

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

**FINANCIAL STATEMENTS AND
INDEPENDENT AUDITORS' REPORT**

YEARS ENDED DECEMBER 31, 2005 AND 2004

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

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INDEPENDENT AUDITORS' REPORT

Chairman
Board of Directors
Federated States of Micronesia
Development Bank:

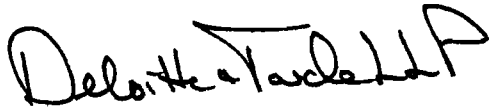
We have audited the accompanying statements of net assets of the Federated States of Micronesia Development Bank, a component unit of the National Government of the Federated States of Micronesia, as of December 31, 2005 and 2004, and the related statements of activities and changes in net assets and 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Federated States of Micronesia Development Bank as of December 31, 2005 and 2004, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated April 15, 2006, on our consideration of the Bank's internal control over financial reporting and our tests of its compliance with certain laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

A handwritten signature in black ink, appearing to read "Deloitte & Touche LLP", with a stylized flourish at the end.

April 15, 2006

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Management Discussion and Analysis Year Ending December 31, 2005

The year 2005 saw slight improvement in the overall FSM economy. However, the positive impact came about mainly due to inflow of Compact funds and substantial FEMA assistance to Yap State. Tourism still plays a minor role in income generation for the country, as arrivals were insignificant in 2005. The bank ended the year with a total increase in net asset of about \$1.3 million, of which \$1 million is from net earnings. Loan approvals for the year were \$6.5 million for 65 projects; a 22 percent increase over 2004 loan approvals. Loan loss provisioning was reduced this year as the quality of the loan portfolio improved and the current Allowance for Doubtful Accounts is at a sufficient level to absorb any losses.

Summary Statement of Net Assets

	<u>2005</u>	<u>2004</u>
Assets:		
Current assets	\$ 5,095,055	\$ 9,508,499
Noncurrent assets	<u>28,628,431</u>	<u>23,119,518</u>
Total assets	\$ <u>33,723,486</u>	\$ <u>32,628,017</u>
Liabilities:		
Current liabilities	\$ <u>568,953</u>	\$ <u>938,598</u>
Total liabilities	<u>568,953</u>	<u>938,598</u>
Net assets:		
Invested in fixed assets	123,127	107,588
Unrestricted	<u>33,031,406</u>	<u>31,581,831</u>
Total net assets	<u>33,154,533</u>	<u>31,689,419</u>
Total liabilities and net assets	\$ <u>33,723,486</u>	\$ <u>32,628,017</u>

Earnings in 2005 improved from \$363,255 in 2004 to \$1,037,199. Provisioning for doubtful loans this past year was reduced because based on the loan grading report the Bank has built up enough reserve for bad loans. The economic outlook appears promising as the flow of Compact fund begins to pour in for the major infrastructure projects.

Changes in the Investment Policy during the year 2004 and improved interest rates for the Company brought some improvement in our Investment Income. At December 31, 2005, the market value of the BDLF stood at \$9,883,134.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Management Discussion and Analysis Year Ending December 31, 2005

Summary Statement of Revenues, Expenses and Changes in Net Assets

	<u>2005</u>	<u>2004</u>
Operating revenues	\$ 2,482,638	\$ 1,991,153
Operating expenses	<u>1,593,528</u>	<u>2,206,190</u>
Earnings (loss) from operations	889,060	(215,037)
Non-operating revenues	<u>576,054</u>	<u>1,036,186</u>
Increase in net assets	1,465,114	821,149
Net assets at beginning of year	<u>31,689,419</u>	<u>30,868,270</u>
Net assets at end of year	\$ <u>33,154,533</u>	\$ <u>31,689,419</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 2005 were \$13,191,731, \$820,602, and \$333,816 respectively. IDF ended the year with a loss of \$1,120,267 whereas PDLF and YDLF earned incomes of \$22,593 and \$11,754 respectively. The Federated Development Authority (FDA) approved a total of \$1,293,708 to be transferred to two of the State Governments. Kosrae State received \$293,708. Pohnpei State received \$1,000,000.

