

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

REPORTS ON THE AUDIT OF FINANCIAL STATEMENTS
IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS

Years Ended September 30, 2013 and 2012



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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
National Development Bank of Palau

Report on the Financial Statements

I have audited the accompanying financial statements of National Development Bank of Palau (a component unit of the Republic of Palau), which comprise the statement of net position as of September 30, 2013, and the related statement of revenues, expenses and changes in net position, and cash flows for the year then ended, and the related notes to the financial statements. The financial statements of National Development Bank of Palau as of September 30, 2012, were audited by other auditors whose report dated March 30, 2013, expressed an unmodified opinion on those statements before restatement.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my 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 I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Opinion

In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of National Development Bank of Palau as of September 30, 2013, and the changes in its net position and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.


Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 16 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. I have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to my inquiries, the basic financial statements, and other knowledge I obtained during my audit of the basic financial statements. I do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, I have also issued my report dated April 7, 2014, on my consideration of National Development Bank of Palau's internal control over financial reporting and on my tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of my testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards in considering National Development Bank of Palau's internal control over financial reporting and compliance.


Saipan, Commonwealth of the Northern Mariana Islands
April 7, 2014



MANAGEMENT'S DISCUSSION AND ANALYSIS YEAR ENDED SEPTEMBER 30, 2013

This Management Discussion and Analysis (MD&A) of the National Development Bank of Palau's (the Bank) financial performance and condition for the fiscal year end 2013 is intended to contribute to the reader's better understanding of the Bank's structure and activities. The report should be read in conjunction with the audited financial statements and associated reports.

Note that this report may at times anticipate future events that are based upon current assumptions subject to risk and uncertainties. Actual events may differ materially from these expectations.

Organization of the Bank

The Bank is a corporation established to initiate and promote economic development in the Republic of Palau (ROP) and was created in February 1982 by Public Law Number 1-27 as codified in Title 26 of the Palau National Code Annotated (PNCA), as amended. The Bank is wholly owned by ROP and operates independently under its own Board of Directors. Its main goals are to promote economic development by providing financing for new enterprise, industry, exports and housing.

The President of ROP appoints six of its seven Board members for a three-year terms subject to Senate confirmation. The seventh member is the President of the Bank who shall serve as an ex-officio member of the Board. The Board of Directors elects their own officers to the posts of Chairman, Vice Chairman and Secretary/Treasurer, to serve the length of their terms. Last year it was mentioned in the MD&A that the Secretary/Treasurer of the Board resigned effective December 29, 2012. However, the President of the ROP did not accept her resignation and thus she returned to the Board on April 5, 2013. This leaves one vacancy on the Board. The vacancy was filled by the sixth Board member which was confirmed on August 19, 2013.

The Bank achieves its mission and goals by relending funds obtained from lenders, donors and the government. Its financial objective is not to maximize profit but to attain sufficient financial strength to achieve its objectives. Therefore, the Bank functions as a development financial institution and not a commercial or central bank. It is exempt from banking supervision by ROP's Financial Institutions Commission as long as it does not take in deposits; however, it is subject to prudential and reporting guidelines established by its Act and oversight hearing by either house of Congress at any time.

The Bank's Act has changed little since its last major revision. The most recent amendment was to specifically allow the Bank to lend to ROP. There is a House Bill No. 9-84-5 pending to allow NDBP to take in deposits.

The Bank's policies and strategies are implemented through the Bank's President and management. The Bank is organized by three functional areas: Finance, Lending and Risk & Compliance. The NDBP Board of Directors approves the hiring of candidates for the manager of each functional area. The Bank President has the authority over all the other positions of the Bank. Staff levels and funding are determined against strategic, corporate and budget plans proposed by management and approved by Board. At fully staffed capacity, the Bank has sixteen full time equivalent employees, including the President / CEO.

All Bank operations are conducted from its main office in Ngetkib Village, Airai State. There are no branches, other offices or subsidiaries operating in 2013. Plans for expansion of the Bank's building are set forth in the Bank's ten-year Strategic Plan.

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September 30, 2013

Significant Events in 2013

Several developments indicate a positive growth is very likely for the Palau economy. This includes increase in airline flights to Palau such as China Airlines, United Airlines, Japan Airlines, Delta Airlines, and Asiana Airlines. The visitors are coming from Republic of China Taiwan, Japan, Korea, North America and Europe. Visitor arrivals have been over the 100,000 mark since 2011. Figures released by Palau Visitor's Authority (PVA) shows 105,066 visitors came to Palau in 2013, 118,754 in 2012 and 109,057 in 2011.

Growth will likely continue in the sectors of construction and trade as private projects continue through 2014. Private sector projects, namely new hotel projects, hotel renovation, apartment construction, luxury yacht for tourism, farming and fisheries are examples of foreign investment projects that may contribute to GDP in the near term. The hotel projects will provide the much needed room count to support the tourism industry and meetings/conventions held on island. Direct industry linkage to large private sector projects will include farming and fishing industry in support of hotel food and beverage activities as well as promotion of similar line of accommodation in tourism projects. The idea of tourism is starting to focus on the quality of tourism such as the "high-end" tourism and eco-tourism rather than the quantity of tourism.

However, the two national policy directions for industry under Palau's leadership are Energy and Agriculture/Aquaculture. A new agriculture and aquaculture loan program was signed into law on August 20, 2013 for NDBP to provide small-scale financing to start-up agriculture and aquaculture, contingent upon the applicant working with the Palau Small Business Development Center (SBDC), the Bureau of Agriculture and the Bureau of Marine Resources to receive technical assistance on creating business plans, strategic planning, and to operate the farm. Under this program, the Bank shall offer loans of not more than \$20,000 to qualified Palauan citizens at the rate of 3% interest per year. NDBP is tasked with annual reporting of the Farm Loan Program to the President of the Republic, the Senate and the House of Delegates. NDBP has to initiate and take an active role in this area of national policy to promote its underserved sectors of the Palau economy and to diversify credit risks and portfolio concentration.

Energy policy is characterized by renewable energy support; i.e., various solar energy systems installed at the National Hospital parking area, the Ministry of Education head office and the Airport. NDBP supports the national policy and has three Energy Loan Program (ELP) Subsidy programs as follows:

- Energy Efficiency Subsidy Loan Program (EESP)
- Renewable Energy Subsidy Loan Program (RESP)
- RETRO-Energy Efficiency Subsidy Loan Program (RETRO-EESP)

The subsidy to support the above mentioned programs come from partners and donors. NDBP was announced as a finalist in the 2013 Ashden Awards, the world's leading green energy prize. The Bank was recognized for its programs to encourage energy-efficient households on the island.

On January 7, 2013 FIC implemented the Secured Transaction Registry (STR). This is used for Lenders to register all chattel mortgage liens, accounts receivables, livestock, and assignments of lease/rents. Lenders need to file notices in the STR to protect their liens against future lenders, buyers or other lien holders. Lenders can file liens on almost anything but income.

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Another significant event in 2013 is the adoption of House Bill RPPL 9-2 on April 30, 2013 which eliminates the mandatory retirement for Government employees after 30 years of service. All employees who are sixty years of age or older shall retire, except for those in employment positions exempted by the Board or those individuals who receive specific exemptions from the Board. Other amendment includes Civil Service Pension which limits the amount of benefits to \$30,000 per year. Surviving beneficiaries of an employee may only receive benefits up to the total present value of the employee's accrued benefit. These changes will affect the repayment capabilities of our borrowers and the retention of our employees.

The most significant event in 2013 is the announcement of NDBP to start taking in deposits. Once the law is approved, the Bank will take in deposit and will fall under the oversight of the Financial Institution Commission (FIC).

Funding for Operations

Historically, the Bank has funded its operations from three main sources: paid-in capital, accumulated retained income and borrowed funds. The most recent paid-in capital received from ROP was in the year 2000 for \$3 million to fund a first-time homeowner program. The Bank has relied on accumulated retained income since 2002, and borrowed funds since 2003, to fund loan operations and the Bank's growth. Additional sources of funds pursued during the year included additional long-term borrowings, loan/asset sales and grants. The Bank's Strategic Plan also considers deposit liabilities as a new source of funds in the future.

Borrowed funds currently outstanding are from signed notes with Mega International Commercial Bank (MICB, previously the International Commercial Bank of China), the Republic of Palau Social Security Administration (ROPSSA), the European Investment Bank (EIB) and the Republic of Palau. All four notes are for long-term intermediary relending funds. A balance remained on the EIB loan, an estimated \$2 million, was cancelled due to noncompliance on the EIB loan covenants resulting from two large accounts that went into arrears with no immediate resolution. The \$3 million from ROP earmarked for PNCC was return on 4/5/2013.

The Bank's BOH line of credit (LOC) was not renewed as a short-term funding contingency this year. This LOC is primarily utilized during periods when liquidity is low for funding loans. The LOC limit is \$300k secured by Cash in the form of a Time certificate of Deposit for \$452k renewable annually. It would save the Bank more to utilize the TCD than to incur more costs to renew the LOC.

A \$750,000 loan from the U.S. Department of Agriculture (USDA) for an Intermediary Relending Program (IRP) loan agreement was signed on March 27, 2013. The Bank is required to match these funds in a revolving fund at the signing of the loan, which the bank has done so with an account at BOH. The USDA IRP funds are to be used to support businesses that have been turned away from other local banks.

The timing and extent to which borrowed funds are utilized for lending activities is determined mainly by cost and availability. The ROP loan proceeds represented the least costly funds available at a 2.00% fixed interest rate per annum. The loan was originally for \$4 million with \$3 million earmarked for PNCC. The loan to PNCC did not materialize and the Bank returned \$3 million to ROP on 4/5/2013.

For Grants, the Bank continuously works to secure grants to expand its Energy Loan Programs. No new grant funding was received in 2013; however, Phase II Grant funding is being worked on with IUCN.

