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AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL

AREA DE ARCHIVO DIGITAL

MUNICIPIO DE CANOVANAS
AUDITORIA 2004-2005

30 DE JUNIO DE 2005

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS

SINGLE AUDIT REPORT

BASIC FINANCIAL STATEMENTS AND SUPPLEMENTAL SCHEDULE

With Independent Auditor's Report Thereon

June 30, 2005

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
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BENITEZ-JAIME, CPA-PSC
Certified Public Accountants and Business Consultants

Independent Auditors' Report on Basic Financial Statements and Supplementary Schedule of Expenditures of Federal Awards

The Honorable Mayor, Members of the
Municipal Legislature and People of
the Municipality of Canóvanas
Canóvanas, 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 Canóvanas of the Commonwealth of Puerto Rico (the "Municipality"), as of and for the year ended June 30, 2005, which collectively comprise the Municipality's basic financial statements as listed in the accompanying table of contents. These financial statements are the responsibility of the Municipality's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Canóvanas of the Commonwealth of Puerto Rico, as of June 30, 2005, and the respective changes in financial position, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards we have also issued our report dated November 23, 2005, on our consideration of the Municipality of Canóvanas of the Commonwealth of Puerto Rico internal control over financial reporting and on our test of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The accompanying Management's Discussion and Analysis and the Budgetary Comparison Schedule are not required parts of the basic financial statements referred to above, but are supplementary information required by accounting principles generally accepted in the United States of America. 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's basic financial statements. The accompanying schedule of expenditures of federal awards is presented fro purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States and Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements of the Municipality. The schedule of expenditures and federal awards have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

November 23, 2005
Toa Alta, Puerto Rico

Stamp No. 202355
affixed to the
original report.

P.O. Box 191503, San Juan, Puerto Rico 00919-1503 TEL. 787-603-1600

As management of the Municipality of Canóvanas (the Municipality), we offer readers the following discussion and analysis of the Municipality's financial activities reported in the accompanying basic financial statements for the fiscal year ended June 30, 2005. We encourage readers to consider the information presented here in conjunction with additional information that is furnished in the Municipality's financial statements, which follow this narrative.

FINANCIAL HIGHLIGHTS

Government-Wide Highlights:

- The Municipality's assets exceeded its liabilities (net assets) by $15,111,528 at June 30, 2005. The Municipality's net assets decreased by $1,714,238 (excess of revenues over expenses) during the fiscal year ended June 30, 2005.

- The Municipality's assets increased from $42,625,989 at June 30, 2004 to $45,823,005 at June 30, 2005, for an increase of $3,197,016 (7.5 percent).

- The liabilities of the Municipality increased from $26,715,695 at June 30, 2004 to $30,711,477 at June 30, 2005, for an increase of $3,995,782 (14.96 percent).

- The revenues of the Municipality decreased from $26,703,129 for the fiscal year ended June 30, 2004 to $15,470,690 for the fiscal year ended June 30, 2005, for a decrease of $11,232,660 (42.06 percent).

- The Municipality's expenses decreased from $19,267,912 for the fiscal year ended June 30, 2004 to $17,184,707 for the fiscal year ended June 30, 2005, for a decrease of $2,083,205 (10.81 percent).

Governmental Funds' Highlights:

- The total fund balances of governmental funds amounted to $4,807,154 at June 30, 2005, which decreased by $3,952,111 (net change in fund balances) during fiscal year ended June 30, 2005.

- The total assets of governmental funds decreased from $21,019,582 at June 30, 2004 to $19,182,584 at June 30, 2005, for a decrease of $1,836,998 (8.74 percent).

- The governmental fund's total liabilities increased from $13,259,436 at June 30, 2004 to $14,375,430 at June 30, 2005, for an increase of $1,115,994 (8.42 percent).

- The total revenues of governmental funds decreased from $22,312,604 for the fiscal year ended June 30, 2004 to $15,991,147 for the fiscal year ended June 30, 2005, for a decrease of $6,321,457 (28.33 percent).

- The governmental fund's total expenditures increased from $21,882,915 for the fiscal year ended June 30, 2004 to $24,493,258 for the fiscal year ended June 30, 2005, for an increase of $2,610,343 (11.93 percent).

- Other financing sources (uses), net, of governmental funds increased from $0 for the fiscal year ended June 30, 2004 to $4,550,000 for the fiscal year ended June 30, 2005, for an increase of $4,550,000 (100 percent).

OVERVIEW OF THE BASIC FINANCIAL STATEMENTS

The purpose of financial reporting is to provide external users of basic financial statements with information that will help them to make decisions or draw conclusions about the Municipality. There are many external parties that use the basic financial statements of the Municipality; however, these parties do not always have the same specific objectives. In order to address the needs of as many parties as reasonably possible, the Municipality, in accordance with required financial reporting standards, presents this Management's Discussion and Analysis (MD&A) as an introduction to the accompanying basic financial statements. This narrative represents an overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2005. Because this MD&A is designed to focus on the current year activities, resulting changes and currently known facts, we encourage readers to consider the information presented in this MD&A in conjunction with the additional information furnished in the accompanying basic financial statements.

The Municipality's basic financial statements include three components: (1) government-wide financial statements (GWFS), (2) governmental fund financial statements (GFFS), and (3) notes to the basic financial statements (NBFS). This report also contains additional required and other supplementary information in addition to the basic financial statements themselves. These components are described below.

The basic financial statements focus on: (1) the Municipality as a whole (government-wide financial reporting) and, (2) the Municipality's major individual governmental funds. Both perspectives allow the users to address relevant questions, broaden a basis for comparison (year to year or government to government) and enhance the Municipality's accountability. The components of the basic financial statements are described below.

a) Government-wide Financial Statements

The GWFS are composed of: (1) the statements of net assets (SNA) and (2) the statement of activities (SA). These financial statements can be found immediately following this MD&A. GWFS are designed to provide readers with a broad overview of the Municipality's operations as a whole in a manner similar to private-sector business. These statements provide short-term and long-term information about the Municipality's financial position, which assist the Municipality's management to determine the economic condition at June 30, 2005. The GWFS are prepared using methods that are similar to those used by most private businesses.

1. Statement of Net Assets

The purpose of SNA is to attempt to report all assets owned and all liabilities owed by the Municipality. The Municipality reports of all of its assets when it acquires ownership over the assets and reports all of its liabilities when they are incurred. For example, the Municipality reports buildings and infrastructure as assets, even though they are not available to pay the obligations incurred by the Municipality. On the other hand, the Municipality reports liabilities, such as claims and judgments, even though these liabilities might not be paid until several fiscal years into the future.

The difference between the Municipality's total assets and total liabilities reported in SNA is presented as *net assets,* which is similar to the total owners' equity reported by a commercial enterprise in its financial statements. Although the purpose of the Municipality is not to accumulate net assets, as this amount increases or decreases over time, such amount represents a useful indicator of whether the financial position of the Municipality is either improving or deteriorating, respectively.

2. Statement of Activities

The SA presents information showing how the Municipality's net assets changed during the fiscal year ended June 30, 2005, by presenting all of the Municipality's revenues and expenses. As previously discussed, the items reported in SA are measured in a manner similar to the approach used by a commercial enterprise in that revenues are recognized when earned or established criteria are satisfied, and expenses are recorded when incurred by the Municipality. Consequently, revenues are reported even when they may not be collected for several months after the end of the fiscal year and expenses are recorded even though they may not have used cash during the current year.

Although SA looks different from a commercial enterprise's income statement, the difference is only in format, not substance. Whereas the bottom line in a commercial enterprise represents its net income, the Municipality reports an amount described as *net change in net assets,* which is essentially the same concept.

The focus of SA is on the *net cost* of various activities provided by the Municipality. The statement begins with a column that identifies the cost of each of the Municipality's major functions. Another column identifies the revenues that are specifically related to the classified governmental functions. The difference between the expenses and revenues related to specific functions/programs identifies the extent to which each function of the Municipality draws from general revenues or is self-financing through fees, intergovernmental aid, and other sources of resources.

This statement also presents a comparison between direct expenses and program revenues for each function of the Municipality.

GWFS and GFFS present all of the Municipality's governmental activities, which are supported mostly by taxes and intergovernmental revenues (such as federal and state grants and contributions). All services normally associated with the Municipality fall into this category, including culture, recreation and education; general government; health and sanitation; public safety; public housing and welfare; and economic and urban development.

b) Governmental Fund Financial Statements

The Municipality's GFFS consist of: (1) the balance sheet – governmental funds and (2) the statement of revenues, expenditures and changes in fund balances – governmental funds. These financial statements report the financial position and results of operations of the Municipality's governmental funds, with an emphasis on the Municipality's major governmental funds.

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Municipality, like most other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Each fund is considered an independent fiscal entity accounted for within a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenue, and expenditures. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with legal, financial and contractual provisions.

Governmental funds are used to account for all of the services provided by the Municipality. These funds are used to account for essentially the same functions reported as governmental activities in the GWFS. Unlike GWFS, the focus of GFFS is directed to specific activities of the Municipality rather than the Municipality as a whole; therefore, GFFS report the Municipality's operations in more detail than the GWFS.

GFFS provide a detailed short-term view of the Municipality's finances that assist in determining whether there will be adequate financial resources available to meet the current needs of the Municipality, which is, evaluating the Municipality's near-term financing requirements. For financial reporting purposes, the Municipality classifies its governmental funds within the following types: (1) general fund, (2) debt service fund, (3) special revenue funds and (4) capital projects funds.

GFFS are prepared on an accounting basis that is significantly different from that used to prepare GWFS. In general, GFFS focus on near-term inflows and outflows of expendable financial resources, consequently, generally measure and account for cash and other assets that can easily be converted to cash. For example, amounts reported on the balance sheet include capital assets within a very short period of time, but do not include capital assets such as land and buildings. Governmental fund liabilities generally include amounts that normally are going to be paid within a very short period after the end of the fiscal year. The difference between a fund's total assets and total liabilities is reported as the fund balance, and generally indicates the amount that can be used to finance the next fiscal year's activities. Likewise, the operating statement for governmental funds reports only those revenues and expenditures that were collected in cash or paid with cash, respectively, during the current fiscal year or very shortly after the end of the fiscal year.

Because the focus of GFFS is narrower than that of the GWFS, it is useful to compare the fund information presented for governmental funds with similar information presented for governmental activities in the GWFS. By doing so, readers may better understand the long-term impact of the Municipality's near-term financial decisions. Both the governmental funds' balance sheet and the governmental funds' statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate the comparison between governmental funds and the governmental activities reported in the government-wide financial statements.

The Municipality has two major governmental funds. Each major fund is presented in a separate column in the governmental funds' balance sheet and the governmental funds' statement of revenues, expenditures and changes in fund balances. The two major governmental funds are: (1) general fund and (2) debt service fund.

c) Notes to Basic Financial Statements

The NBFS provide additional information that is essential for a full understanding of the data provided in the GWFS and GFFS. The NBFS can be found immediately following the basic financial statements.

d) Required Supplementary Information

The basic financial statements are followed by a section of required supplementary information consisting of a budgetary comparison between actual operating results with the original budget and the final amended budget for the general fund and the Schedule of Expenditures of Federal Awards.

FINANCIAL ANALYSIS OF GOVERNMENT-WIDE FINANCIAL STATEMENTS

The Municipality's overall financial position and operations for the last two fiscal years are summarized as follows, based on the information included in the accompanying GWFS:

Condensed Statement of Net Assets
Governmental Activities
June 30, 2005 and 2004

	2005	2004, as restated (note 14)
Assets:		
Current assets	$ 17,346,431	$ 10,544,611
Noncurrent assets:		
Capital assets, net	28,423,313	22,787,981
Other noncurrent assets	53,261	9,209,750
Total assets	$ 45,823,005	$ 42,542,342
Liabilities:		
Current liabilities	$ 8,047,840	$ 6,318,435
Long-term obligations due within one year	2,815,329	2,800,944
Long-term obligations due after one year	19,848,308	16,597,197
Total liabilities	30,711,477	25,716,576
Net assets (deficit):		
Invested in capital assets, net of related debt	$ 17,808,455	$ 14,052,126
Restricted	2,184,128	5,789,102
Unrestricted	(4,881,055)	(3,015,462)
Total net assets	$ 15,111,528	$ 16,825,766

At June 30, 2005, the Municipality's current assets, amounting to $17,346,431, are mainly composed of restricted cash ($7,862,696), unrestricted cash and cash equivalents ($2,687,986), property taxes

receivable ($5,185,957), municipal license taxes receivable ($1,107,749) and intergovernmental receivables ($433,893).

The restricted cash represents resources legally designated for: (1) the payment of debt service, (2) the acquisition, construction and improvement of major capital assets, and (3) the operations of federally and state funded programs. Restricted cash also consists of unspent proceeds of bonds issued to pay accounts payable and certain specific commitments. Restricted property taxes receivable represent resources set aside to redeem the bonds of the Municipality in minimum annual or biannual principal and interest payments.

The Municipality's noncurrent assets, amounting to $28,476,574 at June 30, 2005, are substantially composed of capital assets, with a cost basis of $41,211,338, which are reported net of accumulated depreciation and amortization of $12,788,025.

At June 30, 2005, the assets of the Municipality increased by $3,197,016 (7.5 percent) in comparison with prior fiscal year, principally for the following facts:

- Restricted cash decreased by $1,302,833 mainly due to the usage of the cash in construction projects offset by the proceeds of two new bond issuances made during the current fiscal year, amounting to $3,115,000, and $1,435,000, respectively.

- Unrestricted cash and cash equivalents decreased by $276,396 because of the maturing of $1,200,000 of CD's , which were not renewed, offset by the proceeds of one new bond issuance made during the current fiscal year of $1,435,000.

- Property taxes receivable decreased by $494,014, because the current year property assessment was lower that in the prior year.

- Municipal license receivable decreased by $430,604, mainly due to the collection efforts of the Municipality's Department of Finance.

- Intergovernmental receivables increased by $160,586 principally due to a grant receivable from the Department of Labor.

- Capital assets increased by $5,565,822 principally due to the excess of current year additions of Construction in Progress ($5,518,818) for the fiscal year ended June 30, 2005.

At June 30, 2005, the Municipality's current liabilities amounting to $10,863,169 are mainly composed of deferred revenues ($5,005,351), accounts payable and accrued liabilities ($1,999,225), intergovernmental payables ($861,054), and the portions due within one year of compensated absences ($1,220,607) and bonds payable ($1,553,258). Deferred revenues principally consist of deferred revenues associated with municipal license taxes and intergovernmental grants and contributions related to state and federally funded programs. As noted in the condensed statement of net assets, the Municipality's current assets exceeded current liabilities by $15,111,528, for a current ratio (current assets to current liabilities) of 1.50 to 1.00.

The Municipality's noncurrent liabilities, amounting to $19,848,308 at June 30, 2005, are mainly composed of portions due after one year of bonds payable ($18,428,886) and compensated absences ($1,381,440).

At June 30, 2005, the liabilities of the Municipality increased by $3,995,782 (14.96 percent) in comparison with prior fiscal year-end, principally for the following facts:

- Bonds payable increased by $3,640,000 due to the net effect of the issuance of two new bond series in the aggregate amount of $4,550,000, and the related debt service principal payments of $910,000 made during current fiscal year.

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial position. The assets of the Municipality exceeded liabilities by $15,111,528 at June 30, 2005. The most significant portion of net assets ($17,808,455) reflects the Municipality's investment in capital assets (e.g. land, buildings, machinery, equipment, infrastructure, etc.), net of all related debt still outstanding that was issued to acquire, construct or improve those assets. The Municipality uses these capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although the Municipality's investment in capital assets is reported net of the outstanding related debt, the resources needed to repay that debt must be provided by other sources, since capital assets cannot be used to liquidate these liabilities.

Another significant portion of net assets ($2,184,128) at June 30, 2005, represents resources that are restricted for debt service payments.

The remaining component of total net assets consists of an unrestricted deficit amounting to ($4,881,055) at June 30, 2005. This unrestricted deficit is the consequence of previous budgets that did not provide sufficient funding for incurred long-term obligations, such as bonds payable, compensated absences, claims and judgments, certain obligations under capital leases, etc. Historically, a significant portion of such obligations has been budgeted on a pay-as-you-go basis.

The total net assets of the Municipality decreased by $1,714,238 for the fiscal year ended June 30, 2005. Such increase is due to the excess of total expenses ($17,184,707) over revenues ($15,470,469) for the fiscal year ended June 30, 2005 and is principally composed as follows:

- An increase of $3,756,329 in net assets invested in capital assets, net of related debt. The increase in this net asset category is due to the combination of: (1) the excess of current year additions ($6,770,892) over depreciation/amortization of capital assets ($1,135,560), (2) the net increase of $3,598,545 in outstanding debt related to the acquisition, construction or improvement of capital assets, and (3) and the net increase of $160,529 in the unspent proceeds of debt associated with the acquisition, construction or improvement of capital assets.

- A decrease of $3,604,974 in restricted net assets due principally to the bond's principal and interest paid were higher than the property taxes collected and because prior years' restricted funds were used for construction purposes..

- A decrease of $950,121 in unrestricted net assets due to: (1) a decrease of $494,014 in property taxes receivable and (2) a decrease of $430,604 in intergovernmental receivables of unrestricted resources.

The following is a comparative condensed presentation of the Municipality's results of operations as reported in the GWFS:

Statement of Activities
Governmental Activities
Fiscal Years Ended June 30, 2005 and 2004

	2005	2004, as restated (note 14)
Program revenues:		
Program-specific operating grants and contributions	$ 1,793,930	$ 1,835,705
Program-specific capital grants and contributions	1,944,568	1,972,706
Charges for services	726,257	765,521
Total program revenues	4,464,755	4,573,932
General revenues:		
Property taxes	4,721,341	9,318,696
Municipal license taxes	1,867,937	2,899,112
Construction excise taxes	2,866,035	2,574,181
Unrestricted grants and contributions	898,964	5,552,188
Other general revenues (various sources)	651,437	1,785,020
Total general revenues	11,005,714	22,129,197
Total revenues	15,470,469	26,703,129
Program expenses:		
General government	6,883,218	9,134,901
Urban and economic development	4,188,614	2,958,214
Public safety	589,495	320,841
Health and sanitation	1,970,240	1,619,862
Culture, recreation and education	596,269	33,647
Public housing and welfare	1,862,984	3,455,702
Interest on long-term obligations	1,093,887	829,273
Total expenses	17,184,707	18,352,440
Net increase in net assets	(1,714,238)	8,350,689
Net assets, at beginning of fiscal year	16,825,766	8,475,077
Net assets, at end of fiscal year	$15,111,528	$16,825,766

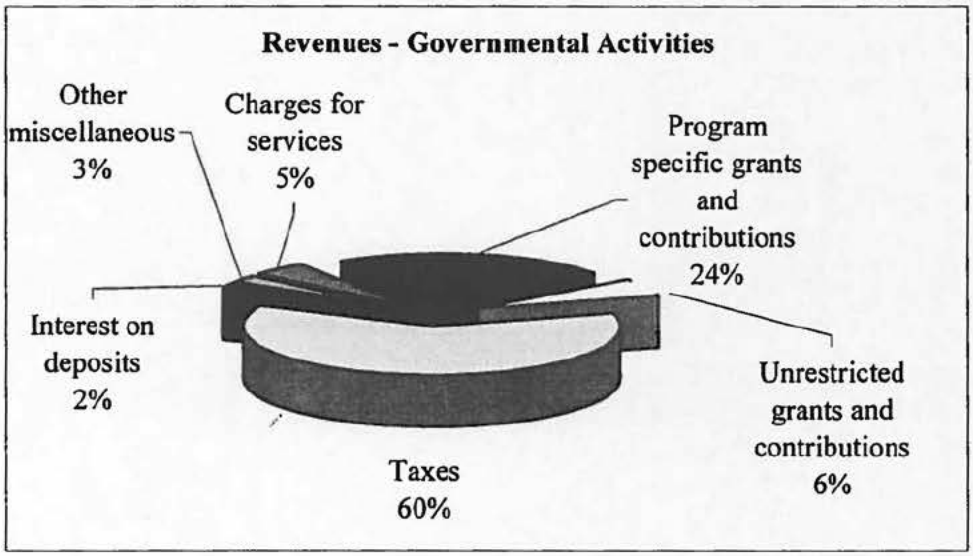
As previously mentioned, the Municipality's net assets decreased by $798,766 or 5.02 percent during the current fiscal year. Approximately 61.12 percent ($9,455,313) of the Municipality's total revenues for the current fiscal year came from property, municipal license and construction excise taxes, while 29.98 percent ($4,637,462) resulted from restricted and unrestricted capital and operating grants and

contributions. Charges for services and other revenues, amounting to $1,377,694, provided 8.91 percent of the total revenues for the current fiscal year.

There was a significant decrease of $9,149,455 (123.06 percent) in the net change in net assets for the Municipality as a whole, when operations for the fiscal current year are compared to those of the prior fiscal year. This occurred because the decrease of $2,083,205 in total expenses was not sufficient to offset the decrease in total revenues of $11,232,660. The most significant fluctuations among the current fiscal year revenues and those of the prior fiscal year were as follows:

- Property taxes revenues decreased by $4,597,355 because the current year property assessment was lower that in the prior year.
- Municipal license revenues decreased by $1,031,175, mainly due to an extraordinary collection at the end of the prior fiscal year, which was not collected during this fiscal year.
- Grants and contributions decreased by $4,653,224, primarily due to less grants funded by the local government.

