

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

**CONSOLIDATED FINANCIAL STATEMENTS,
ADDITIONAL INFORMATION
AND INDEPENDENT AUDITORS' REPORT**

YEARS ENDED DECEMBER 31, 2019 AND 2018

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

Years Ended December 31, 2019 and 2018
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INDEPENDENT AUDITORS' REPORT

Board of Directors
Federated States of Micronesia Petroleum Corporation:

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of the Federated States of Micronesia (FSM) Petroleum Corporation and Subsidiary (the Company), a component unit of the FSM National Government, which comprise the consolidated statements of net position as of December 31, 2019 and 2018, and the related consolidated statements of revenues, expenses and changes in net position and of cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FSM Petroleum Corporation and Subsidiary as of December 31, 2019 and 2018, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

Implementation of New Accounting Standards

As discussed in Note 2 to the consolidated financial statements, the Company adopted Governmental Accounting Standards Board (GASB) Statement No. 90, *Majority Equity Interests - an Amendment of GASB Statements No. 14 and 61*, effective January 1, 2017. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information:

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 4 to 9 be presented to supplement the consolidated financial statements. Such information, although not a part of the consolidated financial statements, is required by GASB who considers it to be an essential part of financial reporting for placing the consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the consolidated financial statements, and other knowledge we obtained during our audit of the consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Supplementary Information:

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information on pages 30 to 33 are presented for the purpose of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual companies, and is not a required part of the consolidated financial statements. This information is the responsibility of the Company's management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audit for the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, such information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated June 19, 2020, 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 solely 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 effectiveness of the Company's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting and compliance.

Deloitte & Touche LLP

June 19, 2020

**FEDERATED STATES OF MICRONESIA
PETROLEUM CORPORATION AND SUBSIDIARY
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Management's Discussion and Analysis
Years Ended December 31, 2019 and 2018

ROLE AND FUNCTION

The primary long term role and function of the Federated States of Micronesia Petroleum Corporation (FSMPC or "the Corporation") is to secure a stable supply of petroleum products to meet the nation's core energy needs. In addition, and as a result of Public Law 18-68 entitled "The Coconut Tree Act", the Corporation transitioned the assets, staff and operations of the former FSM Coconut Development Authority (CDA) and has an additional mission to increase the economic value of the coconut tree and its products to the country and its farmers.

The Corporation remains the single largest supplier of energy in the FSM and continues to engage efficiently, responsibly and profitably in the country to ensure that there are sufficient resources to maintain assets, train people, hold strategic oil inventories, and provide petroleum products in full, on-time, and to international specifications, and to provide the necessary resources to develop and rehabilitate the coconut industry. Opportunities to diversify into alternative energy technology and partnerships, as well as expand into regional markets are investigated thoroughly.

STRATEGIC OBJECTIVES

The Strategic Plan - Voyaging Together 2025 - has been developed in accordance with a balanced scorecard methodology from the Balanced Scorecard Institute (<https://balancedscorecard.org>). The Plan looks at four perspectives - financial, stakeholders, business process, and organizational capacity - and has documented seventeen strategic objectives with 'enhancing commercial viability' as primary. Commercial viability ensures the availability of funding for ongoing activities that deliver the missions defined within the Public Laws.

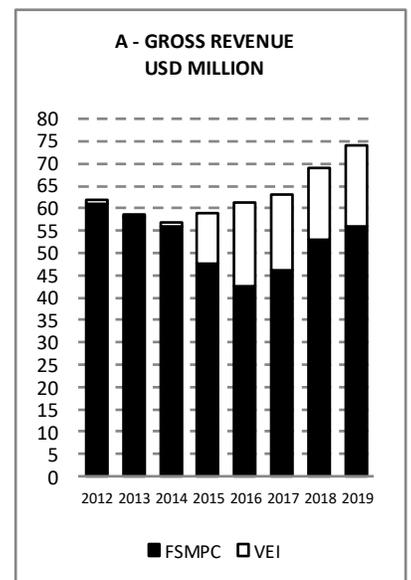
Maintaining and enhancing commercial viability remains challenging given the current external environment. Technological advancement, external interventions that fund a rapid transition to a low carbon economy, and the ever growing threat of extreme weather events that require both capital reserves and strong insurance programs for business continuity, recovery, and reinstatement of critical infrastructure that may be damaged are pressures that need to be continuously monitored and prepared for.

SUMMARY OF OPERATIONS

The Corporation operates a total of eight fuel terminal facilities across the region. It services the international aviation, marine bunkering, and inland market segments. It also owns and operates a copra and coconut processing facility in Pohnpei producing soaps and edible oils. A second integrated coconut processing facility is under construction in Chuuk.

Vital Energy Incorporated (VEI), Guam, is wholly owned by the FSMPC, and is the responsible entity for operations in Guam and Nauru. A supply and terminal operating agreement with the Government of Nauru remains in place.

An FSM Pricing Policy Framework (PPF) provides a mechanism to stabilize domestic prices, and cushion the effect of international volatility. There are no cross subsidies within the PPF, and the prices reflect the costs of procuring, financing, storing, handling and distribution of fuels in the States that we operate.



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A Nauru Pricing Template (NPT) negotiated with the Government of Nauru provides the mechanism to earn a return-on-investment commensurate with the risks of operating in Nauru. The NPT has a similar stabilization mechanism for domestic prices, and cushion the effect of international volatility.

There are no cross subsidies between the PPF or NPT, and the prices in each operating unit reflect the costs of procuring, financing, storing, handling and distribution of fuels in the States that we operate. The Corporation continues to benchmark domestic price competitiveness through comparison of pump prices of island neighbors. Throughout 2019, domestic prices in the FSM remained stable, and by and large slightly above the benchmark Guam pump prices and below most regional neighbors.

Pricing practices did not change throughout 2019. The PPF and NPT maintained scheduled price adjustments in accordance with various price instruments for contract customers such as utilities, airlines, and a quarterly price change for retail service stations. This strategy continues to provide stable energy prices for homes, businesses, and government.

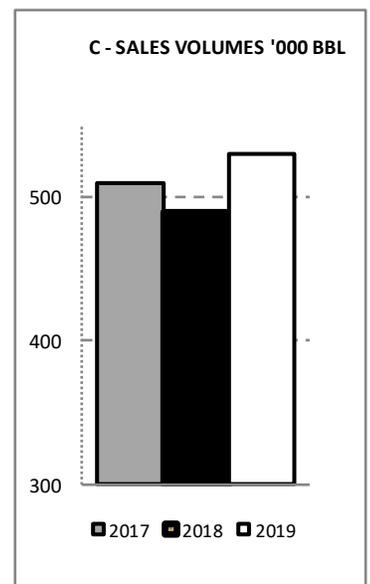
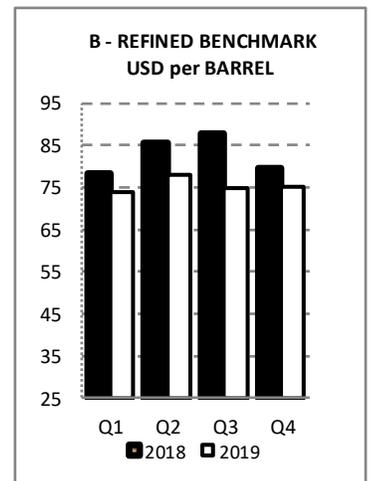
Revenues

Over 99% of company revenues remain petroleum fuels related. Revenues are directly linked to the international oil markets and the adjustment mechanisms in the PPF and NPT that accommodates international oil price increases or decreases.

2019 was a stable year for oil prices, with each quarter averaging at approximately \$US75/BBL, with a quarterly deviation less than \$US2/BBL. The refined product benchmark average for CY2019 was overall lower than 2018 (refer Graph B). An aggressive sales plan in the marine markets saw a significant increase in sales volumes (refer Graph C) due to an additional 1 million gallons in international bunkers in the FSM. As a result, FSMPC revenues have risen by 7% from \$52MM in 2018 to \$56MM in 2019 (refer Graph A).

As a result, the company has managed to grow consolidated gross revenue of the Group to \$74.3 million (refer graph A) with business unit contributions of Kosrae 7%, Yap 9%, Chuuk 21%, Pohnpei (fuel & kwh) 48%, Guam and Nauru 24%. Automotive diesel oil remains the highest revenue component at 44%, followed by unleaded petrol (or gasoline) 33%, and home kerosene and Jet A1 of 16%. Non-fuel related revenues from power plant electricity sales, as well as coconut related products are approximately 5% of total revenues mix.

Our petroleum operations throughout the FSM, Guam and Nauru are supported by fuel, lubricant and technical service agreements with Mobil Oil Micronesia Incorporated (MOGI), Total Oil Asia Pacific (TOAP), and ExxonMobil Aviation (EMA). Throughout 2019, we maintained Winson Oil (HK) Limited and Pacific Bulk Fuels (NZ) Limited as product suppliers to the Company. There were no changes in primary product suppliers in 2019.



