

**MICRONESIA PETROLEUM CORPORATION  
(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

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**FINANCIAL STATEMENTS AND  
INDEPENDENT AUDITORS' REPORT**

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**YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

## **INDEPENDENT AUDITORS' REPORT**

Board of Directors  
Micronesia Petroleum Corporation:

We have audited the accompanying statements of net assets of Micronesia Petroleum Corporation (the Company), a component unit of the State of Kosrae, as of September 30, 2007 and 2006, and the related statements of revenue, expenses, and changes in net assets 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.

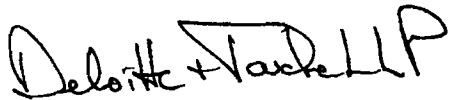
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of Micronesia Petroleum Corporation as of September 30, 2007 and 2006, and the changes in its net assets 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 notes 3 and 9, certain receivables are in arrears and certain liabilities are being negotiated. The ultimate resolution of these matters is not predictable, but could have a material impact on the accompanying financial statements.

The Management's Discussion and Analysis on pages 3-4 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of Micronesia Petroleum Corporation's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 23, 2008, on our consideration of Micronesia Petroleum Corporation'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 of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

May 23, 2008

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Management's Discussion and Analysis  
Year Ended September 30, 2007

**INTRODUCTION**

The following summarizes the financial position and results of operations of Micronesia Petroleum Corporation for fiscal years 2007, 2006 and 2005:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Assets:</b>			
Current assets	\$ 1,142,498	\$ 1,502,578	\$ 1,326,014
Property, plant and equipment, net	2,076,698	2,178,093	2,278,236
Other assets	<u>31,824</u>	<u>31,824</u>	<u>31,824</u>
	<u>\$ 3,251,020</u>	<u>\$ 3,712,495</u>	<u>\$ 3,636,074</u>
<b>Liabilities and net assets:</b>			
Current liabilities	\$ 982,013	\$ 1,016,903	\$ 754,031
Long-term debt	<u>452,235</u>	<u>885,370</u>	<u>1,117,283</u>
Total liabilities	<u>1,434,248</u>	<u>1,902,273</u>	<u>1,871,314</u>
<b>Net assets:</b>			
Invested in capital assets	2,076,698	2,178,093	2,278,236
Unrestricted deficit	<u>(259,926)</u>	<u>(367,871)</u>	<u>(513,476)</u>
Total net assets	<u>1,816,772</u>	<u>1,810,222</u>	<u>1,764,760</u>
	<u>\$ 3,251,020</u>	<u>\$ 3,712,495</u>	<u>\$ 3,636,074</u>
<b>Revenues, Expenses, and Changes in Net Assets</b>			
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Operating revenues	\$ 4,057,717	\$ 4,030,074	\$ 3,091,144
Cost and operating expenses	<u>3,936,977</u>	<u>3,920,997</u>	<u>3,182,806</u>
Net operating income (loss)	<u>120,740</u>	<u>109,077</u>	<u>(91,662)</u>
Other income	2,009	1,644	5,422
Interest expense	(64,230)	(65,259)	(70,607)
Other expense	<u>(51,969)</u>	<u>-</u>	<u>-</u>
Total non-operating expenses, net	<u>(114,190)</u>	<u>(63,615)</u>	<u>(65,185)</u>
Increase (decrease) in net assets	<u>\$ 6,550</u>	<u>\$ 45,462</u>	<u>\$ (156,847)</u>

**Financial Highlights**

For fiscal year 2007, total assets decreased by \$461,475 from \$3,712,495 in prior year to \$3,251,020 or about 12%. This decrease is attributable to a decrease in current assets of \$360,080 and a decrease in property, plant and equipment of \$101,395. The decrease of \$101,395 in property and equipment is mainly due to depreciation of assets, although with a minimal asset purchase of \$5,318. This change in the property, plant and equipment is summarized in detail in Note 4 to the financial statements.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Management's Discussion and Analysis  
Year Ended September 30, 2007

Of the current asset components, cash increased by \$41,221 or about 46%; trade receivables decreased \$165,758 (36%), inventories decreased \$235,419 (25%) and other assets decreased \$124. The decrease in receivables is primarily due to collections and write-offs of some accounts.

