FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION

(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

FINANCIAL STATEMENTS AND INDEPENDENT AUDITORS' REPORT

YEARS ENDED DECEMBER 31, 2010 AND 2009

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Years Ended December 31, 2010 and 2009
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Deloitte & Touche LLP
361 S. Marine Corps Drive
Tamuning, GU 96913-3911
USA

Tel: 1-671-646-3884
Fax: 1-671-649-4932
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

Board of Directors
Federated States of Micronesia Petroleum Corporation:

We have audited the accompanying statements of net assets of Federated States of Micronesia Petroleum Corporation (the Company), a component unit of the FSM National Government, as of December 31, 2010 and 2009, and the related statements of revenue, expenses, and changes in net assets and of 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 the Company as of December 31, 2010 and 2009, and 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.

The Management's Discussion and Analysis on pages 2 through 8 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 the Company'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 March 15, 2011, on our consideration of the Company'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.

Deloitte & Touche LLP

March 15, 2011

STRATEGIC OBJECTIVES

The primary long term role and function of the Federated States of Micronesia Petroleum Corporation (FSMPC) is to secure a stable supply of petroleum products to meet the nation's core energy needs. The Company engages efficiently, responsibly and profitably in the sector. This ensures that it has sufficient resources to maintain assets, train people, hold strategic oil inventories, and provide petroleum products in full, on-time, and to international specifications.

The Company is the largest supplier of energy in the FSM and constantly evaluates opportunities to expand vertically into markets which use and supply modern energy services, or laterally into alternative energy technologies.

BUSINESS PLANNING

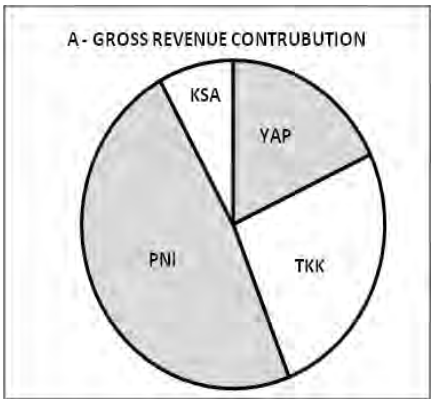
The Company has an annual business plan that sits within a multi-year development window defined by a five year Mission and ten year Vision Statements. Technology is utilized whenever and wherever possible to reduce operating costs and reduce business risk.

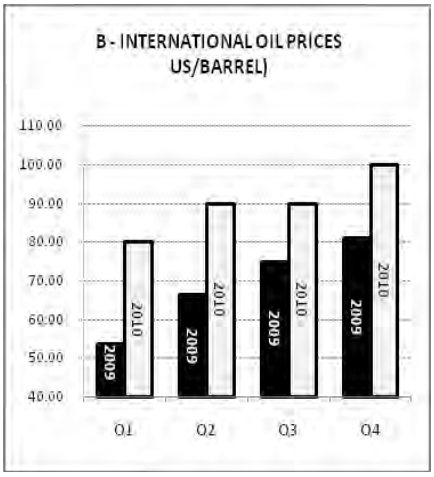
The business conducts itself in accordance with the standards set out in its Statement of General Business Principles (SGBP). Management seeks formal reassurance from each Staff member that they operate within these principles annually.

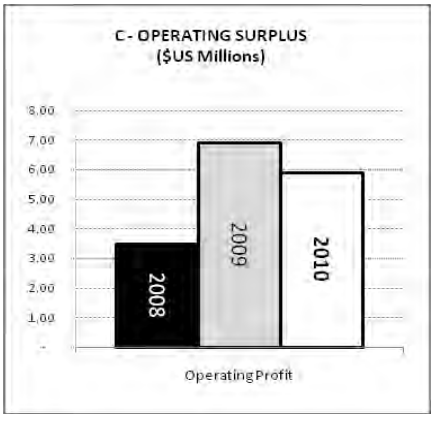
The Company's results in 2010 have again demonstrated the strength of its business model, and its ability to excel under even the most challenging economic conditions. It is committed to a long-term vision of investing with discipline, improving operational efficiency, and increasing shareholder value.

The straightforward business model combines a long-term perspective, disciplined approach to capital investment, and a focus on operational excellence to grow shareholder value. We identify, develop, and execute projects using global best practices that ensure project returns will be resilient across a range of economic scenarios.

