

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

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

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED DECEMBER 31, 2014 AND 2013

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

Table of Contents
Years Ended December 31, 2014 and 2013

	<u>Page No.</u>
I. FINANCIAL STATEMENTS	
<u>Federated States of Micronesia Development Bank</u>	
Independent Auditors' Report	1
Management's Discussion and Analysis	4
Statements of Net Position	7
Statements of Revenues, Expenses and Changes in Net Position	8
Statements of Cash Flows	9
Notes to Financial Statements	11
Supplementary Information:	
Schedule of Net Position – Intermediary Relending Program	24
Schedule of Revenues, Expenses and Changes in Net Position – Intermediary Relending Program	25
<u>Trust Funds Administered by the Federated States of Micronesia Development Bank</u>	
Independent Auditors' Report	27
Statement of Fiduciary Net Position	29
Statement of Changes in Fiduciary Net Position	30
Notes to Financial Statements	31
II. INDEPENDENT AUDITORS' REPORTS ON COMPLIANCE WITH LAWS AND REGULATIONS	
<u>Federated States of Micronesia Development Bank</u>	
Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based On an Audit of Financial Statements Performed In Accordance with <i>Government Auditing Standards</i>	35
<u>Trust Funds Administered by the Federated States of Micronesia Development Bank</u>	
Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based On an Audit of Financial Statements Performed In Accordance with <i>Government Auditing Standards</i>	37

INDEPENDENT AUDITORS' REPORT

Board of Directors
Federated States of Micronesia Development Bank:

Report on the Financial Statements

We have audited the accompanying financial statements of the Federated States of Micronesia Development Bank (the Bank), which comprise the statements of net position as of December 31, 2014 and 2013, and the related statements of revenues, expenses and changes in net position and of cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these 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 from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Federated States of Micronesia Development Bank as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 to 6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Bank's basic financial statements. The supplemental schedule of net position - Intermediary Relending Program and schedule of revenues, expenses and changes in net position - Intermediary Relending Program on pages 24 and 25, respectively, are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The supplemental schedule of net position - Intermediary Relending Program and schedule of revenues, expenses and changes in net position - Intermediary Relending Program are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplemental schedule of net position - Intermediary Relending Program and schedule of revenues, expenses and changes in net position - Intermediary Relending Program are fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated April 7, 2015, on our consideration of the Bank's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Bank's internal control over financial reporting and compliance.

Deloitte & Touche LLP

April 7, 2015

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

Management's Discussion and Analysis
Years Ended December 31, 2014 and 2013

The following is a discussion and analysis of the Federated States of Micronesia Development Bank's (the Bank) financial performance for the fiscal year ended December 31, 2014.

The FSM economy continued to be stagnant in 2014. The loan portfolio grew by 7% over year 2013. In 2014, total assets for the Bank increased 6%, which was mainly due to increases in the loan portfolio as well as in financial investment portfolio. Long term liabilities increased due to drawdown under the European Investment Bank (EIB) loan. In 2014, the Bank approved loans totaling \$10.3 million for 449 borrowers compared to 2013's approval of \$9.9 million for 346 borrowers. Lending to the wholesale/retail trading sector was the highest in terms of total loan amounts followed by lending to tourism and real estate sectors. The Bank was able to generate \$2.2 million in loan interest income in 2014 and was able to cover its operating expenses in full. The Bank ended the year with a total increase in net position of about \$1.7 million, all from internal resources. There was no government contribution received in 2014.

Summary Statements of Net Position

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Assets:			
Current assets	\$ 13,887,315	\$ 14,087,286	\$ 13,688,117
Noncurrent assets	<u>35,560,556</u>	<u>32,411,664</u>	<u>28,631,658</u>
Total assets	\$ <u>49,447,871</u>	\$ <u>46,498,950</u>	\$ <u>42,319,775</u>
Liabilities:			
Liabilities	\$ <u>1,981,559</u>	\$ <u>712,091</u>	\$ <u>934,607</u>
Net position:			
Net investment in capital assets	1,657,506	1,694,055	1,409,335
Unrestricted	<u>45,808,806</u>	<u>44,092,804</u>	<u>39,975,833</u>
Total net position	<u>47,466,312</u>	<u>45,786,859</u>	<u>41,385,168</u>
Total liabilities and net position	\$ <u>49,447,871</u>	\$ <u>46,498,950</u>	\$ <u>42,319,775</u>

During fiscal year 2014, the Bank drew down funds borrowed from the EIB totaling \$1.4 million. The Bank also cancelled undrawn funds under EIB and RECD Intermediary Relending Program. At year end, the outstanding balances of the two loans were \$1.8 million, representing approximately 4% of total assets. For additional information concerning the Bank's debt, please refer to note 8 to the financial statements.

Capital expenditures made during 2014 were for the installation of a new loan management system and additional computers. For additional information concerning the Bank's capital assets, please refer to note 5 to the financial statements.

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

Management's Discussion and Analysis
Years Ended December 31, 2014 and 2013

Earnings from operations were \$680,670, which presents a 34% decrease from last year's results of \$1,025,020. Loan loss provisions of \$446,769 was reversed in 2013 and added back to revenue as there were sufficient loan loss reserves to cover potential losses. In 2014, with the increase in the loan portfolio, \$72,962 loan loss provisions added. As of December 31, 2014, total loan loss provision for total impaired assets (those classified as doubtful and loss) was at 107%. Based on the loan classification policy and review of individual loans, the Bank is adequately reserved for loan losses.