Current liabilities decreased by \$34,890 or 3% compared with prior year's figure of \$1,016,903 to \$982,013. This decrease is due to an increase in the current portion of notes payable of \$150,411 where some of the existing loans of the Corporation will mature in the succeeding year and a decrease in accounts payable and other payables of \$185,301. For additional information concerning the Corporation's debt, please see Note 5 to the financial statements.

The 2007 increase in net assets of \$6,550 represents net profit for the year.

**Operating Revenues**

The gross profit rate is maintained for the current year as shown below.

	<u>2007</u>	<u>2006</u>
Operating revenues	\$ 4,057,717	\$ 4,030,074
Cost of goods sold	<u>3,524,125</u>	<u>3,522,294</u>
Gross profit	\$ <u>533,592</u>	\$ <u>507,780</u>
Gross profit rate	13%	13%

Management's Discussion and Analysis for the year ended September 30, 2006 is set forth in MPC's report on the audit of financial statements, which is dated June 29, 2007. That Discussion and Analysis explains the major factors impacting the 2006 financial statements and can be viewed at the Office of the Public Auditor's website at [www.fsmpublicauditor.fm](http://www.fsmpublicauditor.fm).

**PLAN OF ACTION FOR FISCAL YEAR 2008**

1. To continuously exert effort in collecting accounts receivable in arrears.
2. To come up with a manual on the bulk plant operation and maintenance.
3. To monitor fuel cost and pricing thru sourcing of a steady supply of fuel with the lowest price.
4. To finalize the proposed strategic plan of the Company.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Statements of Net Assets  
September 30, 2007 and 2006

<u>ASSETS</u>	<u>2007</u>	<u>2006</u>
Current assets:		
Cash	\$ 130,008	\$ 88,787
Trade receivables, net	294,533	460,291
Other receivables	3,056	-
Due from employees	8,583	11,430
Inventory	705,418	940,837
Prepaid expenses	900	1,233
Total current assets	1,142,498	1,502,578
Property and equipment, net	2,076,698	2,178,093
Investment in joint venture	31,824	31,824
	<u>\$ 3,251,020</u>	<u>\$ 3,712,495</u>
 <u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Current portion of notes payable	\$ 793,543	\$ 643,132
Accounts payable	115,046	300,460
Accrued liabilities and others	11,146	11,033
Payable to Kosrae State Government	62,278	62,278
Total current liabilities	982,013	1,016,903
Notes payable, net of current portion	452,235	885,370
Total liabilities	1,434,248	1,902,273
Contingencies		
Net assets:		
Invested in capital assets	2,076,698	2,178,093
Unrestricted deficit	(259,926)	(367,871)
Total net assets	1,816,772	1,810,222
	<u>\$ 3,251,020</u>	<u>\$ 3,712,495</u>

See accompanying notes to financial statements.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Statements of Revenue, Expenses, and Changes in Net Assets  
Years Ended September 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Sales and service income	\$ 4,057,717	\$ 4,030,074
Cost of goods sold	<u>3,524,125</u>	<u>3,522,294</u>
Gross profit	<u>533,592</u>	<u>507,780</u>
Operating expenses:		
Taxes	146,060	128,209
Salaries	135,875	130,899
Depreciation	33,009	44,012
Travel and entertainment	20,277	12,412
Professional fees	20,250	26,000
Repairs and maintenance	11,418	6,629
Fuel	8,547	6,771
Utilities	7,645	7,757
Insurance	7,329	6,423
Rent	5,400	5,400
Communication	5,099	4,276
Office supplies	3,193	6,311
Bank service charges	2,309	8,470
Plant supplies	980	1,251
Freight, handling and storage	376	723
Miscellaneous	<u>5,085</u>	<u>3,160</u>
Total operating expenses	<u>412,852</u>	<u>398,703</u>
Income from operations	<u>120,740</u>	<u>109,077</u>
Nonoperating revenues (expenses):		
Other income	2,009	1,644
Loss on investment and others	(51,969)	-
Interest expense	<u>(64,230)</u>	<u>(65,259)</u>
Total nonoperating expenses, net	<u>(114,190)</u>	<u>(63,615)</u>
Change in net assets	6,550	45,462
Net assets at beginning of year	<u>1,810,222</u>	<u>1,764,760</u>
Net assets at end of year	<u><u>\$ 1,816,772</u></u>	<u><u>\$ 1,810,222</u></u>

