

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

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**FINANCIAL STATEMENTS AND  
INDEPENDENT AUDITORS' REPORT**

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**YEARS ENDED DECEMBER 31, 2007 AND 2006**

**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:

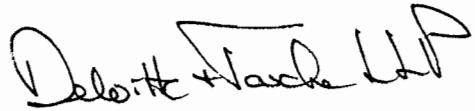
We have audited the accompanying statements of net assets of the Federated States of Micronesia Development Bank, a component unit of the National Government of the Federated States of Micronesia, as of December 31, 2007 and 2006, and the related statements of revenues, expenses and changes in net assets and cash flows for the years 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 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, 2007 and 2006, 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 May 29, 2008, on our consideration of the Bank's internal control over financial reporting and 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 + Tachle LLP". The signature is written in a cursive, stylized font.

May 29, 2008

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK  
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Management Discussion and Analysis  
Years Ending December 31, 2007 and 2006

Earnings in 2007 increased by 102% from \$838,077 in 2006 to \$1,696,723. Provisioning for doubtful loans in 2007 was \$199,890 due to loan receipts against loans classified as doubtful. The economic outlook appears promising as the flow of Compact funds begins to pour in for major infrastructure projects.

At December 31, 2007, the market value of the Bank's investments stood at \$11,349,641, an increase of 7% from \$10,606,544 at the end of 2006.

Summary Statement of Revenues, Expenses and Changes in Net Assets

|                                 | <u>2007</u>          | <u>2006</u>          | <u>2005</u>          |
|---------------------------------|----------------------|----------------------|----------------------|
| Operating revenues              | \$ 3,145,551         | \$ 2,896,826         | \$ 2,482,638         |
| Provision for doubtful loans    | 199,890              | 984,313              | 235,748              |
| Operating expenses              | <u>1,616,993</u>     | <u>1,593,613</u>     | <u>1,357,830</u>     |
| Earnings from operations        | 1,328,668            | 318,900              | 889,060              |
| Non-operating revenues          | <u>368,055</u>       | <u>519,177</u>       | <u>576,054</u>       |
| Increase in net assets          | 1,696,723            | 838,077              | 1,465,114            |
| Net assets at beginning of year | <u>33,992,610</u>    | <u>33,154,533</u>    | <u>31,689,419</u>    |
| Net assets at end of year       | \$ <u>35,689,333</u> | \$ <u>33,992,610</u> | \$ <u>33,154,533</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 2007 were \$12,407,090, \$843,862, and \$329,845 respectively. IDF ended the year with an income of \$344,538 whereas PDLF and YDLF earned incomes of \$32,833 and \$24,595, respectively. Kosrae State drew down \$68,000 from their sub-account to help its operation needs. Pohnpei State received \$1,158,571.

Management's Discussion and Analysis for the year ended September 30, 2006 is set forth in the FSMDB's report on the audit of financial statements, which is dated April 23, 2007. That Discussion and Analysis explains the major factors impacting the 2006 financial statements and can be viewed at the Office of the Public Auditor's website at [www.fsmpublicauditor.fm](http://www.fsmpublicauditor.fm)

