

OFICINA DEL COMISIONADO DE ASUNTOS MUNICIPALES

AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL

AREA DE ARCHIVO DIGITAL

MUNICIPIO DE ARROYO

AUDITORIA 2005-2006

30 DE JUNIO DE 2006

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO
BASIC FINANCIAL STATEMENTS
WITH THE ADDITIONAL REPORTS AND INFORMATION
REQUIRED BY THE SINGLE AUDIT ACT

YEAR ENDED JUNE 30, 2006

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

BASIC FINANCIAL STATEMENTS
WITH THE ADDITIONAL REPORTS AND INFORMATION
REQUIRED BY THE SINGLE AUDIT ACT

YEAR ENDED JUNE 30, 2006

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MUNICIPALITY OF ARROYO

BASIC FINANCIAL STATEMENTS
WITH THE ADDITIONAL REPORTS AND INFORMATION
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YEAR ENDED JUNE 30, 2006

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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 AUDITORS' 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, 2006, 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 \$2,550,264 (net of capital assets accumulated depreciation) as of June 30, 2006, and total revenues of \$503,014 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.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 \$4,074,024 in the total governmental funds column of the Balance Sheet - governmental funds.

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, 2006, 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.

INDEPENDENT AUDITORS' REPORT (CONTINUED)

In addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the governmental activities of the **Municipality of Arroyo, Puerto Rico**, as of June 30, 2006, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 27, 2006, 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 3 through 12 and the Budgetary Comparison Schedule-General Fund on page 42 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.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the **Municipality of Arroyo's** basic financial statements. 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 basic financial statements of the **Municipality of Arroyo**. 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 stated in all material respects in relation to the basic financial statements taken as a whole.


LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
December 27, 2006

Stamp No. 2195984 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, 2006

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, 2006. 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, 2005. 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 2006 deserve special mention:

1. Total assets of the Municipality amounted to \$20,008,846 which represents a decrease of (1%) compared to prior fiscal year;
2. At the end of fiscal year 2006, total liabilities amounted to \$14,345,767. Out of said amount, \$11,089,876 corresponded to long-term liabilities of which \$4,783,008 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 \$5,663,079 which represents a decrease 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 \$10,304,529, derived from the following sources: \$100,998 charges for services; \$2,214,485 from operating grants and contributions; \$646,637 from capital grants and contributions obtained from other sources, and \$7,342,409 from general revenues available;

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2006

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 \$10,598,433;
6. As reflected in the Statement of Activities, the current fiscal year operations contributed to a decrease in the Net Assets figure by \$(293,904);
7. As of the close of the current fiscal, the Municipality's Governmental Funds reported combined ending fund balances of \$36,285;
8. As the end of the current fiscal year, the Municipality's General Fund deficit amounted to \$(3,862,590), compared to a deficit of \$(3,284,843) in the prior fiscal year;
9. The actual General Fund budgetary activities resulted in an unfavorable balance of \$(248,389).

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 2006. 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, 2006

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, 2006, shows total expenses incurred to afford the cost of all functions and programs amounted to \$10,598,433. Upon examining the sources of revenues for the financing of said programs, the Statement reflects that \$2,962,120 was derived from the following sources: \$100,998 charges for services; \$2,214,485 from operating grants and contributions; and \$646,637 from capital grants and contributions obtained from other sources. General revenues for the year amounted to \$7,342,409. When such figure is added to the \$2,962,120 previously mentioned, total revenues available for the financing of activities amounted to \$10,304,529. There was an excess of expenses over revenues in the amount of \$(293,904), which contributed with a decrease 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, 2006

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)

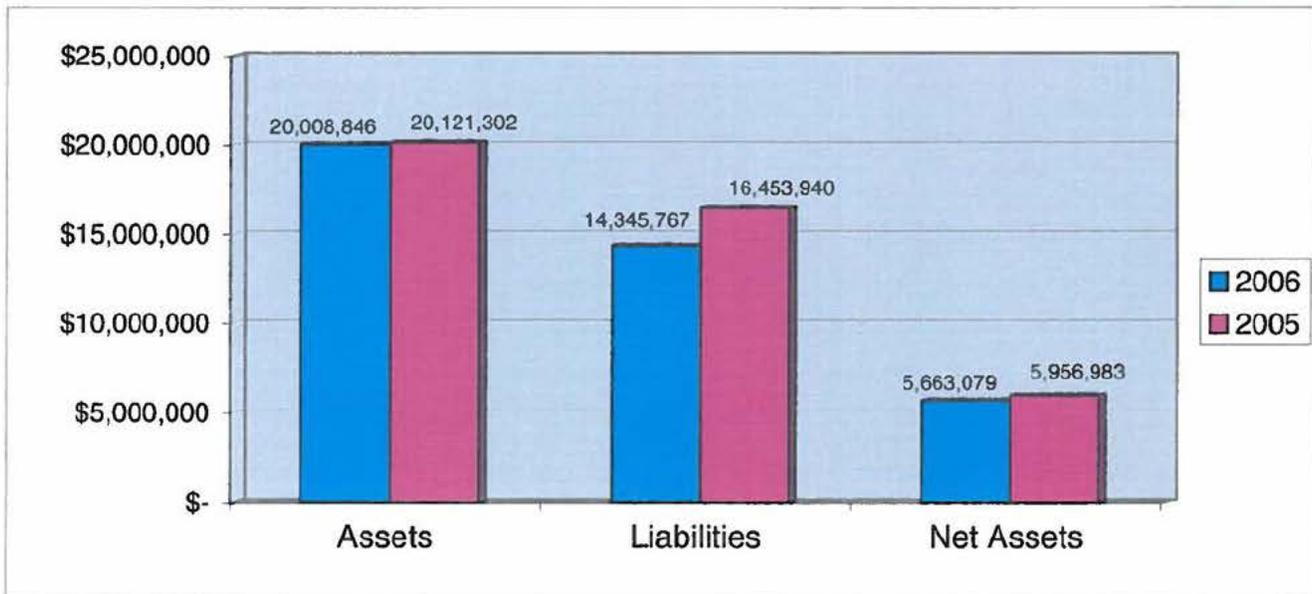
YEAR ENDED JUNE 30, 2006

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 assets exceeded total liabilities by \$5,663,079 at the end of 2006, compared to \$5,956,983 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	2006	2005	Change	%
Current and other assets	\$ 3,095,571	\$ 3,798,902	\$ (703,331)	(19%)
Capital assets	16,913,275	16,322,400	590,875	4%
Total assets	20,008,846	20,121,302	(112,456)	(1%)
Current and other liabilities	3,255,891	3,072,579	183,312	6%
Long-term liabilities	11,089,876	13,381,361	(2,291,485)	(17%)
Total liabilities	14,345,767	16,453,940	(2,108,173)	(13%)
Invested in capital assets, net of related debt	13,435,745	12,787,089	648,656	5%
Restricted	3,841,648	4,151,695	(310,047)	(7%)
Unrestricted deficit	(11,614,314)	(10,981,801)	(632,513)	6%
Total net assets	\$ 5,663,079	\$ 5,956,983	\$ (293,904)	(5%)



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2006

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE (CONTINUED)

Changes in Net Assets

The Statement of Activities reflects that for fiscal year 2006, the net effect of revenues derived from several programs plus current operating revenues compared to the total expenses, amounted to \$(293,904) decrease in the Municipality's net assets. Approximately 24 percent of the Municipality's total revenue came from taxes, while 72 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.

