

MICRONESIA PETROLEUM CORPORATION

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED SEPTEMBER 30, 2002 AND 2001

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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, 2002 and 2001, and the related statements of earnings and 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, 2002 and 2001, 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 disclosed in note 10 to the financial statements, the Company has a receivable of \$360,542 from a customer at September 30, 2002 which is carried net of an allowance of \$103,115. The collectibility of the receivable is under negotiation and it is not currently possible to assess the ultimate outcome of this negotiation or its effect on the accompanying financial statements.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 1, 2003, 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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April 1, 2003

MICRONESIA PETROLEUM CORPORATION

Balance Sheets
September 30, 2002 and 2001

<u>ASSETS</u>	<u>2002</u>	<u>2001</u>
Current assets:		
Cash	\$ 276,342	\$ 269,335
Trade receivables, net (notes 2 and 10)	317,190	524,038
Due from employees	12,849	9,888
Inventory	496,901	478,400
Prepaid expenses	<u>25,797</u>	<u>20,510</u>
Total current assets	1,129,079	1,302,171
Property and equipment, net (note 4)	2,701,089	2,861,340
Investment in joint venture (note 3)	<u>31,824</u>	<u>31,824</u>
	<u>\$ 3,861,992</u>	<u>\$ 4,195,335</u>
 <u>LIABILITIES AND RETAINED EARNINGS</u>		
Current liabilities:		
Current portion of notes payable (note 5)	\$ 165,794	\$ 158,000
Accounts payable	62,841	299,917
Accrued liabilities	13,001	25,778
Payable to Kosrae State Government (note 6)	<u>62,278</u>	<u>62,278</u>
Total current liabilities	303,914	545,973
Notes payable, net of current portion (note 5)	<u>1,506,180</u>	<u>1,643,711</u>
Total liabilities	1,810,094	2,189,684
Retained earnings	<u>2,051,898</u>	<u>2,005,651</u>
Commitments and contingencies (notes 7, 8 and 10)	<u>\$ 3,861,992</u>	<u>\$ 4,195,335</u>

See accompanying notes to financial statements.

MICRONESIA PETROLEUM CORPORATION

Statements of Earnings and Retained Earnings Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Sales (note 9)	\$ 2,827,266	\$ 7,553,329
Cost of goods sold	<u>2,135,336</u>	<u>6,562,547</u>
Gross profit	<u>691,930</u>	<u>990,782</u>
General and administrative expenses:		
Salaries and wages	200,846	213,045
Depreciation	99,171	112,330
Taxes	81,080	91,821
Professional fees	36,762	65,308
Travel and entertainment	31,822	25,219
Rent	12,537	14,400
Plant supplies	8,816	7,173
Communication	7,387	15,729
Utilities	5,557	5,942
Office supplies	3,483	17,482
Insurance	3,427	2,123
Repair and maintenance	3,405	4,406
Bank service charges	2,250	3,997
Freight, handling and storage	1,785	726
Bad debts	-	7,623
Miscellaneous	<u>181,054</u>	<u>60,144</u>
	<u>679,382</u>	<u>647,468</u>
Earnings from operations	<u>12,548</u>	<u>343,314</u>
Other income (expense):		
Operating subsidy from Kosrae State Government	-	500,000
Other income	146,015	154,184
Other expense	<u>(112,316)</u>	<u>(127,970)</u>
Total other income (expense), net	<u>33,699</u>	<u>526,214</u>
Net earnings	46,247	869,528
Retained earnings at beginning of year	<u>2,005,651</u>	<u>1,136,123</u>
Retained earnings at end of year	<u>\$ 2,051,898</u>	<u>\$ 2,005,651</u>

See accompanying notes to financial statements.

MICRONESIA PETROLEUM CORPORATION

Statements of Cash Flows Years Ended September 30, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Earnings from operations	\$ 12,548	\$ 343,314
Adjustments to reconcile earnings from operations to net cash provided by operating activities:		
Doubtful debt expense	-	7,623
Loss on disposal of fixed assets	-	5,307
Depreciation	172,875	226,152
(Increase) decrease in assets:		
Receivables	203,887	(332,471)
Inventories	(18,501)	481,992
Prepayments	(5,287)	374
Increase (decrease) in liabilities:		
Accounts payable	(237,076)	(715,791)
Accrued liabilities	(12,777)	7,813
Net cash provided by operating activities	<u>115,669</u>	<u>24,313</u>
Cash flows from noncapital financing activities:		
Subsidy from Kosrae State Government	-	500,000
Other income (expenses), net	<u>33,699</u>	<u>26,214</u>
Net cash provided by noncapital financing activities	<u>33,699</u>	<u>526,214</u>
Cash flows from capital and related financing activities:		
Purchase of property, plant and equipment	(12,624)	(277,653)
Repayment of notes payable	<u>(129,737)</u>	<u>(265,011)</u>
Net cash used for capital and related financing activities	<u>(142,361)</u>	<u>(542,664)</u>
Net increase in cash	7,007	7,863
Cash at beginning of year	<u>269,335</u>	<u>261,472</u>
Cash at end of year	<u>\$ 276,342</u>	<u>\$ 269,335</u>
Supplemental disclosure of cash flow information:		
Interest expense paid for the year	<u>\$ 112,316</u>	<u>\$ 122,663</u>

See accompanying notes to financial statements.

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(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, 2002 and 2001, \$100,000 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 management's estimate of net realizable value.

