

MICRONESIA PETROLEUM CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2001 AND 2000

Deloitte & Touche LLP
361 South Marine Drive
Tamuning, Guam 96913-3911

Tel: (671)646-3884
Fax: (671)649-4932
www.dttguam.com



INDEPENDENT AUDITORS' REPORT

Board of Directors
Micronesia Petroleum Corporation:

We have audited the accompanying balance sheets of Micronesia Petroleum Corporation, a component unit of the State of Kosrae as of September 30, 2001 and 2000, and the related statements of earnings (loss) and changes in retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Micronesia Petroleum Corporation as of September 30, 2001 and 2000, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 12 to the financial statements, the Authority changed its method of accounting for nonexchange transactions to conform with Government Accounting Standards Board Statement No. 33 and has restated the 2000 financial statements to reflect the change.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 1, 2002, on our consideration of Micronesia Petroleum Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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March 1, 2002

MICRONESIA PETROLEUM CORPORATION

Balance Sheets September 30, 2001 and 2000

<u>ASSETS (note 5)</u>	<u>2001</u>	<u>2000</u>
Current assets:		
Cash	\$ 269,335	\$ 261,472
Trade receivables, net (notes 2 and 11)	524,038	193,794
Due from employees	9,888	15,284
Inventory	478,400	960,392
Prepaid expenses	20,510	20,883
Total current assets	1,302,171	1,451,825
Property and equipment, net (note 4)	2,861,340	2,815,146
Investment in joint venture (note 3)	31,824	31,824
	<u>\$ 4,195,335</u>	<u>\$ 4,298,795</u>
 <u>LIABILITIES AND RETAINED EARNINGS</u> 		
Current liabilities:		
Current portion of notes payable (note 5)	\$ 158,000	\$ 280,175
Accounts payable	299,917	1,015,708
Accrued liabilities	25,778	17,965
Payable to Kosrae State Government (note 6)	62,278	62,278
Total current liabilities	545,973	1,376,126
Notes payable, net of current portion (note 5)	1,643,711	1,786,546
Total liabilities	2,189,684	3,162,672
Retained earnings	2,005,651	1,136,123
Commitments and contingencies (notes 7, 8, 10 and 11)	<u>\$ 4,195,335</u>	<u>\$ 4,298,795</u>

See accompanying notes to financial statements.

MICRONESIA PETROLEUM CORPORATION

Statements of Earnings (Loss) and Changes in Retained Earnings
Years Ended September 30, 2001 and 2000

	<u>2001</u>	<u>2000</u>
Sales	\$ 7,553,329	\$ 6,540,913
Cost of goods sold	<u>6,562,547</u>	<u>6,218,885</u>
Gross profit	<u>990,782</u>	<u>322,028</u>
General and administrative expenses:		
Salaries and wages (note 9)	213,045	268,919
Depreciation	112,330	129,552
Taxes	91,821	102,910
Professional fees	65,308	116,619
Travel and entertainment	25,219	77,937
Office supplies	17,482	11,255
Communication	15,729	45,135
Rent	14,400	12,465
Bad debts	7,623	407,045
Plant supplies	7,173	3,914
Utilities	5,942	8,760
Repair and maintenance	4,406	39,563
Bank service charges	3,997	21,985
Insurance	2,123	19,630
Freight, handling and storage	726	10,774
Miscellaneous	<u>60,144</u>	<u>79,914</u>
	<u>647,468</u>	<u>1,356,377</u>
Earnings (loss) from operations	<u>343,314</u>	<u>(1,034,349)</u>
Other income (expense):		
Operating subsidy from Kosrae State Government	500,000	-
Other income	154,184	80,900
Other expense	<u>(127,970)</u>	<u>(133,155)</u>
Total other income (expense), net	<u>526,214</u>	<u>(52,255)</u>
Revenue over (under) expense	869,528	(1,086,604)
Retained earnings at beginning of year	<u>1,136,123</u>	<u>2,222,727</u>
Retained earnings at end of year	<u>\$ 2,005,651</u>	<u>\$ 1,136,123</u>

See accompanying notes to financial statements.

