

**AIR MARSHALL ISLANDS, INC.**

---

**FINANCIAL STATEMENTS  
AND  
INDEPENDENT AUDITORS' REPORT**

---

**YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

## INDEPENDENT AUDITORS' REPORT

Board of Directors  
Air Marshall Islands, Inc.:

We have audited the accompanying statements of net assets of Air Marshall Islands, Inc. (AMI), a component unit of the Republic of the Marshall Islands, as of September 30, 2003 and 2002, and the related statements of revenues, expenses and changes in net assets 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of AMI's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain all the minutes of AMI Board of Directors' meetings held from October 1, 2001 through August 15, 2005.

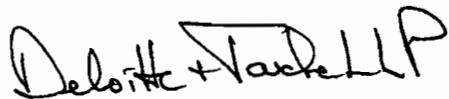
Because of inadequacies in the accounting records and internal control over financial reporting, we were unable to form an opinion regarding trade receivables, expendable parts, accounts payable and air traffic liability as of September 30, 2003 and 2002. Trade receivables, expendable parts, accounts payable and air traffic liability enter materially into the determination of the results of operations for the years ended September 30, 2003 and 2002.

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 and internal control over financial reporting related to trade receivables, expendable parts, accounts payable 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, 2003 and 2002, 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 described in note 2 to the accompanying financial statements, AMI adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments* effective October 1, 2002. AMI has restated the financial statements for the year ended September 30, 2002 to reflect the changes.

The Management's Discussion and Analysis on pages 3 through 8 is not a required part of the basic financial statements but is supplementary information required by GASB. This supplementary information is the responsibility of AMI's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 15, 2005, 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 agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

August 15, 2005

# AIR MARSHALL ISLANDS, INC.

## Management's Discussion and Analysis Year Ended September 30, 2003

### Introduction

Our discussion and analysis of the Air Marshall Islands, Inc. financial performance provides an overview of AMI's financial activities for the fiscal year ended September 30, 2003. This MD&A is to be used in conjunction with the financial statements that follow this section.

Deloitte & Touche, an independent registered public accounting firm, audited AMI's financial statements for FY2003 and issued a qualified opinion on certain accounts. However, except as discussed in the auditors' report, the Statement of Net Assets and the related Statements of Revenues, Expenses and Changes in Net Assets and Cash Flows present fairly, in all material respects, the financial position of AMI for the year ended in conformity with accounting principles generally accepted in the United States of America.

AMI is a component unit of the Republic of the Marshall Islands (RMI) and was established as the official air carrier of the Government of the Republic of the Marshall Islands by virtue of a Corporate Charter granted by the Cabinet of the Marshall Islands on October 12, 1989. AMI subsequently merge with Airline of the Marshall Islands, Inc., AMI being the surviving corporation, on January 26, 1990. AMI is governed by a five - member Board of Directors. The RMI Cabinet appoints members to the Board of Directors and presently, the Minister of Transportation and Communication is appointed as Chairperson of the Board.

### Adoption of GASB 34

For the fiscal year ending September 30, 2003, Air Marshall Islands, Inc. is required to adopt GASB Statement No. 34, Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments, which was issued in June 1999. GASB 34 was developed to make financial reports of government entities easier to understand and more informative to oversight bodies. GASB 34 brought about significant changes in the format of the financial reports, one of which is the management's discussion and analysis.

### Financial Highlights

Total assets amounted to \$3,519,802 as at September 30, 2003. There is a reduction of total assets by 33% or \$1,726,659.00 when compared with FY2002. During the year ended September 30, 2002, AMI received an appropriation of \$1.5M from RepMar, of which, \$481,500 was received during FY2002. The remaining balance of \$1,018,500 is included under Receivable from Affiliates account as of September 30, 2002 and was received during FY2003 for Dornier 228 overhaul.