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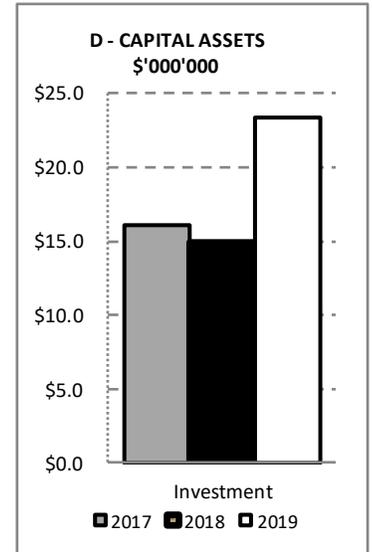
Management's Discussion and Analysis
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Investment and Business Planning

The Statement of General Business Principles (SGBP) was revised in 2019. Management seeks formal reassurance from each staff member that they operate within these principles annually. The Board also confirms their commitment to the SGBP annually. There were no reported breaches of these principles in 2019.

The Strategy Execution Team (SET) has now been resourced and are executing the various initiatives within the Strategic Plan. The establishment of the SET and the resourcing of a project management unit has seen a steady and marked improvement of project and initiative implementation. The success of this team can be observed with the growth of the fixed assets of the corporation. This reverses the concerning trend where capital reinvestment was smaller than depreciation.

The Board and Management continue to investigate options to outsource activities, enter into equipment leasing arrangements, utilize joint ventures to meet much of capital requirements of the business, as well as to transfer risks to entities that are more equipped to manage them. The Investment Appraisal Framework adopted by the Board in 2015 remains in place. The appraisal framework provides clear guidelines for Management for all investments made by the Corporation.



Risks & Risk Management

The risk management system is designed for compliance with the ISO31000:2009 international standard for Risk Management. The organizational risk architecture has been established, with a Board Committee on Risk and Audit (CoRA) accountable for enterprise level risks, remedial action plans, and business internal controls. The risk architecture, strategy and protocols used across the business are in a constant oversight and continuous improvement process.

The highest risks and uncertainties disclosed in 2018 remain unchanged in 2019, namely:

- *Talent and the Talent Pipeline:* The commercial structure, as well as the technology utilized in the domestic energy sector is changing rapidly. An agile, adaptive team is required as the sector, and the business transforms. Attracting and retaining talent remained a challenge throughout 2019;
- *Extreme weather events and natural disasters:* environmental risks are of a growing risk value in our operations due to both likelihood and consequence. Establishing resilient infrastructure, reserve and insurance strategies remained a focus throughout 2019;
- *Substitute energy products and alternatives.* Renewable energy for baseload electricity applications in small island states are now a commercially viable, and a financial imperative. This will threaten the extant business models of power utilities and fossil fuel suppliers alike;
- *Low, or no cost energy transformation capital.* A significant inflow of aid has been targeted within the 2018 Energy Master Plan. The master plan seeks to reduce diesel fuel consumption for power generation by up to eighty (80%) over the coming decade. It will be difficult for the corporation to transform its business model by offering commercially competitive renewable energy alternatives against these free projects;

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- *Cyber security and Cyber Attacks* are increasing in frequency and complexity. The corporation has continued to be subject to an increased number of attacks in recent years. Technology remains a primary enabler of our competitiveness and any threat to our applications or the network will only increase the complexity, and costs of doing business;
- *Aging petroleum distribution infrastructure.* The assets of the corporation are aging, and while petroleum products remain the primary energy driver of the economy, need to undergo various upgrades to meet the current code requirements for such facilities.

Organizational resources continue to be allocated primarily towards risk management, and to reduce uncertainty in the business. The organizational risk architecture demonstrates five (5) levels of assurance that supports enhanced oversight of major and significant risks in the business.

Financial Condition

The Corporation continues to invest all operating surplus into capital improvement projects that are for mandatory compliance, reduction of operating risk, structural cost reduction, improvements in operational efficiency or investment into coconut industry development. We are able to attract competitive long-term financing to fund our proposed investments and obligations in the agricultural sector, as well as Phase III of the Asset Rehabilitation Program.

The following table summarizes the Corporation's consolidated financial position and results of operations as of and for the years ended December 31, 2019 and 2018. The financial position and results of operations as of and for the year ended December 31, 2017 represents FSMPC only, without VEI, which financial statements were not consolidated prior to January 1, 2018.

	2019	2018	2017 (Unconsolidated)
Assets:			
Capital assets, net	\$ 30,513,897	\$ 22,269,110	\$ 18,938,830
Cash	26,152,108	26,135,647	16,697,519
Inventory, net	12,023,399	15,602,384	6,031,288
Investments	2,524,009	2,131,619	2,300,339
Due from related parties	-	-	9,492,876
Receivables and other assets	6,898,329	6,334,213	5,401,352
Total Assets	\$ <u>78,111,742</u>	\$ <u>72,472,973</u>	\$ <u>58,862,204</u>
Liabilities and Net Position:			
Current liabilities	\$ 14,115,482	\$ 12,550,823	\$ 8,159,099
Noncurrent liabilities	10,159,997	10,159,402	4,067,394
Net Position:			
Net investment in capital assets	23,354,838	14,922,657	16,071,791
Unrestricted	30,481,425	34,840,091	30,563,920
Total Net Position	53,836,263	49,762,748	46,635,711
Total Liabilities and Net Position	\$ <u>78,111,742</u>	\$ <u>72,472,973</u>	\$ <u>58,862,204</u>
Revenues, Expenses and Changes in Net Position:			
Operating revenues	\$ 74,282,250	\$ 68,609,799	\$ 47,017,995
Cost of goods sold	(52,453,205)	(49,789,519)	(30,419,682)
Gross profit	21,829,045	18,820,280	16,598,313
Operating expenses	(17,701,800)	(16,537,026)	(11,828,896)
Nonoperating (expense) revenue, net	(53,730)	(1,426,777)	292,635
Change in net position	\$ <u>4,073,515</u>	\$ <u>856,477</u>	\$ <u>5,062,052</u>

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Major changes in the profit and loss and statement of net position components for CY19 are a result of:

- a) The Corporation increased its one-year term Line of Credit with Bank of Guam (BOG) from US\$10M to US\$11M. The short term note with banks remained at a zero balance in CY2019 as a result of prudent cash management. The Corporation continues to invest its operating surplus into capital expenditure to reduce operating risks and strengthen oil distribution infrastructure, into strategic oil inventory to increase the energy security of the nation, and to execution of its strategy (VT2025) for the long term sustainability of the Company;
- b) The higher operating expenses for 2019 are directly attributed to the support required for the various strategic planning initiatives implemented during the year;
- c) 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 in 2019 was \$11,887,258 as compared to \$2,068,568 in 2018;
- d) A total of \$11,965,238 was used for capital and related financing activities mainly for the purchase of capital assets. The Corporation's total net investments in capital assets, inclusive of construction in progress as of December 31, 2019 and 2018 were \$23,354,838 and \$14,922,657, respectively.

CAPITAL ASSETS AND DEBT MANAGEMENT

Capital Assets and Long-Term Debt: At the end of CY2019, the Corporation had \$30.5 million net invested in capital assets. This represents an increase in net capital assets (including additions and deletions) of \$8.2 million or 37% over the previous year. For additional information about the Corporation's capital assets, refer to Note 3 to the consolidated financial statements. The Corporation had a long-term debt of US\$8.4 million outstanding at December 31, 2019.

ECONOMIC OUTLOOK

Two main forms of energy are supplied in the market economy of FSM: fossil fuels by FSM Petroleum Corporation and electricity by four State owned power utilities, namely: Pohnpei Utility Corporation (PUC), Kosrae Utilities Authority (KUA), Yap State Public Services Corporation (YSPSC) and Chuuk Public Utility Corporation (CPUC). It was estimated in 2010 that around 55% of households are connected to the electricity network¹. This has remained largely unchanged throughout 2019 as energy efficiency and renewable energy projects under 2018 FSM Energy Master Plan remain in the pipeline and yet to be constructed.

A partnership with the Micronesian Conservation Trust (MCT) matured in 2019. The delivery of community awareness activities and farmer registration for the Coconut for Life program shows promising results, with a month-on-month improvement in the consistency, quantity, and quality of coconut tree products supplied to the Pohnpei plant. The Participatory Guarantee System (PGS) designed to aid in the coordination of farmers and management of community-based production has been successful, with a number of participating groups maturing to incorporated enterprises. It is expected that in 2020, we should see a further increase in coconut production by smallholder farmers, and an increase in the sale and exports of value added products manufactured at the Pohnpei facility.