The following chart presents the composition of revenues for the fiscal year ended June 30, 2005:



The Municipality's expenses cover a wide range of services. The largest expenses of the Municipality for the fiscal year ended June 30, 2005 were related to: (1) general administrating and operating costs ($6,883,218), which were classified as "general government" and accounted for 40.05 percent of total expenses, (2) culture, recreation and education ($596,269), which accounted for 3.47 percent of total expenses, (3) health and sanitation ($1,970,240), which accounted for 11.47 percent of total expenses, (4) urban and economic development ($4,188,614), which accounted for 24.37 percent of total expenses and (5) public housing and welfare ($1,862,984), which accounted for 10.84 percent of total expenses.

The most significant fluctuations between the current fiscal year's expenses and those of the prior fiscal year occurred in the following functions/activities:

- General government expenses decreased by $3,167,155 the Municipality's department of finance and budget has continually improved its budget control procedures to ensure compliance with the inherent budgetary limitations. With this achievement, the Municipality reduced certain operating costs associated with several activities and improved significantly the effectiveness and efficiency of its operations.

- Urban and economic development expenses increased by $1,230,400 because during current year the Municipality increased its urban development activities by increasing its investment in public permanent improvements, supported principally by resources received from HUD, under the CDBG program, and proceeds from bonds.

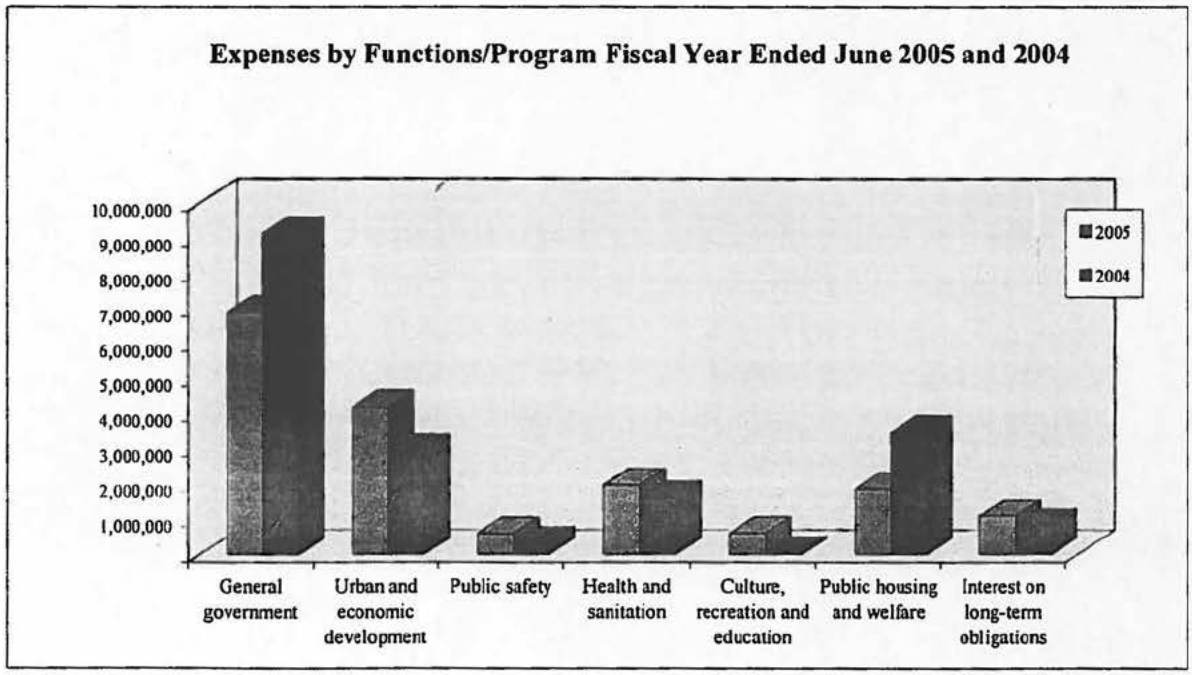
- Public safety expenses increased by $268,681 because during current fiscal year the Municipality increased its municipal police force to increase the public safety of its citizens.

- Health and sanitation expenses increased by $350,378 mainly because: (1) during current fiscal year the Municipality made improvements to their health facilities.

- Public housing and welfare expenses decreased by $1,592,718 mainly because there was a decrease in grants for the elderly.

- Interest on long-term obligations increased by $264,614 in comparison with the prior fiscal year principally for the net increase of $3,640,000 in bonds payable associated with the new bond issuances made during current fiscal year in the aggregate amount of $4,550,000.

The following table presents the composition of expenses for the fiscal years ended June 30, 2005 and 2004:



FINANCIAL ANALYSIS OF GOVERNMENTAL FUNDS

Condensed Balance Sheet - Governmental Funds
June 30, 2005 and 2004

	2005	2004, as restated (note 14)
Assets:		
Total assets - major governmental funds	$ 14,462,195	$ 17,446,998
Total assets - other governmental funds	4,815,502	3,572,584
Combined total assets	19,277,697	21,019,582
Liabilities:		
Total liabilities - major governmental funds	$ 10,847,239	$ 10,145,786
Total liabilities - other governmental funds	3,623,304	2,113,731
Combined total liabilities	14,470,543	12,259,517
Fund balances:		
Reserved - major governmental funds	2,639,837	4,098,431
Reserved - other governmental funds	1,192,198	1,677,555
Unreserved - major governmental funds	975,119	3,202,781
Unreserved - other governmental funds		(218,702)
Combined total fund balances	4,807,154	8,760,065
Total liabilities and fund balances	$ 19,277,697	$ 21,019,582

Analysis of Financial Position of Governmental Funds

As discussed earlier, the Municipality uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows and balances of expendable resources. Such information is useful in assessing the Municipality's compliance with finance-related legal requirements. Specifically, unreserved fund balance may serve as a useful measure of the Municipality's net resources available for spending at the end of the fiscal year.

At June 30, 2005, the total assets of governmental funds decreased by $1,836,998 (8.74 percent) in comparison with the prior fiscal year principally for: (1) the decrease of $1,302,833 in restricted cash, (2) the decrease in unrestricted cash and cash equivalents of $276,396, and (3) the decrease of $751,158 in taxes receivables.

At June 30, 2005, the total liabilities of governmental funds increased by $1,115,994 (8.42 percent) in comparison with the prior fiscal year principally for: (1) the increase of $278,684 in accounts payable and accrued liabilities, (2) the increase in matured bonds due and payable of $385,000, (3) and the increase of $501,489 short-term and long-term amounts due to other funds.

For a detailed explanation of the individual fluctuations of total assets and total liabilities of governmental funds, please refer to the previous financial analysis of the government-wide financial statements included in this management's discussion and analysis, where a detailed discussion of most of these fluctuations has been made.

At the end of the current fiscal year, total unreserved fund balances of the governmental funds amounted to $(975,119), while total fund balance reached $4,807,154. The total fund balances decreased by $3,952,111 during the current fiscal year. The most significant fluctuation in total fund balances occurred in the fund balances reserved for capital projects, which decreased by 61.07 percent ($1,762,467), mainly due to prior years' bonds proceeds, which were used for construction purposes during the current year.

The following is a detailed financial analysis of the Municipality's governmental funds:

Major Governmental Funds

General fund (GF) – The GF's is the principal operating fund of the Municipality. The GF's total assets amounted to $10,633,269 at June 30, 2005. Such assets consist principally of: (1) unrestricted and restricted cash and cash equivalents ($3,561,626), (2) property and municipal license tax receivables ($5,542,548), and (3) short-term and long-term amounts due from other funds ($1,520,824).

The GF's total liabilities amounted to $8,663,227 at June 30, 2005. Such liabilities are composed mainly of: (1) deferred revenues ($6,689,215), and (2) accounts payable and accrued liabilities, including amounts due to other governments ($1,455,512).

At the end of the current fiscal year, unreserved fund balance of the GF's amounted to $975,119, while total fund balance reached $1,970,042. As a measure of the GF's liquidity it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance represents 6.96 percent of the total GF's expenditures, while total fund balance represents 14.06 percent of that same amount.

Debt service fund (DSF)- The DSF's total assets amounted to $3,828,926 at June 30, 2005, which consist mainly of restricted cash in fiscal agent ($2,557,621) and restricted property taxes receivable ($751,158). The DSF's total liabilities amounted to $2,184,012 at June 30, 2005, which are mainly composed of: (1) matured bonds due and payable ($1,295,000), (2) matured interest due and payable ($339,123) and (3) deferred revenues ($539,214). At the end of the current fiscal year, DSF's total and reserved fund balance reached $1644914.

Other governmental funds (OGF)- The OGF's total assets amounted to $4,720,389 at June 30, 2005, which consist mainly of restricted cash ($4,431,375) and receivables from intergovernmental grants and contributions ($287,584). The OGF's total liabilities amounted to $3,623,304 at June 30, 2005, which are mainly composed of deferred revenues ($1,646,769) and short-term and long-term amounts due to other funds ($1,363,840). At the end of the current fiscal year, OGF's total fund balance reached $1,192,198.

Condensed Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds
Fiscal Years Ended June 30, 2005 and 2004

	2005	2004, as restated
Revenues:		
Total revenues - major governmental funds	$ 12,161,266	$ 19,073,668
Total revenues - other governmental funds	3,829,881	3,238,936
Combined total revenues	15,991,147	22,312,604
Expenditures:		
Total expenditures - major governmental funds	15,948,303	16,673,194
Total expenditures - other governmental funds	8,544,955	4,210,602
Combined total expenditures	24,493,258	20,883,796
Excess of expenditures over revenues	(8,502,111)	1,428,808
Other financing sources (uses), net:		
Other financing sources (uses), net - major governmental funds	1,462,760	(233,736)
Other financing sources (uses), net - other governmental funds	3,087,240	233,736
Combined other financing sources (uses), net	4,550,000	
Net change in fund balances	(3,952,111)	1,428,808
Fund balance, at beginning of fiscal year	8,759,265	7,330,457
Fund balance, at end of fiscal year	$ 4,807,154	$ 8,759,265

Analysis of Operating Results of Governmental Funds

Major Governmental Funds

General fund – The total fund balance of the GF decreased by $1,023,591 or 34.19 percent during current fiscal year. Total revenues, expenditures and other financing uses (net) amounted to $11,129,124, $14,008,266 and $913,931, respectively, for the fiscal year ended June 30, 2005.

Approximately 79.35 percent ($8,830,711) of the GF's total revenues for the current fiscal year came from property, municipal license and construction excise taxes, while 9.39 percent ($1,045,273) resulted from intergovernmental grants and contributions. Miscellaneous revenues, amounting to $1,572,156, provided 14.13 percent of the total revenues for the current fiscal year.

There was a significant decrease of $2,591,038 (214.02 percent) in the GF's net change in fund balance when operations for the current fiscal year are compared to those of the prior fiscal year. This occurred because of the decrease in total revenues of $5,753,742, the increase of $1,237,705 in total expenditures and the increase in other financing sources (net) of $1,925,539.

The GF's most significant fluctuations among the current fiscal year revenues and those of the prior fiscal year were as follows:

- Miscellaneous revenues decreased by $1,277,845, due to two budgetary readjustments affecting the miscellaneous revenue account during the previous fiscal year. These readjustments were not performed during the current fiscal year.

- Intergovernmental grants and contributions decreased by $4,368,725 mainly due to the aggregate decrease in: (1) the contributions in lieu of taxes from the Puerto Rico Electric Power Authority, (2) the contributions received from the Puerto Rico Department of Treasury as a partial reimbursement of the Christmas bonuses paid by the Municipality to its employees, and (3) other intergovernmental grants and contributions.

The most significant fluctuation between the current fiscal year expenditures and those of the prior fiscal year occurred in the general government expenditures, which decreased by $2,610,343 because, as previously discussed, the Municipality implemented a strong cost reduction initiative during current fiscal year. This initiative emphasized in reducing general and administrative costs while increasing direct services to citizens. A detailed explanation of these cost reduction initiatives are described in the previous financial analysis of government-wide financial statements.

Other financing uses (net) increased by $1,925,539 mainly due to the proceeds of a current year bond issuance ($1,435,000).

Debt service fund (DSF) – The total fund balance of the DSF decreased by $359,066 or 17.92 percent during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to $1,032,142, $1,940,037 and $548,829, respectively, for the fiscal year ended June 30, 2005.

Approximately 96.79 percent ($998,971) of DSF's total revenues for the current fiscal year came from restricted property taxes. There was a significant decrease of $1,050,027 in the DSF's net change in fund balance when operations for the current fiscal year are compared to those of the prior fiscal year. This occurred because of the decrease in total revenues ($545,634) and other net financing sources ($13,916) and an increase of $490,477 in total expenditures.

The decrease in total DSF's revenues is mainly due to the decrease of 36.05 percent ($563,097) in property tax revenues. The increase in total DSF's expenditures is specifically because of the increase in debt service expenditures. The decrease in other financing sources (net) is mainly due to the increase of 110.54 percent ($17,416) in amounts transferred-out to other funds.

Other governmental funds (OGF) – The total fund balance of the OGF decreased by $1,570,335 or 56.84 percent during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to $3,829,881, $8,544,955 and $3,087,240, respectively, for the fiscal year ended June 30, 2005.

Approximately 97.61 percent ($3,738,498) of OGF's total revenues for the current fiscal year came from intergovernmental grants. There was a decrease of $22,081 in the OGF's total revenues (mainly on intergovernmental grants), while total expenditures increased by $3,345,104 (mainly on direct benefits to citizens and capital outlays). Other financing sources (net) increased by $2,625,910.

The increase in other financing sources (net) is mainly due to the issuance of a new bond series of $3,115,000.

BUDGETARY HIGHLIGHTS

a) General Fund

The original budget of the general fund for the fiscal year ended June 30, 2005 amounted to $16,005,485. Over the course of the fiscal year, the Municipality revised the GF'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. For this reason, during the current fiscal year, the original budget was amended to recognize an increase of $1,587,551 in total budgeted revenues, to reach the total amended budgeted amount of $17,593,036 (including other financing sources. Increases in budgeted expenditures were also made since the laws and regulations of the Commonwealth mandate a balanced budget.

The total actual revenues (budgetary basis) of the general fund for the fiscal year ended June 30, 2005 were $15,942,993, which is 9.38 percent ($1,650,043) less than the budgeted revenues. In addition, the total actual expenditures (budgetary basis) of the general fund for the fiscal year ended June 30, 2005 were $15,051,712, which is 10.77 percent ($1,816,075) less than the budgeted expenditures. Furthermore, the total actual other financing uses (budgetary basis) of the general fund for the fiscal year ended June 30, 2005 were $(692,000), which is 4.58 percent ($33,249) less than the budgeted other financing uses (net).

The total variance in revenues was mainly because actual miscellaneous revenues were $1,448,056 less than budgeted amounts due to a excess of cash from prior year recorded in the amended budget. On the other hand, the total variance in expenditures was principally due to a strong cost reduction initiative implemented by the Municipality during current fiscal year, which emphasized in reducing general and administrative costs while increasing direct services to citizens.

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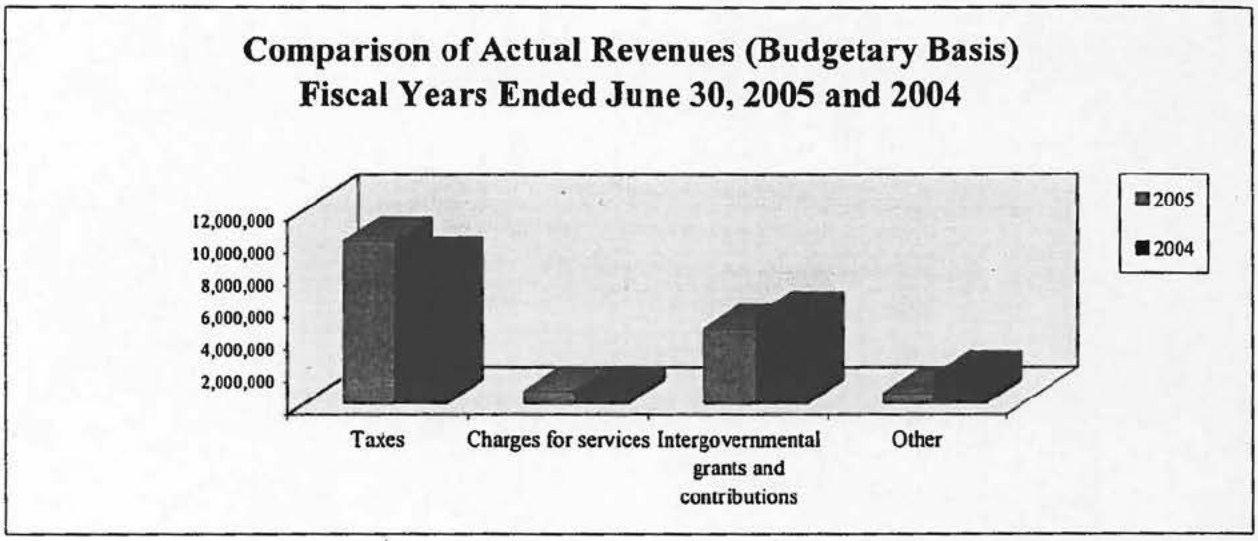
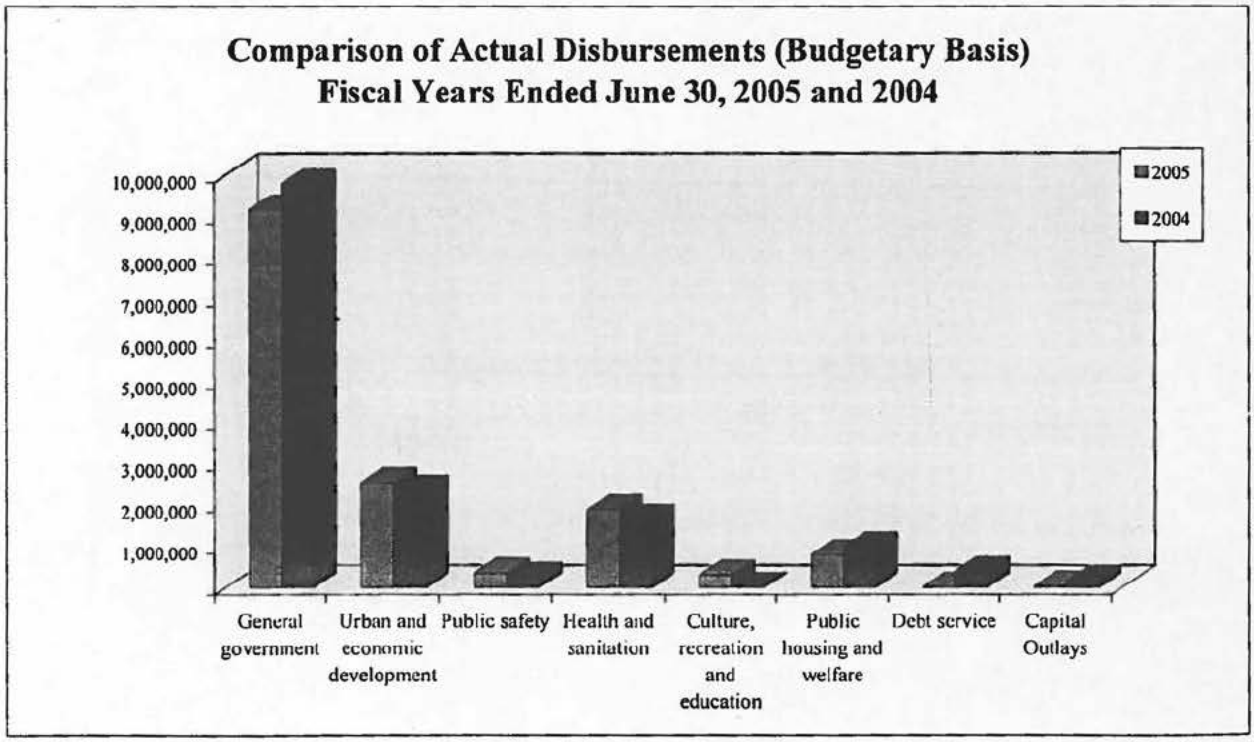
The following tables present the actual revenues and expenditures (budgetary basis) of the GF for the fiscal year ended June 30, 2005:





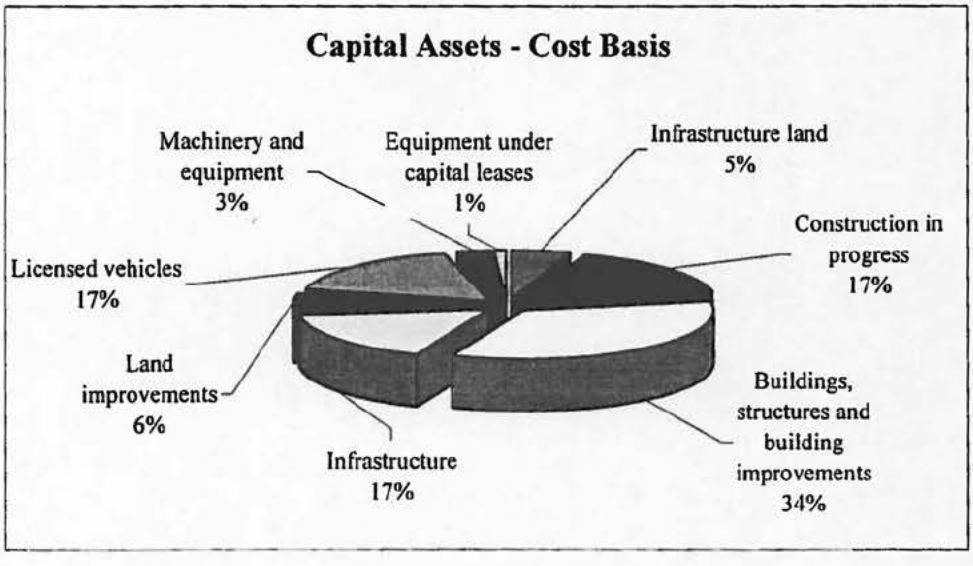
CAPITAL ASSETS AND DEBT ADMINISTRATION

a) Capital Assets

The Municipality has invested $41,211,338 in capital assets used in governmental activities, which have an accumulated depreciation and amortization of $12,788,025 at June 30, 2005. The net capital assets increased by $5,635,334during the current fiscal year mainly due to the current fiscal year's capital additions ($6,770,894), which were partially offset by the depreciation and amortization expense ($1,135,560) for the same period.

