128
General and administrative expenses	<u>(34,714)</u>	<u>(36,573)</u>	<u>(25,552)</u>
Operating income	112,216	65,734	39,576
Nonoperating income	<u>103,307</u>	<u>11,592</u>	<u>75,276</u>
Change in net position	215,523	77,326	114,852
Net position at beginning of year	<u>297,410</u>	<u>220,084</u>	<u>105,232</u>
Net position at end of year	\$ <u>512,933</u>	\$ <u>297,410</u>	\$ <u>220,084</u>

CIA's operating revenues are from \$250k of passenger airfare, \$354k of charter services, \$50k of baggage fees and \$20k of freight and others.

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Management's Discussion and Analysis
Years Ended September 30, 2016 and 2015

3. Summary Statements 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>2016</u>	<u>2015</u>	<u>2014</u>
Cash flows provided by operating activities	\$ 40,813	\$ 105,314	\$ 30,999
Cash flows provided by noncapital financing activities	<u>103,307</u>	<u>11,592</u>	<u>75,276</u>
Net change in cash	144,120	116,906	106,275
Cash at beginning of year	<u>251,039</u>	<u>134,133</u>	<u>27,858</u>
Cash at end of year	\$ <u>395,159</u>	\$ <u>251,039</u>	\$ <u>134,133</u>

4. Debt and Capital Asset Activities

No significant debt or capital asset activities occurred during the year ended September 30, 2016. 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, 2015, is set forth in the report on the audit of financial statements, which is dated March 13, 2016. That Discussion and Analysis explains the major factors impacting the 2015 financial statements and can be viewed at the FSM Office of the National Public Auditors' website at www.fsmopa.fm.

Economic Outlook

CIA succeeded in generating a net profit in FY2016 by operating fully throughout the year. However, CIA continues to face challenges during FY2017. These operating issues are the continued revenue shortfalls to adequately cover operating costs, fuel for airplanes and periodic overhaul of airplane parts. These continue to be the main priorities for the operation and plan of action are focused toward improving these operating issues.

Financial Management Contact

This financial report is designed to provide all interested users with a general overview of the CIA's finances. Inquiries concerning this report, if any, may be directed to Caroline Islands Air, Inc., P.O. Box 2238, Kolonia Pohnpei, FM96941.

CAROLINE ISLANDS AIR, INC.
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Statements of Net Position
September 30, 2016 and 2015

<u>ASSETS</u>	<u>2016</u>	<u>2015</u>
Current assets:		
Cash	\$ 395,159	\$ 251,039
Trade receivables, net of an allowance of \$12,446 at 2016 and 2015	53,280	-
Prepaid expense	9,435	10,377
Inventory	<u>66,789</u>	<u>36,915</u>
Total current assets	524,663	298,331
Property and equipment, net	<u>4,055</u>	<u>10,136</u>
	<u>\$ 528,718</u>	<u>\$ 308,467</u>
<u>LIABILITIES AND NET POSITION</u>		
Current liabilities:		
Accounts payable	\$ 11,383	\$ 9,267
Accrued liabilities and others	<u>4,402</u>	<u>1,790</u>
Total liabilities	<u>15,785</u>	<u>11,057</u>
Commitments		
Net position:		
Net investment in capital assets	4,055	10,136
Unrestricted	<u>508,878</u>	<u>287,274</u>
Total net position	<u>512,933</u>	<u>297,410</u>
	<u>\$ 528,718</u>	<u>\$ 308,467</u>

See accompanying notes to financial statements.

CAROLINE ISLANDS AIR, INC.
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Statements of Revenues, Expenses, and Changes in Net Position
Years Ended September 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Operating revenues:		
Charter services	\$ 354,368	\$ 160,221
Passenger airfare	250,179	202,907
Baggage fees	49,668	46,592
Freight	17,844	20,474
Service fees	600	1,700
Drums	1,410	860
Total operating revenues	<u>674,069</u>	<u>432,754</u>
Operating costs:		
Maintenance and operation	331,288	165,649
Salaries and housing	133,565	114,190
Insurance	27,537	28,428
Taxes	14,911	10,368
Rent	13,757	11,812
Depreciation	6,081	-
Total operating costs	<u>527,139</u>	<u>330,447</u>
Gross profit	<u>146,930</u>	<u>102,307</u>
General and administrative expenses:		
Supplies	9,296	6,693
Travel	8,180	8,856
Utilities	7,450	7,200
Communications	5,484	7,604
Contract labor	2,948	3,029
Janitorial	161	450
Professional fees	63	845
Bank service fees	-	410
Miscellaneous	1,132	1,486
Total general and administrative expenses	<u>34,714</u>	<u>36,573</u>
Operating income	<u>112,216</u>	<u>65,734</u>
Nonoperating income:		
Subsidies from the FSM National Government	103,307	10,000
Gain on sales of Avgas fuel	-	1,592
Nonoperating income	<u>103,307</u>	<u>11,592</u>
Change in net position	215,523	77,326
Net position at beginning of year	<u>297,410</u>	<u>220,084</u>
Net position at end of year	<u>\$ 512,933</u>	<u>\$ 297,410</u>

See accompanying notes to financial statements.