¹ Expression of Interest to Participate in SREP, Micronesia Climate Investment Funds
https://www-cif.climateinvestmentfunds.org/sites/default/files/meeting-documents/federated_states_of_micronesia_eoi_0.pdf

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A Bill for an Act entitled the "Transformation Act" remains with the FSM Congress, and seeks to provide further support for a cleaner, greener economy. The proposed Act provides clarity and direction on the role of the FSMPC moving into the next decade, and the need to transform its business model from a successful fossil fuel importer and distributor to that of a i) low cost carbon free energy supplier, and ii) an exporter of high value agriculture products. It is in these areas that the corporation can obtain organic growth, as well as contribute to the economic development within the FSM.

Management's Discussion and Analysis for the year ended December 31, 2018 is set forth in the report on the audit of FSMPC's financial statements, which is dated July 9, 2019. That Discussion and Analysis explains the major factors impacting the 2018 financial statements and may be obtained from the contact show below.

CONTACT

Questions associated with the above Management's Discussion and Analysis may be sent by post, addressed to Mr. Johnny Adolph, Chief Financial Officer, P.O. Box 1762, Kolonia, Pohnpei, FSM 96941 or via email to petrocorp@fsmpc.com.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidated Statements of Net Position
December 31, 2019 and 2018

<u>ASSETS</u>	<u>2019</u>	<u>2018</u>
Current assets:		
Cash and cash equivalents	\$ 26,152,108	\$ 26,135,647
Time certificates of deposit	400,480	400,000
Trade receivables	2,859,622	2,219,163
Other receivables	197,523	88,091
Inventory, net	12,023,399	15,602,384
Prepaid expenses	1,897,560	1,966,190
Investments	<u>2,524,009</u>	<u>2,131,619</u>
Total current assets	46,054,701	48,543,094
Prepaid expenses, net of current portion	751,966	959,823
Other noncurrent asset	791,178	700,946
Capital assets:		
Nondepreciable capital assets	15,235,168	8,785,660
Other capital assets, net of accumulated depreciation	<u>15,278,729</u>	<u>13,483,450</u>
	<u>\$ 78,111,742</u>	<u>\$ 72,472,973</u>
 <u>LIABILITIES AND NET POSITION</u>		
Current liabilities:		
Current portion of long-term debt	\$ 987,694	\$ 1,296,575
Accounts payable - fuel	7,414,817	6,104,231
Accounts payable - other	1,291,364	946,366
Accrued liabilities and others	<u>4,421,607</u>	<u>4,203,651</u>
Total current liabilities	14,115,482	12,550,823
Long-term debt, net of current portion	7,371,365	7,729,878
Due to States and the FSM National Government	1,747,383	1,747,383
Other noncurrent liability	<u>1,041,249</u>	<u>682,141</u>
Total liabilities	<u>24,275,479</u>	<u>22,710,225</u>
Commitments and contingencies		
Net position:		
Net investment in capital assets	23,354,838	14,922,657
Unrestricted	<u>30,481,425</u>	<u>34,840,091</u>
Total net position	<u>53,836,263</u>	<u>49,762,748</u>
	<u>\$ 78,111,742</u>	<u>\$ 72,472,973</u>

See accompanying notes to consolidated financial statements.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidated Statements of Revenue, Expenses, and Changes in Net Position
Years Ended December 31, 2019 and 2018

	2019	2018
Operating revenues:		
Sales and service income	\$ 74,258,448	\$ 68,591,557
Other	23,802	18,242
	74,282,250	68,609,799
Cost of goods sold	52,453,205	49,789,519
Gross profit	21,829,045	18,820,280
Operating expenses:		
Salaries and benefits	3,737,596	3,675,974
Depreciation and amortization	2,632,139	2,046,436
Taxes	1,888,392	1,462,908
Rent	1,754,273	1,728,419
Professional fees	1,732,996	1,654,486
Repairs and maintenance	1,182,160	1,263,970
Insurance	950,507	842,261
Staff travel, training and development	831,397	931,100
Corporate governance, travel and entertainment	570,574	545,564
Communications	516,437	566,935
Contracted services	462,959	457,859
Utilities	278,719	265,350
Office supplies	263,446	253,147
Bank charges	182,178	172,990
Fuel	166,552	119,505
Miscellaneous	551,475	550,122
Total operating expenses	17,701,800	16,537,026
Operating income	4,127,245	2,283,254
Nonoperating (expenses) revenues:		
Foreign exchange losses, net	(121,530)	(1,072,551)
Investment income (losses), net	392,390	(168,719)
Other income	1,407	103,275
Interest (expense) income, net	(325,997)	(288,782)
Total nonoperating (expenses) revenues, net	(53,730)	(1,426,777)
Change in net position	4,073,515	856,477
Net position at beginning of year	49,762,748	48,906,271
Net position at end of year	\$ 53,836,263	\$ 49,762,748

See accompanying notes to consolidated financial statements.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidated Statements of Cash Flows
Years Ended December 31, 2019 and 2018

	2019	2018
Cash flows from operating activities:		
Cash received from customers	\$ 73,643,198	\$ 68,315,534
Cash paid to suppliers for goods and services	(58,018,344)	(62,570,992)
Cash paid to employees for services	(3,737,596)	(3,675,974)
Net cash provided by operating activities	11,887,258	2,068,568
Cash flows from capital and related financing activities:		
Interest paid on long-term debt	(420,918)	(415,668)
Proceeds from long-term debt	-	5,000,000
Repayment of long-term debt	(667,394)	(1,000,586)
Acquisition of capital assets	(10,876,926)	(5,237,670)
Net cash used for capital and related financing activities	(11,965,238)	(1,653,924)
Cash flows from investing activities:		
Increase in time certificates of deposit	(480)	-
Interest received	94,921	126,886
Net cash provided by investing activities	94,441	126,886
Net change in cash	16,461	541,530
Cash and cash equivalents at beginning of year	26,135,647	25,594,117
Cash and cash equivalents at end of year	\$ 26,152,108	\$ 26,135,647
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 4,127,245	\$ 2,283,254
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	2,632,139	2,046,436
Foreign exchange losses	(121,530)	(1,072,551)
Other income	1,407	103,275
(Increase) decrease in assets:		
Trade receivables	(640,459)	(397,540)
Other receivables	(109,432)	4,469
Inventory	3,578,985	(3,954,718)
Prepaid expenses	276,487	560,964
Other assets	(90,232)	(106,186)
Increase in liabilities:		
Accounts payable	1,655,584	2,312,006
Accrued liabilities and others	577,064	289,159
Net cash provided by operating activities	\$ 11,887,258	\$ 2,068,568

See accompanying notes to consolidated financial statements.

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

Notes to Consolidated Financial Statements
December 31, 2019 and 2018

(1) Organization and Basis of Presentation

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 oil and gas distribution for the entire FSM.

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 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.

Coconut Development Unit (CDU) was established through Public Law No. 18-68 enacted on June 16, 2014, which dissolved the FSM Coconut Development Authority (CDA) and transferred the responsibility of coconut development to FSMPC. Effective January 1, 2015, CDU started operations and was created as a division of FSMPC; therefore, its financial position and activities are included in FSMPC's financial statements.

Vital Energy, Inc. (VEI) was incorporated on February 10, 2012 in Guam for the purpose of carrying on the operation of importation and sale of petroleum products, and operation, management and maintenance of petroleum storage terminals, international marine bunkering services, operation of road and aviation bridging tankers, and aviation refueling operations. On May 22, 2015, VEI established Vital Energy, Inc. (Nauru) (the "Nauru Branch"), a foreign branch operation in the Republic of Nauru for the purpose of providing fuel supply and distribution in Nauru under an agreement with the Government of Nauru (GON). VEI's main operations are in Nauru during the years ended December 31, 2019 and 2018.

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

Basis of Accounting

The accounts of FSMPC are organized as a discretely presented component unit - proprietary fund of the FSM National Government. Proprietary funds are used by governmental units to account for operations that are financed and operated in a manner similar to a private business. This accounting is appropriate when costs of providing goods or services to the general public are to be financed primarily through user charges or where the periodic determination of net income is appropriate for accountability purposes. The accrual basis of accounting is utilized by proprietary funds. Under the accrual basis, revenues are recorded when earned, and expenses are recorded at the time the liabilities are incurred.

FSMPC utilizes the flow of economic resources measurement focus. Its financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units using the accrual basis of accounting. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

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Notes to Consolidated Financial Statements
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(1) Organization and Basis of Presentation, Continued

Basis of Accounting, Continued

The Statement of Net Position presents all of the FSMPC's assets and deferred outflows of resources, and liabilities and deferred inflows of resources, with the difference reported as net position. Net position is classified for accounting and reporting purposes into the following three net position categories:

- Net investment 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 as well as deferred outflows of resources and deferred inflows of resources that are attributable to those assets or related debt.
- Restricted - restricted assets reduced by liabilities and deferred inflows of resources related to those assets that are subject to externally imposed stipulations.
- Unrestricted - the net amount of the assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of net investment in capital assets or the restricted component of net position.