At December 31, 2014, the market value of the Bank's investments stood at \$15.8 million, an increase of about 4% from \$15.2 million at the end of 2013.

Summary Statements of Revenues, Expenses and Changes in Net Position

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Operating revenues	\$ 2,545,945	\$ 2,428,051	\$ 2,476,471
(Provision for) reversal of loan losses	(72,962)	446,769	147,584
Operating expenses	<u>(1,792,313)</u>	<u>(1,849,800)</u>	<u>(1,846,415)</u>
Earnings from operations	680,670	1,025,020	777,640
Non-operating revenues, net	<u>998,783</u>	<u>3,376,671</u>	<u>1,077,123</u>
Change in net position	1,679,453	4,401,691	1,854,763
Net position at beginning of year	<u>45,786,859</u>	<u>41,385,168</u>	<u>39,530,405</u>
Net position at end of year	\$ <u>47,466,312</u>	\$ <u>45,786,859</u>	\$ <u>41,385,168</u>

The Bank now manages two trust funds, namely, the Investment Development Fund (IDF) and Yap Development Loan Fund (YDLF). The total assets for each of these funds at the end of 2014 were \$1,836,125 and \$283,340, respectively. The Pohnpei Development Loan Fund (PDLF) was closed out and all remaining assets transferred to Pohnpei State Treasury and Pohnpei Small Business & Guarantee Corporation. Assets under IDF continues to decrease as there are no new loans under the program and the bank continues to draw management fee to help with the cost of managing the remaining IDF loans which are mostly problem loans. YDLF earned \$1,591 in 2014. Management had submitted a request to the FSM National Government to repeal the IDF law as only two loans remain active in the Private Sector sub-account and all loans in the State sub-accounts have defaulted and the projects are defunct.

Economic Outlook

Management anticipates year 2015 to be similar to 2014 if the release of government infrastructure funds is not realized this year. The Bank will continue to actively seek out projects that are export oriented or import substituting. The Bank is also looking into helping the construction sector by providing real estate development loans and researching programs that could help with Surety bonds. The Bank is set to introduce the Home Energy Loan Program (HELP) this year to help promote energy efficient homes for lower recurring electricity costs. With the creation of the Business Development Officer function and the FSMDB Development Finance Training Institute, the Bank anticipate to be more proactive in developing ideas into viable business proposals and providing entrepreneurial training to help improve the management of successful businesses in the FSM.

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

Management's Discussion and Analysis
Years Ended December 31, 2014 and 2013

Contacting Financial Management

The Management's Discussion and Analysis report is intended to provide information concerning known facts and conditions affecting the Bank's operations. This financial report is designed to provide a general overview of the Bank's finances and to demonstrate the Bank's accountability for the funds it receives and expends.

Management's Discussion and Analysis for the year ended December 31, 2013 is set forth in the Bank's report on the audit of financial statements, which is dated April 14, 2014. That Discussion and Analysis explains the major factors impacting the 2013 financial statements and can be viewed at the Bank's website at www.fsmdb.fm or Office of the Public Auditor's website at www.fsmopa.fm.

For additional information about this report, please contact Anna Mendiola, President/Chief Executive Officer, P.O. Box M, Kolonia, Pohnpei 96941 or visit the website at www.fsmdb.fm.

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

Statements of Net Position
December 31, 2014 and 2013

	2014	2013
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 5,478,528	\$ 6,408,568
Time certificates of deposit	1,993,326	1,410,562
Accounts receivable	37,091	43,414
Receivable from trust funds	79,888	204,108
Prepaid expenses	9,319	667
Interest and other receivables	206,163	210,967
Current portion of loans receivable	6,083,000	5,809,000
Total current assets	13,887,315	14,087,286
Noncurrent assets:		
Depreciable assets, net	1,581,749	1,694,055
Fixed assets in progress	75,757	-
Investments	15,778,622	15,197,400
Equity investment, at cost	1,912,188	1,162,188
Loans receivable, net of current portion and allowance for loan losses	16,212,240	14,358,021
Total noncurrent assets	35,560,556	32,411,664
Total assets	\$ 49,447,871	\$ 46,498,950
<u>LIABILITIES AND NET POSITION</u>		
Current liabilities:		
Current portion of long-term debt	\$ 138,363	\$ 15,294
Accounts payable	84,857	143,034
Accrued interest payable	13,325	-
Credit life payable	61,897	52,479
Payable to trust funds	-	66,715
Total current liabilities	298,442	277,522
Noncurrent liabilities:		
Long-term debt, net of current portion	1,683,117	434,569
Total liabilities	1,981,559	712,091
Commitments and contingencies		
Net position:		
Net investment in capital assets	1,657,506	1,694,055
Unrestricted	45,808,806	44,092,804
Total net position	47,466,312	45,786,859
Total liabilities and net position	\$ 49,447,871	\$ 46,498,950

See accompanying notes to financial statements.