Approximately 81.51 percent of the total capital additions made to capital assets during the fiscal year ended June 30, 2005 were related to construction in progress ($5,518,818). The major capital additions for the fiscal year ended June 30, 2005 were the following:

Construction of the Multi-use Building	$ 929,252
Construction of the Sports Complex at Loiza Valley	213,342
Improvements of Bridges at Lomas del Viento Sector	1,200,639
Construction of the Sports Complex at Barrio San Isidro	444,618
Improvements to the Municipal Library at Barrio Campo Rico	377,945
Construction of the Sports Complex at Las Lomaso	30,511
Improvements to La Central Basketball Court	37,000
Total major capital additions for the fiscal Year ended June 30, 2005	$ 3,233,307



b) Debt Administration

The Municipality finances a significant portion of its construction activities through bond and note issuances, and through state and federal grants. The proceeds from bond issuances designated for

construction activities are committed in its entirety for such purposes and cannot be used for any other purposes.

At June 30, 2005, the Municipality's total bonded debt amounted to $19,982,143, consisting of bonds ($13,960,000) and other notes payable ($6,022,143). Such debt is backed by the full faith and credit of the Municipality. The following is a summary of the debt activity for the fiscal year ended June 30, 2005:

- Bonds payable increased by 35.27 percent ($3,640,000) due to the issuance of two new bond issuances amounting to $4,550,000, which increased the debt. However, such increase was partially reduced by the total principal payments on bonds ($910,000) made during the current fiscal year. The proceeds of the two new bond issuances are being used to acquire machinery and equipment and to perform construction and major capital improvement activities within the Municipality.

- The Municipality has also certain outstanding notes payable due to the U.S. Department of Housing and Urban Development ($4,350,000), and the Treasury Department ($1,672,144). Such notes payable decreased by $555,688 during the current fiscal year mainly due to the principal payments made during the same period.

The total property assessed value the Municipality amounted to $133,625,123 at June 30, 2005. The Municipality's legal debt margin amounted to $2,478,633 at the current fiscal year-end.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

The territory of Canóvanas covers an area of approximately 28 square miles. Canóvanas is a municipality with a population density of 1,546 habitants per square mile.

Of the total population of the Municipality, 54 percent or approximately 25,200 persons are considered to live under the poverty level. This rate is higher than the overall rate for Puerto Rico (48 percent). Approximately 30 percent of the population of the Municipality receives public financial assistance as their principal source of income.

Based on the projections of the Planning Board of the Commonwealth of Puerto Rico, the economy of Puerto Rico, including the Municipality, reflected a real growth of almost 3 percent for the fiscal year ended June 30, 2005. In nominal terms, the economy increased approximately 7 percent during fiscal year 2003-2005.

The Municipality relies primarily on property and municipal license taxes, as well as, federal and state grants to carry out its governmental activities. Historically, property and municipal license taxes have been very predictable with increases or decreases not generally exceeding ten percent. Federal grant revenues may vary if new grants are available but the revenue is also very predictable.

Those factors were considered when preparing the Municipality's budget for the 2004-2005 fiscal year. There were no significant changes between the budgets for fiscal year 2004-2005 and the budgets for fiscal year 2003-2004. The budgets of the GF and the DSF for the fiscal year 2004-2005 amounted to $17,593,036 and $1,410,539, respectively. These amounts represent an increase of $718,628 (4 percent)

in the total budgeted revenues of the GF, and an increase of $327,904 (30 percent) in the total budgeted revenues of the DSF in comparison with the prior fiscal year.

REQUEST FOR INFORMATION

This financial report is designed to provide a general overview of the Municipality's finances for all of the Municipality's citizens, taxpayers, customers, investors and creditors. This financial report seeks to demonstrate the Municipality's accountability for the money it receives. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Municipality of Canóvanas, Department of Finance and Budget, P.O. Box 1612, Canóvanas, Puerto Rico, 00729.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Statement of Net Assets
June 30, 2005

Assets

		Governmental activities
Current assets:		
Cash in commercial banks, including cash equivalents of $1,300,000		$ 2,687,926
Accounts receivable, net of allowance for doubtful accounts of $4,520,004:		
Taxes:		
Property taxes	$ 4,434,799	
Municipal license taxes	1,107,749	
Accrued interest on deposits	11,348	
Intergovernmental grants and contributions	433,893	
Total accounts receivable		5,987,789
Inventories and other current assets		56,862
Restricted assets:		
Cash in commercial banks	2,726,106	
Cash in fiscal agent	5,136,590	
Property taxes	751,158	
Total restricted assets		8,613,854
Total current assets		17,346,431
Noncurrent assets:		
Capital assets, at cost:		
Depreciable capital assets	33,417,756	
Nondepreciable capital assets	7,793,582	
Total capital assets, at cost	41,211,338	
Less: accumulated depreciation and amortization	(12,788,025)	
Total capital assets, net of accumulated depreciation and amortization		28,423,313
Deferred charges, net of accumulated amortization of $76,206		53,261
Total noncurrent assets		28,476,574
Total assets		$ 45,823,005

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Statement of Net Assets (concluded)
June 30, 2005

Liabilities and net assets

		Governmental activities
Current liabilities (due within one year):		
Accounts payable and accrued liabilities, including accrued interest of $442,418		$ 1,999,225
Intergovernmental payables		861,054
Deferred revenues		5,005,351
Reserve for federal cost disallowances		182,210
Current portion of long-term obligations:		
Bonds payable	$ 1,553,258	
Obligation under capital leases	41,464	
Compensated absences	1,220,607	
Total current portion of long-term obligations		2,815,329
Total current liabilities		10,863,169
Noncurrent liabilities, excluding current portion (due in more than one year) :		
Bonds payable		18,428,886
Obligation under capital leases		37,982
Compensated absences		1,381,440
Total noncurrent liabilities		19,848,308
Total liabilities		$ 30,711,477
Net assets (deficit):		
Invested in capital assets, net of related debt		$ 17,808,455
Restricted for:		
Debt service	2,184,128	
Total restricted net assets		2,184,128
Unrestricted deficit		(4,881,055)
Total net assets		$ 15,111,528

Commitments and contingencies (note 13)

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Statement of Activities
June 30, 2005

Functions/programs	Expenses	Program revenues: Charges for services	Program revenues: Program – specific operating grants and contributions	Program revenues: Program – specific capital grants and contributions	Net (expenses) and changes in net assets
Governmental activities:					
General government	$ 6,883,218	726,257	77,009		$ (6,079,952)
Urban and economic development	4,188,614			1,760,205	(2,428,409)
Public safety	589,495		175,093		(414,402)
Health and sanitation	1,970,240				(1,970,240)
Culture, recreation and education	596,269				(596,269)
Public housing and welfare	1,862,984		1,541,828	184,363	(136,793)
Interest on long-term obligations	1,093,887				(1,093,887)
Total governmental activities	$ 17,184,707	726,257	1,793,930	1,944,568	(12,719,952)

General revenues:	
Taxes:	
Property taxes	4,721,341
Municipal license taxes	1,867,937
Construction excise taxes	2,866,035
Total taxes	9,455,313
Intergovernmental grants and contributions, not restricted to specific programs	898,964
Interest on deposits and investments	256,723
Miscellaneous	394,714
Total general revenues	11,005,714
Net change in net assets	(1,714,238)
Net assets at beginning of fiscal year	16,825,766
Net assets at end of fiscal year	$ 15,111,528

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Balance Sheet – Governmental Funds
June 30, 2005

	Major governmental funds			
	General fund	Debt service fund	Other governmental funds	Total governmental funds
Assets				
Cash in commercial banks, including cash equivalents of $1,300,000	$ 2,687,926			$ 2,687,926
Accounts receivable, net of allowance for uncollectible accounts of $4,520,004:				
Taxes:				
Property taxes	4,434,799			4,434,799
Municipal license taxes	1,107,749			1,107,749
Accrued interest on deposits	8,371	1,647	1,330	11,348
Intergovernmental grants and contributions	146,309		287,584	433,893
Due from other funds	1,206,893	518,500		1,725,393
Advances to other funds	167,622		95,113	262,735
Restricted assets:				
Cash in commercial banks			2,726,106	2,726,106
Cash in fiscal agent	873,600	2,557,621	1,705,369	5,136,590
Property taxes receivable, net of allowance for uncollectible accounts of $735,815		751,158		751,158
Total assets	$ 10,633,269	3,828,926	4,815,502	$ 19,277,697
Liabilities				
Accounts payable and accrued liabilities	$ 729,081		517,582	$ 1,246,663
Intergovernmental payables	726,431			726,431
Due to other funds	518,500	10,675	1,196,218	1,725,393
Advances from other funds			262,735	262,735
Deferred revenues	6,689,215	539,214	1,646,769	8,875,198
Matured bonds due and payable		1,295,000		1,295,000
Matured interest due and payable		339,123		339,123
Total liabilities	8,663,227	2,184,012	3,623,304	14,470,543
Fund balances				
Reserved for:				
Encumbrances	827,301			827,301
Debt service		1,644,914		1,644,914
Capital projects			1,123,655	1,123,655
Advances and long-term receivables	167,622		95,113	262,735
Other specified purposes			(26,570)	(26,570)
Unreserved	975,119			975,119
Total fund balances	1,970,042	1,644,914	1,192,198	4,807,154
Total liabilities and fund balances	$ 10,633,269	3,828,926	4,815,502	$ 19,277,697

Commitments and contingencies (note 13)

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Reconciliation of the Balance Sheet – Governmental Funds
to the Statement of Net Assets
June 30, 2005

The amounts of governmental activities reported in the statement of net assets and the balance sheet – governmental funds, are different for the following reasons:

Total fund balance reported in the balance sheet – governmental funds	$ 4,807,154
Add (Deduct):	
Inventories and other current assets are not available to pay the current fiscal year expenditures, therefore, are not reported in the governmental funds.	56,862
Capital assets used in governmental activities are not considered available financial resources at fiscal year-end, therefore, are not reported in the governmental funds (see note 9). This is the carrying amount of capital assets, net of accumulated depreciation and amortization at June 30, 2005.	28,423,313
Certain deferred revenues in the governmental funds are recognized as revenues in the statement of activities. This is the amount of revenues that are measurable but not available at June 30, 2004 (property taxes, municipal licenses, intergovernmental grants and contributions, charges for services and certain miscellaneous revenues) (see note 11).	3,869,847
Debt issued by the Municipality has associated costs (debt issue costs) that are paid from current available financial resources in the governmental funds. However, these costs are deferred in the statement of net assets and reported net of accumulated amortization.	53,261
The following liabilities are not due (mature) in the current fiscal year, therefore, are not reported in the governmental funds at June 30, 2005 (see note 11):	
Bonds payable	(18,687,144)
Obligation under capital leases	(79,446)
Compensated absences	(2,602,047)
Reserve for federal cost dissallowances	(182,210)
Accrued liabilities, including amounts due to other governments	(548,062)
Net assets – governmental activities, as reported in the statement of net assets	$ 15,111,528

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Statement of Revenues, Expenditures and
Changes in Fund Balances – Governmental Funds
June 30, 2005

	Major governmental funds			
	General fund	Debt service fund	Other governmental funds	Total governmental funds
Revenues:				
Taxes:				
Property taxes	$ 4,096,739	998,971		$ 5,095,710
Municipal license taxes	1,867,937			1,867,937
Construction excise taxes	2,866,035			2,866,035
Charges for services	726,257			726,257
Intergovernmental grants and contributions:				
United States of America			2,877,281	2,877,281
Commonwealth of Puerto Rico	1,045,273		861,217	1,906,490
Interest on deposits	132,169	33,171	91,383	256,723
Miscellaneous	394,714			394,714
Total revenues	11,129,124	1,032,142	3,829,881	15,991,147
Expenditures:				
Current:				
General government	6,545,467		258,190	6,803,657
Urban and economic development	2,571,859		809,266	3,381,125
Public safety	351,907		164,289	516,196
Health and sanitation	1,906,000			1,906,000
Culture, recreation and education	316,159			316,159
Public housing and welfare	458,859		1,360,513	1,819,372
Debt service:				
Principal	287,143	1,295,000	310,000	1,892,143
Interest	98,473	645,037	344,204	1,087,714
Capital outlays:				
Construction and remodeling of roads, streets and other public facilities	256,579		5,262,239	5,518,818
Machinery, equipment and vehicles	1,215,820		36,254	1,252,074
Total expenditures	14,008,266	1,940,037	8,544,955	24,493,258
Excess (deficiency) of revenues over (under) expenditures	(2,879,142)	(907,895)	(4,715,074)	(8,502,111)
Other financing sources (uses):				
Transfers-in from other funds	126,657	582,000	720,065	1,428,722
Transfers-out to other funds	(647,726)	(33,171)	(747,825)	(1,428,722)
Proceeds from issuance of bonds	1,435,000		3,115,000	4,550,000
Total other financing sources (uses), net	913,931	548,829	3,087,240	4,550,000
Net change in fund balances	(1,965,211)	(359,066)	(1,627,834)	(3,952,111)
Fund balance at beginning of fiscal year, as restated	3,935,253	2,003,980	2,820,032	8,759,265
Fund balance at end of fiscal year	$ 1,970,042	1,644,914	1,192,198	$ 4,807,154

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Reconciliation of Statement of Revenues, Expenditures and Changes
in Fund Balances – Governmental Funds to the Statement of Activities
June 30, 2005

The amounts of governmental activities reported in the statement of activities and the statement of revenues, expenditures and changes in fund balances - governmental funds, are different for the following reasons:

Excess of revenues and other financing sources over expenditures and other financing uses reported in the statement of revenues, expenditures and changes in fund balances – governmental funds	$ (3,952,111)
Add (Deduct):	
The following revenues recorded in the statement of activities do not provide current financial resources, therefore, are deferred in the governmental funds. This is the net change in deferred revenues of the following revenue items, which are measurable but not available at fiscal year end:	
Property taxes	(374,369)
Intergovernmental grants and contributions	(146,309)
Governmental funds report capital outlays as expenditures. However in the statement of activities the cost of those assets is allocated over their estimated useful lives as depreciation and amortization expense. This is the amount by which capital outlay expenditures ($6,770,892) exceeded depreciation and amortization expense ($1,135,560) for the fiscal year ended June 30, 2005.	5,635,332
Repayment of principal of long-term obligations is reported as an expenditure in the governmental funds, however, the repayment reduces long-term liabilities in the statement of net assets (see note 11).	1,892,143
Certain accrued interest expense reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	(6,173)
Amortization of deferred charges reported in the statement of activities does not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	18,642
Some expenses reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	(206,171)
Generally, inventory and other current assets are recorded as expenditures in the governmental funds when paid rather than capitalized as an asset. However, these assets are capitalized in the statement of net assets. This amount represents the net change in these assets for the current fiscal year.	(25,222)
Proceeds from issuance of bonds provide current financial resources to governmental funds, but issuing such debt increases long-term liabilities in the statement of net assets.	(4,550,000)
Net increase in net assets, as reported in statement of activities	$ (1,714,238)

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

1. Summary of Significant Accounting Policies

The Municipality of Canóvanas (the Municipality) is a local municipal government constituted in 1970 in the Commonwealth of Puerto Rico (the Commonwealth). The Municipality has full legislative, fiscal and all other governmental powers and responsibilities expressly assigned by Public Act No. 81 of August 30, 1991, as amended, known as *Autonomous Municipalities Act of the Commonwealth of Puerto Rico* (Act No. 81). The Municipality is one of seventy-eight municipalities legally separated from the Commonwealth's government.

The Commonwealth's Constitution provides for the separation of powers of the executive, legislative and judicial branches of the Commonwealth and the municipalities. However, the Municipality's governmental system consists of executive and legislative branches only. A Mayor, elected every four years by the citizens, exercises the executive power of the Municipality. The legislative power of the Municipality is exercised by the Municipal Legislature, whose members are also elected every four years. The judiciary power is exercised by the General Justice Court System of the Commonwealth, which has jurisdiction over the Municipality.

The Municipality assumes either partial or full responsibility for providing services to its citizens related to public housing, welfare, public safety, health, sanitation, education, culture, recreation, education, urban development, economic development, and many other fiscal, general and administrative services.

a) Financial Reporting Model

The accompanying basic financial statements present the financial position and the results of operations of the Municipality as a whole, and its various governmental funds as of and for the fiscal year ended June 30, 2005, in conformity with accounting principles generally accepted in the United States of America (GAAP), as prescribed by the Governmental Accounting Standards Board (GASB).

According to the financial reporting model established by GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB No. 34), the required basic financial statement presentation applicable to the Municipality is composed of the following elements: (1) government-wide financial statements (GWFS), (2) governmental fund financial statements (GFFS), (3) notes to basic financial statements, and (4) required supplementary information (RSI).

RSI, consisting of a Management's Discussion and Analysis (MD&A); is information presented along with, but separate from, the Municipality's basic financial statements.

MD&A is a narrative report that introduces the accompanying basic financial statements and provides an analytical overview of the Municipality's financial activities for the fiscal year ended June 30, 2005, based on the Municipality's knowledge of the transactions, events and conditions reflected in the basic financial statements. The MD&A also highlights certain key fiscal policies that control the Municipality's operations.

Other supplementary information presented in this report for purposes of additional analysis consist of: (1) combining and individual nonmajor governmental fund financial statements, (2)

budgetary comparison schedule – debt service fund, and (3) schedules of capital assets used in the operations of governmental funds, as listed in the accompanying table of contents.

b) Financial Reporting Entity

The accompanying basic financial statements include all departments, agencies and municipal operational units that are under the legal and administrative control of the Mayor, and whose financial resources are under the legal custody and control of the Municipality's Director of Finance and Budget, as prescribed by Act No. 81.

The Municipality's management has considered all potential component units (whether governmental, not-for-profit, or profit-oriented) for which it may be financially accountable and other legally separate organizations for which the nature and significance of their relationship with the Municipality may be such that exclusion of their basic financial statements from those of the Municipality would cause the Municipality's basic financial statements to be misleading or incomplete.

GASB Statement No. 14, *The Financial Reporting Entity* (GASB No. 14), as amended, has set forth criteria to be considered in determining financial accountability for financial reporting purposes. These criteria include appointing a voting majority of an organization's governing body and: (1) the ability of the Municipality to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the Municipality.

On July 1, 2003, the Municipality adopted the provisions of GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units – an Amendment of GASB Statement No. 14* (GASB No. 39). GASB No. 39 states that certain organizations for which a primary government is not financially accountable nevertheless warrant inclusion as part of the financial reporting entity because of the nature and significance of their relationship with the primary government, including their ongoing financial support of the primary government and its other component units.

According to GASB No. 39, a legally separate, tax-exempt organization should be reported as a discretely presented component unit of a reporting entity if all of the following criteria are met:

The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.

The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.

The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

In addition, GASB No. 39 states that other organizations should be evaluated as potential component units if they are closely related to, or financially integrated with, the primary government. Such types of entities may be presented as either blended or discretely presented component units, depending upon how they meet the criteria for each specified in GASB No. 14.

The Municipality's management has concluded that, based on the aforementioned criteria, there are no legally separate entities or organizations that should be reported as component units of the Municipality for the fiscal year ended June 30, 2005.

c) Government-wide Financial Statements

The accompanying GWFS are composed of: (1) the statement of net assets and (2) the statement of activities. These financial statements report information of all governmental activities of the Municipality as a whole. These statements are aimed at presenting a broad overview of the Municipality's finances by reporting its financial position and results of operations using methods that are similar to those used by most private businesses.

The focus of GWFS is on the operational accountability of the Municipality as a single economic unit and not on compliance with budgets, regulatory requirements or on the use of available or currently expendable financial resources (referred to as fiscal accountability). Operational accountability is the Municipality's responsibility to report to the extent to which it has met its operating objectives efficiently and effectively, using all resources available for that purpose. It focuses on the Municipality's principal operating objective, which is to provide services to its citizens.

