

**THE DIVING SEAGULL, INC.  
(A COMPONENT UNIT OF THE STATE OF YAP)**

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**FINANCIAL STATEMENTS AND  
INDEPENDENT AUDITORS' REPORT**

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**YEARS ENDED SEPTEMBER 30, 2018 and 2017**

## **INDEPENDENT AUDITORS' REPORT**

The Board of Directors  
The Diving Seagull, Inc.:

### **Report on the Financial Statements**

We have audited the accompanying financial statements of The Diving Seagull, Inc. (the Company), a component unit of the Yap State Government, which comprise the statements of net position as of September 30, 2018 and 2017, 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 The Diving Seagull, Inc. as of September 30, 2018 and 2017, 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.

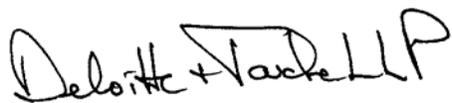
## Other Matters

### *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 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 basic 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 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.

### **Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated June 25, 2019, on our consideration of The Diving Seagull, 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 solely 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 effectiveness of the Company's 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 The Diving Seagull, Inc.'s internal control over financial reporting and compliance.

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

June 25, 2019

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Management's Discussion and Analysis  
Years Ended September 30, 2018 and 2017

The Yap State Government is required to adopt the provisions of the Government Accounting Standard Board (GASB). The Diving Seagull, Inc. ("the Company") is accounted for and is reported as a component unit of the State of Yap.

Total assets of \$8,235,959 at the end of fiscal year 2018 represent a 14% decrease over 2017. By assessment, in 2017, total assets decreased by 4% over 2016 to \$9,575,854. The decrease in total assets in 2018 is primarily the result of depreciation expense and payment of outstanding liability with the Parties of the Nauru Agreement (PNA).

Operating revenue generated from fish sales of \$8,912,280 represents a decrease of 3% over 2017. The Company has applied new fishing technology during the time after when Mathawmarfach was operable to fish efficiently, just gradually recovering from our losses from 2017. In addition, the price per ton of fish sold in 2017 was up by over 15% when compared to 2016. License, agent, and port fees decreased in 2018, and has saved the Company and allowed it to recover some of its loss as shown on our financial statements.

The Company ended fiscal year 2018 with a net loss of \$167,415 an improvement compared to fiscal year 2017 with a net loss of \$1.9 million.

The Company's cash flows from operating activities was a positive of \$302,474 and \$374,602 for fiscal years 2018 and 2017, respectively. For the year ended September 30, 2018, cash and cash equivalents decreased from \$1,708,673 in the prior year to \$1,015,343. The decrease in cash and equivalents in 2018 was due to payment of a previously disputed outstanding liability to PNA, increase in fuel costs, and repairs and maintenance of vessel fishing nets, which all have a direct impact on our cash flows.

The following table summarizes the financial conditions and results of operations of the Company for 2018, 2017 and 2016.

	<u>2018</u>	<u>2017</u>	<u>2016</u>
<u>Assets:</u>			
Property and equipment, net	\$ 2,522,007	\$ 2,907,424	\$ 3,427,541
Current Assets	3,472,206	4,426,684	4,319,511
Other assets	<u>2,241,746</u>	<u>2,241,746</u>	<u>2,241,746</u>
Total assets	\$ <u>8,235,959</u>	\$ <u>9,575,854</u>	\$ <u>9,988,798</u>
<u>Liabilities and net position</u>			
Liabilities:			
Long –term debt, net of current portion	\$ 536,114	\$ 1,126,744	\$ 1,611,119
Other noncurrent liabilities	-	200,000	-
Current portion of long- term debt	606,470	570,098	540,483
Other current liabilities	<u>3,538,828</u>	<u>3,950,236</u>	<u>2,221,478</u>
Total Liabilities	<u>4,681,412</u>	<u>5,847,078</u>	<u>4,373,080</u>

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Management's Discussion and Analysis  
Years Ended September 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>	<u>2016</u>
Net Position:			
Net investment in Capital assets	1,725,646	1,773,467	2,020,366
Restricted	2,241,746	2,241,746	2,241,746
Unrestricted	<u>(412,845)</u>	<u>(286,437)</u>	<u>1,353,606</u>
Total Net position	<u>3,554,547</u>	<u>3,728,776</u>	<u>5,615,718</u>
Total Liabilities and Net position	\$ <u>8,235,959</u>	\$ <u>9,575,854</u>	\$ <u>9,988,798</u>