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

Statements of Revenues, Expenses and Changes in Net Position
Years Ended December 31, 2014 and 2013

	2014	2013
Operating revenues:		
Interest income on loans	\$ 2,194,498	\$ 2,187,963
Interest income on time certificates of deposit	13,005	20,197
Loan fees	174,990	105,321
Rental	50,907	40,277
Miscellaneous	112,545	74,293
	2,545,945	2,428,051
Total operating revenues		
(Provision for) reversal of loan losses	(72,962)	446,769
	2,472,983	2,874,820
Net operating revenues		
Operating expenses:		
Interest expense	34,350	23,847
General and administrative expenses:		
Personnel services	901,661	929,939
Rent	137,084	128,820
Depreciation	131,210	128,940
Travel	114,090	96,176
Contractual services	104,604	81,452
Utilities	56,217	63,771
Communication	40,224	42,904
Retirement plan contributions	39,484	44,524
Training	32,601	52,395
Supplies	32,519	31,923
Equipment	31,638	25,886
Branch automation	20,862	22,743
Community development	20,647	8,667
Staff relations	9,400	12,056
Fuel, oil and petroleum	9,018	10,814
Insurance	7,004	7,159
Repair and maintenance	5,626	7,192
Printing	5,188	5,069
Miscellaneous	58,886	125,523
	1,757,963	1,825,953
Total general and administrative expenses		
Earnings from operations	680,670	1,025,020
Nonoperating revenues:		
IDF reimbursement	250,000	250,000
Investment earnings, net	740,127	2,095,025
Gain on sale of assets	8,656	31,646
FSMNG contributions	-	1,000,000
	998,783	3,376,671
Total nonoperating revenues, net		
Change in net position	1,679,453	4,401,691
Net position at beginning of year	45,786,859	41,385,168
Net position at end of year	\$ 47,466,312	\$ 45,786,859

See accompanying notes to financial statements.

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

Statements of Cash Flows
Years Ended December 31, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Cash received from customers	\$ 2,544,067	\$ 2,451,651
Cash paid to suppliers for goods and services	(782,503)	(696,247)
Cash paid to employees for services	(901,661)	(929,939)
Interest received on time certificates of deposit	13,005	20,197
Interest paid	(21,025)	(38,935)
Net cash provided by operating activities	851,883	806,727
Cash flows from noncapital financing activities:		
Proceeds from long-term debt	1,406,526	139,108
Principal repayment of long-term debt	(34,909)	(400,000)
Net transfers in from trust funds	307,505	508,385
FSMNG contributions	-	1,000,000
Net cash provided by noncapital financing activities	1,679,122	1,247,493
Cash flows from capital and related financing activities:		
Proceeds from sale of fixed assets	8,656	31,646
Acquisition of fixed assets	(94,661)	(413,660)
Net cash used for capital and related financing activities	(86,005)	(382,014)
Cash flows from investing activities:		
Loan origination and principal collections, net	(2,201,181)	65,307
Additions to time certificates of deposit, net	(582,764)	1,440,480
Additions to investments, net	(6,405)	(1,290,797)
Additions to equity investment	(750,000)	-
Interest income on savings accounts	1,060	998
Dividends received	164,250	129,000
Net cash (used for) provided by investing activities	(3,375,040)	344,988
Net change in cash and cash equivalents	(930,040)	2,017,194
Cash and cash equivalents at beginning of year	6,408,568	4,391,374
Cash and cash equivalents at end of year	\$ 5,478,528	\$ 6,408,568

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

Statements of Cash Flows, Continued
Years Ended December 31, 2014 and 2013

	2014	2013
Reconciliation of earnings from operations to net cash provided by operating activities:		
Earnings from operations	\$ 680,670	\$ 1,025,020
Adjustment to reconcile earnings from operations to net cash provided by operating activities:		
Provision for (reversal of) loan losses	72,962	(446,769)
Depreciation	131,210	128,940
(Increase) decrease in assets:		
Accounts receivable	6,323	6,829
Interest and other receivables	4,804	36,968
Prepaid expenses	(8,652)	3,980
Increase (decrease) in liabilities:		
Accounts payable	(58,177)	48,680
Accrued interest payable	13,325	(15,088)
Credit life payable	9,418	18,167
Net cash provided by operating activities	\$ 851,883	\$ 806,727

See accompanying notes to financial statements.

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

Notes to Financial Statements
December 31, 2014 and 2013

(1) Summary of Significant Accounting Policies

Reporting Entities

The Federated States of Micronesia (FSM) Development Bank (the Bank) was created in 1979 by Public Law 1-37 of the First Congress of the Federated States of Micronesia. The 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 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, 2010, the Bank has issued 2,997,883 shares to the FSM National Government (98.7%), Kosrae State (0.3%) and Chuuk State (1.0%). These shares do not convey ownership and have been made in accordance with the aforementioned law but these shares have no financial impact on the accompanying financial statements.

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 United States.

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.

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.

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

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

Notes to Financial Statements
December 31, 2014 and 2013

(1) Summary of Significant Accounting Policies, Continued

Fund Structure and Basis of Accounting, Continued

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 (GAAP) as applied to governmental units using the accrual basis of accounting. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

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

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

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 include 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 position 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

Investment securities 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 and is primarily determined based on quoted market values.

