

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

**(A COMPONENT UNIT OF THE FSM NATIONAL
GOVERNMENT)**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED DECEMBER 31, 2008 AND 2007

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

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INDEPENDENT AUDITORS' REPORT

Chairman
Board of Directors
Federated States of Micronesia
Development Bank:

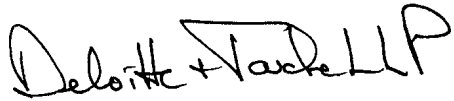
We have audited the accompanying statements of net assets of the Federated States of Micronesia (FSM) Development Bank, a component unit of the FSM National Government, as of December 31, 2008 and 2007, and the related statements of revenues, expenses and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Federated States of Micronesia Development Bank as of December 31, 2008 and 2007, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated June 17, 2009, on our consideration of the Bank's internal control over financial reporting and on our tests of its compliance with certain laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

June 17, 2009

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
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Management's Discussion and Analysis
Years Ending December 31, 2008 and 2007

The year 2008 was a difficult year for the Bank because not only were we affected by the financial market melt-down in the U.S. financial capital market, our loan portfolio was affected as well when private businesses were faced with rising cost of fuel that leads to increased cost of transportation/shipping products to the FSM, increased cost of utilities and all major food imports particularly rice and frozen meat. Although the bank was able to generate \$2.1 million in loan interest income for 2008, it lost (\$1.9 million) in its investment portfolio in the U.S. capital market. The Bank ended the year with a total decrease in net assets of about \$1.7 million representing deterioration in financial position compared with the prior year. Loan approvals for the year were \$4.3 million for 52 projects, which is short of the Bank's target. About \$2.3 million was undisbursed at year end.

Summary Statement of Net Assets

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Assets:			
Current assets	\$ 7,337,839	\$ 4,399,766	\$ 4,851,797
Capital assets	226,565	259,071	254,438
Other noncurrent assets	<u>28,674,350</u>	<u>31,177,153</u>	<u>29,401,810</u>
Total assets	\$ <u>36,238,754</u>	\$ <u>35,835,990</u>	\$ <u>34,508,045</u>
Liabilities:			
Current liabilities	\$ 607,214	\$ 146,657	\$ 515,435
Noncurrent liabilities	<u>1,600,000</u>	<u>-</u>	<u>-</u>
Total liabilities	<u>2,207,214</u>	<u>146,657</u>	<u>515,435</u>
Net assets:			
Invested in fixed assets	226,565	259,071	254,438
Restricted	500,000	500,000	-
Unrestricted	<u>33,304,975</u>	<u>34,930,262</u>	<u>33,738,172</u>
Total net assets	<u>34,031,540</u>	<u>35,689,333</u>	<u>33,992,610</u>
Total liabilities and net assets	\$ <u>36,238,754</u>	\$ <u>35,835,990</u>	\$ <u>34,508,045</u>

No significant capital asset activity occurred during 2008. For additional information concerning the Bank's capital assets, please refer to the notes to financial statements, primarily note 5.

During fiscal year 2008, the Bank borrowed \$2 million to facilitate lending. For additional information concerning the Bank's debt, please refer to note 8 to the financial statements.

Earnings in 2008 decreased by 198% from \$1,696,723 in 2007 to (\$ 1,657,793) mainly due to the decline in the market value of the Bank's investment portfolio. Loan loss provision was \$722,000 in 2008 increasing total loan loss provision to \$5.3 million. The Bank charged off \$770,000 in bad loans and recovered \$261,000 from previously charged off loans. At the end of 2008 total loan loss provision to total impaired assets was at 99%.

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Management's Discussion and Analysis
Years Ending December 31, 2008 and 2007

At December 31, 2008, the market value of the Bank's investments stood at \$10,411,507, a decrease of 8% from \$11,349,641 at the end of 2007.

Summary Statement of Revenues, Expenses and Changes in Net Assets

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Operating revenues	\$ 2,333,226	\$ 2,152,454	\$ 2,141,527
Provision for doubtful loans	722,000	199,890	984,313
Operating expenses	<u>1,677,657</u>	<u>1,616,993</u>	<u>1,593,613</u>
(Loss) earnings from operations	(66,431)	335,571	(436,399)
Non-operating (expenses) revenues, net	<u>(1,591,362)</u>	<u>1,361,152</u>	<u>1,274,476</u>
Change in net assets	(1,657,793)	1,696,723	838,077
Net assets at beginning of year	<u>35,689,333</u>	<u>33,992,610</u>	<u>33,154,533</u>
Net assets at end of year	\$ <u>34,031,540</u>	\$ <u>35,689,333</u>	\$ <u>33,992,610</u>

The Bank manages three trust funds, namely, the Investment Development Fund (IDF), Pohnpei Development Loan Fund (PDLF) and Yap Development Loan Fund (YDLF). The total assets for each of these funds at the end of 2008 were \$10,784,393, \$879,873, and \$306,920 respectively. IDF ended the year with an income of \$350,253 whereas PDLF and YDLF earned incomes of \$19,356 and \$12,452, respectively. Pohnpei State received \$1,635,000.

