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

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT

For The Years Ended September 30, 2014 and 2013

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

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September 30, 2014

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
National Development Bank of Palau

Report on the Financial Statements

We 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, 2014 and 2013, and the related statements of revenues, expenses and changes in net position, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of National Development Bank of Palau as of September 30, 2014 and 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. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to my inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, We have also issued my report dated May 21, 2015, on my consideration of National Development Bank of Palau's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of 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.

Burger Comer Magliari

May 21, 2015

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED SEPTEMBER 30, 2014

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 2014 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.

The Bank achieves its mission and goals by relending funds obtained from lenders, donors and the government. Its financial objective is not to maximize profits 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.

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 seventeen (17) full-time equivalent employees, including the President / CEO.

All Bank operations are conducted from its main office in Ngetkib Village, Airai State. There were no branches, other offices or subsidiaries operating in 2014. Plans for expansion of the Bank's building are set forth in the Bank's ten-year Strategic Plan.

Significant Events in 2014

The International Monetary Fund (IMF) Publication Information Notice dated April 7, 2014 states that Tourism plays an important role in Palau's economy. As a world class diving destination, Palau receives tourist more than five times its population every year. In the recent years, tourism has contributed about three quarters of GDP growth, more than 80 percent of exports of goods and services, 15 percent of total tax revenue, and 40 percent of total employment. Cross-country data indicate that Palau fares well compared to its peers in terms of tourism's contribution. Tourism is susceptible to global economic and financial conditions, and the reliance on tourists and direct flights from only a few Asian economies leads to tourism volatility. Promoting diversification within and outside the tourism industry could improve economic resilience. The tourism growth is projected to increase to 1¾ percent in FY2014 and to 2 ¼ - 2 ½ percent over the medium term." The growth in tourism is apparent in 2014 with 140,784 visitors as compared to 105,066 in 2013.

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 offers 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. At end of 2014, there was only (1) loan in this program.

The 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.

Subsequent to the fiscal year ending September 30, 2014, RPPL No 9-41 was signed by the Republic of Palau President, Tommy E. Remengesau on December 5, 2014. The Bill amends Title 26 of the Palau National Code to facilitate the National Development Bank of Palau to accept deposits and other related purposes. The Act requires the Bank to be regulated by the Financial Institution Commission and to report the progress of the transition to ROP. The qualifications for the Governing Board have changed for each nominee to hold a BA /BS degree have at least two years business management experience and have recognized civic leadership qualities. The Bank may accept deposits from any legitimate source both domestic and foreign as long as the person depositing the funds resides or does business in the Republic.

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 $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. At end of 2014, there were no accounts under this program.

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% fixed interest rate per annum. The loan was originally for$4 million with $3 million earmarked for PNCC. The loan to the Palau National Communications Corporation (PNCC) did not materialize and the Bank returned $3 million to ROP on April 4, 2013

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 re-lending 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 68%. USDA RD requirement for their reserve is a fixed amount of $500,000 maintained at a commercial bank. At end of 2014, the current balance on the account is $532,554 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 2014 for commercial banks and USDA RD home loans was $4 million. The amended Memorandum of Understanding (MPU) with USDA RD provided the requirements for accounts allowable for reserves and several procedural covenants.

A Memorandum of Understanding (MOA) was signed on April 1, 2014, between Bank of Guam (BOG), National Development Bank of Palau (NDBP), and Palau Housing Authority (PHA) pursuant to the Belau Real Estate Financing Program with a total program amount of $5 million. BOG is responsible for receiving and completing all applications not to exceed $100,000 for each individual borrower and will also monitor and collect payments and handle collection for delinquent loans. NDBP will review completed loan packages from BOG and issue a certificate of guaranty within 30 days. If a Guaranty is called, NDBP will pay BOG 80% on the delinquent loan principle only. PHA can also guarantee the loans up to its legal lending limit under the same terms and conditions as NDBP. At end of 2014, there were no completed loan packages received from BOG.

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, operating costs, and long term outstanding loan commitments. At September 2014, 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 Ministry Natural Resources, Environment and Tourism on the Farm Loan Program; and the MOU with the Palau Housing Authority on providing subsidies 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 U.S. dollar denominated.

<u>Direct loans</u>

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 2014, the Bank approved 202 loan applications totaling $11.3 million which includes renewals, extensions, new loans and performance bonds, and new loans. $9.5 million remains undisbursed at 2014 fiscal year end. Undisbursed loans consist of $4.4 million for LOC and guaranteed bonding and $5.1 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.

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 2014, the remaining balance is $350,000.

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 contact clients when a loan is seven or more days past due. 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 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.

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.