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The Finance section of the Bank is accountable for accounting and financing activities including liquidity management. Liquidity management for the Bank includes segregation of bank accounts and transfers from general accounts to support disbursements. Disbursements are generally planned through the annual budget process. Forward estimates for loan disbursements are provided by loan officers each month. Proceeds from loans to the Bank for intermediary relending are requested based on forward estimates and, where necessary, cash flow from operations and non-restricted investments are used if those proceeds are not immediately available. Management is mindful to minimize any additional interest costs in these decisions.

Financial Policies

The Bank's financial policies follow accounting principles generally accepted in the United States of America (GAAP) applicable to governmental entities and specifically proprietary funds. Management is required to make estimates, disclosures and assumptions in preparation of financial statements in conformity with GAAP and actual results may differ from amounts reported during the reporting period. The basis of accounting used is the flow of economic resources measurement focus, which means all assets and liabilities are included within the statement of net position. The accrual basis of accounting is utilized whereby revenues are recorded when earned and expenses recorded when liabilities are incurred.

Significant financial policies of the Bank include a 10% reserve requirement for commercial guaranteed loans. The reserve is held in a time certificates of deposit (TCDs) with a commercial bank with a current ratio of 36%. USDA RD requirement for their reserve is a fixed amount of \$500,000 maintained at a commercial bank. At end of 2013, the current balance on the account is \$525,147 which includes fees collected and interest earned.

All current guarantees are granted under recourse. The PNCA 26 states, "The Bank may at its discretion provide loan guarantees to another bank in support of a qualified applicant's commercial loan application. No such loan guarantee shall guarantee more than ninety percent (90%) of the outstanding amount of the loan except in the case of the guarantee of a home loan to a citizen of the Republic." USDA RD guaranteed home loan contingent liability is 100%. The total amount for which the Bank was contingently liable in 2013 for commercial banks and USDA RD home loans was \$3.7 million. The amended MOU with USDA RD provided the requirements for accounts allowable for reserves and several procedural covenants.

Other financial policies include ROP's full faith and credit guarantee backing for Bank loans up to \$15 million in the aggregate, subject to specific purpose limitations. Maximum Bank external borrowing authorized by ROP is \$100 million. The maximum single exposure to a single borrowing entity is 20% of the Bank's unimpaired paid-in capital, earned surpluses and reserves. Specific targets for exposure to industry are not formally established but concentrations are monitored on a regular basis. Loan maturities are monitored to match borrowings, operation costs, and long outstanding loan commitments. At September 2013, loan maturities remained concentrated in the 15-year range.

Operations

Financial assistance is provided by the Bank for projects involving housing, agriculture, marine resources, commerce and industry. Authorized financing schemes include guarantees, direct loans and direct investment. Further, the Bank is required to provide technical assistance services as part of its operations. The Bank's MOU, financial and logistical support with the Palau Small Business Development Center to assist client with such things as creating business plans; the collaboration with Palau SBDC and the

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Ministry Natural Resources, Environment and Tourism on the Farm Loan Program; and the MOU with the Palau Housing Authority on providing subsidy on the Energy Efficient Homes are efforts towards this responsibility. Information on other financial and technical service providers including government agencies is also provided for client or applicant consideration. Currently, the Bank's financial activities are limited to projects within ROP. All financial transactions are US dollar denominated.

Direct loans

Short term to medium term financing is extended to new or existing businesses to fund short-term working capital and equipment acquisitions. Longer term financing is extended to individuals for housing and business facilities. Rates are fixed depending on the type of financing provided. Posted interest rates range from 6% to 10%. Rates are considered to include the cost of funds, lending spread to cover the cost of operations, risk component, and a small return for growth purposes. Fees are usually 2% of financing extended. Originating and closing costs are also charged to borrowers. Specific programs offered under direct financing are agriculture, fishing, small business, housing and business loans. In 2013, the Bank approved 147 loan applications totaling \$8.3 million which includes renewals, extensions, performance bonds, and new loans. \$5.7 million remains undisbursed at 2013 fiscal year end. The majority of the undisbursed loans is for LOC and guaranteed bonding of \$4.5 and \$1.2 million for term loans.

In the category of small business loans, the Bank offers customers four programs: Small Business, WEDAP, Microfinance and its newest program, Pre-Development Loan. The Bank's general policy is all loans are fully secured; except for micro-finance of up to \$10,000. Micro-finance loans are administered like signature loans; however, the Bank may take collateral if it deems necessary for abundance of caution. The Bank's Microfinance program and Pre-Development Loan are small loans for housing or business purposes at a 6% interest rate targeting those borrowers who are able to secure their loan with an assignment of income. No collateral is required and turnover is intended to be quick. These programs appear to be successful and are popular. Specifically, interests in Microfinance Loans, which are also available for home projects such as extensions and renovations have been popular. This may be due to the postponement of larger investments by borrowers due to the current sentiment regarding a sluggish economy.

Direct housing loans are provided in two categories, the first time homeowner program which offers an 8% interest rate and all other housing loans at a 10% interest rate. Owner contribution to projects is required at 15% of project cost with a maximum amount of \$10,000 under the Pre-Development Loan not to exceed five years. The purpose of Pre-Development Loan is to help borrowers pay for plan design, appraisal, title search and all related soft costs associated with packaging loans and cash equity contribution. Eligible purposes for housing loans include new construction, renovation and extension.

Most loan applications are granted for new constructions. The Bank has observed more loans being approved under the first-time homeowner program than the standard housing program.

Guaranteed Loans

The Bank offers guarantees either backed by the Bank or ROP to commercial banks and other institutions. Commercial banks, government authorities and the regional development financial institution, the Pacific Island Development Bank, either currently accept or hold guarantees from the Bank. The majority of guarantees outstanding from the Bank are to USDA RD loans. In addition to the USDA RD Section 502 and 504 housing loans guaranteed by the Bank, they are the leveraged loans which are co-financed by both the Bank and the USDA RD. Popularity is low with these programs as they often take months to receive approval and are stricter in terms and loan covenants.

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Investments

There are no further investments made by the Bank since its initial investment in Palau Micronesia Air which has been repurchased by other stockholders. However, the Bank took a note assignment of \$820,000 between ROP and the Receivership of the failed Pacific Savings Bank (PSB) for the purpose of assisting certain classes of depositors in the lower bracket. The assignment of the note bears no interest and the monthly payments of \$10,000 previously paid to ROP was directed and assigned to the Bank. The Bank disbursed \$320,000 in 2011 and \$500,000 in 2012 for a total of \$820,000. The PSB Receiver now Creditors Trust will continue paying the \$10,000 monthly payment until the balance of the note is satisfied. As of end of Fiscal Year 2013, the remaining balance is \$470,000.

Approval Process

All requests for financing are reviewed by loan officers who recommend approval or declination of a loan application based on review of business and other plans, income and credit verifications and collateral. A normal approval cycle from application to approval can be obtained within three months with the exception of small loans approved by the President that can have approval cycle within three weeks. The use of outside professionals to research land title, provide valuations on collateral, review and certify plans and conduct progress inspections is an integral part of loan origination but also delays loan approvals. The Bank advocates building codes and requires the use of a recognized code in the design of all construction projects. The Bank utilizes a dual approval process whereby the next higher approval authority reviews loan decisions. The Bank's Board of Directors holds meetings of no less than three times per month to approve loans and review other business. Loan disbursements are made according to progress payments against approved loan purposes. Any deviation requires an amendment to the loan and approval by original approving authorities.

Loan Management

The Bank monitors payment performance and contacts client on a seven, thirty, sixty and ninety day schedule with the degree of reporting based on each borrowers' circumstance. Additionally, Loan Officers conduct account reviews and site visits whenever a weakness becomes evident in a loan. Once a loan is determined by the Loan Officer that it is uncollectible, the loan is placed in non-accrual status. The Compliance Officer takes over the account and work with the Bank's attorneys to cure, recover, or liquidate the collateral.

Financial Reporting

Financial reporting is made by each of the Bank's three sections to the President / CEO of the Bank, who in turn reports to the Board of Directors on a monthly basis. These reports include financial, loan and risk & compliance information as well as administrative, industry and economic environment information. Monthly reports are provided to the Board of Directors and annual reports are provided to the Bank's lenders and ROP.

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Overview of Financial Performance

The following are the basic financial statements of the Bank:

The statement of net position presents information on all of the Bank's assets and deferred outflows of the resources, and liabilities and deferred inflows of resources with the difference between them presented as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the Bank is improving or deteriorating.

The Statement of revenues, expenses and changes in net position presents information showing how the Bank's net position changed during the most recent fiscal year. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing and related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g. interest owed but not due until a future year and earned unused vacation leave).

The statement of cash flows reports inflows and outflows of cash, classified into four major categories:

- Cash flows from operating activities include transactions and events reported as components of operating income in the statement of revenues, expenses and changes in net position.
- Cash flows from non-capital financing activities include operating grant proceeds.
- Cash flows from capital and related financing activities include the borrowing and repayment (principle and interest) of capital-related debt, the acquisition and construction of capital assets, and the proceeds of capital grants and contributions.
- Cash flows from investing activities include proceeds from sale of investment, receipt of interest and changes in the fair value of investments subject to reporting as cash equivalents. Outflows in this category include the purchase of investments

Notes to the Financial Statement

Various notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements and are found immediately following the financial statements to which they refer.