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(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>2002</u>	<u>2001</u>
Trade receivables	\$ 735,715	\$ 942,824
Allowance for doubtful accounts	(418,525)	(418,786)
	\$ <u>317,190</u>	\$ <u>524,038</u>

(3) Investments

At September 30, 2002 and 2001, 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 2001, 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, 2002 and 2001, follows:

	<u>2002</u>	<u>2001</u>
Bulk plant	\$ 2,506,000	\$ 2,506,000
Vehicles and tank trucks	577,103	572,192
Office equipment	118,414	118,062
Furniture and fixtures	61,096	61,096
Machines and equipment	343,696	336,682
Buildings and improvements	206,209	206,209
Land	<u>200,000</u>	<u>200,000</u>
	4,012,518	4,000,241
Less accumulated depreciation	(1,311,429)	(1,138,901)
	\$ <u>2,701,089</u>	\$ <u>2,861,340</u>

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements September 30, 2002 and 2001

(5) Notes Payable

Notes payable of MPC consist of the following at September 30, 2002 and 2001:

	<u>2002</u>	<u>2001</u>
Loan payable to Kosrae State Government, primary government, in the original 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 original 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.	412,133	434,037
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.	342,043	388,418
Loan payable to FSM Development Bank, ten year term, interest at 5%, monthly repayment of \$7,958, collateralized by a guarantee of Kosrae State Government.	<u>639,817</u>	<u>701,275</u>
Total debt		1,671,974
Less current portion	<u>(165,794)</u>	<u>(158,000)</u>
Long-term debt, net of current portion	\$ <u>1,506,180</u>	\$ <u>1,643,711</u>

Future maturities of the above debt are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>
2003	\$ 166,794	\$ 87,000
2004	427,625	71,390
2005	132,500	54,500
2006	139,000	48,200
2007	146,000	41,000
Thereafter	<u>661,055</u>	<u>44,339</u>
	\$ <u>1,671,974</u>	\$ <u>346,429</u>

MICRONESIA PETROLEUM CORPORATION

Notes to Financial Statements
September 30, 2002 and 2001

(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, 2002 and 2001, 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, 2002 and 2001, Micronesia Petroleum Corporation expended approximately \$72,565 and \$82,689, 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) Significant Revenue Sources

Sales to (generated from) one customer accounted for \$ 715,385 or 25% of total sales for the year ended September 30, 2002 and \$4,811,412 or 64% of total revenues from a different customer for the year ended September 30, 2001.

(10) Receivable from Nauru Phosphate Corporation

As of September 30, 2002, approximately \$360,542 of receivables is due from Nauru Phosphate Corporation, a major customer. The Company's ability to collect appears contingent on its current negotiation with the customer. Management is of the opinion that the balance will ultimately be collectible. In addition, the customer has confirmed in writing to pay \$35,000 on a monthly basis.



**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, 2002, and have issued our report thereon dated April 1, 2003. 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

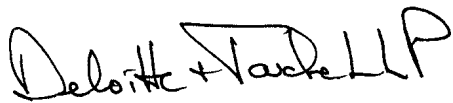
As part of obtaining reasonable assurance about whether Micronesia Petroleum Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and 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 findings number 02-1 through 02-3.

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 believe finding number 02-1 to be a material weakness.

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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April 1, 2003

MICRONESIA PETROLEUM CORPORATION

Schedule of Findings and Questioned Costs Year Ended September 30, 2002

Equity Investment in MPC-Yap

Finding Number 02-1

Criteria: MPC should ensure that financial statements are furnished by its investee at the end of each fiscal year.

Condition: No financial statements for MPC-Yap were furnished in support of MPC's equity investment.

Cause: The cause of this condition is unknown.

Effect: The effect of this condition is a potential misstatement of the financial statements

Recommendation: We recommend that MPC ensure that financial statements are furnished by the investee at the end of each fiscal year.

Auditee Response: MPC has not aware if MPC-Yap is still in operation. Since the change in management of MPC Kosrae in February 2002 the management of MPC-Yap desisted sending required reports from them. MPC Board of Directors and Management are working for a best solution for this Yap operation.

MICRONESIA PETROLEUM CORPORATION

Schedule of Findings and Questioned Costs Year Ended September 30, 2002

Trade Receivables

Finding Number 02-2

Criteria: Trade receivables should be collected in a timely manner.

Condition: Apparently 98% of trade receivables outstanding as of September 30, 2002 are over ninety days old.

Cause: The cause of this condition is unknown.

Effect: The effect of this condition is a negative impact on cash flows from operations.

Recommendation: We recommend that MPC monitor aging of its receivables and implement appropriate collection procedures on accounts past due.

Auditee Response: Accounting Division of MPC will be submitting a monthly schedule of receivable accounts with the aging of same accounts to the management for review and collection measures.

MICRONESIA PETROLEUM CORPORATION

Schedule of Findings and Questioned Costs Year Ended September 30, 2002

Employee Receivable

Finding Number 02-3

Criteria: Money owed by former employees should be collected in a timely manner.

Condition: Cash advanced to former employees aggregating \$7,623 has been outstanding for a number of years.

Cause: The cause of this condition is unknown.

Effect: The effect of this condition is a negative impact on cash flows from operations.

Recommendation: We recommend that MPC pursue the collection of funds owed through legal means.

Auditee Response: Such accounts are being worked on and be submitted to MPC Legal Counsel for actions.