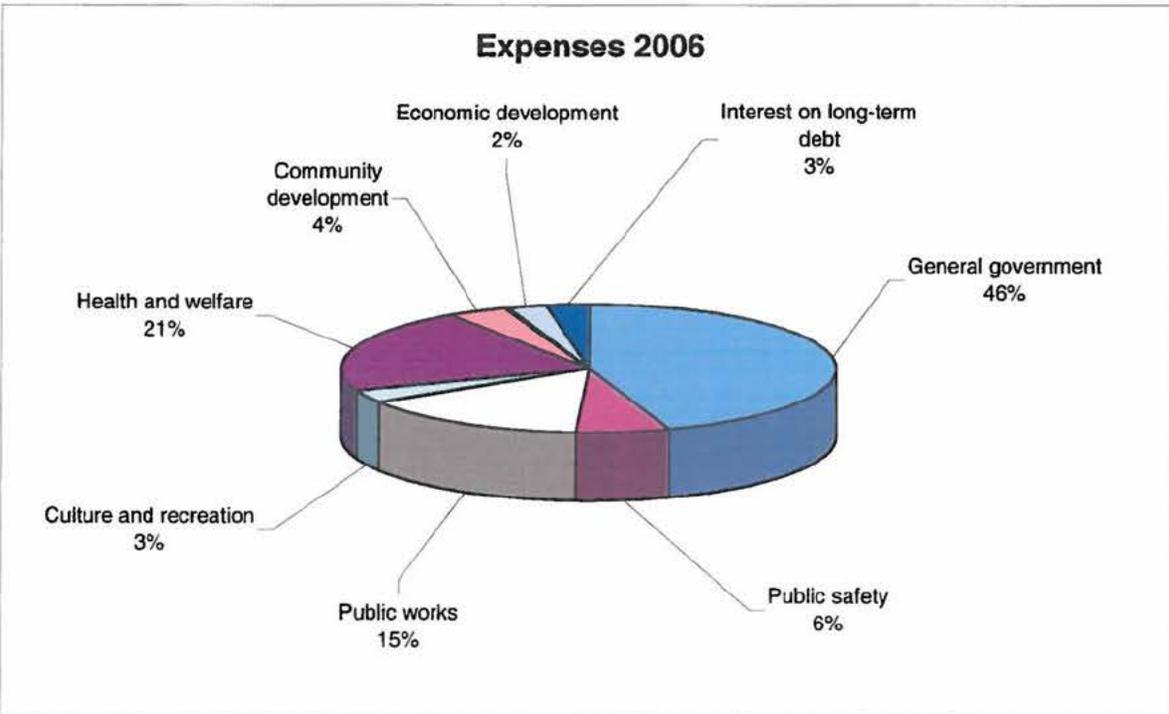
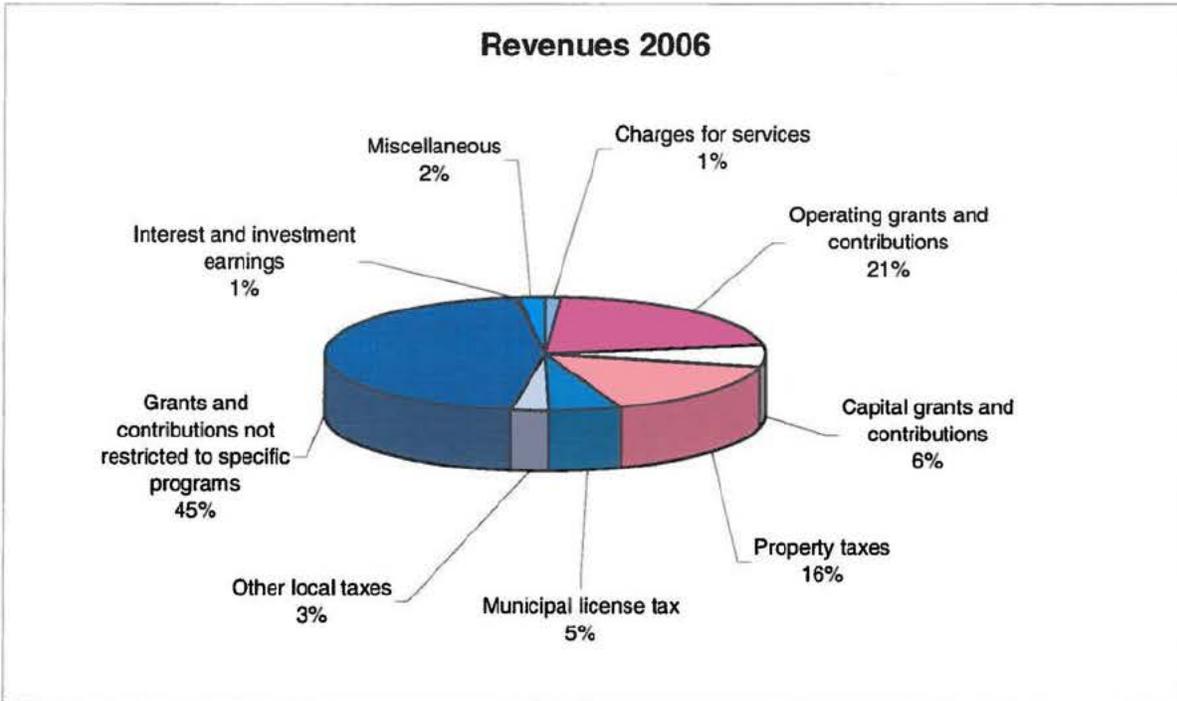
Condensed Statement of Activities	2006	2005	Change	%
Program revenues:				
Charges for services	\$ 100,998	\$ 112,143	\$ (11,145)	(10%)
Operating grants and contributions	2,214,485	2,784,169	(569,684)	(20%)
Capital grants and contributions	646,637	1,280,122	(633,485)	(49%)
General revenues:				
Property taxes	1,620,673	1,743,060	(122,387)	(7%)
Municipal license tax	544,306	814,085	(269,779)	(33%)
Other local taxes	290,698	510,605	(219,907)	(43%)
Grants and contributions not restricted to specific programs	4,645,385	4,138,413	506,972	12%
Interest and investment earnings	53,709	60,916	(7,207)	(12%)
Gain (loss) on retirement of capital assets	-	-	-	-
Miscellaneous	187,638	80,461	107,177	133%
Total revenues	10,304,529	11,523,974	(1,219,445)	(11%)
Expenses:				
General government	4,733,500	4,302,659	430,841	10%
Public safety	643,925	623,542	20,383	3%
Public works	1,639,101	2,172,351	(533,250)	(25%)
Culture and recreation	348,190	587,887	(239,697)	(41%)
Health and welfare	2,222,277	2,494,893	(272,616)	(11%)
Community development	420,245	482,318	(62,073)	(13%)
Education	33,099	116,856	(83,757)	(72%)
Economic development	259,435	268,573	(9,138)	(3%)
Interest on long-term debt	298,661	290,922	7,739	3%
Total expenses	10,598,433	11,340,001	(741,568)	(7%)
Change in net assets	(293,904)	183,973	(477,877)	(260%)
Net assets, beginning of year, as restated	5,956,983	5,773,010	183,973	3%
Net assets, end of year	\$ 5,663,079	\$ 5,956,983	\$ (293,904)	(5%)

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

MANAGEMENT'S DISCUSSION AND ANALYSIS - (CONTINUED)

YEAR ENDED JUNE 30, 2006

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, 2006

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 \$36,285, a decrease of \$(884,938) in comparison with the prior year. There are reservations of fund balance amounting to \$4,263,770. 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 (\$346,772), 2) to pay debt service (\$410,008), 3) to pay for capital projects (\$195,430) and 4) for other purposes (\$3,311,560).

