

**The Diving Seagull, Inc.**  
**(A Component Unit of the State of Yap)**

Financial Statements and  
Independent Auditor's Reports  
as of and for the Years Ended  
September 30, 2010 and 2009



# The Diving Seagull, Inc.

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FORTENBERRY & BALLARD, P.C.  
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT

The Board of Directors  
The Diving Seagull, Inc.

We have audited the accompanying statements of net assets of The Diving Seagull, Inc., a component unit of Yap State Government, as of September 30, 2010 and 2009, and the related statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of The Diving Seagull's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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. 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Diving Seagull, Inc., as of September 30, 2010 and 2009, and the results of its operations, changes in financial position and 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 April 26, 2011 on our consideration of The Diving Seagull's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing over 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

FORTENBERRY & BALLARD, PC

April 26, 2011

## MANAGEMENT'S DISCUSSION AND ANALYSIS

**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE STATE OF YAP)**  
Management Discussion and Analysis  
Year Ended September 30, 2010

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

In 2010, the Company's total assets increased from \$8,775,630 to \$10,215,602. Total net property and equipment, including leased fishing vessel and purse net, lease hold improvements, computers, office furniture and vehicle also increased to \$5,646,174 during the fiscal year ended September 30, 2010, as a consequence of the Bareboat Charter Agreement which has been extended to another 20 years, making this year its 8<sup>th</sup> year, upon inception in July 2002.

In 2010, the Yap Seagull, which was newly purchased in February 2010, operated at a loss, but with a strategy to continue operational until it generates profits for the next three years. Many changes, from crewing to replacement of engines and parts, have taken place at first operation. The result of these extra activities has proven that the vessel can show a profit, if it continues to maintain its original strategy.

In 2005, the Company reported bad debts expense from an impairment loss on Palau Micronesia Airlines, \$300,000 of which was for bad debts, and \$250,000 was for an impairment loss on an investment. Palau Micronesia Air suspended operation on December 23, 2005, to reorganize and restore its business strategy. The note receivable went into effect in June 2005; however, to this date, there has been no payment or communication with Diving Seagull. Management is attempting through our legal Counsel to collect from PMAIR. The collection of the receivable is considered high priority of the Diving Seagull.

Operating revenues generated from fish sales of \$7,051,872 increased by 22% due to the increased number of boats and number of fishing trips. However gross profit decreased \$1,112,230 due to increased cost of sales and decrease in fish prices. The most major portion of cost of sales is the depreciation of \$874,606, reflecting the useful life of the two boats.

The net loss from operations in the fiscal year ended September 30, 2010 was \$552,822. In 2009, income from operations was \$461,509. There was a decrease shown this year due to a fishing net problem with Yap Seagull. The net on the Yap Seagull needed replacement within six months.

In 2009, total liabilities and net assets were \$8,775,630 as compared to \$10,215,602 in 2010. These amounts increased over 16% from 2009 to 2010, due to \$5,000,000 in loans from the Bank of Guam and FSM Development to purchase the fishing vessel Yap Seagull.

The table on the following page summarizes the financial condition and results of operations of the Company for the fiscal years ended 2010, 2009, and 2008.

