

AIR MARSHALL ISLANDS, INC.

FINANCIAL STATEMENTS  
AND  
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2000 AND 1999

INDEPENDENT AUDITORS' REPORT

Board of Directors  
Air Marshall Islands, Inc.:

We have audited the accompanying balance sheets of Air Marshall Islands, Inc. (AMI), a component unit of the Republic of the Marshall Islands, as of September 30, 2000 and 1999, and the related statements of earnings (loss) and deficit and cash flows for the years then ended. These financial statements are the responsibility of AMI's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraphs, 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain minutes of AMI Board of Directors' meetings held from January 23, 1999 through August 24, 2001.

Because of inadequacies in the accounting records, we were unable to form an opinion regarding the amounts at which expendable parts balances, stated at \$433,041 and \$911,978, respectively, are recorded in the accompanying balance sheets as of September 30, 2000 and 1999, and the amount at which air traffic liability, stated at \$659,964, is recorded in the accompanying balance sheet as of September 30, 1999. Expendable parts and air traffic liability enter into the determination of the results of operations for the years ended September 30, 2000 and 1999.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to obtain minutes of Board of Directors' meetings, as discussed in the third paragraph, and had the accounting records regarding expendable parts and air traffic liability been adequate, as discussed in the fourth paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of AMI as of September 30, 2000 and 1999, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 24, 2001, on our consideration of AMI's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

*Deloitte & Touche*

August 24, 2001

AIR MARSHALL ISLANDS, INC.

Balance Sheets  
September 30, 2000 and 1999

	<u>2000</u>	<u>1999</u> (As Restated note 11)
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents (note 6)	\$ 2,162,314	\$ 738,777
Investments (note 4)	381,528	1,516,586
Receivables:		
Trade	568,187	479,400
Affiliates (note 8)	39,641	42,398
	607,828	521,798
Less allowance for doubtful receivables	(383,846)	(272,448)
Receivables, net	223,982	249,350
Expendable parts (net of allowance for obsolescence of \$100,000 and \$-0- at September 30, 2000 and 1999, respectively)	433,041	911,978
Prepaid expenses and deposits	99,486	350,722
Total current assets	3,300,351	3,767,413
Advance to RepMar (note 8)	1,129,080	-
Advance to vendor (note 9)	2,100,000	500,000
Receivables from affiliates (net of allowance for doubtful receivables of \$586,303 and \$211,339 at September 30, 2000 and 1999, respectively) (note 8)	113,305	384,418
Plant and equipment, net (note 5)	3,865,715	10,911,651
	<u>\$ 10,508,451</u>	<u>\$ 15,563,482</u>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Current liabilities:		
Long-term debt, current portion (note 6)	\$ 758,880	\$ 222,111
Accounts payable	353,975	928,806
Air traffic liability	105,775	659,964
Accrued expenses	312,613	472,144
Payable to affiliates (note 8)	210,845	514,897
Advance from RepMar (note 8)	-	500,000
Deferred maintenance expenses	-	64,933
Total current liabilities	1,742,088	3,362,855
Long-term debt, net of current portion (note 6)	-	758,880
Total liabilities	1,742,088	4,121,735
Stockholders' equity:		
Common stock, \$10 par value, 5,000,000 shares authorized, 1,164,773 shares issued and outstanding	11,647,730	11,647,730
Additional paid-in capital (note 1)	1,284,722	1,284,722
Contributed capital (note 7)	3,088,945	9,802,946
Deficit	(7,255,034)	(11,293,651)
Total stockholders' equity	8,766,363	11,441,747
Contingencies (note 9)		
	<u>\$ 10,508,451</u>	<u>\$ 15,563,482</u>

See accompanying notes to financial statements.

AIR MARSHALL ISLANDS, INC.