Overview of Financial Performance

Condensed Statements of Revenues, Expenses and Changes in Net Position

Change in Net Position

The change in net assets for 2014 is a loss of $323 thousand largely due to provisions for loan losses. A condensed year-to-year comparison of operating activity reflecting the foregoing Statement follows:

	2014	2013	Changes Amount	Changes Percent
Operating revenues:				
Interest income on loans	$ 1,902,707	$ 1,937,444	$ (34,737)	-2%
Loans fees, late charges and other revenues	90,933	110,501	(19,568)	-18%
Other	61,409	6,170	55,239	895%
Total operating revenues	2,055,049	2,054,115	934	0%
Recovery of (provision for) loan losses	(1,138,980)	(341,172)	(797,808)	234%
Net Operating revenues	916,069	1,712,943	(796,874)	-47%
General and administrative expenses	(770,462)	(717,294)	(53,168)	7%
Operating Income	145,607	995,649	(850,042)	-85%
Non-operating revenues (expenses), net	(468,689)	(794,192)	325,503	-41%
Change in net position	(323,082)	201,457	(524,539)	-260%
Net Position at beginning of year	17,586,317	17,384,860	201,457	1%
Net position at end of year	$ 17,263,235	$ 17,586,317	$ (323,082)	-2%

	2013	2012	Changes Amount	Changes 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%
Non-operating 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	15,913,197	1,471,663	9%
Restatement	-	(222,673)	-	0%
Net position at end of year	$ 17,586,317	$ 17,384,860	$ 201,457	1%

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, 2014 and 2013 was $1.90 million and $1.94 million respectively. Year ending 2014 interest income decreased 2% from 2013. Loan fees, late charges and bonding fees increased by 31% in 2014. Net operating revenue decreased to $468,689 as compared to $794,192 in 2013. With the increase of provisioning for loan losses from a negative $341,172 to a negative $1,138,980, the Bank is at a net loss of $323,082 or 260% for 2014.

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; and10% for commercial and housing loans. Other accounts in collection continue to be assessed the statutory rate of 9% as required by a court-ordered judgment. At the end of FY2014, the average yield on the Bank's portfolio decreased from 8.59% in 2013 to 8.52% in 2014 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).

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 was received in 2012 and 2013. The Bank received new funds on July 28, 2014 for $34,586. All funds have been earmarked for ongoing projects and the subsidies will be applied once projects have been completed. A continuation of this program but under a Phase II, NDBP was awarded additional funding of $200,020. The Bank received $160,000.00 or 80% of the award during July 2014. The remaining 20% will be forwarded once the final report has been submitted to International Union for conservation of Nature and Natural Resources (IUCN).

Renewable Energy Subsidy Loan Program (RESP) is from the 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 total value of solar equipment inventory received during March 2011 was for $402,819. As of September 30, 2014, remaining inventory of $275,771 consists of $116,586 for Off-Grid and $159,184 for On-Grid.

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 and new funds received on February 14, 2014 of $79,000. The project ended on December 31, 2014. Only loans that were received at this date will be subsidized at completion. Any funds remaining will be returned to Grantor.

Grant from Global Climate Change Alliance: Pacific Small Island States (GCCA: PSIS) project is providing support to help the Republic of Palau in its prioritized water sector climate change adaptation actions. One element of this is the Palau Water Conservation Incentive Program.

The Palau Water Conservation Incentive Program is modeled after the EESP program, where specific requirements are incorporated into a water catchment project and a subsidy payment is applied to the borrower's loan principal. Total awarded grant is $156,450 with a project deadline of September 31, 2015. Initial funding of $56,450 was received during June 2014.

Expenses

Recovery of (Provision for) Loan Losses and Doubtful Accounts

The Bank's net provision for loan losses in 2014 was negative $1,138,980 as compared to negative $341,172 in 2013. The increase is due to additional provisions for non-performing loans. Provisions are net of recoveries for the year.

General and administrative Expenses

			Changes	
	2014	2013	Amount	Percent
Salaries, wages and fringe benefit	$433,399	$426,516	$ 6,883	2%
Professional fees	109,074	69,950	39,124	56%
Depreciation	50,253	51,812	(1,559)	-3%
Dues and subscription	25,953	22,006	3,947	18%
Travel and Transportation	24,381	25,897	(1,516)	-6%
Training	24,011	4,798	19,213	400%
Supplies, printing and reproduction	20,817	16,203	4,614	28%
Repairs and maintenance	16,746	21,459	(4,713)	-22%
Utilities	16,071	15,437	634	4%
Communications	13,484	11,549	1,935	17%
Honorariums and meeting expenses	13,386	11,591	1,795	15%
Insurance	8,607	7,895	712	9%
Rent	-	5,500	(5,500)	-100%
Miscellaneous	14,280	26,681	(12,401)	-46%
	$770,462	$717,294	$ 53,168	7%

			Changes	
	2,013	2,012	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%
	$717,294	$703,166	$ 14,128	2%

Total operating expenses for 2014 increased by 7% to 2013. The increase is spread out in all categories except for travel, repairs and miscellaneous. 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.

Overview of Financial Condition

Condensed Statements of Net Position

	2014	2013	Changes Amount	Changes Percent
Current Assets	$ 10,012,634	$ 9,029,644	$ 982,990	11%
Property and equipment, net	651,710	701,963	(50,253)	-7%
Economic development loans receivable	16,634,339	18,617,524	(1,983,185)	-11%
Other non-current assets	2,502,711	2,354,648	148,063	6%
Total Assets	29,801,394	30,703,779	(902,385)	-3%
Accounts payable and accrued expenses	181,733	71,912	109,821	153%
Other liabilities	339,854	92,265	247,589	268%
Interest payable	94,628	101,805	(7,177)	-7%
Loans payable	11,496,251	12,423,591	(927,340)	-7%
Total liabilities	12,112,466	12,689,573	(577,107)	-5%
Loan origination fees	425,693	427,889	(2,196)	-1%
Total deferred inflows of resources	425,693	427,889	(2,196)	-1%
Net Position	$ 17,263,235	$ 17,586,317	$ (323,082)	-2%