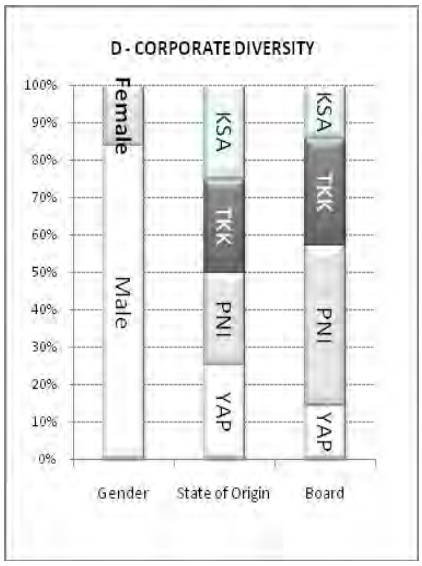
Facilities and terminals are operated using proven management systems to achieve operational excellence. As a result, we consistently generate more income from a highly efficient capital base, as demonstrated by the superior return on average capital employed. We deliver industry-leading financial and operating results that grow long-term shareholder value.







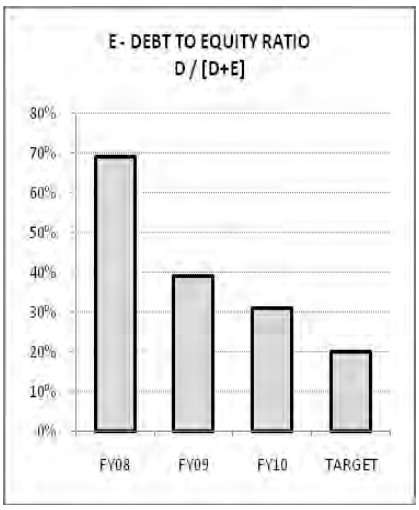
A comprehensive assessment of high risks within the business has been completed for each operating unit and for the enterprise as a whole. Remedial action plans have been developed, resources allocated to risk mitigation, and each risk is assigned to individuals in the Company. The risk management system is fully compliant with ISO31000:2009 international standard for Risk Management.



The Company utilises workplace diversity (refer to Figure D) to capitalize on the talents of our employees from diverse backgrounds. The cultural diversity within the FSM and its differences enrich, expand, and provide the competitive edge needed to address the challenges that face the business and the sector into the future.

Summary of Operations

The Company operates a total of six fuel terminal facilities in the States of Yap, Chuuk, Kosrae, and Pohnpei, and services the international aviation, marine bunkering, and inland market segments.



Gross revenues for CY10 were $51.4 million. Gross revenue contributions (refer to Figure A on page 2) were Kosrae State 9%, Yap State 16%, Chuuk State 25% and Pohnpei State 50%, with a product mix of automotive diesel oil 53%, unleaded petrol (or gasoline) 34%, home kerosene and Jet A1 of 10%, and other revenues of 3%.

Average international oil prices were significantly higher in 2010 than 2009. The average oil price increased steadily from a low of $52/bbl in January 09 to over $90/bbl in December 2010 (refer to Figure B on page 2). This has negatively impacted operating profits and working capital over the period.

A formal Pricing Policy Framework (PPF) converts increases in input product costs into domestic price movements. There are no cross subsidies within the PPF, and prices are reflective of the costs of procuring, financing, storing, handling and distribution of fuels in a respective State. The Company takes a medium term view to domestic product pricing, with a primary goal of smoothing the price volatility observed in international markets. Stable prices provide consumers, businesses and communities with some certainty in energy expenditure, promote effective budgeting, and ultimately stimulate economic development.

The Asset Rehabilitation Program (ARP) has commenced and can be evidenced by the growth of our fixed asset portfolio from $5.8 million to $7.0 million, net of depreciation.

Financial Condition

The Company commenced operations in July 2008 with its entire short and long term capital financed by commercial debt with the Bank of Guam. The Company has maintained a stable cash flow and an appropriate interest cover ratio that has enabled it to survive in a highly leveraged position and reduce debt ratios to manageable levels.

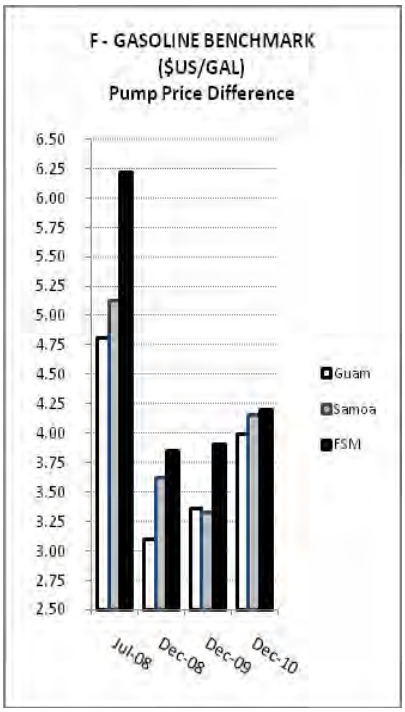
The financial statements reveal that the Company is investing all operating surplus to retire long-term notes, and for capital expenditures to rehabilitate core oil distribution infrastructure. This reinvestment program has positively impacted our overall debt-to-equity ratio, decreasing it from a high of 75% in 2009 to 30% in 2010 (refer to Figure E on page 3). The Company continues to target a debt-to-equity ratio less than 20% given the capital intensity of the business, the volatility in world oil prices, and more importantly, the need to competitively finance the mandatory Asset Rehabilitation Program required throughout all the terminal facilities throughout the FSM.