Revenue Expense and Changes in Net position

Operating revenue	\$ 8,912,280	\$ 9,204,438	\$ 7,912,182
Cost of sales	(8,828,727)	(9,665,911)	(9,137,064)
Fines and penalties	-	(1,200,000)	-
Operating Expenses	<u>(250,968)</u>	<u>(275,573)</u>	<u>(251,927)</u>
Net operating revenues (loss)	(167,415)	(1,937,046)	(1,476,809)
Non - operating revenue (expense)	<u>(6,814)</u>	<u>50,104</u>	<u>(50,341)</u>
Change in net position	\$ <u>(174,229)</u>	\$ <u>(1,886,942)</u>	\$ <u>(1,527,150)</u>

Capital Assets and Debt

The Company's acquisition of capital assets in 2018 and 2017 were related to improvements in machinery and equipment on vessels with developed fishing technology which is necessary for efficient fishing. For additional information concerning capital assets, please refer to note 6 to the financial statements.

The Company obtained a short term loan of \$850,000 and \$250,000 from a bank in 2018 and 2017, respectively. For further information concerning debt, please refer to notes 8 and 9 to the financial statements.

**Plan of Action for 2019 – Economic Outlook**

In 2018, the Company established its international market to Japan to bid on its tuna catches in an attempt to obtain a better tuna price. Considering other challenges being faced, the Vessel Day Scheme (VDS) fishing days at \$4,000 per day, which required prepayment in 2017 and 2018 caused difficulties in the Company operation. Management and Board of Directors have raised concerns related to new regulations that make fishing so hard for its economic value to the Company and in servicing debt with Bank of Guam (BOG) and FSM Development Bank (FSMDB).

In 2018, Company continues to struggle to pay its monthly loan payment to FSMDB and BOG. Management recommended to the Board to delay shipyard of Yap Seagull until 2019, when the Company is cleared of debts being required to be paid off.

**THE DIVING SEAGULL, INC.**  
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Management's Discussion and Analysis  
Years Ended September 30, 2018 and 2017

In 2017, FSMDB approved a loan of \$5.2 million with the intention to purchase a vessel of \$3 million and to consolidate payoff to all loans with BOG and FSMDB. The transaction is currently on hold, due to the vessel being purchased by another buyer. A vessel owned by Koo's Fishing Company was identified for purchase at the end of FY 2017, but again, a sales agreement was on hold awaiting lawyer's opinion from Koo's Fishing Co. It is our plan to continue soliciting other vessels as a replacement.

The above impediments slow down the Company's recovery from all the improvements done to fishing efficiencies. Fish prices being high in 2017 and 2018 saved the Company from incurring interest expense from the letter of credit with Bank of Guam.

Below are some of the issues and challenges that will be facing the Company in 2019.

1. Requirement to prepay VDS fishing days
2. Improving profit margin of Company
3. Increase capital
4. Diversification
5. Partnership arrangements

Ongoing Plan of action in 2019

- Developed FADs for fish farms
- Engage in inter commerce activities
- Acquire land
- Yap Seagull shipyard project
- Proposed DSI loan payoff

**Financial Management Contact**

This financial report is designed to provide all interest users with a general overview of the Company's finances. Inquiries concerning this report, if any, may be directed to the Diving Seagull, Inc. PO Box 1036, Colonia, Yap FM 96943

The Management Discussion and Analysis for the year ended September 30, 2017 is set forth in the Company's report on the audits of financial statement, which is dated June 15, 2018. That Discussion and Analysis explains the major factors impacting the 2017 financial statements and can be viewed at the FSM Office of the Public Auditor's website.

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Statements of Net Position  
September 30, 2018 and 2017

	2018	2017
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 1,015,343	\$ 1,708,673
Time certificates of deposit	569,733	577,433
Investments	1,429,332	1,352,698
Employee and director receivables, net	43,807	35,778
Other receivables, net	53,585	-
Net receivable from broker	211,309	633,005
Prepaid expenses	40,265	10,265
Fuel inventory	108,832	108,832
Total current assets	3,472,206	4,426,684
Restricted cash and cash equivalents	2,241,746	2,241,746
Property and equipment, net	2,522,007	2,907,424
	\$ 8,235,959	\$ 9,575,854
<u>LIABILITIES AND NET POSITION</u>		
Current liabilities:		
Current portion of long-term debt	\$ 606,470	\$ 570,098
Current portion of fines and penalties payable	200,000	750,000
Accounts payable	1,384,972	874,671
Due to Parties to the Nauru Agreement	-	1,190,810
Short term loan	850,000	250,000
Accrued expenses	1,103,856	884,755
Total current liabilities	4,145,298	4,520,334
Fines and penalties payable, net of current portion	-	200,000
Long-term debt, net of current portion	536,114	1,126,744
Total liabilities	4,681,412	5,847,078
Commitments and contingencies		
Net position:		
Net investment in capital assets	1,725,646	1,773,467
Restricted	2,241,746	2,241,746
Unrestricted	(412,845)	(286,437)
Total net position	3,554,547	3,728,776
	\$ 8,235,959	\$ 9,575,854

See accompanying notes to financial statements.

