

AIR MARSHALL ISLANDS, INC.

**INDEPENDENT AUDITORS' REPORTS ON
INTERNAL CONTROL AND ON COMPLIANCE**

YEAR ENDED SEPTEMBER 30, 2004

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

Chairman
Board of Directors
Air Marshall Islands, Inc.:

We have audited the financial statements of Air Marshall Islands, Inc. (AMI), as of and for the year ended September 30, 2004, and have issued our report thereon dated August 15, 2005, which was qualified due to our inability to obtain all the minutes of Board of Directors' meetings held from October 1, 2003 through August 15, 2005, and our inability to obtain adequate accounting records to support trade receivables, expendable parts, and air traffic liability. Except as discussed in the preceding sentence, we conducted our audit 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.

Internal Control Over Financial Reporting

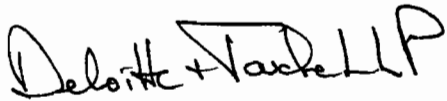
In planning and performing our audit, we considered AMI's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect AMI's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings (pages 6 through 16) as items 2004-1 through 2004-9.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items 2004-2 through 2004-9 to be material weaknesses. We also noted other matters involving the internal control over financial reporting, which we have reported to management of AMI in a separate letter dated August 15, 2005.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether AMI's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Board of Directors and management, the federal awarding agencies, pass-through entities, the cognizant and other federal agencies and is not intended to be and should not be used by anyone other than these specified parties.

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

August 15, 2005

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

Chairman
Board of Directors
Air Marshall Islands, Inc.:

Compliance

We have audited the compliance of Air Marshall Islands, Inc. (AMI) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended September 30, 2004. AMI's major federal program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (page 6). Compliance with the requirements of laws, regulations, contracts, and grants applicable to its one major federal program is the responsibility of AMI's management. Our responsibility is to express an opinion on AMI's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about AMI's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on AMI's compliance with those requirements.

In our opinion, AMI complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2004.

Internal Control Over Compliance

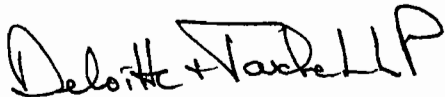
The management of AMI is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered AMI's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of AMI as of and for the year ended September 30, 2004, and have issued our report thereon dated August 15, 2005, which was qualified due to our inability to obtain all the minutes of Board of Directors' meetings held from October 1, 2003 through August 15, 2005 and our inability to obtain adequate accounting records to support trade receivables, expendable parts and air traffic liability. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards (page 5) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of AMI. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, when considered in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the Board of Directors, management, the federal awarding agencies, pass-through entities, the cognizant audit and other federal agencies and is not intended to be and should not be used by anyone other than these specified parties.

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

August 15, 2005

AIR MARSHALL ISLANDS, INC.

Schedule of Expenditures of Federal Awards
Year Ended September 30, 2004

<u>Federal Grantor/Pass-Through Grantor's Program Title</u>	<u>Federal CFDA Number</u>	<u>2004 Receipts</u>	<u>Total Funding Available</u>	<u>2004 Expenditures</u>	<u>September 30, 2004 Available Funds</u>
<u>U.S. Department of the Interior</u>					
Compact of Free Association Section 211 Capital	15.875	\$ <u>900,000</u>	\$ <u>1,850,000</u>	\$ <u>900,000</u>	\$ <u>950,000</u>

The above federal award is passed through RepMar. The Schedule of Expenditures of Federal Awards is prepared on the accrual basis of accounting.

See Accompanying Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings and Questioned Costs
Year Ended September 30, 2004

Section I - Summary of Auditors' Results

1. The Independent Auditors' Report on the financial statements expressed a qualified opinion.
2. Reportable conditions in internal control over financial reporting were identified, some of which are considered to be material weaknesses.
3. No instances of noncompliance considered material to the financial statements were disclosed by the audit.
4. No reportable conditions in internal control over compliance with requirements applicable to major federal award programs were identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. AMI's one major program was:

<u>Name of Federal Program</u>	<u>CFDA Number</u>
Compact of Free Association: Section 211 Capital	15.875

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. AMI did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

Section II - Financial Statement Findings

<u>Reference Number</u>	<u>Findings</u>	<u>Refer Page #</u>
2004-1	Revenue/Receipts	7
2004-2	Purchases/Disbursements	9
2004-3 - 4	Receivables	10 - 11
2004-5 - 6	Expendable Parts	12 - 13
2004-7	Air Traffic Liability	14
2004-8	Related Party Disclosure	15
2004-9	External Financial Reporting	16

Section III - Federal Award Findings and Questioned Costs

No federal award findings were reported for the year ended September 30, 2004.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings Year Ended September 30, 2004

Revenue/Receipts

Finding No. 2004-1

Criteria: Ticket stock should be maintained in an orderly and systematic fashion.