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

Management Discussion and Analysis  
Year Ended September 30, 2010

<u>Assets</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
Property & equipment, net	\$ 5,646,174	\$ 1,554,594	\$ 1,212,126
Current assets	4,569,428	4,968,656	5,605,242
Other assets	-	2,252,380	51,720
<b>Total Assets</b>	<b><u>\$ 10,215,602</u></b>	<b><u>\$ 8,775,630</u></b>	<b><u>\$ 6,869,088</u></b>
<u>Liabilities and Net Assets</u>			
Liabilities:			
Long-term debt, net of current portion	\$ 4,132,808	\$ 2,349,927	\$ 1,471,875
Current portion of long-term debt	1,248,023	1,016,717	512,737
Other current liabilities	1,080,532	568,524	552,313
<b>Total Liabilities</b>	<b><u>6,461,363</u></b>	<b><u>3,935,168</u></b>	<b><u>2,536,925</u></b>
Net Assets:			
Invested in capital assets, net of related debt	516,638	618,667	1,212,127
Restricted-expendable	54,927	2,052,380	-
Unrestricted	3,182,674	2,169,415	3,120,036
<b>Total Net Assets</b>	<b><u>3,754,239</u></b>	<b><u>4,840,462</u></b>	<b><u>4,332,163</u></b>
<b>Total Liabilities and Net Assets</b>	<b><u>\$ 10,215,602</u></b>	<b><u>\$ 8,775,630</u></b>	<b><u>\$ 6,869,088</u></b>
<u>Revenue, Expenses, and Changes in Net Assets</u>			
Operating revenues	\$ 7,051,872	\$ 6,104,827	\$ 8,256,692
Cost of sales	(7,216,227)	(5,156,952)	(6,720,807)
Operating expenses	(388,467)	(486,366)	(468,269)
Net operating revenues	<u>\$ (552,822)</u>	<u>\$ 461,509</u>	<u>\$ 1,067,616</u>

Management's Discussion and Analysis for the year ended September 30, 2010 is set forth in the Company's report on the audit of financial statement, which is dated April 26, 2011. That Discussion and Analysis explains the major factors impacting the 2010 financial statement and can be viewed at the FSM Office of the Public Auditor's Web Site.

Additional questions or comments, can be addressed to Carmen Kigimnang at Diving Seagull, Email address: car@mail.fm.

**Plan of Action for 2011- Economic outlook**

1. 2012 dry dock
2. 2<sup>nd</sup> boat in operational
3. Control and minimized cost
4. Training of staff
5. Work policies and regulation
6. Purchasing new fishing net

## FINANCIAL STATEMENTS

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

Exhibit A

Statement of Net Assets  
September 30, 2010 and 2009

<b><u>ASSETS</u></b>	2010	2009
Current Assets:		
Cash and cash equivalents	\$ 282,349	\$ 301,726
Short-term investments	3,581,100	3,566,000
Investments	475,598	466,896
Net receivable from broker	-	534,846
Employee and director receivables	134,158	37,916
Other receivables, net	1,012	26,100
Prepaid expenses	40,284	35,172
Total current assets	4,514,501	4,968,656
Restricted cash and cash equivalents	54,927	2,052,380
Escrow payment for Yap Seagull	-	200,000
Property & equipment, net	5,646,174	1,554,594
Total Assets	\$ 10,215,602	\$ 8,775,630
<b><u>LIABILITIES &amp; NET ASSETS</u></b>		
Current liabilities:		
Current portion of long- term debt	\$ 1,248,023	\$ 1,016,717
Accounts payable	279,244	287,128
Net payable to broker	151,104	-
Accrued expenses	650,184	281,396
Total current liabilities	2,328,555	1,585,241
Long-term debt, net of current portion	4,132,808	2,349,927
Total liabilities	6,461,363	3,935,168
Net assets:		
Invested in capital assets, net of related debt	516,638	618,667
Restricted expendable	54,927	2,052,380
Unrestricted	3,182,674	2,169,415
Total net assets	3,754,239	4,840,462
Total Liabilities & Net Assets	\$ 10,215,602	\$ 8,775,630

See accompanying notes to financial statements.



**THE DIVING SEAGULL, INC.**  
**(A COMPONENT UNIT OF THE STATE OF YAP)**  
Statement of Revenues, Expenses and Changes in Net Assets  
September 30, 2010 and 2009