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Overview of Financial Performance

Condensed Statements of Revenues, Expenses and Changes in Net Position

Change in Net Position

The change in net position was 88% lower than 2012 resulting largely from large recoveries, large loan payoff in 2012. A condensed year-to-year comparison of operating activity reflecting the foregoing Statement follows:

	2013	2012	Changes	
			Amount	Percent
Operating revenues:				
Interest income on loans	\$ 1,937,444	\$ 2,189,974	\$ (252,530)	(12)
Loans fees and late charges	110,501	81,074	29,427	36
Other	6,170	21,005	(14,835)	(71)
Total operating revenues	2,054,115	2,292,053	(237,938)	(10)
Recovery of (provision for) loan losses	(341,172)	704,127	(1,045,299)	(148)
Net operating revenues	1,712,943	2,996,180	(1,283,237)	(43)
General and administrative expenses	(717,294)	(703,166)	(14,128)	2
Operating income	995,649	2,293,014	(1,297,365)	(57)
Nonoperating revenues (expenses), net	(794,192)	(598,678)	(195,514)	33
Change in net position	201,457	1,694,336	(1,492,879)	(88)
Net position at beginning of year	17,384,860	15,690,524	1,694,336	11
Net position at end of year	<u>\$ 17,586,317</u>	<u>\$ 17,384,860</u>	<u>\$ 201,457</u>	<u>1</u>

	2012	2011	Changes	
			Amount	Percent
Operating revenues:				
Interest income on loans	\$ 2,189,974	\$ 2,241,902	\$ (51,928)	(2)
Loans fees and late charges	81,074	94,990	(13,916)	(15)
Other	21,005	6,073	14,932	246
Total operating revenues	2,292,053	2,342,965	(50,912)	(2)
Recovery of (provision for) loan losses	704,127	(976,280)	1,680,407	(172)
Net operating revenues	2,996,180	1,366,685	1,629,495	119
General and administrative expenses	(703,166)	(883,902)	180,736	(20)
Operating income	2,293,014	482,783	1,810,231	375
Nonoperating revenues (expenses), net	(598,678)	(177,819)	(420,859)	237
Change in net position	1,694,336	304,964	1,389,372	456
Net position at beginning of year	15,913,197	15,608,233	304,964	2
Restatement	(222,673)	-	(222,673)	-
Net position at end of year	<u>\$ 17,384,860</u>	<u>\$ 15,913,197</u>	<u>\$ 1,471,663</u>	<u>9</u>

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Revenue

Operating revenues include all direct revenues such as interest income and fees on loans, interest on investments (savings account with other banks) and other miscellaneous fees (i.e. late charges). Interest income as of September 30, 2013 and 2012 was \$1.9 million and \$2.2 million respectively. Year ending 2013 interest income decreased 12% from 2012. Loan fees, late charges and bonding fees increased by 14% in 2013. With the increase of provisioning for loan losses from recovering of \$704,127 to a \$341,172 provision, net operating revenue decreased by 43%.

Loan Interest Rates

The Bank's interest rates remained fixed according to the type of loan funded. Rates ranged from 6% for agriculture, microfinance and pre-development loans; 8% for fishing and first-time homeowner loans; and 10% for commercial and housing loans. Other accounts in collection continue to be assessed the statutory rate of 9% interest rate as required by a court-ordered judgment. At the end of FY2013, the average yield on the Bank's portfolio decreased from 8.63% in 2012 to 8.59% due to increase in micro financing and pre-development loans.

Grants

In 2011, the NDBP implemented the Energy Loan Program (ELP) to provide loans to business and housing customers to acquire renewable energy technology. The Bank currently has three (3) Grant Programs under its Energy Loan Programs (ELP).

1. Energy Efficiency Subsidy Loan Program (EESP) is from the Government of Italy, Austria, and the Municipality of Milan. The amount of the award is \$500,000 and funds received up to June 30, 2011 were \$438,779. No new funding received in 2012 and 2013.
2. Renewable Energy Subsidy Loan Program (RESP) is from Global Environmental Facility (GEF) through UNDP under the Palau Sustainable Economic Development through Renewable Energy Applications (SEDREA) Project. The NDBP received on-grid and off-grid solar photovoltaic systems from the United Nations Development Program through the Republic of Palau Energy Office under the Sustainable Economic Development through Renewable Energy Applications (SEDREA) Program. The dollar value of solar equipment inventory received on March 2011 was for \$402,880. As of September 30, 2013, remaining inventory of \$ 275,771 consists of \$116,586 Off-Grid and \$159,185 On-Grid.
3. RETRO-Energy Efficiency Subsidy Loan Program (RETRO-EESP) is from North Pacific ACP Renewable Energy and Energy Efficiency Project (North-REP). Funds are from the 10th European Development Fund (EDF-10). The Amount of the award is \$454,545 and funds received December 19, 2012 were \$32,537. No new funds received in 2013.

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Expenses

Recovery of (Provision for) Loan Losses and Doubtful Accounts

The Bank's net provision for loan losses in 2013 was a provision of \$341,172 as compared to \$704,127 recovery in 2012. The increase is due to additional provisions for Non-performing loans and charge offs. Provisions are net of recoveries for the year.

General and administrative Expenses

	2013	2012	Changes	
			Amount	Percent
Salaries, wages and fringe benefit	\$ 426,516	\$ 409,101	\$ 17,415	4
Professional fees	69,950	54,650	15,300	28
Depreciation	51,812	48,223	3,589	7
Travel and transportation	25,897	36,723	(10,826)	(29)
Dues and subscription	22,006	28,542	(6,536)	(23)
Repairs and maintenance	21,459	23,504	(2,045)	(9)
Supplies, printing and reproduction	16,203	18,973	(2,770)	(15)
Utilities	15,437	18,202	(2,765)	(15)
Honorariums and meeting expenses	11,591	12,979	(1,388)	(11)
Communications	11,549	11,275	274	2
Insurance	7,895	7,782	113	1
Rent	5,500	2,000	3,500	175
Training	4,798	3,390	1,408	42
Miscellaneous	26,681	27,822	(1,141)	(4)
	<u>\$ 717,294</u>	<u>\$ 703,166</u>	<u>\$ 14,128</u>	<u>2</u>

	2012	2011	Changes	
			Amount	Percent
Salaries, wages and fringe benefit	\$ 409,101	\$ 481,722	\$ (72,621)	(15)
Professional fees	54,650	94,446	(39,796)	(42)
Depreciation	48,223	52,530	(4,307)	(8)
Travel and transportation	36,723	86,926	(50,203)	(58)
Dues and subscription	28,542	21,030	7,512	36
Repairs and maintenance	23,504	18,247	5,257	29
Supplies, printing and reproduction	18,973	14,923	4,050	27
Utilities	18,202	20,502	(2,300)	(11)
Honorariums and meeting expenses	12,979	15,710	(2,731)	(17)
Communications	11,275	10,698	577	5
Insurance	7,782	8,335	(553)	(7)
Rent	2,000	1,000	1,000	100
Training	3,390	25,554	(22,164)	(87)
Miscellaneous	27,822	32,279	(4,457)	(14)
	<u>\$ 703,166</u>	<u>\$ 883,902</u>	<u>\$ (180,736)</u>	<u>(20)</u>

Total operating expenses for 2013 was 2% more than 2012. Savings were realized in Travel and transportation, dues and subscriptions, supplies and printing, utilities and Board Honorariums and other expenses. The Bank's commitment for training new and existing staff with internet-based, bank-designed and on-island and off-island training continues each year. No major improvement to the Bank's leasehold was recorded. Two new Bank vehicles were purchases on April 2013.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Management Discussion and Analysis
September 30, 2013

Overview of Financial Condition

Condensed Statements of Net Position

	2013	2012	Changes	
			Amount	Percent
Current assets	\$ 9,029,644	\$ 12,882,892	\$ (3,853,248)	(30)
Property and equipment, net	701,963	709,249	(7,286)	(1)
Economic development loans receivable	18,617,524	18,058,755	558,769	3
Other noncurrent assets	2,354,648	2,864,494	(509,846)	(18)
Total assets	<u>30,703,779</u>	<u>34,515,390</u>	<u>(3,811,611)</u>	<u>(11)</u>
Accounts payable and accrued expenses	71,912	73,237	(1,325)	(2)
Other liabilities	92,265	149,573	(57,308)	(38)
Interest payable	101,805	112,925	(11,120)	(10)
Loans payable	12,423,591	16,361,035	(3,937,444)	(24)
Total liabilities	<u>12,689,573</u>	<u>16,696,770</u>	<u>(4,007,197)</u>	<u>(24)</u>
Loan origination fees	427,889	433,760	(5,871)	(1)
Total deferred inflows of resources	<u>427,889</u>	<u>433,760</u>	<u>(5,871)</u>	<u>(1)</u>
Net Position	<u>\$ 17,586,317</u>	<u>\$ 17,384,860</u>	<u>\$ 201,457</u>	<u>1</u>

Net Position				
Net investment in capital assets	\$ 701,963	\$ 709,249	\$ (7,286)	(1)
Restricted				
Debt service	12,525,396	16,473,960	(3,948,564)	(24)
Enabling legislation	4,358,958	201,651	4,157,307	2,062
Total net position	<u>\$ 17,586,317</u>	<u>\$ 17,384,860</u>	<u>\$ 201,457</u>	<u>1</u>

	2012	2011	Changes	
			Amount	Percent
Current assets	\$ 12,882,892	\$ 8,023,467	\$ 4,859,425	61
Property and equipment, net	709,249	738,082	(28,833)	(4)
Economic development loans receivable	18,058,755	18,544,071	(485,316)	(3)
Other noncurrent assets	2,864,494	2,721,434	143,060	5
Total assets	<u>34,515,390</u>	<u>30,027,054</u>	<u>4,488,336</u>	<u>15</u>
Accounts payable and accrued expenses	73,237	91,156	(17,919)	(20)
Other liabilities	149,573	218,869	(69,296)	(32)
Interest payable	112,925	118,192	(5,267)	(4)
Loans payable	16,361,035	13,685,640	2,675,395	20
Total liabilities	<u>16,696,770</u>	<u>14,113,857</u>	<u>2,582,913</u>	<u>18</u>
Loan origination fees	433,760	-	433,760	-
Total deferred inflows of resources	<u>433,760</u>	<u>-</u>	<u>433,760</u>	<u>-</u>
Net Position	<u>\$ 17,384,860</u>	<u>\$ 15,913,197</u>	<u>\$ 1,471,663</u>	<u>9</u>

Net Position				
Net investment in capital assets	\$ 709,249	\$ 738,082	\$ (28,833)	(4)
Restricted				
Debt service	16,473,960	13,803,832	2,670,128	19
Enabling legislation	201,651	1,371,283	(1,169,632)	(85)
Total net position	<u>\$ 17,384,860</u>	<u>\$ 15,913,197</u>	<u>\$ 1,471,663</u>	<u>9</u>

NATIONAL DEVELOPMENT BANK OF PALAU
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Management Discussion and Analysis
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Loan Portfolio

The Bank approved one hundred forty seven (147) loans including line of credit renewals and amendments, amounting to \$8.3 million in 2013 compared to \$11.7 million in 2012. The large decrease in loans approved is the return of \$3 million earmarked for PNCC. The number of applications was steadily received throughout the year following individualized target clients and the Bank's participation in various community events.