When both restricted and unrestricted resources are available for use for the same purposes, it is FSMPC's policy to use unrestricted resources first, then restricted resources as they are needed.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. All other revenues are reported as nonoperating. Operating expenses includes the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues 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.

(2) Summary of Significant Accounting Policies

A. Principles of Consolidation

The consolidated financial statements include the accounts of FSMPC and VEI. All significant intercompany transactions and balances have been eliminated in consolidation.

B. Cash and Cash Equivalents 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. The Company does not have a deposit policy for custodial credit risk.

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Notes to Consolidated Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

B. Cash and Cash Equivalents and Time Certificates of Deposit, Continued

For purposes of the consolidated statements of net position and of cash flows, cash and cash equivalents represent cash on hand, cash in bank accounts and time certificates of deposit with original maturity term up to ninety days. Time certificates of deposit with original maturity term over ninety days are separately classified. As of December 31, 2019 and 2018, total carrying amounts of cash and cash equivalents and time certificates of deposit were \$18,191,731 and \$20,567,916 respectively, and the corresponding bank balances were \$18,487,162 and \$20,583,334, respectively, which were maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2019 and 2018, bank deposits in the amount of \$500,000 were subject to FDIC insurance. Bank balances in excess of FDIC insurance are not collateralized.

Additionally, as of December 31, 2019 and 2018, cash and cash equivalents include deposits in AUD denominated accounts with Bendigo Adelaide Bank Limited (Bendigo), an authorized deposit-taking institution (ADI) subject to the Australian Government Financial Claims Scheme (FCS) of \$8,360,857 and \$5,967,731, respectively. FCS provides guarantee on deposits up to a limit of AUD\$250,000 for each account holder, which was extended to branches of Bendigo in Nauru. As of December 31, 2019 and 2018, bank deposits of approximately \$176,000 were subject to FCS guarantee. Balances in excess of FCS guarantee are not collateralized.

C. Investments

Investments held by the Company consist of money market funds, fixed income securities, exchange-traded funds, and common stock. Investments and related investment earnings or loss are recorded at fair value using quoted market prices. Fair value is the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the date of which the fair value of an asset or liability is determined.

As of December 31, 2019 and 2018, investments at fair value are as follows:

	<u>2019</u>	<u>2018</u>
Fixed income securities:		
Domestic fixed income	\$ 524,016	\$ 478,941
International fixed income	<u>208,123</u>	<u>207,799</u>
	<u>732,139</u>	<u>686,740</u>
Other investments:		
Common equities	1,075,347	887,663
Exchange traded funds	663,159	508,989
Money market funds	<u>53,364</u>	<u>48,227</u>
	<u>1,791,870</u>	<u>1,444,879</u>
	\$ <u>2,524,009</u>	\$ <u>2,131,619</u>

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Notes to Consolidated Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

C. Investments, Continued

As of December 31, 2019, the Company's fixed income securities had the following maturities:

<u>Investment Type</u>	<u>Fair value</u>	<u>Less than 1 year</u>	<u>1 to 5 years</u>	<u>5 to 10 years</u>	<u>More than 10 years</u>
International bonds	\$ 208,123	\$ 208,123	\$ -	\$ -	\$ -
Corporate bonds	211,177	-	-	194,568	16,609
U.S. Government Agency Bonds	<u>312,839</u>	<u>-</u>	<u>89,141</u>	<u>165,404</u>	<u>58,294</u>
	<u>\$ 732,139</u>	<u>\$ 208,123</u>	<u>\$ 89,141</u>	<u>\$ 359,972</u>	<u>\$ 74,903</u>

As of December 31, 2018, the Company's fixed income securities had the following maturities:

<u>Investment Type</u>	<u>Fair value</u>	<u>Less than 1 year</u>	<u>1 to 5 years</u>	<u>5 to 10 years</u>	<u>More than 10 years</u>
International bonds	\$ 207,799	\$ 207,799	\$ -	\$ -	\$ -
Corporate bonds	200,506	14,664	14,726	145,761	25,355
U.S. Government Agency Bonds	<u>278,435</u>	<u>-</u>	<u>177,511</u>	<u>61,013</u>	<u>39,911</u>
	<u>\$ 686,740</u>	<u>\$ 222,463</u>	<u>\$ 192,237</u>	<u>\$ 206,774</u>	<u>\$ 65,266</u>

The Company's exposure to credit risk at December 31, 2019 and 2018, was as follows:

<u>Moody's Rating</u>	<u>2019</u>	<u>2018</u>
AAA	\$ 312,839	\$ 278,436
A2	65,430	44,887
A3	64,401	72,862
BAA1	16,609	40,167
BAA2	48,795	28,570
BAA3	15,942	14,019
Not rated	<u>208,123</u>	<u>207,799</u>
	<u>\$ 732,139</u>	<u>\$ 686,740</u>

The Company categorizes its fair value measurements within the fair value hierarchy established by GAAP. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

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(2) Summary of Significant Accounting Policies, Continued

C. Investments, Continued

The Company has the following recurring fair value measurements as of December 31, 2019 and 2018:

	<u>Fair Value Measurements Using</u>			
	December 31, 2019	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobserva ble Inputs (Level 3)
Investments by fair value level:				
Fixed income securities	\$ 732,139	\$ -	\$ 732,139	\$ -
Equity securities	1,075,347	1,075,347	-	-
Exchange-traded funds	<u>663,159</u>	<u>663,159</u>	-	-
Total investments by fair value level	2,470,645	\$ <u>1,738,506</u>	\$ <u>732,139</u>	\$ <u>-</u>
Investments measured at amortized cost:				
Money market funds	<u>53,364</u>			
	\$ <u>2,524,009</u>			

	<u>Fair Value Measurements Using</u>			
	December 31, 2018	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobserva ble Inputs (Level 3)
Investments by fair value level:				
Fixed income securities	\$ 686,740	\$ -	\$ 686,740	\$ -
Equity securities	887,663	887,663	-	-
Exchange-traded funds	<u>508,989</u>	<u>508,989</u>	-	-
Total investments by fair value level	2,083,392	\$ <u>1,396,652</u>	\$ <u>686,740</u>	\$ <u>-</u>
Investments measured at amortized cost:				
Money market funds	<u>48,227</u>			
	\$ <u>2,131,619</u>			

D. Accounts Receivable

Accounts receivable are due from businesses and individuals located primarily in the FSM and Nauru and are interest free and uncollateralized, except those from utility companies. 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. Bad debts are written-off against the allowance based on the specific identification method. At December 31, 2019 and 2018, accounts receivables are net of an allowance for doubtful accounts of \$0 and \$23,053, respectively.

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(2) Summary of Significant Accounting Policies, Continued

E. Inventory

Inventory on hand is substantially carried at the lower of cost (moving average cost) or market value. Inventory in transit is recorded at invoiced cost.

At December 31, 2019 and 2018, inventory consists of the following:

	<u>2019</u>	<u>2018</u>
Inventory on hand:		
Fuel	\$ 9,106,288	\$ 12,099,502
Lubricants	380,122	484,522
Chemicals	44,607	83,042
Others	<u>975,636</u>	<u>521,011</u>
	10,506,653	13,188,077
Inventory in transit - fuel	<u>1,567,333</u>	<u>2,464,894</u>
	12,073,986	15,652,971
Less allowance for obsolescence	<u>(50,587)</u>	<u>(50,587)</u>
	<u>\$ 12,023,399</u>	<u>\$ 15,602,384</u>

F. Prepaid Expenses

Advance payments relating to goods and services not yet received are recorded as prepaid expenses. Prepayments that are expected to be utilized beyond one year, mainly relating to prepaid land leases (see Note 10), are presented as noncurrent assets.

G. 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:

Buildings	15 years
Leasehold improvements	11 years
Motor vehicles	5 years
Plant and equipment	3 to 15 years
Furniture and fixtures	4 to 7 years
Office equipment	4 to 8 years
Machinery and equipment	4 to 7 years
Boats and vessels	5 to 10 years

H. 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 asset cost until such time as the assets are placed in service. The Company did not capitalize interest for the years ended December 31, 2019 and 2018.

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Notes to Consolidated Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

I. Taxes

FSMPC is responsible for gross receipt taxes, sales taxes and import taxes on its operations in the FSM.

VEI is taxed and files its income tax return in Guam. The Guam income tax code is similar to that of the United States of America. The Company also pays a Business Profits Tax (BPT) in Nauru under the Republic of Nauru Business Tax Act (the "Act"). BPT is calculated as 20% of taxable income at June 30, 2018, and increased to 25% at June 30, 2019, as defined in the Act, for non-resident companies conducting business in Nauru through Permanent establishment. BPT is taken as a foreign tax credit (FTC) on the Guam income tax return, with certain limitations. BPT and provisions for Guam income taxes are presented as a component of taxes in the consolidated statements of revenues, expenses and changes in net position.