Management's Discussion and Analysis for the year ended December 31, 2007 is set forth in the FSMDB's report on the audit of financial statements, which is dated May 29, 2008. That Discussion and Analysis explains the major factors impacting the 2007 financial statements and can be viewed at the Office of the Public Auditor's website at www.fsmpublicauditor.fm

Economic Outlook

Management anticipates that year 2009 will have better results. The Bank foresees an increase in lending in the construction and mining sector plus the hardware businesses due to approval and implementation of major infrastructure projects under the Compact. This inflow of funding is stimulating the economy, not only in the construction businesses but the other support service sectors. Furthermore, aside from its normal term loans, the Bank now offers short-term line of credits to its business borrowers and home loans to the citizens of the FSM. The presences of International and Regional Organizations in Pohnpei is also increasing the need for new real estate development, both for office space as well as rental units for housing.

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Statements of Net Assets
December 31, 2008 and 2007

	2008	2007
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 3,425,012	\$ 1,890,029
Time certificates of deposit	891,275	300,000
Accounts receivable	6,593	2,638
Receivable from trust funds	225,017	306,008
Prepaid expenses	2,700	2,500
Interest and other receivables	244,252	128,529
Current portion of loans receivable	2,542,990	1,770,062
Total current assets	7,337,839	4,399,766
Noncurrent assets:		
Fixed assets, net	226,565	259,071
Investments	10,369,201	11,349,641
Equity investment, at cost	662,188	662,188
Loans receivable, net of current portion and allowance for loan losses	17,642,961	19,165,324
Total noncurrent assets	28,900,915	31,436,224
Total assets	\$ 36,238,754	\$ 35,835,990
<u>LIABILITIES</u>		
Current liabilities:		
Current portion of long-term debt	\$ 400,000	\$ -
Accounts payable	111,049	138,111
Accrued interest payable	69,902	-
Credit life payable	10,425	8,267
Payable to trust funds	15,838	279
Total current liabilities	607,214	146,657
Noncurrent liabilities:		
Long-term debt, net of current portion	1,600,000	-
Total liabilities	2,207,214	146,657
Commitments and contingencies		
Net assets:		
Invested in capital assets	226,565	259,071
Restricted	500,000	500,000
Unrestricted	33,304,975	34,930,262
Total net assets	34,031,540	35,689,333
Total liabilities and net assets	\$ 36,238,754	\$ 35,835,990

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
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Statements of Revenues, Expenses and Changes in Net Assets
Years Ended December 31, 2008 and 2007

	2008	2007
Operating revenues:		
Interest income on loans	\$ 2,130,965	\$ 1,900,360
Interest income on time certificates of deposit	49,572	65,625
Loan fees	71,057	111,767
Miscellaneous	81,632	74,702
Total operating revenues	2,333,226	2,152,454
Provision for loan losses	722,000	199,890
Net operating revenues	1,611,226	1,952,564
Operating expenses:		
Interest expense:		
Interest on long-term debt	103,349	-
General and administrative expenses:		
Personnel services	892,372	934,649
Rent	122,016	121,512
Travel	101,031	72,304
Depreciation	80,564	78,141
Contractual services	79,857	65,478
FSM retirement plan	54,035	52,733
Communications	37,174	39,303
Training	15,354	69,210
Supplies	14,606	13,607
Printing	7,639	1,410
Insurance	4,303	4,691
Miscellaneous expenses	165,357	163,955
Total general and administrative expenses	1,574,308	1,616,993
(Loss) earnings from operations	(66,431)	335,571
Non-operating revenues (expenses):		
IDF reimbursement	250,000	250,000
Allocations from managed funds	25,582	45,130
Investment (loss) earnings	(1,938,134)	993,097
Other income	71,190	72,925
Total non-operating revenues (expenses), net	(1,591,362)	1,361,152
Change in net assets	(1,657,793)	1,696,723
Net assets at beginning of year	35,689,333	33,992,610
Net assets at end of year	\$ 34,031,540	\$ 35,689,333

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
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Statements of Cash Flows
Years Ended December 31, 2008 and 2007

	2008	2007
Cash flows from operating activities:		
Cash received from customers	\$ 2,210,570	\$ 2,092,485
Cash paid to suppliers for goods and services	(626,476)	(667,539)
Cash paid to employees for services	(892,372)	(934,649)
Interest received on time certificates of deposit	53,496	60,188
Interest paid	(33,447)	-
	711,771	550,485
Cash flows from noncapital financing activities:		
Net transfers in from (out to) trust funds	372,132	(110,493)
	372,132	(110,493)
Cash flows from capital and related financing activities:		
Proceeds from issuance of long-term debt	2,000,000	-
Acquisition of fixed assets	(48,058)	(82,774)
Proceeds from sale of fixed assets	-	7,925
	1,951,942	(74,849)
Cash flows from investing activities:		
Loan origination and principal collections, net	27,435	(2,219,525)
Additions to time certificates of deposit	(591,275)	(300,000)
(Additions to) withdrawals from investments	(1,000,000)	250,000
Investment income received	61,474	36,982
Investment fees paid	(63,496)	(40,573)
Dividends received	65,000	65,000
	(1,500,862)	(2,208,116)
Net change in cash and cash equivalents	1,534,983	(1,842,973)
Cash and cash equivalents at beginning of year	1,890,029	3,733,002
Cash and cash equivalents at end of year	\$ 3,425,012	\$ 1,890,029
Reconciliation of (loss) earnings from operations to net cash provided by operating activities:		
(Loss) earnings from operations	\$ (66,431)	\$ 335,571
Adjustment to reconcile (loss) earnings from operations to net cash provided by operating activities:		
Provision for doubtful loans	722,000	199,890
Depreciation	80,564	78,141
(Increase) decrease in assets:		
Accounts receivable	(3,955)	2,895
Prepaid expenses	(200)	-
Interest and other receivables	(65,205)	(2,676)
Increase (decrease) in liabilities:		
Accounts payable	(27,062)	42,793
Accrued interest payable	69,902	-
Credit life payable	2,158	(106,129)
	\$ 711,771	\$ 550,485