The Bank's goal during the year remained growth in income and assets while maintaining credit quality. Emphasis was also made towards increasing the agriculture and fishing sectors of the portfolio which were challenging given the less than favorable industry and economic conditions. Simultaneously, emphasis was placed on adjusting the portfolio distribution to reduce exposure and diversify risk. The outstanding loans by sector for 2013 and 2012 are presented in the following table:

Sector	2013			2012		
	Number	Amount	Percent	Number	Amount	Percent
Agriculture	14	\$ 266,499	1.11%	11	\$ 141,244	0.58%
Fishing	26	133,243	0.55%	15	72,124	0.30%
Commercial	129	12,126,868	50.32%	121	12,375,285	50.97%
Housing	540	11,574,287	48.02%	496	11,689,682	48.15%
	<u>709</u>	<u>\$ 24,100,897</u>	<u>100.00%</u>	<u>643</u>	<u>\$24,278,335</u>	<u>100.00%</u>

The total number of loans on the Bank's books at year end 2013 was seven hundred nine (709) accounts for \$24.1 million. For 2012, the total number of loan notes outstanding was six hundred forty three (643) for \$24.3 million. In dollar value, there is a slight decrease of less than 1% of total outstanding notes in 2013 as compared to 2012.

Arrears

The total number of accounts with amounts in arrears at end of 2013 is sixty-four (64) accounts amounting to \$1.2 million and forty-eight accounts amounting to \$991,000 at end of 2012. The amount of Arrears as a percentage of the value of the total outstanding notes is 5% for 2013 and 4% for 2012.

New Debts

There were no new debts for 2013. The short-term loan at BOH was not renewed.

NATIONAL DEVELOPMENT BANK OF PALAU
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Management Discussion and Analysis
September 30, 2013

Net position

The Bank's overall change in net position for 2013 and 2012 was \$201,457 and \$1,694,336 respectively. This is a decrease of 88% in 2013 as compared to 2012. A major contributing factor was a huge increase in provisioning from \$704,127 in 2012 to a negative \$341,172 in 2013. The total non-operating expenses also increased 33% in 2013 amounting to \$794,192 as compared to 2012 of \$598,678.

Plant and Equipment

At September 30, 2013, 2012 and 2011, the Bank had \$701,963, \$709,249 and \$738,082, respectively invested in capital assets, net of accumulated depreciation where applicable, including leasehold rights, furniture, fixtures and equipment, vehicles and minor leasehold improvements, which represents a net decrease in 2013 of (\$7,286) or negative 1% from 2012. And a net increase in 2012 of \$28,833 or 4% over 2011.

Affiliations

The Bank's membership and partnership affiliations locally and abroad include the Palau Chamber of Commerce, the Risk Management Association, various foreign government agencies, the Association of Development Finance Banks and the Association of Development Finance Institutions in Asia and the Pacific. Benefits received from these associations include information exchanges, professional networking and training opportunities.

Risk Management

Primary risks the Bank faces include Strategic/Operational, Credit, Technology, Economic, Reputation/Political and Climatic/Environmental risks (in no particular order). The Board of Directors manages these risks with the assistance of management.

Monitoring is conducted primarily through management and external audit reporting. Mandatory reporting to the National Government is also provided during the National budget process and through specific reporting requirements under the Bank's enabling legislation.

Loss Provisioning

The Bank's provisions for loan losses with a general provision of 5% and specific provisions of 20%, 50% and 100% depending on the extent loans are past due and the value of security held as collateral. The Bank manages its loans by assigning credit and security risk ratings to each account.

Loans and associated security are rated on a scale ranging from "A thru F" similar to the World Bank system. All loans are individually managed by this system. Loan accounts are required to be reviewed regularly.

Decisions to place loans on non-accrual status are made according to Bank policy. As of September 30, 2013, sixteen (16) loans amounting to \$2 million (principle balance) were on non-accrual status.

NATIONAL DEVELOPMENT BANK OF PALAU
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Management Discussion and Analysis
September 30, 2013

Economic Outlook

Activities of significance planned in 2014 include the Bank to start taking in deposits. The funds received for deposits can be a source of funds for new and existing loans. The expansion and sustainability of the Bank's energy loan products on renewable energy will continue in 2014. Additional credit training and technical assistance for capacity building and client support are also planned. The development of these activities relies upon improving global economy and reduced uncertainty in the local market. The target for loan approvals in the new fiscal year is \$6.6 million with target portfolio growth of \$4.7 million with lending increases in the agriculture and fisheries sectors.

Contacting the Bank's Financial Management

This financial report is designed to provide a general overview of the Bank's finances and to demonstrate the Bank's accountability for the money it receives. That Discussion and Analysis explains the major factors impacting the 2013 financial statements.

If you have questions about the 2013 or 2012 reports, or need additional information, please contact the Comptroller / Chief Financial Officer at the National Development Bank of Palau at PO Box 816, Koror, Republic of Palau 96940, or e-mail sbasilio@ndbp.com or call (680) 587-6327.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Statements of Net Position
September 30, 2013 and 2012

	2013	2012 (Restated)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,895,375	\$ 7,597,730
Restricted time certificates of deposit	452,959	452,281
Receivables:		
Current portion of economic development loans receivable, net	2,627,017	3,425,238
Accrued interest	185,218	232,728
Other receivables, net	560,578	789,062
Inventories	282,621	356,476
Prepaid expenses	25,876	29,377
	9,029,644	12,882,892
Restricted cash and cash equivalents	679,108	716,561
Time certificates of deposit	-	201,809
Economic development loans receivable	18,617,524	18,058,755
Capital assets, net	701,963	709,249
Foreclosed real estate	1,675,540	1,946,124
	30,703,779	34,515,390
LIABILITIES		
Current liabilities:		
Short-term loan payable	-	30,000
Current portion of loans payable	901,513	3,921,245
Due to grantor	92,265	149,573
Accounts payable and accrued expenses	71,912	73,237
Interest payable	101,805	112,925
	1,167,495	4,286,980
Total current liabilities	1,167,495	4,286,980
Loans payable, net of current portion	11,522,078	12,409,790
	12,689,573	16,696,770
DEFERRED INFLOWS OF RESOURCES		
Loan origination fees	427,889	433,760
	427,889	433,760
NET POSITION		
Net investment in capital assets	701,963	709,249
Restricted		
Debt service	12,525,396	16,473,960
Enabling legislation	4,358,958	201,651
	17,586,317	17,384,860
Total net position	\$ 17,586,317	\$ 17,384,860

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Statements of Revenues, Expenses and Changes in Net Position
September 30, 2013 and 2012

	<u>2013</u>	<u>2012</u> (Restated)
Operating revenues:		
Interest income on loans	\$ 1,937,444	\$ 2,189,974
Loans fees and late charges	110,501	81,074
Other	<u>6,170</u>	<u>21,005</u>
Total operating revenues	2,054,115	2,292,053
Recovery of (provision for) loan losses and doubtful accounts, net	<u>(341,172)</u>	<u>704,127</u>
Net operating revenues	<u>1,712,943</u>	<u>2,996,180</u>
Operating expenses:		
Salaries, wages and fringe benefit	426,516	409,101
Professional fees	69,950	54,650
Depreciation	51,812	48,223
Travel and transportation	25,897	36,723
Dues and subscription	22,006	28,542
Repairs and maintenance	21,459	23,504
Supplies, printing and reproduction	16,203	18,973
Utilities	15,437	18,202
Honorariums and meeting expenses	11,591	12,979
Communications	11,549	11,275
Insurance	7,895	7,782
Rent	5,500	2,000
Training	4,798	3,390
Miscellaneous	<u>26,681</u>	<u>27,822</u>
Total operating expenses	<u>717,294</u>	<u>703,166</u>
Operating income	<u>995,649</u>	<u>2,293,014</u>
Nonoperating revenues (expenses), net:		
Grant revenues	50,010	106,601
Interest income on interest bearing accounts	11,891	4,623
Other income (expenses), net	(1,269)	1,019
Interest expense and loan fees	(490,601)	(557,512)
Provision for impairment of deposits	(202,285)	-
Energy Efficiency Home Loan Project	(36,300)	(104,600)
Loss on sale of foreclosed real estate	(31,591)	(48,000)
Energy Retrofit Program	(13,710)	(809)
Energy Loan Program	<u>(80,337)</u>	<u>-</u>
Total nonoperating revenues (expenses), net	<u>(794,192)</u>	<u>(598,678)</u>
Change in net position	201,457	1,694,336
Net position at beginning of year	<u>17,384,860</u>	<u>15,690,524</u>
Net position at end of year	<u>\$ 17,586,317</u>	<u>\$ 17,384,860</u>