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Statements of Revenues, Expenses and Changes in Net Position  
Years Ended September 30, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Operating revenues:		
Fish sales	\$ 8,911,650	\$ 9,202,427
Other revenues	<u>630</u>	<u>2,011</u>
Total operating revenues	8,912,280	9,204,438
Cost of sales	8,828,727	9,665,911
Fines and penalties	<u>-</u>	<u>1,200,000</u>
Gross income (loss)	<u>83,553</u>	<u>(1,661,473)</u>
Operating expenses:		
Payroll, taxes and benefits	71,642	71,970
Travel	37,617	30,505
Professional fees	22,500	44,350
Office expenses	22,408	21,022
Communications and utilities	17,952	23,848
Bank loan fees	13,217	15,070
Rent	11,352	10,320
Board fees and expenses	10,075	10,250
Depreciation and amortization	6,980	6,001
Insurance	1,161	1,294
Bad debts	-	35,522
Miscellaneous	<u>36,064</u>	<u>5,421</u>
Total operating expenses	<u>250,968</u>	<u>275,573</u>
Loss from operations	<u>(167,415)</u>	<u>(1,937,046)</u>
Nonoperating (expenses) revenues , net:		
Interest expense	(107,868)	(108,332)
Investment income, net	<u>101,054</u>	<u>158,436</u>
Total nonoperating (expenses) revenues, net	<u>(6,814)</u>	<u>50,104</u>
Change in net position	(174,229)	(1,886,942)
Net position at beginning of year	<u>3,728,776</u>	<u>5,615,718</u>
Net position at end of year	<u>\$ 3,554,547</u>	<u>\$ 3,728,776</u>

See accompanying notes to financial statements.

**THE DIVING SEAGULL, INC.**  
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Statements of Cash Flows  
Years Ended September 30, 2018 and 2017

	2018	2017
Cash flows from operating activities:		
Cash received from customers	\$ 9,333,976	\$ 8,304,036
Cash payments to suppliers for goods and services	(7,904,387)	(6,568,026)
Cash payments to boat crew and employees for services	(1,127,115)	(1,361,408)
Net cash provided by operating activities	302,474	374,602
Cash flows from investing activity - decrease in short-term investments and time certificates of deposit	32,120	12,185
Cash flows from noncapital financing activities:		
Payment of fines and penalties	(750,000)	(250,000)
Short term loan proceeds	600,000	250,000
Net cash used in noncapital financing activities	(150,000)	-
Cash flows from capital and related financing activities:		
Acquisition of property and equipment	(195,798)	(81,979)
Principal repayments of long-term debt	(554,258)	(454,760)
Interest paid on long-term debt	(107,868)	(108,332)
Advances to government agencies	(20,000)	-
Net cash used in capital and related financing activities	(877,924)	(645,071)
Net change in cash	(693,330)	(258,284)
Cash and cash equivalents at beginning of year	1,708,673	1,966,957
Cash and cash equivalents at end of year	\$ 1,015,343	\$ 1,708,673
Reconciliation of loss from operations to net cash provided by operating activities:		
Loss from operations	\$ (167,415)	\$ (1,937,046)
Adjustments to reconcile operating loss to net cash provided by operating activities:		
Depreciation and amortization	581,215	911,260
Fines and penalties	-	1,200,000
Bad debts	-	35,522
Changes in assets and liabilities:		
Net receivable from/payable to broker	421,696	(900,402)
Employee and director receivables	(8,029)	39,111
Other receivables	(33,585)	-
Prepaid expenses	(30,000)	30,001
Fuel inventory	-	-
Accounts payable	510,301	390,733
Due to Parties to the Nauru Agreement	(1,190,810)	664,169
Accrued expenses	219,101	(58,746)
Net cash provided by operating activities	\$ 302,474	\$ 374,602

See accompanying notes to financial statements.

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Notes to Financial Statements  
September 30, 2018 and 2017

(1) Summary of Significant Accounting Policies

Reporting Entity

The Diving Seagull, Inc. (the Company or DSI), a component unit of the State of Yap, was incorporated in Yap in the Federated States of Micronesia on March 17, 1997. The Company is organized primarily to pursue fishing and other fishing related activities by operating fishing vessels, marketing and selling fish, and developing cold storage and/or transshipment facilities. A five-member Board of Directors is responsible for managing the business affairs and directing the daily operations of the Company.

