

AIR MARSHALL ISLANDS, INC.

FINANCIAL STATEMENTS  
AND  
INDEPENDENT AUDITORS' REPORT

YEARS ENDED SEPTEMBER 30, 2001 AND 2000

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, 2001 and 2000, and the related statements of 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 October 1, 1999 through May 20, 2002.

Because of inadequacies in the accounting records, we were unable to form an opinion regarding the amounts at which expendable parts balances, stated at \$523,581 and \$433,041, respectively, are recorded in the accompanying balance sheets as of September 30, 2001 and 2000. Expendable parts enters into the determination of the results of operations for the years ended September 30, 2001 and 2000. Furthermore, in our report dated May 29, 2000, we qualified our opinion on the 1999 financial statements because of inadequacies in the accounting records to support the air traffic liability balance. Air traffic liability enters into the determination of the results of operations for the year ended September 30, 2000.

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, 2001 and 2000, 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.

As discussed in note 10 to the financial statements, AMI changed its method of accounting for contributions in aid in 2001 to conform with the provisions of Governmental Accounting Standards Board Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* and, retroactively, restated the 2000 financial statements for the change.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 20, 2002, on our consideration of AMI's internal control over financial reporting and 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*

May 20, 2002

AIR MARSHALL ISLANDS, INC.

Balance Sheets  
September 30, 2001 and 2000

	<u>2001</u>	<u>2000</u> (As Restated note 10)
<u>ASSETS</u>		
Current assets:		
Cash (note 6)	\$ 400,397	\$ 2,162,314
Investments (note 4)	194,322	381,528
Receivables:		
Trade	693,280	537,657
Employees	44,648	30,530
Affiliates (note 7)	28,684	39,641
	766,612	607,828
Less allowance for doubtful receivables	(457,151)	(383,846)
Receivables, net	309,461	223,982
Expendable parts (net of allowance for obsolescence of \$100,000 at September 30, 2001 and 2000)	523,581	433,041
Prepaid expenses and deposits	175,714	99,486
Total current assets	1,603,475	3,300,351
Advance to RepMar (note 7)	1,018,163	1,129,080
Advance to vendor (net of allowance of \$2,100,000 and \$-0- at September 30, 2001 and 2000, respectively) (note 8)	-	2,100,000
Receivables from affiliates (net of allowance for doubtful receivables of \$640,146 and \$586,303 at September 30, 2001 and 2000, respectively) (note 7)	92,405	113,305
Plant and equipment, net (note 5)	2,970,907	3,865,715
	<u>\$ 5,684,950</u>	<u>\$ 10,508,451</u>
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Current liabilities:		
Long-term debt, current portion (note 6)	\$ -	\$ 758,880
Accounts payable	293,623	353,975
Air traffic liability	248,197	105,775
Accrued expenses	321,128	312,613
Payable to affiliates (note 7)	214,651	210,845
Total current liabilities	1,077,599	1,742,088
Stockholders' equity:		
Common stock, \$10 par value, 5,000,000 shares authorized, 1,164,773 shares issued and outstanding (note 1)	11,647,730	11,647,730
Additional paid-in capital (note 1)	1,284,722	1,284,722
Deficit	(8,325,101)	(4,166,089)
Total stockholders' equity	4,607,351	8,766,363
Contingencies (note 8)	<u>\$ 5,684,950</u>	<u>\$ 10,508,451</u>

See accompanying notes to financial statements.

AIR MARSHALL ISLANDS, INC.