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Statements of Cash Flows
September 30, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Cash received from customers	\$ 2,330,109	\$ 2,364,453
Cash payments to employees for services	(431,767)	(418,844)
Cash payments to suppliers for goods and services	(157,684)	(296,264)
Net cash provided by operating activities	1,740,658	1,649,345
Cash flows from capital and related financing activities:		
Proceeds from disposal of foreclosed real estate	238,993	125,000
Acquisition of foreclosed real estate	-	(128,233)
Acquisition of property and equipment	(44,526)	(19,390)
Net cash provided by (used for) capital and related financing activities	194,467	(22,623)
Cash flows from investing activities:		
Net change in time certificate of deposits	(678)	2,322
Interest received on interest bearing deposits	11,891	4,623
Net change in restricted cash and cash equivalents	37,453	(143,130)
Loan collections (originations), net	(238,414)	3,002,239
Net cash provided by (used for) investing activities	(189,748)	2,866,054
Cash flows from noncapital financing activities:		
Proceeds from issuance of long-term debt	-	4,000,000
Repayment of long-term debt	(3,907,444)	(1,054,605)
Repayment of short-term borrowing	(30,000)	(270,000)
Interest paid on debt and borrowings	(501,721)	(562,780)
Other income received (expenses paid)	(1,269)	1,019
Cash received from grantor	(7,298)	37,305
Net cash provided by (used by) noncapital financing activities	(4,447,732)	2,150,939
Net increase (decrease) in cash and cash equivalents	(2,702,355)	6,643,715
Cash and cash equivalents at beginning of year	7,597,730	954,015
Cash and cash equivalents at end of year	\$ 4,895,375	\$ 7,597,730

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU
 (A Component Unit of the Republic of Palau)

Statements of Cash Flows
 September 30, 2013 and 2012

	2013	2012
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 995,649	\$ 2,293,014
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	51,812	48,223
(Recovery of) provision for loan losses and doubtful accounts	341,172	(704,127)
Changes in assets and liabilities:		
Accrued interest	47,510	72,400
Other receivables	228,484	(59,571)
Inventories	73,855	9,389
Prepaid expenses	3,501	7,935
Accounts payable and accrued expenses	(1,325)	(17,918)
Net cash provided by operating activities	\$ 1,740,658	\$ 1,649,345

See accompanying notes to financial statements.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(1) Organization

The National Development Bank of Palau (the Bank), a component unit of the Republic of Palau (ROP), was formed on February 24, 1982, under the provisions of the Republic of Palau Public Law (RPPL) No. 1-27, as amended by RPPL 3-4, 4-48, 5-37 and 6-18. The law created a wholly-owned government corporation managed by a Board of Directors appointed by the President of ROP with the advice and consent of the Olbiil Era Kelulau (OEK – Palau National Congress.) The purpose of the Bank is to be the central financial institution responsible for initiating economic development within ROP, and considers all of its net position, except net investment in capital assets, to be restricted for such purposes.

(2) Summary of Significant Accounting Policies

The accounting policies of the Bank conform to accounting principles generally accepted in the United States of America (GAAP), The Governmental Accounting Standards Board (GASB) is responsible for establishing GAAP for state and local governments through its pronouncements (Statements and Interpretations).

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure 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. Basis of Accounting

Proprietary funds are accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and liabilities associated with the operation of this fund are included within the Statement of Net position. Proprietary fund operating statements present increases and decreases in total net position. The accrual basis of accounting is utilized by proprietary funds. Under this method, revenues are recorded when earned and expenses recorded at the time liabilities are incurred.

B. Cash and Cash Equivalents and Time Certificates of Deposit

For the purpose of the Statements of Net Position and Cash Flows, the Bank considers all highly liquid investments, with maturities of three months or less when purchased, to be cash and cash equivalents. Time certificates of deposit with initial maturities of greater than three months are separately classified. The Bank does not require collateralization of its bank accounts. Cash and cash equivalents and time certificates of deposit maintained in Federal Deposit Insurance Corporation (FDIC) insured banks amounted to \$6,174,857 and \$8,842,691 at September 30, 2013 and 2012, respectively. Bank deposits of \$997,962 and \$1,536,797 were FDIC insured at September 30, 2013 and 2012, respectively.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

B. Cash and Cash Equivalents and Time Certificates of Deposit

Time certificates of deposit maintained in an uninsured bank amounted to \$202,285 and \$201,809 as of September 30, 2013 and 2012, respectively. The bank does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. The bank recorded a 100% valuation allowance of this deposit in 2013.

The RPPL 4-48, Section 126, as amended by RPPL 5-37, stipulates that the Bank shall maintain a reserve amount to be applied to all defaults on commercial loans guaranteed by the Bank. The reserve account shall equal ten percent of (10%) of the total amount of all loan guarantees on commercial bank loans, whether or not protected by the full faith and credit of ROP. The bank has restricted \$50,169 and \$50,143 of cash and cash equivalents as of September 30, 2013 and 2012, respectively, to comprise this reserve. The Bank has also restricted cash and cash equivalents held solely for the guarantee of U.S. Department of Agriculture Rural Development (USDA RD) loans in the amount of \$525,147 and \$523,645 as of September 30, 2013 and 2012, respectively. Additionally, \$103,791 and \$142,773 of cash received from grantor agencies was restricted at September 30 2013 and 2012.

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 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 Bank's name; or

Category 3 – Deposits that are collateralized with securities held by 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 an exposure to custodial credit risk. Custodial credit risk is the risk that in the event of a bank failure, the Bank's deposit 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.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

C. Loans and Allowance for Loan Losses

The Bank grants loans to eligible borrowers, including affiliates, officers and employees, all of which are located in ROP. Loans are stated at the amount of unpaid principal and interest, reduced by an allowance for loan losses and deferred loan origination fees.

Loan originations fees are deferred and amortized to income as an adjustment of yield using the straight-line method over the contractual life of the loans.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collection of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may be uncollectible, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to pay.

All of the Bank's loans are subject to review for impairment as a part of management's internal asset review process. A loan is considered impaired when, based on current information and events, the borrower is deemed unable to repay the outstanding amount of the obligation under the loan. When a loan is determined to be impaired, a valuation allowance is established based upon the difference between the outstanding amount due under the loan and the amount considered recoverable given the existing financial condition of the borrower and the underlying collateral. Subsequent collections of cash may be applied as a reduction to the principal balance or recorded as income, depending upon management's assessment of the ultimate collectability of the loan.

D. Inventory

Inventory of on-grid and off-grid solar photovoltaic systems and commemorative coins are stated at the lower of cost (first-in, first out) or market.

In 2011, the Bank implemented the Energy Loan Program to provide loans to business and housing customers to acquire renewable energy technologies. The Bank received on-grid and off-grid solar photovoltaic systems amounting to \$402,819 from the United Nations Development Programme through the ROP Energy Office under the Sustainable Economic Development through Renewable Energy Applications (SEDREA) Program. Inventory of on-grid and off-grid solar photovoltaic systems amounted to \$275,771 and \$348,548 as of September 30, 2013 and 2012, respectively.

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

E. Capital Assets

Capital assets are stated at cost. The Bank capitalizes the property and equipment with cost exceeding \$1,000. Depreciation is provided using the straight-line method over the estimated useful lives of the respective assets.

F. Foreclosed Real Estate

Real estate properties acquired through, or in lieu of, loan foreclosures are held for sale and are initially recorded at the lower of the carrying amount of the loan or the fair value of the property at the date of foreclosure less estimated selling costs. Write downs of the asset at, or prior to, the date of foreclosure are charged to the allowance for losses on loans. Subsequent write downs, income and expense incurred in holding such assets, and gains and losses realized from the sales of such assets are included in current operations.

G. Revenue

Operating revenues include all direct revenues such as interest and fees on loans and interest on investments.

Interest on loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when principal or interest payments are delinquent ninety days or more, or when, in the opinion of the Bank, there is an indication that the borrower may be unable to meet payments as they become due. Interest income thereafter is recognized only to the extent of cash payments received. Nonaccrual loans of approximated \$2,070,657 and \$2,297,307 at September 30, 2013 and 2012.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

H. Net Position

GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, required the Bank to establish net position categories as follows:

Net investment in capital assets - consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of borrowings that are attributable to the acquisition, construction, or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt also should be included in this component of net position.

Restricted:

Nonexpendable - Net position subject to externally imposed stipulations that the Bank maintains them permanently. At September 30, 2013 and 2012, the Bank does not have nonexpendable net assets.

Expendable - Net position 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. As described in Note 1, the Bank considers all assets, except investment in capital assets, to be restricted for economic development.

Unrestricted - Net position that is not subject to externally imposed stipulations. As the Bank considers all assets, except investments in capital assets, to be restricted for economic development, the Bank does not have unrestricted net position as of September 30, 2013 and 2012.

I. New Accounting Standards

During the year ended September 30, 2013, the Bank implemented the following pronouncements:

In April 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which clarifies the appropriate reporting of deferred outflows of resources and deferred inflows of resources to ensure consistency in financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has made a prior period adjustment in the year ended September 30, 2013 to record previously recorded loan originations fees as prior years' income in the amount of \$222,673.

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

Recent Pronouncements

In April 2012, GASB issued Statement No. 66, *Technical Corrections – 2012*, which enhances the usefulness of financial reports by resolving conflicting accounting and financial reporting guidance that could diminish the consistency of financial reporting. The provisions of this statement are effective for periods beginning after December 15, 2012. Management has not yet determined the effect of implantation of this statement on the financial statements of the Bank.