The accompanying statement of net assets provides short-term and long-term information about the Municipality's financial position by presenting all of the Municipality's assets and liabilities, with the difference between these two items reported as "net assets" (equity) and/or accumulated deficit. This statement assists management in assessing the level of services that can be provided by the Municipality in the future and its ability to meet its obligations as they become due. In addition, this statement reports the extent to which the Municipality has invested in capital assets and discloses legal and contractual restrictions on resources.

Net assets are classified in the accompanying statement of net assets within the following three categories:

- **Invested in capital assets, net of related debt** – This net asset category consists of capital assets, net of accumulated depreciation and amortization, reduced by the outstanding balances of bonds payable, notes payable and other debts that are attributed to the acquisition, construction or improvement of those assets. For the purposes of determining the outstanding debt attributed to capital assets, the total long-term debt related to the acquisition, construction or improvement of capital assets has been reduced by any related unspent debt proceeds and any related unamortized debt issuance costs.

- **Restricted net assets** – This net asset category consists of net resources restricted by external parties (such as creditors, grantors, contributors, laws or regulations of other governments, etc.), or net assets for which constraints are imposed by constitutional provisions or enabling legislation. Enabling legislation consists of legislation that authorizes the Municipality to assess, levy, charge or otherwise mandate payment of resources (from external resource providers). Enabling legislation establishes restrictions if it includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation.

The classification of restricted net assets identifies resources that have been received or earned by the Municipality with an explicit understanding between the Municipality and the resource providers that the resources would be used for specific purposes. Grants, contributions and donations are often given under those kinds of conditions. Bond indentures also often limit the use of bond proceeds to specific purposes.

Internally imposed designations of resources, including earmarking, are not reported as restricted net assets. These designations consist of management's plans for the use of resources, which are subject to change at the discretion of the Municipal Legislature.

The Municipality has reported the following types of restricted net assets in the accompanying statement of net assets:

(1) **Debt service** – Represent net resources available to cover future debt service payments of bonds and notes payable.

(2) **Capital projects** – Represent net resources available to finance the acquisition, construction or improvement of major capital assets under contracts and other commitments.

(3) **Other specified purposes** – Represent net resources available from certain federal and state grants, which have been set aside to carry out several programs.

- **Unrestricted deficit** – This category consists of the excess of liabilities over related assets that are neither externally nor legally restricted, neither invested in capital assets. However, assets reported within unrestricted deficit often are designated to indicate that management does not consider them to be available for general operations. Assets reported within this category often have constraints that are imposed by management but can be removed or modified.

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

The accompanying statement of activities presents the Municipality's results of operations by showing, how the Municipality's net assets or deficit changed during the fiscal year ended June 30, 2005, using a net (expense) revenue format. This statement presents the cost of each function/program as well as the extent to which each of the Municipality's functions, programs or other services either contributes to or draws from the Municipality's general revenues (such as property taxes, municipal license taxes, construction excise taxes, etc.).

A function/program describes a group of activities that are aimed at accomplishing a major service or regulatory responsibility. The functions/programs reported in the accompanying basic financial statements are: (1) general government, (2) urban and economic development, (3) public safety, (4) health and sanitation, (5) culture, recreation and education and (6) public housing and welfare. The governmental operations of the Municipality's departments and operational units are classified within the following functions/programs in the accompanying basic financial statements:

General government:
Municipal legislature
Mayor's office
Department of finance and budget
Department of human resources
Department of municipal secretary
Department of internal audit
Department of general services
Department of public relations

Urban and economic development:
Department of public works
Department of transportation and mechanics
Department of conservation and ornate
Department of planning and development
Department of public terminals

Public safety:
Department of emergency management
Department of municipal police

Health and sanitation:
Department of health
Department of recycling

Culture, recreation and education:
Department of recreation and sports

Public housing and welfare:
Department of community affairs
Department of services to citizens
Department of elderly affairs

The statement of activities demonstrates the degree to which program revenues offset direct expenses of a given function/program or segments. Direct expenses are those that are clearly identifiable with a specific function, segment or operational unit. This statement reports revenues in two broad categories: (1) program revenues and (2) general revenues.

Program revenues are generated directly from a program itself or may come from parties outside the Municipality's taxpayers or citizens. In the statement of activities, program revenues reduce the costs (expenses) of the function/program to arrive at: (1) the net cost of the function/program that must be financed from the Municipality's general revenues or (2) the net program revenue that contributes to the Municipality's general revenues. The accompanying statement of activities separately reports the following categories of program revenues:

- **Charges for services** – These revenues generally consist of exchange or exchange-like transactions involving charges to customers or applicants who purchase, use or directly benefit from the goods, services or privileges provided, or are otherwise directly affected by

the services. These revenues include fees charged for specific services, charges for licenses and permits, and fines and forfeitures, among others.

- **Program-specific operating and capital grants and contributions** – These revenues consist of transactions that are either mandatory or voluntary nonexchange transactions with other governments, organizations, or individuals that restrict the resources for use in a particular program. Operating grants and contributions consist of resources that are required to be used to finance the costs of operating a specific program or can be used either for operating or capital purposes of a specific program. Capital grants and contributions consist of revenues or resources that are restricted for capital purposes – to purchase, construct or renovate capital assets associated with a specific program. Restricted operating and capital grants and contributions are program revenues because they are specifically attributable to a program and reduce the net expense of that program to the Municipality. They are reported net of estimated uncollectible amounts.

General revenues are the default category for revenues. It includes all revenues and gains that do not meet the definition of program revenues. Property taxes, municipal license taxes and construction excise taxes are reported as general revenues. All other nontax revenues (including unrestricted interest on deposits, grants and contributions not restricted for specific programs and miscellaneous revenues) that do not meet the definition of program revenues are classified as general revenues. Resources that are dedicated internally by the Municipality are reported as general revenues rather than as program revenues. All general revenues are reported net of estimated uncollectible amounts, which are recorded as reduction of revenues rather than as expenses.

The general government function/program reported in the accompanying statement of activities includes expenses that are, in essence, indirect or costs of other functions/programs of the Municipality. Even though some of these costs have been charged to certain funds in the GFFS as indirect cost allocations permitted under some federal programs, the Municipality has reported these indirect costs as direct expenses of the general government function. Accordingly, the Municipality generally does not allocate general government (indirect) costs to other functions.

The effects of all interfund governmental activities (revenues, expenditures and other financing sources/uses among governmental funds) have been removed from the accompanying statements of net assets and activities.

The Municipality classifies all of its activities as governmental activities in the accompanying GWFS. These are activities generally financed through taxes, intergovernmental revenues and other nonexchange revenues that can be used to support the Municipality's programs or services. These governmental activities are also generally reported in the GFFS.

The Municipality has no fiduciary activities, which are those in which the Municipality would be holding or managing net assets for specific individuals or other external parties in accordance with trust agreements or other custodial arrangements. In addition, the Municipality has no operations or activities that are financed and operated in a manner similar to private business enterprises, where the costs of providing goods or services to the general public (expenses, including depreciation) is financed primarily through user charges; or where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income

is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

d) Governmental Fund Financial Statements

A fund is a fiscal and accounting entity consisting of a self-balancing set of accounts used to record assets, liabilities and residual equities, deficits or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with GAAP and/or special regulations, restrictions or limitations.

The accompanying GFFS are composed of: (1) the balance sheet – governmental funds, and (2) the statement of revenues, expenditures and changes in fund balances – governmental funds.

These financial statements report the financial position and results operations of the Municipality's governmental funds by presenting sources, uses and balances of current financial resources. Some of these financial statements have a budgetary orientation and focus primarily on: (1) the Municipality's major governmental funds, as defined below, (2) the fiscal accountability and (3) the individual parts of the Municipality's government. Fiscal accountability represents the Municipality's responsibility to justify that its actions in the current fiscal year have complied with public decisions concerning the raising and spending of public moneys in the short term (generally one fiscal year).

The accompanying GFFS segregate governmental funds according to their intended purpose and are used in demonstrating compliance with legal, financial and contractual provisions. The minimum number of governmental funds is maintained consistent with legal and self-imposed managerial requirements established by the Municipality. For financial reporting purposes, the Municipality classifies its governmental funds within the following categories:

- ***General fund*** – The general fund is the Municipality's main operating fund and a major governmental fund, as defined below, used to account for all financial resources and governmental activities, except for financial resources required to be accounted for in another fund. It is presumed that the Municipality's governmental activities have been reported in the general fund except for transactions for which one of the following compelling reasons has required the use of another fund: (1) legal requirements, (2) GAAP requirements or (3) the demands of sound financial administration requiring the use of a governmental fund other than the general fund.

- ***Debt service fund*** – The debt service fund is a major governmental fund, as defined below, used by the Municipality to account for the accumulation of resources for, and the payment of, principal and interest for: (1) bonds payable for which debt service payments are legally mandated to be accounted for in a debt service fund and/or (2) bonds payable or any general long-term debt for which the Municipality is being accumulating financial resources in advance to pay principal and interest payments maturing in future years. During the fiscal year ended June 30, 2005, the financial activity accounted for in the debt service fund was specifically related to bonds payable.

  The outstanding balance of general long-term debts for which debt service payments do not involve the advance accumulation of resources (such as notes payable, obligations under

capital leases, accrued compensated absences, accrued legal claims and judgments and the federal cost disallowances) are only accounted for in the accompanying statement of net assets. The debt service payments of such debts are generally accounted for as debt service – principal and debt service – interest expenditures in the general fund, except for certain notes payable to HUD (see note 9), which are accounted for in the HUD Section 108 capital project fund

- ***Special revenue funds*** – The special revenue funds are nonmajor governmental funds, as defined below, used by the Municipality to account for revenues derived from grants, contributions or other revenue sources that are either self-restricted by the Municipality or legally restricted by outside parties for use in specific purposes (except for revenues that are earmarked for expenditures in major capital projects which are accounted for in the capital project funds). The uses and limitations of each special revenue fund are specified by municipal ordinances or federal and state statutes. However, resources restricted to expenditure for purposes normally financed from the general fund are reported in the Municipality's general fund provided that all applicable legal requirements are appropriately satisfied. In this case, a special revenue fund to account for such kind of transactions will be used only if legally mandated.

- ***Capital projects funds*** – Capital projects funds are nonmajor governmental funds, as defined below, used to account for the financial resources used for the acquisition, construction or improvement of major capital facilities and other assets. Significant capital outlays financed from proceeds of general obligation, public improvement or special obligation bonds accounted for also in the capital projects funds.

  The use of the capital projects funds has been reserved only for major capital acquisitions, construction or improvement activities that would distort financial resources trend data if not reported separately from the other Municipality's operating activities. The routine purchases of minor capitalizable assets (such as furniture, office equipment, vehicles and other minor capital assets or improvements) have been reported in the governmental fund from which financial resources were used for the payment.

The focus of the GFFS is on major governmental funds, which generally represent the Municipality's most important funds. Accordingly, the Municipality is required to segregate governmental funds between major and nonmajor categories within the GFFS. Major individual governmental funds are reported individually as separate columns in the GFFS, while data from all nonmajor governmental funds are aggregated into a single column, regardless of fund type.

By definition, the Municipality's general fund is always considered a major governmental fund for financial reporting purposes. In addition, any other governmental fund is classified as a major governmental fund in the GFFS if its total assets, liabilities, revenues or expenditures of that individual governmental fund are at least 10 percent of the corresponding element total (assets, liabilities, revenues or expenditures) for all governmental funds. For the purposes of applying the aforementioned major fund criteria, no eliminations of interfund balances have been made. Total revenues for these purposes means all revenues, including operating and nonoperating revenues (net of allowances for uncollectible accounts), except for other financing sources. Total expenditures for these purposes mean all expenditures, including operating and nonoperating expenditures, except for other financing uses.

Based on the aforementioned criteria, the Municipality's major governmental funds reported in the accompanying GFFS are: (1) the general fund (2) the debt service fund.

The accompanying GFFS are accompanied by other statements and schedules required by GAAP: (1) the statement of revenues and expenditures – budget and actual – budgetary basis – general fund, (2) the reconciliation of the balance sheet – governmental funds to the statement of net assets, and (3) the reconciliation of the statement of revenues, expenditures and changes in fund balances – governmental funds to the statement of activities.

e) Measurement Focus and Basis of Accounting

Government-wide financial statements – The accompanying GWFS are prepared using the economic resources measurement focus and the accrual basis of accounting. Subject to the additional rules and limitations detailed below, revenues (including interest on deposits) are generally recorded when earned and expenses are generally recorded when a liability is incurred, regardless of the timing of related cash flows.

All revenues, expenses, gains, losses, assets and liabilities resulting from exchange and exchange-like transactions are generally recorded when the exchange takes place. In exchange transactions, each party to the transaction receives and gives up essentially equal values. An exchange-like transaction is one in which there is an identifiable exchange and the values exchanged, though related, may not be quite equal. Nevertheless, the exchange characteristics of the exchange-like transaction are strong enough to justify treating it as an exchange for accounting purposes (examples include certain charges for services and miscellaneous revenues, which are recorded as revenues when collected because they are generally not measurable until actually received).

All revenues, expenses, gains, losses and assets resulting from nonexchange transactions are recorded using the criteria set forth by GASB Statement No. 33, Accounting and Financial Reporting for Nonexchange Transactions (GASB No. 33). GASB No. 33 established accounting and reporting standards for nonexchange transactions involving cash and financial or capital resources (for example, most taxes, grants and private donations). In a nonexchange transaction, the Municipality gives (or receives) value without directly receiving (or giving) equal value in return. This is different from an exchange transaction, in which each party receives and gives up essentially equal values. According to GASB No. 33, the Municipality groups its nonexchange transactions into the following four classes in the accompanying basic financial statements: (a) derived tax revenues, (b) imposed nonexchange revenues, (c) government mandated nonexchange transactions, and (d) voluntary nonexchange transactions.

In the case of derived tax revenue transactions, which result from assessments the Municipality places on exchange transactions, receivables and revenues are recorded when the underlying exchange has occurred.

In the case of imposed nonexchange revenue transactions (such as property taxes and municipal license taxes), which result from assessments made by the Municipality on nongovernmental entities, including individuals, other than assessments on exchange transactions, receivables are generally recorded in the period when an enforceable legal claim has arisen. Property taxes and municipal license are generally recorded as revenues (net of amounts considered not collectible)

in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted.

Government-mandated nonexchange transactions (such as grants and contributions) result when a government at one level (such as the federal or state government) provides resources to the Municipality and the provider government requires the Municipality to use those resources for a specific purpose or purposes established in the provider's enabling legislation. In these type of transactions, receivables and revenues are generally recorded when all eligibility requirements imposed by the provider have been met. For the majority of grants, the Municipality must expend resources on the specific purpose or project before the provider reimburses any amounts. Revenue is, therefore, generally recognized as qualifying reimbursable expenditures are incurred.

Voluntary nonexchange transactions (such as donations and certain grants and entitlements) result from legislative or contractual agreements, other than exchanges, willingly entered into by two or more parties. In these types of transactions, receivables and revenues are generally accounted for in the same manner as government-mandated nonexchange transactions discussed above. Events that are neither exchange nor nonexchange transactions are recorded when it is probable that a loss has been incurred and the amount of loss is reasonably estimable.

Receipts of any type of revenue sources collected in advance for use in the following fiscal year are recorded as deferred (unearned) revenues (see note 8).

According to GASB No. 34, all general capital assets and the unmatured long-term liabilities are recorded only in the accompanying statement of net assets. The measurement focus and the basis of accounting used in the accompanying GWFS differ significantly from the measurement focus and basis of accounting used in the preparation of the accompanying GFFS. Therefore, the accompanying GFFS include reconciliations, as detailed in the accompanying table of contents, to better identify the relationship between the GWFS and the GFFS.

Governmental fund financial statements – The accompanying GFFS are reported using the current financial resources measurement focus (flow of current financial resources) and the modified accrual basis of accounting. Accordingly, the accompanying statement of revenues, expenditures and changes in fund balances – governmental funds, reports changes in the amount of financial resources available in the near future as a result of transactions and events of the fiscal year reported. Therefore, revenues are generally recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current fiscal year or soon enough thereafter to pay liabilities of the current fiscal year. For this purpose, the Municipality considers most revenues to be available if collected within 90 days after June 30, 2005, except for property taxes for which the availability period is 60 days. Revenue sources not meeting this availability criterion or collected in advance are recorded as deferred (unavailable) revenues at June 30, 2005 (see note 8).

The principal revenue sources considered susceptible to accrual include property taxes, municipal license taxes, intergovernmental grants and contributions, interest on deposits and charges for services. These principal revenue sources meet both measurability and availability criteria in the accompanying GFFS, except for amounts recorded as deferred (unavailable) revenues (see note 8).

In a manner similar to the GWFS, but subject to and limited by the availability criteria discussed previously, all revenues, expenses, gains, losses, assets and liabilities resulting from exchange and exchange-like transactions are also generally recorded when the exchange takes place. Accordingly, certain charges for services and miscellaneous revenues are recorded as revenues when collected because they are generally not measurable until actually received.

All revenues, expenses, gains, losses and assets resulting from nonexchange transactions are recorded in a similar manner to the GWFS, using the previously discussed criteria set forth by GASB No. 33 for nonexchange transactions, but subject to and limited by the availability criteria discussed above. Accordingly, property tax and municipal license tax receivables are also generally recorded in the fiscal year when an enforceable legal claim has arisen while property tax and municipal license tax revenues (net of amounts considered not collectible) are also generally recorded in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted. Receivables and revenues from federal and state grants and contributions, donations and entitlements are also generally recorded when all eligibility requirements imposed by the provider have been met (generally, as qualifying reimbursable expenditures are incurred).

Interest on deposits is recorded when earned only if collected within 90 days after the fiscal year-end since these revenues would be considered both measurable and available.

Pursuant to the provisions of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements* (GASBI No. 6), in the absence of an explicit requirement (i.e., the absence of an applicable modification, discussed below) the Municipality generally accrues a governmental fund liability and an expenditure (including salaries, professional services, supplies, utilities, etc.) in the period in which the government incurs the liability, to the extent that these liabilities are normally expected to be liquidated in a timely manner and in full with current available financial resources. GASBI No. 6 modified the recognition criteria for certain expenditures and liabilities reported under the modified accrual basis of accounting prior to GASB No. 34, and clarified a number of situations in which the Municipality should distinguish between governmental fund liabilities and general long-term liabilities. Therefore, the accompanying balance sheet – governmental funds generally reflects assets that will be converted into cash to satisfy current liabilities. Long-term assets and those assets that will not be converted into cash to satisfy current liabilities are generally not accounted for in the accompanying balance sheet – governmental funds. At the same time, long-term liabilities (generally, those unmatured that will not require the use of current financial resources to pay them) are not accounted for in the accompanying balance sheet – governmental funds.

Modifications to the accrual basis of accounting in accordance with GASBI No. 6 include:

- Principal and interest on bonds payable are recorded when they mature (when payment is due), except for principal and interest due on July 1, 2005, which have been recorded as governmental fund liabilities at June 30, 2005, which is the date when resources are available in the debt service funds (generally, June 30).

- Notes payable, obligations under capital leases, compensated absences, amounts subject to accrued claims and judgments under litigation are recorded only when they mature (when payment is due).

- Certain accounts payable, intergovernmental payables and other accrued liabilities not due and payable or not normally expected to be liquidated in full and in a timely manner with available and expendable financial resources are recorded in the accompanying statement of net assets. Such liabilities are recorded in the governmental funds when they mature.

- Executory purchase orders and contracts are recorded as a reservation of fund balance in the GFFS.

The measurement focus of the GFFS is on decreases of net financial resources (expenditures) rather than expenses. Most expenditures are measurable and are recorded when the related governmental fund liability is incurred. Allocation of costs, such as depreciation and amortization, are recorded in the accompanying statement of activities, but are not recorded in the accompanying GFFS.

f) ***Stewardship, Compliance and Accountability***

Budgetary Control

According to Act No. 81, the Mayor and its Administrative Cabinet prepare annual budgets each fiscal year for the Municipality's general fund and debt service fund. Such legally adopted budgets are based on expected expenditures by program and estimated resources by source. The annual budgets are developed using elements of performance-based program budgeting and zero-based budgeting, and include estimates of revenues and other resources for the ensuing fiscal year under laws and regulations existing at the time the budgets are prepared.

The Mayor must submit, for each fiscal year commencing on July 1, an annual budgetary resolution project (the Project) to the Commissioner of Municipal Affairs of the Commonwealth (the Commissioner) and the Municipal Legislature no later than the immediately preceding May 10 and May 15, respectively. The Commissioner preliminarily verifies that the Project complies with all the applicable laws and regulations and may provide comments and suggestions to the Mayor on or before the immediately preceding June 13.

The Municipal Legislature has 10 business days, up to the immediately preceding June 13, to discuss and approve the Project with modifications. The Municipal Legislature may amend the budgets submitted by the Mayor but may not increase any items so far to cause a deficit without imposing taxes or identifying other sources of revenue to cover such deficit. After the Municipal Legislature modifies and preliminarily approves the Project, the modified Project is sent back to the Mayor for his approval or rejection within 6 days. The Mayor may decrease or eliminate any line item but may not increase or insert any new line item in the budgets. The Mayor may also veto the budgets in their entirety and return it to the Municipal Legislature with his objections. If the Mayor rejects the Project, the Municipal Legislature will have up to 8 days to adopt or reject the recommendations or objections of the Mayor. The approved Project is sent again to the Mayor, which then would have 3 days to sign and approve it.