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
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Notes to Financial Statements
December 31, 2008 and 2007

(1) Summary of Significant Accounting Policies

Reporting Entities

The Federated States of Micronesia Development Bank (the Bank) was created in 1979 by Public Law 1-37 of the First Congress of the Federated States of Micronesia. The FSM Development Bank began its operations on October 1, 1980. The Bank was reorganized in January 1994 by Public Law 8-47 of the Eighth Congress of the Federated States of Micronesia. The purpose of the FSM Development Bank is to provide loans for economic development of the FSM. Such loans may otherwise be too risky for commercial banks to underwrite. Additionally, the Bank's repayment terms tend to be longer than those offered by commercial banks. As of December 31, 2008, the Bank has issued 2,997,883 shares to the FSM National Government (98.7%), Kosrae State (0.3%) and Chuuk State (1.0%).

The Investment Development Fund (IDF) was established by Public Law 5-122 in January 1989. The purpose of the IDF is to finance projects which will (1) have their operations primarily located within the FSM; (2) improve the balance of payments position of the FSM; (3) increase the value of visible and invisible exports or result in import substitutions; (4) demonstrate positive economic returns; (5) contribute to the furtherance of close economic relations with the USA.

The Pohnpei Development Loan Fund (PDLF) and the Yap Development Loan Fund (YDLF) are administered by the Bank in a Trust capacity. All loan decisions are made by executives of the respective state governments.

The Bank is a component unit (a discretely presented proprietary fund type) of the FSM National Government. The financial statements in this report do not represent the financial position, results of operations or cash flows of the FSM National Government as a whole. The financial statements of the Bank are not obligations of the FSM National Government unless specifically authorized by the FSM National Government. To date, no such authorizations have been made.

The Bank has opted to establish itself more in line with a corporate model. The Bank, through this process, hopes to be able to attract additional capital through non-FSM sources. To that end, the Bank in September 2007 has entered into a line of credit agreement with Export and Import Bank of China for \$2,000,000. As of December 31, 2008 and 2007, the Bank has drawn \$2,000,000 and \$0, respectively, on this line. Additionally, the Bank has entered into a memorandum of understanding with the U.S. Department of Agriculture's Office of Rural Economic and Community Development to provide guarantees for housing loans in the FSM. An escrow account amounting to \$510,543 and \$500,406, respectively, was established for the housing guarantee as of December 31, 2008 and 2007.

Fund Structure and Basis of Accounting

The accounts of the Bank 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.

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Notes to Financial Statements
December 31, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

Fund Structure and Basis of Accounting, Continued

The accounts of the IDF, PDLF and YDLF are accounted for as fiduciary fund types as the amounts are to be reported on the respective entities' financial statements (the FSM National Government, Pohnpei State and Yap State, respectively).

The Bank 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 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. GASB Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting" requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principle Board Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989. The Bank has implemented GASB 20 and elected not to apply FASB Statements and Interpretations issued after November 30, 1989.

The Bank has adopted GASB Statement No. 34, "Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments" (GASB 34) as amended by GASB Statement No. 37, "Basic Financial Statements – Management's Discussion and Analysis-for State and Local Governments: Omnibus" and GASB Statement No. 38, "Certain Financial Statement Note Disclosures". GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into the following four net asset categories:

- Invested in capital assets, net of related debt:

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

- Restricted:

- Nonexpendable – Net assets subject to externally imposed stipulations that require the Bank to maintain them permanently. For the years ended December 31, 2008 and 2007, the Bank does not have nonexpendable restricted net assets.

- Expendable – Net assets whose use by the Bank is subject to externally imposed stipulations that can be fulfilled by actions of the Bank pursuant to those stipulations or that expire by the passage of time.

- Unrestricted:

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

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Notes to Financial Statements
December 31, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

Fund Structure and Basis of Accounting, Continued

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.

Cash and Cash Equivalents

For the purposes of the statements of net assets and the statements of cash flows, cash and cash equivalents are defined as cash in bank checking and savings accounts, money market funds, and commercial paper with original maturities of three months or less from the date of acquisition.

Time certificates of deposit with original maturities of greater than three months are separately classified.

Investments

Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Loans and Allowance for Loan Losses

Loans are stated at unpaid principal balance less the allowance for loan losses.

Management maintains the allowance for loan losses at a level adequate to absorb probable losses. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. Loans deemed uncollectible are charged to the allowance. Provisions for losses and recoveries on loans previously charged off are added to the allowance.

Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed.

Fixed Assets

Fixed assets are stated at cost, less accumulated depreciation. Depreciation is based on the straight-line method over the estimated useful lives of the respective assets. All assets have estimated useful lives of three to five years.

The Bank's policy on fixed assets requires that assets with a purchase value of \$5,000 and over are capitalized and depreciated based on its useful life. Assets with a purchase value less than \$5,000 are expensed fully in the year of purchase.

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Notes to Financial Statements
December 31, 2008 and 2007

(1) Summary of Significant Accounting Policies, Continued

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the FSM Development Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and loan guarantees. Such financial instruments are recorded in the financial statements when they become payable.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for loan losses.

Reclassifications

Certain reclassifications have been made to the 2007 financial statements in order to conform with the 2008 presentation.