MICRONESIA PETROLEUM CORPORATION

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

	<u>2001</u>	<u>2000</u>
Cash flows from operating activities:		
Earnings (loss) from operations	\$ 343,314	\$ (1,034,349)
Adjustments to reconcile earnings (loss) from operations to net cash provided by (used for) operating activities:		
Doubtful debt expense	7,623	407,045
Loss on disposal of fixed assets	5,307	-
Depreciation	226,152	129,552
(Increase) decrease in assets:		
Receivables	(332,471)	224,923
Inventories	481,992	(585,994)
Prepayments	374	17,115
Increase (decrease) in liabilities:		
Accounts payable	(715,791)	(180,193)
Accrued liabilities	7,813	(19,505)
Net cash provided by (used for) operating activities	<u>24,313</u>	<u>(1,041,406)</u>
Cash flows from noncapital financing activities:		
Subsidy from Kosrae State Government	500,000	200,000
Other income (expenses)	26,212	(52,255)
Net cash provided by noncapital financing activities	<u>526,212</u>	<u>147,745</u>
Cash flows from investing activities:		
Cash effect of not consolidating joint venture financial statements (note 3)	-	281,188
Net cash provided by investing activities	<u>-</u>	<u>281,188</u>
Cash flows from capital and related financing activities:		
Purchase of property, plant and equipment	(277,653)	(45,343)
Proceeds from borrowings	-	768,871
Repayment of debts	(265,011)	-
Net cash (used for) provided by capital and related financing activities	<u>(542,664)</u>	<u>723,528</u>
Net increase in cash	7,863	111,055
Cash at beginning of year	<u>261,472</u>	<u>150,417</u>
Cash at end of year	<u>\$ 269,335</u>	<u>\$ 261,472</u>

See accompanying notes to financial statements.

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2001 and 2000

(1) Organization

Micronesia Petroleum Corporation (the Corporation) was established on November 14, 1996 by Kosrae State Law 6-98 and 7-28. The primary purpose of the Corporation is to operate and manage the State's fuel storage facilities and to engage in the business of buying and selling petroleum products.

The affairs of the Corporation are managed by a five-member board consisting of representatives of Kosrae State Government and the private sector. Daily operations of the Corporation are delegated to the Chief Executive Officer, who is hired by and serves at the pleasure of the Board.

(2) Summary of Significant Accounting Policies

The accounting policies of Micronesia Petroleum Corporation (MPC) 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 Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. MPC has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

Cash

For purposes of the balance sheets and the statements of cash flows, cash represents cash on hand and in bank accounts. As of September 30, 2001 and 2000, \$100,000 and \$118,593 of the cash balances were subject to FDIC insurance.

Depreciation

Depreciation of property and equipment is calculated using the straight-line method over the estimated useful lives of the assets. Lives of equipment, vehicles, furniture and fixtures and bulk plant assets range from 3 to 40 years.

Inventory

Inventory is substantially carried at lower of cost (first-in, first-out) or market.

Management 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 disclosures 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.

Investments

Investment in a joint venture is carried at net realizable value in the 2001 financial statements.

