

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEAR ENDED DECEMBER 31, 2002

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INDEPENDENT AUDITORS' REPORT

Chairman
Board of Directors
Federated States of Micronesia
Development Bank:

We have audited the accompanying statement of condition of the Federated States of Micronesia Development Bank, a component unit of the National Government of the Federated States of Micronesia, as of December 31, 2002, and the related statements of revenues, expenses and changes in fund equity and cash flows for the year then ended. These financial statements are the responsibility of the Federated States of Micronesia Development 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 financial position of the Federated States of Micronesia Development Bank, as of December 31, 2002, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 10 to the financial statements, the Federated States of Micronesia Development Bank changed its method of accounting for nonexchange transactions to conform with Government Accounting Standards Board Statement No. 33 and restated the 2001 financial statements to reflect the change.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 31, 2003, on our consideration of the Bank's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

A handwritten signature in black ink that reads "Deloitte & Touche LLP".

March 31, 2003

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statement of Condition
December 31, 2002
(With Comparative Totals as of December 31, 2001)

	(Proprietary Fund Type)			Governmental Fund Types (Capital Projects Funds)			Totals (Memorandum Only)	
	FSMDB				December 31,		2001	
		IDF	PDLF	YDLF	2002			
<u>ASSETS</u>								
Unrestricted assets:								
Cash and equivalents (note 2)	\$ 2,753,746	\$ -	\$ -	\$ -	\$ 2,753,746	\$ 1,729,354		
Investments (note 2)	10,117,576	-	-	-	10,117,576	10,251,976		
Interest receivable	415,969	-	-	-	415,969	308,382		
Accounts receivable	20,890	-	-	-	20,890	16,953		
Prepaid expenses	-	-	-	-	-	500		
Investment at cost (note 3)	662,188	-	-	-	662,188	662,188		
Loans receivable, net (notes 4, 5 and 7)	17,829,488	-	-	-	17,829,488	17,568,859		
Fixed assets, net (note 6)	114,508	-	-	-	114,508	175,014		
Total unrestricted assets	<u>31,914,365</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>31,914,365</u>	<u>30,713,226</u>		
Restricted assets:								
Cash and equivalents (note 2)	-	-	108,642	4,315	112,957	273,998		
Investments (note 2)	-	8,960,860	451,918	124,928	9,537,706	9,136,663		
Interest and other receivables	-	94,943	4,499	1,268	100,710	45,165		
Interfund receivable	141,881	2,402,543	-	-	2,544,424	2,042,411		
Loans receivable, net (notes 4 and 5)	-	4,943,692	198,803	164,623	5,307,118	6,430,158		
Total restricted assets	<u>141,881</u>	<u>16,402,038</u>	<u>763,862</u>	<u>295,134</u>	<u>17,602,915</u>	<u>17,928,395</u>		
	<u>\$ 32,056,246</u>	<u>\$ 16,402,038</u>	<u>\$ 763,862</u>	<u>\$ 295,134</u>	<u>\$ 49,517,280</u>	<u>\$ 48,641,621</u>		
<u>LIABILITIES AND FUND EQUITY</u>								
Liabilities:								
Accounts payable	\$ 38,544	\$ -	\$ -	\$ -	\$ 38,544	\$ 62,201		
Interfund payable	2,402,543	-	43,947	97,934	2,544,424	2,042,411		
Credit life payable	43,470	-	-	2,074	45,544	83,745		
Total liabilities	<u>2,484,557</u>	<u>-</u>	<u>43,947</u>	<u>100,008</u>	<u>2,628,512</u>	<u>2,188,357</u>		
Retained earnings	29,571,689	-	-	-	29,571,689	28,587,244		
Fund balances:								
Reserved for related assets	-	4,943,692	198,803	164,623	5,307,118	6,430,158		
Unreserved	-	11,458,346	521,112	30,503	12,009,961	11,435,862		
Total fund equity	<u>29,571,689</u>	<u>16,402,038</u>	<u>719,915</u>	<u>195,126</u>	<u>46,888,768</u>	<u>46,453,264</u>		
Commitments and contingencies (note 8)	<u>\$ 32,056,246</u>	<u>\$ 16,402,038</u>	<u>\$ 763,862</u>	<u>\$ 295,134</u>	<u>\$ 49,517,280</u>	<u>\$ 48,641,621</u>		