Date funds were received	Fiscal Year		Total
	2002	2003	
December 19, 2001	\$ 71,500	-	
January 08, 2002	20,000	-	
March 12, 2002	50,000	-	
April 05, 2002	170,000	-	
July 11, 2002	170,000	-	
November 28, 2002	-	250,000	
November 30, 2002	-	100,000	
January 09, 2003	-	250,000	
February 28, 2003	-	250,000	
April 05, 2003	-	168,500	
Total	\$ 481,500	1,018,500	\$1,500,000

## AIR MARSHALL ISLANDS, INC.

### Management's Discussion and Analysis Year Ended September 30, 2003

Funds were disbursed as follows:

	Year			
	2002	2003	2004	
Rotable Overhaul	\$ 79,941	\$142,340	\$ 43,560	\$ 265,841
Freight Charges	50,095	21,416	10,339	81,850
Tooling	4,043	6,285	2,480	12,808
Engine Overhaul	107,993	-	142,382	250,375
Manuals		300	300	600
Consumables	115,825	201,650	171,781	489,256
Engine Repairs	-	108,121	-	108,121
Propeller Overhaul	-	5,294	-	5,294
Flight Equipment Repairs	-	22,102	-	22,102
Parts Inventory	<u>50,788</u>	<u>56,032</u>	<u>126,434</u>	<u>233,254</u>
Total	<u>\$408,685</u>	<u>\$563,540</u>	<u>\$497,276</u>	<u>\$1,469,501</u>

### Statement of Net Assets

	Year		US Dollar Change	Percent Change
	2003	2002		
<b>Assets</b>				
Cash	\$ 96,495	\$ 355,932	(259,437)	-73%
Receivables (net of allowance)	799,647	1,541,955	(742,308)	-48%
Expendable parts (net of allowance)	465,295	503,250	(37,955)	-8%
Prepaid expenses and deposits	<u>207,432</u>	<u>126,581</u>	80,851	64%
Total current assets	1,568,869	2,527,718	(958,849)	-38%
Advance to RepMar	793,880	914,149	(120,269)	-13%
Advance to vendor (net of allowance of \$2.1M)	-	-	-	
Plant and equipment (net of allowance)	<u>1,157,053</u>	<u>1,804,594</u>	(647,541)	-36%
Total assets	<u>\$3,519,802</u>	<u>\$5,246,461</u>	(1,726,659)	-33%
<b>Liabilities</b>				
Accounts payable	\$ 326,612	\$ 430,164	(103,552)	-24%
Air traffic liability	309,713	160,387	149,326	93%
Accrued expenses	437,804	359,041	78,763	22%
Payable to affiliates	<u>210,945</u>	<u>201,128</u>	9,817	5%
Total current liabilities	1,285,074	1,150,720	134,354	12%
Advance from RepMar	<u>150,000</u>	-	150,000	100%
Total liabilities	<u>1,435,074</u>	<u>1,150,720</u>	284,354	25%
<b>Net assets</b>				
Invested in capital assets	1,157,053	1,804,594	(647,541)	-36%
Unrestricted	<u>927,675</u>	<u>2,291,147</u>	(1,363,472)	-60%
Total net assets	<u>2,084,728</u>	<u>4,095,741</u>	(2,011,013)	-49%
Total liabilities and net assets	<u>\$3,519,802</u>	<u>\$5,246,461</u>	(1,726,659)	-33%

## AIR MARSHALL ISLANDS, INC.

### Management's Discussion and Analysis Year Ended September 30, 2003

#### Plant and Equipment

	2003	2002	US Dollar Change	Percent Change
Aircraft and improvement	\$ 8,955,595	\$ 8,926,047	\$ 29,548	0%
Rotable spare parts	2,846,219	2,585,410	260,809	10%
Plant and equipment	350,476	1,039,546	(689,070)	-66%
Office furniture and equipment	589,998	571,520	18,478	3%
Motor vehicles	118,396	118,396	0	0%
Buildings	<u>1</u>	<u>1</u>	<u>0</u>	0%
Total	12,860,685	13,240,920	(380,235)	-3%
Less: accumulated depreciation and amortization	<u>11,703,632</u>	<u>11,436,326</u>	<u>267,306</u>	2%
Net	<u>\$ 1,157,053</u>	<u>\$ 1,804,594</u>	<u>\$(647,541)</u>	-36%

AMI records its plant and equipment at acquisition cost including incidental expenses related to procurement. These assets are depreciated on a straight - line basis over their estimated useful lives to their residual values, over periods not to exceed ten years for flight equipment (from date of original manufacture) and five to ten years for rotatable parts, from the date the asset is placed in service. Rotable spare parts are written off when beyond economic repair.