Condition: During the year ended September 30, 2004, ticket stock was not issued to and sold by ticketing agents/stations in sequential order and certain auditor and flight coupons were not reported to revenue accounting in a timely manner. In addition, of fifty tickets tested, we noted the following exceptions:

- Cash sales made by ticketing agents at the following stations were not deposited to the bank in a timely manner:

<u>Station</u>	<u>Sales Date</u>	<u>Deposit Date</u>
Airok	January 16, 2004	February 3, 2004
Airport	October 27, 2003	October 30, 2003
Airport	December 12, 2003	December 19, 2003
Airport	December 19, 2003	December 31, 2003
Airport	December 24, 2003	January 7, 2004
Airport	January 23, 2004	January 27, 2004
Airport	March 24, 2004	March 30, 2004
Airport	May 15, 2004	May 18, 2004
Downtown Majuro	November 26, 2003	December 3, 2003
Downtown Majuro	May 6, 2004	May 11, 2004
Downtown Majuro	May 21, 2004	May 26, 2004
Downtown Majuro	July 8, 2004	September 13, 2004
Downtown Majuro	August 6, 2004	August 10, 2004
Jaluit	April 9, 2004	April 21, 2004
Kili	December 22, 2003	January 6, 2004
Kili	January 9, 2004	February 13, 2004
Kwajalein	March 13, 2004	March 26, 2004

- Deposits on December 31, 2003 of cash sales by ticketing agents at the Airport station were short by \$189. We noted that the \$189 was later deposited to the bank on January 6, 2004. In addition, deposits on May 18, 2004 of cash sales by ticketing agents at the Kwajalein station were over by \$15, for which no explanation was provided.
- For one ticket (ticket # 5500-112130), the associated cash receipt was not made available.
- One ticket (ticket # 5500-118785) was not listed in the daily cash receipts listing, therefore, we were unable to determine whether the related payment was properly recorded in the general ledger and deposited to the bank in a timely manner.
- For ten tickets (ticket #s 4010-205908, 5500-111073, 5500-114965, 5500-114990, 5500-119705, 5500-123861, 5500-124558, 5500-125688, 5500-125834 and 5500-125874), the associated daily sales reports were dated after the related flight manifests. We were informed by revenue accounting personnel that this was due to ticketing agents not submitting their daily sales reports in a timely manner.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Revenue/Receipts

Finding No. 2004-1, Continued

- For three tickets (ticket #s 4010-208079, 4010-209650 and 5500-117560), the fares charged of \$84, \$98 and \$84 did not agree with the established fare of \$93. In addition, for one ticket (ticket # 4010-205908), the fare charged of \$74 did not agree with the established fare of \$77.
- For one ticket (ticket # 5500-133853), there was no properly authorized form to support the non-revenue travel.
- One charge sale (ticket # 5500-109206) on October 31, 2003 at the Kili station was not invoiced until November 30, 2003, one charge sale (ticket # 5500-119705) on February 17, 2004 at the downtown Majuro station was not invoiced until May 17, 2004 and another charge sale (ticket # 4010-211368) on June 15, 2004 was never invoiced, and one charge sale (ticket # 4010-209650) on February 28, 2004 at the Wotje station was not invoiced until June 6, 2004.
- For two tickets (ticket #s 5500-117997 and 5500-125382) issued by ticketing agents at the Airport station, the associated deposit slips were not made available.

Cause: The cause of the above condition is the lack of adherence to established policies and procedures relating to control over and issuance of ticket stock and the depositing of receipts.

Effect: The effect of the above condition is the possible misstatement of cash, revenues, unearned revenues and expenses.

Prior Year Status: Lack of adherence to established policies and procedures relating to control over and issuance of ticket stock was reported as a finding in the audits of AMI for fiscal years 1999 through 2003.

Recommendation: We recommend that management ensure the revenue accounting department adheres to established policies and procedures relating to control over and issuance of ticket stock and that cash over and short amounts be recorded.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The relevant staff have been instructed to adhere to set policies and procedures for issuing and reporting tickets and recording cash shortages and overages.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Purchases/Disbursements

Finding No. 2004-2

Criteria: Disbursements should be properly recorded in the general ledger.

Condition: During the year ended September 30, 2004, aircraft rentals totaling \$606,866 were recorded as maintenance expense. An audit adjustment was proposed to correct these errors.

Cause: The cause of the above condition is the improper recording of disbursements.

