

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEAR ENDED DECEMBER 31, 2003

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

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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, 2003 and 2002, and the related statements of activities 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.

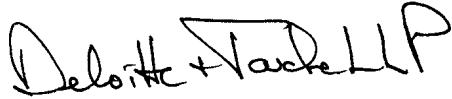
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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, 2003 and 2002, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 1 to the financial statements, the Bank adopted the provisions of the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, and GASB Statement No. 38, *Certain Financial Statements Note Disclosures*, as of October 1, 2002. The accompanying 2002 financial statements have been restated to reflect the changes required by GASB 34.

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. 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 March 31, 2004, on our consideration of the Bank's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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

March 31, 2004

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Management Discussion and Analysis
Year Ending December 31, 2003

The year 2003 was a particularly slow year for the Bank both in terms of lending and collection. The Bank took a cautious approach to lending because of the uncertainty of funding assistance under the renegotiated Compact of Free Association. The FSM Economy is still recovering from the decline in government spending, the attack of September 11, 2001 on the U.S., which resulted in the decline in visitors to the country. On top of this, continued government capital contribution to the Bank remains uncertain. Amidst these scenarios of struggles, FSMDB continued to respond positively to the challenges of the year. We focused our attention to helping our clients to weather the continuing decline in their sales revenues during this difficult year. Many accounts were restructured to accommodate requests by borrowers to reduce monthly payments that the revenue generated by the businesses could reasonably afford without jeopardizing the long-term sustainability of the businesses.

Summary Statement of Net Assets

	<u>2003</u>	<u>2002</u>
Assets:		
Current assets	\$ 8,278,999	\$ 5,221,733
Noncurrent assets	<u>24,864,716</u>	<u>26,834,513</u>
Total Assets	\$ <u>33,143,715</u>	\$ <u>32,056,246</u>
Liabilities:		
Current liabilities	\$ <u>2,275,445</u>	\$ <u>2,484,557</u>
Total Liabilities	\$ <u>2,275,445</u>	\$ <u>2,484,557</u>
Net assets:		
Investment in fixed assets	\$ 74,073	\$ 114,508
Unrestricted	<u>30,794,197</u>	<u>29,457,181</u>
Total Net Assets	\$ <u>30,868,270</u>	\$ <u>29,571,689</u>

We ended the year 2003 with lower than last year achievements nevertheless the results were positive. Earnings from operations declined by about 92% from \$204,967 to \$17,887. The major reason was the substantial increase in provision for doubtful loans, which increased by \$229,837 over year 2002 expenditures of \$630,163. Although based on loan classifications, the Bank was over reserved for loan loss provision by about \$ 2.3 million, Management felt it was prudent to be conservative given the number of loans that were restructured and the amount of loans in the substandard category. As a development bank, it is incumbent on the Bank to work out solutions for business clients rather than closing down the businesses. All other expenses basically remained at the same level as in year 2002. Revenue declined by a mere .3% (\$6,305) overall. The biggest decline was in investment income due to the sharp decline in interest rates for U.S. Treasury bills and U.S. Agency bonds as well as interest rates for TCDs at the local banks. Investment income declined by half compared to year 2002. The other decline was in miscellaneous income, basically no dividends were earned from the investment in Bank of FSM shares. The overall increase in net assets for 2003 was \$1,296,581 inclusive of the National Government's capital contribution.

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Management Discussion and Analysis
Year Ending December 31, 2003

Total assets for the Bank at the end of the year was \$33,143,715 an increase of about \$1 million mainly from the National Government capital contribution. The funds held in trust by Merrill Lynch declined as we continue to draw money for disbursement. Total cash and equivalent remained high because of the undisbursed loan of \$4.4 million, which is expected to be disbursed in early 2004. In addition, due to low interest rates, we have been investing funds in local TCDs. \$2.1 million of the total liabilities is mainly funds owed by the Bank to the IDF.