Expenditures for major additions, improvements and flight equipment modifications (if any) are generally capitalized and depreciated over the shorter of the estimated life of the improvement or the modified assets remaining lives or remaining lease term in the event that any modifications or improvements are made to operating lease equipment (none as of FY2003). Substantially, all property and equipment of AMI as of FY2003, are free from liens and encumbrances and are not pledged as collateral for indebtedness of the company.

Details of capital asset activity for the FY 2003 and 2002.

	2003		2002	
	Additions	Retirements	Additions	Retirements
Aircraft and improvement	\$269,548	\$240,000	\$ -	\$ -
Rotable spare parts	260,809	-	68,846	-
Plant and equipment	4,100	693,170	1,841	-
Office furniture and equipment	18,478	-	15,698	-
Motor vehicles	-	-	1,500	-
Buildings	<u>-</u>	<u>-</u>	<u>-</u>	<u>--</u>
Total	<u>\$552,935</u>	<u>\$933,170</u>	<u>\$87,885</u>	<u>\$ --</u>

Plant and Equipment decreased substantially by 66% or \$689,070 for the fiscal period ending September 30, 2003 when compared with FY2002, brought about by retirement of various SAAB parts and equipment amounting to \$693,170. Plant and equipment are depreciated for 5 years and written off from the books when determined to be beyond economic repair, outmoded or declared as obsolete. For the year ended September 30, 2002, no retirement or disposal of equipment was done.

## AIR MARSHALL ISLANDS, INC.

### Management's Discussion and Analysis Year Ended September 30, 2003

Allowances for obsolescence for expendable parts are provided for excess, outmoded or obsolete. These allowances are based on management estimates, which are subject to change as conditions in AMI's business evolve. The allowance for the period 2003 and 2002 amounted to \$100,000.

#### Subsequent events related to Property and Equipment

AMI entered into aircraft lease agreement with FINOVA for the lease of Dash 8 on December 11, 2002 for three years. Total lease payments for the basic rent and maintenance reserve averages \$47,000 monthly and this is charged as operating expense and not capitalized. Management anticipates an average lease cost of \$53,000 for the FY 2004 as a result of increased utilization or flying hours of the Dash 8 aircraft. The utilization report for DHC - 8 disclosed the following:

V7-0210 Utilization	2003	2004
Flight Hours Flown	704.08	947.31
Number of Landings (Cycles)	905.00	1,286.00
Days Flown	173.00	228.00
Average Daily Flight Hours	4.07	4.15
Average Landings Per Day	5.20	5.60

Capital expenditures (engine overhaul or repair) that extends the life of the leased asset are capitalized and depreciated over 10 years or term of the lease, whichever is shorter.

AMI management is making a study whether to renew the lease or buy the Dash 8 after December 2005.

#### Operating Revenue

Total Operating Revenue increased by \$331,260 or 11% from FY2002. Revenue Passenger Miles (RPM) is the basic measure of productivity for the airline industry. The load factor is the RPM achieved compared to the Available Seat Miles (ASM) flown.

	Year		Annual Change	
	2003	2002		Percent
Passengers Carried	25,673	22,254	3,419	15%
Flight Arrivals	3,344	3,229	115	4%
Block Time	2,939	2,937	2	0%
Available Seats	72,421	52,776	19,645	37%
Available Seat Miles	10,174,634	6,930,034	3,244,600	47%
Revenue Pax Miles	4,640,821	4,014,927	625,894	16%
Load Factor	46%	58%	-12%	-21%
Passenger Revenue	\$2,492,861	\$2,293,894	\$198,967	9%
Cargo Revenue	\$ 408,424	\$ 391,545	\$ 16,879	4%

#### Passengers Carried

For FY2003, AMI achieved 4,640,821 Revenue Passenger Miles (RPM) and produced 10,174,634 Available Seat Miles (ASM), which represents a load factor of 46%. This was a significant improvement (16%) over FY2002 when RPMs were just over 4.0 million and ASMs were just less than 7.0 million for a load factor of 58%. There was an increase in available seat miles in 2003 - that is from 6.9 million in 2002 to 10.2 million, attributed to the lease of the Dash 8 which was operational starting March 2003.