An equity investment in the common stock of Bank of the FSM is stated at cost as there is no active market for this investment.

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

Notes to Financial Statements
December 31, 2014 and 2013

(1) Summary of Significant Accounting Policies, Continued

Loans and Allowance for Loan Losses

Loans receivable 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 their useful lives. Assets with a purchase value less than \$5,000 are expensed fully in the year of purchase.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank enters 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 GAAP 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.

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

Notes to Financial Statements
December 31, 2014 and 2013

(1) Summary of Significant Accounting Policies, Continued

New Accounting Standards

During the year ended December 31, 2014, the Bank implemented the following pronouncements:

- GASB Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, which improves accounting and financial reporting for state and local governments' combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. A disposal of government operations can occur through a transfer to another government or a sale. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The implementation of this statement did not have a material effect on the accompanying financial statements.

In June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions*, which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of this statement on the financial statements of the Bank.

In November 2013, GASB issued Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date - an amendment of GASB Statement No. 68*, which addresses an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The issue relates to amounts associated with contributions, if any, made by a state or local government employer or nonemployer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability. The provisions in Statement 71 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of this statement on the financial statements of the Bank.

(2) Deposits and Investments

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:

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

Notes to Financial Statements
December 31, 2014 and 2013

(2) Deposits and Investments, Continued

- (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.
- (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:

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, 2014 and 2013, the carrying amount of the Bank's total cash and cash equivalents and time certificates of deposit was \$7,471,854 and \$7,819,130, respectively, and the corresponding bank balances were \$7,610,727 and \$9,138,875, respectively, which were all maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2014 and 2013, bank deposits in the amounts of \$500,000 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, 2014 and 2013.

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

Notes to Financial Statements
December 31, 2014 and 2013

(2) Deposits and Investments, Continued

B. Investments

As of December 31, 2014 and 2013, investments at fair value are as follows:

	<u>2014</u>	<u>2013</u>
Fixed income securities:		
Domestic fixed income	\$ 4,987,915	\$ 4,640,931
Other investments:		
Domestic equities	8,387,491	7,985,153
Money market funds	1,375,093	2,571,316
Shares in a mutual fund (Templeton Global BD FD ADV TGBAX)	<u>1,028,123</u>	<u>-</u>
	<u>\$ 15,778,622</u>	<u>\$ 15,197,400</u>

As of December 31, 2014, investments in domestic fixed income are as follows:

	<u>Amount</u>	<u>Maturity</u>	<u>Moody's Rating</u>
U.S. Government Securities			
U.S. Treasury Bond	\$ 514,041	08/15/2021	AAA
U.S. Treasury Note	421,541	11/15/2021	AAA
U.S. Treasury Note	335,838	02/15/2022	AAA
U.S. Treasury Note	<u>594,745</u>	05/15/2022	AAA
	1,866,165		
U.S. Government Agency Securities			
Federal Home Loan Mortgage Corporation (FHLMC) note	214,818	02/09/2015	AA2
Federal Home Loan Bank (FHLB) note	257,302	06/13/2016	A2
FHLB note	341,057	03/27/2017	AAA
FHLB note	522,241	04/28/2017	AAA
Federal National Mortgage Association (FNMA) note	343,751	09/20/2017	AAA
FNMA note	91,720	09/26/2017	AAA
FHLMC note	338,547	12/14/2018	AAA
FHLMC mortgage-backed securities	116,861	10/01/2023	not rated
FNMA mortgage-backed securities	<u>244,339</u>	09/01/2027	not rated
	2,470,636		
Corporate Bonds:			
Aflac, Inc. (CUSIP 001055AC6)	56,237	05/15/2019	A3
Morgan Stanley (CUSIP 61747WAF6)	57,398	01/25/2021	BAA2
Goldman Sachs Group, Inc. (CUSIP 38141GGQ1)	39,503	07/27/2021	BAA1
General Electric Capital Corp (CUSIP 36962G5J9)	50,721	10/17/2021	A1
Bank of America Corp (CUSIP 06051GEM7)	46,338	01/24/2022	BAA2
PNC Funding Corp (CUSIP 693476BN2)	41,137	03/08/2022	A3
Citigroup Inc. (CUSIP 172967GK1)	72,426	07/30/2022	BAA3
Wells Fargo & Company (CUSIP 94974BFJ4)	70,944	02/13/2023	A3
Metlife Inc (CUSIP 59156RBB3)	54,520	09/15/2023	A3
IBM Corp (CUSIP 459200HU8)	83,346	02/12/2024	AA3
Apple Inc (CUSIP 037833AS9)	<u>78,544</u>	05/06/2024	AAA
	651,114		
	<u>\$ 4,987,915</u>		

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

Notes to Financial Statements
December 31, 2014 and 2013

(2) Deposits and Investments, Continued

B. Investments, Continued

As of December 31, 2013, investments in domestic fixed income are as follows:

	<u>Amount</u>	<u>Maturity</u>	<u>Moody's Rating</u>
U.S. Government Securities			
U.S. Treasury Note	\$ 201,750	05/31/2014	AAA
U.S. Treasury Note	256,368	08/15/2014	AAA
U.S. Treasury Note	234,545	02/15/2015	AAA
U.S. Treasury Note	206,038	04/30/2015	AAA
U.S. Treasury Note	190,134	02/15/2016	AAA
U.S. Treasury Note	325,306	01/31/2017	AAA
U.S. Treasury Note	194,852	11/15/2017	AAA
U.S. Treasury Note	192,883	05/15/2018	AAA
U.S. Treasury Note	243,808	01/31/2019	AAA
U.S. Treasury Note	213,126	05/15/2019	AAA
U.S. Treasury Note	108,844	02/15/2020	AAA
U.S. Treasury Note	<u>343,531</u>	02/15/2022	AAA
	<u>2,711,185</u>		
U.S. Government Agency Securities			
FNMA note	139,717	10/15/2014	AAA
FHLMC note	308,772	02/09/2015	AAA
FHLMC note	202,617	09/10/2015	AAA
FHLMC note	291,832	11/17/2015	AAA
FHLMC note	284,380	08/25/2016	AAA
FNMA note	235,603	09/15/2016	AAA
FNMA note	253,008	01/30/2017	AAA
FNMA note	<u>213,817</u>	02/13/2017	AAA
	<u>1,929,746</u>		
	<u>\$ 4,640,931</u>		

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

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 institution at December 31, 2014 and 2013.

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

Notes to Financial Statements
December 31, 2014 and 2013

(2) Deposits and Investments, Continued

B. Investments, Continued

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Bank. As of December 31, 2014, the Bank's investment in U.S. Treasury Notes and agency obligations of the FHLB constituted 12% and 7%, respectively, of its total investments. As of December 31, 2013, the Bank's investment in U.S. Treasury Notes and agency obligations of the FHLMC and FNMA constituted 18%, 7% and 6%, 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

At December 31, 2014 and 2013, the equity investment in Bank of the FSM, carried at cost, represents 225,000 and 150,000 common shares, respectively, and approximately 24.1% and 16.1%, respectively ownership interest. Since the book value of the shares exceeds the carrying value, management believes that the equity investment has not become impaired.

(4) Loans Receivable

A summary of loans receivable at December 31, 2014 and 2013 follows:

	<u>2014</u>	<u>2013</u>
Unpaid principal balance	\$ 26,124,133	\$ 24,415,555
Allowance for loan losses	<u>(3,828,893)</u>	<u>(4,248,534)</u>
	\$ <u>22,295,240</u>	\$ <u>20,167,021</u>

Movements in the allowance for loan losses during the years ended December 31, 2014 and 2013, are as follows:

	<u>2014</u>	<u>2013</u>
Balance at beginning of year	\$ 4,248,534	\$ 4,626,865
Provision for (reversal of) loan losses	72,962	(446,769)
Loans charged off	(1,548,067)	(981,744)
Loan recoveries from previously charged off loans	<u>1,055,464</u>	<u>1,050,182</u>
Balance at end of year	\$ <u>3,828,893</u>	\$ <u>4,248,534</u>

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

Notes to Financial Statements
December 31, 2014 and 2013

(5) Fixed Assets

A summary of fixed assets as of December 31, 2014 and 2013, is as follows:

	Beginning January 1, <u>2014</u>	Additions/ <u>Transfers</u>	Deletions/ <u>Transfers</u>	Ending December 31, <u>2014</u>
Building	\$ 1,674,348	\$ -	\$ -	\$ 1,674,348
Computers and software	466,199	18,904	-	485,103
Vehicles	170,651	-	(26,079)	144,572
Office furniture, fixtures and equipment	<u>39,733</u>	<u>-</u>	<u>-</u>	<u>39,733</u>
	2,350,931	18,904	(26,079)	2,343,756
Less accumulated depreciation	<u>(656,876)</u>	<u>(131,210)</u>	<u>26,079</u>	<u>(762,007)</u>
	1,694,055	(112,306)	-	1,581,749
Projects in progress	<u>-</u>	<u>75,757</u>	<u>-</u>	<u>75,757</u>
Fixed assets, net	\$ <u>1,694,055</u>	\$ <u>(36,549)</u>	\$ <u>-</u>	\$ <u>1,657,506</u>

	Beginning January 1, <u>2013</u>	Additions/ <u>Transfers</u>	Deletions/ <u>Transfers</u>	Ending December 31, <u>2013</u>
Building	\$ 1,413,988	\$ 260,360	\$ -	\$ 1,674,348
Computers and software	411,613	54,586	-	466,199
Vehicles	151,565	90,750	(71,664)	170,651
Office furniture, fixtures and equipment	<u>31,769</u>	<u>7,964</u>	<u>-</u>	<u>39,733</u>
	2,008,935	413,660	(71,664)	2,350,931
Less accumulated depreciation	<u>(599,600)</u>	<u>(128,940)</u>	<u>71,664</u>	<u>(656,876)</u>
Fixed assets, net	\$ <u>1,409,335</u>	\$ <u>284,720</u>	\$ <u>-</u>	\$ <u>1,694,055</u>

(6) Related Party Transactions

As of December 31, 2014 and 2013, the Bank has direct loans with outstanding balances of \$289,127 and \$128,388, respectively, to employees of the Bank and project loans extended to businesses owned by or affiliated with employees of \$497,004 and \$295,216, 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) 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, 2014 and 2013, the account has a balance of \$156,693 and \$178,576, respectively.