	2013	2012	Changes Amount	Changes 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 non-current assets	2,354,648	2,864,494	(509,846)	-18%
Total Assets	30,703,779	34,515,390	(3,811,611)	-11%
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	12,689,573	16,696,770	(4,007,197)	-24%
Loan origination fees	427,889	433,760	(5,871)	-1%
Total deferred inflows of resources	427,889	433,760	(5,871)	-1%
Net Position	$17,586,317	$17,384,860	$ 201,457	1%

Loan Portfolio

NDBP loan portfolio includes new, amended and renewed loans and bonds. The Bank approved two hundred and two (202) loans in 2014 for $11.3 million and one hundred and forty seven (147) loans in 2013 for $6.6 million.

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 2014 and 2013 are presented in the following table:

	2014			2013		
Sector	Number	Amount	Percent	Number	Amount	Percent
Housing	562	$ 11,679,329	50%	540	$ 11,574,287	48%
Commercial	144	11,128,194	48%	129	12,126,868	50%
Agriculture	14	297,372	1%	14	266,499	1%
Fishing	33	170,649	1%	26	133,243	1%
Totals	753	$ 23,275,544	100%	709	$ 24,100,897	100%

The total number of loans on the Bank's books at year end 2014 was seven hundred fifty three (753) accounts for $23.3 million. For 2013, the total number of loan notes outstanding was seven hundred nine (709) for $24.1 million. Portfolio decreased by $825 thousand or 3% of total outstanding notes in 2014 as compared to 2013.

Arrears

The total number of accounts with amounts in arrears at end of 2014 is eighty (80) for $1.5 million as compared to sixty-four (64) accounts amounting to $1.2 million in 2013. The amount of Arrears as a percentage of the value of the total outstanding notes is 7% for 2014 and 5% for 2013.

New Debt

There were no new debt for 2014.

Net Assets

The Bank's overall change in net position for 2014 was a loss of $323,082 as compared to 2013 with a net income of $241,457. Provisions increased from a negative $341,172 in 2013 to a negative $1,138,980 in 2014. The total non-operating expenses decreased by 41% in 2014 amounting to $468,689 as compared to 2013 of $794,192.

Plant and Equipment

At September 30, 2014, 2013 and 2012, the Bank had $651,710, $701,963 and $709,249, 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 2014 of ($50,253) or negative 7% from 2013. And a net decrease of ($7,286) or decrease of 1% increase in 2012 as compared to 2013.

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, 2014, fifteen (15) loans amounting to $2 million (principle balance) were on non-accrual status.

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 2015. 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 $6.9 million with target portfolio growth of $1.6 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. This Management Discussion and Analysis explains the major factors impacting the 2014 financial statements.

If you have questions about the 2014 report, 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, 2014 and 2013

	2014	2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,054,109	$ 4,895,375
Restricted time certificates of deposit	453,639	452,959
Receivables:		
Current portion of economic development loans receivable, net	2,571,600	2,627,017
Accrued interest	181,236	185,218
Other receivables	448,450	560,578
Inventories	282,138	282,621
Prepaid expenses	21,462	25,876
Total current assets	10,012,634	9,029,644
Restricted cash and cash equivalents	915,526	679,108
Time certificates of deposit	-	-
Economic development loans receivable	16,634,339	18,617,524
Capital assets, net	651,710	701,963
Foreclosed real estate	1,587,185	1,675,540
Total assets	29,801,394	30,703,779
LIABILITIES		
Current liabilities:		
Current portion of loans payable	969,694	901,513
Due to grantor	339,854	92,265
Accounts payable and accrued expenses	181,733	71,912
Interest payable	94,628	101,805
Total current liabilities	1,585,909	1,167,495
Loans payable, net of current portion	10,526,557	11,522,078
Total liabilities	12,112,466	12,689,573
DEFERRED INFLOWS OF RESOURCES		
Loan origination fees	425,693	427,889
Total deferred inflows of resources	425,693	427,889
NET POSITION		
Net investment in capital assets	651,710	701,963
Restricted		
Debt service	11,590,879	12,525,396
Enabling legislation	5,020,646	4,358,958
Total net position	$ 17,263,235	$ 17,586,317