	2010	2009
Operating revenues:		
Fish sales	\$ 7,051,872	\$ 5,799,278
Other revenues	-	305,549
Total operating revenues	7,051,872	6,104,827
Cost of sales	7,216,227	5,156,952
Gross margin	(164,355)	947,875
Selling, general and administrative expenses:		
Payroll, taxes and benefits	90,961	72,251
Survey	-	43,855
Professional fees	27,500	-
Travel	77,099	213,826
Board fees and expenses	27,700	34,150
Bank loan fees	71,920	-
Communications and utilities	16,072	5,031
Rent	14,448	10,354
Office expense	51,568	29,241
Depreciation	8,806	10,910
Miscellaneous	2,393	66,748
Total selling, general and administrative expenses	388,467	486,366
Income (loss) from operations	(552,822)	461,509
Non-operating revenues (expenses):		
Interest expense	(290,176)	(114,166)
Investment income	101,763	86,771
Gain on investments	8,702	74,185
Total non-operating revenues (expenses), net	(179,711)	46,790
Change in net assets	(732,533)	508,299
Net assets at beginning of year	4,840,462	4,332,163
Prior period adjustment	(353,690)	
Net assets at end of year	\$ 3,754,239	\$ 4,840,462

See accompanying notes to financial statements.

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Exhibit C  
Statement of Cash Flows  
September 30, 2010 and 2009

	2010	2009
<b>Cash flows from operating activities:</b>		
Cash received from customers	\$ 7,611,806	\$ 5,592,814
Cash payments to suppliers for goods and services	(5,252,575)	(4,017,578)
Cash payments to boat crew and employees for services	(1,558,992)	(993,940)
Net cash provided by operating activities	800,239	581,296
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment	(4,975,584)	(728,717)
Short - term investments and time certificate of deposit transactions	2,237,280	(3,200,660)
Interest received from short - term investments	101,763	86,771
Net cash used in investing activities	(2,636,541)	(3,842,606)
<b>Cash flows from capital and related financing activities:</b>		
Principal repayments of long - term debt	(985,813)	(617,968)
Interest paid on long - term debt	(290,176)	(114,166)
Proceeds from issuance of long - term debt	3,092,914	2,000,000
Net cash (used in) provided by capital and related financing activities	1,816,925	1,267,866
Net change in cash	(19,377)	(1,993,444)
Cash and equivalents at beginning of year	301,726	2,295,170
Cash and equivalents at end year	\$ 282,349	\$ 301,726
<b>Reconciliation of income from operating to net cash provided by operating activities:</b>		
Operating income	\$ (1,053,761)	\$ 461,509
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	883,412	386,249
Changes in assets and liabilities:		
Employee and director receivables	(96,242)	(13,980)
Other receivables	25,088	2,264
Prepaid expenses	(5,112)	(20,687)
Net receivable from Broker	534,846	(500,297)
Deferred charges	-	250,027
Accounts payable	(7,884)	(94,174)
Net payable to Broker	151,104	-
Accrued expenses	368,788	110,385
Net cash provided by operating activities	\$ 800,239	\$ 581,296

See accompanying notes to financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
September 30, 2010 and 2009

**1. Summary of Significant Accounting Policies**

Reporting Entity

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

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

Basis of Accounting

The financial statements of the Company have been prepared in conformity with generally accepted accounting principles (GAAP) as applied to government units. 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 Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The Company has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

The Company adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34 (Basic Financial Statements – Management’s Discussion and Analysis for State and Local Governments). GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into four net asset categories:

- a. *Invested in capital assets, net of related debt* – Capital assets, net of accumulated depreciation, and outstanding principle balances of debt attributable to the acquisition, construction, or improvement of those assets.
- b. *Restricted Nonexpendable* – Net assets subject to externally imposed stipulations that require the Company to maintain them permanently.
- c. *Restricted Expendable* – Net assets whose use by the Company is subject to externally imposed stipulations that can be fulfilled by actions of the Company pursuant to those stipulations or that expire by the passage of time.

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

Operating and Non-Operating Revenue and Expenses

Operating revenues and expenses generally result directly from the operation and maintenance of the Company. Non-operating revenues and expenses result from capital and financing activities, costs and related recoveries from natural disasters, and certain other non-recurring income and costs.

New Accounting Standards

In June 2007, GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this statement are effective for periods beginning after June 15, 2010. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Company.