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

Notes to Financial Statements
December 31, 2014 and 2013

(8) Long-Term Debt

Long-term debt consists of the following at December 31, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Payable on an Intermediary Relending Program (IRP) loan by the U.S. Department of Agriculture, granted in December, 2009 for \$466,254. The loan bears interest fixed at 1% per annum, requires interest only payments for the first three years and semi-annual principal and interest installments of \$19,793 beginning on December 8, 2013 through December 8, 2039.	\$ 414,954	\$ 449,863
Loans payable to European Investment Bank under a August 2010 master finance contract of EUR 4 million:		
Drawn on August 20, 2014; original amount of \$275,000 (equivalent EUR 205,500), bearing interest fixed at 3.705%, and payable through semi-annual principle and interest installments of \$24,778 on January 15, 2015 and equal installments of \$25,772 beginning on July 15, 2015 through maturity on July 15, 2020.	275,000	-
Drawn on August 20, 2014; original amount of \$334,550 (equivalent EUR 250,000), bearing interest fixed at 4.520%, and payable through semi-annual principle and interest installments of \$17,997 on January 15, 2015 and equal installments of \$19,467 beginning on July 15, 2015 through maturity on July 15, 2025	334,550	-
Drawn on August 20, 2014; original amount of \$796,976 (equivalent EUR 595,558), bearing interest fixed at 4.520%, and payable through semi-annual principle and interest installments of \$42,873 on January 15, 2015 and equal installments of \$46,375 beginning on July 15, 2015 through maturity on July 15, 2025	<u>796,976</u>	<u>-</u>
Total long-term debt	1,821,480	449,863
Less current portion	<u>(138,363)</u>	<u>(15,294)</u>
Long-term debt, net of current portion	\$ <u>1,683,117</u>	\$ <u>434,569</u>

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

<u>Year Ending December 31,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2015	\$ 138,363	\$ 58,692	\$ 197,055
2016	144,249	58,771	203,020
2017	149,919	53,102	203,021
2018	155,827	47,193	203,020
2019	161,988	41,032	203,020
2020-2024	691,843	117,084	808,927
2025-2029	216,148	15,182	231,330
2030-2034	92,643	6,322	98,965
2035-2039	<u>70,500</u>	<u>1,667</u>	<u>72,167</u>
	\$ <u>1,821,480</u>	\$ <u>399,045</u>	\$ <u>2,220,525</u>

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

Notes to Financial Statements
December 31, 2014 and 2013

(8) Long-Term Debt, Continued

Long-term debt changes during the years ended December 31, 2014 and 2013 are as follows:

	<u>Balance January 1,</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance December 31,</u>	<u>Due Within One Year</u>
2014:					
Loan payable	\$ <u>449,863</u>	\$ <u>1,406,526</u>	\$ <u>(34,909)</u>	\$ <u>1,821,480</u>	\$ <u>138,363</u>
				<u>Balance December 31,</u>	<u>Due Within One Year</u>
2013:					
Loan payable	\$ <u>710,755</u>	\$ <u>139,108</u>	\$ <u>(400,000)</u>	\$ <u>449,863</u>	\$ <u>15,294</u>

(9) Nonoperating Revenue

The Bank was reimbursed for expenses incurred in administering the IDF program from the IDF Private Sub Account for \$250,000 for each of the years ended December 31, 2014 and 2013. Additionally, the Bank received \$1,000,000 in contributions from FSMNG in 2013.

(10) Retirement Plan

The Bank's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees receive from the FSM Social Security System. The Plan is a contributory plan in which the Bank matches 100% of the participants' contributions up to a maximum of 10 percent of the participant's annual salary, if the participant contributes 3 or more percent from his or her annual salary. Employee participation is optional. The Bank's Chief Financial Officer is the designated Plan Administrator. Matching contributions to the Plan during the years ended December 31, 2014 and 2013 were \$39,484 and \$44,524 respectively. Total Plan assets as of December 31, 2014 and 2013 were \$700,999 and \$676,487, respectively. Management is of the opinion that the Plan does not represent an asset or a liability of the Bank.

(11) 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, 2014 and 2013.

Loan Commitments

Undrawn balances on lines of credit and loan commitments for loans approved but undisbursed approximated \$2,284,000 at December 31, 2014.

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.

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

Notes to Financial Statements
December 31, 2014 and 2013

(11) Commitments and Contingencies, Continued

Insurance

The Bank carries insurance to cover its potential risks from vehicle usage. The 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 during the past three years.

