

OFICINA DEL COMISIONADO DE ASUNTOS MUNICIPALES

AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL

AREA DE ARCHIVO DIGITAL

MUNICIPIO DE ARROYO

AUDITORIA 2004-2005

30 DE JUNIO DE 2005

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO
SINGLE AUDIT REPORT
YEAR ENDED JUNE 30, 2005

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SINGLE AUDIT REPORT

YEAR ENDED JUNE 30, 2005

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SINGLE AUDIT REPORT

YEAR ENDED JUNE 30, 2005

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López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Member of:

- American Institute of Certified Public Accountants
- Puerto Rico Society of Certified Public Accountants

INDEPENDENT AUDITOR'S REPORT

**To the Honorable Mayor and
the Municipal Legislature
Municipality of Arroyo
Arroyo, Puerto Rico**

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the **Municipality of Arroyo, Puerto Rico (Municipality)**, as of and for the year ended June 30, 2005, which collectively comprise the Municipality's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Municipality's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of Brisas de Arroyo Housing Project no. 66-003-660433527, a blended component unit, which statements reflect total assets of \$2,595,659 (net of capital assets accumulated depreciation) as of June 30, 2005, and total revenues of \$490,939 for the year ended. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included in the Special Revenue Fund-FmHA Project and Statement of Net Assets for the Brisas de Arroyo Housing Project, is based on the report of the other auditors.

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the respective financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinions.

The accounting records of the **Municipality of Arroyo** related to interfund transactions are not adequate. Accordingly, we were unable to obtain sufficient evidence to support and to satisfy ourselves about the amount recorded in each major fund and the aggregate remaining fund information as due from/ due to other funds, stated at \$4,333,598 in the total governmental funds column of the Balance Sheet - governmental funds.

As explained in Note 9, the **Municipality** has not performed a study of the estimated landfill closing and postclosing costs that will be recognized in the basic financial statements, as required by the GASB No. 18, *"Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs"*. We were unable to obtain sufficient competent evidential matters through audit procedures to satisfy ourselves regarding the reasonableness of the amounts presented in the basic financial statements. Therefore, we do not express an opinion on such amount.

INDEPENDENT AUDITOR'S REPORT (CONTINUED)

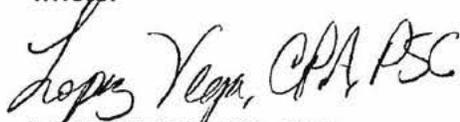
In our opinion, because of the effects of the matter discussed in the fourth paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the governmental activities of the **Municipality of Arroyo, Puerto Rico**, as of June 30, 2005, and the changes in financial position thereof for the year then ended.

In addition, in our opinion, except for the effects of the matters discussed in the third paragraph, the fund financial statements present fairly, in all material respects, the financial position of each major fund, and the aggregate remaining fund information of the **Municipality of Arroyo, Puerto Rico**, as of June 30, 2005, and the respective changes in financial position, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 3 through 12 and the Budgetary Comparison Schedule-General Fund on page 41 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 15, 2005 on our consideration of the Municipality's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

Our audit was performed for the purpose of forming an opinion on the basic financial statements of the **Municipality of Arroyo, Puerto Rico** taken as whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the respective financial statements. The information in that schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented, in all material respects, in relation to the basic financial statements taken as a whole.


LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
December 15, 2005

Stamp No. 2106097 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS

YEAR ENDED JUNE 30, 2005

This discussion and analysis of the Municipality of Arroyo (the Municipality) financial performance provides an overview of the Municipality's financial activities for the fiscal year ended on June 30, 2005. The Management Discussion and Analysis (MD&A) should be read in conjunction with the accompanying basic financial statements and the accompanying notes to those financial statements. The discussion and analysis includes comparative data for prior year as this information is available for the fiscal year ended on June 30, 2004, first year of implementation of Governmental Accounting Standards Board (GASB) Statement No. 34, "*Basic Financial Statements - and Management's Discussion and Analysis-for State and Local Governments.*" This MD & A is prepared in order to comply with such pronouncement and, among other purposes, to provide the financial statements users with the following major information:

1. a broader basis in focusing important issues;
2. acknowledgement of an overview of the Municipality's financial activities;
3. provide for an evaluation of its financial condition as of the end of the indicated fiscal year, compared with prior year results;
4. identification of uses of funds in the financing of the Municipality's variety of activities and;
5. assess management's ability to handle budgetary functions.

FINANCIAL HIGHLIGHTS

The following comments about the financial condition and results of operations as reflected in the financial statements prepared for fiscal year 2005 deserve special mention:

1. Total assets of the Municipality amounted to \$20,121,302, virtually remained unchanged as result of this year's operations;
2. At the end of fiscal year 2005, total liabilities amounted to \$16,453,940. Out of said amount, \$13,381,361 corresponded to long-term liabilities of which \$5,015,789 represented the outstanding balance of bonds and notes issued. The Municipality continued to meet all debt service requirements, most of which was paid from self generated revenues;
3. Total net assets of the Municipality amounted to 3,667,362 which represents an increase of 5% compared to prior fiscal year;
4. Total revenues available for the financing of activities as reflected in the Statement of Activities amounted to \$11,523,974, derived from the following sources: \$112,143 charges for services; \$2,784,169 from operating grants and contributions; \$1,280,122 from capital grants and contributions obtained from other sources, and \$7,347,540 from general revenues available;

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

FINANCIAL HIGHLIGHTS (CONTINUED)

5. Total expenses incurred to afford the cost of all functions and programs as reflected in the Statement of Activities amounted to \$11,340,001;
6. As reflected in the Statement of Activities, the current fiscal year operations contributed to an increase in the Net Assets figure by \$183,973;
7. As of the close of the current fiscal, the Municipality's Governmental Funds reported combined ending fund balances of \$921,223;
8. As the end of the current fiscal year the Municipality's General Fund deficit amounted to \$3,284,843, compared to a fund deficit of \$3,045,154 in the prior fiscal year;
9. The actual General Fund budgetary activities resulted in an unfavorable balance of \$649,733.

FUNDAMENTALS OF FINANCIAL STATEMENTS PRESENTATION

The new approach used in the presentation of the financial statements of the Municipality is based on a government-wide view of such statements as well as a presentation of individual funds behavior during fiscal year 2005. The combination of these two perspectives provide the user the opportunity to address significant questions concerning the content of said financial statements, and provide the basis for a comparable analysis of future years performance. The comparative analysis is a meaningful and useful management tool for municipal management in the decision making process.

Under the aforementioned approach, assets and liabilities are recognized using the accrual basis of accounting which is similar to the method used by most private enterprises. This means that current year's revenues and expenses are accounted for regardless of when cash is received or paid.

FINANCIAL STATEMENTS COMPONENTS

The basic financial statements consist of the government wide financial statements, the major funds financial statements and the notes to the financial statements which provide details, disclosure and description of the most important items included in said statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

FINANCIAL STATEMENTS COMPONENTS (CONTINUED)

The Statement of Net Assets reflects information of the Municipality as a whole of a consolidated basis and provides relevant information about its financial strength as reflected at the end of the fiscal year. Such financial level is measured as the difference between total assets and liabilities, with the difference between both items reported as net assets. It is important to note that although municipalities as governmental public entities were not created to operate under a profit motive framework, the return on assets performance plays an important role in their financial operations. The higher the increments achieved in net revenues, the higher the capacity to increase the net assets figure either thru additional borrowings or thru internally generated funds. This in turn will benefit the welfare of Arroyo constituents.

The Statement of Activities is focused on both gross and net cost of the various activities of the Municipality. It presents information which shows the changes in the Municipality's net assets at the most recent fiscal year. Based on the use of the accrual basis of accounting, changes are reported as soon as the underlying event occurs, regardless of the timing of the related cash flows. Under said approach, revenues and expenses are reported in the Statement of Activities based on the theory that it will result in cash flows to be realized in future periods.

A brief review of The Statements of Activities of the Municipality at June 30, 2005, shows total expenses incurred to afford the cost of all functions and programs amounted to \$11,340,001. Upon examining the sources of revenues for the financing of said programs, the Statement reflects that \$4,176,434 was derived from the following sources: \$112,143 charges for services; \$2,784,169 from operating grants and contributions; and \$1,280,122 from capital grants and contributions obtained from other sources. General revenues for the year amounted to \$7,347,540. When such figure is added to the \$4,176,434 previously mentioned, total revenues available for the financing of activities amounted to \$11,523,974. There was an excess of revenues over expenses in the amount of \$183,973 which contributed with an increase to the figure of net assets attained at the end of the fiscal year.

The Fund Financial Statement is another important component of the Municipality's financial statements. A fund is a grouping of related accounts that are used to maintain accountability and controls over economic resources of the Municipality that have been segregated for specific activities. The Municipal fund type of accounting is used to demonstrate compliance with related legal requirements. Information offered thru this Statement is limited to the Municipality most significant funds and is particularly related to the local government only, instead of the government as a whole. Government funds are used to account for essentially the same functions as those reported as governmental activities. The funds are reported using an accounting method known as modified accrual accounting which measures cash and all other financial assets that can be readily converted into cash.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

FINANCIAL STATEMENTS COMPONENTS (CONTINUED)

The fund statement approach gives the user a short term view of the Municipality's government operations and the basic services it provides. Since the focus of government funds is narrower than that of the financial statements as a whole, it also helps the user with comparable information presented in the governmental activities report. By doing so, readers of the basic financial statements may understand better the long-term effect of the Municipality's short-term financial decisions.

INFRASTRUCTURE ASSETS

Historically, a significant group of infrastructure assets such as roads, bridges, traffic signals, underground pipes not associated with utilities, have not been recognized nor depreciated in the accounting records of the Municipality. GASB 34 requires that such type of assets be inventoried, valued and reported under the governmental column of the Government-Wide Statement. As of July 1, 2002, the Municipality commenced the prospective reporting of infrastructure assets. The Municipality expects to retroactively report historical costs of infrastructure assets during the fiscal year beginning on July 1, 2006.

According to the requirements of GASB 34, the government must elect to either (a) depreciate the aforementioned assets over their estimated useful life or (b) develop a system of asset management designed to maintain the service delivery to near perpetuity. If the government develops the asset management system, (the modified approach) which periodically (at least every three years), by category, measures and demonstrate its maintenance of locally established levels of service standards, the government may record its cost of maintenance in lieu of depreciation. In this particular respect, the Municipality has elected the use of recognizing depreciation under the useful life method and it contemplates to continue this treatment on said basis.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

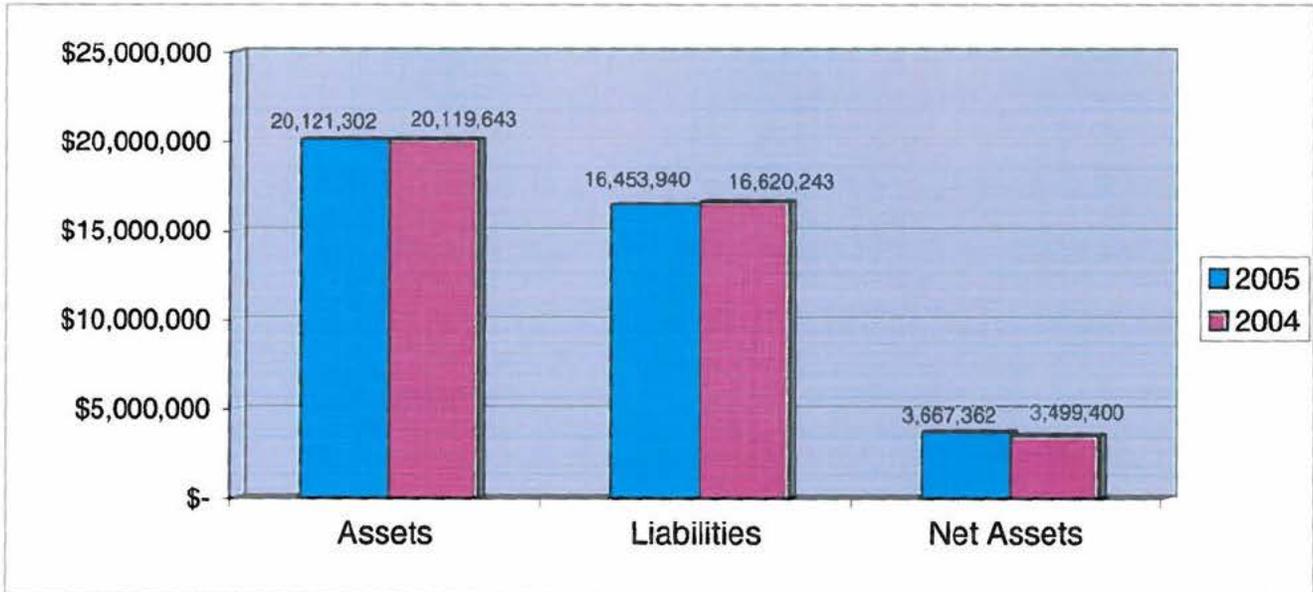
YEAR ENDED JUNE 30, 2005

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE

Net Assets

The Statement of Net Assets serves as an indicator of the Municipality's financial position at the end of the fiscal year. In the case of the Municipality of Arroyo, primary government liabilities exceeded total assets by \$3,667,362 at the end of 2005, compared to \$3,499,400 at the end of the previous year, as showed in the following condensed Statement of Net Assets of the Primary Government.

Condensed Statement of Net Assets	2005	2004	Change	%
Current and other assets	\$ 3,798,902	\$ 4,169,237	\$ (370,335)	(9%)
Capital assets	16,322,400	15,950,406	371,994	2%
Total assets	20,121,302	20,119,643	1,659	-
Current and other liabilities	3,072,579	3,002,263	70,316	2%
Long-term liabilities	13,381,361	13,617,980	(236,619)	(2%)
Total liabilities	16,453,940	16,620,243	(166,303)	(1%)
Invested in capital assets, net of related debt	12,787,089	12,369,678	417,411	3%
Restricted	4,151,695	4,234,964	(83,269)	(2%)
Unrestricted deficit	(13,271,422)	(13,105,242)	(166,180)	1%
Total net assets	\$ 3,667,362	\$ 3,499,400	\$ 167,962	5%



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE (CONTINUED)

Changes in Net Assets

The Statement of Activities reflects that for fiscal year 2005, the net effect of revenues derived from several programs plus current operating revenues compared to the total expenses, amounted to \$167,962 increase in the Municipality's net assets. Approximately 26 percent of the Municipality's total revenue came from taxes, while 71 percent resulted from grants and contributions, including federal aid. The Municipality's expenses cover a range of services. The largest expenses were for general government, health and welfare services, public works, and community development. As follow, is presented a comparative analysis of governmental-wide data. With this analysis, the readers have comparative information with the percentage of change in revenues and expenses from prior year to current year.

