FSMSSA 2005 Annual Report

TABLE OF CONTENTS

Letter from the Chairman

This report covers calendar year 2005, the 19th fiscal year of operation of Social Security as an independent program under the Federated States of Micronesia.

During 2005 the trust realized total investment income of $3,714,922, a 9.44% return which extended the trend of a positive return to three years in a row. Also during 2005, Social Security received $12,129,796 in contributions, paid $940,444 in net administrative expenses and disbursed $12,029,049 in benefit payments and refunds of contributions. Benefit payments increased by 6.2% in 2005 compared to 2004. It is also important to note that the increase in benefit payments was accompanied by a 1.2% decrease in the amount of contributions collected.

During 2005 the Board was pleased to see several positive developments toward the Board's and Administration's ongoing goals to make certain that all contributions due are collected and to improve the Administration's efficiency with respect to benefit payments and administrative expenses. What follows is a list of some of these important developments.

Public Law 14-37 was made law. The principal provisions of this law are to allow interest penalties to be waived in order to facilitate collection of delinquent contributions, increase survivor benefits to surviving children in cases where both parents are covered under Social Security and become deceased, and to allow for a single lump-sum payment in lieu of monthly benefits to certain members who are not citizens of the FSM.

A totalization agreement was signed into law by the Presidents of the FSM, Palau and the Marshall Islands. This was the culmination of years of work and negotiations at which FSM Social Security has been at the forefront. This agreement allows someone who has worked in the FSM, Palau, and/or the Marshall Islands and has earned credited service under two or more of these systems, but is not entitled to a benefit under any one system, to combine his or her credited service and covered earnings in order to determine if he or she may be entitled to receive a benefit from each system.

The update to the computer database was completed during 2005 as well. This was a modernization to the database that will ensure its functionality well into the future. As a part of this update, the staff at Social Security headquarters and those in the Pohnpei branch office received extensive training on the new software.

I would like to thank everyone involved in the ongoing effort to keep Social Security viable, especially the members of the Board of Trustees and the Administration whose tireless efforts keep everything running smoothly on a day-to-day basis. I would also like to extend a special thanks to the President and Congress whose constant interest and involvement ensures that Title 53, the Social Security Act, will continue to evolve as necessary to ensure the future health of Social Security.

Sincerely,

signed
Charles L. Chieng
Chairman
Board of Trustees

Board of Trustees

The Board of Trustees is the governing body of the Federated States of Micronesia Social Security System. Members are nominated by the President, confirmed by the Congress and serve three-year terms.

Nominations to the Board take into account the need to have adequate geographical representation and to have representatives from public and private sector employers and employees. The Social Security Administrator is an ex officio member of the Board.

<u>Board Member</u>		<u>Terms</u>
Yap State Charles L. Chieng Chairman		5/26/89 to 5/26/92 6/5/92 to 6/5/95 5/13/96 to 5/13/99 5/26/99 to 5/26/02 11/5/02 to 11/4/05 11/15/05 to 11/14/08
Pohnpei State Jack Yakana Vice-Chariman		10/10/02 to 10/9/05 10/10/05 to 10/9/08
Kosrae State Nena Ned		3/19/97 to 3/18/00 3/19/00 to 3/19/03 9/4/03 to 9/3/06
Chuuk State Bernes Reselap		2/11/00 to 2/11/03 3/14/03 to 3/14/06
FSM National Government *Nahoy G. Selifis*		10/10/02 to 10/9/05 10/10/05 to 10/9/08
Administrator Alexander R. Narruhn		7/1/00 to 6/30/02 7/1/02 to 6/30/05 7/1/05 to 6/30/08

I submit this Annual Report of the Federated States of Micronesia Social Security System (FSMSSS) covering the period January 1, 2005 to December 31, 2005, the 2005 fiscal year, for the review of all interested parties.

As management of the FSMSSS, the Administration is responsible for the accuracy of the data presented in this report. We believe that this data is accurate in all material aspects and is reported in such a manner as to accurately represent the financial condition of the FSMSSS operations.

In 2005 Social Security celebrated its 37th year of operation and Social Security Week with conferences held by the branch offices for current members and retirees. FSMSSS booklets and brochures were also translated into all four languages spoken by the citizens of the FSM. These conferences and new brochures are intended to increase the public's awareness of their Social Security benefits and how Social Security is managed.

2005 also marked the signing of a totalization agreement, which had been in the works for many years, by the Presidents of The Federated States of Micronesia, The Republic of Palau, and The Republic of the Marshall Islands. This agreement allows someone who has earned credited service under the social security systems in two or more of these countries but is not eligible for a benefit under any one system to combine his or her credited service earned in each country in order to determine entitlement to and the amount of social security benefits that may be paid by each system.

During 2005 Public Law 14-37 was signed into law. Among its many provisions, P.L. 14-37 allows that interest penalties on past due contributions may be waived which increases the tools available to the Administration used to collect delinquent contributions. This law also increases benefits to surviving children in the case where both deceased parents had earned Social Security benefits at the time of their death and provides for a single lump-sum payment to foreign workers who, upon retirement, leave the FSM.

The project to upgrade the database software used by the social security systems in the FSM as well as Palau and the Marshall Islands was completed in 2005. Upon completion of this project, the staff at Administration headquarters as well as the Pohnpei branch received extensive training on how to implement and use the new software.

Board Meetings

The Board of Trustees held three regular meetings and two public forums during 2005.

A public forum was held in Kosrae on February 17, 2005. The forum took place in the gymnasium of Kosrae High School and more than 200 people were in attendance including several students who may not have been entirely aware of how the program works. The Chairman told the audience that similar forums had been held in Pohnpei and Chuuk and that the Board intends to hold a forum in each state at least once each year. The Chairman then turned the floor over to the Administrator who gave a brief history of Social Security including an explanation of how it is governed, explained that it is funded with payroll taxes, and explained the benefit provisions. After this, the floor was opened to questions from the audience.

The first regular Board meeting was held in Honolulu, Hawaii on February 23 and 24. This meeting was scheduled to coincide with the Board's Annual Investment Conference. The meeting began with the

Board entertaining appeal cases and later moved on to the approval of Deputy Administrator Dernista Capelle's contract for another two years. The Board then reviewed the proposed budget for Calendar Year 2005 which, by law, must be less than 11% of projected income for the year. In the end a budget of $982,208 was approved which worked out to be 8% of projected income for 2005. The Board then spent the remainder of the meeting reviewing the financial statements for Calendar Year 2004.

The second regular Board meeting was held in Yap on May 18 and 19. During their stay on Yap, the Board also held a public forum and met with the Yap State Legislature to address any questions and concerns that the people of Yap might have had. The public forum and the visit to the legislature were scheduled for May 19. The Board reviewed a 20-year projection of System assets and liabilities which indicates that without changes to the System, the funded ratio is expected to increase to 25% in 20 years. The projection recommended some changes to the System designed to further increase the funded ratio and the Board asked the Administrator to prepare a bill containing these recommendations for introduction to Congress. The Board then reviewed financial statements for the first quarter of 2005. The Administrator informed the Board of an accounting rule change from a cash to an accrual basis. The Board then entertained an appeal case and approved the Administrator's contract for another three years.

The third and final regular Board meeting was held in Pohnpei on November 11. The primary goal of this meeting was to address a concern the Board had with Merrill Lynch regarding the decision by Provident Investment Counsel to dissolve its fixed income arrangement management division effective March of 2006. Representatives from Merrill Lynch were on hand and presented a quarterly investment review which indicated that the market overall did reasonably well during the third quarter of 2005. The Board then appointed Jack Yakana as the new Chairman and Nahoy G. Selifis as the Vice Chairman. The Administrator then reviewed the financial statements through September 30, 2005. During this review, the Administrator told the Board that as of September 30, three-quarters of the way through the 2005 fiscal year, only 68% of the budget for 2005 had been spent. He also reviewed the amount of delinquent tax collections and mentioned that there had been 39 audits and 47 payment agreements so far in 2005. The Administrator also presented a proposed budget for 2006 of 8.4% of projected income which was less than the maximum of 11% as allowed by law. After discussion, this 2006 budget was approved by the Board. With the goal of improving the funded ratio, the Administrator presented a new bill to the Board that would introduce provisions in the law to improve tax collection methods and close the gap between collections and payments. Following revisions by the Board, this bill was approved for submission to Congress. Finally, the Board addressed a letter from the Chuuk State Health Care Plan calling for the Social Security branch office in Chuuk to enroll its employees in the plan as required by law. After discussion this issue was tabled until the next meeting.