Lease Commitments

The Bank has four operating leases for each of its State operating locations. These leases expire in varying dates through February 2018. Several of these leases provide options to renew upon expiration, based on renegotiated rates. In 2013, the Bank moved its Pohnpei branch and the headquarters office (the "HQ building") to the building which was acquired in a loan settlement during 2011. In July 2013, the Bank entered into a sub-lease agreement for the former location, for which the lease expires in April 2015. Future minimum annual lease payments payable, net of sub-lease income, under the noncancellable lease agreements are as follows:

<u>Year ending December 31,</u>	<u>Expense</u>	<u>Income</u>	<u>Net</u>
2015	\$ 57,990	\$ 8,000	\$ 49,990
2016	16,100	-	16,100
2017	15,000	-	15,000
2018	<u>1,250</u>	<u>-</u>	<u>1,250</u>
	<u>\$ 90,340</u>	<u>\$ 8,000</u>	<u>\$ 82,340</u>

The Bank leases portions of the HQ building under three separate agreements expiring from May 2015 to November 2020. Future minimum annual lease income receivable under the noncancellable lease agreements are as follows:

<u>Year ending December 31,</u>	
2015	\$ 17,600
2016	9,000
2017	9,000
2018	9,000
2019	9,000
2020	<u>7,900</u>
	<u>\$ 61,500</u>

Additionally, the Bank provides housing benefits for certain contract employees with payment included as part of rent expense. The lease agreements are between the respective landlords and the employees.

Total recorded lease expense and income under the aforementioned agreements amounted to \$137,084 and \$50,907, respectively, for the year ended December 31, 2014 and \$128,820 and \$40,277, respectively, for the year ended December 31, 2013.

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

Notes to Financial Statements
December 31, 2014 and 2013

(12) Subsequent Events

In March 2015, Typhoon Maysak ravaged Chuuk and Yap causing severe damages. The ultimate impact on the Bank's branch offices and borrowers' ability for loan repayments is presently indeterminable.

Management has evaluated subsequent events through April 7, 2015, which is the date that the financial statements are available to be issued. Except for the above, there were no other material subsequent events that would require recognition or disclosure in the financial statements for the year ended December 31, 2014.

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

Schedule of Net Position - Intermediary Relending Program
December 31, 2014

ASSETS

Current assets:	
Cash and cash equivalents	\$ 809,878
Interest and other receivables	168
Loans receivable, net	<u>211,745</u>
Total assets	<u>\$ 1,021,791</u>

LIABILITIES AND NET POSITION

Current liabilities:	
Due to FSMDB, net	\$ 126,215
Credit life payable	<u>173</u>
Total current liabilities	126,388
Noncurrent liabilities:	
Long-term debt	<u>414,954</u>
Total liabilities	<u>541,342</u>
Net position:	
Unrestricted	<u>480,449</u>
Total net position	<u>480,449</u>
Total liabilities and net position	<u>\$ 1,021,791</u>

See accompanying Independent Auditors' Report.

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

Schedule of Revenues, Expenses and Change in Net Position -
Intermediary Relending Program
Year Ended December 31, 2014

Operating revenues:	
Interest income on loans	\$ 24,391
Miscellaneous	<u>3,099</u>
Total operating revenues	<u>27,490</u>
Operating expenses:	
Provision for loan losses	16,400
Interest expense	<u>4,677</u>
Total operating expenses	<u>21,077</u>
Income from operations	6,413
Non-operating revenues:	
Interest income on savings account	<u>1,060</u>
Change in net position	7,473
Net position at beginning of year	<u>472,976</u>
Net position at end of year	<u><u>\$ 480,449</u></u>

See accompanying Independent Auditors' Report.

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

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

DECEMBER 31, 2014

INDEPENDENT AUDITORS' REPORT

Board of Directors
Federated States of Micronesia Development Bank:

Report on the Financial Statements

We have audited the accompanying financial statements of the Investment Development Fund, the Pohnpei Development Loan Fund, and the Yap Development Loan Fund (the Funds), administered by the Federated States of Micronesia Development Bank (the Bank), which comprise the respective statement of fiduciary net position as of December 31, 2014, and the related statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express opinions 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 from material misstatement.

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

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

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Investment Development Fund, the Pohnpei Development Loan Fund, and the Yap Development Loan Fund as of December 31, 2014, and the respective changes in financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

As discussed in Note 1 to the financial statements, the financial statements referred to above present only the respective financial position of the Investment Development Fund, the Pohnpei Development Loan Fund, and the Yap Development Loan Fund and are not intended to present fairly the financial position and results of operations of the Federated States of Micronesia Development Bank in conformity with accounting principles generally accepted in the United States of America.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated April 7, 2015, on our consideration of the Bank's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Bank's internal control over financial reporting and compliance.

Deloitte & Touche LLP

April 7, 2015

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

Trust Funds
Statement of Fiduciary Net Position
December 31, 2014

	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>	<u>Total</u>
<u>ASSETS</u>				
Cash and cash equivalents	\$ 1,444,624	\$ -	\$ 116,378	\$ 1,561,002
Time certificates of deposit	-	-	147,833	147,833
Interest and other receivables	4,990	-	623	5,613
Loans receivable, net	<u>386,511</u>	<u>-</u>	<u>18,506</u>	<u>405,017</u>
Total receivables	<u>391,501</u>	<u>-</u>	<u>19,129</u>	<u>410,630</u>
	<u>\$ 1,836,125</u>	<u>\$ -</u>	<u>\$ 283,340</u>	<u>\$ 2,119,465</u>
<u>LIABILITIES AND NET POSITION</u>				
Liabilities:				
Payable to FSMDB	<u>\$ 50,601</u>	<u>\$ -</u>	<u>\$ 29,287</u>	<u>\$ 79,888</u>
Commitments				
Net position:				
Restricted	386,511	-	18,506	405,017
Unrestricted	<u>1,399,013</u>	<u>-</u>	<u>235,547</u>	<u>1,634,560</u>
Total net position	<u>1,785,524</u>	<u>-</u>	<u>254,053</u>	<u>2,039,577</u>
	<u>\$ 1,836,125</u>	<u>\$ -</u>	<u>\$ 283,340</u>	<u>\$ 2,119,465</u>

See accompanying notes to financial statements.