## AIR MARSHALL ISLANDS, INC.

### Management's Discussion and Analysis Year Ended September 30, 2003

#### Air Cargo

The amount of air cargo carried domestically has increased significantly since 1999. Cargo carried for FY2003 vs. FY2002, increased by 4% or \$16,879, when compared against 1999, there is an increase of \$348,767 or 585%.

#### Operating Expenses

Total Operating Expenses increased by 8% or \$386,066 from FY2002. Expenses related to flying operations increased by 101% or \$915,743 over FY2002 when flight operating expenses were just over \$.909M. Increase in expenses were attributed to the lease of Dash 8 aircraft and these are:

<u>Expenses</u>	<u>Amount</u>
Pilot training	\$104,431
Pilot pay	84,332
Hotel accommodation - pilots	30,396
Aircraft fuel	164,168
Aircraft rental	401,225
Aircraft insurance	98,046
Meal allowances	24,574
Other supplies	<u>8,744</u>
<b>Total</b>	<b><u>\$915,916</u></b>

### Statement of Revenues, Expenses and Changes in Net Assets Years Ended September 30, 2003 and 2002

	2003	2002	US Dollar Change	Percent Change
<b>Operating revenues:</b>				
Passenger	\$ 2,492,861	\$ 2,293,894	\$198,967	9%
Cargo	408,424	391,545	16,879	4%
Charter	190,478	133,662	56,816	43%
Other	<u>362,442</u>	<u>303,844</u>	<u>58,598</u>	19%
Total operating revenues	<u>3,454,205</u>	<u>3,122,945</u>	<u>331,260</u>	11%
<b>Operating expenses:</b>				
Flying operations	1,825,220	909,477	915,743	101%
Maintenance	1,309,755	1,499,784	(190,029)	-13%
Depreciation and amortization	1,018,591	1,254,198	(235,607)	-19%
General and administrative	472,490	615,865	(143,375)	-23%
Promotion and sales	411,672	372,930	38,742	10%
Aircraft and traffic servicing	<u>341,330</u>	<u>340,738</u>	<u>592</u>	0%
Total operating expenses	<u>5,379,058</u>	<u>4,992,992</u>	<u>386,066</u>	8%
Operating loss	<u>(1,924,853)</u>	<u>(1,870,047)</u>	<u>(54,806)</u>	3%

**AIR MARSHALL ISLANDS, INC.**

Management's Discussion and Analysis  
Year Ended September 30, 2003

Statement of Revenues, Expenses and Changes in Net Assets, Continued  
Years Ended September 30, 2003 and 2002

	2003	2002	US Dollar Change	Percent Change
Nonoperating income (expenses):				
Contributions from RepMar	-	1,500,000	(1,500,000)	-100%
Interest income	725	1,664	(939)	-56%
Loss on sale of investments	-	(143,227)	(143,227)	-100%
Loss on disposal of plant and equipment	<u>(86,885)</u>	<u>-</u>	<u>86,885</u>	100%
 Total nonoperating (expenses) income, net	 <u>(86,160)</u>	 <u>1,358,437</u>	 <u>(1,444,597)</u>	 -106%
 Change in net assets	 (2,011,013)	 (511,610)	 (1,499,403)	 293%
Net assets at beginning of year	<u>4,095,741</u>	<u>4,607,351</u>	<u>(511,610)</u>	-11%
Net assets at end of year	<u>\$2,084,728</u>	<u>\$4,095,741</u>	(2,011,013)	-49%

**Contingencies**

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, relative to the case filed by AMI against an aircraft manufacturer. On April 2, 2002, the aircraft manufacturer filed for bankruptcy protection. As of September 30, 2003, AMI has not received or has not been repaid the predelivery payments totaling \$2.1M and has recorded a 100% provision for the uncollectible advances.