A total of 65 loans were approved in 2005 totaling \$6,526,341. Loans for start up businesses were very limited due to the many debt-servicing difficulties for similar start-up business clients. The Bank was able to collect about \$4.3 million in loan repayments in 2005.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statements of Net Assets December 31, 2005 and 2004

	(Proprietary Fund Type) FSMDB	
	2005	2004
<u>ASSETS</u>		
Current assets:		
Cash and equivalents	\$ 3,444,057	\$ 7,541,541
Accounts receivable	1,611	15,392
Receivable from trust funds	219,516	180,045
Prepaid expenses	2,000	1,000
Interest and other receivables	95,733	142,008
Current portion of loans receivable	1,332,138	1,628,513
Total current assets	5,095,055	9,508,499
Noncurrent assets:		
Fixed assets, net	123,127	107,588
Investments	9,885,832	7,699,921
Equity investment, at cost	662,188	662,188
Loans receivable, net of current portion	17,957,284	14,649,821
Total noncurrent assets	28,628,431	23,119,518
Total assets	<u>\$ 33,723,486</u>	<u>\$ 32,628,017</u>
<u>LIABILITIES</u>		
Current liabilities:		
Accounts payable	\$ 150,368	\$ 70,318
Credit life payable	57,608	61,868
Payable to trust funds	360,977	806,412
Total liabilities	568,953	938,598
Commitments and contingencies		
Net assets:		
Invested in fixed assets	123,127	107,588
Unrestricted	33,031,406	31,581,831
Total net assets	33,154,533	31,689,419
Total liabilities and net assets	<u>\$ 33,723,486</u>	<u>\$ 32,628,017</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statements of Activities and Changes in Net Assets Years Ended December 31, 2005 and 2004

	(Proprietary Fund Type) FSMDB	
	2005	2004
Operating revenues:		
Loan interest	\$ 1,700,275	\$ 1,634,986
Investment income	613,309	307,754
Loan fees	144,840	22,964
Miscellaneous	24,214	25,449
Total operating revenues	<u>2,482,638</u>	<u>1,991,153</u>
Operating expenses:		
Personnel services	816,946	858,561
Provision for doubtful loans	235,748	860,000
Rent	106,665	113,067
Contractual services	81,032	34,687
Travel	73,329	98,540
FSM retirement plan	47,096	44,273
Training	42,455	38,156
Communication	41,199	32,406
Depreciation	30,226	28,771
Supplies	14,305	17,871
Printing	6,217	7,432
Insurance	4,441	4,060
Miscellaneous expenses	93,919	68,366
Total operating expenses	<u>1,593,578</u>	<u>2,206,190</u>
Earnings (loss) from operations	<u>889,060</u>	<u>(215,037)</u>
Non-operating revenues:		
IDF reimbursement	250,000	250,000
Allocations from managed funds	28,470	21,846
Contributions	250,000	750,000
Other income	47,584	14,340
Total non-operating revenues	<u>576,054</u>	<u>1,036,186</u>
Increase in net assets	1,465,114	821,149
Net assets at beginning of year	<u>31,689,419</u>	<u>30,868,270</u>
Net assets at end of year	<u>\$ 33,154,533</u>	<u>\$ 31,689,419</u>

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Statements of Cash Flows
Years Ended December 31, 2005 and 2004

	(Proprietary Fund Type) FSMDB	
	2005	2004
Increase (decrease) in cash and equivalents		
Cash flows from operating activities:		
Cash received from customers	\$ 2,788,107	\$ 3,089,349
Cash paid to suppliers for goods and services	(4,102,530)	(2,682,364)
Cash paid to employees	(801,385)	(858,561)
Net cash used for operating activities	(2,115,808)	(451,576)
Cash flows from capital and related financing activities:		
Acquisition of fixed assets	(45,765)	(62,286)
Net cash used for capital and related financing activities	(45,765)	(62,286)
Cash flows from investing activities:		
(Increase) decrease in investments	(2,185,911)	2,072,122
Net cash (used for) provided by investing activities	(2,185,911)	2,072,122
Cash flows from noncapital financing activities:		
Cash contribution from the FSM National Government	250,000	750,000
Net change in cash and equivalents	(4,097,484)	2,308,260
Cash and equivalents at beginning of year	7,541,541	5,233,281
Cash and equivalents at end of year	\$ 3,444,057	\$ 7,541,541
Reconciliation of operating earnings (loss) to net cash used for operating activities:		
Earnings (loss) from operations	\$ 889,060	\$ (215,037)
Other earnings from merged funds and other	326,055	286,186
Adjustment to reconcile earnings (loss) from operations to net cash used for operating activities:		
Depreciation	30,226	28,771
(Increases) decreases in assets:		
Receivables	(2,990,503)	785,350
Prepaid expenses	(1,000)	-
(Decrease) in liabilities:		
Accounts payable and other liabilities	(369,646)	(1,336,846)
Net cash used for operating activities	\$ (2,115,808)	\$ (451,576)