New Accounting Standards

During fiscal year 2008, the Bank implemented GASB Statement No. 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, GASB Statement No. 45, Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions, GASB Statement No. 48, Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues, GASB Statement No. 49, Accounting and Financial Reporting for Pollution Remediation Obligations, and GASB Statement No. 50, Pension Disclosures an amendment of GASB Statements No. 25 and 27. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments and GASB Statement No. 50 more closely aligns the financial reporting requirements for pensions with those for other post-employment benefits. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other post employment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. GASB Statement No. 48 establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing, and includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. GASB Statement No. 49 provides guidance and consistency under which a governmental entity would be required to report a liability related to pollution remediation. The implementation of these pronouncements did not have a material effect on the accompanying financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
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Notes to Financial Statements
December 31, 2008 and 2007

(2) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In June 2007, GASB issued statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 addresses whether and when intangible assets should be considered capital assets for financial reporting purposes. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In November 2007, GASB issued Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. GASB Statement No. 52 improves the quality of financial reporting by requiring endowments to report their land and other real estate investments at fair value, creating consistency in reporting among similar entities that exist to invest resources for the purpose of generating income. The provisions of this statement are effective for periods beginning after June 15, 2008. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In June 2008, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 is intended to improve how state and local governments report information about derivative instruments – financial arrangements used by governments to manage specific risks or make investments – in their financial statements. The provisions of this statement are effective for periods beginning after June 15, 2009. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

(2) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The deposit and investment policies of the Bank are governed by its enabling legislation. The Board is required to engage one or more fund custodians to assume responsibility for the physical possession of the Bank's investments. Legally authorized investments are as follows:

- (i) Government obligations - Obligations issued or guaranteed as to principal and interest by the National Government and/or State governments of the Federated States of Micronesia or by the Government of the United States, provided that the principal and interest on each obligation are payable in the currency of the United States.

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Notes to Financial Statements
December 31, 2008 and 2007

(2) Deposits and Investments, Continued

- (ii) Corporate obligations and mortgage-backed securities - Obligations of any public or private entity or corporation created or existing under the laws of the Federated States of Micronesia or of the United States or any state, territory or commonwealth thereof, or obligations of any other government or economic community which are payable in United States dollars, or other mortgage-backed securities provided that the obligation is an agency of the United States Government, the National Government of the Federated States of Micronesia, or is rated in one of the three highest categories by two nationally recognized rating agencies. No investment under this heading shall exceed ten percent of the market value of the investment fund or ten percent of the outstanding value of the issue at the time of purchase.
- (iii) Preferred and common stocks - Shares of preferred or common stocks of any corporation created or existing under the laws of the Federated States of Micronesia or under the laws of the United States or any state, territory or commonwealth thereof provided that the purchase of such shares shall be considered reasonable and prudent by the Bank's investment advisor at the time of purchase, that not more than five percent of the market value of its investments shall be invested in the stock of any one corporation, and that not more than ten percent of the market value of its investments shall be invested in any one industry group.
- (iv) Insurance company obligations - Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in the Federated States of Micronesia or in any state, territory or commonwealth of the United States provided that the total market value of these investments at no time shall exceed ten percent of all investments.

A. Deposits:

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- | | |
|------------|---|
| Category 1 | Deposits that are federally insured or collateralized with securities held by the Bank or its agent in the Bank's name; |
| Category 2 | Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Bank's name;
or |
| Category 3 | Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Bank's name and non-collateralized deposits. |

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Bank'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 Bank does not have a deposit policy for custodial credit risk.

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

Notes to Financial Statements
December 31, 2008 and 2007

(2) Deposits and Investments, Continued

As of December 31, 2008 and 2007, the carrying amount of the Bank's total cash and cash equivalents and time certificates of deposit was \$4,316,287 and \$2,190,029, respectively, and the corresponding bank balances were not materially different. Of the bank balance amounts, all are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2008 and 2007, bank deposits in the amount of \$500,000 and \$200,000, respectively, were FDIC insured. The Bank does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. Management's confidence in the financial strength of their banking institutions was the basis of the decision to not require collateralization. No losses as a result of this practice were incurred for the years ended December 31, 2008 and 2007.

B. Investments:

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

- Category 1 Investments that are insured or registered, or securities held by the Bank or its agent in the Bank's name;
- Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Bank's name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Bank's name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of December 31, 2008 and 2007, investments at fair value are as follows:

	<u>2008</u>	<u>2007</u>
Fixed income securities:		
Domestic fixed income	\$ 3,032,615	\$ 2,859,371
Other investments:		
Domestic equities	3,199,435	5,347,165
Money market funds	<u>4,137,151</u>	<u>3,143,105</u>
	<u>\$ 10,369,201</u>	<u>\$ 11,349,641</u>

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

Notes to Financial Statements
December 31, 2008 and 2007

(2) Deposits and Investments, Continued

B. Investments, Continued

As of December 31, 2008 and 2007, the Bank's fixed income securities had the following maturities:

2008	<u>Less Than 1 Year</u>	<u>1 to 5 Years</u>	<u>6 to 10 Years</u>	<u>Greater Than 10 Years</u>	<u>Fair Value</u>
U.S. Treasury obligations	\$ -	\$ 1,058,189	\$ 659,806	\$ -	\$ 1,717,995
U.S. Government agency obligations	<u>945,651</u>	<u>216,962</u>	<u>152,007</u>	<u>-</u>	<u>1,314,620</u>
	<u>\$ 945,651</u>	<u>\$ 1,275,151</u>	<u>\$ 811,813</u>	<u>\$ -</u>	<u>\$ 3,032,615</u>
2007	<u>Less Than 1 Year</u>	<u>1 to 5 Years</u>	<u>6 to 10 Years</u>	<u>Greater Than 10 Years</u>	<u>Fair Value</u>
U.S. Treasury obligations	\$ 69,976	\$ 904,910	\$ 398,561	\$ -	\$ 1,373,447
U.S. Government agency obligations	<u>351,582</u>	<u>931,443</u>	<u>202,899</u>	<u>-</u>	<u>1,485,924</u>
	<u>\$ 421,558</u>	<u>\$ 1,836,353</u>	<u>\$ 601,460</u>	<u>\$ -</u>	<u>\$ 2,859,371</u>

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations.