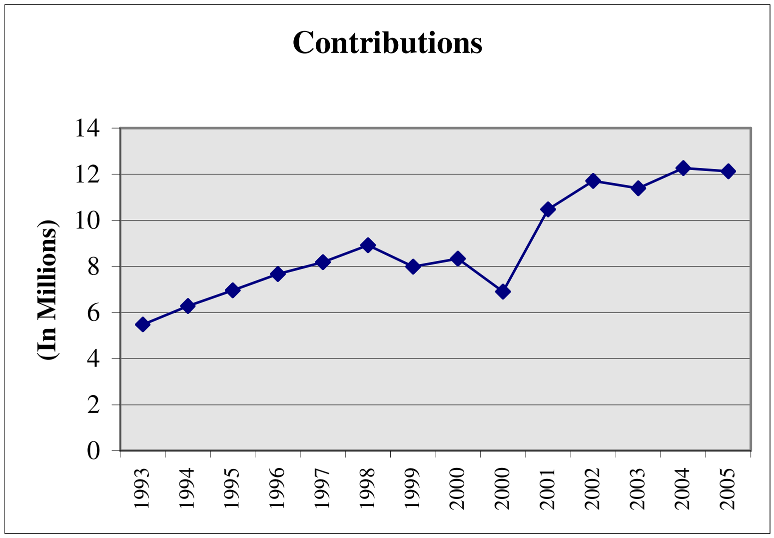
Funding Status

The Administration continues its efforts to ensure that collected contributions and investment income are sufficient to pay current benefits, meet administrative expenses, and reduce the unfunded accrued liability. The long term goal of the Administration is for the FSMSSS to accumulate assets sufficient to guarantee that future benefit obligations will always be met.

The following graphs illustrate current and historical levels of contributions received as well as benefit payments and administrative expenses paid. The graphs also track the overall historical value of the assets and realized past investment performance.

Contributions

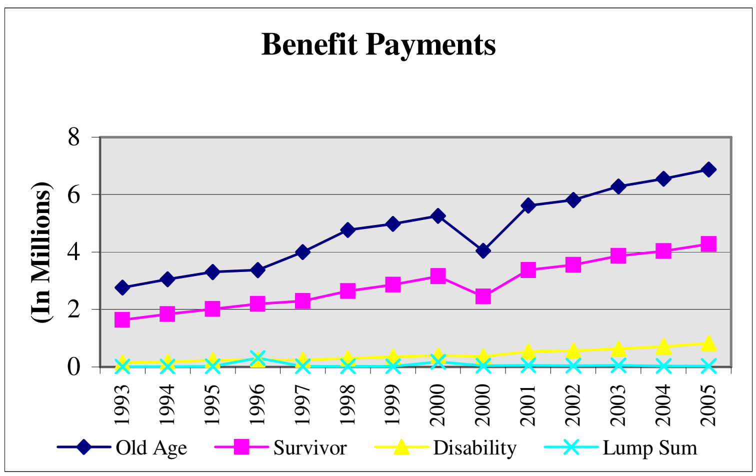
Contributions collected during fiscal year 2005 totaled $12,129,796 which was $146,105 less than what was collected in the prior fiscal year. The administration continues to pursue an aggressive campaign of audits of public and private sector employers to assure compliance with the Social Security Act.



Benefit Payments

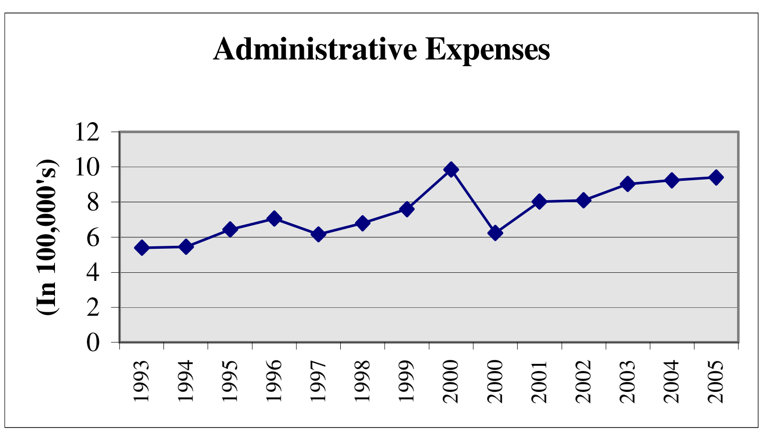
A total of $12,006,929 was disbursed in benefit payments during fiscal year 2005. In addition, $22,120 was disbursed as refunds of contributions. The following benefits were paid during fiscal year 2005:

Type	Amount
Old Age	$ 6,870,291
Survivor	$ 4,269,263
Disability	$ 830,813
Lump Sum	$ 36,562



Administrative Expenses

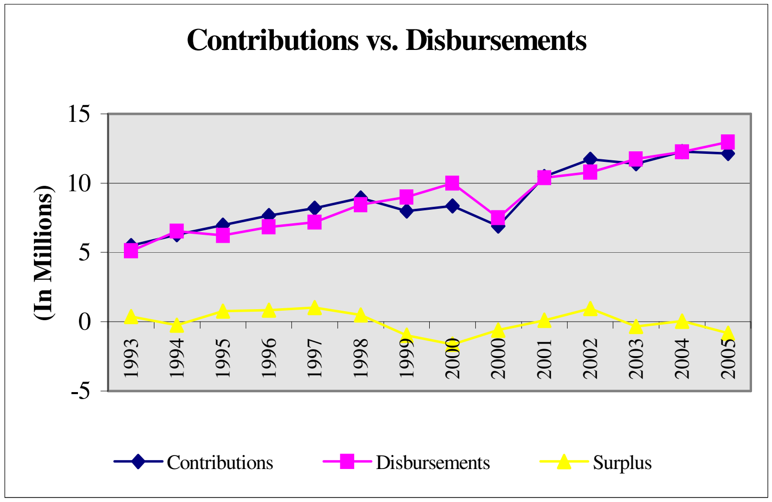
Net administrative expenses of $940,444 were paid during fiscal year 2005. This represents a 1.8% increase from the prior year.



Administrator's Report

Contributions and Disbursements

During fiscal year 2005, disbursements exceeded contributions by $839,697. For this comparison, disbursements consist of payments to beneficiaries and payments for administrative expenses.

