

**OFFICE OF THE NATIONAL PUBLIC AUDITOR
FEDERATED STATES OF MICRONESIA**



**DEFICIENCIES NOTED REFLECT THE NEED TO IMPROVE
ENTERPRISE-WIDE RISK MANAGEMENT**

Report No. 2022-04



FEDERATED STATES OF MICRONESIA

Office of The National Public Auditor

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July 07, 2022

His Excellency President David W. Panuelo
Honorable Members of the 22nd Congress
Federated States of Micronesia
Members of the Board of Directors, FSM Petroleum Corporation

RE: PERFORMANCE AUDIT ON THE FSM PETROLEUM CORPORATION (FSMPC)

We have completed the performance audit on the FSMPC (the Corporation) covering fiscal years 2019 to 2021. The audit primarily focused on processes of governance, internal controls, risk management and operations of the Corporation. This report presents the results of our audit, which was conducted in accordance with *Generally Accepted Government Auditing Standards (GAGAS)*.

Based on our audit, we found the following issues that the management should address:

1. Outdated risk management procedure and no central monitoring of enterprise-wide risks;
2. Procurement Manual remains in draft since 2018 & does not contain procedures for procuring fuel & lubricants; and
3. Inconsistent documentation of minutes of meetings of the Board Committee for Risk and Audit.

We discussed the findings and recommendations with the management of the Corporation and requested a formal management response, which is included in this final report.

Sincerely,

Haser H. Hainrick
National Public Auditor

cc: Vice President
Chief Executive Officer, FSM Petroleum Corporation

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Abbreviations

Abbreviations	Meaning
\$	United States dollars unless otherwise stated
CDA	Coconut Development Authority
CoRA	Committee on Risk and Audit
CTP	Coconut Tree Product
FSM	Federated States of Micronesia
FSMPC	FSM Petroleum Corporation
GAGAS	Generally Accepted Government Audit Standards
ONPA	Office of the National Public Auditor
SKU	Stock Keeping Unit
VEI	Vital Energy Incorporation

1.0 INTRODUCTION

1.1 Reason for the Audit

This performance audit was conducted as part of implementing our Medium Term Risk Based Audit Plan for fiscal years 2019 to 2021, and as part of our duties and responsibilities set forth under the Public Auditor’s Act, Chapter 5 of Title 55 of the FSM Code.

1.2 Background

The Federated States of Micronesia Petroleum Corporation (FSMPC or “*the Corporation*”) was established in 2007 by Public Law No. 15-08 which is referred to as the Federated States of Micronesia (FSM) Petroleum Corporation Act of 2007 and codified as Title 27 of the FSM Code.

The primary long-term role and function of the Corporation is to secure a stable supply of petroleum products to meet the nation’s core energy needs in accordance with Public Law No. 15-08. In addition, as a result of Public Law No. 18-68 entitled “The Coconut Tree Act”, the Corporation merged 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. These two missions are complementary in building resilience within the economy by addressing energy price stability and increasing household incomes to address the energy affordability challenges.¹

In addition, the Corporation is mandated by Section 241 (6) of Chapter 2 of Title 27 of the FSM Code “to make safety, health and environmental considerations a priority in planning, and in the development of new products and processes; to advise promptly, appropriate officials, employees, customers and the public of information on significant industry-related safety, health and environmental hazards, and to recommend protective measures”.

The Vital Group, also known as “Vital” consists of the Corporation and its affiliate, Vital Energy Incorporation (VEI), Guam. VEI was incorporated on February 10, 2012 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 operations². The Corporation operates in all of the FSM states while VEI is responsible for operations in Guam and Nauru. VEI is wholly owned by the Corporation.³ The FSM National Government has the ability to impose its will on Vital.

1.3 Governance Structure

The Corporation is governed by a Board of Directors and is referred to as “the Board”. According to section 213 of Public Law No. 15-08, the affairs of the Corporation shall be managed and its corporate powers exercised by the Board. The Board is composed of seven (7) voting members with:

¹ FSMPC 2020 Financial Statement Management’s Discussion and Analysis

² FSMPC 2020 Report on the Audit of Financial Statements, Notes to the Basic Financial Statements

³ <https://www.vitalenergy.fm/about-us-3/> and the FSMPC 2020 Financial Statement Management’s Discussion and Analysis

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- one (1) member appointed by the FSM President with the advice and consent of the FSM Congress to represent the National Government;
- four (4) members are appointed by each State Governor (with the advice and consent of the respective State legislature) to represent each of the States; and
- two (2) members are appointed by the FSM President with the advice and consent of Congress from a list of private sector candidates nominated by the four (4) State governors.

The Board appoints and reviews the performance of the Chief Executive Officer.

1.4 Operations

The Corporation operates a total of eight fuel terminal facilities across the FSM, Guam and Nauru, and services the international aviation, marine bunkering, and inland market segments in all these economies. The petroleum operations throughout the FSM, Guam and Nauru are supported by fuel, lubricant, and technical service agreements with various vendors. The Corporation owns and operates a coconut tree product (CTP) processing facility in Pohnpei producing crude coconut oil, virgin coconut oils, soaps and edible oils.⁴

2.0 OBJECTIVES, SCOPE AND METHODOLOGY

2.1 Objectives

The audit objectives were to assess and determine the:

- a) extent by which the processes in the *Procedure to Manage Enterprise Risk* have been implemented to minimize the impact of identified key risks;
- b) adequacy of the control environment for procuring fuel and lubricants; and,
- c) extent and effectiveness of implementing section 241 (6) of Chapter 2 of Title 27 of the FSM Code in relation to safety, health and environment.