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statement of Revenues, Expenses and Changes in Retained Earnings - Proprietary Fund Type
 Year Ended December 31, 2002
 (With Comparative Totals for the Year Ended December 31, 2001)

	<u>2002</u>	<u>2001</u>
Operating revenues:		
Loan interest	\$ 1,666,334	\$ 1,511,862
Investment income	402,564	532,177
Loan fees	67,225	58,836
Miscellaneous	<u>45,652</u>	<u>25,349</u>
Total operating revenues	<u>2,181,775</u>	<u>2,128,224</u>
Operating expenses:		
Personnel services	796,745	800,162
Provision for doubtful loans	630,163	128,300
Rent	124,258	118,835
Travel	75,678	76,046
Training	59,731	104,734
Depreciation	57,640	47,606
Contractual services	44,719	70,537
Communications	32,254	48,097
Supplies	21,109	18,276
Printing	9,628	8,407
Insurance	4,778	9,042
Miscellaneous expenses	<u>120,105</u>	<u>36,310</u>
Total operating expenses	<u>1,976,808</u>	<u>1,466,352</u>
Earnings from operations	<u>204,967</u>	<u>661,872</u>
Nonoperating revenues:		
IDF reimbursement (note 9)	250,000	157,194
Allocations from managed funds	29,138	40,928
Contributions (note 9)	500,000	500,000
Other income	<u>340</u>	<u>98,194</u>
Total nonoperating revenues	<u>779,478</u>	<u>796,316</u>
Net earnings	984,445	1,458,188
Retained earnings at beginning of year (note 10)	<u>28,587,244</u>	<u>27,129,056</u>
Retained earnings at end of year	<u>\$ 29,571,689</u>	<u>\$ 28,587,244</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statement of Revenues, Expenditures and Changes in Fund Balances - All Governmental Fund Types
 Year Ended December 31, 2002
 (With Comparative Totals for the Year Ended December 31, 2001)

	Governmental Fund Types (Capital Projects Funds)			Totals	
	IDF	PDLF	YDLF	2002	2001
Operating revenues:					
Investment interest	\$ 256,984	\$ 9,261	\$ 4,395	\$ 270,640	\$ 516,703
Loan interest	186,946	12,534	8,064	207,544	365,969
Miscellaneous	2,188	571	1,085	3,844	7,431
Total operating revenues	<u>446,118</u>	<u>22,366</u>	<u>13,544</u>	<u>482,028</u>	<u>890,103</u>
Operating expenditures:					
Doubtful loans expense	751,831	-	-	751,831	239,588
Total operating expenditures	<u>751,831</u>	<u>-</u>	<u>-</u>	<u>751,831</u>	<u>239,588</u>
Revenues over (under) expenditures	<u>(305,713)</u>	<u>22,366</u>	<u>13,544</u>	<u>(269,803)</u>	<u>650,515</u>
Other uses:					
Investment management fee	(250,000)	-	-	(250,000)	(157,194)
Transfers to FSMDB fund	-	(22,366)	(6,772)	(29,138)	(40,928)
Total other uses, net	<u>(250,000)</u>	<u>(22,366)</u>	<u>(6,772)</u>	<u>(279,138)</u>	<u>(198,122)</u>
Revenues and other sources over (under) expenditures and other uses	<u>(555,713)</u>	<u>-</u>	<u>6,772</u>	<u>(548,941)</u>	<u>452,393</u>
Fund balances at beginning of year	<u>16,957,751</u>	<u>719,915</u>	<u>188,354</u>	<u>17,866,020</u>	<u>17,413,627</u>
Fund balances at end of year	<u>\$ 16,402,038</u>	<u>\$ 719,915</u>	<u>\$ 195,126</u>	<u>\$ 17,317,079</u>	<u>\$ 17,866,020</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statement of Cash Flows
Year Ended December 31, 2002
(With Comparative Totals for the Year Ended December 31, 2001)