If the budgets are not adopted prior to the end of the deadlines referred to above, the annual budgets for the preceding fiscal year, as approved by the Legislature and the Mayor, are automatically renewed for the ensuing fiscal year until the Municipal Legislature and the Mayor approve new budgets. This regulation permits the Municipality to continue doing payments for its operations and other purposes until the new budgets are approved.

The annual budgets may be updated for any estimate revisions as well as fiscal year-end encumbrances, and may include any additional information requested by the Municipal Legislature. The Mayor may request subsequent amendments to the approved budgets, which are subject to the approval of the Municipal Legislature.

The Municipality's Department of Finance and Budget has the responsibility to ensure that budgetary spending control is maintained. For day-to-day management control purposes, expenditures plus encumbrances may not exceed budgeted amounts at the expenditure-type level of each cost center (activity within a program within a fund). The Mayor may transfer unencumbered appropriations within programs within funds. The Municipal Legislature may transfer amounts among programs within and among funds.

The legal level of budgetary control (i.e., the level at which expenditures may not legally exceed appropriation) is at the function/program level (general government, urban and economic development, public safety, health and sanitation, culture, recreation and education, and public housing and welfare) within a fund.

Under the laws and regulations of the Commonwealth, the appropriations made for any fiscal year shall not exceed the total revenue, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided.

Budgetary Accounting

The Municipality's annual budgets are prepared using the budgetary (statutory) basis of accounting, which is not in accordance with GAAP.

According to the budgetary basis of accounting, revenue is generally recorded when cash is received. Short-term and long-term borrowings may be used to finance budgetary excess of expenditures over revenues.

The Municipality uses encumbrance accounting to record the full amount of purchase orders, contracts and other commitments of appropriated resources as deductions from the appropriation prior to actual expenditure. In the governmental funds, encumbrance accounting is a significant aspect of budgetary control. Accordingly, expenditures are generally recorded when the related expenditure is incurred or encumbered. Available appropriations and encumbrances are established to lapse one fiscal year after the end of the fiscal year. Amounts required to settle claims and judgments against the Municipality, and certain other liabilities, are not recognized until they are encumbered or otherwise processed for payment. Unencumbered appropriations and encumbrances lapse at fiscal year-end. Other appropriations, mainly capital projects 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 accompanying statement of revenues and expenditures – budget and actual – budgetary basis – general fund, provides information about the general fund's original budget, its amendments, and the actual results of operations of such governmental fund under the budgetary basis of accounting for the fiscal year ended June 30, 2005. Further details of the Municipality's budgetary control at the legal level may be obtained from the Budgetary Liquidation Report for the fiscal year ended June 30, 2005, which is prepared by the Municipality's Department of Finance and Budget. Copies of that report may be obtained by writing to the Municipality's Director of Finance and Budget.

Because accounting principles applied for the purposes of the developing data on a budgetary basis differ significantly from those used to present the governmental fund financial statements in conformity with GAAP, a reconciliation of the differences between the general fund's budgetary basis and GAAP actual amounts is presented as follows:

Excess of revenues and other financing sources over expenditures and other financing uses – budgetary basis	$ 199,281
Timing differences:	
Add:	
Current year encumbrances recorded as expenditures for budgetary purposes	827,301
Deduct:	
Prior year encumbrances recorded as current year expenditures for GAAP purposes	(819,158)
Entity differences:	
Non-budgeted expenditures	(1,082,062)
Basis of accounting differences:	
Net decrease in property taxes receivable	(373,884)
Net decrease in municipal license taxes receivable	(430,604)
Net increase in intergovernmental receivables	8,119
Net increase in accrued interest receivable	6,525
Net increase in due from/advances to other funds	582,352
Net decrease in deferred revenue	19,146
Net increase in accounts payable and accrued liabilities	(306,647)
Net increase in intergovernmental payables and accrued liabilities	(168,994)
Net increase in due to/advances from other funds	(14,250)
Excess of revenues and other financing sources over expenditures and other financing uses –general fund– GAAP basis	$ (1,552,875)

g) *Unrestricted and Restricted Deposits*

The Municipality's deposits are composed of: (1) cash on hand, (2) demand deposits in commercial banks and (3) demand deposits in the Government Development Bank fro Puerto Rico (fiscal agent) and (4) cash equivalents in commercial banks. Cash equivalents consist of certificates of deposit with original maturities of three months or less, which amounted to

$1,300,000 at June 30, 2005 (see note 2). Cash equivalents are recorded at cost, which approximates fair value.

The Municipality follows the practice of pooling cash. The balance in the pooled cash account is available to meet current operating requirements and any unrestricted excess is invested in certificates of deposit with commercial banks.

Under the laws and regulations of the Commonwealth, public funds deposited by the Municipality in commercial banks must be fully collateralized for the amounts deposited in excess of the federal depository insurance generally provided by the Federal Deposits Insurance Corporation (FDIC). All securities pledged as collateral are held by agents designated by the Commonwealth's Secretary of the Treasury, but not in the Municipality's name.

Cash in fiscal agent in the general and debt service funds consists of cash related to property tax collections amounting to $518,500 and $2,557,621, respectively, which are restricted for the payment of the Municipality's debt service, as required by law. Cash in fiscal agent in the general fund also consists of unspent proceeds of bonds, which are restricted for the acquisition of equipment and other capital assets. Cash with fiscal agent recorded in the nonmajor governmental funds consists of unspent proceeds of bonds and the balance of interest and noninterest bearing accounts amounting to $1,705,369, which are restricted for the acquisition, construction or improvement of major capital assets.

Restricted cash in commercial banks for other governmental funds, amounting to $2,726,106, represents the balance of interest and noninterest bearing accounts restricted to finance the operations of certain federal and state funded programs.

h) Unrestricted and Restricted Accounts and Notes Receivable

- Receivables consist of all revenues earned but not collected at June 30, 2005. These accounts receivables are stated net of estimated allowances for uncollectible accounts, which are determined based upon past collection experience, historical trends, current economic conditions and the periodic aging of accounts receivable.

Activities among governmental 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), as applicable. All other outstanding balances between funds are reported as "due to/from other funds."

i) Inventories and Other Current Assets

Inventories consist of construction materials and inventories of office supplies, food and medicines, which are held for consumption. Other current assets consist of prepaid exepnses. Generally, inventories are capitalized (consumption method) and stated at cost using the first-in, first-out method (FIFO) in the GWFS. Inventories and other current assets in the GFFS are generally recorded as expenditures (purchase method) when purchased (paid) rather than capitalized as an asset.

j) Deferred Charges

Deferred charges in the accompanying statement of net assets consist of bond issuance costs, net of accumulated amortization. Deferred charges are amortized over the term of the related debt using the straight-line method. In the GFFS, bond issuance costs are recorded in the current period as expenditures, whether or not withheld from the actual debt proceeds received.

k) Capital Assets

Capital assets used in governmental activities include land and land improvements, buildings, structures and building improvements, machinery and equipment (including equipment held under capital leases), furniture and fixtures, licensed vehicles, construction in progress, and infrastructure. These assets are capitalized and reported in the accompanying statement of net assets. Infrastructure assets are generally stationary in nature and include roads, bridges, streets and sidewalks, drainage systems and other similar assets.

For financial reporting purposes, the Municipality defines capital assets as assets with an individual cost basis of $500 or more at the date of acquisition, construction or improvement, and with useful lives extending beyond one year. All assets with individual costs under $500 or with useful lives not exceeding one year, are charged directly to expense in the government-wide statement of activities. In the governmental funds, all capital assets are recorded as capital outlays (expenditures), while all assets with individual costs under $500 are recorded as expenditures in the corresponding function/program identified with the asset.

In the statement of net assets, all capital assets are recorded at cost or estimated historical cost if actual cost was unavailable, except for donated capital assets, which are recorded at their estimated fair value at the date of donation. Estimated historical costs based on deflated current costs were used to value a significant portion of the infrastructure constructed or acquired prior to June 30, 2002 and certain lands, buildings, structures and building improvements. The method used to deflate the current costs with an approximate price index was used only in the case of certain items for which the historical cost documentation was not available. Actual historical costs were used to value the infrastructure acquired or constructed after June 30, 2002 as well as, construction in progress, machinery and equipment and licensed vehicles acquired prior or after such date.

Major outlays for capital assets and improvements are capitalized in the statement of net assets as projects are constructed. The costs of normal maintenance and repairs that do not add value to the asset or materially extend capital asset lives are not capitalized.

Depreciation and amortization expense is recorded only in the government-wide statement of activities. However, there is no depreciation or amortization recorded for land and construction in progress. Depreciable capital assets are generally depreciated or amortized over their estimated useful lives under the straight–line method, except for machinery and equipment held under capital leases which is depreciated over the shorter of its estimated useful life or the lease term. The estimated useful lives of major capital asset categories are:

	Years
Land improvements	20
Buildings, structures and building improvements	30 to 50
Infrastructure	20 to 50
Motor vehicles	8
Furniture, fixtures, machinery and equipment, excluding those held under capital leases	5 to 20
Machinery and equipment held under capital leases	3 to 5

Depreciation and amortization expense of capital assets is recorded as a direct expense of the function/program specifically identified with the asset. Depreciation and amortization of infrastructure is not allocated to various functions/programs but reported as direct expenses of the urban and economic development function.

l) Deferred Revenues

In the GFFS, deferred revenue arises when one of the following situations occur:

- Potential revenue does not meet both the "measurable" and "available" criteria for revenue recognition in the current period (unavailable revenue). As previously discussed, available is defined as due (or past due) at June 30, 2005 and collected within 90 days (60 days for property taxes) thereafter to pay obligations due at June 30. In subsequent periods, when both criteria are met, the liability for deferred revenue is removed and revenue is recognized.

- The Municipality receives resources before it has a legal claim to them (deferred revenue). In subsequent periods, when the revenue recognition criterion is met, the liability for deferred revenue is removed and revenue is recognized.

Deferred revenues at the government-wide level arise only when the Municipality receives resources before it has a legal claim to them (deferred revenues).

m) Compensated Absences

Compensated absences are accounted for under the provisions of Statement No. 16, *Accounting for Compensated Absences*, issued by GASB (GASB No. 16). Compensated absences include paid time off made available to employees in connection with vacation, sick leave and compensatory time. The liability for compensated absences recorded in the accompanying statement of net assets is limited to leave that: (1) is attributable to services already rendered on or before June 30, 2005 and (2) is not contingent on a specific event that is outside the control of the Municipality and the employee (such as illness). Compensated absences that relate to future services or are contingent on a specific event outside the control of the employer or the employee are accounted for in the period when those services are rendered or those events take place.

The liability for compensated absences includes salary-related costs, which are directly and incrementally related to the amount of salary paid to the employee (such as employer's share of social security taxes and medicare taxes).

The vacation policy of the Municipality provides for the accumulation of regular vacations at a rate of 2.5 days per month (30 days per fiscal year) per employee. Employees accumulate regular sick leave at a rate of 1.5 days per month (18 days per fiscal year). Employees accumulate compensatory time at a rate of 1.5 times the overtime worked. All vacation and sick leave days accumulated by employees in excess of 30 days and 90 days, respectively, are paid to employees each fiscal year, if not consumed, as required by law. In the case of compensatory time, the excess of 240 hours is paid to employees each fiscal year, if not consumed.

Upon termination of employment, an employee receives compensation for all accumulated unpaid regular vacation leave at the current rate. In the case of regular sick leave, if the employee terminates his or her employment before reaching 10 years of services, such regular sick leave is not paid to the employee, if not consumed. In addition upon termination of employment, an employee does not receive compensation for compensatory time, if not consumed previously. After 10 years of services, any regular sick leave balance is paid to the employee. Accumulated vacation time is fully vested to the employee at any time.

The liability for compensated absences is reported in the statement of net assets. A liability for compensated absences is reported in the GFFS only when matured (when payment is due), for example, as a result of employee resignations or retirements.

n) Long-term Debt

The long-term liabilities reported in the accompanying statements of net assets include the Municipality's bonds payable, notes payable, obligations under capital leases, accrued compensated absences and accrued legal claims and judgments.

All long-term debt to be repaid from governmental resources is reported as liabilities in the accompanying statement of net assets. Principal and interest payments on bonds due on July 1, 2005 are recorded as governmental fund liabilities in the GFFS when resources are available in the debt service fund (June 30, 2005). In the GFFS, the face amount of debt issued (gross debt reported) is reported as other financing sources when issued.

In the GWFS debt issuance costs are capitalized and reported as deferred charges, which are amortized under the straight-line method over the life of the debt, while in the GFFS such costs are recorded as expenditures during the current period.

Non-interest bearing notes payable are accounted for under the provisions of Opinion No. 21, *Interest on Receivables and Payables*, issued by the Accounting Principles Board (APB No. 21). According to APB No. 21, the Municipality has recorded such notes at present value with an imputed interest rate that approximates the rate that would have been used, using the same terms and conditions, if it had been negotiated by an independent lender. In the accompanying statement of net assets, such notes payable are reported net of the applicable unamortized discount, which is the difference between the present value and the face amount of the notes. The discount is amortized over the life of the notes using the effective interest method. Amortization of the notes discount is recorded as part of interest expense in the statement of activities. In the GFFS, notes discount is recognized as other financing uses during the current period.

o) Leases

The Municipality classifies its lease agreements either as operating or capital leases according to Statement No.13, *Accounting for Leases*, issued by Financial Accounting Standards Board (FASB No. 13). Capital lease agreements are generally non-cancelable and involve, substance over form, the transfer of substantially all benefits and risks inherent in the ownership of the leased property, while operating leases do not involve such transfer. Accordingly, a capital lease involves the recording of an asset and a related lease obligation at the inception of the lease. According to FASB No. 13, the Municipality classifies a lease agreement as a capital lease if at its inception the lease meets one or more of the following four criteria:

- By the end of the lease term, ownership of the leased property is transferred to the Municipality.
- The lease agreement contains a bargain purchase option.
- The lease term is substantially equal (75 percent or more) to the estimated useful life of the leased property.
- At the inception of the lease, the present value of the minimum lease payments, with certain adjustments, is 90 percent or more of the estimated fair value of the leased property.

Although the Municipality is prevented legally from entering into obligations extending beyond one fiscal year, most capital lease agreements entered by the Municipality contain fiscal funding clauses or cancellation clauses that make the continuation of the agreements subject to future appropriations. Leases that meet at least one of the aforementioned four criteria and have a fiscal funding or a cancellation clause have been recorded as capital leases in the accompanying GWFS, since the likelihood of invoking the provision is considered remote. The Municipality's lease agreements do not include contingent rental payments nor escalation clauses.

In the GWFS, the obligation under capital leases is recorded at the lesser of the estimated fair value of the leased property or the present value of the minimum lease payments, excluding any portion representing executory costs and profit thereon to be paid by the lessor. A portion of each minimum lease payment is allocated to interest expense and the balance is applied to reduce the lease obligation using the effective interest method.

In the GFFS, the net present value of the minimum lease payments at the inception of the capital lease is recorded simultaneously as: (1) expenditures and (2) other financing sources. Minimum lease payments are recorded as expenditures in the GFFS.

p) Accounting for Pension Costs

For the purpose of applying the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers* (GASB No. 27), the Commonwealth is considered to be the sponsor of the Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities (ERS) and System 2000, a multi-employer cost-sharing defined benefit pension plan and a hybrid defined contribution plan, respectively, in which the employees of the Municipality participate. The Municipality is considered a participant, and not a sponsor, of

these retirement systems since the majority of the participants in the aforementioned pension trust funds are employees of the Commonwealth and the basic financial statements of such retirement systems are part of the financial reporting entity of the Commonwealth. Accordingly, no portion of the net pension obligation (NPO) related to ERS has been allocated to the Municipality in the accompanying basic financial statements. The basic financial statements of the Commonwealth report the total amount of the net pension obligation of ERS, including any amount that may correspond to the Municipality.

The Municipality accounts for pension costs from the standpoint of a participant in a multiple-employer cost-sharing plan. Accordingly, pension costs recognized in the accompanying basic financial statements are equal to the statutorily required contributions, with a liability recorded for any unpaid required contributions.

q) *Risk Management*

The Municipality carries commercial insurance covering casualty, theft, tort claims and other losses. Insurance policies are negotiated by the Commonwealth's Department of Treasury (the Department of Treasury) on behalf of all municipalities of Puerto Rico. The Department of Treasury pays the insurance premiums on behalf of the Municipality and then is reimbursed each fiscal year through monthly equal payments deducted from the Municipality's gross property tax collections made by the Municipal Revenue Collection Center ("CRIM", by its Spanish acronyms), a governmental entity responsible for billing and collecting property taxes on behalf of all municipalities of Puerto Rico (see note 4).

The Municipality carries insurance coverage for death and bodily injuries caused by automobile accidents. This insurance is obtained through the Automobile Accidents Compensation Administration (ACAA), a component unit of the Commonwealth. This insurance is compulsory for all licensed vehicles used on public roads and highways in Puerto Rico. The annual premium is $35 per licensed motor vehicle, which is paid directly to ACAA.

The Municipality obtains workers' compensation insurance coverage through the State Insurance Fund Corporation (SIFC), a component unit of the Commonwealth. This insurance covers workers against injuries, disability or death because of work or employment-related accidents, or because of illness suffered as a consequence of their employment. Workers' compensation insurance premiums are also paid through monthly deductions made by CRIM from the Municipality's gross property tax collections.

The Municipality obtains unemployment compensation, non-occupational disability, and drivers' insurance coverage for its employees through various insurance programs administered by the Commonwealth's Department of Labor and Human Resources (DOL). These insurance programs cover workers against unemployment and provide supplementary insurance coverage for temporary disability, or death because of work or employment-related accidents or because of illness suffered as a consequence of their employment. Unemployment compensation, non-occupational disability and drivers' insurance premiums are paid directly to DOL on a cost reimbursement basis.

The Municipality also obtains medical insurance coverage from several health insurance companies for its employees. Different health insurance coverage and premium options are negotiated each year by the Department of Treasury on behalf of the Municipality. The current

insurance policies have not been canceled or terminated at June 30, 2005. Premiums are paid on a monthly basis directly to the insurance company. In the past three years, the Municipality has not settled claims that exceeded insurance coverage.

r) *Reservations of Fund Balances*

Reservations of fund balances represent portions of fund balances in the GFFS that are legally segregated for specific future uses or are not appropriated for expenditure. The Municipality has recorded the following types of reservations of fund balances in the GFFS:

- ***Encumbrances*** – Represent reservations of fund balances for commitments related to unperformed (executory) contracts for goods or services (future expenditures under purchase orders, contracts and other commitments). These committed amounts represent reservations of unexpired appropriations and generally will become liabilities in future fiscal years as the goods or services are received.

- ***Debt Service*** – Represent fund balances available to cover future debt service payments (principal and interest) on bonds payable, which are accounted for in the debt service fund.

- ***Capital Projects*** – Represent the reservation of financial resources to be used for the acquisition, construction or improvement of major capital assets under contracts and other commitments. These amounts are accounted for in the capital projects funds.

- ***Advances and long-term receivables*** – Represent the reservation of financial resources set aside for long-term accounts and interfund receivables, which are not considered current available financial resources at June 30, 2005.

- ***Other Specified Purposes*** – Represent financial resources set aside for use in federal and state grant programs.

s) *Interfund Activities*

The Municipality has the following types of reciprocal and nonreciprocal interfund activities recorded among governmental funds in the accompanying GFFS:

- ***Interfund loans*** – Represent amounts provided with a requirement for repayment, which are recorded as "due from" in the lender governmental fund and "due to" in the borrower governmental fund. Interfund receivables, which are not considered to be currently available financial resources, are reported as advances. For amounts not expected to be collected within a reasonable period of time, interfund receivables/payables are reduced to the estimated realizable value and the amount that is not expected to be repaid is reported as a transfer from the governmental fund that made the loan.

- ***Iinterfund transfers*** – Represent flows of assets (permanent reallocation of financial resources among governmental funds) without equivalent flows of assets in return and without a requirement for repayment. Transfers are reported as other financing uses in the governmental fund making transfers and as other financing sources in the governmental fund receiving transfers.

- ***Interfund reimbursements*** – Represent repayments from the governmental fund responsible for particular expenditures or expenses to the governmental fund that initially paid for them.

In the GFFS, interfund activity has not been eliminated, as permitted by GAAP.

t) Use of Estimates

The preparation of the accompanying basic financial statements in conformity with GAAP requires management to make significant estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the basic financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

u) Future Adoption of Accounting Pronouncements

In April 2005, GASB issued its Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (GASB No. 43). This statement establishes uniform financial reporting standards for other postemployment benefit plans (OPEB plans, including postemployment healthcare, life insurance, etc.) and supersedes the interim guidance included in GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The approach followed in this statement is generally consistent with the approach adopted in GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, with certain modifications to reflect differences between pension plans and OPEB plans. The requirements of this statement are effective for the Municipality's fiscal year commencing on July 1, 2006.