CAROLINE ISLANDS AIR, INC.
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Statements of Cash Flows
Years Ended September 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash flows from operating activities:		
Cash received from customers	\$ 620,789	\$ 432,753
Cash paid to suppliers for goods and services	(446,461)	(213,249)
Cash paid to employees for services	<u>(133,515)</u>	<u>(114,190)</u>
Net cash provided by operating activities	<u>40,813</u>	<u>105,314</u>
Cash flows from noncapital financing activities:		
Subsidies from the FSM National Government	103,307	10,000
Proceeds from sales of Avgas fuel	<u>-</u>	<u>1,592</u>
Net cash provided by noncapital financing activities	<u>103,307</u>	<u>11,592</u>
Net change in cash	144,120	116,906
Cash at beginning of year	<u>251,039</u>	<u>134,133</u>
Cash at end of year	<u>\$ 395,159</u>	<u>\$ 251,039</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 112,216	\$ 65,734
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	6,081	-
(Increase) decrease in assets:		
Trade receivables	(53,280)	-
Prepaid inventory	-	47,220
Prepaid expense	942	27,245
Inventory	(29,874)	(31,174)
Increase (decrease) in liabilities:		
Accounts payable	2,116	(713)
Accrued liabilities and others	<u>2,612</u>	<u>(2,998)</u>
Net cash provided by operating activities	<u>\$ 40,813</u>	<u>\$ 105,314</u>

See accompanying notes to financial statements.

CAROLINE ISLANDS AIR, INC.
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Notes to Financial Statements
September 30, 2016 and 2015

(1) Organization

Caroline Islands Air, Inc. ("CIA" or the "Company") is a component unit of the Federated States of Micronesia (FSM) National Government. 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 FSM;
- 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; and
- 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 FSM National Government;
- 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; and
- 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

Basis of Accounting

CIA utilizes the flow of economic resources measurement focus. The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units using the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

Net Position

Net position represents the residual interest in CIA's assets after liabilities are deducted and consists of the following categories:

Net investment in capital assets - include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt, net of debt service reserve.

Restricted nonexpendable - net position subject to externally imposed stipulations that require CIA to maintain them permanently.

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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

Net Position, Continued

Restricted expendable - net position whose use is subject to externally imposed stipulations that can be fulfilled by actions of CIA pursuant to those stipulations or that expire with the passage of time.

Unrestricted - net position that is not subject to externally imposed stipulations. Unrestricted net position 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.

Operating and Non-Operating Revenue and Expenses

CIA considers passenger and related charter and cargo revenues and costs directly related to such revenues to be operating revenues and expenses. Revenues and expenses related to financing and other activities are reflected as nonoperating.

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, 2016 and 2015, the carrying amount of CIA's total cash was \$395,159 and \$251,039, respectively, and the corresponding bank balances were \$399,984 and \$256,818, respectively, all of which were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2016 and 2015, bank deposits in the amount of \$250,000 were FDIC insured. CIA does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. CIA has not experienced any losses in such accounts and management believes it is not exposed to any significant custodial credit risk on its deposits.

Trade Receivables

CIA's trade 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.

Prepaid Expense

Prepaid expense consists of insurance premiums paid for the unelapsed policy period.

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.

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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

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 vehicles	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 for the past three years.

New Accounting Standards

During the year ended September 30, 2016, CIA implemented the following pronouncements:

- GASB Statement No. 72, *Fair Value Measurement and Application*, which addresses accounting and financial reporting issues related to fair value measurements and requires entities to expand their fair value disclosures by determining major categories of debt and equity securities within the fair value hierarchy on the basis of the nature and risk of the investment. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, which eliminates two of the four categories of authoritative GAAP that exist under the existing hierarchy prescribed by Statement No. 55. The two categories that will remain under the new standard are (1) GASB Statements and (2) GASB technical bulletins and implementation guides in addition to AICPA guidance that the GASB clears. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*, which addresses for certain external investment pools and their participants the accounting and financial reporting implications that result from changes in the regulatory provisions referenced by previous accounting and financial reporting standards. Those provisions were based on the Investment Company Act of 1940, Rule 2a7. Rule 2a7 contains the Securities and Exchange Commission's regulations that apply to money market funds and were significantly amended in 2014. The implementation of this statement did not have a material effect on the accompanying financial statements.