2.2 Scope

This audit focused on the activities of the Corporation relating to the objectives listed under section 2.1 for fiscal years 2019 to 2021.

2.3 Methodology

We conducted this performance audit in accordance with the generally accepted government audit standards (GAGAS). The standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that we obtained sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions relating to the audit objectives

In executing the audit, various approaches were exercised which include documents review, interviewing with relevant officials from the Corporation and physical visits to plant/manufacturing sites in order to confirm the extent to which the processes highlighted in the procedures to manage

⁴ FSMPC 2020 Financial Statement Management's Discussion and Analysis

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risks have been implemented; and the effectiveness of implementing section 241(6) of Chapter 2 of Title 27 in relation to safety, health and environment.

From 2019 to 2021, the Corporation's spent approximately \$81.6 million⁵ on procurement of fuel and lubricants from three (3) vendors. However, to determine the adequacy of the control environment for procuring fuel and lubricants, we reviewed/analyzed/assessed the procurement documents amounting to \$32.7 million (40%) which were taken for detailed testing.

3.0 AUDIT MANDATE

We conducted this audit pursuant to the authority vested in the National Public Auditor as codified under Chapter 5, Title 55 of the FSM Code which states in part as follows:

"The Public Auditor shall inspect and audit transactions, accounts, books and other financial records of every branch, department, office agency, board, commission, bureau, and statutory authority of the National Government and of other public legal entities, including, but not limited to, States, subdivisions thereof, and nonprofit organizations receiving public funds from the National Government".

4.0 PRIOR AUDIT COVERAGE

This is the first performance audit conducted on the Corporation by the Office of the National Public Auditor (ONPA). Prior year audits conducted on the Corporation were for the FSM-Wide Single Audits which are usually contracted out by ONPA.

5.0 COMMENDATION

Our sincere appreciation is extended to the management and staff of the Corporation for the assistance and cooperation rendered during the audit. We also commend the Corporation for its commitment to strive for effective management of risk and safety in its operations. With respect to the audit objectives listed in 2.1 above, we found the Corporation was in compliance with the law in regards to safety, health and environment. ONPA looks forward to the continuation of such fruitful relationship.

6.0 CONCLUSION

Based on the results of our audit, we concluded that:

- a) Risk management procedure is not relevant and not fully implemented due to various tools used by the business functions which are yet to be centrally monitored for reporting to the Board;
- b) Inadequate control environment in the procurement of fuel and lubricants due to the Procurement Manual being in draft since 2018 and does not contain procedures for procuring fuel & lubricants; and

⁵ Extracted from the *Accounts Payable Vendor Payment Activity Summary* for 2019 to 2021 (run date of 11/05/21)

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- c) The Corporation met the requirements of the FSM Code Title 27 Chapter 2 Section 241(6) in relation to safety, health and the environment.

The results of this audit are discussed in detail in the following pages.

7.0 FINDINGS AND RECOMMENDATIONS

7.1 Finding 1: Outdated Risk Management Procedure and No Central Monitoring of Enterprise-wide Risks

Criteria

The success of risk management will depend on the effectiveness of the management framework providing the foundations and arrangements on what will be embedded throughout the organization at all levels. The framework development encompasses the mandate and commitment; design of the framework for managing risks; implementing risk management; monitoring and review of the framework; and continual improvement of the framework⁶.

Under the *mandate and commitment*, the management of the organization needs to demonstrate a strong and sustained commitment to risk management by defining the risk management policy, objectives, ensuring legal and regulatory compliance, ensuring necessary resources are allocated to risk management, and communicating the benefits of risk management to all stakeholders.⁷

The purpose of *monitoring and review* is to assure and improve the quality and effectiveness of process design, implementation and outcomes. Ongoing monitoring and periodic review of the risk management process and its outcomes should be a planned part of the risk management process, with responsibilities clearly defined.⁸

Condition

It is commendable to note that the Corporation had adopted the Risk Management standard ISO 13000:2009 and has in place some mechanisms and processes for managing risks. The Board's committee on Risk and Audit (CoRA) is responsible for overseeing risk management. We noted Management's general confirmation that establishing an effective reporting structure for risk management remains a challenge for the Corporation due to the absence of a central monitoring and reporting system which the Corporation planned to establish through a contractor this year, 2022.

In April 2018, the Corporation reviewed the 2010 Board-approved Procedure to Manage Enterprise Risk that contains steps to manage enterprise risks and ensure that risks are not unknowingly unidentified, assessed, evaluated and treated. The procedure outlines the eleven (11) steps that must be completed when risks, which may holistically impact the Corporation, are identified.

Other information provided during the audit included the Vital Board Communiqué from a Risk Management Workshop in 2010, Enterprise Risk Management (ERM) Architecture and Protocols, Draft Risk Assessment Matrix, a learning pack for understanding the Vital enterprise risk management, the Crisis Management Manual (2009), Draft Risk and Compliance 2022 Business Plan, Enterprise Risk review report (risks that the Board manages) and the Risk Registers for certain functions.