The following table summarizes the Company financial condition for CY2010, CY2009 and 6 months of operation from inception in July of CY2008.

Assets:	**2010**	**2009**	**2008**
Property, plant and equipment	$ 7,042,956	$ 5,787,083	$ 4,981,934
Cash and cash equivalents	7,626,408	1,687,075	1,637,446
Inventory on hand	5,730,415	5,600,568	3,935,796
Receivables and other current assets	2,548,482	3,040,277	3,120,276
Total Assets	$ 22,948,261	$ 16,115,003	$13,675,452
Current Liabilities	$ 1,866,394	$ 1,560,014	$ 4,998,881
Notes payable - long term	5,561,268	4,729,453	5,193,687
Net assets:			
Invested in capital assets, net of related debt	3,420,136	1,158,500	(65,066)
Unrestricted	12,100,463	8,667,036	3,547,950
	15,520,599	9,825,536	3,482,884
Total Liabilities and Net Assets	$ 22,948,261	$ 16,115,003	$13,675,452

Revenues, Expenses and Changes in Net Assets:	**2010**	**2009**	**2008**
Operating revenues	$ 51,540,037	$ 41,960,542	$23,676,355
Cost of goods sold	(39,776,511)	(30,050,741)	(18,016,070)
Gross margin	11,763,526	11,909,801	5,660,285
Operating expenses	5,802,508	5,060,999	1,810,869
Non-operating expenses	265,955	506,150	366,532
Changes in net assets	$ 5,695,063	$ 6,342,652	$ 3,482,884

Major changes in the balance sheet components for CY10 are a result of:



a) The Company maintained 1 one-year term Line of Credits with Bank of Guam (BOG) for $4,300,000 and with FSM Development Bank (FSMDB) for $2,000,000. The Short Term Notes with both banks remained at a zero balance in CY2010, as a result of prudent cash management, and all cash surplus generated from the operation was used to retire the short term notes with BOG and FSMDB. For more information about short-term debt, please refer to Note 6 to the financial statements.

b) The Company is the implementing agency for the 2008 Japanese Non Project Grant (JNPGA). This has positively affected the cash and cash equivalent position of the company at end CY10. This grant is expected to be disbursed to recipients defined by the State and National Government in January 2012.

c) At the end of December 31, 2010, the Company's Long Term Notes with Bank of Guam for the initial acquisition of fixed assets from Mobil Oil Micronesia Inc. amounted to $3,622,820 of which, $456,347 was classified as current portion of the Note. The principal amount paid during CY2010 was $1,005,763. For additional information concerning long-term debt, please refer to note 5 to the financial statements.

d) The total amount received from sales of petroleum products exceeded the amount paid to vendors and employees for goods and services. The net cash provided by operating activities amounted to $7,178,127 as compared to $6,152,609 for the 12 months of operations in CY2009.

e) $3,122,404 was used for capital and related investing activities for the purchase of Property, Plant and Equipment. The Corporation's total investments in Property, Plant and Equipment for 2010 and 2009 were $7,042,956 and $5,787,083, net of accumulated depreciation of $1,202,117 and $597,555, respectively. For additional information concerning capital assets, please refer to Note 3 to the financial statements.

Management's Discussion and Analysis for the period December 31, 2009 is set forth in the report on the audit of FSMPC's financial statements, which is dated May 5, 2010. That Discussion and Analysis explains the major factors impacting the 2009 financial statements and may be obtained from the contact shown on page 8.

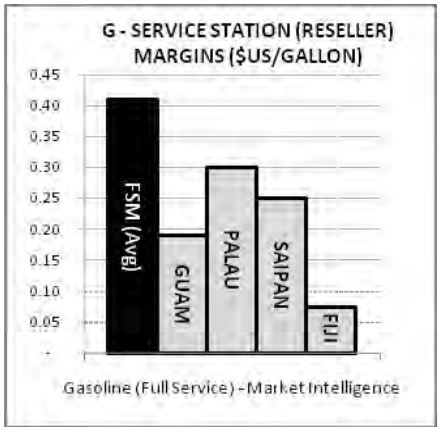
Competitiveness of Offer

Petroleum prices are amongst the most easily comparable around the world, and the Company benchmarks domestic price competitiveness (refer to F on page 5) with main regional centers by comparing public pump prices in Guam and in Samoa. In July 2008, the observable price difference at the pumps was approximately $1.40 per gallon and $1.10 per gallon between FSM, Guam and Samoa, respectively. At the end of CY08, this was reduced to $0.80 per gallon, end CY09, $0.65 per gallon, and a further reduction in CY10 to $0.25 per gallon.