Statements of Loss and Deficit  
Years Ended September 30, 2001 and 2000

	<u>2001</u>	<u>2000</u> (As Restated note 10)
Operating revenues:		
Passenger	\$ 1,997,970	\$ 2,888,044
Cargo	282,112	324,890
Charter	177,929	236,390
Other	<u>315,739</u>	<u>180,578</u>
Total operating revenues	<u>2,773,750</u>	<u>3,629,902</u>
Operating expenses:		
Provision for losses on accounts receivable and advances	2,227,148	486,362
Depreciation and amortization	1,259,912	1,167,146
Maintenance	967,339	1,258,578
Flying operations	828,737	820,828
General and administrative	714,037	1,018,872
Promotion and sales	427,099	414,784
Aircraft and traffic servicing	<u>319,425</u>	<u>380,862</u>
Total operating expenses	<u>6,743,697</u>	<u>5,547,432</u>
Operating loss	<u>(3,969,947)</u>	<u>(1,917,530)</u>
Nonoperating income (expenses):		
Loss on disposal of plant and equipment	(1,099)	(2,244,808)
Contributions from RepMar (note 7)	-	2,000,000
Interest income	24,030	139,463
Interest expense	(24,790)	(67,439)
Net decrease in the fair value of investments	<u>(187,206)</u>	<u>(585,070)</u>
Total nonoperating income (expenses), net	<u>(189,065)</u>	<u>(757,854)</u>
Net loss	(4,159,012)	(2,675,384)
Deficit at beginning of year	<u>(4,166,089)</u>	<u>(1,490,705)</u>
Deficit at end of year	<u>\$ (8,325,101)</u>	<u>\$ (4,166,089)</u>

See accompanying notes to financial statements.

AIR MARSHALL ISLANDS, INC.

Statements of Cash Flows  
Years Ended September 30, 2001 and 2000

	2001	2000 (As Restated note 10)
Cash flows from operating activities:		
Operating loss	\$ (3,969,947)	\$ (1,917,530)
Adjustments to reconcile operating loss to net cash used for operating activities:		
Depreciation and amortization	1,259,912	1,167,146
Provision for losses on accounts receivable and advances	2,227,148	486,362
Provision for obsolescence on expendable parts	-	100,000
(Increase) decrease in assets:		
Receivables:		
Trade	(155,623)	(67,665)
Employees	(14,118)	(21,122)
Affiliates	(21,986)	(101,094)
Expendable parts	(90,540)	378,937
Prepaid expenses and deposits	(76,228)	251,236
Liquidation (disbursement) of advance to RepMar (note 7)	110,917	(1,129,080)
Increase (decrease) in liabilities:		
Accounts payable	(60,352)	(574,831)
Air traffic liability	142,422	(554,189)
Accrued expenses	10,507	(159,531)
Payable to affiliates	3,806	(304,052)
Deferred maintenance expenses	-	(64,933)
Net cash used for operating activities	(634,082)	(2,510,346)
Cash flows from noncapital financing activities:		
Repayment of long-term debt	(758,880)	(222,111)
Interest paid on long-term debt	(26,782)	(67,439)
Contributions from RepMar (note 7)	-	2,000,000
Net cash (used for) provided by noncapital financing activities	(785,662)	1,710,450
Cash flows from capital and related financing activities:		
Acquisition of plant and equipment	(371,873)	(953,669)
Aircraft purchase down payments (note 8)	-	(1,600,000)
Proceeds from disposal of plant and equipment	5,670	4,587,651
Repayment of RepMar advance	-	(500,000)
Net cash (used for) provided by capital and related financing activities	(366,203)	1,533,982
Cash flows from investing activities:		
Proceeds from sale of investments	-	549,988
Interest received	24,030	139,463
Net cash provided by investing activities	24,030	689,451
Net (decrease) increase in cash	(1,761,917)	1,423,537
Cash at beginning of year	2,162,314	738,777
Cash at end of year	\$ 400,397	\$ 2,162,314

See accompanying notes to financial statements.

## AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2001 and 2000

### (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, 2001 and 2000. 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, 2001 and 2000

(2) Summary of Significant Accounting Policies, Continued

Cash

For the purposes of the balance sheets and the statements of cash flows, cash is defined as cash on hand and cash held in demand accounts. As of September 30, 2001 and 2000, cash was \$400,397 and \$2,162,314, respectively, and the corresponding bank balance was \$495,835 and \$2,202,491, respectively. Of the bank balance amounts, \$262,957 and \$2,152,920, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2001 and 2000, bank deposits in the amount of \$180,578 and \$129,533, 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, 2001 and 2000, the accumulated vacation leave liability totals \$57,251 and \$49,182, respectively, and is included within the balance sheets as accrued expenses.