The Bank's exposure to credit risk at December 31, 2008 and 2007, was as follows:

<u>2008</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
Moody's Rating – AAA	\$ <u>3,032,615</u>	\$ <u>3,032,615</u>	\$ <u>-</u>
Total credit risk debt securities	\$ <u>3,032,615</u>	\$ <u>3,032,615</u>	\$ <u>-</u>
<u>2007</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
Moody's Rating – AAA	\$ <u>2,859,371</u>	\$ <u>2,859,371</u>	\$ <u>-</u>
Total credit risk debt securities	\$ <u>2,859,371</u>	\$ <u>2,859,371</u>	\$ <u>-</u>

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Bank will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Bank's investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Bank's name by the Bank's custodial financial institutions at December 31, 2008 and 2007.

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

Notes to Financial Statements
December 31, 2008 and 2007

(2) Deposits and Investments, Continued

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Bank. As of December 31, 2008, the Bank's investment in agency obligations of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association constituted 5% and 7%, respectively, of its total investments. As of December 31, 2007, the Bank's investment in agency obligations of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association constituted 6% and 7%, respectively, of its total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Bank has a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

(3) Equity Investment, at Cost

The equity investment in Bank of the FSM, carried at cost, represents 100,000 common shares and approximately an 11% ownership interest. Since the book value of the shares exceeds the carrying value, management believes that the equity investment has not become impaired.

(4) Loans Receivable

A summary of loans receivable at December 31, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Unpaid principal balance	\$ 25,481,600	\$ 26,020,506
Allowance for loan losses	<u>(5,295,649)</u>	<u>(5,085,120)</u>
	<u>\$ 20,185,951</u>	<u>\$ 20,935,386</u>

Movements in the allowance for loan losses during the years ended December 31, 2008 and 2007, are as follows:

	<u>2008</u>	<u>2007</u>
Balance at beginning of year	\$ 5,085,120	\$ 3,779,247
Provision for loan losses	722,000	199,890
Loans charged off	(772,684)	(1,415,881)
Loan recoveries from previously charged off loans	261,213	471,415
Loan reactivations from previously charged off loans	<u>-</u>	<u>2,050,449</u>
Balance at end of year	<u>\$ 5,295,649</u>	<u>\$ 5,085,120</u>

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

Notes to Financial Statements
December 31, 2008 and 2007

(5) Fixed Assets

A summary of fixed assets as of December 31, 2008 and 2007, is as follows:

	Beginning Balance January 1, <u>2008</u>	<u>Additions</u>	<u>Deletions</u>	Ending Balance December 31, <u>2008</u>
Office furniture, fixtures and equipment	\$ 144,996	\$ 5,968	\$ -	\$ 150,964
Home furniture, fixtures and equipment	13,123	-	-	13,123
Vehicles	232,104	-	-	232,104
Computers and software	<u>478,547</u>	<u>42,090</u>	<u>-</u>	<u>520,637</u>
	868,770	48,058	-	916,828
Less accumulated depreciation	<u>(609,699)</u>	<u>(80,564)</u>	<u>-</u>	<u>(690,263)</u>
Net fixed assets	\$ <u>259,071</u>	\$ <u>(32,506)</u>	\$ <u>-</u>	\$ <u>226,565</u>
	Beginning Balance January 1, <u>2007</u>	<u>Additions</u>	<u>Deletions</u>	Ending Balance December 31, <u>2007</u>
Office furniture, fixtures and equipment	\$ 144,996	\$ -	\$ -	\$ 144,996
Home furniture, fixtures and equipment	13,608	-	(485)	13,123
Vehicles	171,348	76,762	(16,006)	232,104
Computers and software	<u>472,535</u>	<u>6,012</u>	<u>-</u>	<u>478,547</u>
	802,487	82,774	(16,491)	868,770
Less accumulated depreciation	<u>(548,049)</u>	<u>(78,141)</u>	<u>16,491</u>	<u>(609,699)</u>
Net fixed assets	\$ <u>254,438</u>	\$ <u>4,633</u>	\$ <u>-</u>	\$ <u>259,071</u>

(6) Related Party Transactions

As of December 31, 2008 and 2007, the Bank has direct loans with outstanding balances of \$238,941 and \$150,696, respectively, to employees of the Bank and project loans extended to businesses owned by or affiliated with employees of \$2,625,840 and \$2,802,120, respectively. These loans were made under similar terms and conditions as exist with other borrowers. Officers and Board members are not eligible to borrow from the Bank.

(7) Commitments and Contingencies

Guaranty

The Bank, from time-to-time, is contingently liable on loan guarantees ranging from 50% to 90% of the outstanding loan balances for commercial projects within the FSM. There were no outstanding guaranteed loan balances as of December 31, 2008 and 2007.