Attorney's fees and other services rendered by a lawyer amounting to \$160,000 have not been recorded by AMI considering that these were not authorized by AMI's Board of Directors.

**AIR MARSHALL ISLANDS, INC.**

Statements of Net Assets  
September 30, 2003 and 2002

	2003	2002
<u>ASSETS</u>		
Current assets:		
Cash	\$ 96,495	\$ 355,932
Receivables:		
Trade	665,129	654,128
Employees	175,109	77,563
Affiliates (net of allowance for doubtful receivables of \$640,146 at September 30, 2003 and 2002)	416,560	1,216,320
Other	-	51,095
	1,256,798	1,999,106
Less allowance for doubtful receivables	(457,151)	(457,151)
Receivables, net	799,647	1,541,955
Expendable parts (net of allowance for obsolescence of \$100,000 at September 30, 2003 and 2002)	465,295	503,250
Prepaid expenses and deposits	207,432	126,581
Total current assets	1,568,869	2,527,718
Advance to RepMar	793,880	914,149
Advance to vendor (net of allowance of \$2,100,000 at September 30, 2003 and 2002)	-	-
Plant and equipment, net	1,157,053	1,804,594
	\$ 3,519,802	\$ 5,246,461
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Accounts payable	\$ 326,612	\$ 430,164
Air traffic liability	309,713	160,387
Accrued expenses	437,804	359,041
Payable to affiliates	210,945	201,128
Total current liabilities	1,285,074	1,150,720
Advances from RepMar	150,000	-
Total liabilities	1,435,074	1,150,720
Commitments and contingencies		
Net assets:		
Investment in capital assets	1,157,053	1,804,594
Unrestricted	927,675	2,291,147
Total net assets	2,084,728	4,095,741
	\$ 3,519,802	\$ 5,246,461

See accompanying notes to financial statements.

**AIR MARSHALL ISLANDS, INC.**

Statements of Revenues, Expenses and Changes in Net Assets  
Years Ended September 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Operating revenues:		
Passenger	\$ 2,492,861	\$ 2,293,894
Cargo	408,424	391,545
Charter	190,478	133,662
Other	<u>362,442</u>	<u>303,844</u>
Total operating revenues	<u>3,454,205</u>	<u>3,122,945</u>
Operating expenses:		
Flying operations	1,825,220	909,477
Maintenance	1,309,755	1,499,784
Depreciation and amortization	1,018,591	1,254,198
General and administrative	472,490	615,865
Promotion and sales	411,672	372,930
Aircraft and traffic servicing	<u>341,330</u>	<u>340,738</u>
Total operating expenses	<u>5,379,058</u>	<u>4,992,992</u>
Operating loss	<u>(1,924,853)</u>	<u>(1,870,047)</u>
Nonoperating income (expenses):		
Contribution from RepMar	-	1,500,000
Interest income	725	1,664
Loss on sale of investments	-	(143,227)
Loss on disposal of plant and equipment	<u>(86,885)</u>	<u>-</u>
Total nonoperating (expenses) income, net	<u>(86,160)</u>	<u>1,358,437</u>
Change in net assets	(2,011,013)	(511,610)
Net assets at beginning of year	<u>4,095,741</u>	<u>4,607,351</u>
Net assets at end of year	<u>\$ 2,084,728</u>	<u>\$ 4,095,741</u>

See accompanying notes to financial statements.