In November 2007, GASB issued Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. GASB Statement No. 52 improves the quality of financial reporting by requiring endowments to report their land and other real estate investments at fair value, creating consistency in reporting among similar entities that exist to invest resources for the purpose of generating income. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Company.

In June 2009, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 is intended to improve how state and local governments manage specific risks or make investments – in their financial statements. The provisions of this statement are effective for periods beginning after June 15, 2010. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Company.

GASB has issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. This statement establishes new categories for reporting fund balance and revises the definitions for governmental fund types. The requirements of this Statement are effective for periods beginning after June 15, 2010. Management does not believe that the

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implementation of this statement will have a material effect on the financial statements of the Company.

GASB has issued Statement No. 58, Accounting and Financial Reporting for Chapter 9 Bankruptcies. This statement establishes accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. The requirements of this Statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Company.

Cash and Equivalents

Cash includes cash on hand as well as cash in various bank accounts and time certificates of deposits with an initial maturity date of three months or less. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified as short-term investments.

Investments

Investments and related investment earnings and losses are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Property and Equipment

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

Computer and office furniture and equipment	3-5 years
Leased equipment	5-20 years
Leasehold improvements	3-10 years
Vehicles	5 years

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

Revenue Recognition

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

Other revenue is recorded when earned and measurable.

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Translation of Foreign Currencies

Gains and losses that arise from exchange rate changes on transactions denominated in a currency other than U.S. dollars are included in the statement of income as incurred.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Deferred Charges

Direct costs incurred for ongoing fishing trips are recognized as deferred charges. Deferred charges primarily comprise fuel inventory on hand, crew salaries, license fees, port fees and other direct expenses related to the trip, but exclude depreciation.

Allowance for Doubtful Accounts

The Company establishes an allowance for doubtful accounts receivable based on the credit risk of specific customers, historical trends, and other information.

**2. Deposits**

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

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

*Custodial Credit Risk—Deposits:* Custodial credit risk is the risk that in the event of a bank failure, the State's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution but not in the depositor-government's name. The Company does not have a deposit policy for custodial credit risk.

As of September 30, 2010, and 2009, the carrying amount of the Company's total cash and cash equivalents and time certificates of deposit was \$3,918,376 and \$3,867,726, respectively, and the corresponding bank balances were \$3,894,264 and \$4,049,552, respectively. As of September 30, 2010 and 2009, bank deposits in the amount of \$451,457 and \$549,686, respectively, were FDIC insured. The Company does not require

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collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. The Company has not experienced any losses on such accounts and management believes it is not exposed to any significant credit risk on its deposits.

**3. Investments**

Except for (1) nonparticipating investment contracts and for (2) participating interest-earning investment contract and money market investments that had a remaining maturity at the time of purchase of one year or less, investments are reported at fair value, which is based on quoted market price. Nonparticipating investment contracts such as repurchase agreements and nonnegotiable certificates of deposit are reported at cost. Participating interest earning investment contracts and money market investments that had a remaining maturity at the time of purchase of one year or less are reported at amortized cost.

*Interest Rate Risk.* Interest Rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Investments held for longer periods are subject to increased risk of adverse interest rate changes. The Company does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

The following table provides information about the interest rate risks associated with the Company's investments. The investments include certain short-term cash equivalents, various long-term items, and restricted assets by maturity in years.

Investment Type	Fair Value	Interest Rate	Investment maturities in years		
			> 1	1-5	6-10
<u>Government &amp; Government Sponsored Entity Bonds:</u>					
US Treasury Notes	\$ 10,179	4.500%	\$ 10,000		
US Treasury Notes	10,416	5.000%	10,000		
US Treasury Notes	4,249	4.875%		4,000	
US Treasury Notes	10,763	4.000%		10,000	
Federal Natl Mtg Assn	10,888	4.375%		10,000	
US Treasury Notes	15,314	1.375%		15,000	
Federal Home Loan Mtg Corp	11,031	4.500%		10,000	
US Treasury Notes	21,016	2.250%		20,000	
Federal Natl Mtg Assn	7,932	4.625%		7,000	
US Treasury Notes	<u>11,603</u>	4.500%			10,000
Total	113,391				
<u>Other Investments:</u>					
Equity mutual funds	32,360				
Equity securities-- domestic	250,235				