See accompanying notes to financial statements.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Statements of Cash Flows  
Years Ended September 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:		
Cash received from customers	\$ 4,173,475	\$ 4,183,273
Cash paid to suppliers for goods and services	(3,646,066)	(3,911,834)
Cash paid to employees for services	(135,875)	(130,899)
Net cash provided by operating activities	<u>391,534</u>	<u>140,540</u>
Cash flows from noncapital financing activities:		
Other income	1,959	1,644
Interest paid	(64,230)	(65,259)
Principal payment on long-term debt	(282,724)	(200,797)
Proceeds from issuance of long-term debt	-	200,000
Net cash used in noncapital financing activities	<u>(344,995)</u>	<u>(64,412)</u>
Cash flows from capital and related financing activities:		
Purchase of property and equipment	(5,318)	(17,849)
Net cash used in capital and related financing activities	<u>(5,318)</u>	<u>(17,849)</u>
Net change in cash	41,221	58,279
Cash at beginning of year	88,787	30,508
Cash at end of year	<u>\$ 130,008</u>	<u>\$ 88,787</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 120,740	\$ 109,077
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	106,713	117,815
Loss on retirement of asset	-	177
(Increase) decrease in assets:		
Trade receivables	115,758	(111,304)
Other receivables	(3,056)	264,503
Due from employees	878	1,714
Inventory	235,419	(271,965)
Prepaid expenses	333	(1,233)
Increase (decrease) in liabilities:		
Accounts payable	(185,364)	31,215
Accrued liabilities	113	541
Net cash provided by operating activities	<u>\$ 391,534</u>	<u>\$ 140,540</u>

See accompanying notes to financial statements.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

**(1) Organization**

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

A five-member board, which consists of representatives of Kosrae State Government and the private sector, oversee the affairs of the Company. Daily operations of the Company are delegated to the Chief Executive Officer, who is hired by and serves at the pleasure of the Board.

The Company's financial statements are incorporated into the financial statements of the State of Kosrae as a component unit.

**(2) Summary of Significant Accounting Policies**

**Basis of Accounting**

The accounting policies of Micronesia Petroleum Corporation 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. The Company has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

The Company has adopted GASB Statement No. 34, "Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments" as amended by GASB Statement No. 37, "Basic Financial Statements - Management's Discussion and Analysis - for State and Local Governments: Omnibus" and GASB Statement No. 38, "Certain Financial Statement Note Disclosures". 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 the following three net asset categories:

- Invested in capital assets:

Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:

- Nonexpendable – Net assets subject to externally imposed stipulations that require the Company to maintain them permanently. For the years ended September 30, 2007 and 2006, the Company does not have nonexpendable restricted net assets.
- 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 with the passage of time.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

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

**Basis of Accounting, Continued**

- **Unrestricted:**

Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action by management or the Board of Directors or may otherwise be limited by contractual agreements with outside parties.

All proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of the fund are included in the statement of net assets.

The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred.

**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, losses on the carrying value of its joint venture and certain other non-recurring income and costs.

**New Accounting Standards**

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this statement are effective for periods beginning after December 15, 2006.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition and display of other postemployment benefit expenses and related liabilities, note disclosures, and, if applicable, required supplementary information in the reports of the state and local employers. The provisions of this statement are effective for periods beginning after December 15, 2007.

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. GASB Statement No. 48 establishes uniform financial reporting for these types of revenues. The provisions of this statement are effective for periods beginning after December 15, 2006.

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The provisions of this statement are effective for periods beginning after December 15, 2007.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In May 2007, GASB issued Statement No. 50, *Pension Disclosures an amendment of GASB Statements No. 25 and 27*. GASB Statement No. 50 more closely aligns the financial reporting requirements for pensions with those for other post-employment benefits. The provisions of this statement are effective for periods beginning after June 15, 2007.

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, 2009.

Management does not believe that the implementation of these statements will have a material effect on the financial statements of the Company.

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.

Cash

For purposes of the statements of net assets and of cash flows, cash represents cash on hand and in bank accounts. As of September 30, 2007 and 2006, the carrying amount of cash was \$130,008 and \$88,877, respectively, and the corresponding bank balance was \$148,141 and \$85,370, respectively, which were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of September 30, 2007, bank deposits in the amount of \$100,000 were subject to FDIC insurance whereas bank deposits as of September 30, 2006 were fully FDIC insured. Balances in excess of FDIC insurance are not collateralized. Accordingly, these deposits are exposed to custodial credit risk.