In June 2012, GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial report of most pension plans, and Statement No. 68, *Accounting and Financial Reporting for Pensions*, which establishes new financial reporting requirements for most governments that provide their employees with pension benefits. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014. Management has not yet determined the effect of implementation of these statements on the financial statements of the Bank.

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*, which establishes accounting and financial reporting standards related to government combinations and disposals of government operations. As used in this Statement, the term government combinations includes a variety of transactions referred to as mergers, acquisitions, and transfers of operations. This Statement provides specific accounting and financial reporting guidance for combinations in the governmental environment. This Statement also improves the decision usefulness of financial reporting by requiring that disclosures be made by governments about combination arrangements in which they engage and for disposals of government operations. The provisions of Statement 69 are effective for government combinations and disposals of government operations occurring in financial reporting periods beginning after December 15, 2013, and should be applied on a prospective basis. Early application is encouraged. Management has not yet determined the effect of implementation of these statements on the financial statements of the Bank.

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

In April 2013, GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. The requirements of this Statement will enhance comparability of financial statements among governments by requiring consistent reporting by those governments that extend nonexchange financial guarantees and by those governments that receive nonexchange financial guarantees. This Statement also will enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees. This Statement also will augment the ability of financial statement users to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee. The provisions of Statement 70 are effective for financial statements for reporting beginning after June 15, 2013. Earlier application is encouraged.

J. Off-Balance Sheet Financial Risk

In the ordinary course of business, the 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. At September 30, 2013 and 2012, the Bank had not recognized any liability from such off-balance sheet financial instruments.

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(3) Economic Development Loans and Allowance for Loan Losses

The components of loans receivable as of September 30, 2013 and 2012 are as follows:

	2013	2012
Loans receivable	\$ 24,100,897	\$ 24,115,901
Allowance for loan losses	(2,856,356)	(2,631,908)
	21,244,541	21,483,993
Current portion of economic development loans receivable	(2,627,017)	(3,425,238)
	\$ 18,617,524	\$ 18,058,755

Maturities of the above principal balances subsequent to September 30, 2013, will be as follows:

Fully matured and others	\$ 185,792
1 - 6 months	40,942
7 - 18 months	385,756
19 months - 3 years	180,125
After 3 years	23,308,282
	\$ 24,100,897

An analysis of the change in the allowance for loan losses as of September 30, 2013 and 2012 is as follows:

2013					
	Agriculture	Fishing	Commercial	Housing	Total
Balance, beginning of year	\$ 10,468	\$ 2,701	\$ 1,494,126	\$ 1,124,613	\$ 2,631,908
Recoveries of loans previously charged off	-	-	-	-	-
(Recovery) provision for loan losses	2,892	3,984	236,306	97,990	341,172
Loans Charged Off	-	-	(88,509)	(28,215)	(116,724)
Balance, end of year	\$ 13,360	\$ 6,685	\$ 1,641,923	\$ 1,194,388	\$ 2,856,356

2012					
	Agriculture	Fishing	Commercial	Housing	Total
Balance, beginning of year	\$ 6,197	\$ 4,800	\$ 1,988,891	\$ 1,467,674	\$ 3,467,562
Recoveries of loans previously charged off	8,360	-	51,899	31,458	91,717
(Recovery) provision for loan losses	(4,089)	(2,099)	(357,855)	(340,084)	(704,127)
Loans Charged Off	-	-	(188,809)	(34,435)	(223,244)
Balance, end of year	\$ 10,468	\$ 2,701	\$ 1,494,126	\$ 1,124,613	\$ 2,631,908

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(3) Economic Development Loans and Allowance for Loan Losses, Continued

As of September 30, 2013 and 2012, the composition of the Bank's loan portfolio is comprised of unsecured and secured loans as follows:

2013

	Unsecured	Secured	Total
Commercial	187,418	11,939,450	\$ 12,126,868
Housing	872,303	10,701,984	11,574,287
Agriculture	23,154	243,345	266,499
Fishing	80,728	52,515	133,243
Total	<u>\$ 1,163,603</u>	<u>\$ 22,937,294</u>	<u>\$ 24,100,897</u>

2012

	Unsecured	Secured	Total
Commercial	115,326	12,140,970	\$ 12,256,296
Housing	797,722	10,849,923	11,647,645
Agriculture	29,946	110,107	140,053
Fishing	21,770	50,137	71,907
Total	<u>\$ 964,764</u>	<u>\$ 23,151,137</u>	<u>\$ 24,115,901</u>

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(4) Capital Assets

A summary of capital assets as of September 30, 2013 and 2012 is as follows:

	Estimated Useful Lives	Balance at October 1, 2012	Additions	Deletions	Balance at September 30, 2013
Depreciable assets:					
Leasehold rights	39 - 50 years	\$ 493,206	\$ -	\$ -	\$ 493,206
Leasehold improvement	5 years	252,422	-	-	252,422
Furniture, fixtures and equipment	2 - 20 years	216,505	5,200	-	221,705
Vehicles	5 years	74,459	39,326	(22,002)	91,783
		<u>1,036,592</u>	44,526	(22,002)	1,059,116
Accumulated depreciation		<u>(327,343)</u>	<u>(51,812)</u>	<u>22,002</u>	<u>(357,153)</u>
		<u>\$ 709,249</u>	<u>\$ (7,286)</u>	<u>\$ -</u>	<u>\$ 701,963</u>
	Estimated Useful Lives	Balance at October 1, 2011	Additions	Deletions	Balance at September 30, 2012
Depreciable assets:					
Leasehold rights	39 - 50 years	\$ 493,206	\$ -	\$ -	\$ 493,206
Leasehold improvement	5 years	249,774	2,648	-	252,422
Furniture, fixtures and equipment	2 - 20 years	199,763	16,742	-	216,505
Vehicles	5 years	74,459	-	-	74,459
		<u>1,017,202</u>	19,390	-	1,036,592
Accumulated depreciation		<u>(279,120)</u>	<u>(48,223)</u>	<u>-</u>	<u>(327,343)</u>
		<u>\$ 738,082</u>	<u>\$ (28,833)</u>	<u>\$ -</u>	<u>\$ 709,249</u>

(5) Foreclosed Real Estate

A summary of the changes in foreclosed real estate as of September 30, 2013 and 2012 is as follows:

	<u>2013</u>	<u>2012</u>
Balance, beginning of year	\$ 1,946,124	\$ 1,942,891
Additions	-	128,233
Deletions	<u>(270,584)</u>	<u>(125,000)</u>
Balance, end of year	<u>\$ 1,675,540</u>	<u>\$ 1,946,124</u>

Proceeds from sale of foreclosed properties amounted to \$238,993. The Bank recognized a loss of \$31,591 for the year ended September 30, 2013 for this sale of foreclosed real estate.

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(6) Short-Term Loans Payable

The Bank entered into a \$300,000 revolving credit line (credit line) with a local bank on October 27, 2007 for the purpose of supplementing disbursements of approved loans and temporary cash requirements to fund operations. On October 21, 2008, the Bank renewed the credit line under essentially the same terms and conditions. Repayment of the credit line is due one year from the initial drawdown with interest at time certificate of deposit (TCD) rate, plus 1.5% at September 30, 2013 and 2012. The credit line is collateralized by an assignment of \$452,959 and \$452,300 in TCD's as of September 30, 2013 and 2012, respectively.

Changes in the short-term loans payable for the years ended September 30, 2013 and 2012 are as follows:

	Balance October 1, 2012	<u>Additions</u>	<u>Reductions</u>	Balance September 30, 2013	Due Within One Year
Short-term loans payable	\$ 30,000	\$ -	\$ (30,000)	\$ -	\$ -

	Balance October 1, 2011	<u>Additions</u>	<u>Reductions</u>	Balance September 30, 2012	Due Within One Year
Short-term loans payable	\$ 300,000	\$ -	\$ (270,000)	\$ 30,000	\$ 30,000

(7) Loans Payable

On August 28, 2003, the Bank entered into a loan with the Republic of Palau Social Security Retirement Fund (the Fund), an affiliated entity and a component unit of ROP. The loan was for \$3,000,000 with a subsequent \$2,000,000 line of credit to be made available with terms and conditions agreed to by the parties at that time.

On August 7, 2008, the Bank entered into a new loan agreement to restructure the existing loan with the Fund. The loan ceiling increased to \$6,000,000 which will be disbursed in increments of \$500,000, bearing interest at a variable annual rate equal to the Funds Fixed Income Fund Return Rate as reported monthly by Fund's investment consultant, plus 0.5%; provided, however that the interest rate to be charged and paid shall not be less than 4.5% nor more than 7.5% after addition of the 0.5% to the prime rate. Outstanding principal plus all unpaid interest is to be paid semi-annually, on or before June 30 and December 31 of each year, effective June 30, 2011 up to December 31, 2025.

The loan was \$5,255,926 and \$5,563,377 with interest of 4.5% as of September 30, 2013 and 2012, respectively. The loan is collateralized by the full faith and credit of the ROP Government.

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(7) Loans Payable, Continued

On March 5, 2004, the Bank entered into a loan with Mega International Commercial Bank Co., Ltd. (formerly the International Commercial Bank of China) for \$5,000,000 to be used as capital funds for the Bank. The note is uncollateralized and is due on July 1, 2024, with interest fixed at 3.5% per annum, payable in semi-monthly installments of \$142,858, and guaranteed by ROP. Interest is payable semi-annually and commences six months after the advance of proceeds. Annual expected principal payments are \$285,716. The amount outstanding is \$3,142,405 and \$3,428,121 at September 30, 2013 and 2012, respectively.