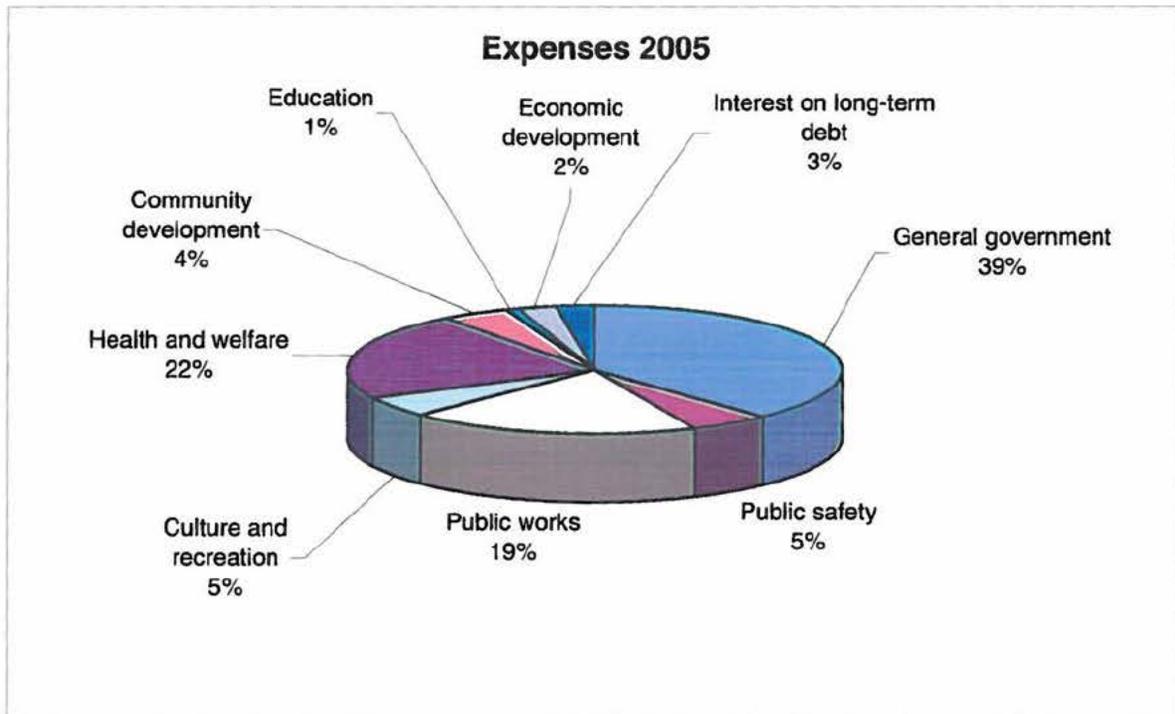
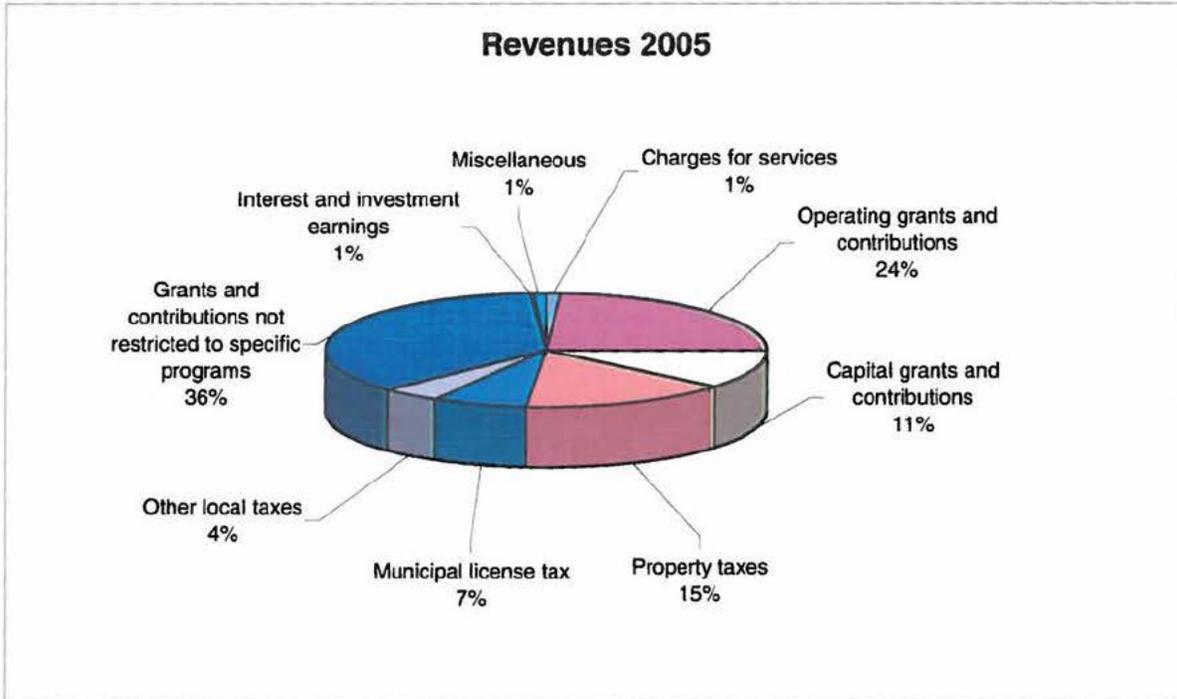
Condensed Statement of Activities	2005	2004	Change	%
Program revenues:				
Charges for services	\$ 112,143	\$ 743,557	\$ (631,414)	(85%)
Operating grants and contributions	2,784,169	3,122,651	(338,482)	(11%)
Capital grants and contributions	1,280,122	1,597,777	(317,655)	(20%)
General revenues:				
Property taxes	1,743,060	1,772,310	(29,250)	(2%)
Municipal license tax	814,085	364,220	449,865	124%
Other local taxes	510,605	794,257	(283,652)	(36%)
Grants and contributions not restricted to specific programs	4,138,413	4,359,413	(221,000)	(5%)
Interest and investment earnings	60,916	47,918	12,998	27%
Gain (loss) on retirement of capital assets		(725)	725	(100%)
Miscellaneous	80,461	7,772	72,689	935%
Total revenues	11,523,974	12,809,150	(1,285,176)	(10%)
Expenses:				
General government	4,302,659	3,310,327	992,332	30%
Public safety	623,542	870,334	(246,792)	(28%)
Public works	2,172,351	2,284,770	(112,419)	(5%)
Culture and recreation	587,887	538,414	49,473	9%
Health and welfare	2,494,893	2,236,749	258,144	12%
Community development	482,318	1,076,662	(594,344)	(55%)
Education	116,856	122,118	(5,262)	(4%)
Economic development	268,573	242,639	25,934	11%
Interest on long-term debt	290,922	318,956	(28,034)	(9%)
Total expenses	11,340,001	11,000,969	339,032	3%
Change in net assets	183,973	1,808,181	(1,624,208)	(90%)
Net assets, beginning of year, as restated	3,483,389	1,691,219	1,792,170	106%
Net assets, end of year	\$ 3,667,362	\$ 3,499,400	\$ 167,962	5%

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE (CONTINUED)



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

FINANCIAL ANALYSIS OF THE MUNICIPALITY'S INDIVIDUAL FUNDS

Governmental Funds

The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the Municipality's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the Municipality's governmental funds reported combined ending fund balances of \$921,223, a decrease of \$303,908 in comparison with the prior year. There are reservations of fund balance amounting to \$4,675,224. This is the fund balance that it is not available for new spending because it has already been committed 1) to liquidate contracts and purchase orders of the prior fiscal year (\$451,035), 2) to pay debt service (\$439,417), 3) to pay for capital projects (\$570,100) and 4) for other purposes (\$3,214,672).

Within the governmental funds, it is included the general fund which is the chief operating fund of the Municipality. As of June 30, 2005, the general fund has an undesignated fund deficit of \$3,754,001.

GENERAL FUND BUDGETARY HIGHLIGHTS

Over the course of the year, the Municipality Council revised the Municipality's budget in order to include increases in revenues that were identified during the course of the fiscal year based on current developments that positively affected the Municipality's finances. Increases in budgeted expenditures were also made since the law mandates a balanced budget.

The actual General Fund budgetary activities resulted in an unfavorable balance of \$649,733.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The Municipality has not maintained complete and adequate records related to the Capital Assets acquired and constructed in the past years, but the Municipality expects to compile documents and other information in the next fiscal years in order to attain complete and accurate records of its Capital Assets, and then, comply with such requirement. The Municipal Administration expects to develop a broad and comprehensive identification and assessments project of all fixed assets owned by the local government in order to capitalize them in its Statement of Net Assets, and then, reflects the correct net assets figure of the Municipality as a whole.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

CAPITAL ASSETS AND DEBT ADMINISTRATION (CONTINUED)

The Municipality's investment in capital assets as of June 30, 2005, amounts to \$26,240,030, net of accumulated depreciation of \$9,917,630 (including depreciation charges for the year totaled \$649,558, leaving a net book value of \$16,322,400. This investment in capital assets includes land, construction in progress, buildings, improvements, equipment, infrastructure and vehicles. Infrastructure assets are items that are normally immovable and of value only to the state, such as roads, bridges, streets and sidewalks, drainage systems, lighting systems, and similar items.

The Municipality finances a significant portion of its construction activities through bond or notes issuances. The proceeds from bond and notes issuances designated for construction activities are committed in its entirety for such purposes and cannot be used for any other purposes. As of June 30, 2005, the Municipality has \$1,242,874 of unexpended proceeds mainly from bond and notes issuances that are committed to future construction activities.

Debt Administration

The Puerto Rico Legislature has established a limitation for the issuance of general obligation municipal bonds and notes for the payment of which the good faith, credit and taxing power of each municipality may be pledged.

The applicable law also requires that in order for a Municipality to be able to issue additional general obligation bonds and notes such Municipality must have sufficient "payment capacity". Act No. 64 provides that a Municipality has sufficient "payment capacity" to incur additional general obligation debt if the deposits in such municipality's Redemption Fund and the annual amounts collected with respect to such Municipality's Special Additional Tax (as defined below), as projected by GDB, will be sufficient to service to maturity the Municipality's outstanding general obligation debt and the additional proposed general obligation debt ("Payment Capacity").

The Municipality is required under applicable law to levy the Special Additional Tax in such amounts as shall be required for the payment of its general obligation municipal bonds and notes. In addition, principal of and interest on all general obligation municipal bonds and notes and on all municipal notes issued in anticipation of the issuance of general obligation bonds issued by the Municipality constitute a first lien on the Municipality's Basic Tax revenues. Accordingly, the Municipality's Basic Tax revenues would be available to make debt service payments on general obligation municipal bonds and notes to the extent that the Special Additional Tax levied by the Municipality, together with moneys on deposit in the Municipality's Redemption Fund, are not sufficient to cover such debt service. It has never been necessary to apply Basic Taxes to pay debt service on general obligation debt of the Municipality.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2005

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

The Municipality relies primarily on property and municipal taxes as well as federal and state grants to carry out the governmental activities. Historically, property and municipal taxes have been very predictable with increases of approximately five percent. Federal and State grant revenues may vary if new grants are available but the revenue also is very predictable. Those factors were considered when preparing the Municipality's budget for the fiscal year 2005-2006.

FINAL COMMENTS

The Municipality is an autonomous governmental entity whose powers and authority vested on its Executive and Legislative Branches are specifically established in the Municipal Autonomous Act approved in August 1991. By virtue of such powers, it provides a wide range of services to its constituents which includes, among others, public works, education, public safety, public housing, health, community development, recreation, waste disposal, welfare and others. The Municipality's principal sources of revenues are derived from property taxes, municipal license taxes, subsidies from the Commonwealth of Puerto Rico's General Fund and contributions from the Traditional and Electronic Lottery sponsored by said Government.

The Municipality's management is committed to a continued improvement in the confection of a budget that will response to the needs of the public and private sectors in accordance with its permissible revenues levels. Such has been the case of the financial operation corresponding to fiscal year 2005. It further contemplates to improve its current figure of net assets, which has been identified as one of the main short and long-term objectives of the Municipality.

FINANCIAL CONTACT

The Municipality's financial statements are designed to present users (citizens, taxpayer, customers, investors and creditors) with a general overview of the Municipality's finances and to demonstrate the Municipality's accountability. If you have questions about the report or need additional financial information, contact the Municipality's Chief Financial Officer at P.O. Box 477, Arroyo, Puerto Rico 00714-0477, or call (787) 839-2030.

Commonwealth of Puerto Rico
Municipality of Arroyo
Statement of Net Assets
June 30, 2005

	Governmental Activities
Assets	
Cash and cash equivalents	\$ 909,416
Cash with fiscal agent	2,009,488
Accounts receivable:	
Municipal license tax	200,000
Property tax	32,003
Intergovernmental	633,471
Interest	785
Other	13,739
Capital assets	
Land, improvements, and construction in progress	4,468,528
Other capital assets, net of depreciation	11,853,872
Total capital assets	<u>16,322,400</u>
Total assets	<u>20,121,302</u>
Liabilities	
Accounts payable and accrued liabilities	1,482,659
Bank overdraft	355,011
Due to other governmental entities	580,991
Deferred revenues:	
Municipal license tax	444,872
Federal grant revenues	136,552
Interest payable	72,494
Noncurrent liabilities:	
Due within one year	636,967
Due in more than one year	12,744,394
Total liabilities	<u>16,453,940</u>
Net Assets	
Invested in capital assets, net of related debt	12,787,089
Restricted for:	
Capital projects	570,100
Debt service	366,923
Other purpose	3,214,672
Unrestricted (deficit)	<u>(13,271,422)</u>
Total net assets	<u>\$ 3,667,362</u>

The notes to the financial statements are an integral part of this statement.

**Commonwealth of Puerto Rico
Municipality of Arroyo
Statement of Activities
For the Year Ended June 30, 2005**

Functions/Programs	Expenses	Program Revenues			Net (Expense) Revenue and Changes in Net Assets
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities
General government	\$ 4,302,659	\$ 718	\$ 152,720	\$ -	\$ (4,149,221)
Public safety	623,542	9,172	4,268		(610,102)
Public works	2,172,351	21,801	261,444	434,914	(1,454,192)
Health and welfare	2,494,893		1,962,131		(532,762)
Culture and recreation	587,887	80,452	105,200		(402,235)
Economic development	268,573		239,569		(29,004)
Community development	482,318			845,208	362,890
Education	116,856		58,837		(58,019)
Interest on long-term debt	290,922				(290,922)
Total governmental activities	\$ 11,340,001	\$ 112,143	\$ 2,784,169	\$ 1,280,122	(7,163,567)
General revenues:					
Property taxes					1,743,060
Municipal license tax					814,085
Other local taxes					510,605
Grants and contributions not restricted to specific programs					4,138,413
Interest and investment earnings					60,916
Miscellaneous					80,461
Total general revenues					7,347,540
Change in net assets					183,973
Net assets - beginning, as restated					3,483,389
Net assets - ending					\$ 3,667,362

Commonwealth of Puerto Rico
Municipality of Arroyo
Balance Sheet
Governmental Funds
June 30, 2005