Summary Statement of Revenues, Expenses and Changes in Net Assets

	<u>2003</u>	<u>2002</u>
Operating revenues	\$ 2,175,470	\$ 2,181,775
Operating expenses	<u>2,157,583</u>	<u>1,976,808</u>
Earnings from operations	17,887	204,967
Non-operating revenues	<u>1,278,694</u>	<u>779,478</u>
Increase in net assets	1,296,581	984,445
Net assets at beginning of year	<u>29,571,689</u>	<u>28,587,244</u>
Net assets - end of year	\$ <u>30,868,270</u>	\$ <u>29,571,689</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 2003 were \$ 15,896,928, \$ 781,690, and \$ 311,121 respectively for IDF, PDLF and YDLF. IDF ended the year with a loss of \$ 505,110 whereas PDLF and YDLF earned income of \$ 21,097 and \$ 13,758 respectively. A total of \$ 628,968 was transferred to Kosrae State Treasury from the IDF Kosrae Sub-Account as approved by Federated Development Authority (FDA).

There were 105 loans approved in 2003 for a total of \$ 3,698,644. Loans provided for start-up businesses were very limited due to the above-mentioned uncertainties coupled with continued debt-servicing difficulties for many loan accounts. The Bank was able to collect about \$ 4.1 million in loan repayments.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statements of Net Assets December 31, 2003 and 2002

	(Proprietary Fund Type) FSMDB	
	2003	2002
<u>ASSETS</u>		
Current assets:		
Cash and equivalents	\$ 5,233,281	\$ 2,753,746
Accounts receivable	20,561	20,890
Interfund receivables	168,818	141,881
Prepaid expenses	1,000	-
Interest and other receivables	345,603	415,969
Current portion of loans receivable	2,509,736	1,889,247
Total current assets	8,278,999	5,221,733
Noncurrent assets:		
Fixed assets, net	74,073	114,508
Investments	9,772,044	10,117,576
Investment, at cost	662,188	662,188
Loans receivable, net of current portion	14,356,411	15,940,241
Total noncurrent assets	24,864,716	26,834,513
Total assets	\$ 33,143,715	\$ 32,056,246
<u>LIABILITIES</u>		
Current liabilities:		
Accounts payable	\$ 42,639	\$ 38,544
Credit life payable	62,889	43,470
Interfund payable	2,169,917	2,402,543
Total liabilities	2,275,445	2,484,557
Commitments and contingencies		
Net assets:		
Invested in fixed assets	74,073	114,508
Unrestricted	30,794,197	29,457,181
Total net assets	30,868,270	29,571,689
	\$ 33,143,715	\$ 32,056,246

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statements of Activities and Changes in Net Assets
Years Ended December 31, 2003 and 2002

	(Proprietary Fund Type) FSMDB	
	2003	2002
Operating revenues:		
Loan interest	\$ 1,758,767	\$ 1,666,334
Investment income	285,387	402,564
Loan fees	109,997	67,225
Miscellaneous	21,318	45,652
Total operating revenues	<u>2,175,469</u>	<u>2,181,775</u>
Operating expenses:		
Provision for doubtful loans	860,000	630,163
Personnel services	815,772	796,745
Rent	113,770	124,258
Travel	83,957	75,678
Depreciation	54,868	59,731
Training	51,119	44,719
Communication	31,575	57,640
Contractual services	26,497	32,254
Supplies	17,195	21,109
FSM retirement plan	11,236	-
Printing	9,058	9,628
Insurance	3,644	4,778
Miscellaneous expenses	78,891	120,105
Total operating expenses	<u>2,157,582</u>	<u>1,976,808</u>
Earnings from operations	<u>17,887</u>	<u>204,967</u>
Non-operating revenues:		
IDF Reimbursement	250,000	250,000
Allocations from managed funds	27,976	29,138
Contributions	1,000,000	500,000
Other income	718	340
Total non-operating revenues	<u>1,278,694</u>	<u>779,478</u>
Increase in net assets	<u>1,296,581</u>	<u>984,445</u>
Net assets at beginning of year	<u>29,571,689</u>	<u>28,587,244</u>
Net assets at end of year	<u><u>\$ 30,868,270</u></u>	<u><u>\$ 29,571,689</u></u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statements of Cash Flows
Years Ended December 31, 2003 and 2002