Resellers of petroleum products in the FSM continue to make significant returns in comparison with other regional markets (refer to Figure G), presumably due to the fact that in Palau, Guam and Fiji, petroleum wholesalers also retail products through company owned service station outlets, and control retail margins. The Company does not set retail prices or margins in the FSM, and in a number of States, is prohibited from being both a wholesaler and retailer of petroleum products.

Contribution to National and State Governments

The Company continues to be a significant contributor to State and National Governments through gross revenue taxes, import duties, sales taxes, land lease payments and other associated government fees and charges.



Total payments for various District, State and National government fees and charges exceeded $3.5 million in CY10. This comprised approximately $2.2 million in the form of gross revenue taxes and import duties, and $1.3 million directly to the various Municipal and State Governments or Agencies for sales taxes and land leases.

Asset Rehabilitation Program (ARP)

It is now estimated that a total of $8.0 million will be spent between 2010 and 2014 on the ARP to ensure that all facilities meet international standards and to reduce overall operating risks in the business.

Management has completed its internal review and audit of all critical fixed assets and has developed a multi-year capital investment and upgrade program. Individual project priorities and investment decisions take into account social and environmental considerations and an appraisal of the commercial investment.

A primary consideration remains the need to minimize injury to people, or damage to the environment, or damage to Company assets and or reputation. The ARP is dynamic and is reviewed annually based on national energy policy, the changing energy demands of the people and economy.

ECONOMIC OUTLOOK

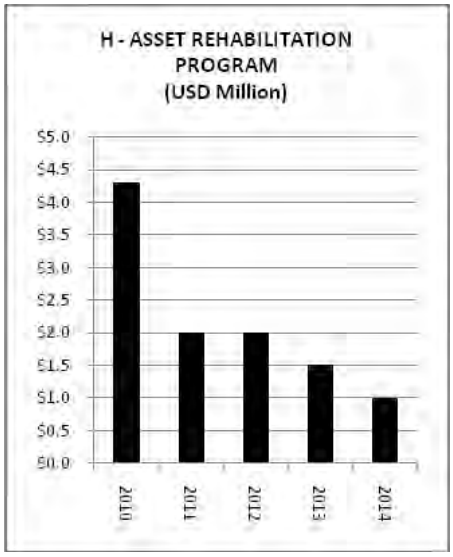
Economic Activity

The outlook for 2011 through 2015 for the FSM is brighter as a result of better global prospects. The Company forecasts the economy to grow in CY2011, mainly due to support by donor-funded construction, including an extension to the airport runway in Pohnpei, a refurbishment of tuna-processing facilities (with a concessional loan from the People's Republic of China), and the implementation of overdue infrastructure projects by Compact funding through an enhanced Program Management Unit (PMU) of the National Government.

The Guam military buildup has had to date a negative effect on the business in the FSM. This is due to increased demand for, and therefore, increased prices for specialized construction and engineering services in Guam. Fiscal policies of the Guam Administration have impacted on the costs of transshipping goods through Guam. This is expected to worsen, as Guam attempts to fund infrastructure upgrades necessary to facilitate the anticipated military build-up, and also addresses significant operating budget deficits.

The FSM economy is starting to see the negative effects on oil prices due to global economic recovery with past commodity price deflation now replaced by a sharp rise in international prices. This was evident throughout CY2010 (refer to Figure B on page 2) and likely to continue throughout CY2011. This will place upwards pressure on inflation and increase the costs of doing business for the private sector in the FSM.

Energy Markets



Energy markets have remained volatile throughout 2008 through 2010, reflecting the dramatic drop in world economic activity early in the year and then economic recovery in the second half. Looking ahead, the long-term outlook is one of growing demand for energy, particularly in Asia, alongside challenges for the industry in meeting this demand.

Under the International Energy Agency's (IEA) Reference Scenario, global energy demand is projected to increase by around 40% between 2007 and 2030. That scenario projects that fossil fuels will still be satisfying as much as 80% of the world's energy needs in 2030. At current rates of consumption, the world has enough proven reserves of fossil fuels to meet these requirements if investment is permitted to turn those reserves into production capacity.