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

Trust Funds
Statement of Changes in Fiduciary Net Position
Year Ended December 31, 2014

	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>	<u>Total</u>
Additions:				
Loan interest	\$ 29,668	\$ -	\$ 754	\$ 30,422
Investment interest	7,325	-	828	8,153
Miscellaneous	-	1,951	9	1,960
	<u>36,993</u>	<u>1,951</u>	<u>1,591</u>	<u>40,535</u>
Deductions:				
Recovery of loan losses	(37,867)	-	-	(37,867)
Investment management fee	250,000	-	-	250,000
Miscellaneous	782	-	-	782
	<u>212,915</u>	<u>-</u>	<u>-</u>	<u>212,915</u>
Change in net position	(175,922)	1,951	1,591	(172,380)
Net position at beginning of year	1,961,446	735,580	252,462	2,949,488
Distributions	-	(737,531)	-	(737,531)
Net position at end of year	<u>\$ 1,785,524</u>	<u>\$ -</u>	<u>\$ 254,053</u>	<u>\$ 2,039,577</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, 2014

(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 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 United States. The IDF is administered by the Bank in a Trust capacity on behalf of the FSM National Government and its four States.

PDLF and YDLF are administered by the Bank in a Trust capacity. All loan decisions are made by executives of the respective state governments as these funds represent local appropriations designated to be loaned for development purposes. During the year ended December 31, 2014, all assets and net equity of PDLF were returned to the Pohnpei State Government.

Fund Structure and Basis of Accounting

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

Cash and Time Certificates of Deposit

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

Loans and Allowance for Loan Losses

Loans receivable are stated at unpaid principal balance less the allowance for loan losses and are reserved in net position as restricted net position.

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.

**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, 2014

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

New Accounting Standards

During the year ended December 31, 2014, the Funds implemented the following pronouncements:

- GASB Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, which improves accounting and financial reporting for state and local governments' combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. A disposal of government operations can occur through a transfer to another government or a sale. The implementation of this statement did not have a material effect on the accompanying financial statements.
- GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The implementation of this statement did not have a material effect on the accompanying financial statements.

In June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions*, which revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of this statement on the financial statements of the Funds.

In November 2013, GASB issued Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date - an amendment of GASB Statement No. 68*, which addresses an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The issue relates to amounts associated with contributions, if any, made by a state or local government employer or nonemployer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability. The provisions in Statement 71 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of this statement on the financial statements of the Funds.

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.

**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, 2014

(2) Deposits

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.
- (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.

Custodial credit risk is the risk that in the event of a bank failure, the Funds' deposits may not be returned to them. 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.

**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, 2014

(2) Deposits, Continued

As of December 31, 2014, the carrying amount and corresponding bank balances of the Funds' total cash and time certificates of deposit was \$1,708,835. All of the bank balances are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. However, none of the balances were covered as the FSMDB have already exceeded the insurable limit per depositor. For purposes of FDIC insurance termination, funds held in trust are not differentiable with regular accounts held by FSMDB. 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, 2014.

(3) Loans Receivable

The following is a schedule of loans receivable as of December 31, 2014:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net</u>
YDLF	\$ 18,506	\$ -	\$ 18,506
IDF	<u>5,479,396</u>	<u>5,092,885</u>	<u>386,511</u>
	<u>\$ 5,497,902</u>	<u>\$ 5,092,885</u>	<u>\$ 405,017</u>

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

(4) Subsequent Events

In March 2015, Typhoon Maysak ravaged Chuuk and Yap causing severe damages. The ultimate impact on the Bank's branch offices and borrowers' ability for loan repayments is presently indeterminable.

Management has evaluated subsequent events through April 7, 2015, which is the date that the financial statements are available to be issued. Except for the above, there were no other material subsequent events that would require recognition or disclosure in the financial statements for the year ended December 31, 2014.

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS 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, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Federated States of Micronesia Development Bank (the Bank), which comprise the statement of net position as of December 31, 2014, and the related statements of revenues, expenses and changes in net position and of cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 7, 2015.

Internal Control Over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

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

We noted certain matters that we reported to management of the Bank in a separate letter dated April 7, 2015.

Purpose of this Report

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

Deloitte & Touche LLP

April 7, 2015

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS 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, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Investment Development Fund, the Pohnpei Development Loan Fund, and the Yap Development Loan Fund, administered by the Federated States of Micronesia Development Bank (the Bank), which comprise the respective statement of fiduciary net position as of December 31, 2014, and the related statement of change in fiduciary net position for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated April 7, 2015.

Internal Control Over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the respective financial statements of the Investment Development Fund, the Pohnpei Development Loan Fund, and the Yap Development Loan Fund are free from material misstatement, we performed tests of their compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Bank in a separate letter dated April 7, 2015.

Purpose of this Report

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

Deloitte & Touche LLP

April 7, 2015