	(Proprietary Fund Type) FSMDB	
	2003	2002
Increase (decrease) in cash and equivalents		
Cash flows from operating activities:		
Cash received from customers	\$ 2,624,776	\$ 1,285,349
Cash paid to suppliers and employees for goods and services	(660,569)	(99,387)
Cash paid to employees	(815,771)	(796,745)
Net cash provided by operating activities	<u>1,148,436</u>	<u>389,217</u>
Cash flows from capital and related financing activities:		
Disposition (acquisition) of fixed assets	(14,433)	775
Net cash provided by (used for) capital and related financing activities	<u>(14,433)</u>	<u>775</u>
Cash flows from investing activities:		
Decrease in investments	345,532	134,400
Net cash provided by investing activities	<u>345,532</u>	<u>134,400</u>
Cash flows from noncapital financing activities:		
Cash contribution from the FSM National Government	1,000,000	500,000
Net increase in cash and equivalents	2,479,535	1,024,392
Cash and equivalents at beginning of year	2,753,746	1,729,354
Cash and equivalents at end of year	<u>\$ 5,233,281</u>	<u>\$ 2,753,746</u>
Reconciliation of operating earnings to net cash provided by operating activities:		
Earnings from operations	\$ 17,887	\$ 204,967
Other earnings from merged funds and other	278,694	279,478
Adjustment to reconcile earnings from operations to net cash provided by operating activities:		
Depreciation	54,868	59,731
(Increases) decreases in assets:		
Accounts receivable	1,007,099	(483,884)
Prepaid expenses	(1,000)	500
Increase (decrease) in liabilities:		
Accounts payable and other liabilities	(209,112)	328,425
Net cash provided by operating activities	<u>\$ 1,148,436</u>	<u>\$ 389,217</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(1) Summary of Significant Accounting Policies

Reporting Entities

The Federated States of Micronesia Development Bank (FSMDB) was created in 1979 by Public Law 1-37 of the First Congress of the Federated States of Micronesia. The FSM Development Bank began its operations on October 1, 1980. The FSMDB was reorganized in January 1994 by Public Law 8-47 of the Eighth Congress of the Federated States of Micronesia. The purpose of the FSM Development Bank is to provide loans for economic development of the FSM. Such loans may otherwise be too risky for the commercial banks to underwrite. Additionally, the FSMDB's repayment terms tend to be longer than those offered by commercial banks.

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

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

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

The Bank has opted to establish itself more in line with a corporate model. The Bank, through this process, hopes to be able to attract additional capital through non-FSM sources. To that end, the Bank as of December 31, 2003, has issued 2,997,883 shares to the FSM National Government (98.7%), Kosrae State (.3%) and Chuuk State (1.0%).

Fund Structure and Basis of Accounting

The accounts of the FSMDB are organized as a discretely presented component unit - proprietary fund of the FSM National Government. Proprietary funds are used by governmental units to account for operations that are financed and operated in a manner similar to a private business. This accounting is appropriate when costs of providing goods or services to the general public are to be financed primarily through user charges or where the periodic determination of net income is appropriate for accountability purposes. The accrual basis of accounting is utilized by proprietary funds. Under the accrual basis, revenues are recorded when earned, and expenses are recorded at the time the liabilities are incurred.

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

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(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 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.

For the year ended December 31, 2003, the Bank 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 and applied those standards on a retroactive basis. 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, 2003 and 2002, the Bank does not have nonexpendable 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.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on the loans receivable of the Bank and does not take into account the outstanding balances of the managed funds. The allowance is maintained at a level adequate to absorb probable losses. Management determines the adequacy of the allowance based upon reviews of individual loans, recent loss experience, current economic conditions, the risk characteristics of the loans and other pertinent factors. Loans deemed uncollectible are charged to the allowance. Provisions for losses and recoveries on loans previously charged off are added to the allowance.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(1) Summary of Significant Accounting Policies, Continued

Allowance for Doubtful Accounts, Continued

Loans for managed funds (PDLF and YDLF) do not carry a provision for loan losses. The loans are reserved in fund balance as a reserve for related assets. Loans are written off directly against income based on discussions with the owners of the managed funds. The Bank has adopted a similar process for IDF funds. However, a loan reserve was established in a prior year before the Bank adopted this policy.

Fixed Assets

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

Interest Income on Loans

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

Cash and Equivalents

For the purposes of the statement of financial condition and the statement of cash flows, cash and equivalents are defined as cash in bank checking and savings accounts, money market funds, and commercial paper with original maturities of three months or less from the date of acquisition. The Bank does not require collateralization of its cash in excess of FDIC limits; therefore, any amounts in excess of those limits are uncollateralized.