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(1) Summary of Significant Accounting Policies

Reporting Entities

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

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

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

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

The Bank has opted to establish itself more in line with a corporate model. The Bank, through this process, hopes to be able to attract additional capital through non-FSM sources. To that end, the Bank as of December 31, 2005, 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 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 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, 2005 and 2004

(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.

The Bank has adopted GASB Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB 34) as amended by GASB Statement No. 37. GASB Statement No. 34 established 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, 2005 and 2004, 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.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Cash and Cash Equivalents

For the purposes of the statements of net assets and the statements 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.

Investments

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

Loans and Allowance for Loan Losses

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

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

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

Fixed Assets

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

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

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.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(1) Summary of Significant Accounting Policies, Continued

Estimates

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

(2) Deposits and Investments

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

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

- (i) Government obligations - Obligations issued or guaranteed as to principal and interest by the National Government and/or State governments of the Federated States of Micronesia or by the Government of the United States, provided that the principal and interest on each obligation are payable in the currency of the United States.
- (ii) Corporate obligations and mortgage-backed securities - Obligations of any public or private entity or corporation created or existing under the laws of the Federated States of Micronesia or of the United States or any state, territory or commonwealth thereof, or obligations of any other government or economic community which are payable in United States dollars, or pass through and 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 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.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(2) Deposits and Investments, Continued

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

A. Deposits:

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

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

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Bank's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The Bank does not have a deposit policy for custodial credit risk.

As of December 31, 2005 and 2004, the carrying amount of the Bank's total cash and cash equivalents was \$3,444,057 and \$7,541,541, respectively, and the corresponding bank balances were not materially different. Of the bank balance amounts, all are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2005 and 2004, bank deposits in the amount of \$200,000 were FDIC insured. Accordingly, these deposits are exposed to custodial credit risk. The Bank does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. 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, 2005 and 2004.

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(2) Deposits and Investments, Continued

B. Investments

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

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

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

As of December 31, 2005 and 2004, investments at fair value are as follows:

	<u>2005</u>	<u>2004</u>
Fixed income securities:		
Domestic fixed income	\$ 2,532,476	\$ 2,326,005
Other investments:		
Domestic equities	<u>7,353,356</u>	<u>5,373,916</u>
	<u>\$ 9,885,832</u>	<u>\$ 7,699,921</u>

As of December 31, 2005, the Bank's fixed income securities had the following maturities:

	<u>Less Than</u> <u>1 Year</u>	<u>1 to 5</u> <u>Years</u>	<u>6 to 10</u> <u>Years</u>	<u>Greater Than</u> <u>10 Years</u>	<u>Fair</u> <u>Value</u>
U.S. Treasury obligations	\$ -	\$ 834,447	\$ 191,398	\$ 431,564	\$ 1,457,409
U.S. Government agency obligations	<u>-</u>	<u>703,468</u>	<u>371,599</u>	<u>-</u>	<u>1,075,067</u>
	<u>\$ -</u>	<u>\$ 1,537,915</u>	<u>\$ 562,997</u>	<u>\$ 431,564</u>	<u>\$ 2,532,476</u>

As of December 31, 2004, the Bank's fixed income securities had the following maturities:

	<u>Less Than</u> <u>1 Year</u>	<u>1 to 5</u> <u>Years</u>	<u>6 to 10</u> <u>Years</u>	<u>Greater Than</u> <u>10 Years</u>	<u>Fair</u> <u>Value</u>
U.S. Treasury obligations	\$ -	\$ 1,229,583	\$ -	\$ -	\$ 1,229,583
U.S. Government agency obligations	<u>356,422</u>	<u>740,000</u>	<u>-</u>	<u>-</u>	<u>1,096,422</u>
	<u>\$ 356,422</u>	<u>\$ 1,969,583</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,326,005</u>

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(2) Deposits and Investments, Continued