**AIR MARSHALL ISLANDS, INC.**

Statements of Cash Flows  
Years Ended September 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Cash flows from operating activities:		
Cash received from customers	\$ 3,276,244	\$ 2,964,641
Cash payments to suppliers for goods and services	(3,050,923)	(2,332,627)
Cash payments to employees for services	(1,247,143)	(1,071,758)
Net cash used in operating activities	<u>(1,021,822)</u>	<u>(439,744)</u>
Cash flows from noncapital financing activities:		
Proceeds from RepMar advance	<u>150,000</u>	<u>-</u>
Net cash provided by noncapital financing activities	<u>150,000</u>	<u>-</u>
Cash flows from capital and related financing activities:		
Acquisition of plant and equipment	(552,935)	(87,885)
Proceeds from disposal of plant and equipment	95,000	-
Contribution from RepMar	<u>1,018,500</u>	<u>481,500</u>
Net cash provided by capital and related financing activities	<u>560,565</u>	<u>393,615</u>
Cash flows from investing activities:		
Interest received	725	1,664
Proceeds from sale of investments	<u>51,095</u>	<u>-</u>
Net cash provided by investing activities	<u>51,820</u>	<u>1,664</u>
Net decrease in cash	(259,437)	(44,465)
Cash at beginning of year	<u>355,932</u>	<u>400,397</u>
Cash at end of year	<u>\$ 96,495</u>	<u>\$ 355,932</u>
Reconciliation of operating loss to net cash used for operating activities:		
Operating loss	\$ (1,924,853)	\$ (1,870,047)
Adjustments to reconcile operating loss to net cash used for operating activities:		
Depreciation and amortization	1,018,591	1,254,198
(Increase) decrease in assets:		
Receivables:		
Affiliates	(218,740)	(76,731)
Trade	(11,001)	39,152
Employees	(97,546)	(32,915)
Expendable parts	37,955	20,331
Prepaid expenses and deposits	(80,851)	49,133
Liquidation of advance to RepMar	120,269	104,014
Increase (decrease) in liabilities:		
Accounts payable	(103,552)	136,541
Air traffic liability	149,326	(87,810)
Accrued expenses	78,763	37,913
Payable to affiliates	<u>9,817</u>	<u>(13,523)</u>
Net cash used for operating activities	<u>\$ (1,021,822)</u>	<u>\$ (439,744)</u>

See accompanying notes to financial statements.

AIR MARSHALL ISLANDS, INC.

Statements of Cash Flows, Continued  
Years Ended September 30, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Supplemental disclosure of noncash items:		
During the year ended September 30, 2002, AMI sold its investments:		
Increase in other receivables	\$ -	\$ 51,095
Loss on sale of investments	-	143,227
Decrease in investments	-	<u>(194,322)</u>
	<u>\$ -</u>	<u>\$ -</u>
During the year ended September 30, 2002, AMI recorded a contribution from RepMar:		
Increase in receivable from affiliates	\$ -	\$ 1,018,500
Contribution from RepMar	-	<u>(1,018,500)</u>
	<u>\$ -</u>	<u>\$ -</u>

See accompanying notes to financial statements.

## AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2003 and 2002

### (1) Organization

Air Marshall Islands, Inc. (AMI) was incorporated on October 12, 1989 to provide domestic and international air 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 (RMIDF), respectively, as of September 30, 2003 and 2002. 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.

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

#### 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 in the statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

## AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2003 and 2002

### (2) Summary of Significant Accounting Policies, Continued

#### Cash

For purposes of the statements of net assets and cash flows, cash is defined as cash on hand and cash held in demand accounts. As of September 30, 2003 and 2002, cash was \$96,495 and \$355,932, respectively, and the corresponding bank balances were \$134,938 and \$536,968, respectively. Of the bank balance amounts, \$65,531 and \$338,482, respectively, are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2003 and 2002, bank deposits in the amount of \$65,531 and \$200,000, respectively, were FDIC insured. AMI does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized.

#### 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

AMI does not have a capitalization policy for plant and equipment; however, items with a cost that equals or exceeds \$5,000 are generally capitalized. Such assets are stated at cost. Maintenance and repairs 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. The estimated useful lives of these assets are as follows:

	<u>Estimated Useful Lives</u>
Aircraft	10 – 15 years
Rotable spare parts	5 – 10 years
Plant and equipment	5 years
Office furniture and equipment	5 – 7 years
Motor vehicles	3 years
Buildings	20 years

## AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2003 and 2002

### (2) Summary of Significant Accounting Policies, Continued

#### 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, 2003 and 2002, the accumulated vacation leave liability totals \$86,784 and \$71,580, respectively, and is included within the statements of net assets as accrued expenses.