Totals - Memorandum Only

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

Off-Balance Sheet Financial Instruments

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

Estimates

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

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(1) Summary of Significant Accounting Policies, Continued

Net Assets

Net assets represent the residual interest in the Bank's assets after liabilities are deducted and consist of three sections: invested in capital assets, net of related debt; restricted and unrestricted. Net assets invested in capital assets, net of debt include capital assets, restricted and unrestricted, net of accumulated depreciation, reduced by outstanding debt net of debt service reserve. Net assets are reported as restricted when constraints are imposed by third parties or enabling legislation. The Bank's restricted assets are expendable. All other net assets are unrestricted.

(2) Deposits and Investments

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

Deposits with financial institutions at December 31, 2003, are categorized by risk as follows:

Amount insured or collateralized	\$ 200,000
Uninsured or uncollateralized	<u>5,773,179</u>
Total deposits	\$ <u>5,973,179</u>

Deposits are held in the following accounts:

FSM Development Bank	\$ 5,233,281
Trust funds:	
Cash	155,196
Time certificates of deposit	<u>584,702</u>
Total deposits	\$ <u>5,973,179</u>

Management's confidence in the financial strength of their banking institutions was the basis of the decision to not require collateralization. No losses as a result of this practice were incurred for the year ended December 31, 2003.

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

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

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(2) Deposits and Investments, Continued

Investments as of December 31, 2003, are carried at cost, which approximates market value, and are comprised of the following:

	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>
U.S. Government obligations	\$ 8,943,044	\$ -	\$ -
Time certificates of deposit with original maturities of greater than ninety days	-	452,350	124,928
Investment premiums and discounts	<u>17,816</u>	<u>-</u>	<u>-</u>
	<u>\$ 8,960,860</u>	<u>\$ 452,350</u>	<u>\$ 124,928</u>

The difference between book and market value is not material. Management is of the opinion that it has the intent and ability to hold all of the securities to maturity and, therefore, no losses will be incurred. The investments have been classified as category 1 investments in accordance with the GASB Statement No. 3 as all investments are held in the name of FSMDB or IDF by Merrill Lynch, Inc.

(3) Available for Sale Securities

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

(4) Loans Receivable

Loans receivable are reported net of the allowance for doubtful loans. The following is a schedule of loans receivable and the respective allowances as of December 31, 2003:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net Amount</u>
FSMDB	\$ 20,996,506	\$ (4,130,359)	\$ 16,866,147
State Development Funds (Pohnpei and Yap)	348,326	-	348,326
IDF	<u>7,635,152</u>	<u>(2,601,828)</u>	<u>5,033,324</u>
	<u>\$ 28,979,984</u>	<u>\$ (6,732,186)</u>	<u>\$ 22,247,766</u>

Maturities of the above principal balances of these loans, subsequent to December 31, 2003, will be as follows:

Fully matured and others	\$ 650,241
1 - 6 months	5,019,613
7 - 18 months	1,018,039
19 months - 3 years	5,558,695
After 3 years	<u>16,733,396</u>
	<u>\$ 28,979,984</u>

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(5) Allowance For Doubtful Accounts

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

	<u>FSMDB</u>	<u>IDF</u>
Balance - December 31, 2002	\$ 3,393,283	\$ 2,601,828
Loans charged off	(287,490)	-
Provision for doubtful loans-FSMDB	860,283	-
Provision for doubtful loans-IDF	-	-
Reactivated loans	57,120	-
Loan recoveries for previously charged off loans	<u>107,163</u>	<u>-</u>
Balance - December 31, 2003	\$ <u>4,130,359</u>	\$ <u>2,601,828</u>

(6) Fixed Assets

A summary of fixed assets as of December 31, 2003, is as follows:

	Balance at Beginning of Year	Additions	Deletions	Balance at End of Year
Office furniture, fixtures and equipment	\$ 165,392	\$ -	\$ -	\$ 165,392
Home furniture, fixtures and equipment	13,608	-	-	13,608
Vehicles	122,286	-	-	122,286
Computers and software	<u>266,096</u>	<u>14,433</u>	<u>-</u>	<u>280,529</u>
	567,382	14,433	-	581,815
Less accumulated depreciation	<u>(452,874)</u>	<u>(54,868)</u>	<u>-</u>	<u>(507,742)</u>
Net fixed assets	\$ <u>114,508</u>	\$ <u>(40,435)</u>	\$ <u>-</u>	\$ <u>74,073</u>

(7) Related Party Transactions

As of December 31, 2003, the Bank has twenty-eight loans with an outstanding balance of \$131,827 to employees of the Bank and project loans with an outstanding balance of \$3,793,631. These loans are made under the same terms and conditions as exist with other borrowers. Officers and Board members are not eligible to borrow from the Bank.

(8) Commitments and Contingencies

The Bank is contingently liable on loan guarantees to the Bank of Guam, ranging from 50% to 90% of the outstanding loan balances for commercial projects within the FSM. Outstanding loan balances on the guarantees as of December 31, 2003, are as follows:

<u>Type of Project</u>	<u>Amount</u>
Real estate	\$ <u>15,808</u>

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2003 and 2002

(8) Commitments and Contingencies, Continued

The FSMDB and YDLF have made loan commitments for loans approved but undisbursed in the amounts of \$3,376,006 and \$5,729, respectively, at December 31, 2003. Also, FSMDB is a party to various legal proceedings, the ultimate impact of which is not currently predictable. Therefore, no liability has been recorded in the accompanying financial statements due to management's inability to predict the ultimate outcome of these proceedings.

Self Insurance

The FSM Development Bank carries insurance to cover its potential risks from fire on its building and the contents and full coverage on property damage. FSM Development Bank is substantially self-insured for all other risks. Management is of the opinion that no material losses have been sustained as a result of this practice.

Lease Commitments

The FSM Development has seven operating leases as of December 31, 2003. Three are residential real estate leases for contract employees. Four represent leases for the branch offices in each state (one with a lease term of two years, two for five years and one for fifteen years). The approximate future minimum annual lease payments payable by FSMDB are as follows:

<u>Fiscal year ending</u>	<u>Total</u>
December 31, 2004	\$ 113,160
December 31, 2005	99,800
December 31, 2006	88,220
December 31, 2007	70,320
December 31, 2008	70,320
Thereafter	<u>410,240</u>
	\$ <u>852,060</u>

(9) Contribution From The FSM National Government

The FSM Development Bank receives periodic subsidies of its operations from appropriations received from the Congress of the FSM. During the year ended December 31, 2003, the Bank received \$1,000,000 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.

(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 received from FSM Social Security System. The Plan is a contributory plan in which the Bank contributes 10 percent of the participant's annual salary, and the participant contributes 3 or more percent from his or her annual salary. Participation is optional. The Bank's controller is the designated Plan administrator. Contributions to the Plan during the year ended December 31, 2003 were \$11,236. Management is of the opinion that the plan does not represent an asset or a liability of the Bank.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

DECEMBER 31, 2003 AND 2002



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, 2003, 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 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 Funds at December 31, 2003 and 2002, and the results of their operations for the years 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 March 31, 2004, on our consideration of the Funds' internal control over financial reporting and our tests of their compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

A handwritten signature in black ink that reads "Deloitte + Touche LLP". The signature is stylized and appears to be written in a cursive or semi-cursive script.

March 31, 2004

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Trust Funds
Statement of Assets
December 31, 2003
(With Comparative Totals for the Year Ended December 31, 2002)