Loan Commitments

The Bank has entered into loan commitments for loans approved but undisbursed in the amount of \$2,321,744 at December 31, 2008.

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

Notes to Financial Statements
December 31, 2008 and 2007

(7) Commitments and Contingencies, Continued

Litigation

The Bank is a party to various legal proceedings, the ultimate impact of which is not currently predictable. Therefore, no liability has been recorded in the accompanying financial statements due to management's inability to predict the ultimate outcome of these proceedings.

Self Insurance

The FSM Development Bank carries insurance to cover its potential risks from vehicle usage. FSM Development Bank 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.

Lease Commitments

The Bank has six operating leases as of December 31, 2008. Three are residential real estate leases for contract employees. Four leases are for the branch offices in each State (one with a lease term of two years, two for five years and one for fifteen years). All leases have an attached option allowing FSMDB to renew the lease upon expiration of the current term. It is likely that these options will be exercised by the Bank and the leases renewed. The approximate future minimum annual lease payments payable by the Bank, assuming all options are exercised, are as follows:

<u>Fiscal year ending December 31,</u>	<u>Total</u>
2009	\$ 122,016
2010	122,016
2011	122,016
2012	122,016
2013	122,016
2014 – 2018	610,080
2019 – 2023	610,080
2024 – 2028	610,080
2029 – 2033	<u>610,080</u>
	\$ <u>3,050,400</u>

(8) Note Payable

On September 29, 2007, the Bank entered into a line of credit agreement with Export and Import Bank of China in the amount of \$2,000,000, due July 21, 2013, for the purpose of funding its loan programs. The loan is uncollateralized, bears interest at 7.38% per annum. Repayment of principal and interest commenced January 21, 2009 in semi-annual installment of \$200,000. As of December 31, 2008 and 2007, the amount outstanding and payable under this loan agreement was \$2,000,000 and \$0, respectively.

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

Notes to Financial Statements
December 31, 2008 and 2007

(8) Note Payable, Continued

Annual debt service requirements to maturity for principal and interest are as follows:

<u>Year ending December 31,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2009	\$ 400,000	\$ 135,844	\$ 535,844
2010	400,000	110,700	510,700
2011	400,000	81,180	481,180
2012	400,000	51,660	451,660
2013	<u>400,000</u>	<u>22,140</u>	<u>422,140</u>
	<u>\$ 2,000,000</u>	<u>\$ 401,524</u>	<u>\$ 2,401,524</u>

Long-term debt changes during the year ended December 31, 2008 is as follows:

	<u>Balance January 1,</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance December 31,</u>	<u>Due Within One Year</u>
2008:					
Loan payable	\$ -	\$ 2,000,000	\$ -	\$ 2,000,000	\$ 400,000

(9) Contribution from the FSM National Government

During the years ended December 31, 2008 and 2007, the Bank was reimbursed for expenses incurred in administering the IDF program from the IDF Private Sub Account for \$250,000 in each of the years.

(10) Retirement Plan

The Bank's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees receive from the FSM Social Security System. The Plan is a contributory plan in which the Bank matches 100% of the participants' contributions up to a maximum of 10 percent of the participant's annual salary, if the participant contributes 3 or more percent from his or her annual salary. Employee participation is optional. The Bank's CFO is the designated Plan Administrator. Matching contributions to the Plan during the years ended December 31, 2008 and 2007 were \$54,035 and \$52,733, respectively. Management is of the opinion that the Plan does not represent an asset or a liability of the Bank.

(11) Staff Loan Revolving Fund

In July 2007, the Bank's Board of Directors approved the establishment of a Staff Loan Revolving Fund. In September 2007, a savings account was established for this purpose. As of December 31, 2008 and 2007, the account has a balance of \$16,423 and \$99,383, respectively.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

DECEMBER 31, 2008

INDEPENDENT AUDITORS' REPORT

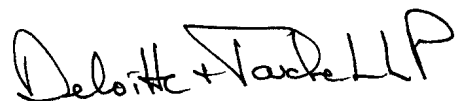
Chairman
Board of Directors
Federated States of Micronesia
Development Bank:

We have audited the accompanying statement of fiduciary net assets of the Investment Development Fund (IDF), the Pohnpei Development Loan Fund (PDLF), and the Yap Development Loan Fund (YDLF) (the Funds) as of December 31, 2008, and the related statement of changes in fiduciary net assets for the year then ended. The Funds are administered by the Federated States of Micronesia Development Bank (FSMDB), a component unit of the National Government of the Federated States of Micronesia. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, such financial statements present fairly, in all material respects, the respective financial status of the Investment Development Fund, the Pohnpei Development Loan Fund and the Yap Development Loan Fund at December 31, 2008, and the changes in their respective financial status for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have issued our report dated June 17, 2009, on our consideration of the Bank's internal control over financial reporting and on our tests of their compliance with certain laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



June 17, 2009

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
(A COMPONENT UNIT OF FSM NATIONAL GOVERNMENT)