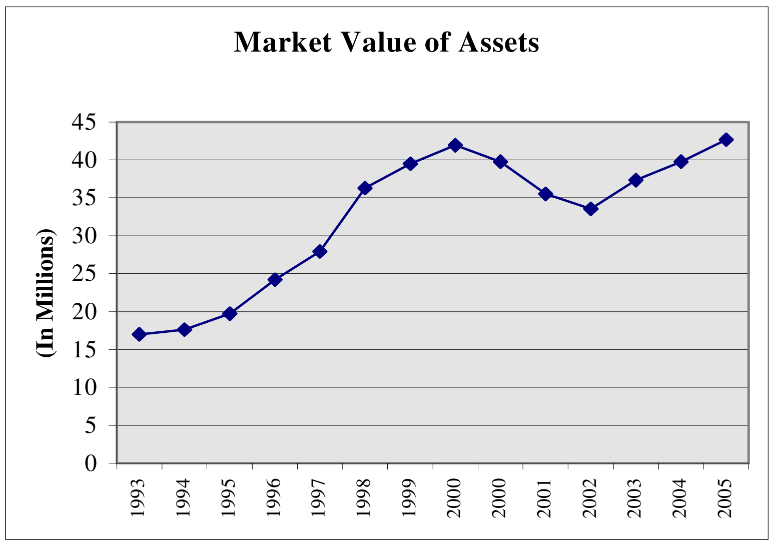


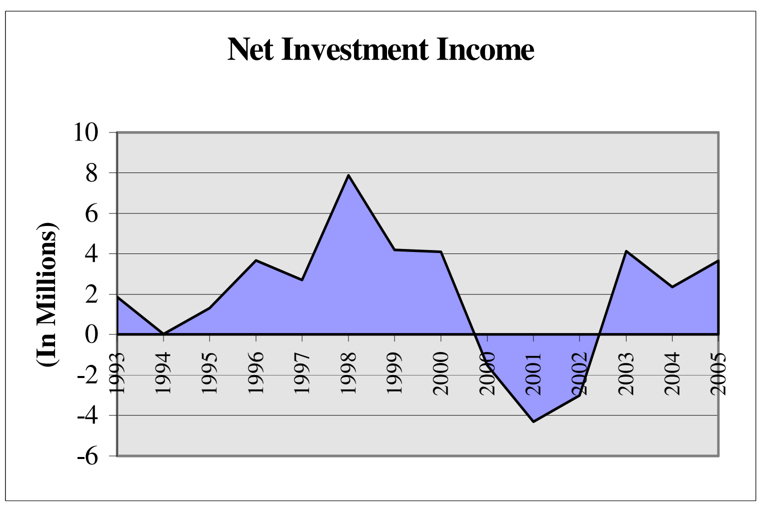
Investments

The Administration retains Merrill Lynch as its investment advisor, Atlanta Sosnoff Capital Corporation, Missouri Valley Partners, and Provident Investment Counsel as money managers and Pacific Century Trust as custodial trustee.

FSMSSA does not own any time deposits at the local banks. They are maintained in our general savings account and miscellaneous accounts with Bank of FSM. They are also maintained in miscellaneous accounts, benefit checking account, payroll checking account and operation checking account with Bank of Guam.

Social Security's assets totaled $42,657,062 at the end of fiscal year 2005, a $2,875,225 increase from the prior year. The fund experienced a net increase in the fair value of investments of $3,648,998.





Professional Service Providers

Actuary

Pacific Actuarial Services
3213 West Wheeler Street
Suite 382
Seattle, WA 98199

Investment Advisor

Merrill Lynch
Pauahi Tower Penthouse
1001 Bishop Street
Honolulu, HI 96813

Money Managers

Atlanta Sosnoff Capital Corporation
101 Park Avenue
New York, NY 10178

Missouri Valley Partners
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St. Louis, MO 63105

Provident Investment Counsel
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Pasadena, CA 91101

Auditors

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361 South Marine Drive
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Custodial Trustee

Pacific Century Trust
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Honolulu, HI 96802

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Federated States of
Micronesia Attorney General

Michael Sipos
P.O. Box 2069
Kolonia, Pohnpei FM 96941

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P.O. Box 1450
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Administrator's Report

System Legislation

The following legislation affecting the System was passed during the 14th Congress and signed into law by the President during 2005:

Resolution	Intended Purpose
PL 14-37	Amendment to Title 53, by allowing for waiver of interest payments, a lump-sum survivor benefit paid on behalf of surviving spouse who is also a retiree, lump-sum benefit paid to surviving children when both parents become deceased based on the earnings record of the parent with the smallest benefit, lump-sum payment to certain non-FSM citizens equal to 100% of their contributions, and clarification of various other administrative matters.

Prior Service Benefits Trust Fund

The Prior Service Benefits Trust Fund (PSBTF) is a supplemental retirement, disability and survivors' plan established pursuant to Section 105(m) of U.S Public Law 99-239. It was established to continue to provide benefits to those who worked for the U.S. Navy Administration or the Government of the Trust Territory of the Pacific Islands for at least 5 years prior to July 1, 1968.

The Administration continues to assist in processing claims for the PSBTF under a contractual agreement. All claim determinations and benefit payments are made by the Prior Service Benefits Trust Fund Administration in Saipan. The Vice-Chairman of the FSMSSS Board of Trustees is also a member of the PSBTF Board.

In 1987 the United States Congress provided $8 million for initial capitalization of the PSBTF. Pursuant to U.S. Public Law 99-239, future funding would be provided if warranted based on the results of actuarial valuations.

In the past five years there have been four appropriations used to pay benefits, the most recent coming from the United States Department of the Interior for $1.5 million which was received in March of 2005. These appropriations are used to reimburse beneficiaries for payments that were missed in the past due to insufficient funds, pay current benefit payments, and to cover administrative expenses.

During 2005 the Prior Service Benefits Trust Fund Board of Trustees continued the process of allocating the liability and responsibility for benefit payments between the countries whose citizens receive Prior Service benefits. After separation, which is expected to be completed in early 2006, the administration of Prior Service benefits will be performed by the Administration of the social security systems in The Federated States of Micronesia, The Republic of the Marshall Islands, The Republic of Palau, and the Retirement Fund in the Commonwealth of the Northern Mariana Islands.

Conclusion

The Administration continues to aggressively pursue its policy of collecting all contributions due and the newly acquired ability to waive interest penalties will help achieve this goal. The provision to pay a lump-sum benefit to certain foreign workers in lieu of monthly retirement payments, which essentially amounts to a refund of their contributions, will, in most cases, reduce the liability associated with these retirees.

Although late in 2003 the quarterly wage base was increased from $3,000 to $5,000 which resulted in more contributions collected during 2004, covered employment and wages did not increase sufficiently during 2005 to generate additional contributions compared to 2004. In fact, the amount of contributions collected during 2005 was 1.2% less than what was collected in 2004.

The FSMSSS continued to realize a positive return on invested assets for the third fiscal year in a row with total investment income of $3,714,922 during 2005 which represented a 9.44% return for the year. However, during 2005 the Administration paid $839,697 more in benefits, refunds of contributions, and administrative expenses than it collected in contributions, reversing the situation in fiscal year 2004 where more was collected than disbursed. This was due not only to the decrease in contributions mentioned above but also to a 6.2% increase in benefit payments.

Although the Administration paid more in benefits, refunds, and expenses than it collected in contributions during 2005, because the trust experienced its third consecutive year of positive returns, the Administration was able to meet all of its benefit obligations without liquidating any trust assets. However, because of the somewhat precarious position of having total expenditures exceed collected contributions by over eight-hundred thousand dollars, the Administration continues to endorse a policy whereby any future benefit increases are accompanied with a means to pay for the additional benefits.

Acknowledgements

My sincere thanks to the Administration staff whose hard work continues to make it possible for Social Security to provide the financial support that is imperative to the ongoing well-being of many citizens of the FSM. I would also like to express my gratitude to the Board of Trustees, for without their commitment and astute direction the Social Security System would not be where it is today. Lastly, I would like to thank all who were involved in the collection and assembly of the information presented in this report.

This report is intended to be a complete and succinct summary of the FSMSSS as a basis for making management decisions, responsible management of the assets contributed by the members and their employers and as a preliminary means of evaluating the effects of legislation pertaining to the System. This report will be submitted to the President and Congress of the Federated States of Micronesia as well as other interested parties.

signed
Alexander R. Narruhn
Administrator

Deloitte.