Within the governmental funds, it is included the general fund which is the chief operating fund of the Municipality. As of June 30, 2006, the general fund ended with a deficit of \$(3,862,590).

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 \$(248,389).

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The Municipality's investment in capital assets as of June 30, 2006, amounts to \$27,517,431, net of accumulated depreciation of \$10,604,156 (including depreciation charges for the year totaled \$686,526), leaving a net book value of \$16,913,275. 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.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

MANAGEMENT'S DISCUSSION AND ANALYSIS – (CONTINUED)

YEAR ENDED JUNE 30, 2006

CAPITAL ASSETS AND DEBT ADMINISTRATION (CONTINUED)

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, 2006, the Municipality has \$460,437 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, 2006

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 2006-2007.

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 2006. 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, 2006

	Governmental Activities
Assets	
Cash and cash equivalents	\$ 889,099
Cash with fiscal agent	1,511,698
Accounts receivable:	
Intergovernmental	529,819
Interest	1,319
Landfill	128,357
Other	8,827
Other assets	26,452
Capital assets	
Land, improvements, and construction in progress	5,310,656
Other capital assets, net of depreciation	11,602,619
Total capital assets	16,913,275
Total assets	20,008,846
 Liabilities	
Bank overdraft	157,823
Accounts payable and accrued liabilities	1,472,181
Due to other governmental entities	874,823
Deferred revenues:	
Municipal license tax	551,265
Federal grant revenues	124,449
Interest payable	75,350
Noncurrent liabilities:	
Due within one year	479,656
Due in more than one year	10,610,220
Total liabilities	14,345,767
 Net Assets	
Invested in capital assets, net of related debt	13,435,745
Restricted for:	
Capital projects	195,430
Debt service	334,658
Other purpose	3,311,560
Unrestricted (deficit)	(11,614,314)
Total net assets	\$ 5,663,079

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, 2006

Functions/Programs	Expenses	Program Revenues			Net (Expense) Revenue and Changes In Net Assets
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	
General government	\$ 4,733,500	\$ -	\$ 114,878	\$ -	\$ (4,618,622)
Public safety	643,925	5,786	29,900		(608,239)
Public works	1,639,101	28,686	502	107,584	(1,502,329)
Health and welfare	2,222,277	714	1,726,707		(494,856)
Culture and recreation	348,190	65,812			(282,378)
Economic development	259,435		281,064		21,629
Community development	420,245			539,053	118,808
Education	33,099		61,434		28,335
Interest on long-term debt	298,661				(298,661)
Total governmental activities	\$ 10,598,433	\$ 100,998	\$ 2,214,485	\$ 646,637	(7,636,313)
General revenues:					
Property taxes					1,620,673
Municipal license tax					544,306
Other local taxes					290,698
Grants and contributions not restricted to specific programs					4,645,385
Interest and investment earnings					53,709
Miscellaneous					187,638
Total general revenues					7,342,409
Change in net assets					(293,904)
Net assets - beginning, as restated					5,956,983
Net assets - ending					\$ 5,663,079

Commonwealth of Puerto Rico
Municipality of Arroyo
Balance Sheet
Governmental Funds
June 30, 2006

	General Fund	Special Revenue Fund Local & State Grants	Special Revenue Fund Housing Project	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
Assets						
Cash and cash equivalents	\$ -	\$ 31,950	\$ 690,562	\$ -	\$ 166,587	\$ 889,099
Cash with fiscal agent	357,755			724,309	429,634	1,511,698
Accounts receivable:						
Intergovernmental	104,082	91,896			333,841	529,819
Interest					1,319	1,319
Landfill	128,357					128,357
Other			8,827			8,827
Due from other funds	810,972	2,913,628		318,112	31,312	4,074,024
Other assets			26,452			26,452
Total assets	\$ 1,401,166	\$ 3,037,474	\$ 725,841	\$ 1,042,421	\$ 962,693	\$ 7,169,595
Liabilities and Fund Balances						
Liabilities :						
Bank overdraft	\$ 157,823	\$ -	\$ -	\$ -	\$ -	\$ 157,823
Accounts payable and accrued liabilities	843,487	1,000	154,318	164,956	83,083	1,246,844
Due to other governmental entities	874,823					874,823
Due to other funds	2,732,276	314,560		682,035	345,153	4,074,024
Deferred revenues:						
Municipal license tax	551,265					551,265
Intergovernmental	104,082					104,082
Federal grant revenues					124,449	124,449
Total liabilities	5,263,756	315,560	154,318	846,991	552,685	7,133,310
Fund balances:						
Reserved for:						
Encumbrances	346,772					346,772
Capital projects				195,430		195,430
Other purposes	18,123	2,721,914	571,523			3,311,560
Reserved reported in nonmajor funds:						
Debt service fund					410,008	410,008
Unreserved:						
Undesigned	(4,227,485)					(4,227,485)
Total fund balances (deficit)	(3,862,590)	2,721,914	571,523	195,430	410,008	36,285
Total liabilities and fund balances	\$ 1,401,166	\$ 3,037,474	\$ 725,841	\$ 1,042,421	\$ 962,693	

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

Accrual basis of accounting accounts receivable recognized in government-wide financial statements	104,082
Accrual basis of accounting accounts payable recognized in government-wide financial statements	(225,337)
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds	16,913,275
Long-term liabilities and accrued interests are not due and payable in the current period, and therefore, are not reported in the funds	(11,165,226)
Net assets of governmental activities	\$ 5,663,079

Commonwealth of Puerto Rico
Municipality of Arroyo
Statement of Revenues, Expenditures and Changes in Fund Balances
Governmental Funds
For the Year Ended June 30, 2006