For VEI's income tax returns on Guam, deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and net operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. At December 31, 2019 and 2018, the majority of VEI's deferred income tax assets relate to FTC carryovers of approximately \$121,000 and \$133,000, respectively, expiring through 2029, and are included as a component of other noncurrent assets in the accompanying consolidated statements of net position.

J. Revenue Recognition

The Company's revenues are derived mainly from sale of fuel. Fuel sales are recognized when charged to customers' charge accounts and when merchandise is delivered to customers and title is passed and collectability is reasonably assured.

K. New Accounting Standards

During the year ended December 31, 2019, the Company implemented the following pronouncements:

- GASB Statement No. 83, *Certain Asset Retirement Obligations*, which addresses accounting and financial reporting for certain asset retirement obligations (AROs) associated with the retirement of a tangible capital asset. The implementation of this statement did not have a material effect on the accompanying consolidated financial statements.
- GASB Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*, which improves the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. The implementation of this statement did not have a material effect on the accompanying consolidated financial statements but resulted in additional disclosures (see note 6).

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(2) Summary of Significant Accounting Policies, Continued

K. New Accounting Standards, Continued

- GASB Statement No. 90, *Majority Equity Interests - an Amendment of GASB Statements No. 14 and No. 61*, which improves the consistency and comparability of reporting a government's majority equity interest in a legally separate organization and the relevance of financial statement information for certain component units. As a result of the implementation, the Company re-evaluated the financial statement presentation of VEI, resulting in a consolidated financial statement presentation with VEI reported as a subsidiary of the Company. As a result of the change, the 2018 financial statements have also been consolidated.

In January 2017, GASB issued Statement No. 84, *Fiduciary Activities*, which establishes criteria for identifying fiduciary activities of all state and local governments. The provisions in Statement No. 84 are effective for fiscal years beginning after December 15, 2018. Management does not believe that the implementation of this statement will have a material effect on the consolidated financial statements.

In June 2017, GASB issued Statement No. 87, *Leases*, which establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. The provisions in Statement No. 87 are effective for fiscal years beginning after December 15, 2019. Management has yet to determine whether the implementation of this statement will have a material effect on the consolidated financial statements.

In June 2018, GASB issued Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*, which requires that interest cost incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. The provisions in Statement No. 89 are effective for fiscal years beginning after December 15, 2019. Management does not believe that the implementation of this statement will have a material effect on the consolidated financial statements.

In May 2019, GASB issued Statement No. 91, *Conduit Debt Obligations*, which clarifies the existing definition of a conduit debt obligation; establishing that a conduit debt obligation is not a liability of the issuer; establishing standards for accounting and financial reporting of additional commitments and voluntary commitments extended by issuers and arrangements associated with conduit debt obligations; and improving required note disclosures. The provisions in Statement No. 91 are effective for fiscal years beginning after December 15, 2020. Management does not believe that the implementation of this statement will have a material effect on the consolidated financial statements.

In May 2020, GASB issued Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, which postpones the effective dates of GASB Statement No. 84, 89, 90 and 91 by one year and GASB Statement No. 87 by 18 months; however, earlier application of the provisions addressed in GASB Statement No. 95 is encouraged and is permitted to the extent specified in each pronouncement as originally issued. With the exception of GASB Statement No. 90, management has yet to ascertain whether implementation of these statements will be postponed as provided in GASB Statement No. 95.

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Notes to Consolidated Financial Statements
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(2) Summary of Significant Accounting Policies, Continued

L. Management Estimates

The preparation of financial statements in conformity with GAAP 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(3) Capital Assets

Capital asset activities for the years ended December 31, 2019 and 2018 are as follows:

	<u>Balance at January 1, 2019</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at December 31, 2019</u>
Buildings	\$ 1,141,431	\$ 899,549	\$ -	\$ 2,040,980
Leasehold improvements	26,191	-	-	26,191
Motor vehicles	1,782,612	288,628	-	2,071,240
Plant and equipment	14,008,111	939,903	-	14,948,014
Furniture and fixtures	377,275	18,528	-	395,803
Office equipment	7,642,620	520,259	-	8,162,879
Machinery and equipment	1,314,418	626,132	-	1,940,550
Boats and vessels	<u>-</u>	<u>1,134,419</u>	<u>-</u>	<u>1,134,419</u>
	26,292,658	4,427,418	-	30,720,076
Less accumulated depreciation	<u>(12,809,208)</u>	<u>(2,632,139)</u>	<u>-</u>	<u>(15,441,347)</u>
	13,483,450	1,795,279	-	15,278,729
Construction in progress	<u>8,785,660</u>	<u>9,416,562</u>	<u>(2,967,054)</u>	<u>15,235,168</u>
	<u>\$ 22,269,110</u>	<u>\$ 11,211,841</u>	<u>\$ (2,967,054)</u>	<u>\$ 30,513,897</u>
	<u>Balance at January 1, 2018</u>	<u>Transfers and Additions</u>	<u>Transfers and Deletions</u>	<u>Balance at December 31, 2018</u>
Buildings	\$ 1,052,403	\$ 89,028	\$ -	\$ 1,141,431
Leasehold improvements	-	26,191	-	26,191
Motor vehicles	1,575,559	207,053	-	1,782,612
Plant and equipment	13,318,781	689,434	(104)	14,008,111
Furniture and fixtures	332,288	45,542	(555)	377,275
Office equipment	5,425,679	2,221,482	(4,541)	7,642,620
Machinery and equipment	<u>1,053,849</u>	<u>260,694</u>	<u>(125)</u>	<u>1,314,418</u>
	22,758,559	3,539,424	(5,325)	26,292,658
Less accumulated depreciation	<u>(10,768,097)</u>	<u>(2,046,436)</u>	<u>5,325</u>	<u>(12,809,208)</u>
	11,990,462	1,492,988	-	13,483,450
Construction in progress	<u>7,087,413</u>	<u>4,811,921</u>	<u>(3,113,674)</u>	<u>8,785,660</u>
	<u>\$ 19,077,875</u>	<u>\$ 6,304,909</u>	<u>\$ (3,113,674)</u>	<u>\$ 22,269,110</u>

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(4) Due to States and the FSM National Government

In 2008, the FSMNG was extended a ¥200,000,000 grant by the Government of Japan ("the Grant"). The Grant and accrued interest shall be used by the FSMNG properly and exclusively for the purchase of products enumerated in a list to be mutually agreed upon between the two governments. The Grant shall be received by the FSMNG in Yen currency, shall be used as described above within a period of twelve months and any excess amounts shall be refunded to the Government of Japan thereafter. The FSMNG is required to deposit in Micronesian currency (US dollars) 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 the FSM.

In 2009, FSMPC signed a memorandum of agreement with the 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 the FSMNG. FSMPC received the equivalent gallons of fuel from the supplier and this is now maintained as strategic inventory in each State. As of December 31, 2019 and 2018, FSMPC recognized a liability to the States and the FSMNG of \$1,247,383.

At December 31, 2019 and 2018, the remaining \$500,000 represents a non-interest bearing advance payable to the FSMNG. There is no specific repayment terms and management has classified the advance as long-term since it has no expectation that such will have to be repaid before December 31, 2020.

(5) Short-Term Borrowings

As of December 31, 2019 and 2018, the Company has a bank standby letter of credit (LC) of \$3,000,000, expiring on September 13, 2020 and September 13, 2019, respectively, in favor of Mobile Oil Guam in relation to its fuel purchase agreement. Additionally, the Company also has a standby LC of \$6,034,500 for the coconut production facility contractor, expiring on September 28, 2020.

Additionally, as of December 31, 2019 and 2018, the Company has bank line of credit (LOC) facility of \$11,000,000 for working capital and support LC's, expiring on February 11, 2021.

The LOCs and the related long-term obligations 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.

Borrowings against the LOCs bear interest at the bank's effective reference rate plus 0.75%, with minimum rate of 5.75% per annum, with interest payable monthly and principal due within 180 days. No borrowings are outstanding against the LOCs at December 31, 2019 and 2018.