	General Fund	Special Revenue Fund Local and State Grants	Special Revenue Fund Federal Grants	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
Assets						
Cash and cash equivalents	\$ -	\$ 11,780	\$ 138,491	\$ -	\$ 759,145	\$ 909,416
Cash with fiscal agent	357,755			1,242,874	408,859	2,009,488
Accounts receivable:						
Municipal license tax	200,000					200,000
Property Tax					32,003	32,003
Intergovernmental		63,061	565,402		5,008	633,471
Interest					785	785
Due from other funds	1,039,850	2,930,804	18,331	344,613		4,333,598
Other					8,254	8,254
Other assets					5,485	5,485
Total assets	\$ 1,597,605	\$ 3,005,645	\$ 722,224	\$ 1,587,487	\$ 1,219,539	\$ 8,132,500
Liabilities and Fund Balances						
Liabilities :						
Bank overdraft	\$ 355,011	\$ -	\$ -	\$ -	\$ -	\$ 355,011
Accounts payable and accrued liabilities	705,443	21,755	126,173	373,512	133,370	1,360,253
Due to other governmental entities	580,991					580,991
Due to other funds	2,796,131	342,072	478,841	643,875	72,679	4,333,598
Deferred revenues:						
Municipal license tax	444,872					444,872
Federal grant revenues			117,210		19,342	136,552
Total liabilities	4,882,448	363,827	722,224	1,017,387	225,391	7,211,277
Fund balances:						
Reserved for:						
Encumbrances	451,035					451,035
Capital projects				570,100		570,100
Other purposes		2,641,818				2,641,818
Reserved reported in nonmajor funds:						
Debt service fund					439,417	439,417
Other purposes	18,123				554,731	572,854
Unreserved:						
Undesigned	(3,754,001)					(3,754,001)
Total fund balances	(3,284,843)	2,641,818		570,100	994,148	921,223
Total liabilities and fund balances	\$ 1,597,605	\$ 3,005,645	\$ 722,224	\$ 1,587,487	\$ 1,219,539	

Amounts reported for governmental activities in the statement of net assets are different because:

Accrual basis of accounting accounts payable recognized in government-wide financial statements	(122,406)
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds	16,322,400
Long-term liabilities and accrued interests are not due and payable in the current period, and therefore, are not reported in the funds	(13,453,855)
Net assets of governmental activities	\$ 3,667,362

Commonwealth of Puerto Rico
Municipality of Arroyo
Statement of Revenues, Expenditures and Changes in Fund Balances
Governmental Funds
For the Year Ended June 30, 2005

	General Fund	Special Revenue Fund Local and State Grants	Special Revenue Fund Federal Grants	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
Revenues						
Property taxes	\$ 1,413,298	\$ -	\$ -	\$ -	\$ 329,762	\$ 1,743,060
Municipal license taxes	814,085					814,085
Licenses, permits and other local taxes	511,005					511,005
Intergovernmental	4,291,133	449,244	50,367	434,914		5,225,658
Rent of property	95,137				490,939	586,076
Fines and forfeitures	9,172					9,172
Interest	60,916					60,916
Federal grants			1,385,262		1,050,450	2,435,712
Miscellaneous	99,536	21,025	519		31,177	152,257
Total revenues	7,294,282	470,269	1,436,148	434,914	1,902,328	11,537,941
Expenditures						
Current:						
General government	4,200,509	4,149				4,204,658
Public safety	579,536	42,813	4,269			626,618
Public works	1,579,118	141,926	216,913	159,747		2,097,704
Health and welfare	620,695	79,251	369,735	1,989	1,535,686	2,607,356
Culture and recreation	495,613	65,864				561,477
Economic development		268,573				268,573
Community development			845,231	6,396		851,627
Education		116,856				116,856
Debt service:						
Principal					200,417	200,417
Interest					306,563	306,563
Total expenditures	7,475,471	719,432	1,436,148	168,132	2,042,666	11,841,849
Excess (deficiency) of revenues over (under) expenditures	(181,189)	(249,163)		266,782	(140,338)	(303,908)
Other financing sources (uses)						
Transfers in		68,502	2,000	78,379	44,500	193,381
Transfers out	(58,500)	(68,502)	(2,000)	(64,379)		(193,381)
Total other financing sources (uses)	(58,500)			14,000	44,500	
Net change in fund balances	(239,689)	(249,163)		280,782	(95,838)	(303,908)
Fund balance (deficit), beginning, as restated	(3,045,154)	2,890,981		289,318	1,089,986	1,225,131
Fund balance (deficit), ending	<u>\$ (3,284,843)</u>	<u>\$ 2,641,818</u>	<u>\$ -</u>	<u>\$ 570,100</u>	<u>\$ 994,148</u>	<u>\$ 921,223</u>

O. Nolasco
 04/07/06

**Commonwealth of Puerto Rico
Municipality of Arroyo
Reconciliation of the Statement of Revenues,
Expenditures, and Changes in Fund Balances of
Governmental Funds to the Statement of Activities
For the Year Ended June 30, 2005**

Net Change in Fund Balances - Total Governmental Funds **\$ (303,908)**

Amounts reported for governmental activities in the Statement of Activities are different because:

Governmental Funds report capital outlays as expenditures. However, in the Government-Wide Statement of Activities and Changes in Net Assets, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount of capital assets recorded in the current period. 1,021,553

Depreciation expense on capital assets is reported in the Government-Wide Statements of Activities and Change in Net Assets, but they do not require the use of current financial resources. Therefore, depreciation expense is not reported as expenditures in Governmental Funds. (649,558)

Interest expense on long-term debt was reported in the Government-Wide Statement of Activities and Change in Net Assets, but it did not require the use of current financial resources. Therefore, interest expense was not reported as expenditures in Governmental Funds. The following amount represented the change in accrued interest from prior year. 15,641

Bonds and notes proceeds provides current financial resources to Governmental Funds, but issuing debt increase long-term liabilities in the Government-Wide Statement of Net Assets. Repayment of bonds and notes principal is an expenditure in Governmental Funds, but the repayment reduces long-term liabilities in the Government-Wide Statement of Net Assets. This is the amount paid in the current year. 200,417

Repayment of long-term Treasury Department debt is an expenditure in Governmental Funds, but the repayment reduces long-term debt in the Government-Wide Statement of Net Assets. This is the amount paid in the current year. 43,231

Repayment of long-term property tax advance debt is an expenditure in Governmental Funds, but the repayment reduces long-term property tax advance debt in the Government-Wide Statement of Net Assets. The following amount represents the change in long-term property tax advance debt from prior year. 91,666

Repayment of long-term Department of Labor and Human Resources debt is an expenditure in Governmental Funds, but the repayment reduces long-term debt in the Government-Wide Statement of Net Assets. The following amount represents the change in long-term debt with the Department of Labor and Human Resources from prior year. (65,340)

Revenues in the Statement of Activities that do not provide current financial resources are not reported as revenue in the funds. The following amount represents the change in this revenues from prior year. (13,967)

Long-term claims and judgments are reported in the Governmental-Wide Statement of Activities and Changes in Net Assets, but they do not require the use of current financial resources. Therefore, claims and judgments are not reported as expenditures in Government Funds. The following amount represent the change in long-term claims and judgments from prior year. (37,600)

Account payables reported in the Government-Wide Statement of Activities and Change in Net Assets but not reported as in the Governmental Funds because they do not require the use of current financial resources. This is the amount reported in the current period. (122,406)

Long-term compensated absences are reported in the Government-Wide Statement of Activities and Changes in Net Assets, but they do not require the use of current financial resources. Therefore, long-term compensated absences were not reported as expenditures in Governmental Funds. The following amount represents the change in long-term compensated absences from prior year. 4,244

Change In Net Assets of Governmental Activities **\$ 183,973**

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The **Municipality of Arroyo** (the Municipality) was founded on the year 1855. The Municipality's governmental system consists of an executive and legislature body. It is governed by a Mayor and a twelve member Municipal Legislature who are elected for a four-year term.

The Municipality provides a full range of services for its citizens. These services include public safety, public works, culture and recreation, health and welfare, community development, education, and other miscellaneous services.

The accounting policies and financial reporting practices of the Municipality conform to accounting principles generally accepted in the United States of America ("GAAP") as applicable to governmental units.

In June 1999, the Governmental Accounting Standards Board (GASB) issued Statement No. 34, "Basic Financial Statements and Management's and Discussion and Analysis for State and Local Governments." This Statement, known as the Reporting Model, provides for the most significant change in financial reporting for state and local governments in over 20 years and affects the way the Municipality prepares and presents financial information. The Statement was adopted as of July 1, 2002. In addition to this Statement, GASB Statement No. 37, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments: Omnibus" and GASB Statement No. 38, "Certain Financial Statement Note Disclosures" have been adopted and are reflected in these financial statements.

As part of this Statement, there is a new reporting requirement regarding the capitalization of local government infrastructure (roads, bridges, traffic signals, etc.). This requirement permits an optional four-year delay for implementation to fiscal year ended on June 30, 2007. The Municipality has elected to delay the capitalization of infrastructure.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The following is a summary of the significant accounting policies of the Municipality:

A. Component Units

In evaluating how to define the Municipality for financial reporting purposes, management has considered all potential component units. The decision to include a potential component unit in the reporting entity was made by applying the provisions of Statement No. 14, The Financial Reporting Entity, of the GASB, as amended by GASB Statement No. 39. The basic, but not the only criterion for including a potential component unit within the reporting entity is if elected officials of a primary government are financially accountable for the entity. Financial accountability exists if the primary governmental appoints a voting majority of the entity's governing body, and if either one of the following conditions exist: the primary government can impose its will on the other entity or the potential exists for the other entity to (1) provide specific financial benefits to or (2) impose specific financial burdens on the primary government. A second criterion used in evaluating potential component units is if the nature and significance of the relationship between the entity and a primary government are such that to exclude the entity from the financial reporting entity would render the financial statements misleading or incomplete. GAAP details two methods of presentation: blending the financial data of the component unit's balances and transactions in a manner similar to the presentation of the Municipality's balances and transactions or discrete presentation of the component unit's financial data in columns separate from the Municipality's balances and transactions.

Based on the above criteria, the financial statements of Brisas de Arroyo Housing Project no. 66-003-660433527 were included in the general-purpose financial statements as a blended component unit.

Blended Component Unit: Brisas de Arroyo Housing Project is a housing development consisting of one hundred four (104) dwelling units located in Arroyo, Puerto Rico. The Project is owned by the Municipality, but the activities on it are carried-on by a management agent unrelated to the Municipality. The housing development is designated to assist various segments of the general public in obtaining adequate and reasonable priced rental housing. The Project operated under financing from US Department of Agriculture Section 515 Rural Rental Housing Loans Program, and with a Section 8 New Construction and Substantial Rehabilitation Program housing assistance grant agreement with US Housing and Urban Development. For financial reporting purposes, the Housing Project is reported as if it were part of the Municipality's operations because its purpose is to provide low-income housing to citizens of the Municipality. The Financial Statements of the blended component unit can be obtained directly from the Municipality's Chief Financial Officer at P.O. Box 477, Arroyo, Puerto Rico 00714-0477, or call (787) 839-2030.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

B. Government-wide and fund financial statements

Financial information of the Municipality is presented in this report as follow:

1. Management's discussion and analysis introduces the basic financial statements and provides an analytical overview of the Municipality's financial activities.
2. The government-wide financial statements (i.e. the statement of net assets and the statement of activities) report information on all the activities of the Municipality and its component units, if any. Governmental activities, which normally are supported by taxes and intergovernmental revenues, are reported separately from business-type activities, if any, which rely to a significant extent on fees and charges for support. Interfund activity has been removed from these statements to minimize the duplicating effect on assets and liabilities within the governmental activities.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment is offset by program revenue. Direct expenses are those that are charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Taxes and other items not properly included among program revenues are reported instead as general revenues.

3. Fund financial statements focus on information about the Municipality's major governmental funds. Major individual governmental funds are reported as separate columns in the fund financial statements. The Municipality reports the following major governmental funds:

General Fund- is the accounting entity in which all governmental activity, except that which is required to be accounted for in another fund, is accounted for. Its revenues consist mainly of taxes, licenses and permits, intergovernmental revenue, charges for services and other.

Special Revenue Fund – Local and State Grants - Special Revenue Funds are used to account for revenues derived from local funds, state grants or other restricted revenue sources. The uses and limitations of each special revenue fund are specified by Municipality ordinances and state statutes.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Special Revenue Fund – Federal Grants- is the accounting entity in which revenues derived from federal grants, is accounted for. The uses and limitations of each special revenue fund are specified by Municipality ordinances or federal statutes.

Capital Projects Fund - Local, State and Federal Grants - is the accounting entity in which revenues derived from local funds, state and federal grants or other restricted revenue sources related to capital projects, is accounted for. The uses and limitations of each capital projects fund are specified by Municipality ordinances or federal and state statutes.

4. The notes to the financial statements provide information that is essential to a user's understanding of the basic financial statements.
5. Required supplementary information such as the budgetary comparison schedule-general fund and other types of data required by GASB.
6. Notes to the budgetary comparison schedule-general fund.

C. Financial reporting presentation

The accounts of the Municipality are organized on the basis of funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues, and expenditures. Fund types are as follows:

General Fund - Is the general operating fund of the Municipality. It is used to account for all governmental activity, except those required to be accounted for in another fund.

Special Revenue Fund – Local and State Grants - Special Revenue Funds are used to account for revenues derived from local funds, state grants or other restricted revenue sources. The uses and limitations of each special revenue fund are specified by Municipality ordinances or federal and state statutes.

Special Revenue Fund – Section 8 - Special Revenue Funds are used to account for revenues derived from section 8 choice voucher program. The uses and limitations of each special revenue fund are specified by Municipality ordinances or federal and state statutes.

Special Revenue Fund – Section 8 Moderate Rehabilitation - Special Revenue Funds are used to account for revenues derived from section 8 moderate rehabilitation program. The uses and limitations of each special revenue fund are specified by Municipality ordinances or federal and state statutes.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Special Revenue Fund – FmHA Housing Project - Special Revenue Funds are used to account for revenues derived from the blended component unit activities. The uses and limitations of each special revenue fund are specified by Municipality ordinances or federal and state statutes.

Special Revenue Fund – Federal Grants - Special Revenue Funds are used to account for revenues derived from federal grants. The uses and limitations of each special revenue fund are specified by Municipality ordinances or federal and state statutes.

Capital Projects Fund – State and Local Grants - Capital Projects Fund are used to account for financial resources used for the acquisition or construction of major capital facilities.

Debt Service Fund - Debt Service Fund are used to account for the accumulation of resources for and the payment of, general long-term debt principal, interest, and related costs.

D. Measurement focus, basis of accounting and financial presentation

Except for budgetary purposes, the basis of accounting used by the Municipality conform to accounting principles generally accepted in the United States of America (“GAAP”) as applicable to governmental units. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus.

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Property taxes are recognized as revenues in the year for which they are levied. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

The Municipality has elected not to apply all Statements and Interpretations issued by the Financial Accounting Standard Board after November 30, 1989, in accordance with GASB Statement No. 20.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the government considers revenues to be available if they are collected within the current period or soon enough thereafter. Expenditures are recorded when the related fund liability is incurred, except for principal and interest on general long-term debt, claims and judgments, and compensated absences, which are recognized as expenditures when payment is due. General capital asset acquisitions are reported as expenditure in governmental funds. Proceeds from issuance of general long-term debt reported as other financing sources.

Property taxes, franchise taxes, licenses, rent, and interest associated with the current fiscal period are all considered to be susceptible to accrual and so have been recognized as revenues of the current fiscal period. All other revenue items are considered to be measurable and available only when the government receives cash.

Private-sector standards of accounting and financial reporting issue prior to December 1, 1989, generally are followed in the government-wide financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. Governments also have the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. The Municipality has elected not to follow subsequent private-sector guidance.

Amounts reported as program revenues include 1) charges to customers or applicants for goods, services, or privileges provided, 2) operating grants, and contributions, and 3) capital grants and contributions, including special assessments, if any. Internally dedicated resources are reported as general revenues rather than as program revenues. Likewise, general revenues include all taxes.

When both restricted and unrestricted resources are available for use, it is the government's policy to use restricted resources first, then unrestricted resources, as they are needed.