On December 5, 2006, the Bank entered into an agreement with the European Investment Bank (EIB) to borrow up to 5,000,000 Euros, which will be converted to U.S. dollars at the effective exchange rate upon disbursement. The available credit shall be drawn in tranches upon written request by the bank. Loan proceeds may be used for purposes of financing 50% of the total cost of projects and portfolio projects of the Bank. The agreement is backed by the full faith and credit of the government of ROP. As of September 30, 2013 and 2012, the Bank has drawn down two tranches of \$1,391,285 and \$3,016,465 with interest rates of 5.175% and 3.379%, respectively. Interest and principal are payable semi-annually until September 10, 2021. On December 12, 2011 EIB cancelled the remaining balance of the Bank's credit line of 1,739,427 Euros. The balance outstanding at September 30, 2013 and 2012 is \$3,052,260 and \$3,339,577, respectively.

On May 17, 2012, the Bank entered into a \$4,000,000 loan agreement with ROP to finance a loan to the Palau National Communications Corporation (PNCC) for the acquisition of underwater fiber-optic cable for \$3,000,000 and for additional Bank lending activities. The note is uncollateralized and is due and payable 120 months after the loan date, with interest fixed at 2.0% per annum and payable in monthly installments. Interest and principal is payable monthly and commences thirty-six months after the advance of proceeds over the remaining period of the loan. The PNCC fiber-optic project did not proceed and \$3,000,000 was returned to ROP on April 5, 2013. The balance outstanding at September 30, 2013 and 2012 is \$1,000,000 and \$4,000,000, respectively.

Principal payments for subsequent years ending September 30 and applicable interest due, are as follows:

<u>Year Ending</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2014	\$ 901,513	\$ 411,771	\$ 1,313,284
2015	938,618	444,667	1,383,285
2016	977,279	406,005	1,383,284
2017	1,017,565	365,719	1,383,284
2018	1,059,544	323,740	1,383,284
2019 – 2023	6,055,310	908,763	6,964,073
2014 – 2026	<u>1,473,762</u>	<u>91,953</u>	<u>1,565,715</u>
	<u>\$12,423,591</u>	<u>\$2,952,618</u>	<u>\$15,376,209</u>

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(7) Loans Payable, continued

Changes in loans payable for the years ended 2013 and 2012, are as follows:

	Balance October 1, 2012	Additions	Reductions	Balance September 30 2013	Due Within One Year
Republic of Palau Social Security Retirement Fund	\$ 5,563,337	\$ -	\$ (307,411)	\$ 5,255,926	\$ 321,435
ROP Government	4,000,000	-	(3,000,000)	1,000,000	-
Mega International Commercial Bank	3,428,121	-	(285,716)	3,142,405	252,417
European Investment Bank	3,339,577	-	(314,317)	3,025,260	327,661
	<u>\$16,311,035</u>	<u>\$ -</u>	<u>\$(3,907,444)</u>	<u>\$ 12,423,591</u>	<u>\$ 901,513</u>

	Balance October 1, 2011	Additions	Reductions	Balance September 30 2012	Due Within One Year
Republic of Palau Social Security Retirement Fund	\$ 5,856,694	\$ -	\$ (293,357)	\$ 5,563,337	\$ 307,393
ROP Government	-	4,000,000	-	4,000,000	3,000,000
Mega International Commercial Bank	3,713,837	-	(285,716)	3,428,121	285,716
European Investment Bank	3,815,109	-	(475,532)	3,339,577	328,136
	<u>\$13,385,640</u>	<u>\$ 4,000,000</u>	<u>\$(1,054,605)</u>	<u>\$ 16,331,035</u>	<u>\$3,921,245</u>

(8) Related Party Transactions

The Bank grants loans to affiliates, officers and employees. Loans made to related parties were extended in the normal course of business and at prevailing interest rates. Loans receivable from officers and employees are \$213,996 and \$360,272 at September 30, 2013 and 2012, respectively. Loans receivable from an affiliate are \$2,677,353 and \$2,805,355 at September 30, 2013 and 2012, respectively. Loans receivable from officers and employees and loans receivable from an affiliate are included with economic development loans receivable in the accompanying Statement of Net position.

On November 29, 2010, the Bank and ROP entered into an agreement to assign \$820,000 owed to ROP from the PSB Receiver to the Bank and the Bank paid ROP \$302,000. On January 5, 2012, the Bank and PSB Receiver agreed to extend the maturity date of the Bank's loans receivable from November 7, 2011 to November 12, 2012. The PSB Receiver will continue to pay installments of \$10,000 at the end of each month until the maturity date. The Bank paid ROP the remaining balance of \$500,000 in August 2012. As of September 30, 2013 and 2012, the loan receivable from the PSB Receiver is \$470,000 and \$600,000, respectively.

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Notes to Financial Statements
September 30, 2013 and 2012

(9) Commitments

Loans Approved

The Bank approved loans aggregating \$6,647,470 and \$7,377,559 in fiscal years 2013 and 2012, respectively. At September 30, 2013, \$5,670,677 was undisbursed. Of the undisbursed loans as of September 30, 2013 relates to performance bonds on various construction contracts where the Bank acts as insurer. At September 30, 2013 no performance bonds have been called.

Loan Guarantees

The Bank offers 90% loan guarantees to local banks; however, the Bank may also guarantee up to 100% of select home loans from commercial banks made to Palauan citizens. The USDA RD contingent liability is 100%. The total amount of commercial bank loans and USDA RD loans guaranteed by the Bank as of September 30, 2013 and 2012 amounted to approximately \$3.5 million.

Leases

On March 20, 2008, the Bank entered into an agreement with Airai State Public Lands Authority for the lease of land to be used for bank operations and other retail businesses. The term of the lease is fifty years commencing March 20, 2008.

Total future minimum lease payments for subsequent years ending September 30, are as follows:

<u>Year ending</u> <u>September 30,</u>	
2014	\$ 4,917
2015	4,917
2016	4,917
2017	4,917
2018	4,917
2019 – 2023	24,587
2024 – 2028	24,587
2029 – 2033	24,587
2034 – 2038	24,587
2039 – 2043	24,587
2044 – 2048	24,587
2049 – 2053	24,587
2054 – 2058	<u>22,129</u>
	\$ <u>218,823</u>

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Notes to Financial Statements
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(11) Republic of Palau Civil Service Pension Trust Fund

The Bank contributes to the Palau Civil Service Pension Trust Fund (the Fund), a defined benefit, cost-sharing multi-employer pension plan established and administered by the ROP.

The Fund provides retirement, security and other benefits to employees, and their spouses and dependents of ROP, ROP State Governments and ROP agencies, funds and public corporations, which are paid monthly and are two percent of each member's average monthly salary. Generally, benefits vest after three years of credited service. Members that retire at or after age 60, with 25 years of vesting service, are entitled retirement benefits. RPPL 2-26 is the authority under which benefit provisions are established. Member contribution rates are established by RPPL 2-26 at 6% of total payroll and matched dollar for dollar by the employer. The Bank contributed \$21,048, 24,710 and \$23,064 to the Fund during the fiscal years 2013, 2012 and 2011, respectively.

Under the provisions of RPPL 2-26, the Fund's Board of Trustees adopted a Trust Fund Operation Plan which has the force of law, and which sets forth the procedures for the administration and coverage of the Plan. Amendments to the Plan are subject to the requirements of Title 6 of the Palau National Code. The Bank's payroll for fiscal years 2013 and 2012 was covered in total by the Fund's plan.

The Fund utilizes the actuarial cost method termed "aggregate cost method" with actuarial assumptions used to compute the pension benefit obligation as follows: (a) rate of return 8.5% per year on the investment of present and future assets, (b) a 3% increase in employee salaries until retirement, and (c) members are assumed to retire at their normal retirement age.

The pension fund benefit obligation, which is the actuarial present value of credited projected benefits, is a standard disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and any step-rate benefits, estimated to be payable in the future as a result of employment service to date. The measure is intended to assist users to evaluate the Funds funding status on a going-concern basis, and evaluate progress made in accumulating adequate assets to pay benefits when due.

The Fund's October 1, 2011 actuarial valuation determined the unfunded pension benefit obligation as follows:

Active participants	\$ 74,716,975
Participants in pay status	62,987,516
Participants with vested deferred benefits	<u>2,323,366</u>
Total pension benefit obligation	140,027,857
Net assets available for benefits, at market value	<u>36,128,666</u>
Unfunded benefit obligation	<u>\$103,899,191</u>

The actuarial valuation did not provide a breakdown of actuarial present value of vested and non-vested accumulated plan benefits by sponsor or net assets available for benefits by sponsor.

NATIONAL DEVELOPMENT BANK OF PALAU
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Notes to Financial Statements
September 30, 2013 and 2012

(12) Risk Management

The Bank is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions, injuries to employees; and natural disasters. The Bank has elected to purchase commercial insurance from independent third parties for the risks of loss to which it is exposed. Settled claims from these risks have not exceeded commercial insurance coverage for the past three years.

(13) Restatement

As a result of application of GASB Statement No. 65, Items Previously Reported as Assets and Liabilities, the Bank made a prior period adjustment in the year ended September 30, 2013 to adjust loan originations fees previously recorded as prior years' income to deferred inflows of resources in the amount of \$222,673.

Accordingly, the Bank restated its beginning restricted net assets for the year ended September 30, 2012. The effect of the restatement was to decrease the Bank's beginning net position by \$222,673.

(14) Subsequent Events

The Bank evaluated subsequent events from September 30, 2013 through April 7, 2014, the date the financial statements were available to be issued. The Bank did not note any subsequent events requiring disclosure or adjustment to the statements of net position.



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

To the Board of Directors
National Development Bank of Palau

I have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the National Development Bank of Palau (the Bank), as of and for the year ended September 30, 2013, and the related notes to the financial statements, which collectively comprise the Bank's basic financial statements and have issued my report thereon dated April 7, 2014.

Internal Control over Financial Reporting

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

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

My consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during my audit I did not identify any deficiencies in internal control that I consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings as Finding 2013-01 and 2013-02, that I consider to be significant deficiencies.