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INDEPENDENT AUDITORS' REPORT

Board of Trustees
FSM Social Security Administration:

We have audited the accompanying statements of net assets of the Federated States of Micronesia Social Security Administration (FSMSSA), a component unit of the FSM National Government, as of December 31, 2005 and 2004, and the related statements of changes in net assets for the years then ended. These financial statements are the responsibility of FSMSSA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

The Management's Discussion and Analysis on pages 2-5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This information is the responsibility of FSMSSA's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 31, 2006, on our consideration of FSMSSA's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

March 31, 2006

FEDERATED STATES OF MICRONESIA
SOCIAL SECURITY ADMINISTRATION

Management's Discussion and Analysis
Year Ended December 31, 2005

Program Description

The FSMSSA is one of the successor systems from the former Trust Territory Social Security System that closed down operation on March 31, 1988. The FSMSSA began its full operation on January 1, 1988 and is administered by a six-member Board of Trustees. Five members of the Board are nominated by the President and confirmed by the Congress of the FSM, while the FSMSSA Administrator serves as an ex-officio member. The FSM Social Security Administration Board of Trustees is comprised of the following individuals:

Charles L. Chieng	Chairman of the Board and representing Yap State;
Lt. Governor Jack E. Yakana	Vice-Chairman, representing the Pohnpei State;
Nahoy G. Selifis	Member representing the National Government;
Bernes O. Reselap	Member from the State of Chuuk;
Nena Ned	Member from the State of Kosrae; and
Alexander R. Narruhn	Administrator serves as the ex-officio member.

The Federated States of Micronesia Social Security Board of Trustees operate the Social Security Program authorized under the FSM Code title 53. Their nominations to the Board should take into account the need to have adequate geographical representation and to have representatives from public and private sector employers and employees. The members of the Board serve a 3-year term, and they shall provide for its own organization and procedure. Should there be any vacancies on the Board, it shall be filled for the un-expired term only. Where a vacancy is 1 year or less, it shall be filled by appointment by the President; otherwise vacancies shall be filled by nomination by the President and confirmation by the Congress. Members of the Board who are not State or National Government employees shall be paid at the rate of $30 per day and necessary travel expenses when actually attending meetings of the Board.

The FSMSSA was established by the Federated States of Micronesia Public Law 2-74 enacted February 2, 1983 to provide retirement, disability and survivor benefits for the citizens of the Federated States of Micronesia.

The FSM Social Security system is financed by employer/employee contributions at a rate of 6% each, or a combined tax rate of 12% paid to the system every quarter. State and national governments and all private employers incorporated or doing business in the FSM are subject to social security tax. At present, the maximum taxable wages per employee for each quarter is $5,000, which was effectuated in the 4th quarter of 2003.

Significant Events

- Public Law 14-37 was signed by the President in November 2005 as an amendment to Title 53 – Social Security Act. The new law includes among other things: waiver of interest payments, lump sum benefits to survivors equal to four percent of the lesser benefits (in cases where a surviving spouse is also a retiree, and in cases where both parents of surviving children become deceased), lump sum payments to foreigners equal to 100% of their contributions, and other administrative matters.

Significant Events, Continued

- The Totalization Agreement with MISSA and ROPSSA was signed by the President and ratified by the Congress for FSM. The agreement would allow a member to combine his or her earnings from the three countries to determine eligibility and to receive social security benefits from each country on a pro-rata basis.
- Completed the computerization upgrade to Visual Fox Pro 10, a grant from the U.S. Department of Interior and jointly shared with MISSA and ROPSSA for $215,000. At the same time during the system's upgrade in August, all HQ and Pohnpei Branch staff received comprehensive computer training.
- Continue to build staff capacity: knowledge, skills and abilities – through participation of key personnel to the APIPA conference held in Palau in July. As of this writing, we have also just concluded the 5-day biannual employees' conference held at the Headquarters and attended by all staff from HQ and from the four branch offices. The conference focused mainly on the newly upgraded system where HQ staff led training of all other branch employees. The new system will significantly improve the processing of information, one key toward better service to the growing number of recipients, employers and members.
- Celebrated the social security week and 37th anniversary by conducting conferences in the branch level attended by members and retirees.
- Work with National Leadership in seeking assistance from U.S. Department of Interior and U.S. Congress in financing the Prior Service Program. Working towards administering the Prior Service Trust Fund – FSM.
- Translated the Program's booklets and brochures into 4 FSM languages.

Financial Highlights

- The System's net assets increased 7.2% from $39,781,837 as of December 31, 2004 to $42,657,062 as of December 31, 2005. This increase was primarily due to the investment's net gain and was approximately 55% higher than the previous year's. At the end of 2005, net investment gain comprised the following:

Interest and dividends earned	$ 837,883
Realized gains on sale	1,221,389
Unrealized gains on Market Value	4,882,324
Realized losses on sale	(261,160)
Unrealized losses on Market Value	(2,768,249)
Investment fees	(263,189)
Net Investment gain	$ 3,648,998

The investment's market value as of December 31, 2005 reached $39,675,318 including automated cash management fund of $1,866,258.

- Tax collections in 2005 totaled $12,129,796. While this amount exceeded projection, it declined slightly by 1.2% when compared to 2004 total of $12,275,901.The administration continues to pursue an aggressive campaign of audit of public and private sector employers to ensure compliance with the Social Security Act.

  Other income during the year included reimbursement from Prior Service Trust Fund Administration amounting to $41,330 and miscellaneous collections of $24,594 from ss card and other fees.

- Benefits payments increased nearly 6.2% due to an increasing number of recipients. Total benefits paid in 2005 were $12,006,929 compared to $11,309,808 paid in 2004. At the end of 2005, the total number of beneficiaries reached 6,404 compared to 6,255 at the end of 2004.

  A breakdown of benefits according to entitlement follows:

	2005	2004
Retirement	$ 6,870,291	$ 6,540,224
Survivor	4,269,263	4,025,827
Disability	830,813	710,668
Lump Sum	36,562	33,088

- Administrative expenses in 2005 totaled $940,444. It was higher by 1.8% compared to 2004 due to increased utilities rates; higher fuel costs, repairs & maintenance, and printing. Also, training expense contributed to the increase. Other expense items remained virtually unchanged during the year's operation.

  Fixed assets acquisition during the year amounted to $24,032. The major asset acquired was a vehicle worth $12,000 for Kosrae Branch. The rest of the acquisitions were for office equipment comprised mostly of computers and computer items.

  Although slightly higher by 1.8% when compared to last year, this year's total administrative expenses were lower than the approved budget by 5.4% and 29.6% lower than the budget ceiling provided in the Social Security Act.

  In November 2005, the Board approved $1,007,412 as budget for FY2006. This amount is 2.57% higher than FY2005 approved budget.

FEDERATED STATES OF MICRONESIA
SOCIAL SECURITY ADMINISTRATION

Management's Discussion and Analysis
Year Ended December 31, 2005

Statement of Net Assets

	2005	2004
Cash and equivalents	$ 2,873,476	$ 1,789,785
Investments	37,809,060	35,855,045
Other current assets	1,970,466	2,156,189
Fixed assets, net	79,944	91,221
	42,732,946	39,892,240
Liabilities	75,884	110,403
Net assets:		
Held in trust for retirement, disability and survivors' benefit	$ 42,657,062	$ 39,781,837

Statement of Changes in Net Assets

Revenues	$ 15,844,718	$ 14,679,843
Expenses	12,969,493	12,244,908
Changes in net assets	2,875,225	2,434,935
Net assets at beginning of year	39,781,837	37,346,902
Net assets at end of year	$ 42,657,062	$ 39,781,837

Conclusion

The System's net assets increased 14.2% over the two year period in 2004 and 2005 primarily due to positive returns of the investment portfolio. During 2005, however, total benefits and administrative expenses exceeded collected revenues and resulted in drawdown of funds from the investments to meet benefits payment in December 2005.

It is the hope of the administration to achieve a better ratio between benefits and contributions, and to realize surplus earlier that what has been projected. We believe that our continued efforts in auditing and pursuing delinquent employers as well as controlling administrative expenses will help pave the way toward achieving this objective.

Furthermore, it is the direction of the administration to move into a define contribution plan and therefore, has submitted a proposed amendment to Congress for that purpose.