We noted the following anomalies from our review:

⁶ ISO 31000 Clause 4: Framework

⁷ ISO 31000 Clause 4.2_Mandate and Commitment

⁸ ISO 31000 Clause 5.6_Monitoring and Review

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1. The Procedure (revised in 2018) provided during the audit was outdated and does not capture the current activities on risk management. Consequently, policies and procedures applied currently or approved after 2018 are not updated in the existing procedure. We also could not verify whether the approved forms to be used in identifying, analyzing, evaluating and treating the risks have been used by the function heads to support the key risks that they reported to the CoRA on a quarterly basis. These forms were:
 - a) F1-GOV-061a Risk Identification Template;
 - b) F1-GOV-060b Risk Analysis Instruction Sheet;
 - c) F1-GOV-060c Risk Analysis Form;
 - d) F1-GOV-060d Risk Evaluation Form;
 - e) F1-GOV-060e Risk Treatment Plan; and
 - f) F1-GOV-060f Residual Risk Form
2. No holistic reporting of key risks of the Corporation to the Board Committee on Risk and Audit. Instead, risks were reported by function heads directly to CoRA; and in our verification we noted that not all functions' key risks were covered in any given CoRA meeting. According to Management, a primary issue that the company has is the use of different tools to collect, register and store information on risks and risk assessments.

Causes

1. No dedicated person was appointed to the risk management function since the adoption of the ISO 13000 standards whose duties should include the periodic review of the procedure as the last review and update was done in 2018. The CEO had been solely responsible for the risk management function since 2010 without the recruitment of dedicated personnel until a new position (Chief Risk & Compliance Officer / CRCO) was recently created at the end of 2021 with a draft Job Description.
2. Absence of a central monitoring, recording and reporting system for consolidating all the organization's key risks which the Corporation is currently addressing through its new intranet portal.

Effects

Risk management will remain a challenge if the procedures are not reviewed and updated to reflect current and desired practices and processes that should be embedded within the entire organization and not on specific functions only. The Board is unaware of the holistic risk information of the Corporation (including all business units) since there is no central recording, monitoring and reporting mechanism in place that they have direct access to.

An example of the above effect is discussed in Finding 2 below. If the Board had been aware of enterprise-wide risks (including all functions and business units such as Finance), then they would have identified the need to finalize the procurement manual years ago so as to give them high level assurance on the effectiveness of controls in the procurement process (a high-risk process) performed by management.

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Recommendations

The Chief Executive Officer should:

1. Ensure the effectiveness of the new CRCO position to carry out enterprise-wide communication, monitoring and reporting of risks and include in his job description the duty of reviewing and improving the procedure to manage risks to include:
 - a. periodic review of the procedure and frequency of review;
 - b. the necessary amendments to ensure that the procedure is complete, relevant and aligned to ISO 31000 (with standard templates for identifying, analyzing, evaluating and treating risks); and
 - c. a procedure for CoRA to require all functions and business units of the Corporation to report on their key risks so it provides them a holistic view of the organization's risks.
2. Ensure the success of the new project on the centralized system for recording, monitoring and reporting key enterprise-wide risks and ensuring that the function managers are periodically updating their relevant risk registers for monitoring by the CRCO and his team.

7.2 Finding 2: Procurement Manual Remains In Draft Since 2018 & Does Not Contain Procedures For Procuring Fuel & Lubricants

Criteria

The FSM Code Title 27 section 231(2) states that “the CEO shall be responsible for the day-to-day operation of the Corporation; and the proper administration and management of the functions and affairs of the Corporation.”

Together, policies and procedures provide a roadmap for day-to-day operations. They ensure compliance with laws and regulations, give guidance for decision-making, and streamline internal processes.

Condition

1. While we acknowledge that the Corporation has a Procurement Manual in place, we noted the following:
 - it is yet to be approved;
 - the Manual has been in draft since 2018;
 - there is no confirmed timeline on when the draft Manual will be submitted to the Board for approval; and
 - it does not include procurements relating to fuel and lubricants even though approximately \$81.6⁹ million was spent on procurement of fuel and lubricants from three (3) vendors in 2019 to 2021 and about 95%¹⁰ of company revenues remain petroleum fuel related. The selection of preferred suppliers of fuel and lubricants, and negotiation of the contract with suppliers is a Board governed and managed process and procedure. (Note: Management had

⁹ Corporation's Accounts Payable Vendor Payment Activity Summary for 2019 to 2021 (run date of 11/05/21)

¹⁰ Financial Statement for FY 2020_Management Discussion and Analysis

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later drafted and approved a procedure on this process following our exit conference; which upon our verification, was neither finalized nor approved by the Board)

2. According to the Finance Team, the payment process for fuel and lubricants follows the requirements of the contract between the Corporation and the fuel/lubricant suppliers. From our review of the contract clauses, it does not include the essential information and step-by-step procedures for procurement for fuel and lubricants such as:
 - entire process from when the fuel and lubricants were procured until it is fully received and paid;
 - responsibilities of various individuals and departments;
 - the delegation of authority;
 - the use of accounting or information system; and
 - the list of documents that are required to support the processing of payments.

Causes

1. No one is assigned the responsibility to ensure that the Procurement Manual is finalized and approved. The Corporation has a Procurement Manager position; however, our review of the position job description reveals that it does not include the responsibility of ensuring that the Procurement Manual is finalized and approved. Responses to the questionnaires¹¹, confirms that that the Corporation contracted a consulting firm that worked with management to draft the manual.
2. Ineffective oversight and monitoring by the Management to ensure that the draft Procurement Manual is finalized and approved; and includes the procurement processes on fuel and lubricants.