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(6) Long-term Debt

Long-term debt consists of the following at December 31 2019 and 2018:

	<u>2019</u>	<u>2018</u>
<p>A \$5,000,000 bank note from the Bank of Guam (BOG), dated December 2017, for capital asset projects. The loan bears interest fixed at 5.75% per annum and is payable in monthly installments of \$55,214 beginning January 20, 2018 to December 20, 2027. In June 27, 2019, BOG approved deferment of principal payments from June 2019 to June 2020 and changes in interest fixed at 6.25% per annum and monthly installments of \$61,865. The loan is 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.</p>	\$ 4,418,874	\$ 4,606,268
<p>A \$3,000,000 bank note from the FSM Development Bank (FSMDB), dated August 2017, a component unit of the FSM National Government, for capital asset projects. The loan bears interest fixed at 5% per annum and is payable in quarterly installments of \$170,461 beginning August 31, 2017 to September 25, 2022. On May 1, 2018, FSMDB approved FSMPC's request for deferment of principal payment from June 2018 to June 2019. On June 24, 2019, FSMDB approved another principal payment deferment up to June 2020. The loan is collateralized by the Company's inventories and related petroleum products.</p>	2,740,185	2,740,185
<p>A \$2,400,000 non-interest bearing, uncollateralized advance from VEI's business partner to fund capital project expenditures incurred on behalf of the GON under the Agreement (see Note 9). The advance is payable in equal quarterly installments of \$120,000, beginning on September 5, 2017.</p>	<u>1,200,000</u>	<u>1,680,000</u>
<p>Total long-term debt</p> <p>Net of current portion</p>	8,359,059 <u>987,694</u>	9,026,453 <u>1,296,575</u>
	\$ <u>7,371,365</u>	\$ <u>7,729,878</u>

**FEDERATED STATES OF MICRONESIA
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Notes to Consolidated Financial Statements
December 31, 2019 and 2018

(6) Long-term Debt, Continued

At December 31, 2019, future minimum loan repayments are as follows:

<u>Year Ending December 31,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2020	\$ 987,694	\$ 276,179	\$ 1,263,873
2021	1,540,235	363,985	1,904,220
2022	1,361,270	302,951	1,664,221
2023	1,185,873	238,348	1,424,221
2024	1,263,595	170,593	1,434,188
2025-2027	<u>2,020,392</u>	<u>257,179</u>	<u>2,277,571</u>
	\$ <u>8,359,059</u>	\$ <u>1,609,235</u>	\$ <u>9,968,294</u>

Debt Covenants

The BOG loan includes covenants relating to timely submission of audited financial and other information as the lender may reasonably request. The Company is also covenanted to, at all times, permit lender through its agents and representatives to visit and inspect properties; maintain and keep in full force and effect its existence, rights and franchise and comply with all laws applicable to the Company; pay or cause to be paid all taxes, assessments and other governmental charges levied upon any of the Company's properties, obtain hazard and liability insurance and other covenants.

The FSMDB loan requires the Company to purchase credit life insurance for its Chief Executive Officer for the coverage of the entire loan, assigning the lender as first beneficiary. The Company is also required to maintain insurance for on security for the loan and to maintain aggregate loan value of at least 120% of loan amount.

VEI's note payable to its business partner requires, as a security of repayment, an irrevocable stand by letter of credit, which is acceptable by the lender's bank in an amount not less than the loan and the lender as beneficiary.

Events of default – the debt agreements specify number of events of default and related remedies. Generally, in the event for default, the lenders reserve the right to accelerate the loan maturities in order to protect their interest or demand immediate settlement. The lenders collateral position must be a first lien on the Company's assets.

Management believes that the Company is in compliance with all covenants as of and for the years ended December 31, 2019 and 2018, and no event of default has been declared by the lenders.

Unused Credit Line

As of December 31, 2019, the Company has an approved long-term debt facility of \$3,000,000 to fund a project. The loan bears interest fixed at 5.5% per annum and maturity date of April 25, 2025. No borrowings are outstanding against this facility at December 31, 2019.

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Notes to Consolidated Financial Statements
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(6) Long-term Debt, Continued

Changes in long-term debt for the years ended December 31, 2019 and 2018 are as follows:

	Balance at January 1, 2019	<u>Additions</u>	<u>Repayments</u>	Balance at December 31, 2019	Due Within <u>One Year</u>
Long-term debt	\$ <u>9,026,453</u>	\$ <u> - </u>	\$ <u>(667,394)</u>	\$ <u>8,359,059</u>	\$ <u>987,694</u>
	Balance at January 1, 2018	<u>Additions</u>	<u>Repayments</u>	Balance at December 31, 2018	Due Within <u>One Year</u>
Long-term debt	\$ <u>5,027,039</u>	\$ <u>5,000,000</u>	\$ <u>(1,000,586)</u>	\$ <u>9,026,453</u>	\$ <u>1,296,575</u>

(7) Changes in Other Long-Term Liabilities

Changes in other long-term liabilities for the years ended December 31, 2019 and 2018 are as follows:

	Balance at January 1, 2019	<u>Additions</u>	<u>Repayments</u>	Balance at December 31, 2019	Due Within <u>One Year</u>
Due to States and the FSM National Government	\$ 1,747,383	\$ -	\$ -	\$ 1,747,383	\$ -
Other noncurrent liability	<u>682,141</u>	<u>4,590,693</u>	<u>(4,231,585)</u>	<u>1,041,249</u>	<u>-</u>
	\$ <u>2,429,524</u>	\$ <u>4,590,693</u>	\$ <u>(4,231,585)</u>	\$ <u>2,788,632</u>	\$ <u>-</u>
	Balance at January 1, 2018	<u>Additions</u>	<u>Repayments</u>	Balance at December 31, 2018	Due Within <u>One Year</u>
Due to States and the FSM National Government	\$ 1,747,383	\$ -	\$ -	\$ 1,747,383	\$ -
Other noncurrent liability	<u>463,844</u>	<u>3,976,502</u>	<u>(3,758,205)</u>	<u>682,141</u>	<u>-</u>
	\$ <u>7,246,266</u>	\$ <u>3,976,502</u>	\$ <u>(3,766,205)</u>	\$ <u>2,429,524</u>	\$ <u>-</u>

(8) Risk Management

Insurance Risk

FSMPC 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.

VEI purchases commercial insurance to cover potential risks from managing, operating and maintaining the Government of Nauru bulk fuel facilities. VEI 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.

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(8) Risk Management, Continued

Foreign Currency Risk

VEI's transactions through its Nauru branch are settled in a foreign currency. VEI is exposed to the risk of unfavorable changes in the exchange rate that may occur.

(9) Concentration Risk and Significant Customers

The Company's revenue from three major customers approximated 27% and 28% of the Company's consolidated revenues for the years ended December 31, 2019 and 2018, respectively. Receivables from the three major customers totaled \$1,382,364 and \$1,025,132 as of December 31, 2019 and 2018, respectively.

FSMPC and VEI purchased substantially all fuel from two suppliers in 2019 and 2018.

Government of Nauru (GON)

Effective June 1, 2015, VEI entered into a Petroleum Supply and Facility Management Agreement (the Agreement) with the GON for a period of five years, with an option to extend for another five years. The Company was appointed to perform: (a) procure the supply of fuel and delivery to the facilities, (b) operate and maintain the facilities for the receipt, storage and distribution of products, (c) sell and distribute products to meet all inland demand, and (d) provide expert advice, technical assistance and other services as GON may reasonably require in related to the matters of the agreement. The Company uses nine tankers in GON's facilities at the storage terminal located in Aiwo District, Republic of Nauru.

The Agreement allows VEI to charge prices based on Nauru Price Template (NPT). For the years ended December 31, 2019 and 2018, Vital recorded fuel sales of \$17.6 million and \$15.7 million, respectively. As of December 31, 2019 and 2018, Vital recorded mooring fees liability of \$82,969 and \$148,489, respectively, and throughput fee liability of \$958,280 and \$533,652, respectively, for the purpose of funding the facilities' mooring system repairs and improvements and Compliance and Integrity Projects, which are included in the other noncurrent liability account in the accompanying consolidated statements of net position.

In April 2020, as per agreement with GON, the Company requested for another 5-year extension under existing terms and conditions. GON has provided a favorable reply with the request. During the extended term, the Agreement is cancellable by either party with a one-year notice.

Additionally, effective November 1, 2018, VEI entered into a Nauru Utilities Corporation (NUC) price subsidy agreement with GON.

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(10) Commitments and Contingencies

Leases

FSMPC leases land, warehouse, airport facilities and other such space through various leases expiring through 2038. Certain lease agreements contain options to renew with rent escalations. Three lease agreements require additional lease payments contingent on the level of gallons sold by the Company from that leased facility. In 2019 and 2018, the Company entered into one and sixteen lease agreements, respectively, for land situated on Tonoas Island, Chuuk State, for the new CDU project site. The agreements have an initial term of twenty-years, with certain options to renew, and require an initial seven-year prepayment. At December 31, 2019 and 2018, unamortized balance of prepayments totaling \$963,898 and \$1,171,755, respectively, of which \$211,932 is presented as current in the accompanying consolidated statements of net position.

In connection with VEI's exclusive right to access, use and occupy the GON bulk fuel facilities, VEI is required to pay annual rent fee of \$529,168 over the 5-year term of the agreement from June 1, 2015 to May 31, 2020, which was subsequently extended.