The Articles of Incorporation authorized the issuance of 6,500,000 shares of common stock at \$1 par value per share. All such shares were issued to the Yap Investment Trust fund, a fund of the State of Yap, under the terms of a twenty-five year lease agreement for use of the fishing vessel, Mathawmarfach, and a purse seine fishing net. This Bareboat Charter Agreement expires in March 2022. The Company also purchased another fishing vessel, the Yap Seagull, in February 2010.

Basis of Accounting

DSI 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 DSI's assets after liabilities are deducted and consists of the following categories:

Net investment in capital assets - includes capital assets, net of accumulated depreciation, reduced by outstanding debt, net of debt service reserve.

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

Restricted expendable - net position which use is subject to externally imposed stipulations that can be fulfilled by actions of DSI 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.

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Notes to Financial Statements  
September 30, 2018 and 2017

(1) Summary of Significant Accounting Policies, Continued

Net Position, Continued

The Company's 6,500,000 shares of authorized, issued and outstanding common stock with par value of \$1 per share represent capital net position. However, since all shares are held by the State and since the Company is a component unit of the State, these shares are not presented in the accompanying statements of net position.

Restricted net position consists of cash accounts restricted in support of certain debt.

Operating and Non-Operating Revenues 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 financing activities, costs and related recoveries from natural disasters, and certain other non-recurring income and costs.

Reclassification

Certain balances in the 2017 presentation have been reclassified to conform to the 2018 presentation.

New Accounting Standards

During the year ended September 30, 2018, the Company implemented the following pronouncements:

- GASB 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.
- GASB 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.
- GASB Statement No. 85, *Omnibus 2017*, which addresses practice issues that have been identified during implementation and application of certain GASB Statements including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (pensions and other postemployment benefits).
- GASB Statement No. 86, *Certain Debt Extinguishment Issues*, which improves consistency in accounting and financial reporting for in-substance defeasance of debt.

The implementation of these statements did not have a material effect on the accompanying financial statements.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In November 2016, GASB issued Statement No. 83, *Certain Asset Retirement Obligations*, which addresses accounting and financial reporting for certain asset retirement obligations (AROs) associated with the retirement of a tangible capital asset. The provisions in Statement No. 83 are effective for fiscal years beginning after June 15, 2018. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In January 2017, GASB issued Statement No. 84, *Fiduciary Activities*, which establishes criteria for identifying fiduciary activities of all state and local governments. The provisions in Statement No. 84 are effective for fiscal years beginning after December 15, 2018. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In June 2017, GASB issued Statement No. 87, *Leases*, which establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. The provisions in Statement No. 87 are effective for fiscal years beginning after December 15, 2019. Management has yet to determine whether the implementation of this statement will have a material effect on the financial statements.

In April 2018, GASB issued Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*, which improves the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. The provisions in Statement No. 88 are effective for fiscal years beginning after June 15, 2018. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In June 2018, GASB issued Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*, which requires that interest cost incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. The provisions in Statement No. 89 are effective for fiscal years beginning after December 15, 2019. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

In August 2018, GASB issued Statement No. 90, *Majority Equity Interests – an Amendment of GASB Statements No. 14 and No. 61*, which improves the consistency and comparability of reporting a government's majority equity interest in a legally separate organization and the relevance of financial statement information for certain component units. The provisions in Statement No. 90 are effective for fiscal years beginning after December 15, 2018. Management does not believe that the implementation of this statement will have a material effect on the financial statements.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(1) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents

Cash and cash equivalents includes cash on hand as well as cash in various bank accounts and time certificates of deposit with initial maturity dates of three months or less but excludes restricted cash and cash equivalents. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified.

Investments

Investments and related investment earnings are reported at fair value using quoted market prices. Fair value is the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the date as of which the fair value of an asset or liability is determined.

Allowance for Doubtful Accounts

The Company establishes an allowance for doubtful accounts receivable based on the credit risk of specific customers, historical trends, and other information. Bad debts are written off against the allowance based on the specific identification method.

Dry docking costs

The Company uses the deferral method for accounting for dry dock costs. Dry docking costs are capitalized and amortized on a straight-line basis over three years.

Fuel Inventory

Fuel inventory consists of fuel on fishing vessels and is stated at purchased cost.

Property and Equipment

Property and equipment is stated at cost less accumulated depreciation. Routine maintenance and repairs are expensed as incurred. Depreciation is recorded in the financial statements under the straight-line method over the estimated useful lives of the assets as follows:

Mathawmarfach vessel	20 years
Yap Seagull vessel	25 years
Fishing net and other vessel parts	5 years
Leasehold improvements	3-10 years
Vessel improvements	3-5 years
Office furniture and equipment	3-5 years
Vehicles	5 years

Leased assets and leasehold improvements are amortized over the lesser of the useful life or the lease term. Capitalization thresholds are \$1,000 for leasehold improvements and \$500 for all other assets.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(1) Summary of Significant Accounting Policies, Continued

Revenue Recognition

The Company's primary source of revenue is derived from the sale of fish. Sales of fish are considered earned upon offloading the catch to a designated third party. The sales are estimated, less a provision for rejected fish, based on broker commitments per ton and are adjusted upon receipt of a final settlement from the broker.