	(Proprietary Fund Type)	
	FSMDB	
	<u>2002</u>	<u>2001</u>
Increase (decrease) in cash and equivalents		
Cash flows from operating activities:		
Operating income	\$ 204,967	\$ 661,872
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	57,640	47,606
Provision for doubtful loans	630,163	128,300
Other income and allocations	779,478	796,316
	<u>1,672,248</u>	<u>1,634,094</u>
Changes in working capital:		
Interest receivable	(107,587)	75,256
Accounts receivable	(3,937)	11,674
Prepaid expenses	500	(500)
Loans receivable	(890,792)	(2,690,987)
Interfund receivable	(111,731)	(30,150)
Accounts payable and other liabilities	(61,857)	52,703
Interfund payables	390,282	1,586,479
	<u>(785,122)</u>	<u>(995,525)</u>
Net cash provided by operating activities	<u>887,126</u>	<u>638,569</u>
Cash flows from capital and related financing activities:		
Disposition (acquisition) of fixed assets	<u>2,866</u>	<u>(130,886)</u>
Net cash provided by (used for) capital and related financing activities	<u>2,866</u>	<u>(130,886)</u>
Cash flows from investing activities:		
Decrease (increase) in investments	<u>134,400</u>	<u>(1,423,253)</u>
Net cash provided by (used for) investing activities	<u>134,400</u>	<u>(1,423,253)</u>
Net increase (decrease) in cash and equivalents	1,024,392	(915,570)
Cash and equivalents at beginning of year	<u>1,729,354</u>	<u>2,644,924</u>
Cash and equivalents at end of year	<u>\$ 2,753,746</u>	<u>\$ 1,729,354</u>

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Notes to Financial Statements
December 31, 2002

(1) Summary of Significant Accounting Policies

Reporting Entities

The Federated States of Micronesia Development Bank (FSMDB) 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 FSMDB 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 the commercial banks to underwrite. Additionally, the FSMDB's repayment terms tend to be longer than those offered by commercial banks.

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 FSMDB 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 FSMDB 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 as of December 31, 2002, has issued 3,047,883 shares to the FSM National Government (98.7%), Kosrae State (.3%) and Chuuk State (1.0%).

Fund Structure and Basis of Accounting

The accounts of the FSMDB 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.

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

**FEDERATED STATES OF MICRONESIA
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Notes to Financial Statements
December 31, 2002

(1) Summary of Significant Accounting Policies, Continued

Fund Structure and Basis of Accounting, Continued

Governmental funds are accounted for on a current financial resources measurement focus. With this measurement, only current assets and current liabilities are presented on the balance sheet. Long-term assets, such as loans, are recorded as reserves for related assets in fund balances. Operating statements of these funds present increases (i.e., revenues and other financing sources) and decreases (i.e., expenditures and other financing uses). The modified accrual basis of accounting is used by all governmental fund types. Under the modified accrual basis of accounting, revenues are recognized when susceptible to accrual (i.e., when they become both measurable and available). Expenditures are generally recorded at the time liabilities are incurred.

The accounting policies of the Bank conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities, specifically proprietary funds. The Government Accounting Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting", requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles 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.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on the loans receivable of the Bank and does not take into account the outstanding balances of the managed funds. The allowance is maintained 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 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.

Loans for managed funds (PDLF and YDLF) do not carry a provision for loan losses. The loans are reserved in fund balance as a reserve for related assets. Loans are written off directly against income based on discussions with the owners of the managed funds.

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 of the assets have an estimated useful life of three years.

Interest Income on Loans

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.

**FEDERATED STATES OF MICRONESIA
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Notes to Financial Statements
December 31, 2002

(1) Summary of Significant Accounting Policies, Continued

Cash and Equivalents

For the purposes of the statement of financial condition and the statement of cash flows, cash and 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. The Bank does not require collateralization of its cash in excess of FDIC limits; therefore, any amounts in excess of those limits are uncollateralized.

Totals - Memorandum Only

The "Totals-Memorandum Only" column represents an aggregate of the individual financial statements. The total column is presented only for information purposes and does not represent consolidated financial information.

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.