Overall, the System's operating results during fiscal years 2005 and 2004 generated net income of $2,875,225 and $2,434,935, respectively.

FEDERATED STATES OF MICRONESIA
SOCIAL SECURITY ADMINISTRATION

Statements of Net Assets
December 31, 2005 and 2004

		2005		2004
ASSETS				
Cash and equivalents	$	2,873,476	$	1,789,785
Investments, at fair value		37,809,060		35,855,045
General receivables		1,813,151		1,979,938
Accrued interest receivable		144,007		167,605
Advances		9,708		5,941
Prepaid expenses		3,600		2,705
Fixed assets, net		79,944		91,221
Total assets	$	42,732,946	$	39,892,240
LIABILITIES				
Accounts payable – general	$	42,569	$	76,807
Taxes/personnel benefits payable		19,604		20,666
Accrued PCT monthly fees		13,711		12,930
Total liabilities		75,884		110,403
Contingencies				
NET ASSETS				
Held in trust for retirement, disability and survivors' benefits		42,657,062		39,781,837
Total liabilities and net assets	$	42,732,946	$	39,892,040

See accompanying notes to financial statements.

FEDERATED STATES OF MICRONESIA
SOCIAL SECURITY ADMINISTRATION

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

	2005	2004
Additions:		
Contributions	$ 12,129,796	$ 12,275,901
Investment income:		
Net increase in the fair value of investments	3,648,998	2,351,940
Miscellaneous income	65,924	52,002
Total investment income	3,714,922	2,403,942
Total additions	15,844,718	14,679,843
Deductions:		
Benefit payments	12,006,929	11,309,808
Refund contributions	22,120	11,430
Administrative expenses, net	940,444	923,670
Total deductions	12,969,493	12,244,908
Change in net assets	2,875,493	2,434,935
Net assets at beginning of year	39,781,827	37,346,902
Net assets at end of year	$ 42,657,062	$ 39,781,837

See accompanying notes to financial statements.

(1) Summary of Significant Accounting Policies

A. Basis of Accounting

The Federated States of Micronesia (FSM) Social Security Administration (the Administration) is accounted for as a Fiduciary Fund Type – Private Purpose Trust Fund and is a component unit of the FSM National Government.

The Administration has adopted GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments* (GASB 34) as amended by GASB Statement No.s 37 and 38. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that FSM Social Security Administration resources be classified, for accounting and reporting purposes, as held in trust for retirement disability and survivors' benefits.

B. Future Liabilities and Contributions

No recognition is given to the present value of the liabilities of prospective benefit payments or the present value of future contributions required from employees or employers.

C. Deposits and Investments

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

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

(i) Government obligations - Obligations issued or guaranteed as to principal and interest by the FSM National Government and/or State governments of the Federated States of Micronesia or by the Government of the United States, provided that the principal and interest on each obligation are payable in the currency of the United States.

(ii) Corporate obligations and mortgage-backed securities - Obligations of any public or private entity or corporation created or existing under the laws of the Federated States of Micronesia or of the United States or any state, territory or commonwealth thereof, or obligations of any other government or economic community which are payable in United States dollars, or pass through and other mortgage-backed securities provided that the obligation is issued by an agency of the United States Government, the FSM National Government, or is rated in one of the three highest categories by two nationally recognized rating agencies. No investment under this heading shall exceed ten percent of the market value of the Fund or ten percent of the outstanding value of the issue at the time of purchase.

(1) Summary of Significant Accounting Policies, Continued

C. Deposits and Investments, Continued

(iii) Preferred and common stocks - Shares of preferred or common stocks of any corporation created or existing under the laws of the Federated States of Micronesia or under the laws of the United States or any state, territory or commonwealth thereof provided that the purchase of such shares shall be considered reasonable and prudent by the Administration's investment advisor at the time of purchase, that not more than five percent of the market value of the Fund shall be invested in the stock of any one corporation, and that not more than ten percent of the market value of the Fund shall be invested in any one industry group.

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

Cash and Equivalents:

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 Administration or its agent in the Administration's name;

Category 2 Deposits that are uninsured but fully collateralized with securities held by the pledging financial institution's trust department or agent in the Administration's name; or

Category 3 Deposits that are collateralized with securities held by the pledging financial institution's trust department or agent but not in the Administration's name and non-collateralized deposits.

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

For the purposes of the statement of net assets, cash and equivalents is defined as cash on hand, in bank checking and savings accounts, time certificates of deposit with initial maturities of ninety days or less and funds held by Pacific Century Trust, the trustee, in an automated cash management fund.

(1) Summary of Significant Accounting Policies, Continued

C. Deposits and Investments, Continued

Cash and Equivalents, Continued:

As of December 31, 2005 and 2004, the carrying amount of the Administration's total cash and cash equivalents was $2,873,476 and $1,789,785, respectively, and the corresponding bank balances were $1,007,218 and $881,686, respectively. These bank balances are maintained in financial institutions subject to Federal Deposit Insurance Corporation (FDIC). As of December 31, 2005 and 2004, bank deposits in the amount of $300,000 were FDIC insured. Accordingly, these deposits are exposed to custodial credit risk. The Administration does not require collateralization of its cash deposits; therefore, deposit levels in excess of FDIC insurance coverage are uncollateralized. The remaining amounts of $1,866,258 and $908,099, respectively, represent short-term investments held and administered by Pacific Century Trust in accordance with a fiduciary trust agreement. Based on negotiated trust and custody contracts, all of these investments were held in the Administration's name by Pacific Century Trust at December 31, 2005 and 2004.

Investments:

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

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

Category 1 Investments that are insured or registered, or securities held by the Administration or its agent in the Administration's name;

Category 2 Investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Administration's name; or

Category 3 Investments that are uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Administration's name.

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

(1) Summary of Significant Accounting Policies, Continued

C. Deposits and Investments, Continued

Investments, Continued:

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

	2005	2004
Fixed income securities:		
Domestic fixed income	$ 13,346,830	$ 14,088,850
Other investments:		
Domestic equities	24,462,230	21,755,629
Mutual funds	-	10,566
	24,462,230	21,766,195
	$ 37,809,060	$ 35,855,045

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

		Investment Maturities (in years)			
Investment Type	Fair Value	Less than 1	1-5	5-10	more than 10
U.S Treasury obligations	$ 12,776,207	$ -	$ 7,347,364	$ 4,586,383	$ 842,460
U.S. Government agency obligations	570,623	-	-	31,869	538,754
	$ 13,346,830	$ -	$ 7,347,364	$ 4,618,252	$ 1,381,214

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

		Investment Maturities (in years)			
Investment Type	Fair Value	Less than 1	1-5	5-10	more than 10
U.S Treasury obligations	$ 5,606,425	$ -	$ -	$ 5,022,508	$ 583,917
U.S. government obligations	6,137,557	-	1,234,004	791,377	4,112,176
Municipal obligations	225,252	-	-	-	225,252
Corporate bonds	2,119,616	-	823,942	898,686	396,988
	$ 14,088,850	$ -	$ 2,057,946	$ 6,712,571	$ 5,318,333

(1) Summary of Significant Accounting Policies, Continued

C. Deposits and Investments, Continued

Investments, Continued:

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

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

Moody's Rating	Total	Domestic	International
AAA	$ 13,346,830	$ 13,346,830	$ -
Total credit risk debt securities	$ 13,346,830	$ 13,346,830	$ -

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

Moody's Rating	Total	Domestic	International
Aaa/AAA	$ 14,088,850	$ 14,088,850	$ -
Total credit risk debt securities	$ 14,088,850	$ 14,088,850	$ -

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

Concentration of credit risk for investments is the risk of loss attributed to the magnitude of an entity's investment in a single issuer. GASB Statement No. 40 requires disclosure by issuer and amount of investments in any one issuer that represents five percent (5%) or more of total investments for the Administration. There was no concentration of credit risk for investments as of December 31, 2005. As of December 31, 2004, the Administration's investment in agency obligations of Federal National Mortgage Association constituted 17% of its total investments.