Other revenue is recorded when earned and measurable.

Translation of Foreign Currencies

Gains and losses that arise from exchange rate changes on transactions denominated in a currency other than U.S. dollars are included in the statements of revenues, expenses and changes in net position.

Use of 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.

(2) Deposits

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The deposit and investment policies of the Company are governed by its enabling legislation. The Board of Directors is required to engage one or more fund custodians to assume responsibility for the physical possession of the Company's investments.

GASB Statement No. 40 requires disclosures for deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Company'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. The Company does not have a deposit policy for custodial credit risk.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(2) Deposits, Continued

As of September 30, 2018 and 2017, the carrying amount of the Company's total cash and cash equivalents and time certificates of deposit was \$3,826,822 and \$4,527,852, respectively, and the corresponding bank balances were \$3,805,415 and \$4,539,664, respectively. Of the bank balances, \$2,458,657 and \$2,979,045, respectively, is maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2018 and 2017, bank deposits in the amount of \$500,000 were FDIC insured. The Company 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. The Company has not experienced any losses on such accounts and management believes it is not exposed to any significant credit risk on its deposits.

(3) Investments

GASB Statement No. 40 requires disclosures addressing common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Company will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Company's investments are held and administered by trustees. Based on negotiated trust and custody contracts, all of these investments were held in the Company's name by the Company's custodial financial institutions. Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Company. As of September 30, 2018 and 2017, the Company did not hold an investment in any one issuer that represented more than 5% of the Company's total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Company does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

Investments and related investment earnings are reported at fair value using quoted market prices. Fair value is the price that would be received to sell an asset or paid to transfer a liability (ie, the exit price) in an orderly transaction between market participants at the date as of which the fair value of an asset or liability is determined.

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Notes to Financial Statements  
September 30, 2018 and 2017

(3) Investments, Continued

As of September 30, 2018 and 2017, investments at fair value comprise the following:

	<u>2018</u>	<u>2017</u>
Fixed income securities:		
U.S. Treasury obligations	\$ 190,799	\$ 157,728
U.S. Government agencies	19,962	72,084
Corporate notes	<u>253,210</u>	<u>254,949</u>
	<u>463,971</u>	<u>484,761</u>
Other investments:		
Common equities	935,873	840,268
Money market funds	<u>29,488</u>	<u>27,669</u>
	<u>965,361</u>	<u>867,937</u>
	<u>\$ 1,429,332</u>	<u>\$ 1,352,698</u>

As of September 30, 2018, the Company's fixed income securities had the following ratings and maturities:

		<u>Fair</u>	<u>Less than</u>	<u>1 to 5</u>	<u>6 to 10</u>
		<u>Value</u>	<u>1 Year</u>	<u>Years</u>	<u>Years</u>
U.S. Treasury obligations	AAA	\$ 190,799	\$ -	\$ 127,934	\$ 62,865
U.S. Government agencies obligations	AAA	19,962	19,962	-	-
Corporate notes	A1	30,245	-	30,245	-
Corporate notes	A2	62,433	14,945	47,488	-
Corporate notes	A3	88,327	10,000	68,485	9,842
Corporate notes	AA2	14,996	-	14,996	-
Corporate notes	BAA1	35,676	-	24,384	11,292
Corporate notes	BAA2	<u>21,533</u>	<u>-</u>	<u>21,533</u>	<u>-</u>
		<u>\$ 463,971</u>	<u>\$ 44,907</u>	<u>\$ 335,065</u>	<u>\$ 83,999</u>

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(3) Investments, Continued

As of September 30, 2017, the Company's fixed income securities had the following ratings and maturities:

		Fair <u>Value</u>	Less than <u>1 Year</u>	1 to 5 <u>Years</u>	6 to 10 <u>Years</u>
U.S. Treasury obligations	AAA	\$ 132,625	\$ -	\$ 123,262	\$ 9,363
U.S. Treasury obligations	Not rated	25,103	-	-	25,103
U.S. Government agencies obligations	AAA	72,084	41,917	30,167	-
Corporate notes	A1	31,246	-	31,246	-
Corporate notes	A2	89,181	20,116	69,065	-
Corporate notes	A3	81,058	-	81,058	-
Corporate notes	AA2	15,441	-	15,441	-
Corporate notes	BAA1	13,452	-	13,452	-
Corporate notes	BAA2	12,144	-	12,144	-
Corporate notes	BAA3	<u>12,427</u>	<u>-</u>	<u>12,427</u>	<u>-</u>
		<u>\$ 484,761</u>	<u>\$ 62,033</u>	<u>\$ 388,262</u>	<u>\$ 34,466</u>