Effects

1. In the absence of an approved Procurement Manual, we found inconsistent procurement practices by the Finance Function such as:
 - the documentations to support payments of fuel and lubricants. There were no clear requirements on the set of documents required by Finance to process payments;
 - controls to confirm that vouchers and supporting documentations have been reviewed by authorized personnel prior to processing of payments;
 - documentation of variances between fuel and lubricants ordered and received (Note: we identified variances in the documents provided. The adjustments were later verified as they were filed separately. There were remaining variances after the review of the adjustments which were not a material representative of our audit scope);
 - the timing when a purchase order should be raised in relation to the receipt of invoices; and
 - documentations to support any deviations from the approved processes or practices.
2. In addition, the lack of documentation of procedures increases the risk of knowledge gaps in which an undue burden is placed on an employee who is well-versed with the process. This can

¹¹ Questionnaire completed by the Supply Coordinator

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also result in disruption to the operations of the Functions when that person is out of the office or no longer employed with the Corporation.

As a result, we are not able to provide assurance on the adequacy of the control environment for the procurement of fuel and lubricants.

Recommendations

1. For increased accountability and monitoring, the Chief Executive Officer should consider:
 - a) assigning the responsibility of ensuring that the Procurement Manual is finalized and approved to a personnel/Unit that has the capabilities to complete this task;
 - b) having this responsibility and the assignment thereof documented; and
 - c) the responsible personnel/Unit made aware of the responsibility and its expectations.
2. The oversight function by the Board and Management needs to improve with regards to:
 - a) expediting the approval of the draft Procurement Manual.
 - b) reviewing and making amendments to the draft Procurement Manual to also include the entire procurement processes for fuel and lubricants.

7.3 Finding 3: Inconsistent Documentation of Minutes of Meetings of The Board Committee for Risk And Audit

Criteria

Section 220 of Chapter 2 of Title 27 of the FSM Code requires that the Board must keep minutes of all its meetings and business transacted under section 216 and 217 in a proper form. All minutes of the meetings shall be made available to the public upon request.

Meeting minutes is an effective reminder of the issues discussed and the decisions made pertaining to the operations of the Corporation. It also serves as a reference for members and others (such as the auditors) who were not present during the meeting.

Condition

We noted the inconsistent practices in the maintenance and documentation of meeting minutes for Committees that have been established by the Board such as the CoRA. We were provided with five (5) Board meeting minutes for 2019 and five (5) Board meeting minutes for 2020; however, for CoRA we were only provided with two (2) meeting minutes, one (1) for each of 2020 and 2021.

Responses received from the Chairman of CoRA confirms that minutes are not generally taken at committee meetings as the minutes of the whole Board reflect the report of the Committee.

Nevertheless, we acknowledge the Board in the documentation and retention of the Board's minutes of meetings.

Causes

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1. It is not a written requirement or included in the enabling law that discussions during all the committee meetings established by the Board be documented in a proper format and maintained for future references.
2. No one is assigned the responsibility of documenting the minutes of the meetings, to accurately capture the agendas and the resolutions made by members and the maintenance of the same documentations.

Effect

In the absence of minutes of meetings, meeting agendas and resolutions by members on important matters relating to risks that will greatly impact the Corporation and its operations, cannot be confirmed.

Recommendations

1. Governance to be strengthened by the Board of Directors on the issue of or amendments of existing policies to include the documentation and maintenance of minutes of meetings for all Board committees established within the Corporation; and
2. The Chief Executive Officer should assign suitable personnel(s) the role of documenting the minutes of meetings of CoRA and other committees of the Board.

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8.0 MANAGEMENT RESPONSE



File Ref. PC/J/8

29 June 2022

Joey Iwo
Auditor-in-Charge
P.O. Box PS-05
Palikir, Pohnpei

Transmitted via e-mail: jiwo@fsmopa.fm; Cc: mnaivalu@fsmopa.fm; jadolph@fsmc.com; cmendiola@fsmc.com; jmorris@fsmc.com

SUBJECT: Vital FSMPC Management's Response to the 2019-2021 Performance Audit Report by the FSMOPA

Dear Mr. Iwo:

Greetings to you and the FSMOPA team. Please find enclosed Management's Response to the 2019-2021 Performance Audit of the Vital FSM Petroleum Corporation, and specifically three findings within the report:

- i) 7.1 Finding 1: "Risk Management Yet to be Fully Embedded Throughout the Organization;"
- ii) 7.2 Finding 2: "Procurement Manual Remains in Draft since 2018 & Does Not Contain Procedures for Procuring Fuel & Lubricants;" and
- iii) 7.3 Finding 3: "Inconsistent Documentation of Minutes of Meeting of the Board Committee for Risk and Audit."

Should there be any further questions or comments, feel free to contact me via e-mail at hisaac@fsmc.com.

My best,

A handwritten signature in black ink, appearing to read "hahaac", is written over a light blue horizontal line.

Hannah-Marie L. Isaac
Key Accounts Manager

Enclosure

Cc: Miriama Naivalu, FSMOPA Audit Manager
Jared Morris, Vital FSMPC CEO
Johnny Adolph, Vital FSMPC CRCO
Cherish Mendiola, Vital FSMPC CFO

FINDING 1: RISK MANAGEMENT YET TO BE FULLY EMBEDDED THROUGHOUT THE ORGANIZATION

Effect: Risk management will remain a challenge if the procedures are not reviewed and updated to reflect current and desired practices and processes that should be embedded within the entire organization and not on specific functions only. The Board is unaware of the holistic risk information of the Corporation since there is no central recording and reporting mechanism in place.