Future minimum lease payments are as follows, including the subsequent renewal of GON lease:

<u>Year Ending December 31,</u>	
2020	\$ 1,061,000
2021	995,000
2022	977,000
2023	861,000
2024	696,000
2025-2029	2,061,000
2030-2034	1,168,000
2035-2038	<u>544,000</u>
	\$ <u>8,363,000</u>

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.

Litigation

The Company is a defendant in several legal actions. The ultimate outcome is presently undeterminable; however, Company management is of the opinion that resolution of these matters will not have a material effect on the accompanying consolidated financial statements.

Joint Venture

On April 24, 2018, the Company and SB Energy Corporation signed an indicative term sheet for a Joint Venture (JV) relating to a project to construct and operate a solar facility and energy storage system in State of Chuuk in the FSM. As of December 31, 2019, final JV agreement is still under negotiation and no transactions have been recorded in the accompanying consolidated financial statements.

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(11) Related Parties

FSMPC sells fuel to the four utility companies in the FSM namely: Pohnpei Utilities Corporation, Chuuk Public Utility Corporation, Kosrae Utility Authority, and Yap State Public Service Corporation. Total fuel sales of \$17 million and \$17.2 million were generated from the four utility companies for the years ended December 31, 2019 and 2018, respectively. As of December 31, 2019 and 2018, FSMPC has total receivables of \$1.4 million and \$1 million, respectively, from the four utility companies. In addition, as of December 31, 2019 and 2018, FSMPC has accrued liabilities in the form of letters of credit to the Pohnpei Utilities Corporation and Chuuk Public Utility Corporation totaling \$1,330,800, in connection with fuel purchases price variances, which are included as a component of accrued liabilities and others in the accompanying consolidated statements of net position.

(12) Condensed Financial Information for Discretely Presented Component Units

The condensed financial information for Vital Energy, Inc. is presented below as of and for the years ended December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Assets:		
Cash, receivables and other assets	\$ 13,924,061	\$ 15,317,140
Capital assets, net	<u>257,889</u>	<u>217,193</u>
Total assets	<u>14,181,950</u>	<u>15,534,333</u>
Liabilities:		
Accounts payable and other current liabilities	1,188,165	3,204,437
Due to primary government	8,932,300	8,471,247
Long-term liabilities	<u>2,241,249</u>	<u>2,362,141</u>
Total liabilities	<u>12,361,714</u>	<u>14,037,825</u>
Net position:		
Net investment in capital assets	257,889	217,193
Unrestricted	<u>1,562,347</u>	<u>1,279,315</u>
	<u>\$ 1,820,236</u>	<u>\$ 1,496,508</u>
Gross profit	\$ 3,424,377	\$ 3,033,798
Operating expenses:		
Depreciation	73,911	60,278
Other operating expenses	<u>2,949,620</u>	<u>2,845,062</u>
Operating income	400,846	128,458
Non operating revenues (expenses)	<u>(77,118)</u>	<u>(902,510)</u>
Change in net position	323,728	(774,052)
Beginning net position	<u>1,496,508</u>	<u>2,270,560</u>
Ending net position	<u>\$ 1,820,236</u>	<u>\$ 1,496,508</u>

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(13) Subsequent Event

As a result of the spread of the COVID-19 coronavirus, governments worldwide implemented actions to restrict travel and economic activities. Uncertainties have arisen, which may have negative impact on the Company's financial and operational results. Such potential impacts are unknown at this time.

Management has considered subsequent events through June 19, 2020, upon which the financial statements were available to be issued. Except for the renewal of the GNO Agreement as discussed in note 9 and the matter discussed above, there are no other material subsequent events that would require recognition or disclosure in the consolidated financial statements for the year ended December 31, 2019.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidating Statement of Net Position
December 31, 2019

<u>ASSETS</u>	FSMPC	Vital	Eliminations	Consolidated
Current assets:				
Cash and cash equivalents	\$ 17,718,648	\$ 8,433,460	\$ -	\$ 26,152,108
Time certificates of deposit	-	400,480	-	400,480
Trade receivables	2,236,702	622,920	-	2,859,622
Due from component unit	2,574,559	-	(2,574,559)	-
Other receivables	197,523	-	-	197,523
Inventory, net	7,823,665	4,199,734	-	12,023,399
Prepaid expenses	1,751,093	146,467	-	1,897,560
Investments	2,524,009	-	-	2,524,009
Total current assets	34,826,199	13,803,061	(2,574,559)	46,054,701
Prepaid expenses, net of current portion	751,966	-	-	751,966
Due from component unit, net of current portion	6,357,741	-	(6,357,741)	-
Other noncurrent asset	670,178	121,000	-	791,178
Capital assets:				
Nondepreciable capital assets	15,235,168	-	-	15,235,168
Other capital assets, net of accumulated depreciation	15,020,840	257,889	-	15,278,729
	\$ 72,862,092	\$ 14,181,950	\$ (8,932,300)	\$ 78,111,742
<u>LIABILITIES AND NET POSITION</u>				
Current liabilities:				
Current portion of long-term debt	\$ 507,694	\$ 480,000	\$ -	\$ 987,694
Accounts payable - fuel	7,414,817	-	-	7,414,817
Accounts payable - other	1,222,169	69,195	-	1,291,364
Due to primary government	-	2,574,559	(2,574,559)	-
Accrued liabilities and others	3,302,637	1,118,970	-	4,421,607
Total current liabilities	12,447,317	4,242,724	(2,574,559)	14,115,482
Long-term debt, net of current portion	6,651,365	720,000	-	7,371,365
Due to primary government, net of current portion	-	6,357,741	(6,357,741)	-
Due to States and the FSM National Government	1,747,383	-	-	1,747,383
Other noncurrent liability	-	1,041,249	-	1,041,249
Total liabilities	20,846,065	12,361,714	(8,932,300)	24,275,479
Commitments and contingencies				
Net position:				
Net investment in capital assets	23,096,949	257,889	-	23,354,838
Unrestricted	28,919,078	1,562,347	-	30,481,425
Total net position	52,016,027	1,820,236	-	53,836,263
	\$ 72,862,092	\$ 14,181,950	\$ (8,932,300)	\$ 78,111,742

See accompanying Independent Auditors' Report.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidating Statement of Revenue, Expenses, and Changes in Net Position
Year Ended December 31, 2019

	FSMPC	Vital	Eliminations	Consolidated
Operating revenues:				
Sales and service income	\$ 56,137,885	\$ 18,120,563	\$ -	\$ 74,258,448
Other	454,786	-	(430,984)	23,802
	<u>56,592,671</u>	<u>18,120,563</u>	<u>(430,984)</u>	<u>74,282,250</u>
Cost of goods sold	<u>37,757,019</u>	<u>14,696,186</u>	<u>-</u>	<u>52,453,205</u>
Gross profit	<u>18,835,652</u>	<u>3,424,377</u>	<u>(430,984)</u>	<u>21,829,045</u>
Operating expenses:				
Salaries and benefits	3,450,452	287,144	-	3,737,596
Depreciation and amortization	2,558,228	73,911	-	2,632,139
Taxes	1,602,392	286,000	-	1,888,392
Rent	1,273,303	480,970	-	1,754,273
Professional fees	1,544,610	188,386	-	1,732,996
Repairs and maintenance	1,035,557	146,603	-	1,182,160
Insurance	372,374	578,133	-	950,507
Staff travel, training and development	831,397	-	-	831,397
Corporate governance, travel and entertainment	467,595	102,979	-	570,574
Communications	391,389	125,048	-	516,437
Contracted services	347,644	115,315	-	462,959
Utilities	238,144	40,575	-	278,719
Office supplies	234,846	28,600	-	263,446
Bank charges	146,774	35,404	-	182,178
Fuel	121,834	44,718	-	166,552
Corporate office shared services	-	430,984	(430,984)	-
Miscellaneous	492,714	58,761	-	551,475
Total operating expenses	<u>15,109,253</u>	<u>3,023,531</u>	<u>(430,984)</u>	<u>17,701,800</u>
Operating income	<u>3,726,399</u>	<u>400,846</u>	<u>-</u>	<u>4,127,245</u>
Nonoperating (expenses) revenues:				
Foreign exchange	-	(121,530)	-	(121,530)
Investment income	392,390	-	-	392,390
Other income	-	1,407	-	1,407
Interest (expense) income, net	<u>(369,002)</u>	<u>43,005</u>	<u>-</u>	<u>(325,997)</u>
Total nonoperating (expenses) revenues, net	<u>23,388</u>	<u>(77,118)</u>	<u>-</u>	<u>(53,730)</u>
Change in net position	3,749,787	323,728	-	4,073,515
Net position at beginning of year	<u>48,266,240</u>	<u>1,496,508</u>	<u>-</u>	<u>49,762,748</u>
Net position at end of year	<u>\$ 52,016,027</u>	<u>\$ 1,820,236</u>	<u>\$ -</u>	<u>\$ 53,836,263</u>