The Company categorizes its fair value measurements within the fair value hierarchy established by GASB Statement No. 72. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs. The Company has the following recurring fair value measurements as of September 30, 2018 and 2017:

	September 30, <u>2018</u>	<u>Fair Value Measurements Using</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Fixed income securities:				
U.S. Treasury obligations	\$ 190,799	\$ -	\$ 190,799	\$ -
U.S. Government agencies	19,962	-	19,962	-
Corporate notes	<u>253,210</u>	<u>-</u>	<u>253,210</u>	<u>-</u>
Total fixed income securities	<u>463,971</u>	<u>-</u>	<u>463,971</u>	<u>-</u>
Equity securities:				
Common equities	<u>935,873</u>	<u>935,873</u>	<u>-</u>	<u>-</u>
Total investments at fair value	1,399,844	<u>\$ 935,873</u>	<u>\$ 463,971</u>	<u>\$ -</u>
Investments measured at amortized cost:				
Money market funds	<u>29,488</u>			
	<u>\$ 1,429,332</u>			

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(3) Investments, Continued

	September 30, <u>2017</u>	<u>Fair Value Measurements Using</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Fixed income securities:				
U.S. Treasury obligations	\$ 157,728	\$ -	\$ 157,728	\$ -
U.S. Government agencies	72,084	-	72,084	-
Corporate notes	<u>254,949</u>	-	<u>254,949</u>	-
Total fixed income securities	<u>484,761</u>	-	<u>484,761</u>	-
Equity securities:				
Common equities	<u>840,268</u>	<u>840,268</u>	-	-
Total investments at fair value	1,325,029	\$ <u>840,268</u>	\$ <u>484,761</u>	\$ <u>-</u>
Investments measured at amortized cost:				
Money market funds	<u>27,669</u>			
	\$ <u>1,352,698</u>			

(4) Net Receivable from/Payable to Broker

Approximately 51% and 49% of fish sales in the year ended September 30, 2018 were conducted with brokers based in Singapore and Taiwan, respectively. Approximately 55% and 45% of fish sales in the year ended September 30, 2017 were conducted with brokers based in Japan and Taiwan, respectively. Upon offloading the fish catch from the vessel to a designated third party, the broker pays 95% of the estimated settlement. When the final settlement is determined, the Company may either be entitled to an additional amount due from the broker or be liable for an amount due to the broker. The net broker account is a receivable of \$211,309 and \$633,005 at September 30, 2018 and 2017, respectively.

(5) Other Receivables

Outstanding balances from other receivables due the Company from various parties are detailed below.

	<u>2018</u>	<u>2017</u>
Palau Micronesia Air (PMAir)	\$ 550,000	\$ 550,000
Insurance company	35,522	35,522
Others	<u>84,725</u>	<u>31,140</u>
	670,247	616,662
Less: allowance for doubtful accounts	<u>(616,662)</u>	<u>(616,662)</u>
	\$ <u>53,585</u>	\$ <u>-</u>

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(6) Property and Equipment

Property and equipment consist of the following at September 30, 2018 and 2017:

	Beginning Balance Oct. 1, 2017	Transfers and Additions	Transfers and Disposals	Ending Balance Sept. 30, 2018
Leased fishing vessel and purse seine net	\$ 7,442,312	\$ -	\$ -	\$ 7,442,312
Purchased fishing vessel and purse seine net	6,242,316	150,000	-	6,392,316
Leasehold improvements	1,475,556	39,795	-	1,515,351
Vessel improvements	403,767	4,703	-	408,470
Office furniture and equipment	42,945	1,300	-	44,245
Vehicles	<u>13,940</u>	<u>-</u>	<u>-</u>	<u>13,940</u>
Total cost	15,620,836	195,798	-	15,816,634
Less accumulated depreciation and amortization	<u>(12,713,412)</u>	<u>(581,215)</u>	<u>-</u>	<u>(13,294,627)</u>
	<u>\$ 2,907,424</u>	<u>\$ (385,417)</u>	<u>\$ -</u>	<u>\$ 2,522,007</u>
	Beginning Balance Oct. 1, 2016	Transfers and Additions	Transfers and Disposals	Ending Balance Sept. 30, 2017
Leased fishing vessel and purse seine net	\$ 7,392,312	\$ 50,000	\$ -	\$ 7,442,312
Purchased fishing vessel and purse seine net	6,242,316	-	-	6,242,316
Leasehold improvements	1,468,141	7,415	-	1,475,556
Vessel improvements	393,143	10,624	-	403,767
Office furniture and equipment	42,945	-	-	42,945
Vehicles	<u>26,568</u>	<u>13,940</u>	<u>(26,568)</u>	<u>13,940</u>
Total cost	15,565,425	81,979	(26,568)	15,620,836
Less accumulated depreciation and amortization	<u>(12,137,884)</u>	<u>(602,096)</u>	<u>26,568</u>	<u>(12,713,412)</u>
	<u>\$ 3,427,541</u>	<u>\$ (520,117)</u>	<u>\$ -</u>	<u>\$ 2,907,424</u>