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

Statements of Net Assets  
December 31, 2007 and 2006

|   | (Proprietary Fund Type) |               |
|---|-------------------------|---------------|
|   | FSMDB                   |               |
|   | 2007                    | 2006          |
| <u>ASSETS</u>   |                         |               |
| Current assets:   |                         |               |
| Cash and cash equivalents   | \$ 1,890,029            | \$ 3,733,002  |
| Time certificates of deposit  | 300,000                 | -             |
| Accounts receivable   | 2,638                   | 5,533         |
| Receivable from trust funds   | 306,008                 | 205,827       |
| Prepaid expenses  | 2,500                   | 2,500         |
| Interest and other receivables  | 128,529                 | 122,262       |
| Current portion of loans receivable                                       | 1,770,062               | 782,673       |
|   | 4,399,766               | 4,851,797     |
| Total current assets  |                         |               |
| Noncurrent assets:  |                         |               |
| Fixed assets, net   | 259,071                 | 254,438       |
| Investments   | 11,349,641              | 10,606,544    |
| Equity investment, at cost  | 662,188                 | 662,188       |
| Loans receivable, net of current portion and allowance<br>for loan losses | 19,165,324              | 18,133,078    |
|   | 31,436,224              | 29,656,248    |
| Total noncurrent assets   |                         |               |
| Total assets  | \$ 35,835,990           | \$ 34,508,045 |
| <u>LIABILITIES</u>  |                         |               |
| Current liabilities:  |                         |               |
| Accounts payable  | \$ 138,111              | \$ 95,318     |
| Credit life payable   | 8,267                   | 114,396       |
| Payable to trust funds  | 279                     | 305,721       |
|   | 146,657                 | 515,435       |
| Total liabilities   |                         |               |
| Commitments and contingencies   |                         |               |
| Net assets:   |                         |               |
| Invested in capital assets  | 259,071                 | 254,438       |
| Restricted  | 500,000                 | -             |
| Unrestricted  | 34,930,262              | 33,738,172    |
|   | 35,689,333              | 33,992,610    |
| Total net assets  |                         |               |
| Total liabilities and net assets  | \$ 35,835,990           | \$ 34,508,045 |

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, 2007 and 2006

|                                 | (Proprietary Fund Type) |               |
|---------------------------------|-------------------------|---------------|
|                                 | FSMDB                   |               |
|                                 | 2007                    | 2006          |
| Operating revenues:             |                         |               |
| Loan interest                   | \$ 1,900,360            | \$ 1,737,372  |
| Investment income               | 1,058,722               | 1,061,913     |
| Loan fees                       | 111,767                 | 72,649        |
| Miscellaneous                   | 74,702                  | 24,892        |
| Total operating revenues        | 3,145,551               | 2,896,826     |
| Provision for doubtful loans    | 199,890                 | 984,313       |
| Net operating revenues          | 2,945,661               | 1,912,513     |
| Operating expenses:             |                         |               |
| Personnel services              | 934,649                 | 850,510       |
| Rent                            | 121,512                 | 119,407       |
| Depreciation                    | 78,141                  | 49,666        |
| Travel                          | 72,304                  | 87,805        |
| Training                        | 69,210                  | 21,623        |
| Contractual services            | 65,478                  | 94,618        |
| FSM retirement plan             | 52,733                  | 52,597        |
| Communication                   | 39,303                  | 40,744        |
| Supplies                        | 13,607                  | 16,332        |
| Insurance                       | 4,691                   | 3,296         |
| Printing                        | 1,410                   | 6,067         |
| Miscellaneous expenses          | 163,955                 | 250,948       |
| Total operating expenses        | 1,616,993               | 1,593,613     |
| Earnings from operations        | 1,328,668               | 318,900       |
| Non-operating revenues:         |                         |               |
| IDF reimbursement               | 250,000                 | 250,000       |
| Allocations from managed funds  | 45,130                  | 35,940        |
| Contributions                   | -                       | 177,721       |
| Other income                    | 72,925                  | 55,516        |
| Total non-operating revenues    | 368,055                 | 519,177       |
| Increase in net assets          | 1,696,723               | 838,077       |
| Net assets at beginning of year | 33,992,610              | 33,154,533    |
| Net assets at end of year       | \$ 35,689,333           | \$ 33,992,610 |

See accompanying notes to financial statements.

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK**  
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Statements of Cash Flows  
Years Ended December 31, 2007 and 2006