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

(1) Summary of Significant Accounting Policies, Continued

D. Fixed Assets

The cost of fixed assets, if greater than $250, is capitalized at the time of acquisition. Depreciation is provided using the straight-line basis over the estimated useful lives of the respective assets.

	Estimated Useful Lives	January 1, 2005	Additions	Retirements	December 31, 2005
Motor vehicles	5 years	$ 112,688	$ 12,007	$ -	$ 124,695
Computer software and hardware	5 years	144,458	2,870	(11,439)	135,889
Office furniture, fixtures and equipment	5 years	110,535	6,198	(2,102)	114,631
Home furnishings	5 years	2,649	2,957	(2,229)	3,377
		370,330	24,032	(15,770)	378,592
Less accumulated depreciation and amortization		(279,109)	(34,711)	15,172	(298,648)
		$ 91,221	$ (10,679)	$ (598)	$ 79,944

	Estimated Useful Lives	January 1, 2004	Additions	Retirements	December 31, 2004
Motor vehicles	5 years	$ 103,054	$ 9,634	$ -	$ 112,688
Computer software and hardware	5 years	115,633	32,860	(4,035)	144,458
Office furniture, fixtures And equipment	5 years	114,192	5,378	(9,035)	110,535
Home furnishings	5 years	3,059	-	(410)	2,649
		335,938	47,872	(13,480)	370,330
Less accumulated depreciation and amortization		(255,411)	(36,430)	12,732	(279,109)
		$ 80,527	$ 11,442	$ (748)	$ 91,221

E. Contributions

Contributions to the Fund are governed by the Federated States of Micronesia Social Security Act of 1983 which imposes a tax on the quarterly income of every employee not currently subject to the United States Social Security Administration or any other recognized social security system. There is imposed on the income of every applicable employee a tax equal to six percent of wages received.

Maximum quarterly taxable wages are currently $5,000. Every employer is required to contribute an amount equal to that contributed by employees.

(1) Summary of Significant Accounting Policies, Continued

E. Contributions, Continued

Contributions as of December 31, 2005 and 2004, comprise of the following:

	2005	2004
Government employment	$ 6,450,475	$ 5,931,863
Private employment	5,662,080	5,896,019
SS Tax contributions	(158,138)	254,882
Judgement	16,320	-
Penalties and interest	159,059	193,137
	$ 12,129,796	$ 12,275,901

F. Benefit Obligations

Retirement benefits are paid to every person who is a fully insured individual as defined by the Federated States of Micronesia Social Security Act, has attained sixty years of age, and has filed an application for old age insurance benefits. Benefits are also paid to surviving spouses of deceased workers, subject to eligibility requirements, as long as they do not remarry or work. Eligible children who are not married or are not working may also receive benefits until age eighteen (18) or up to age twenty-two (22) if in school.

Eligible children who become disabled before age twenty-two (22) will continue to receive benefits for the duration of the disability. Disability benefits are paid to qualified workers for the duration of the disability or until retirement or death at which time retirement or survivor benefits become available.

Benefits are paid monthly and are computed on an annual basis of 16.5% of the first $10,000 of cumulative covered earnings, plus 3.0% of the next $30,000, and 2.0% of any earnings in excess of $40,000. The minimum benefit payment is $50 per month.

Benefit payments as of December 31, 2005 and 2004, are comprised of the following:

	2005	2004
Retirement pension	$ 6,870,291	$ 6,540,224
Survivor pension	4,269,263	4,025,827
Disability pension	830,813	710,668
Lump sum pension	36,562	33,089
	12,006,929	$ 11,309,808

G. Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America require management to make estimates and assumptions that affect the reported amounts of net assets 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.

(1) Summary of Significant Accounting Policies, Continued

H. New Accounting Standards

During fiscal year 2005, the Administration implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)*, and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, GASB Statement No. 40 addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest risk, GASB Statement No. 40 requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. GASB Statement No. 42 establishes standards for impairment of capital assets when its service utility has declined significantly and unexpectedly.

In April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. GASB Statement No. 43 establishes uniform financial reporting for other postemployment benefit plans by state and local governments. The provisions of this Statement are effective for periods beginning after December 15, 2007. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the Administration.

In May 2004, GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section, an amendment to NCGA Statement 1*. GASB Statement No. 44 improves the understandability and usefulness of statistical section information and adds information from the new financial reporting model for state and local governments required by GASB Statement No. 34. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the Administration.

In July 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition, and display of other post employment benefits expense/expenditures and related liabilities, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after December 15, 2008. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the Administration.

In June 2005, GASB issued Statement No. 47, *Accounting for Termination Benefits.* GASB Statement No. 47 establishes guidance for state and local governmental employers on accounting and financial reporting for termination benefits. These benefits include incentives for voluntary terminations (e.g., early retirement window programs) and severance payments with respect to involuntary terminations. The provisions of this Statement are effective for periods beginning after June 15, 2005. Management does not believe that the implementation of this Statement will have a material effect on the financial statements of the Administration.

(1) Summary of Significant Accounting Policies, Continued

I. Risk Management

The Administration 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 Administration has elected to purchase automobile insurance from independent third parties for the risks of loss to which it is exposed. The Administration is substantially self-insured for all other risks. Settled claims have not exceeded commercial coverage in any of the past three years.

(2) Establishment of the Social Security Administration

The Social Security Administration of the Federated States of Micronesia National Government was established by Public Law 2-74, passed on February 8, 1983, and began operations on October 1, 1987, for the purpose of providing retirement, disability and death benefits to qualified individuals and their survivors. The Administration is administered under the authority of a six-member board, five of whom are appointed by the President of the Federated States of Micronesia. The Administrator, who is selected by the board, serves as an ex-officio member.

(3) Net Assets Held in Trust

Net assets are held in trust to comply with the Social Security Act of 1983. All net assets of the Administration are to be used for retirement, disability and survivors' benefits.

(4) Contingencies

The Administration is aware of liabilities of the fund related to retroactive benefit payments for wages not posted to the system due to an unmatched social security number or name provided by the employer, as well as a liability related to overpayment of contributions. Management is unable to determine a reasonable estimate of the abovementioned liabilities at this time; however management is of the opinion that the amount is not material to the financial statements taken as a whole.

In October 2004, the FSM Social Security Administration obtained an actuarial valuation of the Retirement Fund as of January 1, 2004. The valuation reported actuarial accrued liabilities for the Retirement Fund of $240,247,000. As of January 1, 2004, the FSM Social Security Administration recorded a total fund equity of $37,347,000 in the Retirement Fund, as funds available to fund future benefit obligations; these figures resulted in an accrued unfunded liability of $202,900,000. The report indicates that the Administration should not increase future or current benefits until a long-term trend of decreasing the unfunded accrued liability is realized.

(5) Contributions Receivable

The Administration is of the opinion that there are outstanding contributions due to the fund; however, a reasonable estimate of this amount cannot be made due primarily to noncompliance by employers.

(6) Prior Service Claims

Under the terms of the Prior Service Claim Adjudication Service Agreement between the Prior Service Trust Fund Administration and the Social Security Administration of the Federated States of Micronesia, the FSM Social Security Administration is to provide for the processing of benefit claims and to assist in the monitoring of continuing eligibility under the Prior Service Program. The Prior Service Trust Fund Administration will reimburse the Social Security Administrator $8,000 per annum plus an amount equal to 8% of the total amount of automated and manual benefit payments.

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

The Board of Trustees
FSM Social Security Administration:

We have audited the financial statements of the FSM Social Security Administration, as of and for the year ended December 31, 2005, and have issued our report thereon dated March 31, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the FSM Social Security Administration's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FSM Social Security Administration's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

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

Compliance and Other Matters

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

This report is intended for the information of the Board of Trustees and management of FSM Social Security Administration, federal awarding agencies, pass-through entities, the cognizant audit and other federal agencies, and is not intended to be, and should not be, used by anyone other than those specified parties.