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

E. Assets, liabilities and net assets

1. **Cash, cash equivalents, and cash with fiscal agent-** The Municipality's cash and cash equivalents are considered to be cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date of acquisition.

Cash with fiscal agent in the debt services fund represents special additional property tax collections retained by the Commonwealth of Puerto Rico and restricted for the payment of the Municipality's debt service, as established by law.

2. **Receivables and payables-** Activity between funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as either "due to/from other funds" (i.e., the current portion of interfund loans) or "advances to/from other funds" (i.e., the non-current portion of interfund loans). All other outstanding balances between funds are reported as "due to/from other funds."

Advances between funds, as reported in the fund financial statements, if any, are offset by a fund balance reserve account in applicable governmental funds to indicate that they are not available for appropriation and are not expendable available financial resources.

Receivables are stated net of estimated allowances for uncollectible accounts, which are determined, based upon past collection experience and current economic conditions. Intergovernmental receivable in the special revenue or capital project funds represent amounts owed to the Municipality for reimbursement of expenditures incurred pursuant to federally funded or state funded programs.

3. **Inventories-** Inventories in the general fund is recorded as expenditure and, consequently, the inventory is not recorded in the statement of net assets.
4. **Capital assets-** Capital assets, which include property, equipment and infrastructure assets (e.g., roads, bridges, sidewalks and similar items), are reported in the governmental activities column in the governmental-wide financial statements. The Municipality defines capital asset as assets with an initial, individual cost of more than \$25 and an estimated useful life in excess of one year. Such assets are reported at historical cost or estimated historical cost if purchased or constructed. Donated capital assets are recorded at estimated fair market value at the date of donation.

The cost of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Major outlays for capital assets and improvements are capitalized as projects are constructed.

Capital assets of the Municipality are depreciated using the straight-line method over the following estimated useful lives:

<u>Description</u>	<u>Useful Life</u>	<u>Capitalization threshold</u>
Buildings and site improvements	40 years	\$1
Infrastructure	40 years	\$1
Works of art	10 years	\$1
Vehicles	5 years	\$1
Furniture and fixtures	5 years	\$25
Machinery and equipment	3 to 5 years	\$25

- 5. Long-term obligations-** The liabilities reported in the government-wide financial statements included general and special obligation bonds and notes, and other long-term liabilities, such as vacation, sick leave, litigation, long-term liabilities to other governmental entities.

In the fund financial statements, governmental fund types recognize bond issuances cost, during the current period. The face amount of debt issued is reported as other financing sources, while bond issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures.

- 6. Compensated absences-** Employees accumulate vacation leave at a rate of 2.5 days per month up to a maximum of 60 days. Unpaid vacation time accumulated is fully vested to the employees from the first day of work. All vacation pay is accrued when incurred in the government-wide financial statements.

Employees accumulate sick leave at a rate of 1.5 days per month up to a maximum of 90 days. Upon retirement, an employee receives compensation for all accumulated and unpaid sick leave at the current rate, if the employee has at least 10 years of service with the Municipality.

- 7. Claims and judgments-** The estimated amount of the liability for claims and judgments, which is due on demand, such as from adjudicated or settled claims, is recorded in the general fund.

- 8. Reservation of fund balance-** Reservations of fund balance in the fund financial statements, represent portions of fund balances that are legally segregated for specific future use or are not appropriated for expenditure. The Municipality has the following reservations of fund balance:

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

- a. **Capital Projects-** Represent the reservation of amounts to be used for future expenditures for capital projects under contracts and other commitments. These committed amounts generally will become liabilities in future periods as the projects are completed.
 - b. **Encumbrances-** Represent future expenditures under purchase orders, contracts and other commitments. These committed amounts generally will become liabilities in future periods as the goods or services are received.
 - c. **Other Purposes-** Represents net assets available for specific use and/or legally segregated for other specific future use.
 - d. **Debt Service Fund-** Represents net assets available to finance future debt service payments.
- 9. Interfund and intra-entity transactions-** The Municipality has the following types of transactions among funds:
- a. **Operating Transfers-** Legally required transfers that are reported when incurred as "Operating transfer-in" by the recipient fund and as "Operating transfers-out" by the disbursing fund.
 - b. **Intra-Entity Transactions-** Transfers between the funds of the primary government are reported as interfund transfers with receivables and payables presented as amounts due to and due from other funds.
- 10. Risk financing-** The Municipality carries commercial insurance to cover casualty, theft, tort claims and other losses. Insurance policies are negotiated by the Puerto Rico Treasury Department and costs are allocated among all the Municipalities of Puerto Rico.

Cost of insurance allocated to the Municipality and deducted from the gross property tax collections by the Municipal Revenue Collection Center ("CRIM") for the year ended June 30, 2005 amounted to approximately \$174,046. The current insurance policies have not been cancelled or terminated. The CRIM also deducted approximately \$185,719 for workers compensation insurance covering all municipal employees.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

11. Reconciliation of Government-wide and Fund Financial Statements

The governmental fund balance sheet includes reconciliation between fund balance-total governmental funds and net assets-governmental activities as reported in the government-wide statement of net assets. The two elements of that reconciliation explains that "long term liabilities, including compensated absences, bonds and notes payable, are not due and payable in the current period and therefore are not reported in the funds.", and that "capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds. The details of this reconciliation are as follows:

		<u>Total Net Assets Governmental Activities</u>
<u>Net assets invested in capital assets, net of related debt</u>		
Capital assets, net of depreciation	\$ 16,322,400	
Deduct:		
Section 515 direct loan	(2,075,581)	
Bonds payable related to capital assets	<u>(1,459,730)</u>	\$ 12,787,089
<u>Net assets restricted for capital projects</u>		
Fund balance restricted for capital projects		570,100
<u>Net assets restricted for debt service</u>		
Fund balance restricted for debt service	439,417	
Deduct:		
Interest payable	<u>(72,494)</u>	366,923
<u>Net assets restricted for other purposes</u>		
Fund balances restricted for other purpose		3,196,549
<u>Net assets unrestricted (deficit)</u>		
General fund - total fund balance:	\$ (3,284,843)	
Deduct:		
Accrued basic accounts payable	(122,406)	
Deduct:		
Bonds Payable	(1,430,478)	
Notes Payable	(50,000)	
Property Tax Advances	(3,125,940)	
Property Tax - Treasury	(216,159)	
Compensated absences	(1,169,715)	
Landfill obligation	(3,743,418)	
Unemployment	(65,340)	
Claims and judgments	<u>(45,000)</u>	(13,253,299)
Total net assets - governmental activities		<u>\$ 3,667,362</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

2. DEPOSITS

Under Puerto Rico statutes public funds deposited in commercial banks must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of Puerto Rico. In addition, the Municipality maintains deposits with the Government Development Bank for Puerto Rico (GDB).

The Municipality's bank balances in commercial banks of \$11,780 in the special revenue fund – local and state grants and \$138,491 in the special revenue fund – federal grants were fully collateralized at June 30, 2005. In the other governmental funds there were deposits with commercial banks of \$759,145 that were fully collateralized.

The deposits at GDB of \$357,755 in the general fund, the \$1,242,874 in the capital projects fund and \$408,859 in the other governmental funds that is restricted for debt service fund, are unsecured and uncollateralized, as no collateral is required to be carried by governmental banks.

3. RECEIVABLES

A. *Municipal License Tax*- The Municipality impose a municipal license tax on all businesses that operate within the Municipality, which are not totally or partially exempt from the tax pursuant to the Industrial Incentives Acts of the Commonwealth of Puerto Rico. This is a self-assessed tax based on the business volume in gross sales as shown in the tax return that is due on April 15 of each year. Entities with sales volume of \$1,000,000 or more must include audited financial statements together with the tax return. During the fiscal year ended June 30, 2005, the tax rates were as follows:

1. Financial business- 1.50% of gross revenues
2. Other organizations- 0.50% of gross revenues

This tax is due in two equal installments on July 1 and January 1 of each fiscal year. A discount of 5% is allowed when full payment is made on or before April 15. Municipal license tax receivable represents filed municipal license tax returns that were uncollected as of June 30, 2005, net of allowance for uncollectible.

Municipal license taxes collected prior to June 30 but pertaining to the next fiscal year are recorded as deferred revenues.

B. *Property Tax Receivables*- Property tax receivable in the other governmental funds represents the amounts due from the CRIM resulting from the excess of current year property tax collections over current year advances. Following is a detail of the property tax receivable:

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

3. RECEIVABLES (CONTINUED)

<u>Governmental Entity</u>	<u>Amount</u>
Municipal Revenue Collection Center (CRIM)	\$ 32,003
Total	\$ 32,003

C. **Intergovernmental Receivables**- Intergovernmental receivable in special revenue fund - Local and State Grants represent expenditures incurred not yet reimbursed by a state agency. Following is a detail of the intergovernmental receivable:

<u>Program Description</u>	<u>Amount</u>
Commonwealth of Puerto Rico-Department of Labor and Human Resources- Law 52 Grant	\$ 63,061
Total	\$ 63,061

Intergovernmental receivable in special revenue fund - federal grants represent expenditures incurred not yet reimbursed by the pass-through grantors. Following is a detail of the intergovernmental receivable:

<u>Program Description</u>	<u>Amount</u>
Community Development Block Grant	\$ 155,568
Child Care and Development Block Grant	375,568
Hazard Mitigation Grant	28,110
Others	6,156
Total	\$ 565,402

Intergovernmental receivable in the other governmental funds represent expenditures incurred not yet reimbursed by the pass-through grantors. Following is a detail of the intergovernmental receivable:

<u>Program Description</u>	<u>Amount</u>
Lower Income Housing Assistance Program - Section 8 Moderate Rehabilitation	\$ 5,008
Total	\$ 5,008

4. INTERFUND TRANSACTIONS

Interfund receivables and payables at June 30, 2005, and interfund transfers during the fiscal year ended at June 30, 2005, are summarized as follows:

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

4. INTERFUND TRANSACTIONS

a. Due from/to other fund:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Purpose</u>	<u>Amount</u>
General Fund	Special Revenue Fund- Local and State Grants	Payroll and related accruals paid and not reimbursed, and other reimbursable expenditures	\$ 323,250
General Fund	Special Revenue Fund- Federal Grants	Payroll and related accruals paid and not reimbursed, and other reimbursable expenditures	478,841
General Fund	Capital Projects Fund	Payroll and related accruals paid and not reimbursed, and other reimbursable expenditures	165,080
General Fund	Other Governmental Funds	Payroll and related accruals paid and not reimbursed, interest revenue, and other reimbursable expenditures	72,679
Special Revenue Fund- Local and State Grants	General Fund	Cash pool in the same bank account and other reimbursable expenditures	2,452,009
Special Revenue Fund- Local and State Grants	Capital Projects Fund	Cash pool in the same bank account	478,795
Special Revenue Fund- Federal Grants	Special Revenue Fund- Local and State Grants	Reimbursable expenditures	18,331
Capital Projects Fund	Special Revenue Fund- Local and State Grants	Reimbursable expenditures	491
Capital Projects Fund	General Fund	Cash pool in the same bank account and other reimbursable expenditures	<u>344,122</u>
Total			<u>\$ 4,333,598</u>

b. Transfer in/out to other fund

<u>Transfer out</u>	<u>Transfer in</u>	<u>Purpose</u>	<u>Amount</u>
General Fund	Debt Service Fund	Debt retirement	\$ 44,500
General Fund	Capital Projects Fund	Transfer of funds to Capital Projects Fund	14,000
Special Revenue Fund - Local and State Grants	Special Revenue Fund - Local and State Grants	Transfer of funds to Special Revenue Fund - Local and State Grants	68,502
Special Revenue Fund- Federal Grants	Special Revenue Fund- Federal Grants	Transfer of funds to Special Revenue Fund- Federal Grants	2,000
Capital Projects Fund	Capital Projects Fund	Transfer of funds to Capital Projects Fund	<u>64,379</u>
Total			<u>\$ 193,381</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

5. CAPITAL ASSETS

Capital assets; those with an estimated useful life of one year or more from the time of acquisition by the Municipality and a cost of \$25 or more, are primarily funded through the issuance of long-term bonds and loans. A summary of capital assets and changes occurring in 2005, including those changes pursuant to the implementation of GASB Statement No. 34, follows. Land and construction in progress are not subject to depreciation:

<u>Governmental Activities:</u>	<u>Balance</u> <u>July 1, 2004</u>	<u>Additions</u>	<u>Retirements</u>	<u>Balance</u> <u>June 30, 2005</u>
Capital asset, not being depreciated:				
Land	\$ 2,880,490	\$ -	\$ -	\$ 2,880,490
Construction in progress	929,471	404,284	(340,718)	993,037
Housing Project Brisas de Arroyo	<u>595,000</u>	<u>-</u>	<u>-</u>	<u>595,000</u>
Total capital assets not being depreciated	<u>4,404,961</u>	<u>404,284</u>	<u>(340,718)</u>	<u>4,468,527</u>
Capital assets, being depreciated:				
Buildings	13,401,540	156,005		13,557,545
Building improvements	258,580	129,000		387,580
Infrastructure	1,149,977	62,900		1,212,877
Infrastructure improvements	316,235	285,382		601,617
Equipment	445,204	64,223		509,427
Furnishing	281,590	11,265		292,855
Work of Art	3,410			3,410
Computers	55,062	6,704		61,766
Vehicles	1,628,389	37,031	(119,660)	1,545,760
Housing Project - depreciable assets	<u>3,393,189</u>	<u>205,477</u>	<u>-</u>	<u>3,598,666</u>
Total capital assets being depreciated	<u>20,933,176</u>	<u>957,987</u>	<u>(119,660)</u>	<u>21,771,503</u>
Less accumulated depreciation for:				
Buildings	(5,136,187)	(338,028)		(5,474,215)
Building improvements	(18,164)	(8,591)		(26,755)
Infrastructure	(169)	(29,776)		(29,945)
Infrastructure improvements	(23,406)	(32,408)		(55,814)
Equipment	(239,204)	(67,619)		(306,823)
Furnishing	(204,309)	(23,472)		(227,781)
Work of Art	(568)	(341)		(909)
Computers	(34,725)	(9,602)		(44,327)
Vehicles	(1,541,171)	(43,442)	119,660	(1,464,953)
Housing Project - depreciable assets	<u>(2,189,829)</u>	<u>(96,279)</u>	<u>-</u>	<u>(2,286,108)</u>
Total accumulated depreciation	<u>(9,387,732)</u>	<u>(649,558)</u>	<u>119,660</u>	<u>(9,917,630)</u>
Total capital assets being depreciated, net	<u>11,545,444</u>	<u>308,429</u>	<u>-</u>	<u>11,853,873</u>
Governmental activities capital assets, net	<u>\$ 15,950,405</u>	<u>\$ 712,713</u>	<u>\$ (340,718)</u>	<u>\$ 16,322,400</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

5. CAPITAL ASSETS (CONTINUED)

Depreciation expense was charged to functions/programs of the Municipality as follows:

Governmental activities:

General government	\$ 318,187
Public safety	18,839
Public works	41,440
Culture and recreation	120,812
Community Development	53,788
Health and welfare	<u>96,492</u>

Total depreciation expense-governmental activities \$ 649,558

6. PROPERTY TAXES

The personal property tax is self assessed by the taxpayer on a return which is to be filed by May 15 of each year with the Municipal Revenue Collection Center (CRIM), a governmental entity created by the government of Puerto Rico as part of the Municipal Governmental Autonomous Law of August 1991. Real property tax is assessed by the CRIM on each piece of real estate and on each building.