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, 2014 and 2013

	2014	2013
Operating revenues:		
Interest income on loans	$ 1,902,707	$ 1,937,444
Loans fees and late charges	90,933	110,501
Other	61,409	6,170
Total operating revenues	2,055,049	2,054,115
Recovery of (provision for) loan losses and doubtful accounts, net	(1,138,980)	(341,172)
Net operating revenues	916,069	1,712,943
Operating expenses:		
General and administrative expenses:		
Salaries, wages and fringe benefit	433,399	426,516
Professional fees	109,074	69,950
Depreciation	50,253	51,812
Dues and subscription	25,953	22,006
Travel and transportation	24,381	25,897
Training	24,011	4,798
Supplies, printing and reproduction	20,817	16,203
Repairs and maintenance	16,746	21,459
Utilities	16,071	15,437
Communications	13,484	11,549
Honorariums and meeting expenses	13,386	11,591
Insurance	8,607	7,895
Rent	-	5,500
Miscellaneous	14,280	26,681
Total operating expenses	770,462	717,294
Operating income	145,607	995,649
Nonoperating revenues (expenses), net:		
Grant revenues	83,320	50,010
Interest income on interest bearing accounts	4,625	11,891
Other income (expenses), net	4,246	(1,269)
Interest expense and loan fees	(483,272)	(490,601)
Provision for impairment of deposits	-	(202,285)
Energy Efficiency Home Loan Project	(57,200)	(36,300)
Gain (loss) on sale of foreclosed real estate	3,047	(31,591)
Renovation energy loan program	(22,650)	(13,710)
Energy Loan Program	(805)	(80,337)
Total nonoperating revenues (expenses), net	(468,689)	(794,192)
Change in net position	(323,082)	201,457
Net position at beginning of year	17,586,317	17,384,860
Net position at end of year	$ 17,263,235	$ 17,586,317

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, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Cash received from customers	$ 2,171,159	$ 2,330,109
Cash payments to employees for services	(433,399)	(431,767)
Cash payments to suppliers for goods and services	(172,092)	(157,684)
Net cash provided by operating activities	1,565,668	1,740,658
Cash flows from capital and related financing activities:		
Proceeds from disposal of foreclosed real estate	91,402	238,993
Acquistion of property and equipment	-	(44,526)
Net cash provided by (used for) capital and related financing activities	91,402	194,467
Cash flows from investing activities:		
Net change in time certificate of deposits	(680)	(678)
Interest received on interest bearing deposits	4,625	11,891
Net change in restricted cash and cash equivalents	(236,418)	37,453
Loan collections (originations), net	816,781	(238,414)
Net cash provided by (used for) investing activities	584,308	(189,748)
Cash flows from noncapital financing activities:		
Proceeds from issuance of long-term debt	-	-
Repayment of long-term debt	(927,340)	(3,907,444)
Repayment of short-term borrowing	-	(30,000)
Interest paid on debt and borrowings	(490,449)	(501,721)
Other income received (expenses paid)	4,236	(1,269)
Cash received from grantor (payment to grantor)	330,909	(7,298)
Net cash provided by (used for) noncapital financing activities	(1,082,644)	(4,447,732)
Net increase (decrease) in cash and cash equivalents	1,158,734	(2,702,355)
Cash and cash equivalents at beginning of year	4,895,375	7,597,730
Cash and cash equivalents at end of year	$ 6,054,109	$ 4,895,375

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, 2014 and 2013

	2014	2013
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 145,607	$ 995,649
Adjustment to reconcile operating income to net cash provided by operationg activities:		
Depreciation	50,253	51,812
(Recovery of) provision for loan losses and doubtful accounts	1,138,980	341,172
Changes in assets and liabilities:		
Accrued interest	3,982	47,510
Other receivables	112,128	228,484
Inventories	483	73,855
Prepaid expenses	4,414	3,501
Accounts payable and accrued expenses	109,821	(1,325)
Net cash provided by operating activities	$ 1,565,668	$ 1,740,658

See accompanying notes to financial statements.

(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.

(2) Summary of Significant Accounting Policies, Continued

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 $7,423,274 and $6,174,857 at September 30, 2014 and 2013, respectively. Bank deposits of $1,254,945 and $997,962 were FDIC insured at September 30, 2014 and 2013, respectively.

Time certificates of deposit maintained in an uninsured bank amounted to $202,285 and $202,285 as of September 30, 2014 and 2013, 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 as od September 30, 2014 and 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 $50,188 and $50,169 of cash and cash equivalents as of September 30, 2014 and 2013, 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 $532,554 and $525,147 as of September 30, 2014 and 2013, respectively. Additionally, $332,783 and $103,791 of cash received from grantor agencies was restricted at September 30 2014 and 2013.

(2) Summary of Significant Accounting Policies, Continued

B. Cash and Cash Equivalents and Time Certificates of Deposit, Continued

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.

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.

(2) Summary of Significant Accounting Policies, Continued

C. Loans and Allowance for Loan Losses, Continued

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' 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 Program 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 as of September 30, 2014 and 2013, respectively.

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.

(2) Summary of Significant Accounting Policies, Continued

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 $2,024,882 and $2,070,657 at September 30, 2014 and 2013.

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.

(2) Summary of Significant Accounting Policies, Continued

H. Net Position, Continued

Restricted:

Nonexpendable – Net assets subject to externally imposed stipulations that the Bank maintains them permanently. At September 30, 2014 and 2013, the Bank does not have nonexpendable net assets.

Expendable – Net assets whose use by the Bank is subject to externally imposed stipulations that can be fulfilled by actions of the Bank pursuant to those stipulations or that expire by the passage of time. 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 are 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, 2014 and 2013.

I. New Accounting Standards

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

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 implementation of this Statement did not have a material effect on the financial statements of the Bank.

GASB issued Statement No. 67, *Financial Reporting for Pension Plans*, which revises existing guidance for the financial reports of most pension plans. The implementation of this Statement did not have a material effect on the financial statements of the Bank.

GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, which requires a state or local government guarantor that offers a nonexchange financial guarantee to another organization or government to recognize a liability on its financial statements when it is more likely than not that the guarantor will be required to make a payment to the obligation holders under the agreement. The implementation of this Statement did not have a material effect on the financial statements of the Bank.

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

Recent Pronouncements

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

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations* which improves accounting and financial reporting for state and local governments' combinations and disposals of government operations. Government combinations include mergers, acquisitions and transfers of operations. The Statement is effective for financial statements for periods beginning after December 15, 2014. Management has not yet determined the effect of implementation of this Statement on the financial statements of the Bank.

In November 2013, GASB issued Statement No. 71, *Accounting and Financial Reporting for Pensions*. This Statement amends paragraph 137 of Statement 68 to require that, at transition, a government recognize a beginning deferred outflow of resources for its pension contributions, if any, made subsequent to the measurement date of the beginning net pension liability. Statement 68, as amended, continues to require that beginning balances for other deferred outflows of resources and deferred inflows of resources related to pensions be reported at transition only if it is practical to determine all such amounts. The provisions of this Statement are required to be applied simultaneously with the provisions of Statement 68. Management has not yet determined the effect of implementation of this Statement will have on Bank's financial statements.

(2) Summary of Significant Accounting Policies, Continued

I. New Accounting Standards, Continued

Recent Pronouncements, Continued

In February 2015, GASB issued Statement No. 72, *Fair Value Measurement and Application* which addresses accounting and financial reporting issues related to fair value measurements and guidance for determining a fair value measurement for financial reporting purposes. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. This Statement requires a government to use valuation techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value. This Statement establishes a hierarchy of inputs to valuation techniques used to measure fair value. This Statement requires additional analysis of fair value if the volume or level of activity for an asset or liability has significantly decreased. It also requires identification of transactions that are not orderly. This Statement requires measurement at acquisition value (an entry price) for donated capital assets, donated works of art, historical treasures, and similar assets and capital assets received in a service concession arrangement. This Statement requires disclosures to be made about fair value measurements, the level of fair value hierarchy, and valuation techniques. It also requires additional disclosures regarding investments in certain entities that calculate net asset value per share (or its equivalent). The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015. Earlier application is encouraged. Management has not yet determined the effect of implementation of this Statement will have on Bank's financial statements.

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, 2014 and 2013, the Bank had not recognized any liability from such off-balance sheet financial instruments.

(3) Economic Development Loans and Allowance for Loan Losses

The components of loans receivable as of September 30, 2014 and 2013 are as follows:

	2014	2013
Loans receivable	$ 23,275,544	$ 24,100,897
Allowance for loan losses	(4,069,605)	(2,856,356)
	19,205,939	21,244,541
Current portion of economic development loans receivable	(2,571,600)	(2,627,017)
	$ 16,634,339	$ 18,617,524

Maturities of the above principal balances subsequent to September 30, 2014, will be as follows:

Fully matured and others	$ 347,146
1 to 6 months	1,157,191
7 to 18 months	2,571,580
After 3 years	19,199,627
	$ 23,275,544

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

An analysis of the change in the allowance for loan losses as of September 30, 2014 and 2013 is as follows:

9/30/2014

	Agriculture	Fishing	Commercial	Housing	Total
Beginning of the year	$ 13,360	$ 6,685	$ 1,641,923	$ 1,194,388	$ 2,856,356
Recoveries of loans previously charged off	(3,750)	-	(56,437)	(14,082)	(74,269)
(Recovery) provision for loan losses	6,378	1,887	927,290	277,694	1,213,249
Loans charged off	3,750	-	56,437	14,082	74,269
Balance, end of year	$ 19,738	$ 8,572	$ 2,569,213	$ 1,472,082	$ 4,069,605

9/30/2013

	Agriculture	Fishing	Commercial	Housing	Total
Beginning of the 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

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

As of September 30, 2014 and 2013, the composition of the Bank's loan portfolio is comprised of unsecured and secured loans as follows:

9/30/2014

	Unsecured	Secured	Total
Housing	946,887	10,732,443	11,679,330
Commercial	$ 236,712	$ 10,891,481	$ 11,128,193
Agriculture	53,318	244,054	297,372
Fishing	134,205	36,444	170,649
Total	$ 1,371,122	$ 21,904,422	$ 23,275,544

9/30/2013

	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	52,215	132,943
Total	$ 1,163,603	$ 22,936,994	$ 24,100,597

(4) Capital Assets

A summary of capital assets as of September 30, 2014 and 2013 is as follows:

	Estimated Useful Lives	Balance at October 1, 2013	Additions	Deletions	Balance at September 30, 2014
Depreciable assest:					
Leasehold rights	39 - 50 years	$ 493,206	$ -	$ -	$ 493,206
Leasehold improvements	5 years	252,422	-	-	252,422
Furniture, fixtures and equipment	2 - 20 years	221,705	-	-	221,705
Vehicles	5 years	91,783	-	-	91,783
		1,059,116	-	-	1,059,116
Accumulated depreciation		(357,153)	(50,253)	-	(407,406)
		$ 701,963	$ (50,253)	$ -	$ 651,710