See accompanying Independent Auditors' Report.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidating Statement of Net Position
December 31, 2018

<u>ASSETS</u>	<u>FSMPC</u>	<u>Vital</u>	<u>Eliminations</u>	<u>Consolidated</u>
Current assets:				
Cash and cash equivalents	\$ 20,018,916	\$ 6,116,731	\$ -	\$ 26,135,647
Time certificates of deposit	-	400,000	-	400,000
Trade receivables	1,772,508	446,655	-	2,219,163
Due from component unit	1,931,856	-	(1,931,856)	-
Other receivables	88,091	-	-	88,091
Inventory, net	7,716,159	7,886,225	-	15,602,384
Prepaid expenses	1,631,661	334,529	-	1,966,190
Investments	2,131,619	-	-	2,131,619
Total current assets	35,290,810	15,184,140	(1,931,856)	48,543,094
Prepaid expenses, net of current portion	959,823	-	-	959,823
Due from component unit, net of current portion	6,539,391	-	(6,539,391)	-
Other noncurrent asset	567,946	133,000	-	700,946
Capital assets:				
Nondepreciable capital assets	8,785,660	-	-	8,785,660
Other capital assets, net of accumulated depreciation	13,266,257	217,193	-	13,483,450
	\$ 65,409,887	\$ 15,534,333	\$ (8,471,247)	\$ 72,472,973
<u>LIABILITIES AND NET POSITION</u>				
Current liabilities:				
Current portion of long-term debt	\$ 816,575	\$ 480,000	\$ -	\$ 1,296,575
Accounts payable - fuel	3,761,344	2,342,887	-	6,104,231
Accounts payable - other	882,254	64,112	-	946,366
Due to primary government	-	1,931,856	(1,931,856)	-
Accrued liabilities and others	3,406,213	797,438	-	4,203,651
Total current liabilities	8,866,386	5,616,293	(1,931,856)	12,550,823
Long-term debt, net of current portion	6,529,878	1,200,000	-	7,729,878
Due to primary government, net of current portion	-	6,539,391	(6,539,391)	-
Due to States and the FSM National Government	1,747,383	-	-	1,747,383
Other noncurrent liability	-	682,141	-	682,141
Total liabilities	17,143,647	14,037,825	(8,471,247)	22,710,225
Commitments and contingencies				
Net position:				
Net investment in capital assets	14,705,464	217,193	-	14,922,657
Unrestricted	33,560,776	1,279,315	-	34,840,091
Total net position	48,266,240	1,496,508	-	49,762,748
	\$ 65,409,887	\$ 15,534,333	\$ (8,471,247)	\$ 72,472,973

See accompanying Independent Auditors' Report.

FEDERATED STATES OF MICRONESIA PETROLEUM CORPORATION AND SUBSIDIARY
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Consolidating Statement of Revenue, Expenses, and Changes in Net Position
Year Ended December 31, 2018

	FSMPC	Vital	Eliminations	Consolidated
Operating revenues:				
Sales and service income	\$ 52,444,478	\$ 16,147,079	\$ -	\$ 68,591,557
Other	401,413	-	(383,171)	18,242
	<u>52,845,891</u>	<u>16,147,079</u>	<u>(383,171)</u>	<u>68,609,799</u>
Cost of goods sold	<u>36,676,238</u>	<u>13,113,281</u>	<u>-</u>	<u>49,789,519</u>
Gross profit	<u>16,169,653</u>	<u>3,033,798</u>	<u>(383,171)</u>	<u>18,820,280</u>
Operating expenses:				
Salaries and benefits	3,329,943	346,031	-	3,675,974
Depreciation and amortization	1,986,158	60,278	-	2,046,436
Rent	1,184,880	543,539	-	1,728,419
Professional fees	1,403,202	251,284	-	1,654,486
Taxes	1,409,540	53,368	-	1,462,908
Repairs and maintenance	1,123,858	140,112	-	1,263,970
Staff travel, training and development	867,456	63,644	-	931,100
Insurance	364,159	478,102	-	842,261
Communications	478,545	88,390	-	566,935
Corporate governance, travel and entertainment	431,646	113,918	-	545,564
Contracted services	345,641	112,218	-	457,859
Utilities	210,267	55,083	-	265,350
Office supplies	234,518	18,629	-	253,147
Bank charges	137,148	35,842	-	172,990
Fuel	71,452	48,053	-	119,505
Corporate office shared services	-	383,171	(383,171)	-
Miscellaneous	436,444	113,678	-	550,122
Total operating expenses	<u>14,014,857</u>	<u>2,905,340</u>	<u>(383,171)</u>	<u>16,537,026</u>
Operating income	<u>2,154,796</u>	<u>128,458</u>	<u>-</u>	<u>2,283,254</u>
Nonoperating (expenses) revenues:				
Foreign exchange	-	(1,072,551)	-	(1,072,551)
Investment losses	(168,719)	-	-	(168,719)
Other income	-	103,275	-	103,275
Interest (expense) income, net	(355,548)	66,766	-	(288,782)
Total nonoperating expenses, net	<u>(524,267)</u>	<u>(902,510)</u>	<u>-</u>	<u>(1,426,777)</u>
Change in net position	1,630,529	(774,052)	-	856,477
Net position at beginning of year	<u>46,635,711</u>	<u>2,270,560</u>	<u>-</u>	<u>48,906,271</u>
Net position at end of year	<u>\$ 48,266,240</u>	<u>\$ 1,496,508</u>	<u>\$ -</u>	<u>\$ 49,762,748</u>

See accompanying Independent Auditors' Report.

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

The Board of Directors
Federated States of Micronesia Petroleum Corporation:

We have audited, in accordance with the 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, the consolidated financial statements of the Federated States of Micronesia Petroleum Corporation and Subsidiary (the Company), which comprise the consolidated statement of net position as of December 31, 2019, and the related consolidated statements of revenues, expenses and changes in net position, and cash flows for the year then ended, and the related notes to the consolidated financial statements, and have issued our report thereon dated June 19, 2020.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements, we considered the Company's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify a certain deficiency in internal control, described in the accompanying Schedule of Findings and Responses as item 2019-001 that we consider to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the consolidated financial statements are free from 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*.

The Company's Response to Findings

The Company's responses to findings identified in our audit are described in the accompanying Schedule of Findings and Responses. The Company's responses were not subjected to the auditing procedures applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on them.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Company's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deloitte & Touche LLP

June 19, 2020

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

Schedule of Findings and Responses
December 31, 2019

Finding No.: 2019-001

Construction-in-Progress (CIP) Project Monitoring

Criteria: An effective system of internal control includes policies and procedures related to periodic monitoring of capital project status that includes coordination between project management and the finance and accounting personnel.

Condition: The following construction in progress matters were noted:

1. Project status reports or equivalent documentation could not be provided timely, which resulted in various adjusting entries during the course of audit through April 2020.
2. Twenty (23) open projects approximating \$1,114,000 with no recent costs incurred were noted as of December 31, 2019. Specifically, two projects with total costs of \$400,000 are on hold as such ultimate realization is uncertain. Moreover, status reports could also not be provided for one project with total cost of \$18,000.
3. Expense items (e.g., food allowance, travel, hotel expenses and professional fees not directly attributable in bringing the asset to its working condition) amounting to approximately \$206,000 were capitalized as CIP. Approximately \$65,000 was corrected through adjusting journal entries while the remaining balance is still under review.

Cause: The cause of the above condition is lack of periodic monitoring of capital projects status between project management and accounting personnel.

Effect: The effect of the above condition is a potential misstatement of capitalized assets and related expenses.

Recommendation: We recommend that management conduct a comprehensive and periodic review of CIP projects. Quarterly reports as to percentage of completion should be obtained from the project managers. FSMPC should also review all project codes to determine those that are no longer relevant and valid. Further, FSMPC should strengthen control procedures over determining and identifying costs that are allowed to be capitalized in accordance with applicable accounting standards.

Identification as a Repeat Finding: Finding 2018-002

Auditee Response and Corrective Action Plan: Management concurs with the finding. A project management unit called Strategy Execution Team has been established. It is staffed with full time personnel comprising process guidance officers, project managers, project engineers, economists and accountants. The Team's primary goal is aimed at improving the effectiveness of results delivery in the Company, improve Client engagement, and deliver projects on time, on scope, and within budget. This is a work in progress and it will take several years to institutionalize the project management process already adopted, which will address this audit finding.

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

Schedule of Findings and Responses
December 31, 2019

Summary Schedule of Prior Audit Findings

<u>Finding Number</u>	<u>Finding Title</u>	<u>Status</u>
2018-001	Procurement Documents	Corrected or Resolved.
2018-002	Construction-in-Progress (CIP) Project Monitoring	Not Corrected or Resolved.
2018-003	Inventory	Corrected or Resolved.