B. Investments, Continued

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

The Bank's exposure to credit risk at December 31, 2005, was as follows:

<u>Moody's Rating</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
AAA	\$ <u>2,532,476</u>	\$ <u>2,532,476</u>	\$ <u>-</u>
Total credit risk debt securities	\$ <u>2,532,476</u>	\$ <u>2,532,476</u>	\$ <u>-</u>

The Bank's exposure to credit risk at December 31, 2004, was as follows:

<u>Moody's Rating</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
AAA	\$ <u>2,326,005</u>	\$ <u>2,326,005</u>	\$ <u>-</u>
Total credit risk debt securities	\$ <u>2,326,005</u>	\$ <u>2,326,005</u>	\$ <u>-</u>

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Bank will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Bank's investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Bank's name by the Bank's custodial financial institutions at December 31, 2005 and 2004.

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, 2005, the Bank's investment in agency obligations of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association constituted 14% and 28%, respectively, of its total investments. As of December 31, 2004, the Bank's investment in agency obligations of the Federal National Mortgage Association constituted 12% 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 does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

(3) Equity Investment, at Cost

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

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements December 31, 2005 and 2004

(4) Loans Receivable

A summary of loans receivable at December 31, 2005 and 2004 follows:

	<u>2005</u>	<u>2004</u>
Unpaid principal balance	\$ 22,424,442	\$ 21,402,989
Allowance for loan losses	<u>(3,135,020)</u>	<u>(5,124,655)</u>
	\$ <u>19,289,422</u>	\$ <u>16,278,334</u>

Movements in the allowance for loan losses during the years ended December 31, 2005 and 2004, are as follows:

	<u>2005</u>	<u>2004</u>
Balance at beginning of year	\$ 5,124,655	\$ 4,130,359
Provision for loan losses	235,748	860,000
Loans charged off	(2,477,789)	(302,689)
Loan recoveries from previously charged off loans	109,421	436,985
Loan reactivations from previously charged off loans	<u>142,985</u>	<u>-</u>
Balance - December 31, 2005	\$ <u>3,135,020</u>	\$ <u>5,124,655</u>

(5) Fixed Assets

A summary of fixed assets as of December 31, 2005 and 2004, is as follows:

	Beginning Balance January 1, <u>2005</u>	<u>Additions</u>	<u>Deletions</u>	Ending Balance December 31, <u>2005</u>
Office furniture, fixtures and equipment	\$ 191,972	\$ -	\$ (1,707)	\$ 190,265
Home furniture, fixtures and equipment	13,608	-	-	13,608
Vehicles	170,961	20,897	-	191,858
Computers and software	<u>268,207</u>	<u>26,575</u>	<u>-</u>	<u>294,782</u>
	644,748	47,472	(1,707)	690,513
Less accumulated depreciation	<u>(537,160)</u>	<u>(30,226)</u>	<u>-</u>	<u>(567,386)</u>
Net fixed assets	\$ <u>107,588</u>	\$ <u>17,246</u>	\$ <u>(1,707)</u>	\$ <u>123,127</u>

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements December 31, 2005 and 2004

(5) Fixed Assets, Continued

	Beginning Balance January 1, 2004	<u>Additions</u>	<u>Deletions</u>	Ending Balance December 31, 2004
Office furniture, fixtures and equipment	\$ 180,472	\$ 11,500	\$ -	\$ 191,972
Home furniture, fixtures and equipment	13,608	-	-	13,608
Vehicles	122,286	48,675	-	170,961
Computers and software	<u>266,096</u>	<u>2,111</u>	<u>-</u>	<u>268,207</u>
	582,462	62,286	-	644,748
Less accumulated depreciation	<u>(508,389)</u>	<u>(28,771)</u>	<u>-</u>	<u>(537,160)</u>
Net fixed assets	\$ <u>74,073</u>	\$ <u>33,515</u>	\$ <u>-</u>	\$ <u>107,588</u>

(6) Related Party Transactions

As of December 31, 2005 and 2004, the Bank has direct loans with an outstanding balance of \$173,986 and \$147,956, respectively to employees of the Bank and project loans extended to businesses owned by or affiliated with the employees with an outstanding balance of \$3,227,274 and \$3,067,455, respectively. These loans are made under similar terms and conditions as exist with other borrowers. Officers and Board members are not eligible to borrow from the Bank.