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2001 and 2000

(2) Summary of Significant Accounting Policies, Continued

Accounts Receivable

Accounts receivable are due from businesses and individuals located in the Federated States of Micronesia and in the Republic of Nauru. The allowance for doubtful accounts is stated at an amount which management believes will be adequate to absorb potential losses on accounts receivable that may become uncollectible based on evaluations of the collectibility of these accounts and prior collection experience

	<u>2001</u>	<u>2000</u>
Trade receivables	\$ 942,824	\$ 604,981
Allowance for doubtful accounts	(418,786)	(411,187)
	\$ <u>524,038</u>	\$ <u>193,794</u>

(3) Investments

At September 30, 2001 and 2000, MPC holds a 55% interest in a joint venture, Micronesia Petroleum Corporation-Yap (MPC-Yap). MPC-Yap's main business objective is to provide competitive priced petroleum products to support the economic activities in the State of Yap. MPC's participation in MPC-Yap primarily involves management of the joint venture. In 2000, management determined that it has no substantial control over this investment and its assets and has elected to record the investment at its best estimate of net realizable value. Management is reviewing its options with respect to this investment which may include discontinuation or sale of MPC's interest to its joint venture partner.

(4) Property, Plant and Equipment

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

	<u>2001</u>	<u>2000</u>
Bulk plant	\$ 2,506,000	\$ 2,506,000
Vehicles and tank trucks	572,192	294,357
Office equipment	118,062	122,075
Furniture and fixtures	61,096	59,532
Machines and equipment	336,682	352,146
Buildings and improvements	206,209	222,489
Land	<u>200,000</u>	<u>200,000</u>
	4,000,241	3,756,599
Less accumulated depreciation	(1,138,901)	(941,453)
	\$ <u>2,861,340</u>	\$ <u>2,815,146</u>

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2001 and 2000

(5) Notes Payable

Notes payable of MPC consist of the following at September 30, 2001 and 2000:

	<u>2001</u>	<u>2000</u>
Loan payable to Kosrae State Government, primary government, in the amount of \$300,000 due in monthly installments of \$2,628, interest at 1%, maturing in February 1, 2009.	\$ 277,981	\$ 277,981
Loan payable to FSM Development Bank in the amount of \$500,000 due in monthly installments of \$5,100, with a balloon payment of approximately \$264,000 due at maturity. Interest is at 9%, maturity in September 2008, collateralized by the property and inventory of the Company.	434,037	465,058
A \$160,000 short-term credit facility with the Bank of the FSM to finance purchase of inventory. The line of credit is collateralized by a first security interest in essentially all MPC assets and a time certificate of deposit held by Kosrae State Government.	-	150,000
Term loan payable to Bank of the FSM, interest at 2.75% greater than TCD rate pledged as collateral by Kosrae State Government, collateralized by a first security interest in essentially all MPC assets and a time certificate of deposit held by Kosrae State Government.	388,418	423,682
Loan payable to FSM Development Bank, ten year term, interest at 5%, monthly repayment of \$7,958.	<u>701,275</u>	<u>750,000</u>
Total debt	1,801,711	2,066,721
Less current portion	<u>(158,000)</u>	<u>(280,175)</u>
Long-term debt, net of current portion	\$ <u>1,643,711</u>	\$ <u>1,786,546</u>

Future maturities of the above debt are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>
2002	\$ 158,000	\$ 95,000
2003	166,500	87,000
2004	426,919	71,390
2005	132,500	54,500
2006	139,000	48,200
Thereafter	<u>778,792</u>	<u>85,339</u>
	\$ <u>1,801,711</u>	\$ <u>441,429</u>

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2001 and 2000

(6) Payable to Kosrae State Government

During fiscal year 1997, Kosrae State Government incurred expenditures under various appropriations for Micronesia Petroleum Corporation. The amount payable to Kosrae State Government at September 30, 2001 and 2000, reflects expenditures incurred in excess of such appropriations. Kosrae State Government and Micronesia Petroleum Corporation are currently negotiating a payment schedule for the amount.

(7) Commitments and Contingencies

During the fiscal years ended September 30, 2001 and 2000, Micronesia Petroleum Corporation expended approximately \$82,689 and \$89,120, respectively, for gross receipts tax. Management is of the opinion that the Corporation is a tax-exempt organization and is therefore not liable for gross receipts taxes. The FSM National Government Customs Division has maintained that Micronesia Petroleum Corporation is not tax exempt. The Corporation and the FSM National Government are currently attempting to resolve this issue through their respective attorney general's offices.