In May 2005, GASB issued its Statement No. 44, *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1* (GASB No. 44). This statement amends the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, which provides guidance for the preparation of the statistical section of the Municipality's Comprehensive Annual Financial Report (CAFR). The statistical section presents detailed information, typically in ten-year trends, that assists users in utilizing: (1) the basic financial statements, (2) the notes to basic financial statements, and (3) the required supplementary information, to assess the economic condition of a government. This statement applies to any statistical section of a CAFR that accompanies a government's basic financial statements. The provisions of this statement are effective for the Municipality's fiscal year commencing on July 1, 2005.

In June 2005, GASB issued its Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB No. 45). This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities/assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local government employers. The requirements of this statement are effective for the Municipality's fiscal year commencing on July 1, 2007.

The Municipality's management has concluded that the future adoption of GASB Statements No. 43, 44 and 45 will not have a significant impact on the Municipality's basic financial statements.

2. Deposits

The Municipality maintains its deposits in various commercial banks located in Puerto Rico and GDB. Proceeds from bonds and funds related to certain grant awards are required by law to be held with GDB.

The balances deposited in commercial banks are insured by the Federal Deposit Insurance Corporation (FDIC) generally up to a maximum of $100,000 per depositor. Under the laws and regulations of the Commonwealth, public funds deposited in commercial banks must be fully collateralized for the amounts deposited in excess of the federal depository insurance. All securities pledged as collateral are held, in the Municipality's name, by the agents of the Commonwealth's Secretary of Treasury. Deposits with GDB are uninsured and uncollateralized. However, no losses related to defaults by GDB on deposit transactions have been incurred by the Municipality through June 30, 2005.

On July 1, 2004, the Municipality adopted the provisions of GASB Statement No. 40 (GASB No. 40), Deposit and Investment Risk Disclosure, an Amendment to GASB Statement No. 3. This statement requires that state and local governments disclose essential risk information about deposits and investments. The disclosure requirements cover four main areas: (1) credit risk, (2) interest rate risk, (3) custodial credit risk, (4) foreign exchange exposure.

Credit risk – This is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Municipality has no credit risk policy, since there are no investments.

Interest rate risk – This is the risk that changes in interest rates of debt investments will adversely affect the fair value of an investment. The Municipality manages its exposure to declines in fair values by limiting the weighted average maturity of its investments portfolio (cash equivalents consisting of certificates of deposit) to less than three months.

Custodial credit risk – In the case of deposits, this is the risk that in the event of a bank failure, the Municipality's deposits may not be recovered. The Municipality has no deposit policy for custodial credit risk.

Foreign exchange risk – The risk that changes in exchange rates will adversely affect the value of an investment or a deposit. The Municipality has no policy for foreign exchange risk, since there are no foreign exchange deposits or investments.

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Cash and cash equivalents as of June 30, 2005, are classified in the accompanying financial statements as follows:

Statement of net assets:	
Unrestricted cash, including cash equivalents of $1,300,000	$ 2,687,926
Restricted cash	7,862,696
Total cash and cash equivalents	$10,550,622

Cash and cash equivalents as of June 30, 2005, consist of the following:

Cash, including cash equivalents of $1,300,000, in commercial banks	$ 5,414,032
Cash in fiscal agent	5,136,590
Total cash and cash equivalents	$10,550,622

Pursuant to the Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico, the Municipality may invest in obligations of the Commonwealth, obligations of the United States of America, certificates of deposit, commercial paper, bankers' acceptances, or in pools of obligations of the municipalities of Puerto Rico, which are managed by GDB.

3. Municipal License Taxes

The Municipality is authorized by Act No. 81 to impose and collect municipal license taxes to any natural or legal person having trade or business activities within the territory of Canóvanas. This is a self-assessed tax generally based on the business volume of taxpayers, measured by gross revenues. The Municipality establishes the applicable tax rates. At June 30, 2005, the municipal license tax rates imposed by the Municipality were 1.50 percent for financial institutions and 0.50 percent for other types of taxpayers. Any taxpayers that have been granted with a partial tax exemption under any of the tax incentive acts of the Commonwealth ultimately pay municipal license taxes at reduced tax rates, generally between 60 percent and 90 percent under standard rates.

Each taxpayer must asses the corresponding municipal license tax by declaring the volume of business through a tax return filed every April 15, based on the actual volume of business (revenues) earned in the preceding calendar year. Taxpayers with a sales volume of $1 million or more must include audited financial statements with their tax return filings. The tax can be paid by the taxpayer in two equal installments due on July 15 and January 15, subsequent to the filing of the declaration on April 15. The first installment of the tax covers the six-month period ended December 31, subsequent to the filing date of the declaration, while the second installment of the tax covers the six-month period ended June 30 of the subsequent calendar year. If a taxpayer elects to pay the tax in full on the filing date of the declaration (generally April 15), a 5 percent discount is granted automatically on the total tax amount due.

Any municipal license taxes collected in advance (that is, pertaining to a future fiscal year) are recorded as deferred revenues in the GWFS and the GFFS (see note 8). Total municipal license tax receivable, net of an allowance for uncollectible accounts of $31,552, amounted to $1,107,749 at June

30, 2005. Deferred municipal license tax revenues recorded in the accompanying GWFS and GFFS amounted to $3,358,582 respectively at June 30, 2005.

4. Property Taxes

The Municipality is authorized by Act No. 81 to impose and collect property taxes from any natural or legal person that, at January 1 of each calendar year: (1) is engaged in trade or business and is the owner of personal or real property used in trade or business or (2) owns residential real property with a value in excess of $15,000 (at 1957 estimated market prices).

CRIM is responsible for the billings and collections of real and personal property taxes on behalf of the Municipality. Prior to the beginning of each fiscal year, CRIM informs to the Municipality the estimated amount of property tax expected to be collected for the ensuing fiscal year. Throughout the fiscal year, CRIM advances funds to the Municipality based on the initial estimated collection amounts for the fiscal year. 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 the property tax amounts actually collected from taxpayers on behalf of the Municipality during the fiscal year. This settlement has to be completed on a preliminary basis not later than December 31 following the fiscal year end. If in any given fiscal year, CRIM remits to the Municipality property tax advances that are less than the property taxes actually collected, on behalf of the Municipality, an intergovernmental receivable is recorded at June 30 in the Municipality's basic financial statements. However, if advances exceed the amount actually collected by CRIM, an intergovernmental payable is recorded at June 30. For the fiscal year ended June 30, 2005, the actual property tax collections exceeded the advances remitted by CRIM by $412,336, which are recorded within intergovernmental receivables in the accompanying GWFS and GFFS (see note 5).

Personal property taxes are self-assessed by taxpayers every year using the book value of personal property assets owned by the taxpayer at January 1 (assessment date) and reporting such taxable value through a personal property tax return filed on May 15 subsequent to the assessment date. The total personal property tax rate in force at June 30, 2005 was 6.83 percent (of which taxpayers pay 6.63 percent and the remaining 0.20 percent is paid by the Department of Treasury, as a subsidy).

Real property taxes are assessed by CRIM. The assessment on real property is made every January 1 and is based on estimated current values of the property, deflated to 1957 market prices. The total real property tax rate in force at June 30, 2005 was 8.83 percent (of which 8.63 percent is paid by taxpayers and the remaining 0.20 percent is also paid by the Department of Treasury, as a subsidy).

Residential real property occupied by its owner (not engaged in trade or business) is exempt from property taxes only on the first $15,000 of the assessed value (at 1957 market prices). For exempt amounts, the Department of Treasury assumes the payment of the basic tax (4.00 percent and 6.00 percent for personal and real property, respectively), except for property assessed for less than $3,500 (at 1957 market prices), for which no payment is made by the Department of Treasury.

According to Act No. 81, included within the total personal and real property tax rates of 6.83 percent and 8.83 percent, respectively, there is a levy of an annual special tax of 1.03 percent of the assessed value of all real and personal property not exonerated from taxation. This special tax is levied by the Commonwealth but is collected by CRIM. Collections of this special tax are directly remitted by CRIM to the Commonwealth's debt service fund, for the payment of the general long-term debt of the Commonwealth.

In addition, included within the total personal and real property tax rates of 6.83 percent and 8.83 percent, respectively, there is a portion of the tax rate in the amount of 1.80 percent that is restricted for the Municipality's debt service requirements on bonds. Such amounts are recorded in the Municipality's debt service fund.

Furthermore, included within the total personal and real property tax rates of 6.83 percent and 8.83 percent, respectively, there is a portion of the tax rates that is recorded in the Municipality's general fund, of which a portion is restricted for the payment of: (1) the insurance premiums acquired through the Department of Treasury, (2) the principal and interest on the Municipality's 2003 serial bonds of $3,375,000, (3) the monthly contributions to CRIM, which are statutorily required as the Municipality's share of CRIM's operating expenses, (4) statutory contributions to the Puerto Rico Health Services Administration (PRHSA), as the Municipality's share of the cost of the public health insurance coverage provided to qualifying low-income citizens, (5) certain notes payable to CRIM (see note 9) and, (6) certain amounts due to certain agencies and component units of the Commonwealth, which are recorded within intergovernmental payables in the accompanying GWFS and GFFS. The 0.20 percent of unrestricted personal and real property taxes paid by the Department of Treasury as a subsidy is recorded in the Municipality's general fund.

The Additional Lottery System of the Commonwealth (the Additional Lottery) is an operational unit reported as an enterprise fund in the Commonwealth's basic financial statements, which currently operates several betting alternatives to the citizens of Puerto Rico. The Additional Lottery is required every fiscal year to distribute a portion of its excess of revenues over expenses as follows:

- Thirty five percent of its net earnings (defined as the excess of revenues over expenses less an amount earmarked for the Fund for Rent and Home Improvement Subsidy Program for the Low-Income Qualifying Elderly) is earmarked to the municipalities of the Commonwealth, of which a maximum of $26 million, on an annual basis, is distributed to the Municipal Equalization Fund held by CRIM to cover operating expenses and permanent improvements of the municipalities.

- An additional amount not exceeding $16 million, on an annual basis, is distributed to the Municipal Equalization Fund, provided it is within the thirty-five percent corresponding to the municipalities of the Commonwealth. When the accumulated municipal appropriations from the municipalities' Puerto Rico Health Reform are covered up to June 30, 1997, these resources will be assigned to PRHSA.

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The composition of property taxes receivable and the related deferred revenue is as follows at June 30, 2005:

	General fund	Debt service fund	Total
Gross property taxes receivable	$ 8,883,351	1,486,973	$ 10,370,324
Less:			
Allowance for uncollectible accounts	(4,448,552)	(735,815)	(5,184,367)
Net property tax receivable	$ 4,434,799	751,158	$ 5,185,957
Deferred (unavailable) property tax revenues in GFFS (note 10)	$ 3,184,324	539,214	$ 3,723,538

On March 1, 2004, the Commonwealth's Legislature approved Public Act No. 74 by which a property tax amnesty and incentive plan (the Amnesty) was approved to encourage taxpayers to pay, at discounted amounts, past due property taxes from previous fiscal years.

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5. Intergovernmental Receivables and Payables

Intergovernmental receivables and payables recorded in the accompanying GWFS and GFFS are as follows:

	Major governmental funds	Other governmental funds	Total governmental funds	Statement of net assets
Intergovernmental receivables:				
Grants and contributions:				
U.S. Department of Housing and Urban Development - HUD Section 8 fund	$	38,069	38,069	$ 38,069
U.S. Department of Justice - COPS fund		61,023	61,023	61,023
Puerto Rico Treasury Department – general fund	146,309		146,309	146,309
Puerto Rico Department of Labor – Law 52 fund		188,492	188,492	188,492
Total intergovernmental receivables	$ 146,309	287,584	433,893	$ 433,893
Intergovernmental payables:				
Payroll withholdings - general fund:				
State Insurance Fund Corporation	$			$ 46,206
Puerto Rico Department of Labor – general fund	2,976		2,976	7,299
Employees Retirement Sysytem of the Government of the Commonwealth of Puerto Rico (note 10)				78,211
Excess of property tax advances over collections - general fund - CRIM (note 4)	412,336		412,336	412,336
Utilities - general fund:				
Puerto Rico Acqueduct and Sewer Authority	15,000		15,000	15,000
Municipality of Juncos	197,609		197,609	197,609
Miscellaneous:				
Puerto Rico General Services Administration				5,883
Puerto Rico Police Department	49,064		49,064	49,064
Association of Employees of the Commonwealth of Puerto Rico	49,446		49,446	49,446
Total intergovernmental payables	$ 726,431		726,431	$ 861,054

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6. Interfund Transactions

The composition of interfund balances at June 30, 2005 and for the fiscal year then ended is as follows:

	Due from / advances to:			
	Major governmental funds			
Due to / advances from:	General fund	Debt service fund	Other governmental funds	Total governmental funds
Major governmental funds:				
General fund	$	518,500		$ 518,500
Debt service fund	10,675			10,675
Nonmajor governmental funds:				
Special revenue funds	603,513			603,513
Capital project funds	760,327		95,113	855,440
Total	$ 1,374,515	518,500	95,113	$ 1,988,128

	Transfers in:			
	Major governmental funds			
Transfers out:	General fund	Debt service fund	Other governmental funds	Total governmental funds
Major governmental funds:				
General fund	$	582,000	65,726	$ 647,726
Debt service fund	33,171			33,171
Nonmajor governmental funds:				
Special revenue funds				
Capital project funds	93,486		654,339	747,825
Total	$ 126,657	582,000	720,065	$ 1,428,722

The principal purposes of interfund receivables and payables are:

- Recognize in the debt service fund the amounts due from the general fund to cover the principal and interest payments of certain bonds, amounting to $518,500. These payments are due on July 1, 2005.

- Recognize in the general fund the outstanding balance of the loans granted to nonmajor special revenue funds ($1,363,840) to temporarily cover principally the payroll and other operating costs of several federally and state funded programs.

The principal purposes of interfund transfers are to:

- Make a routinary transfer of interest income, amounting to $33,171, from the debt service fund to the general fund, as permitted by law. This interest income is generated by the debt service fund's deposits and is transferred on a quarterly basis to the general fund.

- Make a routinary transfer of resources, amounting to $582,000, from the general fund to the debt service fund to cover the principal and interest payments on certain bonds. These debt service payments were made on January and July 2005.

- Make a routinary transfer of interest income amounting to $93,486, from the capital project funds to the general fund. This interest income is generated by certain capital project fund's deposits and is transferred on a monthly basis, as permitted by law.

Interfund receivables and payables represent the pending settlements of the aforementioned transfers, which are considered by management to be fully realizable at June 30, 2005.

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7. Capital Assets

Capital assets activity for the fiscal year ended June 30, 2005:

COST BASIS:	Balance at June 30, 2004, as restated	Additions	Reclassifications	Balance at June 30, 2005
Cost basis of capital assets, not subject to depreciation and amortization:				
Infrastructure land	$ 1,611,480			$ 1,611,480
Construction in progress	6,028,187	5,518,818	(5,364,903)	6,182,102
Total cost basis of capital assets, not subject to depreciation and amortization	7,639,665	5,518,818	(5,364,903)	7,793,582
Cost basis of capital assets, subject to depreciation and amortization:				
Buildings, structures and building improvements	11,711,499		1,655,888	13,367,387
Infrastructure	5,786,424		3,709,015	9,495,439
Land Improvements	2,094,491			2,094,491
Licensed vehicles	5,885,808	282,448		6,168,256
Furnitures, fixtures, machinery and equipment	1,117,312	969,626		2,086,938
Equipment held under capital leases	205,245			205,245
Total cost basis of capital assets subject to depreciation and amortization	26,800,779	1,252,074	5,364,903	33,417,756
Total cost basis of capital assets	$ 34,440,444	6,770,892		$ 41,211,338

ACCUMULATED DEPRECIATION AND AMORTIZATION:	Balance at June 30, 2004	Depreciation and Amortization Expense	Reclassifications	Balance at June 30, 2005
Buildings, structures and building improvements	$ 2,600,733	244,656		$ 2,845,389
Infrastructure	4,069,327	104,805		4,174,132
Land Improvements	1,133,414	84,798		1,218,212
Licensed vehicles	3,246,904	527,917		3,774,821
Machinery and equipment	507,657	132,634		640,291
Equipment under capital leases	94,430	40,750		135,180
Total accumulated depreciation and amortization	$ 11,652,465	1,135,560		$ 12,788,025
	11,558,035			
CAPITAL ASSETS, NET	$ 22,787,979	5,635,332		$ 28,423,313

Depreciation and amortization expense was charged to functions in the accompanying government-wide statement of activities as follows:

General government	$ 115,433
Urban and economic development	683,594
Public safety	37,776
Health and sanitation	30,058
Culture, recreation and education	259,015
Public housing and welfare	9,684
Total depreciation and amortization expense	$ 1,135,560

At June 30, 2005 the estimated aggregate replacement cost of the Municipality's capital assets amounted to approximately $45.7 million.

8. Deferred Revenues

At June 30, 2005, deferred revenues recorded in the GWFS and the GFFS are as follows:

	Major governemntal funds				
	General fund	Debt service fund	Other governmental funds	Total governmental funds	Statement of net assets
Measurable but not available revenues:					
Property taxes	$ 3,184,324	539,214		3,723,538	$
Christmas Bonus reimbursement	146,309			146,309	
Total measurable but not available revenue	3,330,633	539,214		3,869,847	
Unearned revenues:					
Municipal licenses	3,358,582			3,358,582	3,358,582
Intergovernmental grants and contributions:					
Commonwealth of Puerto Rico			353,588	353,588	353,588
United States of America			1,293,181	1,293,181	1,293,181
Total unearned revenues	3,358,582		1,646,769	5,005,351	5,005,351
Total deferred revenues	$ 6,689,215	539,214	1,646,769	8,875,198	$ 5,005,351

9. Long-Term Obligations

The general long-term debt activity for the fiscal year ended June 30, 2005 is as follows:

	Balance at beginning of fiscal year, as restated (note 14)	Borrowings or additions	Payments or deductions	Discount accretion	Balance at end of fiscal year	Balance due within one year
Bonds payable	$ 10,320,000	4,550,000	(910,000)		$13,960,000	$ 1,295,000
Notes payable:						
CRIM	1,917,832		(401,064)	155,376	1,672,144	258,258
HUD	4,660,000		(310,000)		4,350,000	
Obligation under capital leases	120,901		(41,455)		79,446	41,464
Reserve for federal cost disallowance	182,210				182,210	182,210
Compensated absences	2,197,198	1,953,650	(1,548,801)		2,602,047	1,220,607
Total	$ 19,398,141	6,503,650	(3,211,320)	155,376	$22,845,847	$ 9,393,282

Historically, the general fund has been used to liquidate certain notes payable, compensated absences, federal cost disallowances, obligations under capital leases and any other long-term liabilities other than bonds.

a) Debt Limitation

The Municipal Legislature is legally authorized to approve the contracting of debts of the Municipality. Nevertheless, the laws and regulations of the Commonwealth also provide that:

- Direct obligations of the Municipality (evidenced principally by bonds and bond anticipation notes) are backed by the full faith, credit and taxing power of the Municipality; and

- Direct obligations are not to be issued by the Municipality if the amount of the principal of, and the interest on, such bonds and bond anticipation notes (and on all bonds and notes issued thereafter) which are payable in any fiscal year, together with any amount paid by the Municipality in the preceding fiscal year on account of bonds or bond anticipation notes guaranteed by the Municipality, exceed 10 percent of the total assessed value of the property located within the Municipality plus the balance of the ad valorem taxes in the debt service fund, for bonds payable and bond anticipation notes to be repaid with the proceeds of property taxes restricted for debt service.

In addition, before any new bonds or notes are issued, the revenues of the debt service fund should be sufficient to cover the projected debt service requirement. Total property assessed value at June 30, 2005 amounted to $133,625,123. The Municipality's available legal debt margin amounted to $2,478,633.

b) Bonds Payable

The Municipality issues general obligation, special obligation and public improvement bonds to finance the acquisition, construction and improvement of capital assets, as well as, to finance certain operating needs, including the payment to suppliers in certain circumstances.

The laws and regulations of the Commonwealth provide that the Municipality's public debt will constitute a first claim on the available revenue of the Municipality. Public debt is composed of bonds payable. The good faith, credit and taxing power of the Municipality are irrevocably pledged for the prompt payment of the principal and interest of bonds.

As described in Note 4, the Municipality levies an annual additional special tax of 1.80 percent of the assessed value of personal and real property. The proceeds of this additional special tax are deposited in a sinking fund established at GDB whereby sufficient funds are set aside to redeem the bonds payable of the Municipality in minimum annual or semiannual principal and interest payments. The collections of this special tax are recorded in the Municipality's debt service fund.