Management Response

We note the anomalies and causes identified in the Report, however do not believe that these causes will necessarily result in the identified effect.

We regret that the individuals consulted in the audit process were unable to provide you the Risk Registers for the maritime and logistics operations. These are embedded within the Safety Management System for each vessel – M.V. Carrier, and MV. Seawatch - and are under the direct oversight, monitoring and control of the Captain as per standard maritime practice and law. Copies have been provided with this response, albeit late. These have been provided in the portal established for information sharing.

The Function of Finance and Accounting have disclosed the most material risks within the risks in their Business Plan. The other three material risks are enterprise level risks managed by the Board, namely financial position of the corporation to fund the annual plan, funding of the five-year business plan, and the ability to be resilient in the face of major damage to an operating facility. While these are not as extensive as the risk register identified in other Functions they reflect management's judgement on what is material, ranked as a priority, needs disclosure and continuous monitoring. If there are risks that you believe that have been missed, and should be reflected within the risk register, we look forward to receiving them, and will conduct a risk assessment process to make judgement on its materiality.

We note and will update the procedures to reflect the current practices, and more importantly the role that online and electronic tools have taken. The core elements of the GOV-60 series of forms have been embedded within online risk information tools – PetroX BCR Module, Sharepoint, Mini Risk Assessment Excel Tool, and other risk register and analysis tools. Standalone MS-Word based forms have been largely replaced with electronic tools that improve analysis and reporting. Rightly stated, the procedures will be modified to provide guidance on which risk tool to use, and how to use the risk tools rather than reference Forms that are outdated and now incorporated elsewhere.

Vital currently categorize risks and group them around a common taxonomy, and then record and report in a way that meaningful discussions can be held on those sets of risks, that are often related, and have common risk treatment approaches and actions. Extant risk register tool(s) at various levels across the organization register, track and monitor risks, and then risks that are material in managements judgement are disclosed to the Board. Each tool is deemed appropriate for the risk category or classification being managed.

The Vital Board is well aware of the material risks the business faces at strategic, operation, tactical and compliance levels. Risk is a standing agenda item in their Board Meeting. A dedicated Committee on Risk and Audit has been chartered for a number of years. 15 Enterprise risks have

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been documented and are being monitored. Operational and tactical risk disclosures are provided in the quarterly Business Performance Review soliciting updates on Function level Business Plans, and the risk register therein. The lack of a 'wholistic risk information' from 'a central reporting and recording mechanism' i.e. the lack of a single comprehensive risk report does not mean that risks are not comprehensively reported, understood and subject to appropriate oversight.

The implementation of a tool(s) that will enable a central reporting system, will improve the efficiency, timeliness, and possibly version controls for the various risk registers and treatment plans but not necessarily improve risk analysis or oversight. What we are seeking to achieve is an appropriate level of reporting of and oversight of material risks. This can and is achieved - and undoubtedly being achieved by countless other organizations around the world - without a central reporting database.

Risk management is not the role of a single person. Dedicated positions of Manager SAFER, Manager Quality Assurance, Officer (Asset Integrity), Program Manager (Emergency Preparedness) are all dedicated risk positions, with individuals appointed and appropriately resourced to manage programs and activities associated with specific material risks identified within the business. To suggest that no dedicated person was appointed for risk management role is incorrect, as the organizational architecture for risk management as defined in the ERM Architecture, a document that clearly identifies the roles and responsibilities of the Board, board and executive committees, managers, and each staff member in risk management at Vital. All are needed to establish an effective risk management system and culture in the organization.

We thank the audit team for identifying that there are significant knowledge gaps across the organization, and that despite our best attempts, a significant amount of knowledge within the business remains tacit, and therein is a major risk to the company and its ongoing operations. We will register this as a new material enterprise risk within the company and establish treatment plans as appropriate to ensure critical organizational knowledge is made explicit, and available to be easily searched and retrieved to aid in verification, validation and audit purposes.

FINDING 2: PROCUREMENT MANUAL REMAINS IN DRAFT SINCE 2018 & DOES NOT CONTAIN PROCEDURES FOR PROCURING FUEL & LUBRICANTS

Effect

1. In the absence of an approved Procurement Manual, we found inconsistent procurement practices followed by the Finance Function such as:

- the documentations to support payments of fuel and lubricants as there were no clear requirements on the set of documents required by Finance in order to proceed with payments.
- controls to confirm that vouchers and supporting documentations have been reviewed by authorized personnel prior to processing of payments.
- documentation of variances between fuel and lubricants ordered and received (Note: we identified variances from the documents provided; however the adjustments were later verified as they were filed separately. There were remaining variances after the review of the adjustments which were not a material representative of our audit scope).

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- the timing when a purchase order should be raised in relation to the receipt of invoices; and
- documentations to support any deviations from the approved processes or practices.

2. In addition, the lack of documentation of procedures increases the risk of knowledge gaps in which an undue burden is placed on an employee who is well-versed with the process. This can also result in disruption to the operations of the Functions when that person is out of the office or has exited the office.

As a result, we are not able to provide assurance on the adequacy of the control environment for the procurement of fuel and lubricants.

Management Response

We acknowledge the inconsistencies in the procurement activities of the Finance Function and will seek to understand this further and will document the processes and procedure variants for fuel and lubricants that exist in the Procure-to-Pay documented process of the business to provide greater clarity at an operational level.