(2) Deposits and Investments

FSM National Government statutes permit the FSMDB to invest in shares, stocks, mortgages, bonds, obligations, securities and investments of all kinds. IDF funds must be invested in short-term, readily marketable, investment grade nonconvertible bonds, guaranteed investment contracts issued by an insurance company with over \$1 billion in assets, or shares in a money market, open-ended, mutual fund.

Deposits with financial institutions at December 31, 2002, are categorized by risk as follows:

Amount insured or collateralized	\$ 200,000
Uninsured or uncollateralized	<u>2,666,703</u>
Total Deposits	\$ <u>2,866,703</u>

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, 2002.

GASB Statement No. 3 requires government entities to categorize investments in the following categories to give an indication of the level of risk assumed by the entity at year end.

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Notes to Financial Statements
December 31, 2002

(2) Deposits and Investments, Continued

- Category 1 - Securities insured or registered and held by the FSMDB or IDF or its agent in the FSMDB's or IDF's name.
- Category 2 - Securities uninsured and unregistered and held by a party other than the FSMDB or IDF or its agent, in the FSMDB's or IDF's name.
- Category 3 - Securities uninsured and unregistered and held by a party other than the FSMDB or IDF and not in the FSMDB's or IDF's name.

Investments as of December 31, 2002, are carried at cost, which approximates market value, and are comprised of the following:

	<u>FSMDB</u>	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>
U.S. Government obligations	\$ 10,021,773	\$ 8,943,044	\$ -	\$ -
Time certificates of deposit with original maturities of greater than ninety days	-	-	451,918	124,928
Investment premiums and discounts	<u>95,803</u>	<u>17,816</u>	<u>-</u>	<u>-</u>
	<u>\$ 10,117,576</u>	<u>\$ 8,960,860</u>	<u>\$ 451,918</u>	<u>\$ 124,928</u>

Management is of the opinion that it has the intent and ability to hold all of the securities to maturity and, therefore, no losses will be incurred. The investments held by the FSMDB and IDF have been classified as category 1 investments in accordance with the GASB Statement No. 3 as all investments are held in the name of FSMDB or IDF by Merrill Lynch, Inc.

(3) Investment at Cost

An investment in Bank of the FSM is carried at the lower of cost or market. The FSMDB owns 100,000 shares (approximately 11%) of the stock outstanding. Prior to the year ending December 31, 1993, the stock in the Bank of the FSM was accounted for using the equity method which is required by APB Opinion No. 18 for an investor with shareholdings between 20% and 50% and exercising significant influence over the investee. Subsequent to that time, the FSMDB has elected to carry the investment at cost, which was the carrying value at cost on the date the number of shares held by the FSMDB became less than 20% of the outstanding shares. Since the shares are not readily tradeable and the book value of the shares exceed the carrying value, management does not believe that carrying the shares at cost represents a material difference from market value.

(4) Loans Receivable

Loans receivable are reported net of the allowance for doubtful loans. The following is a schedule of loans receivable and the respective allowances as of December 31, 2002:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net Amount</u>
FSMDB	\$ 21,222,771	\$ (3,393,283)	\$ 17,829,488
State Development Funds (Pohnpei and Yap)	363,426	-	363,426
IDF	<u>7,545,521</u>	<u>(2,601,829)</u>	<u>4,943,692</u>
	<u>\$ 29,131,718</u>	<u>\$ (5,995,112)</u>	<u>\$ 23,136,606</u>

**FEDERATED STATES OF MICRONESIA
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Notes to Financial Statements
December 31, 2002

(4) Loans Receivable, Continued

Maturities of the above principal balances of these loans will be as follows:

Fully matured and others	\$ 578,243
1 - 6 months	290,615
7 - 18 months	5,579,928
19 months - 3 years	6,420,079
After 3 years	<u>16,262,853</u>
	<u>\$ 29,131,718</u>

(5) Allowance For Doubtful Loans

An analysis of the change in the allowance for doubtful loans is as follows:

	<u>FSMDB</u>	<u>IDF</u>
Balance - December 31, 2001	\$ 2,356,390	\$ 1,849,997
Provision for doubtful loans-FSMDB	630,163	-
Provision for doubtful loans-IDF	-	751,832
Loan recoveries for previously charged off loans	<u>406,730</u>	<u>-</u>
Balance - December 31, 2002	<u>\$ 3,393,283</u>	<u>\$ 2,601,829</u>

(6) Fixed Assets

A summary of fixed assets as of December 31, 2002, is as follows:

	<u>FSMDB</u>
Office furniture, fixtures and equipment	\$ 165,392
Home furniture, fixtures and equipment	13,608
Vehicles	122,286
Computers and software	<u>266,096</u>
Total	567,382
Less accumulated depreciation	<u>(452,874)</u>
Net fixed assets	<u>\$ 114,508</u>

(7) Related Party Transactions

As of December 31, 2002, the Bank has thirty-seven loans totaling \$4,070,843 to employees and spouses of employees of the Bank of which nine loans totaling \$3,872,439 are considered to be normal bank project loans. These loans are made under the same terms and conditions as exist with other borrowers. Officers and Board members are not eligible to borrow from the Bank.

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Notes to Financial Statements
December 31, 2002

(8) Commitments and Contingencies

The Bank is contingently liable on loan guarantees to the Bank of Guam, ranging from 50% to 90% of the outstanding loan balances for commercial projects within the FSM. Outstanding loan balances on the guarantees as of December 31, 2002, are as follows:

<u>Type of Project</u>	<u>Amount</u>
Real estate	\$ <u>33,279</u>

The FSMDB and YDLF have made loan commitments for loans approved but undisbursed in the amounts of \$3,376,006 and \$5,729 respectively, at December 31, 2002. Also, FSMDB 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.

Litigation

The bank has been named as a party to several lawsuits. However, it is not possible to predict a reasonable estimation or outcome for these cases, and therefore no provision for any liability that may result has been made in the accompanying financial statements.

Self Insurance

The FSM Development Bank carries insurance to cover its potential risks from fire on its building and the contents and full coverage on property damage. 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 FSM Development Bank has seven operating leases as of December 31, 2002. Three are residential real estate leases for contract employees, one which has a term of two years and two for five years. Four represent leases for the branch offices in each state (one with a lease term of two years, two for five years and one for fifteen years). The approximate future minimum annual lease payments payable by FSMDB are as follows:

<u>Fiscal year ending</u>	<u>Total</u>
December 31, 2003	\$ 103,400
December 31, 2004	85,820
December 31, 2005	83,820
December 31, 2006	76,220
December 31, 2007	58,320
Thereafter	<u>427,680</u>
	\$ <u>835,260</u>

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Notes to Financial Statements
December 31, 2002

(9) Contribution From The FSM National Government

The FSM Development Bank receives periodic subsidies of its operations from appropriations received from the Congress of the FSM. During the year ended December 31, 2002, the Bank did not receive such subsidies, but the Bank was reimbursed for expenses incurred in administrating the IDF program from the IDF Private Sub Account for \$250,000.

Additionally, the Bank received \$500,000 of contributions during the year ended December 31, 2002, from the FSM National Government.

(10) Retained Earnings at Beginning of Year

The FSM Development Bank adopted GASB Statement 33, "Accounting and Financial Reporting for Nonexchange Transactions." GASB 33 established more uniform revenue recognition criteria and financial reporting standards regarding the timing of recognition of the results of nonexchange transactions involving cash and other financial and capital resources. The provisions of GASB 33 were applied to all periods presented; and accordingly, the statement of revenues, expenditures and changes in retained earnings (proprietary fund type) for 2001 has been restated to reflect contributions of \$500,000. Implementation of GASB 33 also impacted the statement of condition for the same amount. There was no impact on the statement of cash flows.



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS
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, as of December 31, 2002, and for the year then ended, and have issued our report thereon dated March 31, 2003. 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.

Compliance

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*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Federated States of Micronesia Development Bank's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect the Federated States of Micronesia Development Bank's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in the accompanying Schedule of Findings and Questioned Costs as item 2002-1.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

This report is intended for the information of Board of Directors and management of the 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.