	General Fund	Special Revenue Fund Local & State Grants	Special Revenue Fund Housing Project	Capital Projects Fund	Other Governmental Funds	Total Governmental Funds
Revenues						
Property taxes	\$ 1,254,228	\$ -	\$ -	\$ -	\$ 262,364	\$ 1,516,592
Municipal license taxes	544,306					544,306
Licenses, permits and other local taxes	290,928					290,928
Intergovernmental	4,760,262	370,205		88,352	4,808	5,223,627
Rent of property	65,812		503,014			568,826
Fines and forfeitures	5,786					5,786
Interest	53,709					53,709
Federal grants					1,750,042	1,750,042
Miscellaneous	180,373	66,259				246,632
Total revenues	7,155,404	436,464	503,014	88,352	\$ 2,017,214	10,200,448
Expenditures						
Current:						
General government	4,244,246	23				4,244,269
Public safety	625,119	14,463			2,695	642,277
Public works	1,742,822	11,023		128,752	19,232	1,901,829
Health and welfare	630,587	10,066	307,320		1,193,870	2,141,843
Culture and recreation	437,674	54,603		307,770		800,047
Economic development		259,435				259,435
Community development		156			539,053	539,209
Education		6,599		26,500		33,099
Debt service:						
Principal					227,573	227,573
Interest					295,805	295,805
Total expenditures	7,680,448	356,368	307,320	463,022	2,278,228	11,085,386
Excess (deficiency) of revenues over (under) expenditures	(525,044)	80,096	195,694	(374,670)	(261,014)	(884,938)
Other financing sources (uses)						
Transfers in					231,605	231,605
Transfers out	(52,703)		(178,902)			(231,605)
Total other financing sources (uses)	(52,703)		(178,902)		231,605	
Net change in fund balances	(577,747)	80,096	16,792	(374,670)	(29,409)	(884,938)
Fund balances (deficit), beginning	(3,284,843)	2,641,818	554,731	570,100	439,417	921,223
Fund balances (deficit), ending	<u>\$ (3,862,590)</u>	<u>\$ 2,721,914</u>	<u>\$ 571,523</u>	<u>\$ 195,430</u>	<u>\$ 410,008</u>	<u>\$ 36,285</u>

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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, 2006

Net Change in Fund Balances - Total Governmental Funds \$ (884,938)

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. 1,277,401

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. (686,526)

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. (2,856)

Bonds and notes proceeds provide 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 by which the debt service principal payments exceed debt proceeds. 232,781

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 represent the change in long-term property tax advance debt from prior year. (223,679)

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. The following amount represents the change in long-term debt with the Treasury Department from prior year. 43,232

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. 11,764

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 represents the change in long-term claims and judgments from prior year. 27,000

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

Repayment of long term Land Information Management System (LIMS) is an expenditure in Governmental Funds, but the repayment reduces long term LIMS in the Government-Wide Statement of Net Assets. The following amount represent the change in long term LIMS debt from prior year. (154,574)

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. 104,082

Some expenses reported in the Statement of Activities do not require the use of current financial resources and, therefore, are not reported as expenses in the Governmental Funds. The following amount represents the change in this expenses from prior year. (102,931)

Change in Net Assets of Governmental Activities \$ (293,904)

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2006

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 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, 2006

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, 2006

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 & 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, 2006

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

Special Revenue Fund – 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.

Capital Projects Fund - 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, 2006

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

Special Revenue Fund – 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 - 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, 2006

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, 2006

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, 2006

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, 2006

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, 2006 amounted to approximately \$184,504. The current insurance policies have not been cancelled or terminated. The CRIM also deducted approximately \$136,092 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, 2006

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	\$ 16,913,275	
Deduct:		
Section 515 direct loan	(2,048,008)	
Bonds payable related to capital assets	<u>(1,429,522)</u>	\$ 13,435,745
<u>Net assets restricted for capital projects</u>		
Fund balance restricted for capital projects		195,430
<u>Net assets restricted for debt service</u>		
Fund balance restricted for debt service	410,008	
Deduct:		
Interest payable	<u>(75,350)</u>	334,658
<u>Net assets restricted for other purposes</u>		
Fund balances restricted for other purpose		3,311,560
<u>Net assets unrestricted (deficit)</u>		
General fund - total deficit:	(3,862,590)	
Add:		
Accrued basic accounts receivable	104,082	
Deduct:		
General fund - fund balances restricted for other purposes	(18,123)	
Accrual basis accounts payable	(225,337)	
Bonds payable	(1,305,478)	
Property tax advances	(3,349,619)	
Property tax - Treasury	(172,927)	
Compensated absences	(1,157,951)	
Landfill obligation	(1,453,797)	
LIMS repayment plan	(154,574)	
Claims and judgments	<u>(18,000)</u>	<u>(11,614,314)</u>
Total net assets - governmental activities		<u>\$ 5,663,079</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

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 \$31,950 in the special revenue fund - local and state grants and \$690,562 in the special revenue fund - housing project were fully collateralized at June 30, 2006. In the other governmental funds there were deposits with commercial banks of \$166,587 that were fully collateralized.

The deposits at GDB of \$357,755 in the general fund, the \$724,309 in the capital projects fund and the \$429,634 in the other governmental funds, 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, 2006, 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, 2006, 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. *Intergovernmental Receivables*- Intergovernmental receivable in the general fund 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 intergovernmental receivable:

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

3. RECEIVABLES (CONTINUED)

<u>Governmental Entity</u>	<u>Amount</u>
Municipal Revenue Collection Center (CRIM)	\$ <u>104,082</u>
Total	\$ <u>104,082</u>

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>Governmental Entity</u>	<u>Amount</u>
Commonwealth of Puerto Rico-Department of Labor and Human Resources- Law 82 Grant	\$ <u>91,896</u>
Total	\$ <u>91,896</u>

Intergovernmental receivable in the other governmental funds represent expenditures incurred not yet reimbursed by the pass-through grantors. Also, represents property tax receivable at June 20, 2006. Following is a detail of the intergovernmental receivable:

<u>Description</u>	<u>Amount</u>
Community Development Block Grant	\$ 125,468
Child Care and Development Block Grant	165,953
Pre-Disaster Mitigation Competitive Grants	28,110
Disaster Grants – Public Assistance	6,156
Municipal Revenue Collection Center (CRIM)	<u>8,154</u>
Total	\$ <u>333,841</u>

- C. **Landfill:** Landfill account receivable amounting to \$128,357 in the general fund represents the landfill administration royalties' debt accumulated at June 30, 2006 and collected by the Municipality on August 21, 2006.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

4. INTERFUND TRANSACTIONS

Interfund receivables and payables at June 30, 2006, and interfund transfers during the fiscal year ended at June 30, 2006, are summarized as follows:

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	\$ 295,739
General Fund	Capital Projects Fund	Reimbursable expenditures	170,080
General Fund	Other Governmental Funds	Payroll and related accruals paid and not reimbursed, interest revenue, and other reimbursable expenditures	345,153
Special Revenue Fund - Local and State Grants	General Fund	Cash pool in the same bank account and other reimbursable expenditures	2,402,300
Special Revenue Fund - Local and State Grants	Capital Projects Fund	Cash pool in the same bank account	511,328
Capital Projects Fund	General Fund	Cash pool in the same bank account	317,622
Capital Projects Fund	Special Revenue Fund- Local and State Grants	Reimbursable expenditures	490
Other Governmental Funds	General Fund	Cash pool in the same bank account	12,354
Other Governmental Funds	Capital Projects Fund	Cash pool in the same bank account	627
Other Governmental Funds	Special Revenue Fund- Local and State Grants	Reimbursable expenditures	<u>18,331</u>
Total			<u>\$ 4,074,024</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	\$ 52,703
Special Revenue Fund - Housing Project	Debt Service Fund	Debt retirement	<u>178,902</u>
Total			<u>\$ 231,605</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