The selection of preferred suppliers of fuel and lubricants, and negotiation of the contract with these suppliers is a Board governed and managed process and procedure. Specific procedures are extant and have been uploaded into the portal with this response. We regret that the individuals consulted in the audit process did not have access, or were unaware of the process, procedures, or their existence, however, they are unlikely to have been involved in the last international bid and procurement process that was conducted over five (5) years ago. Copies have been provided with this response in the information sharing portal, albeit late.

Procurement under a Board negotiated contract with a preferred supplier for fuel is under the following primary controls:

- **Control #1: Independent Supplier Selection Procedure.** The establishment of the value-for-money assessment criteria, and the management of the process for selecting a supplier are by the Board, a nominated committee, and appointed experts. The separation of duties between those that are responsible for administering a contract on a daily basis opposed to those that are awarding a contract means that the likelihood of company executives or managers that have close working relationships with extant suppliers unduly influencing the appointment of a strategic supplier is extremely low.
- **Control #2: Independent Quantity and Quality Verification.** Each and every cargo that is imported into our locations is supervised and verified by an independent surveyor who will verify the quality and quantity of products discharged to FSM ports. The likelihood of the company not receiving what it paid for is extremely low.
- **Control #3: Independent Price Verification.** All fuel contracts negotiated by the Board have a requirement to be formulaic, with independently verifiable international market benchmarks, and fixed or variable add-ons. The likelihood of supplier price manipulation, and the company paying more than what it negotiated for under contract is extremely low.
- **Control #4: Standard accounting procedures** are used to recognize the cost of fuel in our inventory incorporating industry standard bulk wet stock operational tolerances. These tolerances are documented in the supplier contracts as well operational procedures. The operational variances of bulk wet stock imported by the company have been immaterial to date.

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We acknowledge that there are primary knowledge gaps across the organization due to the way fuel and lubricant suppliers are selected, contracts negotiated, controls designed and implemented, and contracts administered. We will establish an initiative within the Business Plan of the Function of Finance and Accounting to organize and formalize this knowledge explicitly by end 2023. We acknowledge that the Procurement Manual (Draft) has been under a disproportionately long 'field testing' phase due to other business priorities and activities of the Function Managers in their annual Business Plans. We will set a date to finalize the Procurement Manual. This initiative will be included within the Business Plan of the Finance and Accounting Function, led by Chief Financial Officer for completion by end 2023. Depending on the Board of Directors judgement, this may or may not include the selection of preferred suppliers for fuel and lubricants – and any other product of service that the Board deem of strategic importance – as that process and procedure will be the sole responsibility of the Board, a committee, and experts appointed by the Board.

We thank the audit team for identifying that there are significant knowledge gaps across the organization, and that despite our best attempts, a significant amount of knowledge within the business remains tacit, and therein is a major risk to the company and its ongoing operations. We will register this as a new material enterprise risk within the company and establish treatment plans as appropriate to ensure critical organizational knowledge is made explicit, and available to be easily searched and retrieved to aid in verification, validation and audit purposes.

FINDING 3: INCONSISTENT DOCUMENTATION OF MINUTES OF MEETING OF THE BOARD COMMITTEE FOR RISK AND AUDIT

Effect: In the absence of minutes of meetings, meeting agendas and resolutions by members on important matters relating to risks that will greatly impact the Corporation and its operations cannot be confirmed.

Management Response

The Board and its Committee on Risk and Audit utilize a number of methods to achieve their risk oversight objectives. These include any of the following techniques horizon scanning; brainstorming; SWIFT analysis; facilitated workshops; deep dives; and finally structured meetings. Discussions that occur when a number of these tools and techniques are utilized are not easily 'minuted', as the focus is a specifically designed output – such as a risk communique, a risk register, a risk assessment, a risk treatment plan, a report, or a new major version of a document – that documents the final decisions of the group. Anecdotal evidence throughout the region confirm that there are seldom minutes of a workshop only outputs from those workshops.

It is in the latest version of the outputs - in Vital's case the Risk Communique, the Risk Assessment Matrix, the Risk Register, the Risk Assessment the Remedial Action Plan (RAP) and any change logs that may have been maintained - that one will find the agreed risk context, the collective decisions, and the judgements made on risk materiality (considering likelihood and consequence) and risk treatment appropriateness by those identified as the risk owners.

Operational risk is the prime focus of the daily and weekly toolbox meetings of each operating facility. Business Control Reviews (BCR) that look at operational and tactical risk is the first standing agenda item of the weekly toolbox and monthly Function Managers meetings. Operational,

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tactical and strategic Risk is a standing agenda item of a full Board Meeting, as well as incorporated within the Business Performance Review Agenda soliciting updates on Function level Business Plans, and the risk register within. Enterprise level risks are the subject of board Committee on Risk and Audit (CoRA).

We thank the audit team for identifying that there may be documentation gaps surrounding discussions that are held during risk oversight activities at these various levels of the organization. The Management will work with the Board, board committees, and management committees and team to improve how discussions during oversight activities may be documented, in addition to maintaining and producing accurate outputs (which contain the final decisions and judgements).

9.0 ONPA EVALUATION OF MANAGEMENT RESPONSE

The audit team requested for responses from the management of FSM Petroleum Corporation (FSMPC). We noted new information in the management response that should have been provided during the fieldwork phase of the audit. These have led us to make amendments to the contents of the draft report which are now reflected in this final report. Furthermore, while the responses generally acknowledged and agreed with the findings and recommendations in this report, we would like to clarify some statements made in the management responses as follows:

9.1 Findings 1: Risk Management Yet to be Fully Embedded throughout the Organization

- *“We note the anomalies and causes identified in the Report, however do not believe that these causes will necessarily result in the identified effect.”*

We acknowledge that the Corporation has noted the anomalies and the causes or why the anomalies happened. We wish to clarify the effect is included to raise more emphasis on **why the anomalies matter** and/or what could be the possible impacts on the Corporation if the condition(s) are not addressed.