#### 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 Revenues

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

#### Adoption of New Accounting Standards

GASB has issued Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, which was subsequently amended by Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, and modified by Statement No. 38, *Certain Financial Statement Disclosures*. These statements establish financial reporting standards for governmental entities which require that management's discussion and analysis of the financial activities be included with the basic financial statements and notes and modifies certain other financial statement disclosure requirements. AMI is required to adopt GASB Statement No. 34, as amended by GASB Statement No. 37, and certain provisions of GASB Statement No. 38 in fiscal year 2003.

To conform to the requirements of GASB 34, the following changes have been made to AMI's financial statements:

- Retained earnings have been reclassified into the following net assets categories:
  - Investment in capital assets; capital assets, net of accumulated depreciation, plus construction or improvement of those assets, less related debt.
  - Unrestricted; net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.
- The statement of cash flows has been presented using the direct method.

#### Reclassifications

Certain reclassifications have been made to the 2002 financial statements to conform with the 2003 presentation.

## AIR MARSHALL ISLANDS, INC.

### Notes to Financial Statements September 30, 2003 and 2002

#### (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) Plant and Equipment

Capital assets activity for the years ended September 30, 2003 and 2002, was as follows:

	2003			
	October 1, <u>2002</u>	<u>Additions</u>	<u>Retirements</u>	September 30, <u>2003</u>
Aircraft and improvements	\$ 8,926,047	\$ 269,548	\$ (240,000)	\$ 8,955,595
Rotable spare parts	2,585,410	260,809	-	2,846,219
Plant and equipment	1,039,546	4,100	(693,170)	350,476
Office furniture and equipment	571,520	18,478	-	589,998
Motor vehicles	118,396	-	-	118,396
Buildings	<u>1</u>	<u>-</u>	<u>-</u>	<u>1</u>
	13,240,920	552,935	(933,170)	12,860,685
Less accumulated depreciation and amortization	<u>(11,436,326)</u>	<u>(1,018,591)</u>	<u>751,285</u>	<u>(11,703,632)</u>
	<u>\$ 1,804,594</u>	<u>\$ (465,656)</u>	<u>\$ (181,885)</u>	<u>\$ 1,157,053</u>
	2002			
	October 1, <u>2001</u>	<u>Additions</u>	<u>Retirements</u>	September 30, <u>2002</u>
Aircraft and improvements	\$ 8,926,047	\$ -	\$ -	\$ 8,926,047
Rotable spare parts	2,516,564	68,846	-	2,585,410
Plant and equipment	1,037,705	1,841	-	1,039,546
Office furniture and equipment	555,822	15,698	-	571,520
Motor vehicles	116,896	1,500	-	118,396
Buildings	<u>1</u>	<u>-</u>	<u>-</u>	<u>1</u>
	13,153,035	87,885	-	13,240,920
Less accumulated depreciation and amortization	<u>(10,182,128)</u>	<u>(1,254,198)</u>	<u>-</u>	<u>(11,436,326)</u>
	<u>\$ 2,970,907</u>	<u>\$ (1,166,313)</u>	<u>\$ -</u>	<u>\$ 1,804,594</u>

**AIR MARSHALL ISLANDS, INC.**

Notes to Financial Statements  
September 30, 2003 and 2002

(5) Related Party Transactions

AMI is owned by RepMar, MIDA, MIDB and RMIDF, 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.

During the year ended September 30, 2003, AMI obtained advances totaling \$150,000 from RepMar, in accordance with Cabinet Minute C.M. 150 (2002), which approved a loan to AMI in the amount of \$2,000,000. The amount of the loan was subsequently reduced to \$1,600,000. The advances bear no interest and have a repayment term of no more than five years.

During the year ended September 30, 2002, AMI received an appropriation of \$1,500,000 (derived from Compact Section 211 funding) from RepMar, of which \$481,500 was received during 2002. The remaining balance of \$1,018,500 is included in receivable from affiliates as of September 30, 2002 and was received in 2003. No appropriation was received during the year ended September 30, 2003.