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2001 and 2000

(2) Summary of Significant Accounting Policies, Continued

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 2000 financial statements in order to conform with the 2001 presentation.

Change in Accounting Principle

Beginning in fiscal year 2001, AMI implemented GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. The provisions of this statement require AMI to recognize grants and contributions as non-operating revenue on the Statement of Loss and Deficit. In prior periods, grants and contributions had been recorded as a direct increase to contributions in aid in the equity section of the Balance Sheet.

(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, 2001 and 2000, is as follows:

	<u>Fair Value</u>	
	<u>2001</u>	<u>2000</u>
<u>Equities:</u>		
Common stock	\$ <u>194,322</u>	\$ <u>381,528</u>

AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2001 and 2000

(4) Investments, Continued

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).

(5) Plant and Equipment

A summary of plant and equipment as of September 30, 2001 and 2000, is as follows:

	<u>Estimated Useful Lives</u>	<u>2001</u>	<u>2000</u>
Aircraft	10 - 15 years	\$ 8,551,844	\$ 8,551,844
Rotable spare parts	5 - 10 years	2,516,564	2,175,432
Plant and equipment	5 years	1,037,705	1,024,874
Office furniture and equipment	5 - 7 years	555,822	543,912
Flight equipment	4 - 10 years	374,203	374,203
Motor vehicles	3 years	116,896	126,435
Buildings	20 years	<u>1</u>	<u>1</u>
		13,153,035	12,796,701
Less accumulated depreciation and amortization		<u>(10,182,128)</u>	<u>(8,930,986)</u>
		<u>\$ 2,970,907</u>	<u>\$ 3,865,715</u>

(6) Long-Term Debt

A schedule of AMI's long-term debt as of September 30, 2001 and 2000, is as follows:

	<u>2001</u>	<u>2000</u>
Note to bank, due February 17, 2004, interest at 7% as of September 30, 2000, payable in monthly installments of \$18,509, plus interest, collateralized by a savings account. This note was paid in full on April 17, 2001.	\$ -	\$ 758,880
Less current installments	<u>-</u>	<u>758,880</u>
Long-term debt	<u>\$ -</u>	<u>\$ -</u>



AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2001 and 2000

(8) 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, 2001 and 2000, AMI received cash contributions of \$-0- and \$2,000,000, 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.

On May 15, 2000, AMI cancelled a purchase agreement to acquire two Dornier 328 aircraft at a total cost of \$28,045,780. As of September 30, 2001, AMI had made predelivery payments totaling \$2,100,000, including a payment of \$1,600,000 during the year ended September 30, 2000. In October 2000, AMI sued the aircraft manufacturer for repayment of the predelivery payments 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. As of September 30, 2001, AMI has not been repaid the predelivery payments and has recorded a provision for uncollectible advances of \$2,100,000.

(9) Subsequent Event

On April 2, 2002, the aircraft manufacturer filed for bankruptcy protection (see note 8).

(10) Restatement

Effective October 1, 2000, AMI implemented GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. The provisions of this statement require capital grants and contributions to be recognized as non-operating revenue on the Statements of Loss and Deficit. In prior periods, capital grants and contributions had been recorded as a direct increase to contributions in aid in the equity section of the Balance Sheet. As a result, contributed capital and deficit as of October 1, 1999 and (loss) gain on disposal of plant and equipment for the year ended September 30, 2000 have been restated from the amounts previously reported as follows:

	<u>As Previously Reported</u>	<u>As Restated</u>
At October 1, 1999:		
Contributed capital	\$ <u>9,802,946</u>	\$ <u>-</u>
Deficit	\$ <u>(11,293,651)</u>	\$ <u>(1,490,705)</u>
For the year ended September 30, 2000:		
Nonoperating income (expense):		
Gain (loss) on disposal of plant and equipment	\$ <u>4,199,193</u>	\$ <u>(2,244,808)</u>