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Equity securities-- international	<u>79,612</u>
Total	<u>362,207</u>
 Total Investments	 <u><u>\$ 475,598</u></u>

*Concentration of Credit Risk.* Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Company. This requirement does not apply to investments issued or explicitly guaranteed by the U.S. government, investments in mutual funds and external investment pools, and other pooled investments. As of September 30, 2010, this requirement did not apply to the Company.

*Credit Risk.* Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Company does not presently have a formal policy that addresses credit risk.

*Custodial Credit Risk - Investments.* Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Company will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Company does not have a formal investment policy that addresses custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Company's custodial financial institutions at September 30, 2010.

<u>Investment Type</u>	<u>Fair Value</u>	<u>Moody's</u>	<u>S &amp; P</u>	<u>% of Total Investments</u>
U. S. Treasury Securities	\$ 83,540	AAA	AAA	18%
U. S. Government Backed Mortgage Securities	18,820		AAA	4%
Federal Home Loan Mortgage Corp.	11,031	Aaa	AAA	2%
Equity Mutual Funds	32,360		AAAm	7%
Equity securities-- domestic	250,235		unrated	53%
Equity securities-- international	79,612		unrated	17%
 Total	 <u><u>\$ 475,598</u></u>			 <u><u>100%</u></u>

**4. Net Receivable from/Payable to Broker**

Approximately 100% of fish sales in the years ended September 30, 2010 and 2009 were conducted with a single broker based in Taiwan. Upon offloading the fish catch from the vessel to a designated third party, the broker pays 95% of the estimated settlement. When the final settlement is determined, the Company may either be entitled to an additional amount due from the broker or be liable for an amount due to the broker. The net broker

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Notes to Financial Statements  
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account is a payable of \$151,104 at September 30, 2010 and a receivable of \$534,846, at September 30, 2009.

**5. Property and Equipment**

Property and equipment consist of the following as of September 30, 2010 and 2009:

	Beginning Balance 1-Oct-09	Transfers and Additions	Transfers and Disposals	Ending Balance 30-Sep-10
Leased fishing vessel and purse seine net	\$ 6,821,012	\$ -	\$ -	\$ 6,821,012
Purchased fishing vessel and purse seine net	-	5,552,316	-	5,552,316
Leasehold improvements	3,849,555	-	-	3,849,555
Vessel improvements	-	167,598	-	167,598
Computer and office furniture and equipment	32,200	915	-	33,115
Vehicle	26,568	-	-	26,568
Construction in progress	228,667	5,323,649	(5,552,316)	-
Total cost	10,958,002	11,044,478	(5,552,316)	16,450,164
Less accumulated depreciation	(9,403,408)	(1,400,582)	-	(10,803,990)
	<u>\$ 1,554,594</u>	<u>\$ 9,643,896</u>	<u>\$(5,552,316)</u>	<u>\$ 5,646,174</u>

	Beginning Balance 1-Oct-08	Transfers and Additions	Transfers and Disposals	Ending Balance 30-Sep-09
Leased fishing vessel and purse seine net	\$ 6,320,962	\$ 500,050	\$ -	\$ 6,821,012
Leasehold improvements	3,849,555	-	-	3,849,555
Computer and office furniture and equipment	32,200	-	-	32,200
Vehicle	26,568	-	-	26,568
Construction in progress	-	228,667	-	228,667
Total cost	10,229,285	728,717	-	10,958,002
Less accumulated depreciation	(9,017,159)	(386,249)	-	(9,403,408)
	<u>\$ 1,212,126</u>	<u>\$ 342,468</u>	<u>\$ -</u>	<u>\$ 1,554,594</u>