(7) Commitments and Contingencies

Guaranty

The Bank, from time-to-time, is contingently liable on loan guarantees ranging from 50% to 90% of the outstanding loan balances for commercial projects within the FSM. There were no outstanding guaranteed loan balances as of December 31, 2005 and 2004.

Loan Commitments

The Bank has made loan commitments for loans approved but undisbursed in the amount of \$3,277,844 at December 31, 2005.

Litigation

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

Self Insurance

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

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Notes to Financial Statements
December 31, 2005 and 2004

(7) Commitments and Contingencies, Continued

Lease Commitments

The FSM Development has six operating leases as of December 31, 2005. Two 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). All leases have an attached option allowing FSMDB to renew the lease upon expiration of the current term. It is likely that these options will be utilized by FSMDB and the leases renewed. The approximate future minimum annual lease payments payable by FSMDB are as follows:

<u>Fiscal year ending December 31,</u>	<u>Total</u>
2006	\$ 108,660
2007	108,660
2008	108,660
2009	108,660
2010	108,660
2011 – 2015	434,640
2016 – 2020	434,640
2021 – 2025	434,640
2026 – 2030	<u>434,640</u>
	\$ <u>2,281,860</u>

(8) 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 years ended December 31, 2005 and 2004, the Bank received \$250,000 and \$750,000, respectively, from the FSM Congress and the Bank was reimbursed for expenses incurred in administering the IDF program from the IDF Private Sub Account for \$250,000 in both years.

(9) Retirement Plan

The Bank's retirement plan (the Plan) is a self-administered program established to pay retirement, disability and survivor income to employees and their survivors to supplement similar benefits that employees 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 years ended December 31, 2005 and 2004 were \$47,096 and \$44,273, respectively. 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, 2005

INDEPENDENT AUDITORS' REPORT

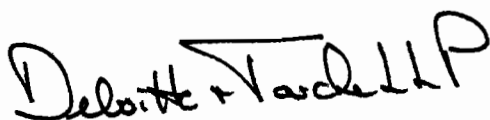
Chairman
Board of Directors
Federated States of Micronesia
Development Bank:

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, 2005, and the related statement of activities and changes in net assets for the year then ended. The Funds are administered by the Federated States of Micronesia Development Bank (FSMDB), a component unit of the National Government of the Federated States of Micronesia. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Funds at December 31, 2005, and the changes in their net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have issued our report dated April 15, 2006, on our consideration of the Funds' internal control over financial reporting and our tests of their compliance with certain laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



April 15, 2006

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Trust Funds
Statement of Net Assets
December 31, 2005
(With Comparative Totals as of December 31, 2004)

	Trust Funds			Totals (Memorandum Only)	
	IDF	PDLF	YDLF	2005	2004
<u>ASSETS</u>					
Current assets:					
Held by FSMDB:					
Cash in bank and on hand	\$ -	\$ 174,206	\$ 60,151	\$ 234,357	\$ 182,446
Time certificate of deposits	-	503,127	129,006	632,133	619,568
Held by trustee:					
Investments	5,743,084	-	-	5,743,084	7,270,802
Total cash and equivalents	5,743,084	677,333	189,157	6,609,574	8,072,816
Receivable from FSMDB	360,977	-	-	360,977	806,412
Interest and other receivables	6,099	5,764	344	12,207	60,395
Loans receivable, net	7,081,571	137,504	144,315	7,363,390	6,481,445
Total receivables	7,448,647	143,268	144,659	7,736,574	7,348,252
	<u>\$ 13,191,731</u>	<u>\$ 820,601</u>	<u>\$ 333,816</u>	<u>\$ 14,346,148</u>	<u>\$ 15,421,068</u>
<u>LIABILITIES AND NET ASSETS</u>					
Current liabilities:					
Payable to FSMDB	\$ -	\$ 100,686	\$ 118,830	\$ 219,516	\$ 180,045
Credit life payable	-	-	2,073	2,073	2,074
Total liabilities	-	100,686	120,903	221,589	182,119
Commitments					
Net assets:					
Restricted	7,081,571	137,504	144,315	7,363,390	6,481,445
Unrestricted	6,110,160	582,411	68,598	6,761,169	8,757,504
Total net assets	13,191,731	719,915	212,913	14,124,559	15,238,949
	<u>\$ 13,191,731</u>	<u>\$ 820,601</u>	<u>\$ 333,816</u>	<u>\$ 14,346,148</u>	<u>\$ 15,421,068</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, 2005
(With Comparative Totals for the Year Ended December 31, 2004)