The key to energy security and reduced vulnerability for Micronesia is to diversify energy supply, and to include a balance between demand-side management, increases in the efficiency of existing energy supplies, and the development of new fuel and electricity sources that use cheaper fossil fuels or are renewable. For Micronesia, such a mix must include renewable energy sources such as wind, biofuels and solar power.

With appropriate international and development partner assistance, the Company estimates that for the FSM a 45% target can be achieved within 10 years. Alternative and renewable energy from domestic resources will prove to make the most significant contribution to a more resilient economy when the Compact Funding ceases.

CONTACT

Questions associated with the above MD&A may be sent by post, addressed to Mr. Mathias Lawrence Chief Financial Officer, P. O. Box 1762, Kolonia, Pohnpei, FSM 96941 or via email to petrocorp@fsmpc.com.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Statements of Net Assets
December 31, 2010 and 2009

ASSETS	2010	2009
Current assets:		
Cash	$ 7,626,408	$ 1,687,075
Trade receivables, net of allowance for doubtful accounts of $0 in 2010 and $92,545 in 2009	593,833	864,526
Due from employees	29,377	10,330
Inventory	5,730,415	5,600,568
Deposit with supplier	1,022,678	1,598,131
Prepaid expenses	387,971	54,103
Total current assets	15,390,682	9,814,733
Time certificate of deposit	514,623	513,187
Property and equipment, net	7,042,956	5,787,083
	$ 22,948,261	$ 16,115,003
LIABILITIES AND NET ASSETS		
Current liabilities:		
Current portion of long-term debt	$ 456,347	$ 399,130
Accounts payable	481,326	336,858
Accrued liabilities and others	928,721	824,026
Total current liabilities	1,866,394	1,560,014
Long-term debt, net of current portion	3,166,473	4,229,453
Due to states and primary government	2,394,795	500,000
Total liabilities	7,427,662	6,289,467
Contingencies		
Net assets:		
Invested in capital assets, net of related debt	3,420,136	1,158,500
Unrestricted	12,100,463	8,667,036
Total net assets	15,520,599	9,825,536
	$ 22,948,261	$ 16,115,003

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Statements of Revenue, Expenses, and Changes in Net Assets
Years Ended December 31, 2010 and 2009

	2010	2009
Operating revenue:		
Sales and service income	$ 51,366,135	$ 41,853,012
Recovery of bad debts	92,545	-
Other	81,357	107,530
	51,540,037	41,960,542
Cost of goods sold	39,776,511	30,050,741
Gross profit	11,763,526	11,909,801
Operating expenses:		
Taxes	1,499,509	1,226,625
Salaries	996,704	989,150
Depreciation	604,562	434,502
Rent	548,749	703,701
Professional fees	524,267	265,074
Insurance	302,153	302,501
Travel and entertainment	202,670	214,757
Contractual	181,537	178,586
Repairs and maintenance	164,602	106,611
Office supplies	144,819	115,524
Utilities	129,933	84,788
Communications	117,836	105,440
Fuel	72,722	40,981
Provision for bad debts	-	92,545
Miscellaneous	312,445	200,214
Total operating expenses	5,802,508	5,060,999
Operating income	5,961,018	6,848,802
Nonoperating expenses:		
Interest expense	(265,955)	(506,150)
Change in net assets	5,695,063	6,342,652
Net assets at beginning of year	9,825,536	3,482,884
Net assets at end of year	$ 15,520,599	$ 9,825,536

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Statements of Cash Flows
Years Ended December 31, 2010 and 2009

	2010	2009
Cash flows from operating activities:		
Cash received from customers	$ 51,810,730	$ 42,051,629
Cash paid to suppliers for goods and services	(41,722,058)	(34,901,845)
Cash paid to employees for services	(1,015,750)	(997,175)
Net cash provided by operating activities	9,072,922	6,152,609
Cash flows from noncapital financing activities:		
Interest paid on bank line of credit facility	(11,185)	(253,081)
Net repayments of borrowings under bank line of credit facility	-	(3,930,617)
Net cash used for noncapital financing activities	(11,185)	(4,183,698)
Cash flows from capital and related financing activities:		
Acquisition of capital assets	(1,833,393)	(1,239,651)
Principal repayments of long-term debt	(1,005,763)	(418,417)
Interest paid on long-term debt	(283,248)	(261,214)
Net cash used for capital and related financing activities	(3,122,404)	(1,919,282)
Net change in cash	5,939,333	49,629
Cash at beginning of year	1,687,075	1,637,446
Cash at end of year	$ 7,626,408	$ 1,687,075
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 5,961,018	$ 6,848,802
Adjustments to reconcile operating income to net cash provided by operating activities:		
Purchase of fuel	1,894,795	-
Depreciation	604,562	434,502
Provision for bad debts	-	92,545
(Increase) decrease in assets:		
Trade receivables	270,693	(1,458)
Due from employees	(19,047)	(8,025)
Inventory and related deposit with supplier	445,606	(1,609,329)
Prepaid expenses	(333,868)	(50,361)
Increase in liabilities:		
Accounts payable	144,468	296,997
Accrued liabilities and others	104,695	148,936
Net cash provided by operating activities	$ 9,072,922	$ 6,152,609

Non-cash operating activity:

The Company purchased from its supplier the equivalent gallons of fuel in the amount of $1,894,795 funded by a grant from the Government of Japan. The grant money was paid directly to the supplier.