**6. Long-Term Debt**

On July 28, 2006, the Company signed a five-year loan agreement with the Federated States of Micronesia Development Bank (FSMDB) authorizing a maximum loan of \$1,300,000 to cover the dry-dock costs of the fishing vessel. The agreement stipulates a 1.5% loan fee and interest rate of 9%. Interest is due monthly during the six-month grace period. Interest and principal are payable in monthly installments of \$26,986, which began January 30, 2007. Part of the agreement requires the Company to establish a joint account with FSMDB and to make deposits therein as required by that agreement. As of September 30, 2010, the balance of this restricted account was \$54,927 and in 2009, it was \$52,380.

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

Notes to Financial Statements  
September 30, 2010 and 2009

On February 16, 2007, a new loan was granted by FSMDB amounting to \$1,370,000, to cover additional dry dock costs of the fishing vessel at an interest rate of 9%. Interest and principal are payable in monthly installments of \$28,606, which began June 15, 2007.

On September 29, 2010, a new loan in the amount of \$2,000,000 was granted by the Bank of Guam, with an interest rate of 2.755%, to assist in the purchase of a new vessel after the end of the fiscal year. Interest and principal are payable in monthly installments of \$35,777.94, beginning on October 29, 2010.

On October 27, 2009, a new loan in the amount of \$3,000,000 was granted by the Federated States of Micronesia Development Bank, with an interest rate of 9%, to purchase a fishing vessel. Interest and principal are payable in monthly installments of \$38,003, beginning on April 25, 2010.

On June 16, 2010, a line of credit was issued for working capital from the Federated States of Micronesia Development Bank in the amount of \$500,000, with an interest rate of 9%. At September 30, 2010, the balance of this line of credit was \$0.

All notes are collateralized by a chattel mortgage on all property and equipment, including the fishing vessels Mathawmarfach and Yap Seagull.

A summary of changes in long-term debt is provided below:

	<u>2010</u>	<u>2009</u>
Balance at beginning of year	\$ 3,366,644	\$ 1,984,612
Additions	3,000,000	2,000,000
Payments	<u>(985,813)</u>	<u>(617,968)</u>
Balance at end of year	5,380,831	3,366,644
Less current portion	<u>(1,248,023)</u>	<u>(1,016,717)</u>
Long - term debt	<u>\$ 4,132,808</u>	<u>\$ 2,349,927</u>

Future debt service on the above debt is as follows:

<u>Period Ending</u>	<u>Principal</u>	<u>Interest</u>
9/30/2011	\$ 1,248,023	\$ 336,056
9/30/2012	829,625	227,084
9/30/2013	724,514	160,857
9/30/2014	825,143	92,699
9/30/2015	<u>1,753,526</u>	<u>24,936</u>
Total	<u>\$ 5,380,831</u>	<u>\$ 841,632</u>

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

Notes to Financial Statements

September 30, 2010 and 2009

**7. Lease Commitments**

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

**8. Cost of Sales**

The detail of cost of sales for the years ended September 30, 2010 and 2009 are as follows:

	<u>2010</u>	<u>2009</u>
Fuel	\$ 2,150,977	\$ 1,869,050
Depreciation	874,606	375,339
Crew salaries and wages	1,371,789	1,032,074
Repair and maintenance	856,150	639,870
License, agent and port fees	696,340	371,963
Insurance	402,522	259,471
Management fee	166,417	153,350
Salt and provisioning	253,961	82,871
Supplies and freight	18,709	17,689
Crew travel	135,511	111,346
Communications	194,496	183,691
Stevedoring	75,532	50,413
Other vessel expenses	19,217	9,825
	<u>\$ 7,216,227</u>	<u>\$ 5,156,952</u>

**9. Risk Management**

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

**10. Related Parties**

The Company has entered into significant transactions with the State, as discussed in Note 7. Several Board members and officers of the Company hold management positions and other positions of influence with the State. Certain officers of the Company represented on the Board of the Yap Investment Trust, the sole owner of the Company, also represent the State on the Board of Palau Micronesia Air.