	Estimated Useful Lives	Balance at October 1, 2013	Additions	Deletions	Balance at September 30, 2013
Depreciable assest:					
Leasehold rights	39 - 50 years	$ 493,206	$ -	$ -	$ 493,206
Leasehold improvements	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
		1,036,592	44,526	(22,002)	1,059,116
Accumulated depreciation		(327,343)	(51,812)	(357,153)	(357,153)
		$ 709,249	$ (7,286)	$ (379,155)	$ 701,963

(5) Foreclosed Real Estate

A summary of the changes in foreclosed real estate as of September 30, 2014 and 2013 is as follows:

	2014	2013
Beginning of the year	$ 1,675,540	$ 1,946,124
Additions	146	-
Deletions	(88,501)	(270,584)
Balance, end of year	$ 1,587,185	$ 1,675,540

Proceeds from sale of foreclosed properties amounted to $102,300. The Bank recognized a gain of $13,799 for the year ended September 30, 2014 for this sale of foreclosed real estate.

(6) 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 $4,934,525 and $5,255,926 with interest of 4.5% as of September 30, 2014 and 2013, respectively. The loan is collateralized by the full faith and credit of the ROP Government.

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 $2,857,130 and $3,142,405 at September 30, 2014 and 2013, respectively.

(6) Loans Payable, Continued

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 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, 2014 and 2013, the Bank has drawn down two tranches of $1,391,285 and $3,016,465 with interest rates of 5.175% and 3.679%, 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, 2014 and 2013 is $2,704,596 and $3,025,260, 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, 2014 and 2013 is $1,000,000, respectively.

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

Year ending	Principal	Interest	Total
2015	$ 972,694	$ 442,571	$ 1,415,265
2016	1,013,117	402,149	1,415,266
2017	1,055,253	360,012	1,415,265
2018	1,099,180	316,086	1,415,266
2019	1,144,975	270,291	1,415,266
2020 - 2014	5,426,163	658,207	6,084,370
2025 - 2029	781,869	33,997	815,866
	$11,493,251	$ 2,483,313	$ 13,976,564

(6) Loans Payable, Continued

Changes in loans payable for the years ended 2014 and 2013, are as follows:

	Balance at October 1, 2013	Additions	Deletions	Balance at September 30, 2014	Due Within One Year
Republic of Palau Social Security Retirement Fund	$ 5,255,926	$ -	$ (321,401)	$ 4,934,525	$ 333,935
ROP Government	1,000,000	-	-	1,000,000	-
Mega Internations Commercial Bank	3,142,405	-	(285,275)	2,857,130	262,504
European Investment Bank	3,025,260	-	(320,664)	2,704,596	373,255
	$ 12,423,591	$ -	$ (927,340)	$ 11,496,251	$ 969,694

	October 1, 2012	Additions	Deletions	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 Internations 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
	$ 16,331,035	$ -	$ (3,907,444)	$ 12,423,591	$ 901,513

(7) 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 $71,074 and $213,996 at September 30, 2013 and 2012, respectively. Loans receivable from an affiliate are $2,539,902 and $2,677,353 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, 2014 and 2013, the loan receivable from the PSB Receiver is $350,000 and $470,000, respectively.

(8) Commitments

Loans Approved

The Bank approved loans aggregating $11,285,262 and $6,647,470 in fiscal years 2014 and 2013, respectively. At September 30, 2014, $9,527,843 was undisbursed. Of the undisbursed loans as of September 30, 2014, $3,897,800 relates to performance bonds on various construction contracts where the Bank acts as insurer and $474,951 relates letters of credit. At September 30, 2014 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, 2014 and 2013 amounted to approximately $4 million and $3.7 million, respectively.

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. NDBP exchanged certain real property and allowed the use the property rent free.

(9) 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 $21,333 $21,048 and $24,710 to the Fund during the fiscal years 2014, 2013 and 2012, 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 2014 and 2013 was covered in total by the Fund's pension plan.

(9) Republic of Palau Civil Service Pension Trust Fund, Continued

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 7.5% 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 the earlier of age 60 or at 30 years of service.

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	$ 82,099,216
Participants in pay status	61,865,857
Participants with vested deferred benefits	3,323,468
Total pension benefit obligation	147,288,541
Net assets available for benefits, at market value	(34,261,206)
Unfunded benefit obligation	$ 113,027,335
The funded ration (ratio of assets to liabilities)	23.3%

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.

(9) Republic of Palau Civil Service Pension Trust Fund, Continued

Medical and Life Insurance Benefit

In April 2010, the Republic of Palau (ROP) enacted RPPL No. 8-14 "*The National Healthcare Financing Act*". The law requires each resident in the Republic of Palau to have coverage for healthcare costs. The law establishes a national Medical Savings Fund and a Health Insurance System in the ROP.

In October 2010, in compliance with the requirements of RPPL 8-14, the Bank began withholding from its employees 2.5% of gross earnings each pay period, with a matching employer share (a 5% combined contribution) for remittance to the ROP Social Security Administration that administers the Medical Savings Fund and Palau Health Insurance. For the years ended December 31, 2014, 2013 and 2012, the Bank's employer's share paid to the Social Security Administration was for these costs was $25,135, $23,101 and $24,931, respectively.

(10) 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.