For financial reporting purposes, the outstanding balances of bonds represent the total principal to be repaid. Bonds payable is composed as follows at June 30, 2005:

General Obligation Bonds:	**Outstanding Amount**
2003 serial bonds due in annual principal installments ranging from $405,000 to $565,000; plus interests due in semiannually installments at variable rates (5.00% at June 30, 2005) through July, 1, 2009	$ 2,540,000
2001 serial bonds due in annual principal installments ranging from $75,000 to $475,000; plus interests due in semiannually installments at variable rates (2.89% at June 30, 2005) through July, 1, 2026	5,255,000
2004 serial bonds due in annual principal installments ranging from $175,000 to $235,000; plus interests due in semiannually installments at variable rates (3.28% at June 30, 2005) through July, 1, 2011	1,435,000
Total general obligation bonds	9,230,000
Public Improvement Bonds:	
1991 serial bonds due in annual principal installments ranging from $80,000 to $255,000; plus interests due in semiannually installments at variable rates (6.31% at June 30, 2005) through July, 1, 2006	490,000
1995 serial bonds due in annual principal installments ranging from $95,000 to $265,000; plus interests due in semiannually installments at variable rates (5.93% at June 30, 2005) through July 1, 2009	1,125,000
2005 serial bonds due in annual principal installments ranging from $145,000 to $285,000; plus interests due in semiannually installments at variable rates (3.28% at June 30, 2005) through July 1, 2019	3,115,000
Total public improvement bonds	4,730,000
Total bonds and notes payable	$ 13,960,000

Variable interest rates on serial bonds are reviewed periodically by GDB and are based on the fluctuation of GDB's weighted average rate for its commercial paper program. Under this program, GDB issues commercial paper: (1) in the taxable and tax-exempt markets of the United States of America, (2) in the Eurodollar market, and (3) to corporations having tax exemptions under the Commonwealth's Industrial Incentives Acts and, which qualify for benefits provided by the former Section 936 of the U.S. Internal Revenue Code.

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

Fiscal year ending June 30,	Principal	Interest	Total
2006	$ 1,295,000	670,253	$ 1,965,253
2007	1,375,000	624,817	1,999,817
2008	1,195,000	555,859	1,750,859
2009	1,265,000	490,709	1,755,709
2010	1,350,000	420,907	1,770,907
2011-2015	2,065,000	1,624,035	3,689,035
2016-2020	2,735,000	1,073,184	3,808,184
2021-2025	1,765,000	517,124	2,282,124
2026-2030	915,000	52,220	967,220
Totals	$13,960,000	6,029,107	$19,989,107

At June 30, 2005, accrued interest payable on bonds amounted to $339,123.

c) Notes Payable to CRIM

The Municipality entered into a financing agreement of $2,627,775 with the Municipal Revenue Collection Center (CRIM) through 2011. The financing agreement allows for the financing of a debt that the Municipality has from the final settlements of property tax advances versus actual collections through fiscal year 1992. The note is payable with monthly installments ranging from $25,000 to $28,000, at no interest.

This note has an imputed interest rate of 5.00 percent. The outstanding balance of this note, net of the unamortized discount of $254,624, amounted to $1,672,143 at June 30, 2005. Amortization of the note discount amounted to $155,376 for the year ended June 30, 2005, which has been recorded as interest expense in the accompanying statement of activities. The principal maturities and schedule amortization discount are as follows:

Fiscal year ending June 30,	Principal	Discount Accretion	Total
2006	$ 258,258	77,742	$ 336,000
2007	271,471	64,529	336,000
2008	285,360	50,640	336,000
2009	299,959	36,041	336,000
2010	315,306	20,694	336,000
2011	241,788	4,979	246,767
Totals	$1,672,143	254,624	$1,926,767

d) Notes Payable to HUD

The Municipality has a loan guarantee commitment of $4,770,000 with HUD pursuant to an application under Section 108 of the Housing and Community Development Act of 1974 (Section 108). Section 108 commitments are required to be supported by a credit subsidy appropriation pursuant to the Federal Credit Reform Act of 1990 (Credit Reform Act) and implementing guidance issued by the U.S. Office of Management and Budget (OMB). Therefore, in connection with its guarantee of these notes, HUD obligated appropriated funds to cover the credit subsidy cost of the loan guarantee, as required under the Credit Reform Act. Under the Credit Reform Act procedures, such funds are disbursed into a financing account as loan proceeds are disbursed by the lender (a local commercial bank). The financing account is in some respects equivalent to an internal loss reserve for the federal government. Each disbursement into the financing account is equal to the loan advance times the credit subsidy rate, which is part of HUD's budget approved by OMB and the Congress.

Pursuant to the credit subsidy implementation guidance issued by OMB, the undisbursed balance of the credit subsidy obligation must be canceled on September 30th of the 5th fiscal year after the period of availability for obligation of a fixed appropriation account ends.

The proceeds of the loan guarantee commitment are used by the Municipality to provide low-income communities with another source of financing for the economic development, housing rehabilitation, public facilities and large-scale physical development projects. The notes on the loan guarantee commitment bear interest at various rates ranging from of 3.82 percent to 6.67 percent. The proceeds and uses of the loan guarantee commitment are accounted for in the Loan guarantee section 108 fund, a capital projects fund. The loan guarantee commitment is repaid with grant awards received from of the Community Development Block Grant (CDBG) program, administered by HUD. Principal and interest on these notes are accounted for in the debt service fund. At June 30, 2005, the outstanding principal balance of the loan guarantee commitment amounted to $4,350,000. The loan guarantee commitment is subject to various positive, negative and restrictive covenants that the Municipality has complied with at June 30, 2005. The principal and interest maturities due on August 2005 had already been paid at June 30, 2005.

The principal and interest maturities on the Section 108 loan guarantee commitment are as follows:

Fiscal year ending June 30,	Principal	Interest	Total
2006	$	114,079	$ 114,079
2007	265,000	216,260	481,260
2008	275,000	206,517	481,517
2009	285,000	195,243	480,243
2010	515,000	625,711	1,140,711
2011-2015	1,525,000	374,771	1,899,771
2016-2020	1,485,000	18,675	1,503,675
Totals	$4,350,000	1,751,255	$6,101,255

e) Federal Cost Disallowances

On August 25, 2003, the Office of Inspector General of HUD (OIG) issued an audit report for the operation of the Community Development Block Grant (CDBG) and the Section 108 Loan Guarantee programs administered by the Municipality. The audit covered program years 1999 through 2001. Such report shows $288,285 of ineligible costs. During fiscal year 2003-2004, the Municipality made a payment of $106,075 to reduce such debt. At June 30, 2005. the outstanding balance of $182,210 of such debt has been objected by the Municipality with written responses and evidence provided to HUD. The final settlement of this debt is subject to de final evaluation of HUD.

f) Lease Obligations

The Municipality is obligated under capital leases with third parties that expire through 2008 for the acquisition of machinery and equipment. At June 30, 2005, the capitalized costs and the related accumulated amortization of the leased machinery and equipment amounted to $205,245 and $135,180, respectively, which are accounted for as capital assets in the accompanying statement of net assets. Amortization charges applicable to capital leases and included within depreciation expense amounted to $40,750 for the fiscal year ended June 30, 2005. The present value of the future minimum capital lease payments reported in the accompanying statement of net assets is as follows:

Fiscal year ending June 30,	Amount
2006	$ 41,464
2007	$ 37,946
2008	36
Present value of minimum lease payments	79,446
Less:	
Current portion of obligation under capital leases	41,464
Obligation under capital leases, excluding current portion	$ 37,982

g) Compensated Absences

At June 30, 2005, the liability for compensated absences is composed as follows:

	Due within one year	Due after one year	Total
Vacations	$ 737,940	545,453	$1,283,393
Sick leave	438,265	835,987	1,274,252
Compensatory time	44,402		44,402
Total	$1,220,607	1,381,440	$2,602,047

10. Employees' Retirement Systems

a) Plan Description

The Municipality's employees participate in the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS), a cost-sharing multi-employer (as related to the Municipality's reporting entity) defined pension plan established by the Commonwealth. Substantially all full-time employees of the Commonwealth and substantially all municipalities are covered by ERS under the terms of Public Act No. 447 of May 15, 1951, as amended (Act No. 447). All regular and temporary employees of the Municipality become plan members of ERS at the date of employment, while it is optional for officers appointed.

ERS members, other than those joining it after March 31, 1990, are eligible for the benefits described below:

- ***Retirement Annuity***

  ERS members are eligible for a retirement annuity upon reaching the following age:

Policemen and firemen:	Other employees:
50 with 25 years of credited service	55 with 25 years of credited service
58 with 10 years of credited service	58 with 10 years of credited service

  ERS members are eligible for monthly benefit payments determined by the application of the stipulated benefit ratios to the member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by ERS. The annuity, for which a member is eligible, is limited to a minimum of $300 per month and a maximum of 75 percent of the average compensation.

- ***Merit Annuity***

  ERS members are eligible for merit annuity with a minimum of 30 years or more of credited service. The annuity for which the plan member is eligible is limited to a minimum of 65 percent and a maximum of 75 percent of the average compensation.

- ***Deferred Retirement Annuity***

  A participating employee who ceases to be an employee of the Municipality after having accumulated a minimum of ten years of credited service qualifies for retirement benefits provided his/her contributions are left in ERS until reaching 58 years of age.

- ***Coordinated Plan***

  On the coordinated plan, by the time the employee reaches 65 years old and begins to receive social security benefits, the pension benefits are reduced by the following:

  (a) $165 per month, if retired with 55 years of age and 30 years of credited service.

(b) $110 per month, if retired with less than 55 years of age and 30 years of credited service.

(c) All other between $82 and $100 per month.

(d) Disability annuities under the coordinated plan are also adjusted at age 65 and in some cases can be reduced over $165 per month.

- ***Non-Coordinated Plan***

On the non-coordinated plan the participating employee and does not have any change on the pension benefits upon receiving social security benefits.

- ***Reversionary Annuity***

An ERS member, upon retirement, could elect to receive a reduced retirement annuity giving one or more benefit payments to his/her dependents. The life annuity payments would start after the death of the retiree for an amount not less than $240 per year or greater than the annuity payments being received by the retiree.

- ***Occupational Disability Annuity***

A participating employee, who as a direct result of the performance of his/her occupation is totally and permanently disabled, is eligible for a disability annuity of 50 percent of the compensation received at the time of the disability.

- ***Nonoccupational Disability Annuity***

A participating employee, totally and permanently disabled for causes not related to his/her occupation and with no less than 10 years of credited service, is eligible for an annuity of 1.50 percent of the average compensation of the first 20 years of credited services, increased by 2 percent for every additional year of credited service in excess of 20 years.

- ***Death Benefits***

Occupational:

(a) **Surviving spouse** – annuity equal to 50 percent of the participating employee's salary at the date of the death.

(b) **Children** – $10 per month for each child, minor or student, up to a maximum benefit per family of $100.

Nonoccupational:

Beneficiary – the contributions and interest accumulated as of the date of the death plus an amount equal to the annual compensation at the time of the death.

Post-retirement:

Beneficiary with surviving spouse age 60 or over and a child, 18 or under, up to 30 percent (60 percent, if not covered under Title II of the Social Security Act) (increased to 50 percent effective January 1, 2005) of retiree's pension or otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of $750.

- ***Refunds***

A participating employee who ceases his/her employment with the Municipality without the right to a retirement annuity has the right to a refund of the contributions to ERS plus any interest earned thereon.

- ***Cost of Living Adjustment for Pension Benefits***

Public Act No. 10 of May 21, 1992 (Act No. 10) provided for increases of 3 percent every three or more years of retirement. Act No. 10 requires further legislation to grant this increase every three years subject to the presentation of actuarial studies regarding its costs and the source of financing. To protect the financial health of ERS, the increase granted during 2001 and the one granted on January 1, 2005 are being financed by the Municipality and the other participating employers.

To avoid any economic impact on ERS, the employers are responsible for contributing to ERS the amounts to cover the benefit payments and the employer and employee contributions with respect to the participants covered until the participants reach the normal retirement age.

- ***Amendment to Act No. 447 effective January 1, 2000 to create a Defined Contribution Plan***

On September 24, 1999, Public Act No. 305, an amendment to Act No. 447, was enacted to establish a defined contribution plan, known as System 2000, to cover employees joining ERS on or after January 1, 2000.

Employees that participated in the original plan as of December 31, 1999, had the opportunity to elect to either stay in the defined benefit plan or transfer to System 2000. Employees that joined the Municipality on or after January 1, 2000, were only allowed to become members of System 2000.

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there is a pool of plan assets, which is invested by the System, together with those of the cost-sharing multi-employer defined benefit plan. Neither the Commonwealth nor the Municipality guarantee benefits at retirement age. The annuity is based on a formula which assumes that each fiscal year the employee's contribution (with a minimum of 8.28 percent of the employee's salary up to a maximum of 10 percent) is invested as instructed by the employee in an account which either: (1) earns a fixed rate based on the two-year Constant Maturity Treasury Notes, (2) earns a rate equal to 75 percent of the return of the ERS' investment portfolio (net of management fees), or (3) earns a combination of both alternatives. Participants receive periodic account statements similar to those of defined

contribution plans showing their accrued balances. Disability benefits are not granted under System 2000, rather are provided to those participants that voluntarily elect to participate in a private insurance long-term disability program. The employers' contributions (9.28 percent of the employee's salary) with respect to employees under System 2000 will continue and will be used to fund the cost-sharing multi-employer defined benefit plan.

System 2000 reduced the retirement age from 65 years to 60 for those employees who joined the current plan on or after January 1, 2000.

Historically, the Commonwealth has reported ERS and System 2000 in its basic financial statements as pension trust funds. Accordingly, the Commonwealth is currently assuming any actuarial deficiency that may exist or arise related to the Municipality's participating employees because ERS does not allocate to the Municipality any actuarial deficiencies pertaining to participating municipal employees. The Municipality is only required by law to make statutory contributions at the rates detailed below.

- ***Recent Amendments to Act No. 447***

In June and July 2003, the Governor of the Commonwealth signed three Public Acts that provided the following certain benefits to retirees:

(a) Increase in minimum monthly pension payments to $300, effective January 1, 2005.

(b) Triennial 3 percent increase in all pensions, effective January 1, 2005.

(c) Increase in widow and/or beneficiaries to 50 percent of the benefit received by the deceased pensioner, effective January 1, 2005.

All the benefits granted will be funded through budgetary assignments in the Municipality's general fund with respect to its retired employees.

The Board of Trustees of ERS approved, effective November 17, 2003, an increase in the amount granted on personal loans to participating employees from $3,000 to $5,000.

b) Funding Policy

The contribution requirement to ERS is established by law and is not actuarially determined. These contributions are as follows:

Municipality and other employers	9.28 percent of applicable payroll
Employees:	
Coordination plan:	5.78 percent of gross salary up to $6,600 per year, plus 8.28 percent gross salary in excess of $6,600.
Supplementation plan:	8.28 percent of gross salary. This is the only choice available to policemen, firemen and majors

c) Annual Pension Cost and Net Pension Obligation

The net pension obligation and the annual pension cost of ERS and System 2000 as of and for the fiscal year ended June 30, 2003 (most recent available data), which includes the employees of the Municipality, the Commonwealth and other municipalities, have been recorded in the basic financial statements of the Commonwealth. No allocation of such amounts has been made in the accompanying basic financial statements. The following aggregate annual pension cost and net pension obligation as of and for the fiscal year ended June 30, 2003 (most recent official data available) which are assumed and accounted for by the Commonwealth, is presented in this report only for the purposes of additional analysis (amounts expressed in thousands):

Annual required contributions	$ 802,536
Interest on net pension obligation	192,416
Adjustment to annual required employers' contributions	(134,870)
Annual pension cost	860,082
Statutory employers' contributions made	(330,404)
Increase in net pension obligation	529,678
Net pension obligation at beginning of fiscal year	2,815,576
Net pension obligation at end of fiscal year	$3,345,254

11. Commitments and Contingencies

The Municipality is defendant in various legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended, persons are authorized to sue the Municipality only for causes of actions set forth in said Act to a maximum amount of $75,000 or $150,000 if it involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as provided in Act No. 9 of November 26, 1975, as amended, the Municipality may provide its officers and employees with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the payment of such judgment.

With respects to pending or threatened litigation, the Municipality has not reported liabilities of for awarded or anticipated unfavorable judgments as of June 30, 2005. Management believes that any unfavorable outcome in relation to pending or threatened litigation would not be significant, if any.

The Municipality has reported, outstanding encumbrances amounting to $827,301 in the general fund at June 30, 2005. The Municipality intends to honor these encumbrances, which will continue to be liquidated under the current year's budget during a lapse period that extends into the subsequent fiscal year.

At June 30, 2003, the Municipality's CRIM – Lims special revenue fund, FHA capital projects fund, Rural Development capital projects fund and CDBG – IDIS capital projects fund, four nonmajor governmental funds, reported fund deficits amounting to $100,472, $700, $4,067 and $622,070, respectively. It is the intention of the Municipality to cover such deficits through future budgetary appropriations of the general fund. However, no resources have been provided by the general fund for such purposes at June 30, 2005.

12. Prior-period Adjustments and Restatements

The following schedule reconciles the total net asset balance at June 30, 2004, as previously reported by the Municipality, to the beginning net assets, as restated in the accompanying GWFS:

Net assets at beginning of fiscal year, as previously reported	Other adjustments	Net assets at beginning of fiscal year, as restated
$ 15,910,294	915,472	$ 16,825,766

The prior period adjustments were primarily due to a CD of $1,000,000, recorded as deferred revenue in the capital projects fund, was detected to be from general fund resources. Also, because the prior year's payroll payments made on behalf of special revenue funds were overstated by $75,500. There was also a receivable from the federal government for $18,000, which was to be reimbursed to the general fund that was unrecorded since there was no certainty of its collection as of June 30, 2004.

The following schedule reconciles the fund balances, as previously reported by the Municipality, to beginning fund balances, as restated:

	Fund balances at the beginning of fiscal year, as previously reported	Reclassifications and other adjustments	Fund balances at the beginning of fiscal year, as restated
Major governmental funds:			
General fund	$ 2,993,633	941,620	$ 3,935,253
Debt service fund	2,003,980		2,003,980
	4,997,613	941,620	5,939,233
Other governmental funds:			
Capital projects fund	2,981,235	(18,001)	2,963,234
Special revenue funds	(218,702)	75,500	(143,202)
	2,762,533	57,499	2,820,032
Total governmental funds	$ 7,760,146	999,119	$ 8,759,265

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Statement of Revenues and Expenditures – Budget and
Actual –Budgetary Basis – General Fund
June 30, 2005

	Budgeted amounts		Actual amounts (budgetary basis)	Variance with final budget -
	Original	Final	(see note 1)	over (under)
Revenues:				
Taxes:				
Property taxes	$ 4,467,241	4,467,241	4,467,241	$
Municipal license taxes	2,680,000	2,680,000	2,686,994	6,994
Construction excise taxes	3,267,720	3,267,720	2,866,035	(401,685)
Charges for services	942,500	942,500	726,257	(216,243)
Intergovernmental grants and contributions	3,967,451	4,212,805	4,621,912	409,107
Interest on deposits and investments	180,000	180,000	179,840	(160)
Miscellaneous	500,573	1,842,770	394,714	(1,448,056)
Total revenues	16,005,485	17,593,036	15,942,993	(1,650,043)
Expenditures:				
Current:				
General government	8,426,304	10,106,976	9,158,058	(948,918)
Urban and economic development	3,033,118	2,954,338	2,544,615	(409,723)
Public safety	445,589	396,139	348,000	(48,139)
Health and sanitation	1,900,091	2,066,311	1,880,682	(185,629)
Culture, recreation and education	435,819	386,885	295,212	(91,673)
Public housing and welfare	1,048,364	884,838	794,688	(90,150)
Debt service:				
Principal				
Interest				
Capital outlays	111,500	72,300	30,457	(41,843)
Total expenditures	15,400,785	16,867,787	15,051,712	(1,816,075)
Excess of revenues over expenditures	604,700	725,249	891,281	166,032
Other financing sources (uses):				
Transfers-in from other funds				
Transfers-out to other funds	(604,700)	(725,249)	(692,000)	33,249
Total other financing sources (uses), net	(604,700)	(725,249)	(692,000)	33,249
Net changes in fund balances	$		199,281	$ 199,281

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Schedule of Expenditures of Federal Awards
June 30, 2005

	Federal CFDA Number	Pass-through Grantor's Number	Expenditures
U.S. Department of Housing and Urban Development			
Lower Income Housing Program (Section 8 Voucher)	14.856	RQ-46V-07501	$ 282,738
Housing Opportunities for persons with AIDS	14.241	N/A	28,507
Community Development Grant/ Entitlement Grant	14.218	B-04-MC-72-0018	1,378,904
State Block Grant Program	14.219	N/A	14,103
Loan Guarantee Section 108	N/A	B-99-MC-72-0018*	1,544,733
Total U.S. Department of Housing and Urban Development			3,248,985
U.S. Department of Health and Human Services			
Pass-through of the Governor's Office for Human development – Child Care	93.575	N/A*	849,944
Total U.S. Department of Health and Human Services			849,944
U.S. Department of Agriculture			
Pass-through of the Puerto Rico Elderly Commission – Food Distribution	10.558	N/A	76,562
Total U.S. Department of Agriculture			76,562
U.S. Department of Justice			
Pass-through of the Puerto Rico Department of Justice – Public Safety Partnership and Community Policing Grant (COPS)	16.710	2000SHWX0307	164,289
Total U.S. Department of Justice			164,289
Total Federal Financial Assistance			$ 4,339,780

* Major programs

1. General

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Municipality of Canóvanas of the Commonwealth of Puerto Rico and is presented on the accrual basis of accounting. The Municipality of Canóvanas reporting entity is defined in Note 1 to the Municipality's basic 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. Therefore, some amounts presented in this schedule may differ from amounts presented in our used in the preparation of the basic financial statements.