The assessment is made as of January 1 of each year and is based on current values for personal property and on estimated values as of 1957 for real property tax. The tax on personal property must be paid in full together with the return by May 15. The tax on real property may be paid in two installments by July 1 and January 1. The CRIM is responsible for the billing and collections of real and personal property taxes on behalf of all the municipalities of Puerto Rico. Prior to the beginning of each fiscal year, the CRIM informs the Municipality of the estimated amount of property tax expected to be collect for the ensuing fiscal year. Throughout the year, the CRIM advances funds to the Municipality based on the initial estimated collections. The CRIM is required by law to prepare a settlement statement on a fiscal year basis, whereby a comparison is made between the amounts advanced to the Municipality and amounts actually collected from taxpayers. This settlement has to be completed on a preliminary basis not later than three months after fiscal year-end, and a final settlement made not later than six months after year-end. If the CRIM remits to the Municipality property tax advances, which are less than the tax actually collected, a receivable from the CRIM is recorded at June 30. However, if advances exceed the amount actually collected by the CRIM, a payable to the CRIM is recorded at June 30. The CRIM issued the final liquidation noting that the advances exceeded collections by \$74,257. This excess will not be funded with available expendable financial resources at June 30, 2005. Based on this, such amount was presented in the government-wide financial statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

6. PROPERTY TAXES (CONTINUED)

On December 31, 1992 the Municipality entered into an agreement with the Commonwealth of Puerto Rico for the repayment of excess property tax advances. As of June 30, 2005, the related unpaid property tax advances presented in the statement of net assets amounted to approximately \$216,159.

On January 26, 2000, Public Law 42 was enacted which authorized the CRIM to obtain a loan up to \$200,000,000, and for a term not to exceeding 10 years, to allow for the financing of the debt that the Municipalities of Puerto Rico have with the CRIM arising from final settlements of property tax advances versus actual collections through fiscal year ended June 30, 2000. The amounts that the Municipalities will collect from additional property taxes resulting from increases in the subsidy from the Commonwealth of Puerto Rico to the Municipalities are assigned through this law to repay such loan. The increase in this subsidy was the result of the Public Law 238, enacted on August 15, 1999. On October 11, 2001, Public Law 146 was enacted to amend Public Law 42, to extend the loan amortization period up to 30 years.

Also, on October 11, 2002, Public Law 172 was enacted, to provide as an option for the Municipalities to include the debt that the Municipalities of Puerto Rico have with the CRIM arising from final settlements of property tax advances versus actual collections for the fiscal year ended June 30, 2001 with the loan authorized through Public Law 42 enacted on January 26, 2000.

On June 26 1997, Public Law Num. 21 was enacted authorizing the CRIM, among other things, to sell the property tax receivables related to taxpayers who owned property taxes from 1974 to 1996. Such property tax receivables were purchased by the Public Financing Corporation, a subsidiary of the Government Development Bank of Puerto Rico (GDB) using the proceeds of a bond issuance executed for such purposes. Said Law imposed the CRIM the obligation to replace uncollectible property tax receivables with any valid property tax receivable or equivalent in money. Subsequent to the approval of the Law and to the sale transaction, it was detected that a substantial percentage of the receivables sold were uncollectible. In order to protect the economic damage to the financial structure of municipalities caused by the substitution of uncollectible tax receivables with sound collectible receivables, on October 11, 2001, Public Law 146 was approved and enacted. Through this Law, the CRIM was authorized to obtain a loan from any qualified financial institution and pay in advance the outstanding balance of the bonds issued and any related cost incurred for the purchase by the Public Financing Corporation (a GDB subsidiary) of the tax receivables. The loan is being paid by the municipalities thru a 30 year long term financing negotiated by the CRIM with GDB on behalf of such municipalities as authorized by the indicated Law.

The Government-Wide Statement of Net Assets includes an outstanding debt balance of \$2,088,451 and \$947,998 related to Law 42 and Law 146, respectively.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

6. PROPERTY TAXES (CONTINUED)

Residential real property occupied by its owner is exempt by law from the payment of property taxes on the first \$ 15,000 of the assessed value. For such exempted amounts, the Puerto Rico Treasury Department assumes payment of the basic tax to the Municipalities, except for property assessed at less than \$ 3,500 for which no payment is made. As part of the Municipal Autonomous Law of 1991, the exempt amount to be paid by the Puerto Rico Treasury department to the Municipalities was frozen as of January 1, 1992. In addition, the law grants a tax exemption from the payment of personal property taxes of up to \$ 50,000 of the assessed value to retailers having annual net sales of less than \$ 150,000.

The annual tax rate is 8.83% for real property and 6.08% for personal property of which 1.03% of both tax rates are for the redemption of public debt issued by the Commonwealth of Puerto Rico. The remaining percentage is distributed as follows: (a) 5.8% and 3.8%, respectively, represents the Municipality's basic property tax rate which is appropriated for basics and accounted for in the general fund. A portion of such amount is deposited in an equalization fund together with a percentage of the net revenues of the Puerto Rico electronic lottery and a subsidy from the Commonwealth of Puerto Rico. From such fund, a distribution is made to all municipalities; (b) 2.00% represents the ad valorem tax restricted for debt service and accounted for in the debt service fund.

7. DUE TO OTHER GOVERNMENTAL ENTITIES:

The amounts due to other governmental entities in the general fund include the following:

<u>Governmental Entity</u>	<u>Amount</u>
Puerto Rico Aqueduct and Sewer Authority	\$ 35,821
General Services Administration	8,957
PR Electric Power Authority (PREPA)	1,624
Department of Treasury	408,007
Internal Revenue Service	72,253
Retirement System Administration	<u>54,329</u>
Total	<u>\$ 580,991</u>

8. DEFERRED REVENUES

- A. **Municipal License Tax**- The deferred revenues of approximately \$444,872 in the general fund relates to municipal license tax collected in fiscal year 2004-05 that will be earned in fiscal year 2005-06.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

8. DEFERRED REVENUES (CONTINUED)

B. Federal Government- The deferred revenues presented in special revenue fund – federal grants represents the portion of federal grants received for which qualifying expenditures have not been incurred. Deferred revenues from the federal government are as follows:

<u>Program Description</u>	<u>Amount</u>
Public Assistance Grants	\$ 66,848
Juvenile Justice and Delinquency Prevention	12,340
Public Safety Partnership and Community Policing Grant	22,130
Child and Adult Care Food Program	7,433
Others	<u>8,459</u>
Total	<u>\$ 117,210</u>

The deferred revenues presented in other governmental funds represent the portion of federal grants received for which qualifying expenditures have not been incurred. Deferred revenues from the federal government are as follows:

<u>Program Description</u>	<u>Amount</u>
Section 8 Housing Choice Voucher	\$ <u>19,342</u>
Total	<u>\$ 19,342</u>

9. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2005, was as follows:

<u>Description</u>	<u>Beginning Balance</u>	<u>Borrowings or Additions</u>	<u>Payments or Deductions</u>	<u>Ending Balance</u>	<u>Due Within One Year</u>
Bonds Payable	\$ 3,025,208	\$ -	\$ (135,000)	\$ 2,890,208	\$ 155,208
Notes Payable	90,000		(40,000)	50,000	50,000
Property Tax Advances	3,217,606	89,491	(181,157)	3,125,940	196,390
Property Tax – Treasury	259,391		(43,232)	216,159	43,232
Section 515 direct loan	2,100,998		(25,417)	2,075,581	29,699
Compensated absences	1,173,959	92,854	(97,098)	1,169,715	97,098
Landfill obligation	3,743,418			3,743,418	
Unemployment		65,340		65,340	65,340
Claims and judgments	<u>7,400</u>	<u>45,000</u>	<u>(7,400)</u>	<u>45,000</u>	<u>-</u>
Total	<u>\$ 13,617,980</u>	<u>\$ 292,685</u>	<u>\$ (529,304)</u>	<u>\$13,381,361</u>	<u>\$ 636,967</u>

1. Legal debt margin- The Municipality is subject to a legal debt margin requirement, which is equal to 10% of the total assessment of property located within the Municipality plus balance of the ad valorem taxes in the debt service fund, for bonds payable to be repaid with the proceeds of property taxes restricted for debt service. In addition, before any new bonds are issued, the revenues of the debt service fund should be sufficient to cover the projected debt service requirement. Long-term debt, except for the bonds and notes payable, is paid with unrestricted funds.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

9. LONG-TERM LIABILITIES (CONTINUED)

2. Bonds payable- The Municipality issues general and special obligation bonds to provide funds for the acquisition and construction of major capital facilities. Bonds payable outstanding at June 30, 2005 are as follows:

<u>Type of bonds</u>	<u>Maturity Date</u>	<u>Original Amount</u>	<u>Range of Interest Rates</u>	<u>Balance at June 30, 2005</u>
1997-Series	1/1/2004	\$ 96,000	4.88%	\$ 5,208
2000-Series	7/1/2009	1,065,000	5.00% to 8.00%	630,000
2002-Series	7/1/2026	1,410,000	2.70% to 5.60%	1,350,000
2002-Series	7/1/2026	940,000	5.00% to 7.50%	905,000
Total general obligation bonds				<u>\$ 2,890,208</u>

These bonds are payable from the ad valorem property tax of 2.00% which is restricted for debt service and retained by the Government Development Bank for Puerto Rico for such purposes.

Annual debt service requirements to maturity for bonds payable are as follows:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>
2006	\$ 155,208	\$ 141,502
2007	160,000	170,115
2008	175,000	158,083
2009	185,000	145,070
2010	205,000	130,883
2011-2015	355,000	570,098
2016-2020	505,000	444,131
2021-2025	750,000	253,238
2026-2030	<u>400,000</u>	<u>25,672</u>
Total	<u>\$ 2,890,208</u>	<u>\$ 2,038,792</u>

3. Notes Payable- The proceeds of the issuance of notes payables were used principally to pay debt incurred in prior years and to cover the expenditures of a special event. The notes are payable as follows:

<u>Type of notes</u>	<u>Maturity Date</u>	<u>Original Amount</u>	<u>Range of Interest rates</u>	<u>Balance at June 30, 2005</u>
1987-Series	7-1-2006	\$ 440,000	0.00% to 8.50%	\$ 50,000
Section 515 loan	7-1-2029	5,125,000	7.00% to 9.00%	2,075,581
Total notes payable				<u>\$ 2,125,581</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

9. LONG-TERM LIABILITIES (CONTINUED)

The 1987 Series Note is payable with General Fund sources of revenues, and the Section 115 Note is payable with the blended component unit source of revenues

Annual debt service requirements to maturity for notes payable are as follows:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>
2006	\$ 79,698	\$ 150,019
2007	31,901	144,264
2008	41,354	141,705
2009	44,344	138,955
2010	47,550	135,999
2011-2015	265,953	627,263
2016-2020	381,360	511,856
2021-2025	547,417	345,799
2026-2030	<u>686,004</u>	<u>110,954</u>
 Total	 <u>\$ 2,125,581</u>	 <u>\$ 2,306,814</u>

4. **Compensated absences-** The government-wide statement of net assets includes approximately \$834,740 of accrued sick leave benefits, and approximately \$334,975 of accrued vacation benefits, representing the Municipality's commitment to fund such costs from future operations.
5. **Landfill obligation-** According to the Environmental Protection Agency's (EPA) regulations, the Municipality must follow certain closure functions and postclosure monitoring and maintenance procedures. In addition, the Municipality has not adopted the GASB Number 18 in order to comply with these regulations.

As of June 30, 2005, the Municipality has not performed a study of the estimated closing and postclosing cost, but accrued \$3,743,418 in the Statement of Net Assets as of June 30, 2005.

10. PENSION PLAN

The Employee's Retirement System of the Commonwealth and its Instrumentalities (the Retirement System) is a cost-sharing multiple defined benefit pension plan sponsored by, and reported as a component unit of the Commonwealth of Puerto Rico. All regular employees of the Municipality under 55 years of age at the date of employment become members of the Retirement System as a condition to their employment.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

10. PENSION PLAN (CONTINUED)

The Retirement System provides retirement, death and disability benefits pursuant to legislation enacted by the Commonwealth's legislature. Disability retirement benefits are available to members for occupational and non-occupational disabilities. Retirement benefits depend upon age at retirement and the number of years of creditable service. Benefits vest after ten years of plan participation.

Members who have attained 55 years of age and have completed at least 25 years of creditable service or members who have attained 58 years of age and have completed ten years of creditable service are entitled to an annual benefit payable monthly for life.

The amount of the annuity shall be one and one-half percent of the average compensation, as defined, multiplied by the number of years of creditable service up to twenty years, plus two percent of the average compensation, as defined, multiplied by the number of years of creditable service in excess of 20 years. In no case will the annuity be less than \$200 per month.

Participants who have completed at least 30 years of creditable service are entitled to receive the Merit Annuity. Participants who have not attained 55 years of age will receive 65 percent of the average compensation, as defined; otherwise they will receive 75 percent of the average compensation, as defined. No benefits are payable if the participant receives a refund of his/her accumulated contributions.

Commonwealth legislation requires employees to contribute 5.775% for the first \$550 of their monthly gross salary and 8.275% for the excess over \$ 550 of monthly gross salary. The Municipality is required by the same statute to contribute 9.275% of the participant's gross salary. Total Municipality contributions during the year ended June 30, 2005 amounted to approximately \$227,165.

On September 24, 1999, an amendment to Act. No. 447 of May 15, 1951, which created the Retirement System, was enacted with the purpose of establishing a new pension program (System 2000). Employee's participation in the current system as of December 31, 1999, may elect to stay in the defined benefit plan or transfer to the new program. Persons joining the Municipality on or after January 1, 2000, will only be allowed to become members of System 2000. System 2000 will reduce the retirement age from 65 years to 60 for those employees who joined the current plan on or after April 1, 1990.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

10. PENSION PLAN (CONTINUED)

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there will be a pool of pension assets, which will be invested by ERS together with those of the current defined benefit plan. The Commonwealth of Puerto Rico will not guarantee benefits at retirement age. The annuity will be based on a formula which assumes that each year the employee's contribution (with a minimum of 8.275% to the employee's salary up to a maximum of 10%) will be invested in an account which will either: (1) earn a fixed rate based on the two-year Constant Maturity Treasury Note or, (2) earn a rate equal to 75% of the return of the ERS's investment portfolio (net of management fees), or (3) earn a combination of both alternatives. Participants will receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability pensions will not be granted under System 2000. The employer's contribution (9.275% of the employee's salary) will be used to fund the current plan.

Additional information on the Retirement System is provided in its financial statements for the year ended June 30, 2005, a copy of which can be obtained from the Retirement System, Minillas Station, P.O. Box 42003, San Juan, PR 00940.

11. RISK MANAGEMENT

The Finance Department is responsible of assuring that the Municipality's property is properly insured. Annually, the Finance Department Division compiles the information of all property owned and its respective market value. After evaluating this information, the Finance Department Division submits the data regarding the Municipality's properties to the Public Insurance Department at the Department of the Treasury of the Commonwealth of Puerto Rico who is responsible for purchasing all property and casualty insurance policies of all municipalities.

12. CONTINGENCIES

The Municipality is a defendant in a number of lawsuits arising principally from claims against the Municipality for alleged improper actions, and other legal matters that arise in the ordinary course of the Municipality's activities.