- *“We regret that the individuals consulted in the audit process were unable to provide you the Risk Registers for the maritime and logistics operations. These are embedded within the Safety Management System for each vessel – M.V. Carrier, and MV. Seawatch - and are under the direct oversight, monitoring and control of the Captain as per standard maritime practice and law. Copies have been provided with this response, albeit late. These have been provided in the portal established for information sharing”.*

We acknowledge the response and would like to point out that the above is a reflection of the challenges faced by management as it is still unable to embed and communicate the knowledge and implementation of risk management throughout the corporation. Key officials assigned to provide information to the audit team were given more than enough time to obtain the correct and complete information; however, we observed that the information stated above were not known to other key senior officials of the organization therefore it is also a reflection of knowledge gap in enterprise-wide risk management process.

Based on new information provided in the management response (risk registers for the Maritime and Logistics operations and Finance functions), we will retain Finding 1 and only revise the wording of the title and contents of the finding as well as remove condition 3 of the same finding. We encourage management to align its standardization efforts to the standard ISO 31000 which the Corporation adopted years ago.

- *“The Function of Finance and Accounting have disclosed the most material risks within the risks in their Business Plan. The other three material risks are enterprise level risks managed by the Board, namely financial position of the corporation to fund the annual plan, funding of the five-year business plan, and the ability to be resilient in the face of major damage to an operating facility. While these are not as extensive as the risk register identified in other Functions, they reflect management’s judgement on what is material, ranked as a priority, needs disclosure and continuous monitoring”.*

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We acknowledge the response; however, we would like to clarify that these material risks were not captured in a central location together with the risks of other business operations to allow holistic monitoring by Management as well as the CoRA. We did not find evidence to prove that CoRA was consistently monitoring the material risks of all business units by looking into their business plans. If they had, then the need to review and approve the Draft Procurement Manual (discussed in Finding 2) would have been identified prior to our audit (considering that procurement of fuel and lubricants involved a significant portion of the corporation's resources).

- *"If there are risks that you believe that have been missed, and should be reflected within the risk register, we look forward to receiving them, and will conduct a risk assessment process to make judgement on its materiality."*

We are grateful for this opportunity; however, this will be or might be considered in future audits. Risk identification is the responsibility of management and the new CRCO position should work with function managers and heads of business units to assess their respective risk materiality and be able to identify material risks that may have not been recorded.

- *"The lack of a 'wholistic risk information' from a 'central reporting and recording mechanism' i.e., the lack of a single comprehensive risk report does not mean that risks are not comprehensively reported, understood and subject to appropriate oversight."*

We found that the above statement is not completely true for the Corporation's oversight, as there were findings raised in this report, and acknowledged by the Corporation confirming that the enterprise-wide risks management for the Corporation is not effective. As an example, CoRA's oversight neither identified the need to revise the "procedure for managing enterprise risks" even though it is receiving risk reports from management, nor identified the need to review and approve the draft procurement manual, even though the Board is involved in major procurement decisions.

- *"The Vital Board is well aware of the material risks the business faces at strategic, operation, tactical and compliance levels. Risk is a standing agenda item in their Board Meeting. A dedicated Committee on Risk and Audit has been chartered for a number of years."*

We do not fully agree with the above statement and we will maintain our position that key enterprise-wide risks are not reported and not known to the Board; otherwise, the Board would have required management to revise the procedure for managing enterprise risks and the procurement manual which are key controls to minimize the impact of fraud risks, financial risks, knowledge gap risks etc.

The committee on Risk and Audit was verified to exist however as discussed in Finding 3, their meetings were never recorded in minutes; therefore, it was impossible for audit to assess the effectiveness of CoRA in providing the relevant oversight for enterprise-wide risk management.

- *"The implementation of a tool(s) that will enable a central reporting system, will improve the efficiency, timeliness, and possibly version controls for the various risk registers and treatment plans but not necessarily improve risk analysis or oversight."*

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We agree with the statement and further emphasize that management is responsible for risk analysis while the Board provides the oversight.

- *“To suggest that no dedicated person was appointed for risk management role is incorrect, as the organizational architecture for risk management as defined in the ERM Architecture, a document that clearly identifies the roles and responsibilities of the Board, and Executive Committees, Managers, and each staff member in risk management at Vital.”*

We acknowledge the responses however we had raised in our finding that the *Procedure for Managing Enterprise Risks*, although revised in 2018; was outdated and does not capture the current activities on risk management as policies and procedures applied currently or approved after 2018 were not updated in the existing Procedure. We found that this finding exists as there were no dedicated person for the risk management role whose duties should include the periodic review of the ‘Procedure’ as well as continuous communication with all employees of the Corporation in order to achieve an effective enterprise-wide risk management process.

We agree that risk management involve the entire organization and we would like to clarify that we were referring to a dedicated person for the risk function of the corporation; which has now been assigned to the newly created CRCO position. We have therefore replaced the work “role” in the final report with “function” to refer to the key person coordinating all risk management processes of the corporation.