|  | (Proprietary Fund Type) |              |
|--|-------------------------|--------------|
|  | FSMDB                   |              |
|  | 2007                    | 2006         |
| Increase (decrease) in cash and cash equivalents   |                         |              |
| Cash flows from operating activities:  |                         |              |
| Cash received from customers   | \$ 3,510,234            | \$ 3,207,831 |
| Cash paid to suppliers for goods and services  | (1,073,162)             | (733,766)    |
| Cash paid to employees   | (934,649)               | (850,510)    |
| Net cash provided by operating activities  | 1,502,423               | 1,623,555    |
| Cash flows from capital and related financing activities:                                      |                         |              |
| Acquisition of fixed assets  | (82,774)                | (3,256)      |
| Net cash used for capital and related financing activities                                     | (82,774)                | (3,256)      |
| Cash flows from investing activities:  |                         |              |
| Loan origination and principal collection, net   | (2,219,525)             | (610,642)    |
| Increase in investments and time certificates of deposit                                       | (1,043,097)             | (720,712)    |
| Net cash used for investing activities   | (3,262,622)             | (1,331,354)  |
| Net change in cash and cash equivalents  | (1,842,973)             | 288,945      |
| Cash and cash equivalents at beginning of year   | 3,733,002               | 3,444,057    |
| Cash and cash equivalents at end of year   | \$ 1,890,029            | \$ 3,733,002 |
| Reconciliation of operating earnings to net cash provided by operating activities:             |                         |              |
| Earnings from operations   | \$ 1,328,668            | \$ 318,900   |
| Other earnings from managed funds and other  | 368,055                 | 341,456      |
| Adjustment to reconcile earnings from operations to net cash provided by operating activities: |                         |              |
| Provision for doubtful loans   | 199,890                 | 984,313      |
| Depreciation   | 78,141                  | 49,666       |
| (Increases) decreases in assets:   |                         |              |
| Receivables  | (103,553)               | (16,762)     |
| Prepaid expenses   | -                       | (500)        |
| (Decrease) in liabilities:   |                         |              |
| Accounts payable and other liabilities   | (368,778)               | (53,518)     |
| Net cash provided by operating activities  | \$ 1,502,423            | \$ 1,623,555 |

Supplemental disclosure of non-cash financing activity:

During the year ended December 31, 2006, FSMDB received fixed assets valued at \$177,721 as a contribution from the FSM National Government.

During the years ended December 31, 2007 and 2006, the Bank received \$1,916,253 and \$1,698,433, respectively of interest income from loans in cash.

See accompanying notes to financial statements.



**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK  
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Notes to Financial Statements  
December 31, 2007 and 2006

(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, 2007, 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 as of December 31, 2007, has entered into a line of credit agreement with Export and Import Bank of China for \$2 million. As of December 31, 2007, the Bank has not drawn on this line. Additionally, the Bank has entered into a memorandum of understanding with USDA RECD to provide guarantees for housing loans in the FSM. An escrow account amounting to \$500,000 was established for the housing guarantee.

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, 2007 and 2006

(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 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).

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 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, 2007 and 2006, 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.

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK  
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Notes to Financial Statements  
December 31, 2007 and 2006

(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.

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK  
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Notes to Financial Statements  
December 31, 2007 and 2006

(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.

Reclassification

Certain reclassifications have been made to the 2006 financial statements to correspond with the 2007 presentation.

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.

New Accounting Standards

In September 2006, GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*. 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. The statement also includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. The provisions of this statement are effective for periods beginning after December 15, 2006. Management does not believe that the implementation of this statement had a material effect on the financial statements of the Bank.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other postemployment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK  
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Notes to Financial Statements  
December 31, 2007 and 2006

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards, Continued

In December 2006, GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. 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 provisions of this statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this statement will have a material effect on the financial statements of the Bank.

In May 2007, GASB issued Statement No. 50, *Pension Disclosures an amendment of GASB Statements No. 25 and 27*. GASB Statement No. 50 more closely aligns the financial reporting requirements for pensions with those for other postemployment benefits. The provisions of this statement are effective for periods beginning after June 15, 2007. Management does not believe the implementation of this statement will have a material effect on the financial statements of the Bank.

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.

(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.
- (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.

**FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK  
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Notes to Financial Statements  
December 31, 2007 and 2006

(2) Deposits and Investments, Continued

- (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.

As of December 31, 2007 and 2006, the carrying amount of the Bank's total cash and cash equivalents was \$1,890,029 and \$3,733,002, 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, 2007 and 2006, bank deposits in the amount of \$200,000 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, 2007 and 2006.