With respect to pending and threatened litigation, the Municipality has reported liabilities of approximately \$45,000 for awarded and anticipated unfavorable judgments. This amount was included in the financial statements and represents the amount estimated as probable liability or a liability with a fixed or expected due date, which will require future available financial resources for its payment.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

12. CONTINGENCIES (CONTINUED)

It is management's opinion, based on the advice of the legal counsel, that the potential claims against the Municipality not covered by insurance will not materially affect the financial resources for its payment.

The Municipality participates in a number of federal financial assistance programs funded by the Federal Government. Expenditures financed by these programs are subject to financial and compliance audits by the appropriate grantor. The amount, if any, of expenditures which may be disallowed by such audits cannot be determined at this time, although the Municipality management expects such amounts, if any, will not be material.

13. BEGINNING FUND BALANCES RESTATEMENT

The following restatements have been made in the financial statements, which are reported as an adjustment to beginning fund balance or net assets:

Adjustments to fund balance of governmental funds in the fund financial statements:

Special Revenue Fund - Local and State Grants	
Reclassification of funds from Special Revenue Fund - Federal Grants	\$ 22,805
Total increase in fund balance	<u>22,805</u>
Special Revenue Fund - Federal Grants	
Reclassification of funds to Special Revenue Fund - Local and State Grants	<u>(22,805)</u>
Total decrease in fund balance	<u>(22,805)</u>
Other Governmental Funds	
To correct the Special Revenue Fund - FmHA Project prior year fund balance	<u>(16,011)</u>
Total decrease in fund balance	<u>(16,011)</u>
Net decrease in fund balance, governmental funds	<u>(16,011)</u>
Adjustments to net assets in the government-wide financial statement	
To correct the Special Revenue Fund - FmHA Project prior year fund balance	<u>(16,011)</u>
Total decrease in net assets	<u>\$ (16,011)</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO
BUDGETARY COMPARISON SCHEDULE - GENERAL FUND
(SEE NOTES TO BUDGETARY COMPARISON SCHEDULE)
YEAR ENDED JUNE 30, 2005

	<u>Budgeted Amounts</u>		Actual Amounts (Budgetary Basis) (See Note 1)	Variance with Final Budget Positive (Negative)
	Original	Final		
REVENUES:				
Property taxes	\$ 1,243,051	\$ 1,243,051	\$ 1,413,298	\$ 170,247
Fines and forfeiture	10,000	10,000	9,172	(828)
Municipal license tax	541,000	541,000	614,085	73,085
Licenses, permits and other local taxes	1,541,045	1,541,045	511,005	(1,030,040)
Intergovernmental	4,112,225	4,112,225	4,298,694	186,469
Interest	80,000	80,000	59,366	(20,634)
Rent of property	230,000	230,000	95,137	(134,863)
Miscellaneous	<u>228,098</u>	<u>228,098</u>	<u>99,536</u>	<u>(128,562)</u>
Total revenues	<u>\$ 7,985,419</u>	<u>\$ 7,985,419</u>	<u>\$ 7,100,293</u>	<u>\$ (885,126)</u>
EXPENDITURES, ENCUMBRANCES AND OTHER FINANCING USES:				
Current:				
General government	3,865,296	4,318,996	4,225,584	93,412
Public safety	700,066	603,145	597,158	5,987
Public works	1,657,736	1,770,724	1,743,752	26,972
Health and welfare	647,453	627,026	622,130	4,896
Culture and recreation	722,157	517,392	516,902	490
Operating transfer to other funds	<u>392,711</u>	<u>148,136</u>	<u>44,500</u>	<u>103,636</u>
Total expenditures, encumbrances and other financing uses	<u>7,985,419</u>	<u>7,985,419</u>	<u>7,750,026</u>	<u>235,393</u>
EXCESS (DEFICIENCY) OF REVENUES OVER (UNDER) EXPENDITURES, ENCUMBRANCES AND OTHER FINANCING SOURCES (USES)				
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (649,733)</u>	<u>\$ (649,733)</u>
Explanation of Differences:				
Sources/inflows of resources:				
Actual amounts (budgetary basis) "available for appropriation" from the budgetary comparison schedule				\$ 7,100,293
Differences-budget to GAAP:				
GAAP adjustments to revenues				<u>193,989</u>
Total revenues and other financing sources as reported on the statement of revenues, expenditures, and changes in fund balances				<u>\$ 7,294,282</u>
Uses/outflows of resources:				
Actual amounts (budgetary basis) "total charges to appropriations" from the budgetary comparison schedule				\$ 7,750,026
Differences-budget to GAAP:				
Non-budgeted expenditures				75,064
Prior year encumbrances recorded as current year expenditures for GAAP basis				145,916
Current year encumbrances recorded as expenditures for budgetary purposes				(451,035)
No budgeted transfer out				<u>14,000</u>
Total expenditures and other financing uses as reported on the statement of revenues, expenditures, and changes in fund balances				<u>\$ 7,533,971</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

YEAR ENDED JUNE 30, 2005

1. STEWARDSHIP, COMPLIANCE AND ACCOUNTABILITY

A. Budgetary Control

The Municipality's annual budget is prepared on the budgetary basis of accounting, which is not in accordance with GAAP, and represents departmental appropriations recommended by the Mayor and approved by the Municipal Legislature prior to the beginning of the fiscal year. Amendments to the budget require the approval of the Municipal Legislature. Transfers of appropriations within the budget, known as Mayor's Resolutions, do not require the approval of the Municipal Legislature.

The Municipality prepares its annual budget including the operations of the general fund.

For budgetary purposes, encumbrance accounting is used. The encumbrances (i.e., purchase orders, contracts) are considered expenditures when incurred. For GAAP reporting purposes, encumbrances outstanding at year-end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be honored during the subsequent year.

The unencumbered balance of any appropriation at the end of the fiscal year will lapse at the end of such fiscal year. Other appropriations, mainly capital project appropriations, are continuing accounts for which the Municipal Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending.

The annual budget as presented in the Budgetary Comparison Schedule-General Fund is the budget ordinance at June 30, 2005 representing the original budget. There were no supplemental appropriations for the year ended June 30, 2005.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

YEAR ENDED JUNE 30, 2005

<u>Federal Grantor/Pass-through Grantor/Program or Cluster Title</u>	<u>Federal CFDA Number</u>	<u>Pass-through Entity Identifying Number</u>	<u>Expenditures</u>
U.S. DEPARTMENT OF AGRICULTURE:			
Pass-through the Commonwealth of Puerto Rico - Department of Education: Child and Adult Care Food Program	10.558	Not Available	\$ <u>17,380</u>
Total U.S. Department of Agriculture			<u>17,380</u>
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT:			
Direct Program: Lower Income Housing Assistance Program Section 8 Moderate Rehabilitation	14.856		634,374
Direct Program: Section 8 Housing Choice Vouchers Program	14.871		416,076
Pass-through the Commonwealth of Puerto Rico - Office of the Commissioner of Municipal Affairs: Community Development Block Grants - State's Program	14.228	98-DR-07 00-FD-07 01-FD-07 02-AB-FC-RI-07 03-AB-FC-07 04-AB-FC-07	<u>847,969</u>
Total U.S. Department of Housing and Urban Development			<u>1,898,419</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Federal Grantor/Pass-through Grantor/Program or Cluster Title	Federal CFDA Number	Pass-through Entity Identifying Number	Expenditures
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES:			
Pass-through the Commonwealth of Puerto Rico - Administration for Children and Families: Child Care and Development Block Grant	93.575	Not Available	<u>351,862</u>
Total U.S. Department of Health and Human Services			<u>351,862</u>
U.S. DEPARTMENT OF HOMELAND SECURITY:			
Pass-through the Commonwealth of Puerto Rico - Governor Authorized Representative (GAR): Public Assistance Grant	83.544	1552-DR-PR	135,672
Pass-through the Commonwealth of Puerto Rico - Emergency Management Agency Pre-Disaster Mitigation Competitive Grants	97.017	Not Available	28,110
Emergency Management Performance Grant	97.042	Not Available	<u>4,269</u>
Total U.S. Department of Homeland Security			<u>168,051</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS			<u>\$2,435,712</u>

The accompanying notes are an integral part of this schedule.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

YEAR ENDED JUNE 30, 2005

1. BASIS OF PRESENTATION:

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the **Municipality of Arroyo** and is presented on the modified accrual basis of accounting. The basis of accounting is the same used to prepare the fund financial statements. The information in this Schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

2. RELATIONSHIP TO FEDERAL FINANCIAL REPORTS:

Amounts reported in the accompanying Schedule are included in the Special Revenue Fund - Federal Grants and Other Governmental funds in the Municipality's fund financial statements. The reconciliation between the expenditures in the fund financial statements and the expenditures in the Schedule of Expenditures of Federal Awards is as follows:

<u>Description</u>	<u>Special Revenue Fund Federal Grants</u>	<u>Other Governmental Funds</u>	<u>Total</u>
Per Schedule of Expenditures of Federal Awards	\$ 1,385,262	\$ 1,050,450	\$ 2,435,712
Non federal programs Expenditures	<u>50,886</u>	<u>992,216</u>	<u>1,043,102</u>
Total expenditures in the fund financial statements	<u>\$ 1,436,148</u>	<u>\$ 2,042,666</u>	<u>\$ 3,478,814</u>



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Member of:

- American Institute of Certified Public Accountants
- Puerto Rico Society of Certified Public Accountants

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

**To the Honorable Mayor
and the Municipal Legislature
Municipality of Arroyo
Arroyo, Puerto Rico**

We have audited the basic financial statements of the **Municipality of Arroyo** as of and for the year ended June 30, 2005, and have issued our report thereon dated December 15, 2005, which was unqualified. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the **Municipality of Arroyo's** basic 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 basic financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

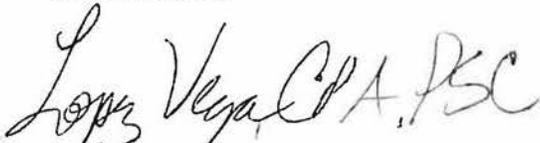
Internal Control Over Financial Reporting

In planning and performing our audit, we considered the **Municipality of Arroyo's** internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a matter involving the internal control over financial reporting that, in our judgment, could adversely affect **Municipality of Arroyo's** ability to record, process, summarize, and report financial data consistent with the assertions of management in the basic financial statements. The reportable conditions are described in the accompanying schedule of findings and questioned costs items **05-01** through **05-04**.

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

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the general purpose 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 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 reportable conditions that are also considered to be material weaknesses. However, we believe items **05-01** and **05-03** of the reportable conditions described in the accompanying Schedule of Findings and Questioned Costs is material weaknesses. We also noted other matters involving internal control over financial reporting, which we have reported to management of the **Municipality of Arroyo** in a separate letter dated December 15, 2005.

This report is intended for the information of the management and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.



LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
December 15, 2005

Stamp No. 2106098 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.





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

**To the Honorable Mayor
and the Municipal Legislature
Municipality of Arroyo
Arroyo, Puerto Rico**

Compliance

We have audited the compliance of the **Municipality of Arroyo** with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2005. The **Municipality of Arroyo's** major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the **Municipality of Arroyo's** management. Our responsibility is to express an opinion on the **Municipality of Arroyo's** compliance based on our audit.

The **Municipality of Arroyo's** basic financial statements include the operations of the Brisas de Arroyo Housing Project no. 66-003-660433527, a blended component unit, which received \$490,939 in federal awards which is not included in the schedule during the year ended June 30, 2005. Our audit, described below, did not include the operations of Brisas de Arroyo Housing Project no. 66-003-660433527 because the Housing Project Administrator engaged other auditors to perform an audit in accordance with *U.S. Office of Management and Budget (OMB) Circular A-133*.

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

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

We were unable to obtain sufficient documentation supporting the compliance of the **Municipality of Arroyo** with Child Care and Development Block Grant Program, regarding Reporting Requirement and Financial Administration related to the Standards for Financial Management System (Finding **05-11**), nor were we able to satisfy ourselves as to the **Municipality of Arroyo's** compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the **Municipality of Arroyo's** compliance with the Reporting Requirement and Financial Administration related to the Standards for Financial Management System, the **Municipality of Arroyo** complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements that are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items, **05-05** through **05-11**.

Internal Control Over Compliance

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

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the **Municipality of Arroyo's** ability to administer a major federal program in accordance with applicable requirements of laws, regulations, contracts and grants. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as items **05-05** through **05-11**.



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

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees on the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weakness. However, of the reportable conditions described above, we consider items **05-07, 05-08 and 05-11** to be material weaknesses. We also noted other matters involving the internal control over compliance and certain immaterial instance of noncompliance, which we have reported to management of the **Municipality of Arroyo** in a separate letter dated March 24, 2006.

This report is intended for the information of the management and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.


LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
March 24, 2006

Stamp No. 2106099 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

YEAR ENDED JUNE 30, 2005

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued:	Unqualified	
Internal control over financial reporting:		
Material weakness identified?	Yes X	No
Reportable conditions identified not considered to be material weaknesses?	Yes X	None reported
Noncompliance material to financial statements noted?	Yes	No X

Federal awards

Internal Control over major programs:		
Material weakness identified?	Yes X	No
Reportable conditions identified not considered to be material weaknesses?	Yes X	None reported
Type of auditor's report issued on compliance for major programs:	Unqualified except for qualified for Child Care and Development Block Grant 93.575	
Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)?	Yes X	No

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster
14.228	Community Development Block Grants - State's Program Lower Income Housing Assistance Program Section 8
14.856	Moderate Rehabilitation
14.871	Section 8 Housing Choice Voucher Program
93.575	Child Care and Development Block Grant Program

Dollar threshold used to distinguish between Type A and Type B programs	\$300,000
Auditee qualified as low-risk auditee?	Yes No X

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section II – Financial Statements Findings

Finding Reference	05-01
Requirement	Financial Reporting – Accounting Records
Statement of Condition	The Municipality has not updated the estimate of the obligation for landfill closure and post closure cost recorded as a liability in the Municipality's government-wide financial statements for the year ended June 30, 2005.
Criteria	<i>GASB Statements No. 18</i> requires that the Municipality should estimate the closure and post closure costs of its landfill facilities. That estimate should include the current cost of capital assets, final cover, and monitoring and maintenance activities.
Cause of Condition	The Municipality did not perform a study of the estimated cost of the closure and post closure costs of its landfill facilities.
Effect of Condition	The Municipality is not in compliance with the <i>GASB Statement No. 18</i> requirements.
Recommendation	We recommend that the Municipality should contract professional services in order to prepare a formal study of the costs related to the landfill closure. Also, we recommend that the Municipality should include in its government-wide financial statement the landfill costs necessary to comply with the <i>GASB Statement No. 18</i> .
Questioned Costs	None
Management Response and Corrective Action	As part of our corrective action plan, we'll estimate the closure and post closure cost of its landfill facilities in order to include that liability in the fiscal year 2005-06 government-wide financial statements. Implementation Date: December 30, 2006 Responsible Person: Néstor Alicea Finance Department Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section II – Financial Statements Findings

Finding Reference	05-02
Requirement	Financial Reporting – Accounting Records
Statement of Condition	During our examination of the Municipality's accounting system we noted that it does not summarize the transactions in a formal General Ledger in order to properly record and account for the transactions of all of its Governmental Funds (Local, State and Federal funds) and Account Groups.
Criteria	Chapter VIII, Article 8.010 of the State Act Number 81 of August 30, 1991 states that the Municipality should maintain an effective and updated accounting system.
Cause of Condition	The Municipality did not establish effective internal control over the transactions recorded on its accounting records. Also, the accounting data is not summarized in the form of a double-entry general ledger record.
Effect of Condition	The Municipality's accounting system did not provide update and complete financial information that present the financial position and the result of operations and the change in fund balances. Such information is necessary to take management decisions.
Recommendation	We recommend that the Municipality should implement internal control and procedures in order to maintain an accounting system that contains information pertaining to authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, interfund transactions, etc.
Questioned Costs	None
Management Response and Corrective Action	The Municipality maintains two set of accounting records; a manual system and a computerized system provided in the past by the Office of the Commissioner of Municipal Affairs (OCAM). Actually, all of the transactions were recorded in both systems, but the manual system is the primary financial records for financial statements preparation purposes at the end of each fiscal year due to the fact that the computerized system real accounts balances carried forward from prior years were affected by accounting errors in the first years of the system operation.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section II – Financial Statements Findings

Finding Reference **05-02 (Continued)**

Nevertheless, as part of our corrective action plan, we are considering alternatives to improve our accounting system, including the acquisition of new accounting software, and therefore, we will hope to solve our accounting system condition in a near future.