5. CAPITAL ASSETS

Capital assets; those with an estimated useful live 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 2006, 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>Balance</u>
	<u>July 1, 2005</u>	<u>Additions</u>	<u>Retirements</u>	<u>June 30, 2006</u>
Capital asset, not being depreciated:				
Land	\$ 2,880,490	\$ -	\$ -	\$ 2,880,490
Construction in progress	993,037	898,484	(56,355)	1,835,166
Housing Project Brisas de Arroyo	<u>595,000</u>	<u>-</u>	<u>-</u>	<u>595,000</u>
Total capital assets not being depreciated	<u>4,468,527</u>	<u>898,484</u>	<u>(56,355)</u>	<u>5,310,656</u>
Capital assets, being depreciated:				
Buildings	13,557,545			13,557,545
Building improvements	387,580	52,700		440,280
Infrastructure	1,212,877			1,212,877
Infrastructure improvements	601,617	51,930		653,547
Equipment	509,427	83,334		592,761
Furnishing	292,855	2,472		295,327
Work of Art	3,410			3,410
Computers	61,766	11,777		73,543
Vehicles	1,545,760	205,445		1,751,205
Housing Project - depreciable assets	<u>3,598,666</u>	<u>27,614</u>	<u>-</u>	<u>3,626,280</u>
Total capital assets being depreciated	<u>21,771,503</u>	<u>435,272</u>	<u>-</u>	<u>22,206,775</u>
Less accumulated depreciation for:				
Buildings	(5,474,215)	(338,938)		(5,813,153)
Building improvements	(26,755)	(10,807)		(37,562)
Infrastructure	(29,945)	(30,322)		(60,267)
Infrastructure improvements	(55,814)	(41,796)		(97,610)
Equipment	(306,823)	(74,806)		(381,629)
Furnishing	(227,781)	(24,424)		(252,205)
Work of Art	(909)	(341)		(1,250)
Computers	(44,327)	(11,121)		(55,448)
Vehicles	(1,464,953)	(43,222)		(1,508,175)
Housing Project - depreciable assets	<u>(2,286,108)</u>	<u>(110,749)</u>	<u>-</u>	<u>2,396,857</u>
Total accumulated depreciation	<u>(9,917,630)</u>	<u>(686,526)</u>	<u>-</u>	<u>(10,604,156)</u>
Total capital assets being depreciated, net	<u>11,853,873</u>	<u>(251,254)</u>	<u>-</u>	<u>11,602,619</u>
Governmental activities capital assets, net	<u>\$ 16,322,400</u>	<u>\$ 647,230</u>	<u>\$ (56,355)</u>	<u>\$ 16,913,275</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

5. CAPITAL ASSETS (CONTINUED)

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

Governmental activities:

General government	\$ 328,600
Public safety	18,153
Public works	40,094
Culture and recreation	128,515
Community Development	58,802
Health and welfare	<u>112,362</u>
Total depreciation expense-governmental activities	<u>\$ 686,526</u>

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 collections exceeded advances by \$104,082. In the governmental funds, the entire receivable has been offset by deferred revenue since the excess was not available to pay liabilities of the current period. In the government-wide financial statements, the entire receivable is recognized as revenue.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

6. PROPERTY TAXES (CONTINUED)

The governmental-wide statement of net assets includes an outstanding debt balance of \$74,257 corresponding to the 2005 CRIM final liquidation.

On December 31, 1992, the Municipality entered into an agreement with the Commonwealth of Puerto Rico - Treasury Department, for the repayment of excess property tax advances. As of June 30, 2006, the related unpaid property tax advances presented in the statement of net assets amounted to approximately \$172,927.

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.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

6. PROPERTY TAXES (CONTINUED)

The Government-Wide Statement of Net Assets includes an outstanding debt balance of \$2,327,363 and \$947,999 related to Law 42 and Law 146, respectively.

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 6.83% 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	\$ 173,840
General Services Administration	10,667
Puerto Rico Telephone Company	22,047
Puerto Rico Electric Power Authority (PREPA)	1,625
Commonwealth of Puerto Rico - Treasury Department	444,734
Internal Revenue Service	150,547
Retirement System Administration	<u>71,363</u>
Total	<u>\$ 874,823</u>

The Municipality reached agreements with other governmental entities for the payment of debts on a long-term basis. These liabilities are presented in the Statement of Net Assets as non-current liabilities.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

7. DUE TO OTHER GOVERNMENTAL ENTITIES (CONTINUED)

During the fiscal year 2001-2002, the Municipality authorized the CRIM to retain the corresponding portion for the financing project of Land Information Management System - LIMS, contracted by the CRIM. A total of \$248,774 is to be retained in a ten years period at an interest rate of 5.95%, until November 28, 2011. At June 30, 2006, the outstanding debt balance was \$ 154,574. This amount will be presented in the government wide statement of net assets.

8. DEFERRED REVENUES

- A. **Municipal License Tax**- The deferred revenues of approximately \$551,265 in the general fund relates to municipal license tax collected in fiscal year 2005-06 that will be earned in fiscal year 2006-07.
- B. **Intergovernmental** - The deferred revenues of approximately \$104,082 in the general fund relates to the balance owed from the Municipal Revenue Collection Center (CRIM) at June 30, 2006, as described in Note 6.
- C. **Federal Government**- The deferred revenues presented in the other governmental funds 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>
Disaster Grants - Public Assistance	\$ 47,399
Section 8 Moderate Rehabilitation	3,284
Section 8 Housing Choice Voucher	22,840
Juvenile Justice and Delinquency Prevention	12,340
Public Safety Partnership and Community Policing Grant	22,130
Child and Adult Care Food Program	6,193
Others	<u>10,263</u>
Total	<u>\$ 124,449</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

9. LONG-TERM LIABILITIES

Long-term liability activity for the year ended June 30, 2006, 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	\$ 2,890,208	\$ -	\$ (155,208)	\$ 2,735,000	\$ 160,000
Notes Payable	50,000		(50,000)	-	
Property Tax Advances	3,125,940	274,408	(50,729)	3,349,619	111,983
Property Tax – Treasury	216,159		(43,232)	172,927	43,232
Section 515 direct loan	2,075,581		(27,573)	2,048,008	29,913
Compensated absences	1,169,715	102,623	(114,387)	1,157,951	110,000
Landfill obligation	3,743,418		(2,289,621)	1,453,797	
LIMS Repayment Plan		177,705	(23,131)	154,574	24,528
Unemployment	65,340		(65,340)	-	
Claims and judgments	<u>45,000</u>	<u>18,000</u>	<u>(45,000)</u>	<u>18,000</u>	<u>-</u>
Total	<u>\$13,381,361</u>	<u>\$ 572,736</u>	<u>\$ (2,864,221)</u>	<u>\$11,089,876</u>	<u>\$ 479,656</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.
- 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, 2006 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, 2006</u>
2000-Series	7/1/2009	\$ 1,065,000	5.00% to 8.00%	\$ 520,000
2002-Series	7/1/2026	1,410,000	2.70% to 5.60%	1,325,000
2002-Series	7/1/2026	940,000	5.00% to 7.50%	<u>890,000</u>
Total general obligation bonds				<u>\$ 2,735,000</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.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