Deloitte & Touche LLP

March 31, 2006

19

Pacific Actuarial Services

October 20, 2006

Mr. Alexander Narruhn
Administrator
FSM Social Security Administration
P. O. Box L
Kolonia, Pohnpei, Federated States of Micronesia

Dear Mr. Narruhn:

This report summarizes the results of an actuarial valuation of the Federated States of Micronesia Social Security Administration which was conducted as of January 1, 2006 and was performed using worker data and asset information supplied by the Federated States of Micronesia Social Security Administration. This data was not audited, but was checked for reasonableness and consistency with the prior year's data when possible. The valuation results presented are dependent on the accuracy of the worker and asset information.

The purpose of this actuarial valuation is to compare the accrued liability to the market value of Trust assets in order to determine the current funded status and to provide a basis for determining the effect of any future proposed changes to the system.

This valuation has been completed in accordance with generally accepted actuarial principles and practices. The valuation has been prepared under the supervision of Michael W. Spaid, a Fellow of the Conference of Consulting Actuaries, an Associate of the Society of Actuaries, an Enrolled Actuary under ERISA, a Member of the American Society of Pension Professionals and Actuaries, a Member of the American Academy of Actuaries and a Member of the College of Pension Actuaries.

Pacific Actuarial Services

Actuary's Report

Summary of Valuation Results

The principal results of this valuation are the calculation of the accrued liability, the funded ratio, and the deficiency.

The accrued liability represents the current value of benefits already earned, as of the valuation date including benefits currently in pay status.

The funded ratio is an indication of how well-funded the Administration is at any point in time with respect to benefits already earned. A funded ratio of 100% would indicate that the Administration's liability for benefits already earned was fully funded by current Trust assets. A funded ratio of 25% would indicate that current Trust assets were only great enough to cover 25% of the benefits already earned. The greater the funded ratio, the better funded the Administration is with respect to benefits already earned.

The deficiency is calculated as the accrued liability less the market value of Trust assets and further reduced by the estimated value of future employee contributions in excess of that needed to fund future benefits and system expenses.

As of January 1, 2006 the total accrued liability stood at $262,187,000 and the market value of Trust assets was $42,657,000, resulting in an unfunded accrued liability of $219,530,000.

In addition, as of January 1, 2006 the estimated value of future employee contributions in excess of that needed to fund future benefits and system expenses was $42,056,000. Once this is subtracted from the unfunded accrued liability this means that the deficiency is $177,474,000. The deficiency represents the value of benefits already earned that are not covered by existing assets and are not anticipated to be covered by expected future contributions.

The unfunded accrued liability is greatly affected by the level of Trust assets which, in return is affected by the investment performance of the Trust. After experiencing negative investment returns for fiscal years 2001 and 2002 the Trust has realized positive returns beginning in 2003 with the Trust earning 9.44% during fiscal year 2005.

When discussing the funded status of a retirement system, a common benchmark is the funded ratio of the system which, as mentioned above, is calculated as the market value of Trust assets divided by accrued liability. The funded ratio as of January 1, 2006 is 16%.

Unfunded Accrued Liability, Funded Ratio, and Deficiency

The accrued liability represents the value of benefits already earned and which are in pay status as well as benefits earned as of the valuation date by those who are still working and are expected to earn future benefits. One can think of this as the amount needed today to pay for all benefits earned as of today that are either already being paid or may be paid in the future.

This determination of the accrued liability does not include former workers who are no longer making contributions, are not fully insured, and therefore are not entitled to a future benefit. Should these workers re-enter the workforce in the future, their benefits will then be included in the category of workers currently earning benefits.

	Accrued Liability and Market Value of Assets as of January 1	
Accrued Liability For:	2004	2006
Workers Earning Benefits	$ 139,405,000	$ 148,638,000
Retirees, Spouses, Children, and Disabled Workers Receiving Benefits	75,949,000	83,957,000
Fully Insured Inactive Workers Entitled to a Future Benefit	24,893,000	29,592,000
Total Accrued Liability	$ 240,247,000	$ 262,187,000
Market Value of Assets	(37,347,000)	(42,657,000)
Unfunded Accrued Liability	$ 202,900,000	$ 219,530,000
Funded Ratio	16%	16%

The unfunded accrued liability is the excess of the accrued liability over the market value of assets. The funded ratio indicates what percentage of the accrued liability is covered by the market value of assets.

Actuary's Report

The unfunded accrued liability can also be further reduced by considering the current value of future employee and employer contributions that are in excess of that needed to pay for future benefits earned and future expenses.

Currently we estimate that a combined employee and employer contribution rate of approximately 8.8% would pay for future benefits earned by new workers who would enter the Administration in the future and would cover future expenses. Since the current combined tax rate is 12% of covered earnings, this excess can be used to reduce the unfunded accrued liability as shown below. It is important to note that because the current contribution rate is sufficient to cover future benefits that the unfunded accrued liability and total deficiency shown below do not exist because of current system provisions but are the result of prior benefits already earned.

	Determination of the Total Deficiency as of January 1	
	2004	2006
Total Accrued Liability	$ 240,247,000	$ 262,187,000
Market Value of Assets	(37,347,000)	(42,657,000)
Current Value of Excess Employee Contributions from Active Workers	(39,465,000)	(42,657,000)
Total Deficiency*	$ 163,435,000	$ 177,474,000

*The current value of excess employee contributions from active workers includes an allowance for future system expenses.

Discussion of the Unfunded Accrued Liability

The unfunded accrued liability is the excess of the accrued liability over the market value of assets. The funded ratio indicates what percentage of the accrued liability is covered by the market value of assets. The accrued liability is expected to increase from year to year as workers earn additional benefits and get closer to retirement age and in fact the accrued liability shown in this valuation is greater than that in the prior valuation.

When the market value of assets equals or exceeds the accrued liability, there is no unfunded accrued liability and the retirement system is said to be fully funded. Although it is not critical that the Administration be fully funded, it is important that there is a positive trend in increasing the funded ratio from year-to-year. It is important to note that the funded ratio can decrease due to poor performance by the Trust assets and also due to increasing benefits payable to both current and future beneficiaries.

Past valuations have gone into great detail describing the danger of an ever increasing unfunded accrued liability and this report agrees that this is a continuing and serious issue. If the Administration were to cease operations with an unfunded accrued liability, there would not be enough money in the Trust at that time to fully provide benefits already in pay status or promised in the future. Therefore it is important that benefits are not increased until a long-term trend of increasing the funded ratio and decreasing the unfunded accrued liability has been realized.

Comments and Suggestions to Manage the Unfunded Accrued Liability

Benefit payments and administrative expenses exceeded the amount of contributions collected during fiscal year 2005, and continue to do so for fiscal year 2006. This puts the Administration in the position of having to dip into the Trust in order to meet its financial commitments. As the amount of benefit payments grow in the future it is possible that enough of the Trust will be spent that the actual corpus of the Trust will diminish enough that the dollar amount of investment income will also decrease significantly because there will be less money in the Trust on which to earn income. This could develop into a dangerous situation where the Trust becomes completely depleted. Because of this the Administration has asked that we include in this report means to limit the growth of benefit payments and the unfunded accrued liability.

The accrued liability is expected to increase from year to year and in fact the accrued liability has increased since the prior valuation. Because the unfunded accrued liability is simply the difference between the accrued liability and Trust assets, the size of the unfunded accrued liability can be limited in three ways; increase the return on invested assets, increase revenue through additional funding, and limit the growth of future benefit payments. We will only deal with the last two of these issues here because the topic of investment return is much better addressed with the Administration's investment advisors. We will first discuss ways that the Administration may increase revenue though additional funding and will then address ways to limit future benefit growth.