9.2 Findings 2: Procurement Manual remains in Draft since 2018 & Does Not Contain Procedures for Procuring Fuel & Lubricants

- *“The selection of preferred suppliers of fuels and lubricants, and negotiations of the contract with these suppliers is a Board governed and managed process and procedure.”*

While we acknowledge the responses, our issue was not directed towards the selection of suppliers for fuel and lubricants. The focus of our finding was on the Procurement Manual; that it is still in draft since 2018 and it does not include the processes and procedures for the procurement lifecycle for fuel and lubricants (that included the nomination, ordering, shipment, receiving and payment processes). These processes are implemented by management and should be documented clearly to guide employees, management and the Board alike.

We also note that the management response included 4 primary controls with “extremely low” risk ratings for the procurement process under a Board negotiated contract with a preferred supplier for fuel. We would like to clarify that the audit team was not provided any risk register to prove the risk assessments and ratings that management has shared in their response.

- *We regret that the individuals consulted in the audit process did not have access, or were unaware of the process, procedures, or their existence, however, they are unlikely to have been involved in the last international bid and procurement process that was conducted over five (5) years ago. Copies have been provided with this response in the information sharing portal, albeit late.*

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We note the response and would like to clarify that the individuals assigned to assist with the audit should have consulted the right officials if they did not have access to the information requested by the audit team. Their lack of knowledge clearly reflects the need to document processes and procedures which is the core issue of Finding 2. The selection of supplier is only a portion of the entire procurement cycle for fuel and lubricants.

We also acknowledge that management has recently drafted a procedure to describe how fuel is procured from preferred suppliers. This procedure was drafted and approved by the CEO during the reporting phase of this audit and we found that it was still in draft (with highlighted text and copyright year was 2013 when the draft procedure was newly documented in the past month). The procedure showed that it had been approved by the CEO and effective on June 1, 2022; while we recommend that it should be finalized first and submitted to the Board for their awareness (since the Board takes part in the process of selecting the suppliers) and approval. Awareness to the relevant employees should be carried out after the Board's approval.

Management needs to understand that they must document the procedure for the entire cycle and not only for the selection of supplier(s) which they have drafted and provided with this response in the online information sharing portal. It is important that every employee involved in the procurement cycle understand the process through a documented procedure manual.

- *“Depending on the Board of Directors judgement, this may or may not include the selection of preferred suppliers for fuels and lubricants – and any other product of service that the Board deem of strategic importance – as that process and procedure will be the sole responsibility of the Board, a committee, and experts appointed by the Board.”*

We would like to emphasize that irrespective of whether it is operational or strategic, any process or procedure of the corporation should be documented to provide guidance to those that will perform those procedures now and in the future. The loss of corporate memory is a risk if procedures are not clearly documented for guidance to future Board members, management and employees. Documenting policies and procedures is a basic control to ensure consistent practices and minimize errors and/or fraud. We encourage management to ensure that the procedures for the procurement cycle for fuel and lubricant is documented as it involves various functions including Operations and Finance as well as the Board.

We have evaluated the management responses and have retained how the finding 2 was written based on our explanation above. Also, the Corporation has acknowledged our findings and have indicated their support in addressing these findings.

9.3 Findings 3: Inconsistent Documentation of Minutes of Meeting of The Board Committee for Risk and Audit (CoRA)

- *“The Board and its Committee on Risk and Audit utilize a number of methods to achieve their risk oversight objectives. These include any of the following techniques horizon scanning; brainstorming; SWIFT analysis; facilitated workshops; deep dives; and finally structured meetings. Discussions that occur when a number of these tools and techniques are utilized are not easily ‘minuted’, as the focus is a specifically designed output – such as a risk communicate, a risk register,*

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a risk assessment, a risk treatment plan, a report, or a new major version of a document – that documents the final decisions of the group. Anecdotal evidence throughout the region confirm that there are seldom minutes of a workshop only outputs from those workshops.

While we acknowledge the response, we would like to clarify that we were only referring to the periodic meetings of the Board committee for Risk and Audit (CoRA) and we are not referring to the other methods (brainstorming sessions, workshops etc.) that are discussed above.

- *“Enterprise level risks are the subject of board Committee on Risk and Audit (CoRA).”*

The statement above is acknowledged and we agree that it is the role of CoRA to discuss enterprise level risks; however, we would like to clarify that we could not verify evidence of the members of CoRA discussing identified key risks and treatment plans due to the absence of minutes of meetings for or comprehensive reports by CoRA to the Board. Management may consider enhancing the reports to the Board so it captures the main discussions held and decisions of CoRA during its periodic meetings.

We have maintained Finding 3 based on our response above with minor edits to the contents of the finding.

10.0 NATIONAL PUBLIC AUDITOR'S COMMENTS

We would like to thank the staff and management of the FSM Petroleum Corporation (FSMPC) for their assistance and cooperation during the course of the performance audit. Whilst this was our first audit of the Corporation; we commend them for their efforts to assist with the audit team's understanding of their operations and their commitment to address our audit recommendations.

We have provided copies of the final audit report to the President and Members of the 22nd FSM Congress and those charged with governance. Furthermore, we will make copies available to other interested parties upon request.

If there are any questions or concerns regarding this report, please do not hesitate to contact our office. Contact information for the office can be found on the last page of this report along with the National Public Auditor and staff that conducted the audit and prepared this report.



Haser H. Hainrick
National Public Auditor

July 07, 2022

11.0 ONPA CONTACTS & STAFF ACKNOWLEDGEMENT

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