(11) Subsequent Events

On November 25, 2014, the Bank was sued by a former employee alleging breach of contract and defamation. The case is currently ongoing, and the outcome is to be determined. Management intends on contesting the former employee's alleged claims. The case is currently ongoing and the outcome is yet to be determined. Therefore, no liability which may ultimately arise from this matter has been recorded in the accompanying financial statements.

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

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND ON COMPLIANCE

Year Ended September 30, 2014

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

To the Board of Directors
National Development Bank of Palau

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the National Development Bank of Palau (the Bank), as of and for the year ended September 30, 2014, and the related notes to the financial statements, which collectively comprise Bank's basic financial statements and have issued our report thereon dated May 21, 2015.

Internal Control over Financial Reporting

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

Our consideration of internal control was for the limited purpose described in the preceding paragraph 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. However, as described in the accompanying schedule of findings and responses we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

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. We consider the deficiencies described in the accompanying schedule of findings and responses as Finding 2014-01 to be a material weakness.

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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. We consider the deficiencies described in the accompany schedule of findings and responses as Finding 2014-02 to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Bank's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed 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 and responses as Finding 2014-03.

National Development Bank of Palau's Response to Findings

The Bank's response to the findings identified in our audit is described in the accompanying schedule of findings and responses. The Bank's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we 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 entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Burger Comer Magliari

May 21, 2015

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

Schedule of Findings and Responses
September 30, 2014

SECTION I – SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued:	Unmodified
Internal control over financial reporting:	
• Material weakness(es) identified?	Yes
• Significant deficiency(ies) identified that are not considered to be material weaknesses?	Yes
Noncompliance material to financial statements noted?	Yes

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-01 - 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:

Rating	General Description
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:

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

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-01 - Asset Classification and Provisioning

Condition:

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

Loan No.	Principal Balance	Days Delinquent	% of Provision	Bank Provision @ 9/30/14	Under Provision @ 9/30/14
1930	$ 1,051,929.77	1460	50%	$ 525,964.89	$ 262,982.44
1931	259,300.53	1399	50%	129,650.37	129,650.16
1949	109,255.62	1399	50%	54,627.81	54,627.81
2031	1,445.94	1394	50%	726.18	719.76
2123	123,589.09	1314	50%	61,794.55	61,794.54
2121	71,569.62	1088	20%	17,618.73	53,950.89
1957	182,681.26	1050	50%	105,527.06	77,154.20
2075	41,282.74	943	5%	2,064.14	39,218.60
1723	43,501.42	822	50%	21,750.71	21,750.71
1924	187,723.52	807	50%	113,179.02	74,544.50
2155	74,260.06	711	50%	37,130.03	37,130.03
1768	18,448.95	700	50%	9,224.48	9,224.47
2283	6,973.01	656	50%	3,518.26	3,454.75
1946	45,192.76	579	50%	22,596.38	22,596.38
2499	1,836.72	517	50%	918.36	918.36
2163	1,123.45	488	5%	61.57	1,061.88
2549	8,532.45	457	20%	1,822.76	6,709.69
2738	9,966.55	274	5%	524.47	4,484.95
2391	5,074.40	248	20%	1,062.76	1,522.32
2393	8,366.49	227	5%	433.18	3,764.92
2437	27,343.46	190	20%	5,513.64	8,203.04
1696	11,311.73	188	5%	586.25	2,262.35
2149	161,009.92	187	5%	8,050.50	72,454.46
2305	6,395.45	184	5%	321.49	2,877.95
2482	37,508.04	168	5%	1,969.92	16,878.62
2396	4,319.24	165	5%	223.63	1,943.66
1882	33,124.17	152	5%	1,660.93	14,905.88
2579	3,803.72	143	5%	194.22	1,711.67
2147	27.64	127	5%	1.40	12.44
2647	8,506.91	105	5%	425.97	3,828.11
1673	9,247.77	103	5%	466.70	4,161.50
	$ 2,554,652.40			$ 1,129,610.36	$ 996,501.03

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-01 - Asset Classification and Provisioning, Continued

Condition, continued:

The above loans were not properly reviewed and evaluated for collectability in a timely manner. We noted that loans are initially reviewed for completion by the Operations Officer and the Compliance Officer; however, their reviews are performed prior to the full disbursement. Loans are not routinely reviewed after full disbursement. As a result, the loans are not adequately reviewed for collectability, provisioning and charge-off in a timely manner. Additionally, compliance reviews and recovery efforts were not properly documented in the loan files and loans are not provisioned for in accordance with the Bank’s existing policies and procedures. Consequently, based on the above loans files reviewed delinquent for one hundred (100) days or more, we determined that the provision for loan losses was understated by $996,501.03 as of September 30, 2014.

Cause:

The above condition is due a lack of internal control monitoring procedures over the loan compliance review process.

Effect:

The Bank is not 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. An audit adjustment of $996,501.03 was made to increase the provision for loan losses as of September 30, 2014.

Prior Year Status:

The above condition was cited as a similar finding in the prior year audit of the Bank.

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

Schedule of Findings and Responses
September 30, 2014

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-01 - Asset Classification and Provisioning, Continued

Recommendation:

Management should its existing methodology used in determining its allowance for loan losses ensure that it conforms to current banking industry standards. We recommend that the Bank consider conducting an evaluation of its allowance for loan losses to access and validate the methodology used and the related policies and procedures. Loans should be independently reviewed the Compliance Officer after the loan has been fully disbursed. Loans should be monitored once they become 30 days delinquent and before they become 90 days delinquent or nonperforming and the provision for loan losses should be adjusted in accordance with the credit risk assessment and the Bank’s policies.