Implementation Date: June 30, 2007

Responsible Person: Néstor Alicea
Finance Department Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section II – Financial Statements Findings

Finding Reference	05-03
Requirement	Financial Reporting – Interfund Transactions
Statement of Condition	During our examination, we noted that for the fiscal year 2004-2005, the accounting records of the Municipality related to interfund transactions are not adequate.
Criteria	Article 8.010 (C) (2) and (3) of State Act Number 81 of August 30, 1991, stated that Municipality should maintain accurate accounting records and fund controls.
Cause of Condition	The Management's controls and procedures failed to assure that the Municipality maintained accurate accounting records related to interfund transactions.
Effect of Condition	The Municipality did not maintain an adequate control of the accountability regarding interfund transactions.
Recommendation	We recommend that the Municipality should implement internal control and procedures in order to maintain an accounting system that contains information pertaining to interfund transactions.
Questioned Costs	None
Management Response and Corrective Action	As part of our corrective action plan, we'll gave instructions to the Municipality's accountant to correct the accounting records in order to comply with State Act Number 81. Implementation Date: April 1, 2006 Responsible Person: Néstor Alicea Finance Department Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section II – Financial Statements Findings

Finding Reference 05-04

Requirement **Expenditures for Goods and Services and Accounts Payables-
Purchasing and receiving**

Statement of Condition We performed a cash disbursement test and examined thirty three (33) disbursement vouchers which belonged to General Fund, nineteen (19) which belonged to Community Development Block Grant (CDBG)-State Program and eight (8) which belonged to Section 8 Housing Choice Vouchers Program. The following will summarize the internal control exceptions noted:

- a. In nine (9) General Fund disbursement vouchers, there was no evidence of receiving report or the certification of the Municipality's employee who received the goods or services;
- b. Eight (8) General Fund disbursement vouchers did not include the signature of the pre-intervention officer;
- c. One (1) General Fund disbursement voucher did not include the signature of the functionary who authorized the requisition;
- d. Three (3) General Fund disbursement vouchers did not include the original invoice;
- e. In one (1) General Fund disbursement voucher, the purchase order, the requisition and the invoice were not marked as paid.

Criteria The Revised Regulations on Basic Standards for the Municipalities of Puerto Rico establish in the Chapter Four (4) that the Finance Director will be responsible to account and prepare disbursements through documents duly prepared and certified, including sufficient evidential matter to support the transactions.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section II - Financial Statements Findings

Finding Reference 05-04 (Continued)

Cause of Condition The Municipality internal control procedures failed to assure that all transactions include all the required documentation.

Effect of Condition The Municipality is not in compliance with Chapter Four (4) of the Revised Regulations on Basic Standards for the Municipalities of Puerto Rico.

Recommendation We recommend that the Municipality should improve its internal control and procedures in order to assure that disbursement vouchers contain all the necessary supporting documents before making the payments.

Questioned Costs None

Management Response As part of our corrective action plan, we'll review the disbursement process in order to improve the procedures to evaluate them and will instruct the Finance Department staff to assure that disbursement vouchers contain all the necessary supporting documents before making the payments.

Implementation Date: April 1, 2006

Responsible Person: Néstor Alicea
Finance Department Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-05
Program	Community Development Block Grants – State's Program (CFDA No. 14.228); U.S. Department of Housing and Urban Development; Pass through the Commonwealth of Puerto Rico – Office of Commissioner of Municipal Affairs (OCAM)
Requirement	Allowable Activities
Statement of Condition	<p>We performed a housing rehabilitation test of ten (10) participant files and found the following exceptions:</p> <ul style="list-style-type: none">a) In two (2) participant files, we did not observe evidence of the program's inspector visits to follow up the rehabilitation work;b) In six (6) participant files, we did not observe evidence of the program's inspector final visit. The files only include photos of the completion of works;
Criteria	<p>Code of Federal Regulations 24, Section 570.506 (b) state that at a minimum, the grantee should maintain records demonstrating that each activity undertaken meets one of the three national objectives of the CDBG Program, i.e., benefit low- and moderate-income persons, prevent or eliminate slums or blight, or meet community development needs having a particular urgency. Also, Code of Federal Regulations 24, Section 570.506 (b) (9) states that when CDBG- State Program funds are used for residential rehabilitation activity to aid in the prevention or elimination of slums or blight in a slum or blighted area, the grantee must maintain records to support the local definition of "substandard", must document a pre-rehabilitation inspection report describing the deficiencies in each structure to be rehabilitated, and must document the details and scope of CDBG assisted rehabilitation, by structure.</p>
Cause of Condition	<p>The Municipality's controls and procedures failed to assure that inspections to monitor the rehabilitation activities were conducted, as established in the program's operational guide.</p>
Effect of Condition	<p>The Municipality is not in compliance with Code of Federal Regulations 24, Section 570.506 (b) and 570.506 (b) (9).</p>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III - Major Federal Award Program Findings and Questioned Costs

Finding Reference 05-05 (continue)

Recommendation We recommend the Program Management to strengthen its controls and procedures to assure that the program staff inspects the rehabilitation work upon completion to assure that is carried out in accordance with contracts specifications.

Questioned Costs None

Management Response and Corrective Action As part of our correction action plan, we gave specific instructions to the program staff to assures that the procedures established in the operational guide are followed.

Implementation Date: April 1, 2006

Responsible Person: Néstor Ramirez
Federal Program Director

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-06
Program	Community Development Block Grants – State’s Program (CFDA No. 14.228); U.S. Department of Housing and Urban Development; Pass through the Commonwealth of Puerto Rico – Office of Commissioner of Municipal Affairs (OCAM)
Requirement	Cash Management
Statement of Condition	During our Cash Management test, we noted that the Municipality requested funds that were not disbursed on a reasonable lapse of time. In a sample of fourteen (14) fund requisitions (a total of \$478,695), we observed that the Municipality made the disbursements between six (6) and thirty three (33) days after the deposits.
Criteria	Code of Federal Regulations 24, Subpart I, Sec.570.489 (c) requires a cash management system in order to minimize the time elapsed between the transfer of funds from the pass-through grantor and disbursements made by the grantee.
Cause of Condition	The Municipality’s disbursements procedures failed to assure that funds requested and received from the Pass-through Grantor be disbursed in compliance with the Code of Federal Regulations Requirements.
Effect of Condition	The Municipality is not in compliance with Code of Federal Regulations 24, Subpart I, Sec.570.489 (c).
Recommendation	We recommend management to strengthen its disbursement procedures to minimize the time elapsed between the transfer of funds from the Pass-through Grantor and the disbursements made by the Municipality.
Questioned Costs	None

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III - Major Federal Award Program Findings and Questioned Costs

Finding Reference 05-06 (Continued)

**Management Response
and Corrective Action**

As part of our corrective action plan, we are going to start the disbursement process when the requisitions of funds are submitted to the Office of the Commissioner of Municipal Affairs (OCAM) in order to assure that when the funds are transferred by the Pass-through Grantor the program will disburse them immediately.

Implementation Date: April 1, 2006

Responsible Person: Néstor Ramirez
Federal Program Director

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-07
Program	Community Development Block Grants – State’s Program (CFDA No. 14.228); U.S. Department of Housing and Urban Development; Pass through the Commonwealth of Puerto Rico – Office of Commissioner of Municipal Affairs (OCAM)
Requirement	Davis-Bacon Act
Statement of Condition	During our Davis-Bacon Act test, we noted the following situation: For the construction project 00-FD-56-007, the Municipality did not perform the required visits for monitoring the classifications of the workers and the wage rates paid. Also, the weekly payrolls provided by the contractor were not monitored to verify the compliance with the prevailing wage rates.
Criteria	Davis-Bacon Act, as amended DOL (40 USC 276a to 276a-7).
Cause of Condition	The Municipality’s controls and procedures failed to apply all monitoring system procedures developed to test applicable contractors with respect to payment of prevailing wages.
Effect of Condition	The Municipality is not in compliance with Davis-Bacon Act, as amended DOL (40 USC 276a to 276a-7).
Recommendation	We recommend management to follow monitoring system procedures developed, including obtaining contractor's and subcontractor's weekly payrolls to be reviewed on a weekly basis by the responsible municipal employee, and interview contractor’s and subcontractor’s laborers periodically (up to ten percent (10%) of the workers on long term projects) to establish the degree of compliance and the nature and extend of violations, if any, and then, communicate contractors, promptly, about any failure in the payroll process.
Questioned Costs	None
Management Response	As part of our corrective action plan, we gave instructions to the program staff to assure that they apply all monitoring system procedures developed to test applicable contractors with respect to payment of prevailing wages.

COMMONWEALTH OF PUERTO RICO
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SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III - Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-07 (Continued)
	Implementation Date: April 1, 2006
	Responsible Person: Néstor Ramirez Federal Program Director

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-08
Program	Community Development Block Grants – State’s Program (CFDA No. 14.228); U.S. Department of Housing and Urban Development; Pass through the Commonwealth of Puerto Rico – Office of Commissioner of Municipal Affairs (OCAM)
Requirement	Program Income
Statement of Condition	<p>During our audit of the program income requirements, we noted that the Municipality did not maintain internal controls to assure:</p> <ul style="list-style-type: none">a. That the program income was properly determined or calculated in accordance with stated criteria and that program income was only collected from allowable sources.b. That all program income was properly recorded in the accounting records.c. That program income was used in accordance with the program requirements and other regulations applicable.
Criteria	<p>Code of Federal Regulations 24, Subpart C, Part 85.20 (b) (2) states that the grantees and sub grantees must maintain records, which adequately identify the source and application of funds, provided for financially-assisted activities. These records must contain information pertaining to grant or sub grant awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income. Also, the CDBG-state program grant agreement states that the Municipality submit to the Office of the Commissioner of Municipal Affairs (“OCAM”) an annual report about the program income.</p>
Cause of Condition	<p>Municipality did not maintain adequate internal controls in order to assure the proper determination, accounting, and use of program income.</p>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-08 (continue)
Effect of Condition	Municipality is not in compliance with Code of Federal Regulations 24, Subpart C, Part 85.20 (b) (2) and with the CDBG-state program grant agreement.
Recommendation	We recommend management to develop internal controls and procedures in order to assure that the program income is: properly determined and calculated, properly recorded and used for allowable costs.
Questioned Costs	None
Management Response	As part of our corrective action plan, we will discuss with the Finance Director the procedures to update the program's accounting records regarding program income. Implementation Date: April 1, 2006 Responsible Person: Néstor Ramirez Federal Program Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Reference	05-09
Program	Section 8 Housing Choice Vouchers Program (CFDA 14.871) U.S. Department of Housing and Urban Development
Requirement	Eligibility of Individuals
Statement of Condition	<p>We performed an eligibility test of fifteen (15) participants files related to Section 8 Housing Choice Vouchers Program. The following summarize the situations found:</p> <ul style="list-style-type: none">a. In two (2) cases, we observe that the PHA used a Total Tenant Payment (TTP) of \$50 instead of \$25, as stated by PHA Administrative Plan (revised on October 2004)b. In three (3) cases, the Privacy Act Notice was not signed by members of the family with more than eighteen (18) years old.
Criteria	<p>Code of Federal Regulations 24, Subpart K, Section 982.505 establishes the procedures to be followed to calculate the Housing Assistance Payment. Also, the PHA Administrative Plan states that the minimum rent established by the PHA will be \$25.00.</p> <p>Code of Federal Regulations 24, Sections 5.230, 5,212 and 982.516 states that as a condition of admission or continued occupancy, the PHA must require the tenant and other family members to provide necessary information, documentation and releases for the PHA to verify income eligibility. As part of this regulation the participant and other members of the family who are at least 18 years old must sign an application form, one or more releases forms, a federally prescribed general release form for employment information and a Privacy Act Notice.</p>
Cause of Condition	<p>The Municipality controls and procedures failed to assure that the Total Tenant Payment (TTP) used by the PHA was in accordance with the administrative plan. Also, controls and procedures failed to assure that the participant files include all required documentation and releases required by federal agencies.</p>
Effect of Condition	<p>The Municipality is not in compliance with Code of Federal Regulations 24, Subpart K, Sections 982.505, 5.230, 5,212, 982.516 and with the PHA Administrative Plan.</p>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-10
	Section 8 Housing Choice Vouchers Program (CFDA 14.871) U.S. Department of Housing and Urban Development
Requirement	Special Test – Selection from the Section 8 Waiting List
Statement of Condition	In our Waiting List test, we noted the following situation: In a sample of twenty (20) applicants included in the Waiting List, we observed that the PHA did not maintain the required information to assure that the selection of new tenants admitted to the program were in accordance with the administrative plan.
Criteria	<p>Code of Federal Regulations 24, Sections 982.54 (d) and 982.201 through 982.207 states the waiting list procedures and that the selection from the waiting list generally occurs when the PHA notifies a family, whose names reaches the top of the waiting list, to come in to verify eligibility for admission.</p> <p>The PHA's administrative plan states that, except for special admissions, participant will be selected from the PHA waiting list. The PHA must select participants from the waiting list on a first-come, first-served basis, in accordance with this same plan, which includes equal opportunity. Also, the Municipality will maintain information that permits proper selection from the waiting list.</p>
Cause of Condition	The Municipality controls and procedures failed to assure that the participants were selected from the top of the waiting list according with the PHA's applicant selection policies.
Effect of Condition	The Municipality is not in compliance with Code of Federal Regulations 24, sections 982.54 (d), 982.201 through 982.207 and with the PHA's administrative plan.
Recommendation	We recommend management to improve monitoring procedures to assure that the participants are admitted to the program or are provided the opportunity to be admitted to the program according with the PHA administrative plan.
Questioned Costs	None

COMMONWEALTH OF PUERTO RICO
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SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	05-11
Program	Child Care and Development Block Grant (CFDA No. 93.575); U.S. Department of Health and Human Services; Pass through the Commonwealth of Puerto Rico – Family Department (ACUDEN)
Requirement	Financial Administration – Standard for Financial Management System and Reporting Requirements
Statement of Condition	<p>During our reporting test we noted that the Annual Closing Report (CC-006) for the program fiscal year ended September 30, 2004 and, the Trial Balance as of September 30, 2004 were not submitted to the Pass-through Agency during the thirty (30) days period stated in the grant agreement. The Municipality submitted those reports on January, 2005 as detailed in the closing report.</p> <p>Also, during our audit we noted that federal program books are maintained in Peachtree Accounting Software by an external consultant. Those books were not available for our examination. As result we could not verify the accuracy of accounting record with the closing reports submitted to the Pass-through Agency.</p>
Criteria	<p>Code of Federal Regulations 45, Subpart C, Section 92.20 (b) (1) and (2) states that accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or sub grant. Grantees and sub grantees must maintain records, which adequately identify the source and application of funds, provided financially-assisted activities. These records must contain information pertaining to grant or sub grant awards and authorizations, obligations, unobligated balances, assets liabilities, outlays or expenditures, and income.</p> <p>Also, the grant agreement states that the Trial Balance must be submitted to (ACUDEN) no later than fifteen (15) days after the grant agreement closing date, and the Annual Closing Report (CC-006) must be submitted to (ACUDEN) no later than thirty (30) days after the grant agreement closing date.</p>

COMMONWEALTH OF PUERTO RICO
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SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Section III - Major Federal Award Program Findings and Questioned Costs

Finding Reference 05-11 (Continued)

Cause of Condition The Municipality's controls and procedures failed to assure that the financial and programmatic reports were prepared and submitted on time to the pass-through agency according with federal regulations and the grant agreement.