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

Notes to Financial Statements  
December 31, 2007 and 2006

(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 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, 2007 and 2006, investments at fair value are as follows:

|                          | <u>2007</u>          | <u>2006</u>          |
|--------------------------|----------------------|----------------------|
| Fixed income securities: |                      |                      |
| Domestic fixed income    | \$ 2,859,371         | \$ 2,660,969         |
| Other investments:       |                      |                      |
| Domestic equities        | 5,347,165            | 7,945,575            |
| Money market funds       | <u>3,143,105</u>     | <u>-</u>             |
|                          | <u>\$ 11,349,641</u> | <u>\$ 10,606,544</u> |

As of December 31, 2007 and 2006, the Bank's fixed income securities had the following maturities:

|                                    | Less Than<br><u>1 Year</u> | 1 to 5<br><u>Years</u> | 6 to 10<br><u>Years</u> | Greater Than<br><u>10 Years</u> | Fair<br><u>Value</u> |
|------------------------------------|----------------------------|------------------------|-------------------------|---------------------------------|----------------------|
| 2007                               |                            |                        |                         |                                 |                      |
| 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>  |
| 2006                               |                            |                        |                         |                                 |                      |
| U.S. Treasury obligations          | \$ -                       | \$ 928,597             | \$ -                    | \$ -                            | \$ 928,597           |
| U.S. Government agency obligations | <u>403,068</u>             | <u>870,821</u>         | <u>458,483</u>          | <u>-</u>                        | <u>1,732,372</u>     |
|                                    | <u>\$ 403,068</u>          | <u>\$ 1,799,418</u>    | <u>\$ 458,483</u>       | <u>\$ -</u>                     | <u>\$ 2,660,969</u>  |

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

Notes to Financial Statements  
December 31, 2007 and 2006

(2) Deposits and Investments, Continued

B. Investments, Continued

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, 2007 and 2006, was as follows:

| <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>    |
| <br>                              |                     |                     |                      |
| <u>2006</u>                       | <u>Total</u>        | <u>Domestic</u>     | <u>International</u> |
| Moody's Rating – AAA              | \$ <u>2,660,969</u> | \$ <u>2,660,969</u> | \$ <u>      -</u>    |
| Total credit risk debt securities | \$ <u>2,660,969</u> | \$ <u>2,660,969</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, 2007 and 2006.

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, 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. As of December 31, 2006, the Bank's investment in agency obligations of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association constituted 21% and 27%, 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.



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

Notes to Financial Statements  
December 31, 2007 and 2006

(4) Loans Receivable

A summary of loans receivable at December 31, 2007 and 2006 follows:

|                           | <u>2007</u>          | <u>2006</u>          |
|---------------------------|----------------------|----------------------|
| Unpaid principal balance  | \$ 26,020,506        | \$ 22,694,998        |
| Allowance for loan losses | <u>(5,085,120)</u>   | <u>(3,779,247)</u>   |
|                           | <u>\$ 20,935,386</u> | <u>\$ 18,915,751</u> |

Movements in the allowance for loan losses during the years ended December 31, 2007 and 2006, are as follows:

|  | <u>2007</u>         | <u>2006</u>         |
|--|---------------------|---------------------|
| Balance at beginning of year                         | \$ 3,779,247        | \$ 3,135,020        |
| Provision for loan losses                            | 199,890             | 984,313             |
| Loans charged off                                    | (1,415,881)         | (744,149)           |
| Loan recoveries from previously charged off loans    | 471,415             | 243,969             |
| Loan reactivations from previously charged off loans | <u>2,050,449</u>    | <u>160,094</u>      |
| Balance at end of year                               | <u>\$ 5,085,120</u> | <u>\$ 3,779,247</u> |

(5) Fixed Assets

A summary of fixed assets as of December 31, 2007 and 2006, is as follows:

|  | Beginning<br>Balance<br>January 1,<br><u>2007</u> | <u>Additions</u>  | <u>Deletions</u> | Ending<br>Balance<br>December 31,<br><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>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>                                |
|  | Beginning<br>Balance<br>January 1,<br><u>2006</u> | <u>Additions</u>  | <u>Deletions</u> | Ending<br>Balance<br>December 31,<br><u>2006</u> |
| Office furniture, fixtures and equipment | \$ 190,265  | \$ -              | \$ (45,269)      | \$ 144,996                                       |
| Home furniture, fixtures and equipment   | 13,608  | -                 | -                | 13,608   |
| Vehicles                                 | 191,858   | -                 | (20,510)         | 171,348  |
| Computers and software                   | <u>294,782</u>                                    | <u>180,997</u>    | <u>(3,244)</u>   | <u>472,535</u>                                   |
|  | 690,513   | 180,997           | (69,023)         | 802,487  |
| Less accumulated depreciation            | <u>(567,386)</u>                                  | <u>(49,666)</u>   | <u>69,003</u>    | <u>(548,049)</u>                                 |
| Net fixed assets                         | <u>\$ 123,127</u>                                 | <u>\$ 131,331</u> | <u>\$ (20)</u>   | <u>\$ 254,438</u>                                |