Loans outstanding greater than one (1) year should be fully charged off and the associated collateral should be evaluated to determine its value to mitigate collateral and credit risks. These loans should be forwarded the Bank’s legal counsel for foreclosure proceedings.

Monthly delinquency reports should be prepared by the Compliance Officer with explanation of efforts to cure the loan and recommendations to the Board of Directors for the approval to charge off delinquent loans.

Auditee response:

The Bank is required to do a complete account review when increasing/decreasing provisions as well as upgrading/downgrading a loan classification. This process creates a delay in a correctly analyzing asset classification and provisioning as it takes time to complete an account review. The Bank is currently in the process of updating its policies on the methodology used in determining its allowance and loan classification. The new policies for updating provisioning and grading will be based on days past due and collateral value. This past due threshold will also be used when charging off a loan. A report will also be prepared by the Compliance Officer to the Board on a monthly basis to update on changes to provisions, grading and charge offs.

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

Schedule of Findings and Responses
September 30, 2014

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-02 – Loan Documentation

Criteria:

Loan files should be reviewed annually and maintain proper documentation to ensure compliance with loan covenants and bank policies.

Conditions:

1. For 12 or 21% of 56 selected loans tested, insurance policies were either outdated or not on-hand file for independent inspection.

2. For Loan number 2420, the borrower's financial statements submitted did not balance, were inaccurate and not current as of September 30, 2014. There were no 2014 or 2013 gross receipt tax returns on-file to verify or substantiate borrower's income and ability to service the debt.

3. For Loan No. 2795, the title search for collateral was not on-file for independent inspection.

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 loan underwriting policies. Loans that did not go through the proper approval process and with missing documentation often result in substandard and nonperforming loans and poor collectability.

Prior Year Status:

The above condition was cited as a similar finding in the prior year audit of the Bank.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-02 – Loan Documentation, Continued

Recommendation:

The Bank should adhere to its loan approval policies and all supporting documents should be obtained and properly filed. The Bank should also adopt a document retention policy. Furthermore, the loan officers should review their loans at least once a year to ensure proper classification and compliance with loan conditions and covenants and the review should be confirmed independently by the Compliance Officer.

Auditee response:

Conditions:

1. Insurance policies: The Bank has a tickler list for all insurance renewal dates which loan clerk updates as she receives renewed insurance policies. There are some delays in receiving renewed policies from the insurance providers and the Bank will work with the insurance company to ensure that policies are received on time and in file.

2. Loan 2420 borrower's financial statement – this borrower had challenges with his accounting staff and had to hire part time staff to prepare businesses financials which caused the delay. The Bank has since requested and received copies of GRT filings up to September 2014 and will collect copies of annual GRT filings for continued to monitor borrower's business conditions as well as review business prepared financials as they become available.

3. Loan No. 2795 – Title Search not in file. The Bank's attorney was asked to do a title search due to the property. It was documented via e-mail but was not printed for the file. It has been printed out and put in file.

The Bank has an Annual Account Performance Review & Escrow Evaluation Form in place which the Loan Officers are to use to review each of their accounts annual. Management will work with the loan officers to ensure that this review takes place so that above conditions are minimized.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-03 – Disaster Recovery Plan

Criteria:

The Bank should have an Information Technology (IT) strategic planning and risk management process in place to support its financial reporting requirements. The Bank should also maintain reliable systems that include appropriate data backup and recovery processes.

Condition:

The Bank maintains separate accounting and loan software programs for its banking operations. A backup and data retention policy/schedule does not exist, specifying how often backups are to be performed, how long they are to be retained, and where the backup media is to be stored.

Cause:

The Bank has not established a disaster recovery plan and related policies and procedures. There is a lack of internal control over the Bank's IT strategic planning and risk management process to support its financial reporting requirements.

Effect:

The Bank is exposed to the risk of loss of data and business interruption. In the event of a system failure or corruption of data, the Bank would not able to properly account for its loans and financial reporting requirements.

Recommendation:

The Bank should establish and document an Information Technology (IT) strategic planning and risk management process to support its financial reporting requirements. The Bank should also maintain reliable systems that include appropriate data backup and recovery processes. Backup tapes or other media should be maintained and properly secured (accessible only by authorized personnel). Application data and file server recovery procedures should be periodically tested at least once annually to ensure data integrity and recovery.

SECTION II – FINDINGS ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Finding No. 2014-03 – Disaster Recovery Plan, Continued

Auditee response:

The Bank was and is backing up data to a Network Attached Storage (NAS) daily on site. The Bank is currently backing up data to an external hard-drive stored off site with Computer Pluz who is NDBP's system service provider. The Bank is in the process of researching an adequate off site system to be used to recover the data.

Auditors' comment to Auditee response:

The Bank should consider our recommendation of establishing and documenting its disaster recovery plan. Although the Bank is using a third-party service provider to store its data, the Bank has not gone through the process of restoring the data. Application data and file server recovery procedures should be periodically tested at least once annually to ensure data integrity and recovery.