Effect: The effect of the above condition is the misstatement of expenses.

Prior Year Status: Improper recording of disbursements was reported as a finding in the audit of AMI for fiscal year 2003.

Recommendation: We recommend that management ensure that all expenses are properly recorded in the general ledger.

Auditee Response and Corrective Action Plan: We partially agree with the finding and recommendation. There are three basic cost components of the Dash 8 aircraft lease rentals:

- 1) Basic rent – charged to flight operations
- 2) Maintenance reserve – charged to maintenance
- 3) Engine rental – charged to flight operations

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Receivables

Finding No. 2004-3

Criteria: Accounts receivable should be recorded at net realizable value.

Condition: As of September 30, 2004, the aged accounts receivable subsidiary ledger, excluding affiliate accounts, indicated that customer accounts with balances greater than 120 days represented ninety-three (93) percent of the \$779,748 balance. Although many of these balances have not had any recent activity, AMI has not evaluated the ultimate collectibility of these balances. A total allowance of \$429,532 has been recorded to offset this balance.

Cause: The cause of the above condition is the lack of procedures to evaluate the collectibility of recorded receivables.

Effect: The effect of the above condition is the possible misstatement of receivables.

Prior Year Status: Collectibility of receivables was reported as a finding in the audits of AMI for fiscal years 2000 through 2003.

Recommendation: We recommend that management review all outstanding receivables for collectibility.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. All receivable accounts were critically reviewed starting October 12, 2004 to determine if such are valid and collectible. The policy on provisions for bad debts (120 days and over) can be fully implemented once the aging analysis report is reconciled with the General Ledger.

Policy on bad debts provision shall be documented and approved to ensure consistency and uniformity of application.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Receivables

Finding No. 2004-4

Criteria: Accounts receivable should be collected in a timely manner.

Condition: As of September 30, 2004, AMI recorded receivable from the government of the Republic of the Marshall Islands (RepMar) agencies amounting to \$1,105,222; the majority of which are more than eight years old. A summary of these receivables is as follows:

Ministry of Health and Environment	\$ 271,544
Ministry of Finance	191,869
Cabinet	147,915
Office of the President	144,160
Ministry of Resources and Development	125,873
Nitijela	51,368
Ministry of Foreign Affairs and Trade	41,420
Ministry of Education	37,893
Other	<u>93,180</u>
	<u>\$ 1,105,222</u>

Cause: The cause of the above condition is the lack of response by RepMar to management's efforts to collect the above balances and the lack of concurrence by RepMar with the amount due.

Effect: The effect of the above condition is that receivables from related parties are potentially overstated, which resulted in an allowance for doubtful receivables of \$640,146 as of September 30, 2004.

Prior Year Status: Long outstanding receivables from related parties was reported as a finding in the audits of AMI for fiscal years 1998 through 2003.

Recommendation: We recommend that management continue its efforts to reach an agreement on the collection of the receivable balances.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The allowance for doubtful accounts as of this given date (for government accounts) is adequate. Reconciliation of Government Accounts is done with the Office of the Assistant Secretary of Finance on a regular and continuing basis (the latest is August 12, 2005) and as a result accounts were updated (both books of accounts) and some aging accounts were obligated or funded for payment.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Expendable Parts

Finding No. 2004-5

Criteria: Expendable parts should be supported by a reconciled subsidiary ledger.

Condition: As of September 30, 2004, AMI recorded gross expendable parts totaling \$595,119 that did not reconcile to the supporting subsidiary ledger balance of \$834,772. No explanation was made available regarding the unreconciled variance.

Cause: The cause of the above condition is the lack of monthly reconciliations.

Effect: The effect of the above condition is the misstatement of expendable parts.

Prior Year Status: Lack of proper reconciliation of expendable parts to the supporting subsidiary ledger was reported as a finding in the audit of AMI for fiscal year 2003.

Recommendation: We recommend that management ensure that expendable parts are properly reconciled to the supporting subsidiary ledger on a monthly basis and in a timely manner.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Monthly reconciliation of the general ledger versus subledger on balances and review of movements (receipts, issuances and adjustments) during the month may not be practical, however, quarterly reconciliation and the procedure in taking up the discrepancy (if any) is being done starting April 2005.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Expendable Parts

Finding No. 2004-6

Criteria: Expendable parts cost should be supported by vendor invoices.

Condition: Of forty-four expendable parts items tested, totaling \$246,885, the vendor invoices for twenty-seven items were not made available. Furthermore, we noted that three items (part #s M81964/14-02, P4-01-0021 and SAFETYCARD-228) selected from the count sheets were not listed in the subsidiary ledger.