Trust Funds
Statement of Fiduciary Net Assets
December 31, 2008

	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>	<u>Total</u>
<u>ASSETS</u>				
Held by FSMDB:				
Cash in bank and on hand	\$ -	\$ 262,139	\$ 94,683	\$ 356,822
Time certificates of deposit	541,482	557,995	140,282	1,239,759
Held by trustee:				
Investments	2,471,854	-	-	2,471,854
Total cash and equivalents	<u>3,013,336</u>	<u>820,134</u>	<u>234,965</u>	<u>4,068,435</u>
Receivable from FSMDB	15,838	-	-	15,838
Interest and other receivables	19,544	4,500	139	24,183
Loans receivable, net	7,735,675	55,239	71,816	7,862,730
Total receivables	<u>7,771,057</u>	<u>59,739</u>	<u>71,955</u>	<u>7,902,751</u>
	<u>\$ 10,784,393</u>	<u>\$ 879,873</u>	<u>\$ 306,920</u>	<u>\$ 11,971,186</u>
<u>LIABILITIES AND NET ASSETS</u>				
Liabilities:				
Payable to FSMDB	\$ -	\$ 159,958	\$ 65,059	\$ 225,017
Credit life payable	-	-	1,975	1,975
Total liabilities	<u>-</u>	<u>159,958</u>	<u>67,034</u>	<u>226,992</u>
Commitments				
Net assets:				
Restricted	7,735,675	55,239	71,816	7,862,730
Unrestricted	3,048,718	664,676	168,070	3,881,464
Total net assets	<u>10,784,393</u>	<u>719,915</u>	<u>239,886</u>	<u>11,744,194</u>
	<u>\$ 10,784,393</u>	<u>\$ 879,873</u>	<u>\$ 306,920</u>	<u>\$ 11,971,186</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
(A COMPONENT UNIT OF FSM NATIONAL GOVERNMENT)

Trust Funds
Statement of Changes in Fiduciary Net Assets
Year Ended December 31, 2008

	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>	<u>Total</u>
Additions:				
Investment interest	\$ 94,264	\$ 14,496	\$ 5,152	\$ 113,912
Loan interest	250,548	4,417	7,268	262,233
Miscellaneous	5,441	443	32	5,915
	<u>350,253</u>	<u>19,356</u>	<u>12,452</u>	<u>382,061</u>
Deductions:				
Investment management fee	250,000	-	-	250,000
Transfer to Pohnpei State Government	1,635,000	-	-	1,635,000
Transfers to FSMDB	-	19,356	6,226	25,582
	<u>1,885,000</u>	<u>19,356</u>	<u>6,226</u>	<u>1,910,582</u>
Change in net assets	(1,534,747)	-	6,226	(1,528,521)
Net assets at beginning of year	<u>12,319,140</u>	<u>719,915</u>	<u>233,660</u>	<u>13,272,715</u>
Net assets at end of year	<u>\$ 10,784,393</u>	<u>\$ 719,915</u>	<u>\$ 239,886</u>	<u>\$ 11,744,194</u>

See accompanying notes to financial statements.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)**

Notes to Financial Statements
December 31, 2008

(1) Purpose and Summary of Significant Accounting Policies

Purpose

The Investment Development Fund (IDF), the Pohnpei Development Loan Fund (PDLF), and the Yap Development Loan Fund (YDLF), are administered by the Federated States of Micronesia Development Bank (the Bank). The Bank utilizes the Funds to carry out its stated purpose of providing loans for the economic development of the FSM. The specific purpose of each fund is as follows:

IDF – IDF was created to finance projects which will (1) have their operations primarily located within the FSM; (2) improve the balance of payments position of the FSM; (3) increase the value of visible and invisible exports or result in import substitutions; (4) demonstrate positive economic returns; (5) contribute to the furtherance of close economic relations with the USA. The IDF is administered by the Bank in a Trust capacity.

The Pohnpei Development Loan Fund (PDLF) and the Yap Development Loan Fund (YDLF) are administered by the Bank in a Trust capacity. All loan decisions are made by executives of the respective state governments.

Fund Structure and Basis of Accounting

The accounts of the IDF, PDLF and YDLF are accounted for as fiduciary fund types as the amounts are to be reported on the respective entities' financial statements (the FSM National Government, Pohnpei State and Yap State, respectively).

Cash

For the purposes of the statement of fiduciary net assets, cash is defined as cash in bank checking and savings accounts, and commercial paper with original maturities of three months or less from the date of acquisition. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified.

Investments

Investments and related investment earnings are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Loan and Allowance for Loan Losses

Loans under the trust funds are usually reported at gross unpaid principal balances, without an allowance for loan losses. The loans are reserved in net assets as restricted net assets. Loans are written off directly against income based on discussions with the owners of the managed funds. When the loans are recorded in the respective owner's financial statements, the owners of these funds will bear responsibility for establishing the related loan loss reserve.

Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK
(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)**

Notes to Financial Statements
December 31, 2008

(1) Purpose and Summary of Significant Accounting Policies, Continued

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Deposits and Investments

GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk and foreign currency risk. As an element of interest rate risk, disclosure is required of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 40 also requires disclosure of formal policies related to deposit and investment risks.

The deposit and investment policies of the Funds are governed by their enabling legislation. The Bank is required to engage one or more fund custodians to assume responsibility for the physical possession of the Funds' investments. Legally authorized investments are as follows:

- (i) Government obligations - Obligations issued or guaranteed as to principal and interest by the National Government and/or State governments of the Federated States of Micronesia or by the Government of the United States, provided that the principal and interest on each obligation are payable in the currency of the United States.
- (ii) Corporate obligations and mortgage-backed securities - Obligations of any public or private entity or corporation created or existing under the laws of the Federated States of Micronesia or of the United States or any state, territory or commonwealth thereof, or obligations of any other government or economic community which are payable in United States dollars, or other mortgage-backed securities provided that the obligation is an agency of the United States Government, the National Government of the Federated States of Micronesia, or is rated in one of the three highest categories by two nationally recognized rating agencies. No investment under this heading shall exceed ten percent of the market value of the Funds' investments or ten percent of the outstanding value of the issue at the time of purchase.
- (iii) Preferred and common stocks - Shares of preferred or common stocks of any corporation created or existing under the laws of the Federated States of Micronesia or under the laws of the United States or any state, territory or commonwealth thereof provided that the purchase of such shares shall be considered reasonable and prudent by the Funds' investment advisor at the time of purchase, that not more than five percent of the market value of its investments shall be invested in the stock of any one corporation, and that not more than ten percent of the market value of its investments shall be invested in any one industry group.