9. LONG-TERM LIABILITIES (CONTINUED)

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

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>
2007	\$ 160,000	\$ 152,471
2008	175,000	158,083
2009	185,000	145,070
2010	205,000	130,882
2011	60,000	121,738
2012-2016	380,000	548,896
2017-2021	545,000	412,362
2022-2026	820,000	203,645
2027-2031	<u>205,000</u>	<u>6,500</u>
Total	<u>\$ 2,735,000</u>	<u>\$ 1,879,647</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, 2006</u>
Section 515 loan	7-1-2029	\$ 5,125,000	7.00% to 9.00%	<u>\$ 2,048,008</u>
Total notes payable				<u>\$ 2,048,008</u>

This 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>
2007	\$ 29,913	\$ 144,264
2008	31,901	141,705
2009	41,354	138,955
2010	44,344	135,999
2011	47,550	132,820
2012-2016	285,810	607,407
2017-2021	409,915	483,301
2022-2026	588,535	304,681
2027-2031	<u>568,686</u>	<u>67,663</u>
Total	<u>\$ 2,048,008</u>	<u>\$ 2,156,795</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

9. LONG-TERM LIABILITIES (CONTINUED)

- 4. Compensated absences-** The government-wide statement of net assets includes approximately \$880,991 of accrued sick leave benefits, and approximately \$276,960 of accrued vacation benefits, representing the Municipality's commitment to fund such costs from future operations.
- 5. Landfill Obligation-** State and federal laws and regulations require the Municipality to place a final cover on its landfill site, when it stopped accepting waste, and perform certain maintenance and monitoring functions at the site for 30 years after closure. In accordance with Statement No. 18 of the GASB, "Accounting for Municipal Solid Waste Landfill Closure and Post-closure Care Costs", the Municipality has performed a study of the activities that need to be implemented at the Municipality's landfill to guarantee the maximum yield of available space and to comply with applicable state and federal regulations.

Based on this study, the Municipality has recognized \$1,453,797 as the Municipality's estimated current cost for landfill closure and post-closure costs as of June 30, 2006. The annual estimate of post closure costs has been assessed approximately to be \$15,500 for a period of approximately 30 years. Actual costs may be different due to inflation, changes in technology, or changes in laws and regulations. The balance of closure and post-closure costs are reported in the government-wide statement of net assets.

- 6. LIMS Repayment Plan-** This amount represents the balance owed to the CRIM at June 30, 2006, as described in Note 7.

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.

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.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

10. PENSION PLAN (CONTINUED)

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, 2006 amounted to approximately \$256,738.

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.

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, 2006, a copy of which can be obtained from the Retirement System, Minillas Station, P.O. Box 42003, San Juan, PR 00940.

**COMMONWEALTH OF PUERTO RICO
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NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

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 \$18,000 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.

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 GOVERNMENTAL ACTIVITIES NET ASSETS RESTATEMENT:

The beginning Governmental Activities Net Assets has been restated by approximately \$2,289,621 to properly present the previously reported net assets at June 30, 2005. The restatement is due to change in estimate related to the landfill obligation presented in the Governmental Activities Net Assets for the year ended June 30, 2005.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BASIC FINANCIAL STATEMENTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

14. SUBSEQUENT EVENTS

On October 9, 2006, the Municipal Legislature by Ordinance Number 08-2006-2007 authorized the Mayor to accept and apply the funds derived from the donation provided to the Municipality by the Commonwealth of Puerto Rico of the 2006, Series A, Public Improvement Bond Issuance of \$675,000,000. During the fiscal year 2006-2007, the Municipality of Arroyo will receive approximately \$1,370,886 from the issuance. Those funds will be used for improvements of Municipality's properties.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO
BUDGETARY COMPARISON SCHEDULE- GENERAL FUND
(SEE NOTES TO BUDGETARY COMPARISON SCHEDULE)
YEAR ENDED JUNE 30, 2006**

	<u>Budgeted Amounts</u>		<u>Actual Amounts (Budgetary Basis) (See Note 1)</u>	<u>Variance with Final Budget Positive (Negative)</u>
	<u>Original</u>	<u>Final</u>		
REVENUES:				
Property taxes	\$ 1,254,228	\$ 1,254,228	\$ 1,254,228	\$ -
Fines and forfeiture	10,000	10,000	5,786	(4,214)
Municipal license tax	561,500	561,500	744,306	182,806
Licenses, permits and other local taxes	1,000,500	1,000,500	290,928	(709,572)
Intergovernmental	4,876,182	4,662,718	4,760,262	97,544
Interest	40,463	40,463	52,132	11,669
Rent of property	85,000	85,000	65,812	(19,188)
Miscellaneous	<u>120,000</u>	<u>120,000</u>	<u>52,016</u>	<u>(67,984)</u>
Total revenues	<u>7,947,873</u>	<u>7,734,409</u>	<u>7,225,470</u>	<u>(508,939)</u>
EXPENDITURES, ENCUMBRANCES AND OTHER FINANCING USES:				
Current:				
General government	4,209,401	4,174,239	4,052,914	121,325
Public safety	698,523	633,281	627,502	5,779
Public works	1,864,118	1,766,723	1,673,877	92,846
Health and welfare	671,355	662,163	629,354	32,809
Culture and recreation	451,773	445,300	437,509	7,791
Operating transfer to other funds	<u>52,703</u>	<u>52,703</u>	<u>52,703</u>	<u>-</u>
Total expenditures, encumbrances and other financing uses	<u>7,947,873</u>	<u>7,734,409</u>	<u>7,473,859</u>	<u>260,550</u>
EXCESS (DEFICIENCY) OF REVENUES OVER (UNDER) EXPENDITURES, ENCUMBRANCES AND OTHER FINANCING SOURCES (USES)				
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (248,389)</u>	<u>\$ (248,389)</u>
Explanation of Differences:				
Sources/inflows of resources:				
Actual amounts (budgetary basis) "available for appropriation" from the budgetary comparison schedule				\$ 7,225,470
Differences-budget to GAAP:				
GAAP adjustments to revenues				<u>(70,066)</u>
Total revenues and other financing sources as reported on the statement of revenues, expenditures, and changes in fund balances				<u>\$ 7,155,404</u>
Uses/outflows of resources:				
Actual amounts (budgetary basis) "total charges to appropriations" from the budgetary comparison schedule				\$ 7,473,859
Differences-budget to GAAP:				
GAAP adjustment to expenditures				56,067
Prior year encumbrances recorded as current year expenditures for GAAP basis				416,089
Current year encumbrances recorded as expenditures for budgetary purposes				<u>(212,864)</u>
Total expenditures and other financing uses as reported on the statement of revenues, expenditures, and changes in fund balances				<u>\$ 7,733,151</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