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>2007</u>	<u>2006</u>
Trade receivables	\$ 726,346	\$ 875,234
Allowance for doubtful accounts	(431,813)	(414,943)
	\$ <u>294,533</u>	\$ <u>460,291</u>

Inventory

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

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

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

**Property, Plant and Equipment**

The Company capitalizes individual items with estimated useful lives of more than one year without regard to a capitalization threshold. 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.

**Reclassifications**

Certain reclassifications have been made to the 2006 financial statements to correspond with the 2007 presentation.

**(3) Investment and Receivables**

At September 30, 2007 and 2006, MPC held 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 has entered into an agreement to sell its investment in MPC Yap to Yap State Government for \$200,000, which includes recovery of the investment and other net receivables. Subsequent to September 30, 2007, management has prepared a new agreement reducing the amount to \$150,000. Yap State's ability to pay appears contingent on certain future events. Management is of the opinion that the amount will ultimately be collectible. If the amount is not collectible, the accompanying financial statements will be materially impacted.

**(4) Property, Plant and Equipment**

A summary of property, plant, equipment at September 30, 2007 and 2006, is as follows:

	Balance at October 1, 2006	Transfers and Additions	Transfers and Deletions	Balance at September 30, 2007
Bulk plant	\$ 2,506,000	\$ -	\$ -	\$ 2,506,000
Vehicles and tank trucks	310,664	-	-	310,664
Office equipment	49,418	783	-	50,201
Furniture and fixtures	58,606	-	-	58,606
Machines and equipment	398,346	4,535	-	402,881
Buildings and improvements	<u>207,346</u>	<u>-</u>	<u>-</u>	<u>207,346</u>
	3,530,380	5,318	-	3,535,698
Less accumulated depreciation	<u>(1,552,287)</u>	<u>(106,713)</u>	<u>-</u>	<u>(1,659,000)</u>
Depreciable assets, net	1,978,093	(101,395)	-	1,876,698
Land	<u>200,000</u>	<u>-</u>	<u>-</u>	<u>200,000</u>
Property, plant and equipment, net	\$ <u>2,178,093</u>	\$ <u>(101,395)</u>	\$ <u>-</u>	\$ <u>2,076,698</u>

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

**(4) Property, Plant and Equipment, Continued**

	Balance at October 1, 2005	Transfers and Additions	Transfers and Deletions	Balance at September 30, 2006
Bulk plant	\$ 2,506,000	\$ -	\$ -	\$ 2,506,000
Vehicles and tank trucks	295,664	15,000	-	310,664
Office equipment	47,604	2,090	(276)	49,418
Furniture and fixtures	61,521	-	(2,915)	58,606
Machines and equipment	397,587	759	-	398,346
Buildings and improvements	207,346	-	-	207,346
	3,515,722	17,849	(3,191)	3,530,380
Less accumulated depreciation	(1,437,486)	(117,815)	3,014	(1,552,287)
Depreciable assets, net	2,078,236	(99,966)	(177)	1,978,093
Land	200,000	-	-	200,000
Property, plant and equipment, net	\$ 2,278,236	\$ (99,966)	\$ (177)	\$ 2,178,093

**(5) Notes Payable**

Notes payable consist of the following at September 30, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Loan payable to Kosrae State Government in the original amount of \$300,000, due in monthly installments of \$2,628, interest at 1%, maturing on February 1, 2009.	\$ 272,500	\$ 272,500
Loan payable to Kosrae State Government in the original amount of \$300,000, due in monthly installments of \$2,000. Commencing June 1, 2008 installments shall be increased to \$4,000 per month, interest at 1%.	260,172	272,106
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.	269,686	298,777
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 Company assets and a time certificate of deposit held by Kosrae State Government. Interest rate effective as of September 30, 2007 and 2006 is 6.25% and 5.25%, respectively.	83,986	144,641
Loan payable to FSM Development Bank, ten year term, maturing on July 18, 2010, interest at 5%, monthly repayment of \$7,958, collateralized by the Company's accounts receivable and inventory.	272,117	356,538

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

**(5) Notes Payable, Continued**

Loan payable to FSM Development Bank, two year term, maturing on July 31, 2008, interest at 9%, monthly repayment of \$9,136, collateralized by an interest in essentially all Company assets.