**TRUST FUNDS ADMINISTERED BY THE
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(A COMPONENT UNIT OF THE FSM NATIONAL GOVERNMENT)**

Notes to Financial Statements
December 31, 2008

(2) Deposits and Investments, Continued

- (iv) Insurance company obligations - Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in the Federated States of Micronesia or in any state, territory or commonwealth of the United States provided that the total market value of these investments at no time shall exceed ten percent of all investments.

A. Deposits

GASB Statement No. 3 previously required government entities to present deposit risks in terms of whether the deposits fell into the following categories:

- Category 1 Deposits that are federally insured or collateralized with securities held by the Funds or its agent in the Funds' name;
- Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Funds' name;
or
- Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Funds' name and non-collateralized deposits.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Funds' 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 Funds do not have a deposit policy for custodial credit risk.

As of December 31, 2008, the carrying amount of the Funds' total cash and cash equivalents and time certificates of deposits was \$1,596,581 and the corresponding bank balances approximated the same amount. All of the bank balances are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2008, bank deposits in the amount of \$500,000 were FDIC insured. The Funds do not require collateralization of their cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. Accordingly, these deposits are exposed to custodial credit risk. Management's confidence in the financial strength of their banking institutions was the basis of the decision to not require collateralization. No losses as a result of this practice were incurred for the year ended December 31, 2008.

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Notes to Financial Statements
December 31, 2008

(2) Deposits and Investments, Continued

B. Investments

GASB Statement No. 3 previously required government entities to present investment risks in terms of whether the investments fell into the following categories:

- Category 1 Investments that are insured or registered, or securities held by the Funds or its agent in the Funds' name;
- Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Funds' name; or
- Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Funds' name.

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for investments falling into categories 1 and 2, and provided for disclosure requirements addressing other common risks of investments such as credit risk, interest rate risk, concentration of credit risk, and foreign currency risk. GASB Statement No. 40 did retain and expand the element of custodial credit risk in GASB Statement No. 3.

As of December 31, 2008, investments at fair value are as follows:

Fixed income securities:	
Domestic fixed income	\$ 949,595
Other investments:	
Money market funds	<u>1,522,259</u>
	<u>\$ 2,471,854</u>

As of December 31, 2008, the Funds' fixed income securities had the following maturities:

	<u>Less Than 1 Year</u>	<u>1 to 5 Years</u>	<u>6 to 10 Years</u>	<u>Greater 10 Years</u>	<u>Fair Value</u>
U.S. Government agency obligations	\$ <u>949,595</u>	\$ _____	\$ _____	\$ _____	\$ <u>949,595</u>

Credit risk for investments is the risk that an issuer or other counterparty to an investment will not fulfill its obligations.

The Funds' exposure to credit risk at December 31, 2008, was as follows:

<u>Moody's Rating</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
AAA	\$ <u>949,595</u>	\$ <u>949,595</u>	\$ _____
Total credit risk debt securities	\$ <u>949,595</u>	\$ <u>949,595</u>	\$ _____

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Notes to Financial Statements
December 31, 2008

(2) Deposits and Investments, Continued

B. Investments, Continued

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Funds will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Funds' investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Funds' name by the Funds' custodial financial institutions at December 31, 2008.

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Bank. As of December 31, 2008, the Funds' investment in agency obligations of Federal Home Loan Bank and Federal Home Loan Mortgage Corporation constituted 20% and 18%, respectively, of its total investments.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of debt instruments. The Funds do not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

(3) Loans Receivable

The following is a schedule of loans receivable as of December 31, 2008:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net</u>
State Development Funds (Pohnpei and Yap)	\$ 127,055	\$ -	\$ 127,055
IDF	<u>7,749,175</u>	<u>13,500</u>	<u>7,735,675</u>
	<u>\$ 7,876,230</u>	<u>\$ 13,500</u>	<u>\$ 7,862,730</u>

Management is of the opinion that since these are trust funds, they are unable to provide against these balances, and therefore these loans have been presented as restricted net assets.

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

The Board of Directors
Federated States of Micronesia Development Bank:

We have audited the financial statements of the Federated States of Micronesia Development Bank (the Bank), as of and for the year ended December 31, 2008, and have issued our report thereon dated June 17, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Bank's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Bank's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Bank's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Bank's financial statements that is more than inconsequential will not be prevented or detected by the Bank's internal control.

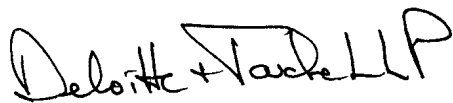
A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Bank's internal control.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Federated States of Micronesia Development Bank's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended for the information of the Board of Directors and management of Federated States of Micronesia Development Bank, federal awarding agencies, pass-through entities, the cognizant audit and other federal agencies, and is not intended to be, and should not be, used by anyone other than those specified parties.

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

June 17, 2009