NOTES TO BUDGETARY COMPARISON SCHEDULE- GENERAL FUND

YEAR ENDED JUNE 30, 2006

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, 2006 representing the original budget. There were no supplemental appropriations for the year ended June 30, 2006.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

YEAR ENDED JUNE 30, 2006

<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	\$ 48,506
Total U.S. Department of Agriculture			<u>48,506</u>
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT:			
Direct Program: Lower Income Housing Assistance Program Section 8 Moderate Rehabilitation	14.856		619,912
Direct Program: Section 8 Housing Choice Vouchers Program	14.871		370,954
Pass-through the Commonwealth of Puerto Rico - Office of the Commissioner of Municipal Affairs: Community Development Block Grants - State's Program	14.228	00-FD-07 01-FD-07 02-AB-FC-RI-07 03-AB-FC-07 04-AB-FC-07 05-AB-FC-07	539,053
Total U.S. Department of Housing and Urban Development			<u>1,529,919</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO**

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (CONTINUED)

YEAR ENDED JUNE 30, 2006

<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 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>171,017</u>
Total U.S. Department of Health and Human Services			<u>171,017</u>
U.S. DEPARTMENT OF HOMELAND SECURITY:			
Pass-through the Commonwealth of Puerto Rico - Governor Authorized Representative (GAR): Disaster Grants - Public Assistance	97.036	1552-DR-PR	14,424
Pass-through the Commonwealth of Puerto Rico - Emergency Management Agency Emergency Management Performance Grant	97.042	Not Available	<u>2,695</u>
Total U.S. Department of Homeland Security			<u>17,119</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS			<u>\$1,766,561</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, 2006

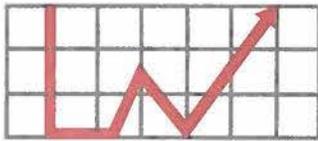
1. BASIS OF PRESENTATION:

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 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>Other Governmental Funds</u>
Per Schedule of Expenditures of Federal Awards	\$ 1,766,561
Non federal programs Expenditures	<u>511,667</u>
Total expenditures in the general purpose financial statements	<u>\$ 2,278,228</u>



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

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

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

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the **Municipality of Arroyo, Puerto Rico**, as of and for the year ended June 30, 2006, which collectively comprise the **Municipality's** basic financial statements and have issued our report thereon dated December 27, 2006, which was unqualified at the governmental-wide financial statement level, but qualified at the fund financial statements level because 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. Except as discussed in the preceding sentence, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the **Municipality of Arroyo's** internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting 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 financial reporting that, in our judgment, could adversely affect **Municipality of Arroyo's** ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items **06-01** through **06-03**.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we considered items **06-02** to be a material weakness.

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

Compliance

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

We noted certain other matters that we reported to management of the **Municipality of Arroyo** in a separate letter dated December 27, 2006.

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


LÓPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
December 27, 2006

Stamp No. 2195985 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.





López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Member of:

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- Puerto Rico Society of Certified Public Accountants

**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, 2006. The **Municipality of Arroyo's** major federal programs are identified in the summary of auditors' 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 \$503,014 in federal awards which is not included in the schedule during the year ended June 30, 2006. 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*.

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 Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about 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.

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

In our opinion, 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, 2006. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which 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 **06-04** through **06-07** and **06-09** through **06-11**.

Internal Control Over Compliance

The management of the **Municipality of Arroyo** is responsible for establishing and maintaining effective internal control over compliance with the 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 the 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 the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as items **06-04** through **06-11**.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants cause by errors or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable condition, and accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items **06-06**, **06-07**, **06-10** and **06-11**, to be material weaknesses.



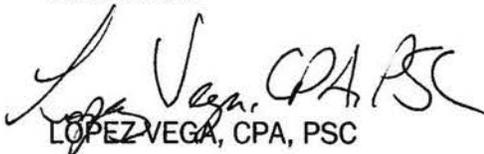
López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

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 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 February 8, 2007.

This report is intended for the information of 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
February 8, 2007

Stamp No. 2195986 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

YEAR ENDED JUNE 30, 2006

Section I – Summary of Auditor’s Results

Financial Statements

Type of auditor’s report issued:	Unqualified, except for qualify for fund financial statements	
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	
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
14.871	Section 8 Housing Choice Voucher 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, 2006

Section II - Financial Statements Findings

Finding Reference	06-01
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, 2006

Section II - Financial Statements Findings

Finding Reference

06-01 (Continued)

Nevertheless, as part of the corrective action plan, the Commissioner of Municipal Affairs ("OCAM") consider alternatives to improve the 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: July, 2007

Responsible Person: Néstor Alicea
Finance Department Director

no

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

2

Section II - Financial Statements Findings

Finding Reference	06-02
Requirement	Financial Reporting - Interfund Transactions
Statement of Condition	During our examination, we noted that for the fiscal year 2005-2006, 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 will review the interfund balance as of June 30, 2006, in order to determine the correct balance. Implementation Date: July, 2007 Responsible Person: Néstor Alicea Finance Department Director

No

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

3

Section II - Financial Statements Findings

Finding Reference 06-03

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

Statement of Condition We performed a cash disbursement test and examined twenty nine (29) disbursement vouchers which belonged to General Fund, nineteen (19) which belonged to Community Development Block Grant (CDBG)-State Program and twelve (12) which belonged to Joint Resolutions account. The following will summarize the internal control exceptions noted:

- a. In ten (10) disbursement vouchers (three (3) related to General Fund, six (6) related to CDBG and one (1) related to Joint Resolutions), several documents were not marked as paid;
- b. Eight (8) disbursement vouchers did not include the pre-intervention officer signature (five (5) related to General Fund and three (3) related to Joint Resolutions);
- c. One (1) General Fund disbursement voucher did not include the original invoice;
- d. Two (2) General Fund disbursement vouchers were not available for our examination;
- e. One (1) CDBG disbursement voucher did not include the date of the pre-intervention officer signature;
- f. In one (1) CDBG disbursement voucher, the purchase order was not issued before the receiving of services;
- g. In one (1) Joint Resolutions disbursement voucher, we noted that the invoice did not include the supplier's signature;

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, 2006

Section II - Financial Statements Findings

Finding Reference 06-03 (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
and Corrective Action 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, 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, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-04
	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 five (25) 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
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-05
Program	Section 8 Housing Choice Vouchers Program CFDA (14.871); U.S. Department of Housing and Urban Development
Requirement	Special Test – Utility Allowance Schedule
Statement of Condition	The PHA did not maintain an up-to-date utility allowance schedule for the audit period ending June 30, 2006. The PHA did not perform a review of the utility rates during the fiscal year to ascertain if there has been a change of ten percent or more in a utility rate.
Criteria	Code of Federal Regulations 24, Subpart K, Section 982.517 states that the PHA must maintain an up-to-date utility allowance schedule. The PHA must review utility rate data for each utility category on a yearly basis and must adjust its allowance schedule if there has been a rate change of ten percent or more for a utility category or fuel type since the last time utility allowance was revised.
Cause of Condition	The PHA did not follow the procedures established to review utility rate date each year.
Effect of Condition	The PHA is no in compliance with Code of Federal Regulations 24, Subpart K, Section 982.517.
Recommendation	The PHA should evaluate utility allowance rate each year as established in the federal regulations.
Questioned Costs	None.
Management Response and Corrective Action	To correct the condition reported by the external auditors, we will review the utility rate data for each category in order to determine any adjustment necessary to the utility allowance in force. Implementation Date: April 1, 2007 Responsible Person: Luis A. Torres Mariani Section 8 Program Sub-Coordinator

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

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YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-06
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	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's files, we did not observe evidence of the program's inspector visits to follow up the rehabilitation work;b. In eight (8) participant's files, we did not observe evidence of the program's inspector final visit. Also, six (6) of these files did not include photos of the completion of the rehabilitation works;c. In one (1) participant's file, we observed evidence of the program's inspector final visit; however, it did not include photos of the completion of the rehabilitation 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>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference 06-06 (Continued)

Effect of Condition The Municipality is not in compliance with Code of Federal Regulations 24, Section 570.506 (b) and 570.506 (b) (9).