See accompanying notes to financial statements.

(1) Organization

Federated States of Micronesia Petroleum Corporation (FSMPC or the Company) is a component unit of the Federated States of Micronesia (FSM) National Government (FSMNG). FSMPC was created under Public Law 15-08, as passed by the FSM Congress and which was signed into law on September 11, 2007, for the purpose of providing the oil and gas distribution for the entire FSM. Through December 31, 2008, operations were conducted in the States of Chuuk, Yap and Pohnpei. In April 2009, operations were expanded to include business in the State of Kosrae.

FSMPC is governed by a seven-member Board of Directors appointed as follows:

- 1 member appointed by the President with the advice and consent of the FSM Congress to represent the FSMNG.
- 4 members appointed by the each State governor to represent each of the States.
- 2 members from the private sector, appointed by the President with the advice and consent of the FSM Congress.

FSMPC's financial statements are incorporated into the financial statements of the FSM National Government as a component unit.

(2) Summary of Significant Accounting Policies

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

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*, establish 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, net of related debt: 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. As of December 31, 2010 and 2009, 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.

(2) Summary of Significant Accounting Policies, 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.

Basis of Accounting

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 statements of net assets. Proprietary fund operating statements present increases and decreases in net total assets. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses are 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 related financing activities as well as certain other non-recurring income and expense items.

Cash and Time Certificates of Deposit

Custodial credit risk is the risk that in the event of a bank failure, the Company'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 or held by the pledging financial institution but not in the depositor-government's name. FSMPC does not have a deposit policy for custodial credit risk.

For purposes of the statements of net assets and of cash flows, cash represents cash on hand and cash in bank accounts. Time certificates of deposit with an original maturity in excess of ninety days are separately classified. As of December 31, 2010 and 2009, the carrying amounts of cash and time certificates of deposit were $8,141,031 and $2,200,262, respectively, and the corresponding bank balances were $8,177,890 and $3,441,621 respectively, which were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2010 and 2009, bank deposits in the amount of $572,421 and $250,000, respectively, were subject to FDIC insurance. Balances in excess of FDIC insurance are not collateralized.

Accounts Receivable

Accounts receivable are due from businesses and individuals located in the Federated States of Micronesia and are interest free and uncollateralized. 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 collectability of these accounts and prior collection experience.

Inventory

Inventory is substantially carried at the lower of cost (moving average cost) or market.

(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. Estimated useful lives of property and equipment are as follows:

Building	15 years
Motor vehicle	5 years
Plant and equipment	3 to 15 years
Furniture and fixtures	4 years
Office equipment	4 years
Machinery and equipment	4 years

Capitalized Interest

Interest cost for assets that require time to bring them to the condition and location necessary for their intended use is capitalized as part of the assets' cost until such time as the assets are placed in service. The Company capitalized $27,042 for the year ended December 31, 2010.

Taxes

Corporate profits of major corporations are subject to 21 percent income tax in the FSM. Corporations not classified as major corporations are instead imposed a gross receipts tax of 3% on revenues. The Company is responsible for gross receipt taxes, sales taxes and import taxes on its operations in the FSM. The Company is a major corporation. A legal opinion is being sought to state that the Company is not subject to 21 percent income tax.

Reclassification

Certain account balances in the 2009 financial statements have been reclassified to correspond with the 2010 presentation.

New Accounting Standards

During fiscal year 2010, FSMPC implemented the following pronouncements:

- GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which addresses whether and when intangible assets should be considered capital assets for financial reporting purposes.

- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is intended to improve how state and local governments report information about derivative instruments - financial arrangements used by governments to manage specific risks or make investments - in their financial statements.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

- GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, which provides guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code, and establishes requirements for recognizing and measuring the effects of the bankruptcy process on assets and liabilities, and for classifying changes in those items and related costs.

The implementation of these pronouncements did not have a material effect on the accompanying financial statements.

In March 2009, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which enhances the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of FSMPC.

In December 2009, GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, which amends Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and addresses issues related to measurement of OPEB obligations by certain employers participating in agent multiple-employer OPEB plans. The provisions of Statement 57 related to the use and reporting of the alternative measurement method are effective immediately. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011. Management does not believe that the implementation of this statement will have a material effect on the financial statements of FSMPC.