	Trust Funds			Totals (Memorandum Only)	
	IDF	PDLF	YDLF	2003	2002
<u>ASSETS</u>					
Current assets:					
Cash and equivalents:					
Held by trustee:					
Investments	\$ 8,570,619	\$ -	\$ -	\$ 8,570,619	\$ 8,960,860
Held by FSMDB:					
Cash in bank and on hand	-	122,594	32,602	155,196	112,957
Time certificate of deposits	-	459,497	125,205	584,702	576,846
Total cash and equivalents	8,570,619	582,091	157,807	9,310,517	9,650,663
Interfund receivables	2,169,917	-	-	2,169,917	2,402,543
Interest and other receivables	123,068	3,831	756	127,655	100,710
Loans receivable, net	5,033,324	195,768	152,558	5,381,650	5,307,118
Total receivables	7,326,309	199,599	153,314	7,679,222	7,810,371
	<u>\$ 15,896,928</u>	<u>\$ 781,690</u>	<u>\$ 311,121</u>	<u>\$ 16,989,739</u>	<u>\$ 17,461,034</u>
<u>LIABILITIES AND NET ASSETS</u>					
Current liabilities:					
Interfund payable	\$ -	\$ 61,775	\$ 107,043	\$ 168,818	\$ 141,881
Credit life payable	-	-	2,074	2,074	2,074
Total liabilities	-	61,775	109,117	170,892	143,955
Net assets:					
Restricted	5,033,324	195,768	152,558	5,381,650	5,307,118
Unrestricted	10,863,604	524,147	49,446	11,437,197	12,009,961
Total net assets	15,896,928	719,915	202,004	16,818,847	17,317,079
	<u>\$ 15,896,928</u>	<u>\$ 781,690</u>	<u>\$ 311,121</u>	<u>\$ 16,989,739</u>	<u>\$ 17,461,034</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Trust Funds
Statement of Activities and Net Assets
Year Ended December 31, 2003
(With Comparative Totals for the Year Ended December 31, 2002)

	Governmental Fund Types (Trust Funds)			Totals (Memorandum Only)	
	IDF	PDLF	YDLF	2003	2002
Operating revenues:					
Investment interest	\$ 236,729	\$ 7,679	\$ 2,647	\$ 247,055	\$ 270,640
Loan interest	135,803	13,353	11,110	160,266	207,544
Miscellaneous	1,326	65	-	1,391	3,844
Total operating revenues	373,858	21,097	13,757	408,712	482,028
Operating expenditures:					
Doubtful loan expense	-	-	-	-	751,831
Total operating expenditures	-	-	-	-	751,831
Revenues over expenditures	373,858	21,097	13,757	408,712	(269,803)
Other sources (uses):					
Investment management fee	(250,000)	-	-	(250,000)	(250,000)
Transfer to Kosrae Government	(628,968)	-	-	(628,968)	-
Transfers to FSMDB fund	-	(21,097)	(6,879)	(27,976)	(29,138)
Total other uses, net	(878,968)	(21,097)	(6,879)	(906,944)	(279,138)
Revenues and other sources over expenditures and other uses	(505,110)	-	6,878	(498,232)	(548,941)
Net assets at beginning of year	16,402,038	719,915	195,126	17,317,079	17,866,020
Net assets at end of year	<u>\$ 15,896,928</u>	<u>\$ 719,915</u>	<u>\$ 202,004</u>	<u>\$ 16,818,847</u>	<u>\$ 17,317,079</u>

See accompanying notes to financial statements.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK**

Notes to Financial Statements
December 31, 2003 and 2002

(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 (FDMDB). FDMDB 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 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).

Allowance for Doubtful Accounts

Loans for managed funds (PDLF and YDLF) do not carry a provision for loan losses. The loans are reserved in fund balance as a reserve for related assets. Loans are written off directly against income based on discussions with the owners of the managed funds. The Bank has adopted a similar process for IDF funds. However, a loan reserve was established in a prior year before the Bank adopted this policy.

Interest Income on Loans

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

Cash and Equivalents

For the purposes of the statement of financial condition and the statement of cash flows, cash and equivalents are defined as cash in bank checking and savings accounts, money market funds, and commercial paper with original maturities of three months or less from the date of acquisition. The Bank does not require collateralization of its cash in excess of FDIC limits; therefore, any amounts in excess of those limits are uncollateralized.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK**

Notes to Financial Statements
December 31, 2003 and 2002

(1) Purpose and Summary of Significant Accounting Policies

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

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

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

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

Investments as of December 31, 2003, are carried at cost, which approximates market value, and are comprised of the following:

	<u>IDF</u>	<u>PDLF</u>	<u>YDLF</u>
U.S. Government obligations	\$ 8,943,044	\$ -	\$ -
Time certificates of deposit with original maturities of greater than ninety days	-	452,350	124,928
Investment premiums and discounts	<u>17,816</u>	<u>-</u>	<u>-</u>
	<u>\$ 8,960,860</u>	<u>\$ 452,350</u>	<u>\$ 124,928</u>

The difference between book and market value is not material. Management is of the opinion that it has the intent and ability to hold all of the securities to maturity and, therefore, no losses will be incurred. The investments held by the FSMDB and IDF have been classified as category 1 investments in accordance with the GASB Statement No. 3 as all investments are held in the name of FSMDB or IDF by Merrill Lynch, Inc.