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 assure that the procedures established in the operational guide are followed.

Implementation Date: April 1, 2007



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, 2006

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Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-07
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	Allowable Activities
Statement of Condition	<p>We performed a housekeeping assistance project test of ten (10) participant’s files and found the following exceptions:</p> <ul style="list-style-type: none">a. In the ten (10) participant’s files, we did not observe evidence of the family composition;b. In seven (7) participant’s files, we noted that the Service Coordinator realized the required visits to the housing unit to ensure the quality of services; however, none of the visits were made only when the participant was in the house;c. In one (1) participant’s file, we noted that the Service Coordinator did not realized the required visits to the housing unit to ensure the quality of services;d. In seven (7) participant’s files, we noted that, as part of the visits procedures, the Service Coordinator did not document in the Form OCAM-AH-006, the housekeeper performance;e. In three (3) participant’s file, we noted that the Form OCAM-AH-006 was not completed in all its parts. Also, this Form did not include the Service Coordinator signature.
Criteria	<p>Code of Federal Regulations 24, Section 570.484 states that the Municipality must assure that the program funds benefit very low, low- and moderate income persons and retain documentation justifying its certification. Also, the Office of the Commissioner of Municipal Affairs (“OCAM”) issued a procedures manual for housekeeper activities.</p>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Section III - Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-07 (Continued)
Cause of Condition	The Municipality controls and procedures failed to assure that the housekeeper activities participant's files include all the required documents to comply with the program requirements.
Effect of Condition	The Municipality is in noncompliance with 24 CFR, Section 570.484 and with the Office of the Commissioner of Municipal Affairs ("OCAM") procedures manual.
Recommendation	We recommended management to follow the procedures established by the Office of the Commissioner of Municipal Affairs (OCAM) in the procedures manual, including the use of the forms included on it.
Questioned Costs	None
Management Response and Corrective Action	The Municipality's Management concurs with the finding. The Federal Program Director will give instructions to the Program Coordinator to follow the procedures established by the Office of the Commissioner of Municipal Affairs (OCAM) in the procedures manual, and will give instructions for use of the forms included on it.
	Implementation Date: April 1, 2007 
	Responsible Person: Nilda García Housekeeping Program Coordinator

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs



Finding Reference **06-08**

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 **Allowable Cost and Cost Principles**

Statement of Condition **Section II – Financial Statements Findings- Finding Reference 06-03.-**

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

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Finding Reference	06-09
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	<p>During our Cash Management test, we noted that the Municipality requested funds that were not disbursed on a reasonable lapse of time. We selected a sample of thirteen (13) fund requisitions (a total of \$383,642) and found the following exceptions:</p> <ul style="list-style-type: none">a. In four (4) fund requisitions (a total of \$173,006), we observed that the Municipality made the disbursements between six (6) and twenty six (26) days after the deposits;b. In one (1) fund requisition (a total of \$16,106), we observed that the Municipality made the disbursements one hundred seventy (170) days after the deposit.
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, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference 06-09 (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, 2007

NO

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, 2006

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Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-10
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 of two (2) construction projects, we noted that 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 (for one (1) project, the contractor did not submit all the required certified payrolls).
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 and Corrective Action	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.

NO

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference **06-10 (Continued)**

Implementation Date: April, 2007

Responsible Person: Néstor Ramirez
Federal Program Director

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

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YEAR ENDED JUNE 30, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference	06-11
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, 2006

Section III – Major Federal Award Program Findings and Questioned Costs

Finding Reference 06-11 (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 and Corrective Action

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. (12)

Implementation Date: April, 2007

Responsible Person: Néstor Ramirez
Federal Program Director

No se consideran los señalamientos de años anteriores por estos por los mismos de este año solo. 13/06/07

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS

YEAR ENDED JUNE 30, 2006

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
05-05	14.228	<p><u>The auditors performed a housing rehabilitation test of ten (10) participant files and found the following exceptions: (a) In two (2) participant files, the auditors did not observe evidence of the program's inspector visits to follow up the rehabilitation work; (b) In six (6) participant files, the auditors did not observe evidence of the program's inspector final visit. The files only include photos of the completion of works.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 06-06.</p>
05-06	14.228	<p><u>During the Cash Management test, the auditors 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), the auditors observed that the Municipality made the disbursements between six (6) and thirty three (33) days after the deposits.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 06-09.</p>
05-07	14.228	<p><u>During the Davis-Bacon Act test, the auditors 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.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 06-10.</p>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
05-08	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; (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 06-11.</p>
05-09	14.871	<p><u>The auditors performed an eligibility test of fifteen (15) participants files related to Section 8 Housing Choice Vouchers Program. The following summarize the situations found: (a) In two (2) cases, the auditors 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.</u></p> <p>Full corrective action has been taken.</p>
05-10	14.871	<p><u>In the Waiting List test, the auditors noted the following situation: In a sample of twenty (20) applicants included in the Waiting List, the auditors 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.</u></p> <p>No corrective action was taken. The auditors reissued the finding for the current year. Finding Reference 06-04.</p>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
05-11	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, 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. Also, during the examination, the auditors noted that federal program books are maintained in Peachtree Accounting Software by an external consultant. Those books were not available for the examination. As result, the auditors could not verify the accuracy of accounting record with the closing reports submitted to the Pass-through Agency.</u></p> <p>Partially corrective action was 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 06-04.</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 06-10.</p>

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

YEAR ENDED JUNE 30, 2006

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
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 06-11.</p>
04-15	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, 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.</u></p> <p>Partially corrective action was taken.</p>
03-12	14.871	<p><u>The PHA did not select the participant from the top of the waiting list according to the PHA's applicant selection policies.</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>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF ARROYO

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS (CONTINUED)

YEAR ENDED JUNE 30, 2006

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
03-17	14.228	<p><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></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>
03-19	14.228	<p><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></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>
03-21	93.575	<p><u>The Municipality did not maintain, for the Child Care and Development Block Grant Program, a reliable set of accounting records that present the financial position of the program, the results of operations and changes in fund balance.</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>

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

YEAR ENDED JUNE 30, 2006

Original Finding Number	CFDA No.	Current Status of Prior Audit Findings
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>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>