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

Notes to Financial Statements  
December 31, 2007 and 2006

(6) Related Party Transactions

As of December 31, 2007 and 2006, the Bank has direct loans with outstanding balances of \$150,696 and \$171,605, respectively, to employees of the Bank and project loans extended to businesses owned by or affiliated with employees of \$2,802,120 and \$3,268,519, 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, 2007 and 2006.

Loan Commitments

The Bank has entered into loan commitments for loans approved but undisbursed in the amount of \$6,382,254 at December 31, 2007.

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, 2007. Two 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:

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

Notes to Financial Statements  
December 31, 2007 and 2006

(7) Commitments and Contingencies, Continued

| <u>Fiscal year ending December 31,</u> | <u>Total</u>               |
|--|----------------------------|
| 2008                                   | \$ 122,016                 |
| 2009                                   | 122,016                    |
| 2010                                   | 122,016                    |
| 2011                                   | 122,016                    |
| 2012                                   | 122,016                    |
| 2013 – 2017                            | 610,080                    |
| 2018 – 2022                            | 610,080                    |
| 2023 – 2027                            | 610,080                    |
| 2028 – 2032                            | <u>610,080</u>             |
|  | <b>\$ <u>3,050,400</u></b> |

In September 2007, the Bank entered into a line of credit agreement with Export and Import Bank of China for \$2 million. As of December 31, 2007, the Bank has not drawn on this line. Additionally in 2007, the Bank entered into a memorandum of understanding with USDA RECD to provide a guarantee of housing loans in the FSM. An escrow account amounting to \$500,000 was established for the housing guarantee. Net assets have been accordingly restricted in this amount.

(8) Contribution from the FSM National Government

The FSM Development Bank receives periodic subsidies of its operations from appropriations made by the Congress of the FSM. During the years ended December 31, 2007 and 2006, the Bank received \$0 and \$177,721, respectively, from the FSM Congress and 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.

(9) 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 controller is the designated Plan Administrator. Matching contributions to the Plan during the years ended December 31, 2007 and 2006 were \$52,733 and \$52,597, respectively. Management is of the opinion that the Plan does not represent an asset or a liability of the Bank.

(10) 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, 2007, the account has a balance of \$99,383.

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

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**FINANCIAL STATEMENTS AND  
INDEPENDENT AUDITORS' REPORT**

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**DECEMBER 31, 2007**

## INDEPENDENT AUDITORS' REPORT

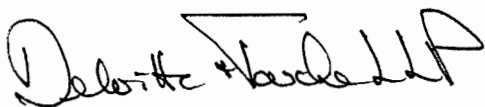
Chairman  
Board of Directors  
Federated States of Micronesia  
Development Bank:

We have audited the accompanying statement of 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, 2007, and the related statement of activities and changes in 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 Funds' 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 financial position of the Funds at December 31, 2007, and the changes in their net assets 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 May 29, 2008, on our consideration of the Funds' internal control over financial reporting and 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.



May 29, 2008

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

Trust Funds  
Statement of Net Assets  
December 31, 2007  
(With Comparative Totals as of December 31, 2006)