Deloitte + Touche LLP

March 31, 2003



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS
APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

The Board of Directors
Federated States of Micronesia Development Bank:

Compliance

We have audited the compliance of the Federated States of Micronesia Development Bank with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended December 31, 2002. Federated States of Micronesia Development Bank's major federal program is identified in the Schedule of Expenditures of Federal Awards (page 16). Compliance with the requirements of laws, regulations, contracts and grants applicable to its one major federal program is the responsibility of Federated States of Micronesia Development Bank's management. Our responsibility is to express an opinion on Federated States of Micronesia Development Bank's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Federated States of Micronesia Development Bank's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on Federated States of Micronesia Development Bank's compliance with those requirements.

In our opinion, the Federated States of Micronesia Development Bank complied, in all material respects, with the requirements referred to above that are applicable to its one major federal financial assistance program for the year ended December 31, 2002.

Internal Control Over Compliance

The management of the Federated States of Micronesia Development Bank is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing the audit, we considered the Federated States of Micronesia Development Bank's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the Federated States of Micronesia Development Bank, as of and for the year ended December 31, 2002, and have issued our report thereon dated March 31, 2003. Our audit was performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the financial statements. This schedule is the responsibility of the management of the Federated States of Micronesia Development Bank. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

This report is intended for the information of Board of Directors and management of the 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, flowing style.

March 31, 2003

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Schedule of Expenditures of Federal Awards
Year Ended December 31, 2002
CFDA #15.875 - Department of the Interior

The Bank receives funds in a subrecipient capacity through the FSM National Government. The loan portfolio established through Section 111 of the Compact of Free Association and the loan portfolio established through Section 211 of the Compact of Free Association were selected for detailed compliance testing in accordance with applicable OMB Circular A-133 requirements. The following sets forth these contributions, by Sections, which are administered by the Bank.

Section 211 Compact Capital	Total funding received through December 31, 2002	\$ <u>23,700,000</u>
Section 111 IDF Funds	Total funding available through December 31, 2002	\$ 16,957,751
	Amount of revenues and other sources over expenditures and other uses during year ended December 31, 2002	<u>(555,713)</u>
	Fund balance as of December 31, 2002	\$ <u>16,402,038</u>

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs
Year Ended December 31, 2002

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were identified, none of which are considered to be material weaknesses.
3. No instance of noncompliance considered material to the financial statements was disclosed by the audit.
4. Reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were not identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. The Organization's major program is:

<u>Name of Federal Program or Cluster</u>	<u>CFDA Number</u>
Compact of Free Association	15.875

8. No Type B programs as those terms are defined in OMB Circular A-133 are administered by the Organization.
9. The Organization did qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

Part II - Financial Statement Findings Section

<u>Reference Number</u>	<u>Findings</u>	<u>Questioned Costs</u>	<u>Refer Page #</u>
2002-1	Investment Schedules	\$ -	18

Part III - Federal Award Findings and Questioned Cost Section

No matters are reportable.

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs, Continued
Year Ended December 31, 2002

Investment Schedule

Finding No. 2002-1

Criteria: Detail supporting schedules should be prepared for certain account balances.

Condition: Schedules detailing accrued interest on investments were not prepared.

Cause: The cause of this condition is unknown.

Effect: There is no material impact on the financial statements as a result of this condition. However, not preparing and analyzing schedules for these accounts may translate into erroneous entries.

Prior Year Status: This finding was also noted in our schedule of findings and questioned costs for the fiscal year ended December 31, 2001.

Recommendation: Detailed supporting schedules should be prepared for accrued interest receivable, which include the description of the investment, the principal amount, date of purchase, due date, effective date, date interest last paid, number of days to fiscal year end, days to maturity, amount receivable and amount of income to ensure that such are properly recorded and substantiated. The client should also implement the use of four new accounts being unrealized gain, realized gain, unrealized loss, realized loss.

Auditee Response dated April 21, 2003: We have reviewed the FY 2002 audit finding, however, in FY 2003 we have implemented the change in booking investment transactions to comply with the accounting requirements.

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Summary Schedule of Prior Audit Findings
Year Ended December 31, 2002

There are no prior audit findings relative to Federal awards.