Statements of Earnings (Loss) and Deficit  
Years Ended September 30, 2000 and 1999

	<u>2000</u>	<u>1999</u> (As Restated note 11)
Operating revenues:		
Passenger	\$ 2,888,044	\$ 3,392,934
Cargo	324,890	506,208
Charter	236,390	896,033
Other	<u>180,578</u>	<u>399,419</u>
Total operating revenues	<u>3,629,902</u>	<u>5,194,594</u>
Operating expenses:		
General and administrative	1,505,234	526,598
Maintenance	1,258,578	1,636,321
Depreciation and amortization	1,167,146	1,630,232
Flying operations	820,828	1,365,103
Promotion and sales	414,784	704,340
Aircraft and traffic servicing	<u>380,862</u>	<u>648,089</u>
Total operating expenses	<u>5,547,432</u>	<u>6,510,683</u>
Operating loss	<u>(1,917,530)</u>	<u>(1,316,089)</u>
Nonoperating income (expenses):		
Gain on sale of plant and equipment	4,199,193	42,830
Contributions from RepMar (note 8)	2,000,000	-
Interest income	139,463	30,358
Interest expense	(67,439)	(211,485)
Net (decrease) increase in the fair value of investments	(585,070)	1,452,782
Other expense	<u>-</u>	<u>(26,286)</u>
Total nonoperating income (expenses), net	<u>5,686,147</u>	<u>1,288,199</u>
Net earnings (loss)	3,768,617	(27,890)
Add depreciation on contributed plant and equipment that reduces contributed capital	<u>270,000</u>	<u>702,000</u>
	4,038,617	674,110
Deficit at beginning of year	<u>(11,293,651)</u>	<u>(11,967,761)</u>
Deficit at end of year	<u>\$ (7,255,034)</u>	<u>\$ (11,293,651)</u>

See accompanying notes to financial statements.

AIR MARSHALL ISLANDS, INC.

Statements of Cash Flows  
Years Ended September 30, 2000 and 1999

	2000	1999 (As Restated note 11)
Cash flows from operating activities:		
Operating loss	\$ (1,917,530)	\$ (1,316,089)
Adjustments to reconcile operating loss to net cash used for operating activities:		
Depreciation and amortization	1,167,146	1,630,232
Provision for losses on accounts receivable	486,362	-
Provision for obsolescence on expendable parts	100,000	-
(Increase) decrease in assets:		
Receivables:		
Trade	(88,787)	467,315
Affiliates	(101,094)	12,277
Expendable parts	378,937	(323,749)
Prepaid expenses and deposits	251,236	(142,185)
Advance to RepMar (note 8)	(1,129,080)	-
Increase (decrease) in liabilities:		
Accounts payable	(574,831)	(378,967)
Air traffic liability	(554,189)	47,610
Accrued expenses	(159,531)	(271,252)
Payable to affiliates	(304,052)	101,421
Deferred maintenance expenses	(64,933)	8,928
Net cash used for operating activities	(2,510,346)	(164,459)
Cash flows from noncapital financing activities:		
Repayment of long-term debt	(222,111)	(222,111)
Interest paid on long-term debt	(67,439)	(85,472)
Contributions from RepMar (note 8)	2,000,000	-
Net cash provided by (used for) noncapital financing activities	1,710,450	(307,583)
Cash flows from capital and related financing activities:		
Acquisition of plant and equipment	(953,669)	(1,410,593)
Aircraft purchase down payments (note 9)	(1,600,000)	(500,000)
Proceeds from sale of plant and equipment	4,587,651	874,566
(Repayment of) proceeds from RepMar advance (note 8)	(500,000)	500,000
Repayment of long-term debt	-	(1,218,750)
Interest paid on long-term debt	-	(87,288)
Capital contributions by RepMar (note 8)	-	1,874,173
Net cash provided by capital and related financing activities	1,533,982	32,108
Cash flows from investing activities:		
Proceeds from sale of investments	549,988	666,216
Interest received	139,463	32,896
Net cash provided by investing activities	689,451	699,112
Net increase in cash and cash equivalents	1,423,537	259,178
Cash and cash equivalents at beginning of year	738,777	479,599
Cash and cash equivalents at end of year	\$ 2,162,314	\$ 738,777

See accompanying notes to financial statements.

AIR MARSHALL ISLANDS, INC.