In June 2010, GASB issued Statement No. 59, *Financial Instruments Omnibus*, which updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The provisions of this statement are effective for periods beginning after June 15, 2010. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of FSMPC.

In December 2010, GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements,* which addresses how to account for and report service concession arrangements (SCAs), a type of public-private or public-public partnership that state and local governments are increasingly entering into. The provisions of this statement are effective for periods beginning after December 15, 2011. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of the Company.

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In December 2010, GASB issued Statement No. 61, *The Financial Reporting Entity: Omnibus*, which is designed to improve financial reporting for governmental entities by amending the requirements of Statements No. 14, *The Financial Reporting Entity*, and No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively. The provisions of this statement are effective for periods beginning after June 15, 2012. Management has not evaluated the effect that the implementation of this statement will have on the financial statements of the Company.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* which supersedes Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. The provisions of this statement are effective for periods beginning after December 15, 2011. Management has not evaluated the effect that the implementation of this statement will have 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 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.

(3) Property, Plant and Equipment

Capital asset activities for the year ended December 31, 2010 are as follows:

	Balance at January 1, 2010	Transfers and Additions	Transfers and Deletions	Balance at December 31, 2010
Buildings	$ 380,329	$ 14,611	$ -	$ 394,940
Motor vehicles	286,190	261,096	-	547,286
Plant and equipment	4,812,337	25,655	-	4,837,992
Furniture and fixtures	33,026	15,192	-	48,218
Office equipment	862,476	491,618	-	1,354,094
Machinery and equipment	10,280	138,070	-	148,350
	6,384,638	946,242	-	7,330,880
Less accumulated depreciation	(597,555)	(604,562)	-	(1,202,117)
	5,787,083	341,680	-	6,128,763
Construction in progress	-	1,438,616	(524,423)	914,193
	$ 5,787,083	$ 1,780,296	$ (524,423)	$ 7,042,956

(3) Property, Plant and Equipment, Continued

Capital asset activities for the year ended December 31, 2009 are as follows:

	Balance at January 1, 2009	Transfers and Additions	Transfers and Deletions	Balance at December 31, 2009
Buildings	$ 264,238	$ 116,091	$ -	$ 380,329
Motor vehicles	45,000	241,190	-	286,190
Plant and equipment	4,807,604	4,733	-	4,812,337
Furniture and fixtures	15,111	17,915	-	33,026
Office equipment	13,034	849,442	-	862,476
Machinery and equipment	-	10,280	-	10,280
	5,144,987	1,239,651	-	6,384,638
Less accumulated depreciation	(163,053)	(434,502)	-	(597,555)
	$ 4,981,934	$ 805,149	$ -	$ 5,787,083

(4) Due to States and Primary Government

In 2008, the FSMNG was extended a grant by the Government of Japan amounting to ¥200,000,000 ("the Grant"). The Grant and its accrued interest shall be used by FSMNG properly and exclusively for the purchase of products enumerated in a list to be mutually agreed upon between the two governments. The Grant will be received by FSMNG in Yen currency, will be used as described above within a period of twelve months and any excess amounts will be refunded to the Government of Japan thereafter. FSMNG is required to deposit in Micronesian currency all the proceeds from the sale and lease of the products purchased referred to above. The amount of the proceeds to be deposited shall not be less than half of the total yen disbursement paid with respect to the purchase of the products. The deposit shall be made within the period of three years from the date of entry into force of the understanding between the two governments. The deposited fund shall be utilized for economic and social development purposes in FSM.

In 2009, FSMPC signed a memorandum of agreement with FSMNG that the Grant be utilized for the supply of petroleum fuels to FSMPC to assist in the implementation of a number of initiatives aimed at mitigating the social and economic difficulties caused by volatile and sustained high oil prices. The Grant was paid directly by the Government of Japan through an independent procurement agent, Crown Agents, to FSMPC's supplier of fuel instead of to FSMNG. FSMPC has received the equivalent gallons of fuel from the supplier and this is now maintained as strategic inventory in each State. FSMPC recognized a liability to the States and FSMNG equivalent to the grant amount of $1,894,795.

The rest of the portion of due to primary government represents a $500,000 non-interest bearing advance from the FSM National Government. There is no specific repayment terms associated with the advance and management has classified the advance as long-term since it has no expectation that such will have to be repaid before December 31, 2011. The advance has been deposited in a time certificate of deposit, which has been similarly classified as long-term.