In June 2015, GASB issued Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not Within the Scope of GASB Statement No. 68, and Amendments to Certain Provisions of GASB Statements No. 67 and No. 68*, which aligns the reporting requirements for pensions and pension plans not covered in GASB Statements No. 67 and No. 68 with the reporting requirements in Statement No. 68. The provisions in Statement No. 73 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the 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 June 2015, GASB issued Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which replaces Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, as amended*, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, and addresses financial reporting requirements for governments whose employees are provided with postemployment benefits other than pensions (other postemployment benefits or OPEB). The provisions in Statement No. 74 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In June 2015, GASB issued Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which replaces the requirements of Statements No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, as amended*, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, and provides guidance on reporting by governments that provide OPEB to their employees and for governments that finance OPEB for employees of other governments. The provisions in Statement No. 75 are effective for fiscal years beginning after June 15, 2017. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In August 2015, GASB issued Statement No. 77, *Tax Abatement Disclosures*, which requires governments that enter into tax abatement agreements to disclose certain information about the agreements. The provisions in Statement No. 77 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In December 2015, GASB issued Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*, which addresses a practice issue regarding the scope and applicability of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The provisions in Statement No. 78 are effective for fiscal years beginning after December 15, 2015. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In January 2016, GASB issued Statement No. 80, *Blending Requirements for Certain Component Units - an amendment of GASB Statement No. 14*, which improves financial reporting by clarifying the financial statement presentation requirements for certain component units. The provisions in Statement No. 80 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In March 2016, GASB issued Statement No. 81, *Irrevocable Split-Interest Agreements*, which improves accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. The provisions in Statement No. 81 are effective for fiscal years beginning after December 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

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Notes to Financial Statements
September 30, 2016 and 2015

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In March 2016, GASB issued Statement No. 82, *Pension Issues - an amendment of GASB Statements No. 67, No. 68, and No. 73*, which addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. The provisions in Statement No. 82 are effective for fiscal years beginning after June 15, 2016. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

Management Estimates

The preparation of financial statements in conformity with GAAP 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 years ended September 30, 2016 and 2015 are as follows:

	Balance at October <u>1, 2015</u>	Transfers and <u>Additions</u>	Transfers and <u>Deletions</u>	Balance at September <u>30, 2016</u>
Motor vehicles	\$ 19,776	\$ -	\$ -	\$ 19,776
Equipment	10,300	-	-	10,300
Furniture and fixtures	<u>1,638</u>	-	-	<u>1,638</u>
	31,714	-	-	31,714
Less accumulated depreciation	<u>(21,578)</u>	<u>(6,081)</u>	-	<u>(27,659)</u>
	<u>\$ 10,136</u>	<u>\$ (6,081)</u>	<u>\$ -</u>	<u>\$ 4,055</u>
	Balance at October <u>1, 2014</u>	Transfers and <u>Additions</u>	Transfers and <u>Deletions</u>	Balance at September <u>30, 2015</u>
Motor vehicles	\$ 19,776	\$ -	\$ -	\$ 19,776
Equipment	10,300	-	-	10,300
Furniture and fixtures	<u>1,638</u>	-	-	<u>1,638</u>
	31,714	-	-	31,714
Less accumulated depreciation	<u>(21,578)</u>	-	-	<u>(21,578)</u>
	<u>\$ 10,136</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,136</u>

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

Notes to Financial Statements
September 30, 2016 and 2015

(4) Commitments

Leases

CIA operates a hangar through an annual lease with the Pohnpei Port Authority, a component unit of the State of Pohnpei. Annual rent is \$8,556, and the current lease term expires in March 2017. The approximate future minimum lease payments through the date of lease expiration are \$4,278. CIA also leases a storage space in Chuuk under a month-to-month agreement.

(5) Related Party Transactions

For the years ended September 30, 2016 and 2015, \$60,084 and \$20,474, respectively, of operating revenues were earned from the FSM National Government.

During the years ended September 30, 2016 and 2015, CIA received \$103,307 and \$10,000, respectively, of subsidies from the FSM National Government.

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, in accordance with the 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, the financial statements of Caroline Islands Air, Inc. (the Company), which comprise the statement of net position as of September 30, 2016, and the related statements of revenues, expenses and changes in net position and of cash flows for the year then ended and the related notes to the financial statements, and have issued our report thereon dated February 14, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Company's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

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. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company's financial statements are free from 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*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deloitte & Touche LLP
February 14, 2017

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

Unresolved Prior Year Findings
Year Ended September 30, 2016

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