Statements of Cash Flows, Continued  
 Years Ended September 30, 2000 and 1999

	<u>2000</u>	<u>1999</u> (As Restated note 11)
Supplemental schedule of noncash investing, capital and financing activities:		
During the years ended September 30, 2000 and 1999, AMI sold assets previously transferred from RepMar (see note 7):		
Decrease in plant and equipment	\$ 7,200,001	\$ 670,000
Decrease in contributed capital	<u>(7,200,001)</u>	<u>(670,000)</u>
	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

## AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

### (1) Organization

Air Marshall Islands, Inc. (AMI) was incorporated on October 12, 1989 to provide domestic and international carrier service within and from the Marshall Islands. AMI has issued 54,400, 460,528, 348,845 and 301,000 shares of \$10 par value common stock to the Republic of the Marshall Islands (RepMar), the Marshall Islands Development Authority (MIDA), the Marshall Islands Development Bank (MIDB) and the Republic of the Marshall Islands Investment Development Fund (RMIIDF), respectively, as of September 30, 2000 and 1999. During AMI's initial operating year, RepMar contributed equity capital (including amounts resulting from the merger with Airline of the Marshall Islands, Inc.) amounting to \$1,284,722.

AMI's financial statements are incorporated into the general purpose financial statements of RepMar as a component unit.

### (2) Summary of Significant Accounting Policies

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

#### 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.

#### Basis of Accounting

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

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

(2) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents

For the purposes of the balance sheets and the statements of cash flows, cash and cash equivalents include cash held in demand accounts as well as time certificates of deposit with a maturity date within three months of the date acquired. As of September 30, 2000 and 1999, the carrying amount of cash and cash equivalents was \$2,162,314 and \$738,777, respectively, and the corresponding bank balance was \$2,202,491 and \$841,433, respectively. Of the bank balance amounts, \$2,152,920 and \$491,406, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2000 and 1999, bank deposits in the amount of \$129,533 and \$136,797, respectively, were FDIC insured. AMI does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

Investments

Investments are carried at fair value. Fair value is the amount at which an investment could be exchanged in a current transaction between willing parties.

Receivables

Receivables are both interest free and uncollateralized and are primarily due from government agencies, businesses and individuals located within the Republic of the Marshall Islands.

Allowance for Doubtful Receivables

The allowance for doubtful receivables is stated at an amount which management believes will be adequate to absorb possible losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience. The allowance is established through a provision for losses on accounts receivable charged to expense.

Expendable Parts

Flight equipment expendable parts are carried at the lower of average cost or net realizable value..

Plant and Equipment

Plant and equipment are stated at cost. Maintenance and repairs, including major overhauls, are charged to operating expenses as they are incurred. Depreciation of plant and equipment and amortization of leasehold equipment are calculated on the straight-line method based on the estimated useful lives of the respective assets.

Compensated Absences

Vested or accumulated vacation leave is recorded as an expense and liability as the benefits accrue to employees. No liability is recorded for nonvesting accumulating rights to receive sick pay benefits. As of September 30, 2000 and 1999, the accumulated vacation leave liability totals \$49,182 and \$44,282, respectively, and is included within the balance sheets as accrued expenses.

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

(2) Summary of Significant Accounting Policies, Continued

Contributed Capital

Contributed capital is comprised of plant and equipment contributed by RepMar and is stated at its estimated fair value at the date of transfer. Depreciation expense for capital assets contributed by RepMar is recorded as a reduction of contributed capital.

Taxes

Corporate profits are not subject to income tax in the Republic of the Marshall Islands. The Government of the Republic of the Marshall Islands imposes a gross revenue tax of 3% on revenues. Pursuant to the Income Tax Act of 1989, as amended, revenue from domestic flights and operations of any government owned corporation providing air transportation services are exempt from gross revenue tax. Accordingly, AMI is exempt from this tax relating to gross revenue.

Passenger and Cargo Revenues

Passenger and cargo revenues are recognized as earned revenue when the transportation is provided.

Reclassifications

Certain reclassifications have been made to the 1999 financial statements in order to conform with the 2000 presentation.

(3) Risk Management

AMI 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. AMI has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed. Settled claims from these risks have not exceeded commercial insurance coverage for the past three years.