(7) Due to Parties to the Nauru Agreement

During fiscal year 2017, the Company settled a dispute of outstanding liabilities with the Parties to the Nauru Agreement. At September 30, 2017, the Company recognized an outstanding liability of \$1,190,810.

(8) Short-Term Debt

In August 2018, the Company obtained short-term loans of \$500,000 and \$350,000 from a bank used for partial payment of the agreed fine relating to fishing violation. Interest of 2.12% and principal are due on November 7, 2018 and November 28, 2018, respectively.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(9) Long-Term Debt

On October 27, 2009, a \$3,000,000 loan was obtained from the FSM Development Bank to purchase a fishing vessel. The loan is collateralized by the vessel and DSI's joint savings deposit of \$150,000. Interest of 9% and principal are payable in monthly installments of \$38,003, which began on April 25, 2010. Loan has maturity date of August 31, 2020. The loan balance was \$796,361 and \$1,133,957 as of September 30, 2018 and 2017, respectively.

On April 30, 2015, a \$1,000,000 loan, with maturity date of May 10, 2020, was obtained from a bank to fund fishing operations. The loan is collateralized by a \$2,031,271 time certificates of deposit. Interest of 2.12% and principal are payable in monthly installments of \$17,605, which began on June 10, 2015. The loan balance was \$346,223 and \$562,885 as at September 30, 2018 and 2017, respectively.

Future debt service on the above long-term debt is as follows:

<u>Year ending September 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2019	\$ 606,470	\$ 60,830	\$ 667,300
2020	<u>536,114</u>	<u>19,005</u>	<u>555,119</u>
	<u>\$ 1,142,584</u>	<u>\$ 79,835</u>	<u>\$ 1,222,419</u>

Changes in long-term debt during the years ended September 30, 2018 and 2017 are as follows:

<u>2018</u>				
<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Due Within One Year</u>
\$ <u>1,696,842</u>	\$ <u>          -</u>	\$ <u>(554,258)</u>	\$ <u>1,142,584</u>	\$ <u>606,470</u>

<u>2017</u>				
<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Due Within One Year</u>
\$ <u>2,151,602</u>	\$ <u>          -</u>	\$ <u>(454,760)</u>	\$ <u>1,696,842</u>	\$ <u>570,098</u>

(10) Commitments

Lease

The Company leases a fishing vessel and a purse seine fishing net from Yap Investment Trust, a fund of the Yap State Government (the "State"), with a lease term through July 2022. Common stock was issued by the Company as total consideration for the agreement.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(10) Commitments, Continued

Fines and Penalties

In July 2017, the Company entered into a settlement agreement with Nauru Fisheries and Marine Resources Authority relating to fishing violations committed by the Company in the waters of Nauru. The Company was required to pay a sum of \$1,200,000 payable in installment. As of September 30, 2018, the Company has partially paid \$1,000,000 with remaining balance of \$200,000 to be paid in fiscal year 2019.

(11) Cost of Sales

Details of cost of sales for the years ended September 30, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
Fuel	\$ 3,219,346	\$ 2,401,352
License, agent, and port fees	1,849,410	3,572,985
Crew salaries and wages	1,260,060	1,023,550
Depreciation and amortization	574,235	905,259
Repair and maintenance	519,013	481,450
Insurance	303,382	298,982
Management fee	287,431	170,061
Communications	238,671	58,310
Crew travel	143,342	215,219
Salt and provisioning	118,795	292,228
Stevedoring	88,657	72,561
Supplies and freight	72,021	77,921
Other vessel expenses	<u>154,364</u>	<u>96,033</u>
	<u>\$ 8,828,727</u>	<u>\$ 9,665,911</u>

(12) Risk Management

The Company is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Company has elected to purchase commercial insurance for the risks of loss to which it is exposed. The Company claims expenses and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. No losses as a result of these risks have occurred in any of the past three years.