(8) Risk Management

Micronesia Petroleum Corporation purchases commercial insurance to cover its potential risks from refueling operations, maintains Workmen's Compensation coverage and purchases commercial coverage relative to its risks covering inventory and facilities. Micronesia Petroleum Corporation is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

(9) Related Party

The former Chief Executive Officer (CEO), in the first several months of 2000, had an employment agreement with the Company. Under the terms of the agreement, the CEO was entitled to receive a commission of 0.5 percent of all third-party sales. Commissions paid to the former CEO approximated \$16,307 in 2000 and are included in salaries and wages expense in the accompanying financial statements.

In 2001 and 2000, the Company chartered an oil tanker from a partnership. On approximately July 27, 2000, one partner was appointed as general manager of MPC. During the year ended September 30, 2001 and 2000, the expense associated with the tanker lease was \$740,600 and \$1,031,034, respectively. On approximately July 1, 2001, the lease was discontinued as MPC acquired the tanker for \$275,000.

(10) Significant Revenue Sources

Sales to (generated from) one customer accounted for \$4,811,412 or 64% and \$3,498,395 or 54% of total revenues for the years ended September 30, 2001 and 2000, respectively.

(11) Contingencies

As of March 1, 2002, approximately \$374,822 of receivables is due from one customer. The customer's ability to pay appears contingent on certain future events, of which management cannot currently predict the outcome. Management is of the opinion that the balance will ultimately be collectible. Accordingly, no reserve for this balance has been made in the accompanying financial statements.

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2001 and 2000

(12) Adoption of New Accounting Principle

Effective October 1, 2000, the Company adopted GASB Statement No. 33, "Accounting and Financial Reporting for Nonexchange Transactions." GASB No. 33 establishes more uniform revenue recognition criteria and financial reporting standards regarding the timing of recognition of the results of nonexchange transactions involving cash and other financial and capital resources. The provisions of GASB No. 33 were applied to all periods presented. Implementation of GASB No. 33 had no material impact on the 2000 financial statements.



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL
CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Board of Directors
Micronesia Petroleum Corporation:

We have audited the consolidated financial statements of the Micronesia Petroleum Corporation (MPC), as of and for the year ended September 30, 2001, and have issued our report thereon dated March 1, 2002. 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.

Compliance

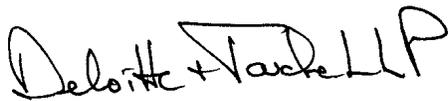
As part of obtaining reasonable assurance about whether Micronesia Petroleum Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and 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 is required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Micronesia Petroleum Corporation'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 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 Micronesia Petroleum Corporation'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 and Questioned Costs in finding number 01-1.

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, we believe the reportable condition described above is not a material weaknesses.

This report is intended for the information of the Board of Directors and management of MPC and the cognizant audit and other federal agencies and is not intended to be, and should not be, used by anyone other than those specified parties.

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March 1, 2002

MICRONESIA PETROLEUM CORPORATION

Schedule of Findings and Questioned Costs
Year Ended September 30, 2001

Fixed Assets

Finding Number 01-1

Criteria: Property should be tagged to facilitate identification and control.

Condition: Four of the sixteen assets tested were not properly tagged.

Cause: The cause of this condition is unknown.

Effect: Currently, it appears that management, to some degree, may rely on institutional knowledge to exercise physical control over fixed assets. However, in the event of employee turnover, such controls may break down. This matter does not currently have an effect on the financial statements.

Recommendation: We recommend that all property be tagged and periodically inventoried.

Auditee Response dated July 12, 2002: We acknowledged this shortcoming on our part. Currently the company maintains a Fixed Asset Register with numbers assigned to each asset. However, some assets were inadvertently not tagged. Management will see to it that all fixed assets will be periodically inventoried and properly tagged.