(5) Long-term Debt

Long-term debt consists of the following:

	2010	2009
Note payable to bank for purposes of acquiring capital assets, due in monthly installments of $57,949, with interest at 7% per annum, final payment due on March 2019, unconditionally guaranteed by the FSM National Government. The loan is essentially collateralized by all assets of FSMPC.	$ 3,622,820	$ 4,628,583

Future repayment requirements to maturity for principal and interest are as follows:

Year Ending December 31,	Principal	Interest	Total
2011	$ 456,347	$ 239,035	$ 695,382
2012	489,337	206,045	695,382
2013	524,711	170,671	695,382
2014	562,642	132,740	695,382
2015	603,316	92,066	695,382
2016-2020	986,467	55,326	1,041,793
	$ 3,622,820	$ 895,883	$ 4,518,703

(6) Short-Term Borrowings

As of December 31, 2010 and 2009, the Company has two bank line of credit facilities (LOC) of $4,300,000 and $2,000,000, respectively. The LOC is evidenced by promissory notes drawn on various dates for various amounts. This line of credit is utilized by the Company to fund fuel inventory purchases. The LOC and the related long-term obligation are secured and collateralized by an executed Pledge and Security Agreement for the assignment of the Reserve Bank Account and Revenue, an executed Notice of Security Interest and Chattel Mortgage and are guaranteed by the FSM National Government.

Changes in short-term borrowings for the year ended December 31, 2010 were as follows:

	Beginning Balance	Increases	Reductions	Ending Balance
Line of credit facility	$ -	$ 2,000,000	$ (2,000,000)	$ -

(6) Short-Term Borrowings, Continued

Changes in short-term borrowings for the year ended December 31, 2009 were as follows:

	Beginning Balance	Increases	Reductions	Ending Balance
Line of credit facility	$ 3,930,617	$ 15,301,583	$ (19,232,200)	$ -

(7) Changes in Long-Term Liabilities

Changes in long-term liabilities for the year ended December 31, 2010 was as follows:

	Balance at January 1, 2010	Additions	Repayments	Balance at December 31, 2010	Due Within One Year
Note payable	$ 4,628,583	$ -	$ (1,005,763)	$ 3,622,820	$ 456,347
Due to states and primary government	500,000	1,894,795	-	2,394,795	-
	$ 5,128,583	$1,894,795	$(1,005,763)	$ 6,017,615	$ 456,347

Changes in long-term liabilities for the year ended December 31, 2009 was as follows:

	Balance at January 1, 2009	Additions	Repayments	Balance at December 31, 2009	Due Within One Year
Note payable	$ 5,047,000	$ -	$ (418,417)	$ 4,628,583	$ 399,130
Due to states and primary government	500,000	-	-	500,000	-
	$ 5,547,000	$ -	$ (418,417)	$ 5,128,583	$ 399,130

(8) Risk Management

The Company has adopted the International Standards Organization 150:31000 (2009) Standards on 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.

(9) Significant Customers

Total revenues from one major customer for the years ended December 31, 2010 and 2009 approximated 18 percent of the Company's total revenues.

The Company purchased substantially all fuel from one supplier in 2009 and 2010.

(10) Commitments

Leases

The Company leases land, warehouse, airport facilities and other such space through various leases expiring through 2023. Some lease agreements afford the Company option to renew the lease periods subject to escalation of the lease consideration. Three lease agreements require additional lease payments contingent on the level of gallons sold by the Company from that leased facility. Contingent rental of $599 was paid in 2010. No contingent rental was paid in 2009.

The future minimum lease payments are as follows:

Year Ending December 31,	
2011	$ 424,204
2012	376,171
2013	375,004
2014	314,848
2015	312,254
2016-2020	1,430,166
2021-2023	452,875
	$ 3,685,522

Sales

The Company has entered into agreements to sell fuel at an agreed pricing method. The agreements are for one year and automatically renew at the end of their respective terms every 30 days, unless terminated by either party.

Deloitte & Touche LLP
361 S. Marine Corps Drive
Tamuning, GU 96913-3911
USA

Tel: 1-671-646-3884
Fax: 1-671-649-4932
www.deloitte.com

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

Board of Directors
Federated States of Micronesia Petroleum Corporation:

We have audited the financial statements of Federated States of Micronesia Petroleum Corporation (the Company) as of and for the year ended December 31, 2010, and have issued our report thereon dated March 15, 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 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 *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 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.

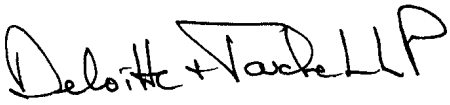
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses.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

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 March 15, 2011.

This report is intended for the information and use of the Board of Directors, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.



March 15, 2011

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)

Unresolved Prior Year Findings
Year Ended December 31, 2010

There were no unresolved audit findings from the prior year audits of the Company.