**THE DIVING SEAGULL, INC.**  
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Notes to Financial Statements  
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**11. Prior Period Adjustments**

A prior period adjustment in the amount of \$147,249 was recorded because, when the Company reconciled bank accounts after the completion of the fiscal year end September 30, 2009, cash was adjusted. The adjustment was made to record the expenditure in the correct fiscal year.

A prior period adjustment in the amount of \$(500,939) was also made to adjust the beginning balance in accumulated depreciation for capitalized dry dock costs.

**REPORT REQUIRED BY *GOVERNMENT AUDITING STANDARDS (GAS)***

**FORTENBERRY & BALLARD, P.C.**  
CERTIFIED PUBLIC ACCOUNTANTS

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

Board of Directors  
The Diving Seagull, Inc.

We have audited the financial statements of the The Diving Seagull, Inc. as of and for the year ended September 30, 2010, and have issued our report thereon dated April 26, 2011. 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 the Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Corporation's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting, described in the accompanying schedule of findings and questioned costs that we consider to be significant deficiencies in internal control over financial reporting, Findings 2010-1 and 2010-2. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit

and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under Government Auditing Standards and which are described in the accompanying schedule of findings and questioned costs as item 2010-1.

We noted certain matters that we reported to management of The Diving Seagull, Inc. in a separate letter dated April 26, 2011.

The Diving Seagull, Inc.'s responses to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit The Diving Seagull, Inc.'s responses and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Yap Investment Trust board of directors, the board and management of The Diving Seagull, Inc., and is not intended to be and should not be used by anyone other than these specified parties.

*FORTENBERRY & BALLARD, PC*

April 26, 2011



## FINDINGS AND CORRECTIVE ACTION PLAN

**The Diving Seagull, Inc.**  
Schedule of Findings and Questioned Costs  
For the Years Ended September 30, 2010 and 2009

Section 1: Summary Schedule of Auditor's Results:

Financial Statements:

1. Type of auditor's report issued on the financial statements: Unqualified.
2. Material noncompliance and other matters relating to the financial statements? Yes.
3. Internal control over financial reporting:
  - a. Material weakness(es) identified? No.
  - b. Significant deficiency(ies) identified that are not considered to be material weaknesses? Yes.

Section 2: Findings Relating to the Financial Statements

Finding 2010-1

Condition: Board members owe for personal expenditures on the Corporation's credit card in the amount of \$104,464.88 at September 30, 2010.

Cause: Board members overrode purchasing controls while using The Diving Seagull, Inc.'s credit card. Additionally, advances were received for business travel and expenses then unused advances were not repaid.

Criteria: *Government Auditing Standards* July 2007 Revision paragraph 4.12 describe abuse as behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate.

Effect: Cash flow was not always available as needed for operations and citizen's trust of the government corporation's activities were diminished.

Recommendation: We recommend that all credit card purchases be supported by original invoices or other itemized receipts. We also recommend that all advances be documented by sufficient supporting documentary evidence of its use in a timely manner. Credit card and advance privileges should be discontinued for delinquent personnel.

Auditee Response and Corrective Action Plan: As recorded in the May, 2011 board minutes the board members of the Diving Seagull have signed personal notes payable to The Diving Seagull, Inc. These notes will be repaid with periodic payments.

Responsible Party: The Diving Seagull Board Members

Finding 2010-2

Condition: Reconciliations of the bank balances to the corporate general ledger were not always performed in a timely manner.

Criteria: An effective system of internal controls should provide for timely and accurate bank reconciliations.

Effect: Cash was not always available as needed for operations because reports utilized by the director for operating decisions were not accurate.

Recommendation: The Diving Seagull staff or contractors should reconcile the bank accounts in a timely manner.

Auditee Response and Corrective Action Plan: Bank reconciliations will be performed on a monthly basis.

Responsible Party: Carmen Kigimnang