(4) Investments

A summary of investments as of September 30, 2000 and 1999, is as follows:

	<u>Fair Value</u>	
<u>Equities:</u>	<u>2000</u>	<u>1999</u>
Common stock (see note 10)	\$ <u>381,528</u>	\$ <u>1,516,586</u>

AMI's investments are categorized as either (1) insured or registered or for which the securities are held by AMI or its agent in AMI's name, (2) uninsured and unregistered for which the securities are held by the broker's or dealer's trust department or agent in AMI's name or (3) uninsured and unregistered for which the securities are held by the broker or dealer or by its trust department or agent but not in AMI's name. All of AMI's investments are classified in category (1).

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

(5) Plant and Equipment

A summary of plant and equipment as of September 30, 2000 and 1999, is as follows:

	<u>Estimated Useful Lives</u>	<u>2000</u>	<u>1999</u>
Aircraft	10 - 15 years	\$ 8,551,844	\$ 15,450,000
Rotable spare parts	5 - 10 years	2,175,432	2,460,312
Plant and equipment	5 years	1,024,874	1,024,257
Office furniture and equipment	5 - 7 years	543,912	507,173
Flight equipment	4 - 10 years	374,203	413,137
Motor vehicles	3 years	126,435	81,387
Buildings	20 years	<u>1</u>	<u>40,002</u>
		12,796,701	19,976,268
Less accumulated depreciation and amortization		<u>(8,930,986)</u>	<u>(9,064,617)</u>
		<u>\$ 3,865,715</u>	<u>\$ 10,911,651</u>

(6) Long-Term Debt

A schedule of AMI's long-term debt as of September 30, 2000 and 1999, is as follows:

	<u>2000</u>	<u>1999</u>
Note to bank, due February 17, 2004, interest at 7% as of September 30, 2000 and 1% above bank's time certificate of deposit (TCD) floating rate (6.4%) as of September 30, 1999, payable in monthly installments of \$18,509, plus interest, collateralized by a savings account in 2000 and a TCD owned by RepMar in 1999 (see note 10).	\$ 758,880	\$ 980,991
Less current installments	<u>758,880</u>	<u>222,111</u>
Long-term debt	<u>\$ -</u>	<u>\$ 758,880</u>

(7) Contributed Capital

Contributed capital is derived from the following sources as of September 30, 2000 and 1999:

	<u>2000</u>	<u>1999</u>
RepMar	\$ 5,374,174	\$ 12,574,175
Less accumulated depreciation of contributed assets	<u>(2,285,229)</u>	<u>(2,771,229)</u>
	<u>\$ 3,088,945</u>	<u>\$ 9,802,946</u>

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

(7) Contributed Capital, Continued

Changes in AMI's contributed capital account were as follows:

	<u>2000</u>	<u>1999</u>
Balance at beginning of year	\$ 12,574,175	\$ 11,370,002
Contributing sources (see note 8):		
Contributions from RepMar	-	1,874,173
Reductions:		
Sale of aircraft previously transferred from RepMar	(7,200,000)	(670,000)
Disposal of hangar previously transferred from RepMar	<u>(1)</u>	<u>-</u>
Balance at end of year	<u>\$ 5,374,174</u>	<u>\$ 12,574,175</u>

(8) Related Party Transactions

AMI is owned by RepMar, MIDA, MIDB and RMIIDF, and is therefore affiliated with all RepMar-owned and affiliated entities.

AMI's airline service is provided to RepMar and all RepMar-owned and affiliated entities. Services are extended to these entities at the same terms and conditions provided to third parties.

AMI utilizes services from certain affiliated entities at substantially the same terms and conditions as those incurred from third parties with the exception of services provided by the Marshall Islands Airports Authority (MIAA), a component unit of RepMar. Specifically, AMI utilizes MIAA's airport facilities at the Amata Kabua International Airport, including landing rights, for which no fees or charges are levied by MIAA.