Compliance and Other Matters


As part of obtaining reasonable assurance about whether the Bank's financial statements are free from material misstatement, I performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of my audit, and accordingly, I do not express such an opinion. The results of my tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings as Finding 2013-01.

National Development Bank of Palau's Response to Findings

The Banks's response to the findings identified in my audit is described in the accompanying schedule of findings. The Bank's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, I express no opinion on it.

Purpose of this Report

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


Saipan, Commonwealth of the Northern Mariana Islands
April 7, 2014

NATIONAL DEVELOPMENT BANK OF PALAU
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Schedule of Findings
September 30, 2013

SECTION I – SUMMARY OF AUDITOR’S RESULTS

Financial Statements

Type of auditor’s report issued: Unqualified

Internal control over financial reporting:

- Material weakness(es) identified? yes X no

- Significant deficiency(ies) identified
that are not considered to be material
weaknesses? X yes none reported

Noncompliance material to financial statements
noted? X yes no

NATIONAL DEVELOPMENT BANK OF PALAU
(A Component Unit of the Republic of Palau)

Schedule of Findings
September 30, 2013

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2013-01 – Asset Classification and Provisioning

Criteria:

Pursuant to the Bank's Credit Risk Management Policy, the Bank uses a Credit Risk Rating System to risk rate all customers and provide information on the quality of the Bank's total loan portfolio. The Banks' credit risk scale is as follows:

<u>Rating</u>	<u>General Description</u>
A	Strong
B	Above average
C1	Average
C2	Watch
D	Substandard
E	Doubtful
F	Loss

The Bank's policy requires for general provisioning of 3% (increased to 5% as directed by the Board of Directors). Apart from the general provisions, the Bank must maintain a total amount of additional provisions, which is not less than the sum of the following:

<u>Rating</u>	<u>Allowance</u>
a) D (Substandard)	20%
b) E (Doubtful)	50%
c) F (Loss)	100%

Conditions:

The following were noted during the audit of loans receivable and the related provision:

- a. Loans No. 1930 and No. 1931 with principal amount due of \$1,051,929.77 and \$259,300.00, respectively, as of September 30, 2013, due from one borrower were 1,033 days past due and are classified as non-accrual loans. Loan provision for these loans was at 50% of loan balance. Furthermore, loan recovery efforts were not properly documented for these loans.
- b. Loan No. 2222 with principal amount due of \$259,300.53 as of September 30, 2013 was 258 days past due and was provided 5% allowance for loan losses. Loan recovery efforts are not properly documented for this loan.
- c. Loan No. 1924 with principal amount due of \$187,723.52 as of September 30, 2013, was 350 days past due and was provided 5% allowance for loan losses. This loan was previously loan No. 1783 which was restructured due to inability to make full and timely repayment.

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SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2013-01 – Asset Classification and Provisioning, Continued

Conditions, continued:

- d. Loan No. 1957 with principal amount due of \$182,681.26 as of September 30, 2013, was 593 days past due and was provided 5% allowance for loan losses. This loan was originally a one-year loan restructured on January 29, 2007 with a maturity of November 15, 2011. There have been no principal repayments since restructuring.
- e. Loan No. 2149 with principal amount due of \$181,917.79 as of September 30, 2013, was 65 days past due and was provided 5% allowance for loan losses. This loan appears to be a rollover of a previous loan. Loan recovery efforts were not properly documented for this loan.
- f. Loan No. 2123 with principal amount due of \$123,589.09 as of September 30, 2013, was 1,005 days past due and was provided 50% allowance for loan losses. Collection attempts and notice to foreclose were documented for this loan.

Cause:

The above conditions are due internal control weakness in the loan documentation and related review process.

Effect:

The Bank may not be in compliance with the requirements of the Bank's Credit Risk Management Policy. Additionally, the allowance for loan losses may be misstated and loans misclassified. Furthermore, fraud or abuse may occur and not be timely detected.

Recommendation:

For conditions a through e, the Bank should consider classifying these loans using higher loss condition considering the number of days delinquent.

For conditions a, e and f, the bank should consider exercising its rights over the collateral since these accounts were already classified as nonaccrual.

We further recommend that the Bank consider conducting an evaluation of its allowance for loan losses to assess and validate the methodology used and the related policies and procedures.

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Finding No. 2013-01 – Asset Classification and Provisioning, Continued

Auditee response:

For Conditions a and f for Loan Nos. 1930, 1931 and 2123, the Bank currently pursuing legal foreclosure on these accounts.

For Conditions b to d for Loan Nos. 2222, 1924 and 1957, the Loan Officer recommended to the Board the Risk Rating Change for these accounts. The Risk Rating Change was approved for these accounts on September 20, 2013, October 17, 2013 and January 9, 2014. Loan provisioning for these accounts have been increased to 50%.

For Condition e for Loan No. 2149, the provisioning adjustment is pending for this account.

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Finding No. 2013-02 – Loan Documentation

Criteria:

Pursuant to Palau National Code Annotated 26 and the Bank policies, loan application should be properly completed and approved. The loan application and approval documentation should be properly retained and waiver of any documentation should be properly documented.

Conditions:

1. For 6 or 12% of 50 randomly selected loans tested, there was insufficient documentation of approval and required supporting documents as follows:
 - a. For Loan No. 2652 for \$7,076.77, the loan amount and maturity date was not indicated on the loan application.
 - b. For Loan No. 2672 for \$9,958.24, the loan was made payable to the borrower. This was for a residential loan for which loan proceeds should have been made payable to the vendor, unless there is evidence that the borrower had already paid the vendor. Such documentation was not file for this loan.
 - c. For Loan No. 2646 for \$15,726, loan disbursement was authorized to buy a partnership interest, but there was no documentation that the partnership interest was actually transferred. It appears that the money borrowed might not have been used for its intended purpose.
 - d. For Loan No. 2650 for \$9,997.69, the loan document review checklist was not on file.
 - e. For Loan No. 2675 for \$8,779.01, the loan document review checklist was not on file.
 - f. For Loan No. 2627 for \$100,000, amounts disbursed were not in accordance with the loan agreement regarding allocation/use of loan proceeds. The request for working capital of this loan and amount disbursed for this purpose was \$40,000 but the approved amount for working capital was \$39,380. The remaining amounts were released for the purchase of vehicles, building improvements, a boat, various equipment and supplies and there are specific dollar amounts for each of these categories. However, there is a lack of documentation to support that amounts were used for intended purpose. The real property securing this loan secures another loan and there is no indication in the loan file that the security is sufficient for both loans.

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SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTINGG

Finding No. 2013-02 – Loan Documentation, Continued

Conditions, continued:

2. For 7 or 29% of 24 key item loans tested, there was insufficient documentation of approval and required underlying supporting documents for the following loans:
 - a. For Loan No. 1930 for \$1,051,929.77, there was no indication of any approval other than that of the Loan Officer and President.
 - b. For Loan No. 2515 for \$725,297.10, justification for the waiver of the submission of audited financial statements requirement was not on file.
 - c. For Loan No. 2561 for \$400,000, the loan was disbursed for the purchase of a boat. Money was disbursed to the borrower and not directly to the vendor. The vendor invoice shows money was received in escrow but there was no proof of payment by the borrower to the vendor.
 - d. For Loan No. 1931 for \$259,300.53, the loan documents were prepared in such a way that the Bank is only second in a collateral position should borrow default and the loan is foreclosed. There is no indication of any approval other than that of the Loan Officer and President.
 - e. For Loan No. 2149 for \$181,917.79, the documentation of request for loan proceeds, voucher indicating to whom the loan was disbursed and loan officer approval was not on file. There was no evidence to support disbursement was used for the intended loan purpose.
 - f. For Loan No. 2119 for \$148,667.81, the borrower's financial statements, cash flow and ratio analysis and evidence to show proceeds were used for intended purpose were not on file. Also, the documentation of the justification of the waiver of collateral appraisal, loan establishment fee and other loan costs were not on file.
 - g. For Loan No. 1898 for \$143,999.98, the required inventory schedule, gross revenue tax returns, promissory note, loan agreement, signature/approval of closing costs, assignment of income, chattel and mortgage were not on file.

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SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2013-02 – Loan Documentation, Continued

Cause:

The above conditions are due to a lack of internal control over the monitoring of required loan documentation, inconsistent application of internal control and possible override of loan approval process.

Effect:

The Bank is not in compliance with its policies. Also, loans that did not go through the proper approval process and with missing documentation often result in substandard and nonperforming loans and poor collectability. Abuse and possible fraud could exist and not be timely detected.

Recommendation:

The Bank should adhere to its loan approval policies and all supporting documents should be obtained and properly filed. All waivers of loan requirements should be properly justified and approved. The Bank's current practice of documenting the request for waiver in under the "Policy Exceptions" heading of the Account Review should be supplemented with a written documentation of the basis of granting the waiver.

The Bank should also adopt a document retention policy.

Auditee response:

NDPB have located all the unaccounted documents except for the justifications for the waivers approved by the Board. It is the Bank's policy to document any request for waiver in the Credit Memorandum.

The Bank has instituted a Compliance Office beginning 2011 and since then has instituted internal reviews to ensure compliance with NDPB's policies. The Compliance Officer reviews all new loans after approval to ensure conditions and policies are adhered to. Furthermore, the Loan Officers review their loans at least once a year to ensure proper classification and compliance with loan conditions and covenants.

Auditor's comment to Auditee response:

NDBP should consider my recommendation of documenting the justification or basis for the approval of the waiver. Although the current procedures documents that the waivers are approved, the basis for such approval is lacking. Without any written documentation as to the basis or justification for the waiver, the approval of the waiver would be presumed to be override of policies without basis. It may be construed as accommodation to borrowers.