	Governmental Fund Types (Trust Funds)			Totals (Memorandum Only)	
	IDF	PDLF	YDLF	2005	2004
Operating revenues:					
Investment interest	\$ 152,144	\$ 12,243	\$ 2,639	\$ 167,026	\$ 74,382
Loan interest	269,823	9,925	9,087	288,835	146,015
Miscellaneous	1,474	426	28	1,928	63,815
Total operating revenues	423,441	22,594	11,754	457,789	284,212
Operating expenditures:					
Doubtful loan expense	-	-	-	-	412,468
Total operating expenditures	-	-	-	-	412,468
Revenues over expenditures	423,441	22,594	11,754	457,789	(128,256)
Other sources (uses):					
Investment management fee	(250,000)	-	-	(250,000)	(250,000)
Transfer to Kosrae State Government	(293,708)	-	-	(293,708)	(151,292)
Transfer to Pohnpei State Government	(1,000,000)	-	-	(1,000,000)	(500,000)
Transfer to Chuuk State Government	-	-	-	-	(528,503)
Transfers to FSMDB fund	-	(22,594)	(5,877)	(28,471)	(21,847)
Total other uses, net	(1,543,708)	(22,594)	(5,877)	(1,572,179)	(1,451,642)
Revenues and other sources over expenditures and other uses	(1,120,267)	-	5,877	(1,114,390)	(1,579,898)
Net assets at beginning of year	14,311,998	719,915	207,036	15,238,949	16,818,847
Net assets at end of year	<u>\$ 13,191,731</u>	<u>\$ 719,915</u>	<u>\$ 212,913</u>	<u>\$ 14,124,559</u>	<u>\$ 15,238,949</u>

See accompanying notes to financial statements.

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

Notes to Financial Statements
December 31, 2005

(1) Purpose and Summary of Significant Accounting Policies

Purpose

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

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

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

Fund Structure and Basis of Accounting

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

Cash and Cash 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. Deposits maintained in time certificates of deposit with original maturity dates greater than three months are separately classified on the statement of net assets.

Loan and Allowance for Loan Losses

Loans under the trust funds are reported at gross unpaid principal balances, without an allowance 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.

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.

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.

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

Notes to Financial Statements
December 31, 2005

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

Estimates

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

(2) Deposits and Investments

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

The deposit and investment policies of the Funds are governed by its 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 pass through and other mortgage-backed securities provided that the obligation is an agency of the United States Government, the National Government of the Federated States of Micronesia, or is rated in one of the three highest categories by two nationally recognized rating agencies. No investment under this heading shall exceed ten percent of the market value of the Funds' investments or ten percent of the outstanding value of the issue at the time of purchase.
- (iii) Preferred and common stocks - Shares of preferred or common stocks of any corporation created or existing under the laws of the Federated States of Micronesia or under the laws of the United States or any state, territory or commonwealth thereof provided that the purchase of such shares shall be considered reasonable and prudent by the Funds' investment advisor at the time of purchase, that not more than five percent of the market value of its investments shall be invested in the stock of any one corporation, and that not more than ten percent of the market value of its investments shall be invested in any one industry group.

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

Notes to Financial Statements
December 31, 2005

(2) Deposits and Investments, Continued

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

A. Deposits:

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

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

GASB Statement No. 40 amended GASB Statement No. 3 to in effect eliminate disclosure for deposits falling into categories 1 and 2 but retained disclosures for deposits falling under category 3. Category 3 deposits are those deposits that have exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Funds' deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized, or collateralized with securities held by the pledging financial institution or held by the pledging financial institution but not in the depositor-government's name. The Funds do not have a deposit policy for custodial credit risk.

As of December 31, 2005, the carrying amount of the Funds' total cash and cash equivalents and time certificates of deposits was \$866,490 and the corresponding bank balances approximated the same amount. All of the bank balances are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC) insurance. As of December 31, 2005, bank deposits in the amount of \$200,000 were FDIC insured. Accordingly, these deposits are exposed to custodial credit risk. The Funds do not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. 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, 2005.