**TRUST FUNDS ADMINISTERED BY THE
FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK**

Notes to Financial Statements
December 31, 2003 and 2002

(3) Loans Receivable

Loans receivable are reported net of an allowance for doubtful loans. The following is a schedule of loans receivable and the respective allowances as of December 31, 2003:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net Amount</u>
State Development Funds (Pohnpei and Yap)	\$ 348,326	-	\$ 348,326
IDF	<u>7,635,152</u>	<u>(2,601,828)</u>	<u>5,033,324</u>
	\$ <u>7,983,478</u>	\$ <u>(2,601,828)</u>	\$ <u>5,381,650</u>



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS
PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

The Board of Directors
Federated States of Micronesia Development Bank:

We have audited the financial statements of the Federated States of Micronesia Development Bank, as of December 31, 2003, and for the year then ended, and have issued our report thereon dated March 31, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Federated States of Micronesia Development Bank's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we did note an immaterial finding that has been brought to management's attention in a separate report dated March 31, 2004.

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

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

March 31, 2004



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

The Board of Directors
Federated States of Micronesia Development Bank:

Compliance

We have audited the compliance of the Federated States of Micronesia Development Bank with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended December 31, 2003. Federated States of Micronesia Development Bank's major federal program is identified in the Schedule of Expenditures of Federal Awards (page 25). Compliance with the requirements of laws, regulations, contracts and grants applicable to its one major federal program is the responsibility of Federated States of Micronesia Development Bank's management. Our responsibility is to express an opinion on Federated States of Micronesia Development Bank's compliance based on our audit.

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

In our opinion, the Federated States of Micronesia Development Bank complied, in all material respects, with the requirements referred to above that are applicable to its one major federal financial assistance program for the year ended December 31, 2003.

Internal Control Over Compliance

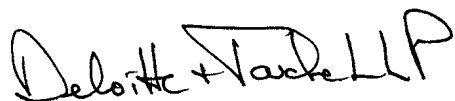
The management of the Federated States of Micronesia Development Bank is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing the audit, we considered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

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

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the Federated States of Micronesia Development Bank, as of and for the year ended December 31, 2003, and have issued our report thereon dated March 31, 2004. Our audit was performed for the purpose of forming an opinion on the financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the financial statements. This schedule is the responsibility of the management of the Federated States of Micronesia Development Bank. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

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

A handwritten signature in black ink that reads "Deloitte + Tachle LLP". The signature is stylized, with the "D" being large and the "LLP" being written in a more compact, cursive-like font.

March 31, 2004

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Schedule of Expenditures of Federal Awards Year Ended December 31, 2003 CFDA #15.875 - Department of the Interior

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

Section 211 Compact Capital	Total funding received through December 31, 2003	\$ <u>24,700,000</u>
Section 111 IDF Funds	Total funding available through December 31, 2003	\$ 16,402,038
	Amount of revenues and other sources over expenditures and other uses during year ended December 31, 2003	<u>(505,110)</u>
	Fund balance as of December 31, 2003	\$ <u>15,896,928</u>

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs
Year Ended December 31, 2003

Part I - Summary of Auditors' Results

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. Reportable conditions in internal control over financial reporting were not identified.
3. No instance of noncompliance considered material to the financial statements was disclosed by the audit.
4. Reportable conditions in internal control over compliance with requirements applicable to major federal awards programs were not identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed an unqualified opinion.
6. The audit disclosed no findings required to be reported by OMB Circular A-133.
7. The Organization's major program is:

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

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

Part II - Financial Statement Findings Section

No matters are reportable.

Part III - Federal Award Findings and Questioned Cost Section

No matters are reportable.

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Schedule of Prior Year Findings and Questioned Costs
Year Ended December 31, 2003

There are no prior audit findings relative to Federal awards.