|  | Governmental Fund Types |                   |                   | Totals               |                      |
|--|-------------------------|-------------------|-------------------|----------------------|----------------------|
|  | Trust Funds             |                   |                   | (Memorandum Only)    |                      |
|  | IDF                     | PDLF              | YDLF              | 2007                 | 2006                 |
| <b><u>ASSETS</u></b>                     |                         |                   |                   |                      |                      |
| Current assets:                          |                         |                   |                   |                      |                      |
| Held by FSMDB:                           |                         |                   |                   |                      |                      |
| Cash in bank and on hand                 | \$ -                    | \$ 226,858        | \$ 70,628         | \$ 297,486           | \$ 245,852           |
| Time certificates of deposit             | 532,777                 | 540,013           | 136,286           | 1,209,076            | 1,164,065            |
| Held by trustee:                         |                         |                   |                   |                      |                      |
| Investments                              | 4,020,881               | -                 | -                 | 4,020,881            | 5,139,752            |
| Total cash and equivalents               | <u>4,553,658</u>        | <u>766,871</u>    | <u>206,914</u>    | <u>5,527,443</u>     | <u>6,549,669</u>     |
| Receivable from FSMDB                    | 279                     | -                 | -                 | 279                  | 305,721              |
| Interest and other receivables           | 2,895                   | 9,988             | 377               | 13,260               | 8,734                |
| Loans receivable, net                    | 7,850,258               | 67,003            | 122,554           | 8,039,815            | 7,736,428            |
| Total receivables                        | <u>7,853,432</u>        | <u>76,991</u>     | <u>122,931</u>    | <u>8,053,354</u>     | <u>8,050,883</u>     |
|  | <u>\$ 12,407,090</u>    | <u>\$ 843,862</u> | <u>\$ 329,845</u> | <u>\$ 13,580,797</u> | <u>\$ 14,600,552</u> |
| <b><u>LIABILITIES AND NET ASSETS</u></b> |                         |                   |                   |                      |                      |
| Current liabilities:                     |                         |                   |                   |                      |                      |
| Payable to FSMDB                         | \$ 87,950               | \$ 123,947        | \$ 94,111         | 306,008              | \$ 205,827           |
| Credit life payable                      | -                       | -                 | 2,074             | 2,074                | 2,274                |
| Total liabilities                        | <u>87,950</u>           | <u>123,947</u>    | <u>96,185</u>     | <u>308,082</u>       | <u>208,101</u>       |
| Commitments                              |                         |                   |                   |                      |                      |
| Net assets:                              |                         |                   |                   |                      |                      |
| Restricted                               | 7,850,258               | 67,003            | 122,554           | 8,039,815            | 7,736,428            |
| Unrestricted                             | 4,468,882               | 652,912           | 111,106           | 5,232,900            | 6,656,023            |
| Total net assets                         | <u>12,319,140</u>       | <u>719,915</u>    | <u>233,660</u>    | <u>13,272,715</u>    | <u>14,392,451</u>    |
|  | <u>\$ 12,407,090</u>    | <u>\$ 843,862</u> | <u>\$ 329,845</u> | <u>\$ 13,580,797</u> | <u>\$ 14,600,552</u> |

See accompanying notes to financial statements.

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

Trust Funds  
Statement of Activities and Net Assets  
Year Ended December 31, 2007  
(With Comparative Totals for the Year Ended December 31, 2006)

|  | Governmental Fund Types<br>(Trust Funds) |                   |                   | Totals<br>(Memorandum Only) |                      |
|--|--|-------------------|-------------------|-----------------------------|----------------------|
|  | IDF                                      | PDLF              | YDLF              | 2007                        | 2006                 |
| Operating revenues:  |  |                   |                   |                             |                      |
| Investment interest  | \$ 244,198                               | \$ 26,134         | \$ 4,829          | \$ 275,161                  | \$ 474,702           |
| Loan interest  | 99,040                                   | 6,569             | 19,487            | 125,096                     | 122,562              |
| Miscellaneous  | 1,300                                    | 130               | 278               | 1,708                       | 6,568                |
| Total operating revenues                                       | <u>344,538</u>                           | <u>32,833</u>     | <u>24,594</u>     | <u>401,965</u>              | <u>603,832</u>       |
| Operating expenditures:  |  |                   |                   |                             |                      |
| Doubtful loan expense  | -  | -                 | -                 | -                           | -                    |
| Total operating expenditures                                   | <u>-</u>                                 | <u>-</u>          | <u>-</u>          | <u>-</u>                    | <u>-</u>             |
| Revenues over expenditures                                     | <u>344,538</u>                           | <u>32,833</u>     | <u>24,594</u>     | <u>401,965</u>              | <u>603,832</u>       |
| Other sources (uses):  |  |                   |                   |                             |                      |
| Investment management fee                                      | (250,000)                                | -                 | -                 | (250,000)                   | (250,000)            |
| Transfer to Kosrae State Government                            | (68,000)                                 | -                 | -                 | (68,000)                    | (50,000)             |
| Transfer to Pohnpei State Government                           | (1,158,571)                              | -                 | -                 | (1,158,571)                 | -                    |
| Transfers to FSMDB   | -  | (32,833)          | (12,297)          | (45,130)                    | (35,940)             |
| Total other uses, net  | <u>(1,476,571)</u>                       | <u>(32,833)</u>   | <u>(12,297)</u>   | <u>(1,521,701)</u>          | <u>(335,940)</u>     |
| Revenues and other sources over<br>expenditures and other uses | <u>(1,132,033)</u>                       | <u>-</u>          | <u>12,297</u>     | <u>(1,119,736)</u>          | <u>267,892</u>       |
| Net assets at beginning of year                                | <u>13,451,173</u>                        | <u>719,915</u>    | <u>221,363</u>    | <u>14,392,451</u>           | <u>14,124,559</u>    |
| Net assets at end of year                                      | <u>\$ 12,319,140</u>                     | <u>\$ 719,915</u> | <u>\$ 233,660</u> | <u>\$ 13,272,715</u>        | <u>\$ 14,392,451</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, 2007