(13) Related Parties

The Company has entered into significant transactions with the State, as discussed in Note 10. Several board members and officers of the Company hold management positions and other positions of influence with the State. Furthermore, included in employee and director receivables are \$9,121 and \$11,421, at September 30, 2018 and 2017, respectively, of amounts owed by previous board members and current management for reimbursement of travel expenses, net of an allowance for doubtful accounts of \$33,013, in each of those years.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2018 and 2017

(14) Contingencies

DSI has incurred losses from operations of \$167,415, \$1,937,046 and \$1,476,809 for the years ended September 30, 2018, 2017, and 2016, respectively. DSI depends on its fishing activities to continue its operations. However, DSI is behind in paying its current fuel liabilities and has deferred required dry docking. The Company has entered into a short term loan with a financial institution to support maturing obligations. For the last three years, the Company has not received subsidies from the State or the national government. The continuation of DSI's operations is dependent upon successful fishing activities, improvement in external industry factors, and on time collection from fish brokers. In addition, in order for DSI to continue as a going concern, it may need to improve its cash management, reduce operating expenses, and obtain support from the State or the national government.

(15) Subsequent Event

Management has considered subsequent events through June 25, 2019, the date upon which the financial statements were available to be issued. There were no material subsequent events that would require recognition or disclosure in the financial statements for the year ended September 30, 2018.

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

The Board of Directors  
The Diving Seagull, 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 The Diving Seagull, Inc. (the Company), which comprise the statement of net position as of September 30, 2018, 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 June 25, 2019.

### **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 and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did identify certain deficiencies in internal control, described in the accompanying Schedule of Findings and Responses as items 2018-001 and 2018-002 that we consider to be material weaknesses.

## Compliance and Other Matters

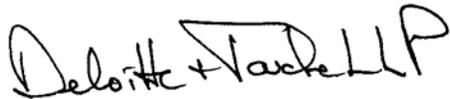
As part of obtaining reasonable assurance about whether the Company's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material 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*.

## The Company's Responses to Findings

The Company's responses to the findings identified in our audit are described in the accompanying Schedule of Findings and Responses. The Company's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

## 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.

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

June 25, 2019

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE YAP STATE GOVERNMENT)**

Schedule of Findings and Responses  
Year Ended September 30, 2018

Finding No. 2018-001 – Reconciliation

Criteria: The Company should maintain an adequate system of accounting and should be able to reconcile the general ledger (GL) with subsidiary ledgers.

Condition: Management did not maintain an adequate system of accounting during the year. Reconciliations of numerous GL accounts were not performed, such as cash, TCDs, investments, inventories, prepaid expenses, accounts receivable, fixed assets, accounts payable, accrued expenses, loans, salaries, sales and cost of sales.

Cause: The cause of this condition is primarily due to the lack of adequate accounting assistance, absence of management supervision and lack of adequate filing and document maintenance systems.

Effect: The effect of this condition is a possible inability to substantiate financial statement balances, financial statement transactions and compliance with laws and regulations.

Recommendation: Management should acquire adequate accounting assistance, should prepare monthly financial statements that are supported by the books and records, and should maintain an adequate filing and retention system and be able to demonstrate compliance with laws and regulations.

Identification as a Repeat Finding: Finding 2017-001.

Auditee Response and Corrective Action Plan: DSI agrees to acquire adequate accounting assistance, by preparing monthly financial statements supported by books and records, and shall maintain an adequate filing and retention system and be able to demonstrate compliance with laws and regulations. DSI to receive and review hard copy of monthly bank account statement with copy of reconciliation by 14th of each month forward.

**THE DIVING SEAGULL, INC.**  
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Schedule of Findings and Responses, Continued  
Year Ended September 30, 2018

Finding No. 2018-002 – Cash and Time Certificates of Deposit

Criteria: Effective internal control necessitates that reconciliation of cash accounts should be timely and completely performed.

Condition:

1. BOG TCD was overstated by \$3,626. As the amount was not deemed material to the financial statements, an adjustment was not proposed.
2. TCD deposited in Community Ayuw was understated by \$7,700. An adjustment was recorded during the audit process.
3. Petty cash account was overstated by \$15,069 due to unrecorded vessel expenses. An adjustment was recorded during the audit process.

Cause: The cause of the above condition is a lack of adequate internal control to facilitate timely performance and review of cash reconciliations.

Effect: The effect of the above condition results in misstated general ledger balances.

Recommendation: We recommend that cash account reconciliations and attendant review be timely performed.

Identification as a Repeat Finding: Finding 2017-002.

Auditee Response and Corrective Action Plan: DSI concurs with the audit finding. Corrective action plans are as follow:

- a. To review monthly reconciliation progress with accountant and correct any account variance if any. This procedure is applied to conditions no. 1,2, and 3.
- b. To hire an accountant to assist with accounting work.