On February 21, 1997, RepMar entered into a loan agreement with the Asian Development Bank for the Public Sector Reform Program (PSRP). The objectives of the PSRP include the use of loan proceeds by RepMar for the retirement of commercial debt of AMI, specifically, debt associated with the purchase of aircraft. Accordingly, RepMar provided funding during the year ended September 30, 1999, totaling \$1,874,173, for the retirement of debt (see notes 7 and 9).

During the year ended September 30, 2000, AMI received a cash contribution from RepMar in the amount of \$2,000,000 (see note 9).

RepMar advanced \$500,000 to AMI during the year ended September 30, 1999 to fund a predelivery payment relating to the purchase of two aircraft. This \$500,000 advance was repaid in November 1999.

During the year ended September 30, 2000, AMI advanced \$1,750,000 to RepMar. This advance was applied against AMI's delinquent payroll taxes, totaling \$438,979, and related penalties and interest amounting to \$181,941 as of September 30, 2000. AMI management expects that the remaining balance of \$1,129,080 will be applied against future payroll taxes withheld by AMI.

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

(8) Related Party Transactions, Continued

A summary of related party transactions for the years ended September 30, 2000 and 1999 and related receivable (less allowance for doubtful receivables) and payable balances as of September 30, 2000 and 1999, is as follows:

	2000		
	Receivables	Expenses	Payables
RepMar	\$ 691,980	\$ 157,962	\$ 96,118
Marshall Islands Social Security Administration	1,398	85,332	88,449
Marshall Islands National Telecommunications Authority	77	176,326	18,945
Marshalls Energy Company, Inc.	592	31,489	3,734
Other	45,202	-	3,599
	739,249	\$ <u>451,109</u>	\$ <u>210,845</u>
Less allowance for doubtful receivables	<u>(586,303)</u>		
	<u>\$ 152,946</u>		
		1999	
	Receivables	Expenses	Payables
RepMar	\$ 568,546	\$ -	\$ 472,049
Marshall Islands Social Security Administration	3,281	88,283	42,019
Marshall Islands National Telecommunications Authority	196	260,208	829
Marshalls Energy Company, Inc.	2,087	34,999	-
Other	64,045	-	-
	638,155	\$ <u>383,490</u>	\$ <u>514,897</u>
Less allowance for doubtful receivables	<u>(211,339)</u>		
	<u>\$ 426,816</u>		

(9) Contingencies

Management acknowledges that it is currently dependent on RepMar for cash funding in order to maintain AMI as a going concern. For the years ended September 30, 2000 and 1999, AMI received cash contributions of \$2,000,000 and \$1,874,173, respectively, from RepMar. Although RepMar has provided funding in the past, AMI does not have a formal agreement with RepMar to provide funds in the future. Management believes that the continuation of AMI's operations is dependent upon the future financial support of RepMar, the offering of additional common stock and/or significant improvements in operations, achieved through significant reductions in operating expenses.

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2000 and 1999

(9) Contingencies, Continued

During the year ended September 30, 1999, AMI entered into a purchase agreement to acquire two Dornier 328 aircraft at a total cost of \$28,045,780. On May 15, 2000, AMI cancelled the purchase agreement. At the time of cancellation, AMI had made predelivery payments, totaling \$1,600,000 and \$500,000, during the years ended September 30, 2000 and 1999, respectively. As of September 30, 2000, AMI has not been repaid the predelivery payments (see note 10).

(10) Subsequent Events

In October 2000, AMI sued the aircraft manufacturer for repayment of the predelivery payments amounting to \$2,100,000 and for other claims. On August 17, 2001, a court awarded damages in favor of AMI in the amount of \$4,065,000, plus pre-judgment interest in the amount of \$115,411. The ultimate outcome of collection of this judgment is uncertain.

On April 17, 2001, AMI paid in full the note to bank for \$649,883 (see note 6).

As of August 24, 2001, AMI's equity investments in common stock were valued at \$134,110 (see note 4).

(11) Restatement

Subsequent to the issuance of AMI's 1999 financial statements, AMI's management determined that prepaid expenses were overstated by \$29,822 as of September 30, 1999. As a result, prepaid expenses and deposits and deficit as of September 30, 1999 and flying operations expenses for the year then ended have been restated from the amounts previously reported.