	<u>87,317</u>	<u>183,940</u>
Total debt	1,245,778	1,528,502
Less current portion	<u>(793,543)</u>	<u>(643,132)</u>
Long-term debt, net of current portion	\$ <u>452,235</u>	\$ <u>885,370</u>

Future maturities of the above debt are as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2008	\$ 793,543	\$ 53,587	\$ 847,130
2009	131,597	11,899	143,496
2010	136,352	7,144	143,496
2011	60,488	2,169	62,657
2012	46,994	1,006	48,000
2013-2014	<u>76,804</u>	<u>597</u>	<u>77,401</u>
	\$ <u>1,245,778</u>	\$ <u>76,402</u>	\$ <u>1,322,180</u>

Changes in long-term liabilities during the year ended September 30, 2007 occurred as follows:

<u>Balance at beginning of year</u>	<u>Additions</u>	<u>Repayments</u>	<u>Balance end of year</u>	<u>Balance due currently</u>
\$ <u>1,528,502</u>	\$ <u>-</u>	\$ <u>282,724</u>	\$ <u>1,245,778</u>	\$ <u>793,543</u>

Changes in long-term liabilities during the year ended September 30, 2006 occurred as follows:

<u>Balance at beginning of year</u>	<u>Additions</u>	<u>Repayments</u>	<u>Balance end of year</u>	<u>Balance due currently</u>
\$ <u>1,529,299</u>	\$ <u>200,000</u>	\$ <u>200,797</u>	\$ <u>1,528,502</u>	\$ <u>643,132</u>

**(6) Payable to Kosrae State Government**

During fiscal year 1997, Kosrae State Government incurred expenditures under various appropriations for the Company. The amount payable to Kosrae State Government at September 30, 2007 and 2006, reflects expenditures incurred in excess of such appropriations. Kosrae State Government and the Company are currently negotiating a payment schedule for the amount.

**(7) Risk Management**

The Company purchases commercial insurance to cover its potential risks from refueling operations, inventory and facilities. It also maintains workmen's compensation coverage. It 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 during the past three years.

**MICRONESIA PETROLEUM CORPORATION**  
**(A COMPONENT UNIT OF THE STATE OF KOSRAE)**

Notes to Financial Statements  
September 30, 2007 and 2006

**(8) Significant Customers**

Revenues from two customers for the years ended September 30, 2007 and 2006, represented approximately 46% and 45%, respectively, of the Company's total revenues, which included sales to a Kosrae State component unit of \$1,238,787 and \$1,316,131, respectively.

**(9) Contingencies**

As of September 30, 2007 and 2006, approximately \$385,040 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. However, an allowance amounting to \$267,777 has been made in the accompanying financial statements as of September 30, 2007 and 2006. If the balance is not collectible, the accompanying financial statements will be materially impacted.

Management is of the opinion that the Company is a tax-exempt organization and is therefore not liable for gross receipts taxes. The FSM National Government Customs Division has maintained that the Company is not tax exempt. The Company and the FSM National Government have attempted to resolve this issue through their respective attorney general's offices. Maximum potential exposure is currently estimated at \$300,000. No liability has been recorded for any portion of this balance as it is management's opinion that the amount will be reduced and the liability will be recorded upon finalization of the settlement. Therefore, the ultimate resolution of this matter may materially impact the accompanying financial statements.

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

Board of Directors  
Micronesia Petroleum Corporation:

We have audited the financial statements of Micronesia Petroleum Corporation (the Company) as of and for the year ended September 30, 2007, and have issued our report thereon dated May 23, 2008. 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 Company'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 Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

A *control deficiency* 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Company's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Company's financial statements that is more than inconsequential will not be prevented or detected by the Company's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Company's internal control.

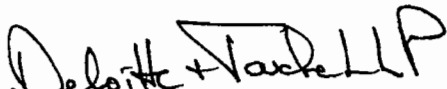
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company'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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Company in a separate letter dated May 23, 2008.

This report is intended for the information of the Board of Directors and management of the Company and is not intended to be and should not be used by anyone other than those specified parties.

  
May 23, 2008