Cause: The cause of the above condition is the lack of retention of appropriate documentation.

Effect: The effect of the above condition is the misstatement of expendable parts.

Prior Year Status: Errors in expendable parts valuation were reported as a finding in the audits of AMI for fiscal years 1992 through 2003.

Recommendation: We recommend that management ensure that supporting invoices to substantiate expendable parts cost be retained and that expendable parts are properly recorded.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Most of the vendors of AMI are paid in advance (CIA) before delivery or shipment is made. Payment to such vendor cannot be initiated unless a Pro-forma Invoice is received and attached to the Purchase Order and Request for Check Payment or Wire Transfer. The vendor invoices that were not made available the time of audit might have been misplaced.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Air Traffic Liability

Finding No. 2004-7

Criteria: Air traffic liabilities should represent the value of unused transportation sold by the air carrier.

Condition: As of September 30, 2004, AMI recorded air traffic liability of \$576,270 that did not reconcile to the supporting subsidiary ledger balance of \$295,704. No explanation was made available regarding the unreconciled variance.

Cause: The cause of the above condition is the lack of reconciliation by the revenue accounting department of unused tickets sold by AMI.

Effect: The effect of the above condition is the possible misstatement of unearned and earned passenger revenues.

Prior Year Status: Lack of proper reconciliation of air traffic liability to the supporting subsidiary ledger was reported as a finding in the audits of AMI for fiscal years 2002 and 2003.

Recommendation: We recommend that management ensure the revenue accounting department adheres to established policies and procedures relating to the reconciliation of unused tickets sold by AMI.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. Unearned revenue based on the subsidiary records is generated the Dash Revenue Accounting System. This system is not in sync with MAS90, the general ledger system that generates the balance sheet account. Monthly reconciliation and update (considering the existing manning complement for both revenue and accounts receivable) may not be practical unless a new Accounting System Platform (Oracle Financials) specifically designed for Airline Accounting is adopted.

Moreover, the unearned traffic tickets indicated in the Trial Balance is a conservative figure and this is a potential adjustment (earned income) within the next twelve months. One year is the cut-off period in treating traffic liability as earned for international tickets and six months for domestic tickets. This policy is a must consistent with Airline Accounting Practices.

All of the above are corrective measures taken or to be taken by management to ensure that earned and unearned revenues are accurately captured by the system.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

Related Party Disclosure

Finding No. 2004-8

Criteria: In accordance with Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, material related party transactions are required to be disclosed.

Condition: A schedule of revenues earned from related parties during the fiscal year was not made available.

Cause: The cause of the above condition is the lack of policies and procedures for maintaining related party information.

Effect: The effect of the above condition is noncompliance with Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*.

Prior Year Status: Noncompliance with Statement of Financial Accounting Standards No. 57, *Related Party Disclosures* was reported as a finding in the audits of AMI for fiscal years 1999 through 2003.

Recommendation: We recommend that management establish policies and procedures for maintaining related party information during the year.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. All related party transactions are fully disclosed in the subsidiary records and these are included in the list of earned and unearned revenues. The auditee(s) may not be informed or aware of the format of the schedule acceptable to the auditor(s) during the audit engagement period or fieldwork. We will ensure that the required information is made available in future audits.

AIR MARSHALL ISLANDS, INC.

Schedule of Findings
Year Ended September 30, 2004

External Financial Reporting

Finding No. 2004-9

Criteria: Board minutes are a primary means by which regulatory agencies and independent auditors can evaluate the administration of AMI's operations.

Condition: The Board of Directors' minutes of meetings held from October 1, 2002 through August 15, 2005 were not made available.

Cause: The cause of the above condition is the lack of adherence to established policies and procedures relating to documentation of Board of Directors minutes of meetings.

Effect: The effect of the above condition is the possibility that directives of the Board are not properly disclosed or recorded in the financial statements of AMI.

Prior Year Status: Lack of formal documentation of minutes of meetings of the Board of Directors was reported as a finding in the audits of AMI for fiscal years 1999 through 2003.

Recommendation: We recommend that the Board of Directors ensure that all minutes of meetings are formally documented by the Secretary and approved by the Chairman.

Auditee Response and Corrective Action Plan: We agree with the finding and recommendation. The minutes of meetings during the period in question were documented (some were not yet signed by the Board) and received by the incumbent General Manager from the Board Secretary (resigned) in April 2005. We are making progress in documenting all board minutes of meetings and will secure approval from the Chairman of the Board.

AIR MARSHALL ISLANDS, INC.

Unresolved Prior Year Findings
Year Ended September 30, 2004

The status of unresolved prior year findings is disclosed within the Schedule of Findings section of this report (pages 6 through 16).