Increasing Revenue

Perhaps the most immediate source of additional revenue could come through an increase in the tax rate levied on workers, self-employed workers, and employers, but if this is to be seriously considered one must proceed with extreme caution. If the tax rate is increased too much it will further encourage both employees and employers to avoid paying the Social Security tax and this could have the result of actually decreasing the contributions collected. If the tax rate is increased, the increase should be large enough to boost the contributions collected to cover 115% to 120% of current benefit payments and administrative expenses. Based on the 2005 financial data it appears that an immediate increase in the tax rate from 6% to 7% would suffice and based on actual contributions collected during 2005 this would result in approximately $14.2 million in total annual contributions collected (of course, the actual figure will depend on actual future covered payroll.) This increase should give the Administration some room to cover upcoming benefit payments which will most likely also increase in the future.

Another source of additional funding is to look directly to the FSM Federal Government for additional funds. Keeping in mind that the more money there is in the Trust the larger the potential dollar amount of investment return; the Federal Government could make a one-time investment in Social Security by allocating six months of benefit payments to the Trust, which currently would be approximately $6 million. Alternatively or in addition to a single payment, some of the funding received through Compact II could be allocated to Social Security on an annual basis.

Limiting Benefit Growth

We understand that the Administration has drafted a bill that would add a fourth tier to the existing benefit structure. This proposed change will not affect those who are already in pay status but will limit future benefit payments to high wage earners while leaving the benefits for many workers unchanged. According to a benefit study completed in 2005, if implemented, this new benefit structure will immediately reduce the unfunded accrued liability and we endorse this very important change to the benefit structure.

The benefit paid to a surviving spouse is currently paid until the earlier of the date the spouse remarries or dies and is subject to the earnings test. Limiting the actual period that a benefit is paid to a surviving spouse under the age of 60, perhaps to the later of five years or the date the youngest surviving child of the deceased spouse turns 18, could also reduce the unfunded accrued liability as well as future benefit payments.

The Administration has asked us to explore the financial impact of increasing the age at which a worker is eligible for full, unreduced benefits to 65. Fully insured workers would be eligible for early retirement at age 60 with benefits reduced 2/3% for each month prior to age 65 that benefits commence. This means that at age 60 a worker could retire and receive a benefit equal to 60% of his or her benefit earned as of that date that would otherwise be payable at age 65. Those who choose to retire prior to age 65 and continue to work would not be subject to the Earnings Test until they reach 65 and would continue to be subject to Social Security taxes with their benefit adjusted January 1 of each year following their early retirement to reflect their additional covered wages. The following is an example of how the benefit would be calculated for someone who had earned an annual benefit of $3,000 that would otherwise be payable at age 65, elects early retirement on January 1 when he turns 60, and then continues to work until age 65, earning $12,000 each year. His initial annual benefit beginning at age 60 would be 60% (100% minus 2/3% per month for 60 months) of the unreduced benefit he could receive at age 65 so his initial annual early retirement benefit beginning at age 60 would be $1,800. We will assume that under the current benefit structure he will earn an additional annual benefit payable at age 65 equal to 2% of $12,000, or $240, each year that he continues to work until age 65. Each of these increments will then be subject to the appropriate adjustment factor depending on when they start to be paid.

Benefit paid From	Adjustment Factor	Benefit Increase Effective January 1	Total Benefit
Age 60 to 61	0.60	$ 1,800 (initial benefit)	$ 1,800 (initial benefit)
Age 61 to 62	0.68	163	1,963
Age 62 to 63	0.76	182	2,145
Age 63 to 64	0.84	202	2,347
Age 64 to 65	0.92	221	2,568
Age 65 on	1.00	240	2,808

We have estimated that these changes in the retirement age and benefit structure would reduce the unfunded accrued liability by approximately $41 million and increase the funded ratio to 19%.

Summary of Principal System Provisions

Applicable Laws

Public Law 2-74, as amended by Public Laws 5-120, 6-111, 7-118, 7-119,7-120, 9-56, 12-51, 12-76, and 14-37.

Workers and Employer's Contributions

Workers, self-employed workers and employers each pay 6% of earnings up to a maximum of $5,000 of earnings per quarter.

Self-employed with employees - remuneration shall be deemed to be twice the amount paid to the highest paid employee reported by the self-employed person in quarter, up to $5,000 taxable per quarter.

Self-employed with no employees- Remuneration is deemed to be 2.5% of the gross revenue of the business for the previous calendar year subject to $5,000 taxable per quarter.

Coverage

All employees employed by an employer incorporated or doing business in the Federated States of Micronesia are covered unless both the employer and employee are currently subject to another recognized social security system.

Eligibility for and Computation of Benefits is based on the following definitions:

Quarters of Coverage: A calendar quarter in which contributions were made for at least $50 of earnings.

Currently Insured: Credited with at least 8 quarters of coverage during the most recent previous 13 calendar quarters.

Fully Insured: Credited with at least one quarter of coverage for each year since the later of attainment of age 21 or June 30, 1968 and having not less than 12 quarters of coverage.

Maximum Covered Earnings: Earnings up to a maximum of $5,000 each quarter.

Minimum Benefit: $50 per month.

Basic Benefit

A worker's Basic Benefit is calculated as 1/12 of:

1. 16.5% of the first $10,000 of total Maximum Covered Earnings for which contributions have been made, plus

2. 3.0% of the next $30,000 of total Maximum Covered Earnings for which contributions have been made, plus

3. 2.0% of total Maximum Covered Earnings in excess of $40,000 for which contributions have been made.

Old Age Insurance Benefit

Eligibility: Age 60 and Fully Insured

Amount: Greater of the Basic Benefit and the Minimum Benefit, subject to the earnings test.

Disability Insurance Benefit

Eligibility: Disabled for three months and Fully Insured at time of disability

Amount: Unreduced Basic Benefit earned at time of disability. Sum of disability benefit and workers compensation benefit may not exceed 80% of the highest covered compensation earned in the year of disability and the prior five years. The benefit ceases should the worker recover from the disability.

Surviving Spouse Benefit

Eligibility: Worker must have been Fully Insured at time of death.

Amount: 60% of the Basic Benefit earned at the time of death, subject to the earnings test. Paid until the earlier of the date the spouse remarries or dies. This benefit is reduced by any Old Age Insurance Benefit that the spouse may be entitled to based on his or her own earnings history.

Surviving Child Benefit

Eligibility: Worker must have been Fully or Currently Insured at time of death.

Amount: 15% of the Basic Benefit for each dependent child under the age of 18 or 22 if a student. The benefit ceases if the child marries or is adopted by a close relative.

The minimum total Survivor benefit is $50 per month and is subject to the Earnings Test.

The sum of all survivors' benefits cannot exceed 100% of the Basic Benefit earned at the time of death.

Payment to Foreign Citizens residing outside the FSM

Payments to citizens and nationals of the Republic of Palau, the Republic of the Marshall Islands and the United States shall be made as if they were citizens or nationals of the Federated States of Micronesia as long as those nations give citizens and nationals of the Federated States of Micronesia reciprocal treatment. For citizens and nationals of other countries, a lump sum payment equal to total worker paid contributions as of the date the worker turned age 60, became disabled, or died. The lump sum payment is reduced by any payments already made to the employee, surviving spouse or child before the lump sum is paid.

Lump Sum Death Benefit

Eligibility: After the death of any covered worker and rights to all survivors' benefits have ceased.

Amount: Four percent of total Maximum Covered Earnings for which contributions have been paid, less the value of any benefits already paid.

Lump Sum Benefit (other than death)

Eligibility: Age 60 and not fully insured, native born citizen of the Federated States of Micronesia or resident for at least 10 years and must have lived in the Federated States of Micronesia for at least one year immediately preceding death.

Amount: Four percent of total Maximum Covered Earnings for which contributions have been paid.

Earnings Test

Benefits are reduced by $1 for every $2 of earnings in excess of $300 received each quarter.

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