During the year ended September 30, 2000, AMI advanced \$1,750,000 to RepMar. AMI's liability for payroll taxes totaling \$120,269 and \$104,014 during the years ended September 30, 2003 and 2002, respectively, and delinquent payroll taxes and related penalties and interest totaling \$731,837 for prior years has been applied against this advance. AMI management expects that the remaining advance balance of \$793,880 and \$914,149 as of September 30, 2003 and 2002, respectively, will be applied against future payroll taxes withheld by AMI.

A summary of related party transactions for the years ended September 30, 2003 and 2002 and related receivable (less allowance for doubtful receivables) and payable balances as of September 30, 2003 and 2002, is as follows:

	<u>2003</u>		
	<u>Receivables</u>	<u>Expenses</u>	<u>Payables</u>
RepMar	\$ 984,343	\$ -	\$ 84,174
Marshall Islands Social Security Administration	224	114,318	63,508
Marshall Islands National Telecommunications Authority	898	174,390	7,441
Marshall's Energy Company, Inc.	5,847	46,486	3,322
Other	<u>65,394</u>	<u>-</u>	<u>52,500</u>
	1,056,706	\$ <u>335,194</u>	\$ <u>210,945</u>
Less allowance for doubtful receivables	<u>(640,146)</u>		
	<u>\$ 416,560</u>		

**AIR MARSHALL ISLANDS, INC.**

Notes to Financial Statements  
September 30, 2003 and 2002

(5) Related Party Transactions, Continued

	2002		
	Receivables	Expenses	Payables
RepMar	\$ 1,820,419	\$ -	\$ 85,761
Marshall Islands Social Security Administration	224	100,572	55,551
Marshall Islands National Telecommunications Authority	-	156,756	16,762
Marshalls Energy Company, Inc.	2,645	38,011	4,157
Other	33,178	-	38,897
	1,856,466	\$ 295,339	\$ 201,128
Less allowance for doubtful receivables	(640,146)		
	\$ 1,216,320		

As of September 30, 2003 and 2002, AMI maintained a demand deposit account with an affiliated financial institution, amounting to \$15,224 and \$60,524, respectively.

(6) Commitments and Contingencies

Commitments

AMI entered into an aircraft lease agreement on December 11, 2002 for three years, with a base rent of \$33,000 monthly. Future minimum lease payments under this lease for subsequent years ending September 30 are as follows:

<u>Year Ending</u> <u>September 30,</u>	
2004	\$ 396,000
2005	396,000
2006	79,200
	\$ 871,200

AMI entered into two lease agreements for its offices in Majuro and Ebeye expiring on January 31, 2006 and March 1, 2006, respectively. Total future minimum lease payments under these leases for subsequent years ending September 30 are as follows:

<u>Year Ending</u> <u>September 30,</u>	
2004	\$ 55,049
2005	55,049
2006	18,862
	\$ 128,960

## AIR MARSHALL ISLANDS, INC.

Notes to Financial Statements  
September 30, 2003 and 2002

### (6) Commitments and Contingencies, Continued

#### Contingencies

Management acknowledges that it is currently dependent on RepMar for cash funding in order to maintain AMI as a going concern. 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. 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. On April 2, 2002, the aircraft manufacturer filed for bankruptcy protection. The ultimate outcome of collection of this judgment is uncertain. As of September 30, 2003, AMI has not been repaid the predelivery payments and has recorded a provision for uncollectible advances of \$2,100,000.

Management does not believe that AMI is liable for certain billings, totaling approximately \$160,000, that pertain to attorney fees for services which were not authorized by AMI's Board of Directors. The billings are not recorded by AMI and the ultimate resolution of this matter is uncertain.

### (7) Subsequent Events

During the period from October 1, 2003 through August 15, 2005, AMI received advances from RepMar amounting to \$1,850,000.

On June 10, 2005, AMI entered into an \$800,000 loan agreement with a bank.