The Municipality accounting records where not available for examination.

Effect of Condition The Municipality is not in compliance with Code of Federal Regulation 45, Subpart C, Section 92.20 (b) (1) and (2) and with the grant agreement.

Recommendation We recommend that the Municipality should strength its controls and procedures in order to assure that accurate accounting records are maintained and current and complete disclosure of financial results are presented in the financial reports. Also, we recommend that the financial and programmatic report must be submitted on time to the pass-through agency.

We recommend that the Municipality should implement controls and procedures in order to assure that an accurate set of accounting records are maintained in the program offices for all transactions realized during the period, in order to be available for the examination of auditors.

Questioned Cost None

Management Response The Municipality's Management concurs with the finding. In the month of October 2005 the Municipality contracted a new consultant that will be responsible of the Program accounting records and financial reports of the Child Care Program.

Implementation Date: April, 2006

Responsible Person: Néstor Alicea
Finance Department Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
04-04	14.856	<p><u>During the verification of ten (10) participant's files, the auditors noted the following situation: In six (6) cases, the program staff detected deficiencies as roof leaking, broken doors etc. as detailed in the inspections report. The re-inspections were not performed immediately. Those re-inspections were performed after sixty (60) days of the original inspections. After the results of the re-inspections, the deficiencies were not corrected.</u></p> <p>Corrective action has been taken.</p>
04-05	14.871	<p><u>The auditors verified if five (5) participants were selected from the top of the waiting list according with the PHA's applicant selection policies. After the procedures, the auditors found that three (3) participants were not included in the waiting list.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 05-10.</p>
04-06	14.871	<p>The determination of reasonable rent (reasonable rent certification) was not duly documented. The auditors examined a sample of ten (10) participant's files and found the following situations: (a) In one (1) new participant file the certification of reasonable rent included only one comparable unassisted unit; (b) in three (3) participant's files the determination of reasonable rent included only one comparable unassisted unit in a change of unit during fiscal year 2003-2004 and; (c) in two (2) participant file the determination of reasonable rent did not include the comparable rent with other similar unit in a change of unit during fiscal year 2003-2004.</p> <p>Corrective action has been taken.</p>
04-07	14.228	<p><u>The auditors performed a cash disbursement test and examined thirty one (31) disbursements related to CDBG State Program, thirty nine (39) related to General Fund and twelve (12) related to Child Care and Development Block Grant. The following will summarize the internal control exceptions noted: (a) Twenty nine (29) General Fund disbursement vouchers, twenty one (21) CDBG State Program disbursement vouchers and eight (8) Child Care Development Block Grant disbursement vouchers were not approved and evaluated by the pre-interventor's office; (b) five (5) General Fund disbursement</u></p>

COMMONWEALTH OF PUERTO RICO
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SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
		<p><u>vouchers amounting to \$9,011 did not include evidence of the invoice, duly approved by the suppliers; (c) five (5) General Fund invoices included with the disbursements vouchers amounting to \$7,535 were not signed by the suppliers; (d) sixteen (16) General Fund disbursement vouchers did not include a certification with the name, title and signature of the functionary who requested the quotations and authorized the purchases and; (e) in five (5) General Fund disbursement vouchers amounting to \$14,744, the auditors did not found evidence in the disbursement voucher which support that three (3) quotations were requested and obtained prior to order the goods or services, or prior to the contract date.</u></p> <p>Corrective action has been taken.</p>
04-08	14.228	<p><u>During the examination of six (6) housekeeping assistance project participant files, the auditors noted the following situations: (a) In six (6) files the participant did not maintained evidence the Application Form OCAM-AH-002; (b) in four (4) files the participant did not complete a housekeeper assessments form OCAM-AH-006, when visited the participant housing unit; (c) in six (6) cases the Service Coordinator performed periodical visits to the participant housing unit, but not visited twice a month to ensure quality of services.</u></p> <p>Corrective action has been taken.</p>
04-09	14.228	<p><u>In the project 01-FD-07-003 with a cost of \$1,512,000, the auditors did not found evidence supporting that the federal program staff, applied adequately the monitoring system developed to ensure contractors compliance with payment of prevailing wages rates to employees. The auditors noted the following: (a) The contract begun in October 8, 2003 to June 6, 2004 for a period of eight months and the auditors did not find in the contractor's file the contract weekly payrolls related to the period from October, 2003 to February, 2004 and; (b) the program staff performed only two interviews to the contractor's and subcontractor's laborers in March 31, 2004 and June 25, 2004. Also, the Davis Bacon file related to the project 00-FD-07-006 with a cost of \$84,505 was not available for examination.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 05-07.</p>

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MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
04-10	14.228	<p><u>During the contract provision test, the auditors noted the following situations: (a) Two (2) contracts did not include a provision for compliance with Sections 103 and 107 of the Contract Work Hours & Safety Standards Act; (b) two (2) contracts did not include a provision for granting accesses to GAO or other federally agency, to books and other documents; (c) one (1) contract did not include a provision for compliance with the Clean Air Act and Water Act; (d) two (2) contracts did not include a provision for compliance with Energy Policy and Conservation Act; (e) two (2) contracts did not include a provision for compliance with the Copeland "Anti-Kickback"; (f) two (2) contracts did not include a provision for retention of all required records for three years; (g) two (2) contracts did not include a provision for executive order 11246 "Equal Employment Opportunity"; (h) two (2) contracts did not include a provision for Davis Bacon Act and; (i) one (1) contract did not include provision for suspension and debarment.</u></p> <p>Corrective action has been taken.</p>
04-11	14.228	<p><u>During the audit of the program income requirements, the auditors noted that the Municipality did not maintain internal controls to assure: (a) That the program income was properly determined or calculated in accordance with stated criteria and that program income was only collected from allowable sources; (b) that all program income was properly recorded in the accounting records and; (c) that program income was used in accordance with the program requirements and other regulations applicable.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 05-08.</p>
04-12	93.575	<p><u>During the disbursement test of the Child Care and Development Block Grant Program, the auditors verified electronic fund transfers from the program's account to the Municipality's General account, for a total of \$305,928.58 and \$69,809.60 to the Municipality's payroll account. Those electronic transfers were related to expenditures paid by the Municipality current account on behalf of the Child Care program. The Municipality did not prepare a disbursement or journal voucher to support the electronic transfers. The program maintains separately the support of those expenditures.</u></p>

**COMMONWEALTH OF PUERTO RICO
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SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
		Corrective action has been taken.
04-13	93.575	<u>During the Cash Management test, the auditors noted that for one (1) of the cash advances received during the fiscal year of \$136,972, \$91,560.55 were maintained in bank for two months approximately and \$45,413.07 for three months later. As result, the Municipality did not disburse the funds on a reasonable lapse of time.</u>
		Corrective action has been taken.
04-14	93.575	<u>During the examination of equipment and real property management requirement, the auditors noted that the Municipality does not detail the serial number, location and use and condition of the property.</u>
		Corrective action has been taken.
04-15	93.575	During the reporting test, the auditors noted that the Annual Closing Report (CC-006) for the program fiscal year ended September 30, 2003 and, the Trial Balance as of September 30, 2003 were not submitted to the Pass through Agency during the fifteen (15) day period stated in the grant agreement. The Municipality submitted those reports on July 8, 2004 as detailed in the closing report. Also, during the intervention, the auditors noted that federal program books are maintained in Peachtree Accounting Software by an external consultant. Those books where not available for examination. As result, the auditors could not verify the accuracy of accounting record with the closing reports submitted to the pass through agency.
		No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 05-11.
03-06	14.856	<u>Two (2) participant's files did not indicate if Housing Quality Inspections were performed at the time of the initial occupancy and at least annually, to assure that units are decent, safe and sanitary. In nine (9) cases, the correction period has ended and the participant's files did not contain a unit inspection report or evidence of other verification documenting that any PHA required repairs were complete. Also, we did not find documents in the files that showed</u>

**COMMONWEALTH OF PUERTO RICO
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SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
		<u>that the PHA property stopped HAP's or terminated the HAP contract.</u>
		Corrective action has been taken.
03-10	14.871	<u>In one (1) new participant file the certification of reasonable rent included only one comparable unassisted unit. In two (2) new participant's files the certification of reasonable rent did not include the comparable rent with other similar units. In seven (7) participant's files the determination of reasonable rent included only one comparable unassisted unit in a change of unit during fiscal year 2002-2003. In one (1) participant file the determination of reasonable rent did not include the comparable rent with other similar unit in a change of unit during fiscal year 2002-2003.</u>
		Corrective action has been taken.
03-12	14.871	<u>The PHA did not select the participant from the top of the waiting list according to the PHA's applicant selection policies.</u>
		No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 05-10.
03-13	14.228	<u>Three (3) CDBG State Program disbursement vouchers did not have all supporting documents stamped as paid. Three (3) CDBG State Program disbursement vouchers did not include the invoice. One (1) CDBG State Program disbursement voucher was not available for examination. Nineteen (19) CDBG State Program disbursement vouchers did not include the requisition form. Fourteen (14) CDBG State Program disbursement vouchers did not include in the purchases orders.</u>
		Corrective action has been taken.
03-15	14.228	<u>Five (5) files did not include the evidence regarding the identity verification for the family members. In five (5) files the participant did not complete the Approval Application Form OCAM-AH-004A. In five (5) files the participant did not complete a participation contract form OCAM-AH-005, establishing the service plan to be offered by the CDBG program. In five (5) cases the Service Coordinator visited only one time per month the participant house to ensure the quality of services.</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
		Corrective action has been taken.
03-17	14.228	<u>The Municipality did not apply adequately the monitoring system developed to ensure contractors compliance with payment of prevailing wages rates to employees. The contractor's and subcontractor's laborers interviews were not made. During the fiscal year 2002-2003, the contractor weekly payrolls were not requested to be reviewed by the municipal employee responsible of applying monitoring procedures.</u>
		No corrective action has been taken. The auditors reissued the finding for the current year. Finding Reference 05-07.
03-18	14.228	<u>Two (2) contracts did not include a provision for compliance with Sections 103 and 107 of the Contract Work Hours & Safety Standards Act. Two (2) contracts did not include a provision for granting access to GAO or other federally agency, to books and other documents. One (1) contract did not include a provision for compliance with the Clean Air Act and Water Act. Two (2) contracts did not include a provision for compliance with Energy Policy and Conservation Act. Two (2) contracts did not include a provision for compliance with the Copeland "Anti-Kickback". Two (2) contracts did not include a provision for retention of all required records for three years.</u>
		Corrective action has been taken.
03-19	14.228	<u>The Municipality did not maintain internal controls to assure that the program income was properly determined or calculated in accordance with stated criteria and that program income was only collected from allowable sources; that all program income was properly recorded in the accounting records; that program income was used in accordance with the program requirements and other regulations applicable.</u>
		No corrective action has been taken. The auditors reissued the finding for the current year. Finding Reference 05-08.
03-21	93.575	<u>The Municipality did not maintain, for the Child Care and Development Block Grant Program, a reliable set of accounting</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
		<p><u>records that present the financial position of the program, the results of operations and changes in fund balance.</u></p> <p>No corrective action has been taken. The auditors reissued the finding for the current year. Finding Reference 05-11.</p>
03-22	93.575	<p><u>During the disbursement test of the Child Care and Development Block Grant Program, the auditors verified four (4) electronic fund transfers from the program's account to the Municipality's current account, for a total of \$365,343. Those electronic transfers were related to expenditures paid by the Municipality current account on behalf of the Child Care program. The Municipality did not prepare a disbursement or journal voucher to support the electronic transfers. The program maintains separately the support of those expenditures.</u></p> <p>Corrective action has been taken.</p>
03-23	93.575	<p><u>During the Cash Management test, the auditors noted that for two (2) of the cash advances received during the fiscal year the Municipality did not disburse the funds on a reasonable lapse of time.</u></p> <p>Corrective action has been taken.</p>
03-25	93.575	<p><u>During the examination of equipment and real property management requirement, the auditors noted that the Municipality does not have property records that include all required specifications required by federal agencies.</u></p> <p>Corrective action has been taken.</p>
03-26	93.575	<p><u>During the reporting test, the auditors noted that the Annual Closing Report (CC-006) for the program fiscal year ended September 30, 2002 and, the Trial Balance as of September 30, 2002 were not submitted to the Pass Through Agency during the fifteen (15) day period stated in the grant agreement. The Municipality submitted those reports on January 20, 2003.</u></p> <p>No corrective action has been taken. The auditors reissued the finding for the current year. Finding Reference 05-11.</p>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
02-11	14.856	<p><u>The Municipality should improve its monitoring procedures in order to assure that annual inspections are properly completed by the inspectors verifying the housing unit's compliance with all Housing Quality Standards Requirements. Also, we recommend management to improve its monitoring procedures to assure that the inspections are properly documented in the participant files and to assure that the exceptions detailed in the inspection reports are duly corrected by the owner or the participant in the required period.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-12	14.871	<p><u>The Municipality should establish monitoring procedures to assure that the participant's files include all documentation required by federal agencies.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-15	14.871	<p><u>The Municipality should establish controls to assure appropriate documentation of the determination of reasonable rent is maintained in participant's files.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-17	14.871	<p><u>The Municipality should improve monitoring its procedures to assure that annual inspections and quality control re-inspections are properly documented in the participant files and to assure that the exceptions detailed in the inspection reports are duly corrected by the owner or the participant in the required period.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-18	14.228	<p><u>The Municipality should follow monitoring system procedures</u></p>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2005

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
		<p><u>developed, including obtaining contractor's and subcontractor's weekly payrolls to be reviewed on a weekly basis by the responsible Municipal employee to establish the degree of compliance and the nature and extend of violations, if any, and then, communicate contractors promptly about any failure in the payroll process.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-21	14.228	<p><u>The Municipality should update contract model according with the federal requirements, executive orders and regulations.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-22	14.228	<p><u>The Municipality should develop internal controls and procedures in order to assure that the program income is: properly determined and calculated, properly recorded and used for allowable costs.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>
02-24	14.228	<p><u>The Municipality should sign written agreements with all sub recipients before disbursing any CDBG funds. Those contracts will include the following: a provision concerning the statement of work (scope of work, goals, budget, etc.), a provision concerning the record and reports to be maintained by the sub recipient, a provision concerning the program income requirement applicable to CDBG program and a provision concerning the uniform administrative requirement.</u></p> <p>The audit finding does not warrant further action because two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse.</p>