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

Notes to Financial Statements
December 31, 2005

(2) Deposits and Investments, Continued

B. Investments

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

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

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

As of December 31, 2005, investments at fair value are as follows:

Fixed income securities:	
Domestic fixed income	\$ 5,208,000
Other investments:	
Money market funds	<u>535,084</u>
	\$ <u>5,743,084</u>

As of December 31, 2005, the Funds' fixed income securities had the following maturities:

	<u>Less Than 1 Year</u>	<u>1 to 5 Years</u>	<u>6 to 10 Years</u>	<u>Greater 10 Years</u>	<u>Fair Value</u>
U.S. Government agency Obligations	<u>\$5,208,000</u>	\$ _____	\$ _____	\$ _____	<u>\$5,208,000</u>

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

The Funds' exposure to credit risk at December 31, 2005, was as follows:

<u>Moody's Rating</u>	<u>Total</u>	<u>Domestic</u>	<u>International</u>
AAA	\$ <u>5,208,000</u>	\$ <u>5,208,000</u>	\$ _____
Total credit risk debt securities	\$ <u>5,208,000</u>	\$ <u>5,208,000</u>	\$ _____

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

Notes to Financial Statements
December 31, 2005

(2) Deposits and Investments, Continued

B. Investments, Continued

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to the transaction, the Funds will not be able to recover the value of investment or collateral securities that are in the possession of an outside party. The Funds' investments are held and administered by trustees. Accordingly, these investments are exposed to custodial credit risk. Based on negotiated trust and custody contracts, all of these investments were held in the Funds' name by the Funds' custodial financial institutions at December 31, 2005.

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, 2005, the Funds' investment in agency obligations of Federal Home Loan Mortgage Corporation, Federal National Mortgage Association and Federal Home Loan Bank constituted 57%, 29% and 14%, respectively, of its total investments.

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

(3) Loans Receivable

The following is a schedule of loans receivable as of December 31, 2005:

	<u>Loan Balance</u>	<u>Allowance</u>	<u>Net Amount</u>
State Development Funds (Pohnpei and Yap)	\$ 281,819	\$ -	\$ 281,819
IDF	<u>7,082,772</u>	<u>1,201</u>	<u>7,081,571</u>
	\$ <u>7,364,591</u>	\$ <u>1,201</u>	\$ <u>7,363,390</u>

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

(4) Commitments

Loan commitments for loans approved but undisbursed approximated \$1,594,467 at December 31, 2005.

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

The Board of Directors
Federated States of Micronesia Development Bank:

We have audited the financial statements of the Federated States of Micronesia Development Bank, as of December 31, 2005, and for the year then ended, and have issued our report thereon dated April 15, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the 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. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Federated States of Micronesia Development Bank's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

This report is intended for the information of 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.

Debitte & Tade LLP

April 15, 2006

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER COMPLIANCE AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

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, 2005. Federated States of Micronesia Development Bank's major federal program is identified in the Schedule of Expenditures of Federal Awards (page 26). 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, 2005.

Internal Control Over Compliance

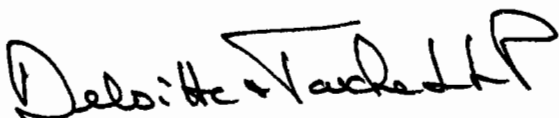
The management of the Federated States of Micronesia Development Bank is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing the audit, we considered 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, 2005, and have issued our report thereon dated April 15, 2006. 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, appearing to read "Deloitte Touche LLP", is written over a horizontal line.

April 15, 2006

FEDERATED STATES OF MICRONESIA DEVELOPMENT BANK

Schedule of Expenditures of Federal Awards Year Ended December 31, 2005 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, 2005	\$ <u>25,700,000</u>
Section 111 IDF Funds	Total funding available through December 31, 2005	\$ 14,311,998
	Amount of revenues and other sources over expenditures and other uses during year ended December 31, 2005	<u>(1,120,267)</u>
	Fund balance as of December 31, 2005	\$ <u>13,191,731</u>

**FEDERATED STATES OF MICRONESIA
DEVELOPMENT BANK**

Schedule of Findings and Questioned Costs
Year Ended December 31, 2005

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, 2005**

There are no prior audit findings relative to Federal awards.