(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 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).

Cash

For the purposes of the statement of 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, 2007

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

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.

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.

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Notes to Financial Statements  
December 31, 2007

(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, 2007, the carrying amount of the Funds' total cash and cash equivalents and time certificates of deposits was \$1,506,563 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, 2007, bank deposits in the amount of \$200,000 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, 2007.

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Notes to Financial Statements  
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(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, 2007, investments at fair value are as follows:

|                          |                     |
|--------------------------|---------------------|
| Fixed income securities: |                     |
| Domestic fixed income    | \$ 3,187,275        |
| Other investments:       |                     |
| Money market funds       | <u>833,606</u>      |
|                          | <u>\$ 4,020,881</u> |

As of December 31, 2007, the Funds' fixed income securities had the following maturities:

|                                    | <u>Less Than<br/>1 Year</u> | <u>1 to 5<br/>Years</u> | <u>6 to 10<br/>Years</u> | <u>Greater<br/>10 Years</u> | <u>Fair<br/>Value</u> |
|------------------------------------|-----------------------------|-------------------------|--------------------------|-----------------------------|-----------------------|
| U.S. Government agency obligations | <u>\$3,187,275</u>          | \$ _____                | \$ _____                 | \$ _____                    | <u>\$3,187,275</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, 2007, was as follows:

| <u>Moody's Rating</u>             | <u>Total</u>        | <u>Domestic</u>     | <u>International</u> |
|-----------------------------------|---------------------|---------------------|----------------------|
| AAA                               | \$ <u>3,187,275</u> | \$ <u>3,187,275</u> | \$ _____             |
| Total credit risk debt securities | \$ <u>3,187,275</u> | \$ <u>3,187,275</u> | \$ _____             |

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Notes to Financial Statements  
December 31, 2007

(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, 2007.

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, 2007, the Funds' investment in agency obligations of Federal Home Loan Mortgage Corporation and Federal National Mortgage Association constituted 55% and 25%, 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, 2007:

|   | <u>Loan Balance</u> | <u>Allowance</u> | <u>Net</u>          |
|---|---------------------|------------------|---------------------|
| State Development Funds (Pohnpei and Yap) | \$ 189,557          | \$ -             | \$ 189,557          |
| IDF                                       | <u>7,853,558</u>    | <u>3,300</u>     | <u>7,850,258</u>    |
|   | <u>\$ 8,043,115</u> | <u>\$ 3,300</u>  | <u>\$ 8,039,815</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.

(4) Commitments

Loan commitments for loans approved but undisbursed approximated \$99,724 at December 31, 2007.

## **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, 2007, and have issued our report thereon dated May 29, 2008. 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.

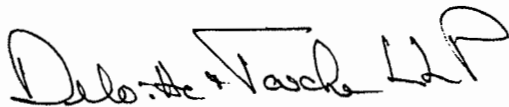
A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Bank's internal control.

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, appearing to read "Delo & Vasche LLP". The signature is written in a cursive, flowing style with some stylized capital letters.

May 29, 2008