2. Relationship to the Basic Financial Statements

Revenues and expenditures of the federal awards are included in the Municipality's basic financial statements within the Major and Nonmajor Governmental Funds. The reconciliation between the expenditures in the basic financial statements and expenditures in the Schedule of Expenditures of Federal Awards is as follows:

Expenditures in the basic financial statements:

Nonmajor governmental funds	$ 8,544,955
Less: Non-federal expenditures	(4,205,175)
Total expenditures in the Schedule of Federal Awards	$ 4,339,780

3. Loans or loans guarantees

Section 108 Loan Guarantee is included in the Statement of Net Assets within the long-term debt. Outstanding balance of the note payable to HUD at June 30, 2005, amounted to $4,605,000.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Report on Compliance and on Internal Control over Financial Reporting Based on an audit of Financial Statements performed in accordance with Government Auditing Standards
June 30, 2005

To the Honorable Mayor
and the Municipality of Canóvanas
Canóvanas, Puerto Rico

We have audited the financial statements of the Municipality of Canóvanas of the Commonwealth of Puerto Rico as of and for the year ended June 30, 2005, and have issued our report thereon dated November 23, 2005. 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 *Governmental Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Municipality of Canóvanas of the Commonwealth of Puerto Rico financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as items 05-13 thru 05-25.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Municipality's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. 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 the Municipality's ability to record, process, summarize, 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 05-01 thru 05-12.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the 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 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.

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Report on Compliance and on Internal Control over Financial Reporting Based on an audit of Financial Statements performed in accordance with Government Auditing Standards
June 30, 2005

However, of the reportable conditions described above, we consider item 05-01 to be a material weakness.

This report is intended solely for the information and use of the Municipality's management, municipal legislature, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specific parties.

Toa Alta, Puerto Rico
November 23, 2005

Stamp No. 202356
was affixed to the original report.

CPA-PSC

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BENITEZ-JAIME, CPA-PSC
Certified Public Accountants and Business Consultants

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Report on compliance with requirements applicable to each major program and on
Internal Control over compliance in accordance with OMB Circular A-133
June 30, 2005

To the Honorable Mayor
and the Municipality of Canóvanas
Canóvanas, Puerto Rico

Compliance

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

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 *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 Municipality'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 of Municipality's compliance with those requirements.

In our opinion, except for the instances of noncompliance disclosed below, the Municipality of Canóvanas, Commonwealth of Puerto Rico complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005. The results of our auditing procedures also disclosed other 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 05-13 thru 05-25.

Internal Control Over Compliance

The management of Municipality of Canóvanas, Commonwealth of Puerto Rico 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'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

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Report on compliance with requirements applicable to each major program and on
Internal Control over compliance in accordance with OMB Circular A-133
June 30, 2005

purpose of expressing our opinion con 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'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 05-01 thru 05-12.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees 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 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 consider item 05-01 to be material weakness.

This report is intended solely for the information and use of the Municipality's management, Municipal Legislature, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Toa Alta, Puerto Rico
November 23, 2005

Stamp No. 202357
was affixed to
the original report.

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Schedule of Finding and Questioned Costs
June 30, 2005

Section I - Summary of Auditors' Results

Financial Statements

Type of auditors' report issued:	Unqualified	
Internal control over financial reporting:		
Material weakness(es) identified?	X yes	____ no
Reportable condition(s) identified not considered to be material weakness?	X yes	____ none reported
Noncompliance material to financial statements noted?	X yes	____ no

Federal Awards

Internal Control over major programs:		
Material weakness(es) identified?	X yes	____ no
Reportable condition(s) identified not considered to be material weaknesses?	X yes	____ none reported
Type of auditor's report issued on compliance For major programs:	Qualified	
Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)?	X yes	____ no

Identification of major programs:

CFDA Numbers	Name of Federal Program or Cluster
N/A	Section 108 Loan Guarantee
93.575	Pass-through Governor's Office for Human Development Child Care Program

Dollar threshold used to distinguish Between Type A and Type B programs:		$500,000
Auditee qualified as low-risk auditee?	____ yes	X no

Section II - Financial Statement Findings

The current year findings and questioned costs were discussed with the Municipality's management which generally concurred with our comments and recommendations. The Municipality of Canóvanas will respond to the following findings through the issuance of a separate letter addressed to the Cognizant Agency.

05-1 ACCOUNTING SYSTEM

The Municipality's current accounting system does not comply with requirements established in the Revised Regulation on Basic Standards for the Municipalities of Puerto Rico and Law 81 of August 30, 1991. Such regulations provide, among other things that the municipal accounting shall be based on generally accepted accounting principles.

Also, the computerized accounting system should provide for financial information that will serve as the basis for the effective control of revenues, expenditures, property and investments, since this information is necessary for the preparation of reliable financial statements in accordance to generally accepted accounting principles. Finally, the Municipality is responsible for designing fiscal procedures for the system's operations and establishing proper internal controls for the purpose of preventing or minimizing irregularities.

The Municipality's accounting system only provides for the recording of revenues and expenditures and other limited transactions. In addition, the accounting records are not integrated, and a double entry system (debits and credits) is not used. Accounting records were maintained on a cash basis during the year and at end of year the corresponding adjustments were made to convert the records to the modified accrual basis. The conversion to the modified accrual basis requires a significant effort because the information has to be gathered from different informal accounting records. The system lacks the necessary supporting records for the preparation of financial statements in accordance with generally accepted accounting principles. Additionally, we noted that certain records in use were not adequately maintained or posted on a timely basis.

Due to the deficiencies above mentioned, the examination of the financial statements for the year ended June 30, 2005, was more difficult and less efficient than would have been in ordinary circumstances. A significant amount of adjusting entries had to be made in order to account for unrecorded transactions, or to correct transactions recorded in the wrong accounting period. Since the accounts and other records are not designed to provide the information as is presented in financial statements, it was necessary to obtain such information from various departments and persons within the Municipality and from numerous accounting records which are not integrated.

05-2 CASH AND BANK ACCOUNTS

The Municipality has not established sufficient controls in the handling of bank accounts to prevent errors and irregularities from being timely detected. The following control deficiencies were noted during our examination:

a) The cash balance shown by the Municipality's Treasury Department for the Debt Service Fund as of June 30, 2005, did not agree with the notification of the Account Activity of the Municipal Revenues Collection Center, known by its Spanish acronym as CRIM. This is due to transactions for the fiscal year which were not recorded for in the Municipality's books. Although such information was received late from the CRIM, the Municipality had not closed the books at that date and such transactions could have been properly recorded.

RECOMMENDATION:

We recommend that transactions affecting funds held by the CRIM for the Municipality's Debt Service Fund should be recorded on a timely basis and balances reconciled periodically, especially at year end.

b) Checks totaling $767, as of June 30, 2005, have been outstanding for more than one year. The bank reconciliation are the following:

	Account Name	Amount
-	Cuenta Regular	$375
-	Cuenta Nómina	392
		$ 767

c) Reconciling items or differences have been outstanding for more than one year without adequate explanation. The bank reconciliations are the following:

-Cuenta corriente
-Cuenta Nómina
-CDBG IDIS
-Emprestito $2,315,000
-Aportación Child Care

RECOMMENDATION:

The Municipality should improve its control procedures over bank reconciliations to record the necessary adjustments when there are outstanding checks for more than one year. Stop payments should be issued to cancel checks outstanding over twelve months. Such checks should be substituted with new checks and deposited in the appropriate accounts in order to make the funds available to the Municipality.

All bank accounts shall be reconciled every month and all reconciling differences, if any, must be investigated and adjusted, accordingly.

05-3 LONG-TERM DEBT

The Municipality does not maintain adequate records of its outstanding long-term obligations, and consequently, solely relies on the notifications from the Government Development Bank for Puerto Rico to acknowledge and record the balance of the outstanding debt and the amounts needed to fund its debt service.

RECOMMENDATION:

The Municipality should design a system and establish adequate procedures to maintain accounting records of its outstanding long-term obligations. These records will be used to verify the correctness of the amounts informed by the CRIM for the Municipality's Debt Service Fund under the custody of the Government Development Bank for Puerto Rico and the outstanding balance of the long-term debt.

05-4 INTERFUND TRANSACTIONS

The Municipality does not maintain adequate control over interfund transactions. Cash transferred between funds is recorded as revenue in the receiving fund and as an expenditure in the disbursing fund. Several adjustments were made to reconcile such interfund transactions and properly account for these transfers as interfund receivables or payables.

RECOMMENDATION:

We recommend that adequate control procedures be established to assure proper accountability of interfund transactions. These procedures should be designed to properly segregate cash transferred on a loan basis from cash which represents revenue to the program since these transactions have different accounting treatment for financial statement presentation.

05-5 ACCOUNTS PAYABLE AND ENCUMBRANCES

Under the Municipality's current accounting system, there is no adequate segregation between items representing actual accounts payable and those representing encumbrances because the liability is recognized when the purchase order is issued.

RECOMMENDATION:

The Municipality should establish procedures to clearly distinguish between encumbrances and amounts actually owed for goods and services received at year end. Governmental generally accepted accounting principles required that purchase orders issued for which the goods or services have not been received at year end be reported as an encumbrance, while the goods or services received but not paid at year end be recorded as a liability.

05-6 CASH MANAGEMENT

The OMB Common Rule requires that grantees' cash management system includes administrative procedures to minimize the time elapsing between the transfer of federal funds and the disbursement of these by the grantee. When advances of funds are made by the letter of credit method, funds shall be disbursed not later than three days after the date of the drawdown.

Although the Municipality has established procedures to ensure compliance with the above requirement, our disbursement test revealed instances in which disbursements were made several weeks after the funds were received.

RECOMMENDATION:

We recommend that the Municipality's management to instruct the Federal Programs personnel to strictly follow the established procedures regarding cash management requirements.

05-7 MUNICIPAL LICENSE TAX

We selected 40 municipal license taxpayers files for examination amounting to $25,882.

The following deficiencies were noted during our test:

- In 3 (5%) municipal license taxpayers files examined amounting to $877, the municipal license issued were not present in file.
- In 2 (3%) municipal license tax payer files amounting to $2,000, the income section of the volume of business tax return was not properly supported.
- 1 (2%) the municipal license tax payer files were not available for examination.
- In 11 (18%) municipal license taxpayer files selected for examination, the taxpayer did not file the income tax return and there were no evidence of the closing of business operations.

RECOMMENDATION:

The Municipality should improve its control procedures to ascertain that municipal license tax files should contain sufficient information and documentation to support the reason for issuing or denying a gross volume of business license certificate.

05-8 DISBURSEMENT TEST

As part of our test of cash disbursements during the year (amounting to approximately $35 million), we selected 40 disbursement vouchers amounting to $746,050. The following deficiencies were noted during our examination:

- In 40 our of 40 (100%) disbursement vouchers amounting to $72,012, the disbursements could not be traced to Model 28, since it was not prepared during the fiscal year.
- In 21 (53%) disbursement vouchers amounting to $424,814, pertaining to special funds could not be traced to Model 26 - Orders and Contracts Book since it is not prepared for the special funds.
- In 21 (53%) disbursement vouchers amounting to $424,814, pertaining to special funds could not be traced to the General Ledger since it is not prepared for the special funds.

- 40 (100%) disbursements vouchers amounting to $746,050, were not posted to the Cash Receipts Ledger.

- In seven (18%) disbursement vouchers amounting to $90,270, the Municipality did not followed the required purchasing procedures.

According to the Revised Regulation on Basic Standards for the Municipalities of Puerto Rico, the pre-auditing unit or person in charge of pre-auditing the documents shall keep a record of the authorized signatures of the Municipality. He shall check against such record to ascertain that the officers certifying the documents are so authorized. He shall check the documents correctness in all of its parts and that the transactions in order to pursuant the correct legislation, ordinances, resolutions, contracts and regulations. Once everything is found to be in order, the document shall be certified as preaudited and shall be sent for the approval of the Finance Director. In addition, of the aforementioned regulation, the vouchers, all canceled checks and any other document, that justifies a payment, shall be filed by the Finance Director to be audited by the Puerto Rico Comptroller's Office or any other agency as required by law.

RECOMMENDATION:

The Municipality should enforce strict compliance with the procedures prescribed by the Revised Regulation on Basic Standards for the Municipalities of Puerto Rico during the process of acquisition of materials and supplies, equipment, and construction and service contracts.

05-9 PERSONNEL FILES AND RELATED PAYROLL PROCEDURES

During our audit, we tested a sample of 40 employee files and noted that several files lacked documentation supporting the employee's salary, status or eligibility. The following exceptions were noted during our examination:

Employee evaluations	5 files	13%
Eligibility verification form (Form I-9)	4 files	10%

RECOMMENDATION:

The Personnel Department should review each employee file and ascertain their completeness. Management could design a standard checklist where the file reviewer could determine if documents are missing from each file. Signed exemptions certificates and authorizations for non -statutory withholdings should always support the amounts withheld from employees.

05-10 CASH RECEIPT TEST

As part of our test of cash receipts during the year (amounting to approximately 30 million), we selected 40 receipts amounting to $895,719, representing 3% of the total receipts. The following deficiencies were noted during our examination:

The following reports were not prepared nor maintained during the 2004-2005 fiscal year:

- "Modelo 3 - Informe diario de Clasificación y Fondos Municipales"
- "Modelo 28 - Informe Mensual"

- One (3%) cash receipt form selected for examination did not included the correct accounting distribution.
- One (3%) cash receipt form selected for examination did not included the account to be charged.
- 9 (22%) cash receipts forms selected for examination amounting to $266,543, were not posted in the General Ledger.

According to Law 81, the books, documents and funds in the possession of the collectors must remain available for examination by Officers from the Office of the Comptroller, the Treasury Department, the Administration or any other duly authorized agency.

RECOMMENDATION:

The Municipality should enforce strict compliance with the procedures prescribed by the Revised Regulation on Basic Standards for the Municipalities of Puerto Rico during the revenues and cash receipts cycle.

05-11 INACTIVE AND UNNECESSARY FUNDS AND INACTIVE BANK ACCOUNTS

The Municipality is maintaining an excessive number of funds and bank accounts that have been inactive for a long period. The accounting records include over 131 different funds, many of which have been inactive or had insignificant movement on operations during the year under audit.
The bank accounts are the following:

- CDBG - HUD
- CSBG '92
- INSEC
- Farmer Home Administration
- 1999 Reserve Surplus
- Rural Development
- FEMA Georges Hurricane
- Bond Issuance $815,000
- Bond Issuance $2,315,000
- Bond Issuance $ 2,270,000

This situation results from the need to analyze and close inactive funds and bank accounts when the fund's objective has been achieved or are no longer of significance. The internal control structure should provide for the accurate maintenance of the books, records, funds and accounts necessary to carry out the Municipality's operations.

RECOMMENDATION:

The Municipality should close all unnecessary and inactive funds or accounts. Budgetary balances or deficits, remaining in those funds should be investigated and properly closed as established by law.

05-12 INTEREST AND OVERDRAFT CHARGES INCURRED

The Municipality does not have adequate control over its cash disbursements to avoid incurring interest costs and bank overdraft charges. The Municipality incurred interest of $18 resulting from a bank overdraft amounting to $961, in its CDBG IDIS bank account during the fiscal year ended June 30, 2005.

This situation occurs because the Municipality does not effectively monitor its cash balances before issuing payments, thus resulting in bank overdraft charges and interest costs.

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Section III - Federal Award Findings and Questioned Costs

Program	Findings/Noncompliance Recommendations	Questioned Cost
Section 8-Voucher CFDA No. 14.156 RQ-46-V075-002-004	**05-13 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program had an average cash balance of $72,156, during the fiscal year. There were months which reported balances as high as $87,822, at the end of the month.	NONE
	Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Program's immediate cash needs.	
	Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely and possible to the actual disbursements.	
SBGP CFDA No. 14.228 All Program Years	**05-14 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The Program had an average cash balance of approximately $20,962, during the fiscal year.	NONE
	Criteria: Federal Regulation required that grantees shall conform to the standards applicable to advances from Federal Agencies. Amounts requested should be limited to the Program's immediate cash needs.	
	Recommendation: In accordance with Federal Regulations, the Municipality should estimate drawdown of Federal funds as closely as possible to the actual disbursements.	

Program	Findings/Noncompliance Recommendations	Questioned Cost
UMTA CFDA NO. 20.500 PR 90-X071	**05-15 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $12,254, during the fiscal year. There were months which reported balances as high as $12,698, at the end of the month.	NONE
	Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.	
	Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	
Child Care CFDA NO. 93.575	**05-16 FINANCIAL REPORTING** Statement of Condition: During our tests of the quarterly financial reports submitted to Administración para el Cuidado y Desarrollo Integral de la Niñez, we could not trace the report for the quarter ended September 30, 2004, to the General Ledger since it was not available for examination.	NONE
	Criteria: Federal regulations require that the financial management system must meet some requirements, including the financial reporting. It states that accurate, current and complete disclosure of the financial results of the financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.	

Program	Findings/Noncompliance Recommendations	Questioned Cost

Recommendation:

The Municipality should prepare financial reports based on the Program's underlying accounting records. Any difference should be investigated and reconciled, accordingly.

Child Care
CFDA NO. 93.575

05-17 FINANCIAL REPORTING

Our review of the quarterly financial reports submitted to Administración para el Cuidado y Desarrollo Integral de la Niñez, disclosed that they were submitted after the required submission date, as detailed below. NONE

Quarter Ended	Due Date	Date Submitted	Past Due Days
December 31, 2004	January 30, 2005	May 9, 2005	100 days
March 31, 2005	April 30, 2005	May 9, 2005	10 days

Criteria:

According to federal regulations quarterly reports, Forms CC-004, CC-003 and CC-005 among others must be submitted at least 30 days after the close of each quarter.

Recommendation:

The Municipality should improve existing procedures to ensure the timely submission of the Quarterly Reports, in order to comply with Federal regulation. Also, the Municipality should consider implementing a reporting calendar to maintain all personnel aware of the reporting deadlines of each federal financial report. This will provide an additional tool to help the Municipality in complying with the federal regulation.

Child Care
CFDA NO. 93.575

05-18 FEDERAL MANAGEMENT SYSTEM

Statement of Condition:

The Municipality has not established effective cash management procedures. The program has an average cash balance of $31,620 during the fiscal year. There were months which reported balances as high as $39,024, at the end of the month. NONE

Program	Findings/Noncompliance Recommendations	Questioned Cost
	Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs. Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	
CDBG B-02-MC-72-0018 CFDA No. 14.218	**05-19 FEDERAL CASH MANAGEMENT SYSTEM**	
	Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $185,883, during the fiscal year. There were months which reported balances as high as $397,727, at the end of the month.	NONE
	Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs. Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	
CDBG 2003 CFDA No. 14.218 B-99-MC-72-0018	**05-20 INADEQUATE DOCUMENTATION OF PARTICIPANT FILES**	
	Statement of Condition: As part of our test to determine whether the grantee assure that the rehabilitation work is properly completed, we selected a sample of 40 participants. The following documents were not available for examination:	NONE

Program	Findings/Noncompliance Recommendations		Questioned Cost
	a. Property title deed	20 Files	50%
	b. Form OCAM DM 01-003, Document describing the work to be performed.	40 Files	100%
	c. Final inspection	9 Files	23%
	d. Estimate cost of work to be performed.	1 File	3%
	e. Purchase order	1 File	3%

Criteria:

According to 24 CFR, 570.506 the grantee must assure that the work is properly completed. For each residential rehabilitation activity the following records are needed:

a) Re-habilitation contract describing the deficiencies in each structure to be corrected.

b) An inspection of the rehabilitation work upon completion to assure that it was carried out in accordance with contract specifications.

Recommendation:

The Municipality must inspect the rehabilitation work upon completion to assure that it is carried out in accordance with the contract specifications.

Section 108
B-01-MC-72-0018

05-21 DAVIS-BACON ACT

Statement of Condition:

As part of our audit tests we selected 1 weekly payroll from the following construction project:

- Construcción de Edificio Multiuso y Estacionamiento

Then following exceptions were noted during our examination: NONE

Program	Findings/Noncompliance Recommendations	Questioned Cost
	(a) The certified payrolls selected for examination did not include the required employees' information.	
	(b) Construction contract did not contain the clause related to the Davis-Bacon Act.	
	Criteria:	
	According to HUD Handbook:	
	Contractor weekly payrolls and other basic records should be reviewed during routine compliance enforcement activity on every construction project. Submitted payrolls shall be examined to assure compliance with the labor standards. Also, a preconstruction conference must be held to explain labor standards.	
	Recommendation:	
	The Municipality should establish procedures to ascertain that all documents submitted by the contractor are reviewed and approved on a timely basis to ensure compliance with labor standards.	
CDBG 2002 and 2003 CFDA 14.218	**05-22 DAVIS-BACON ACT**	
	Statement of Condition:	
	As part of our audit tests we selected 1 weekly payroll from the following construction projects:	
	– Construcción de Aceras, Barrio La Central – Mejoras al Parque de Pelota y Construcción Cancha de baloncesto, Barrio San Isidro	
	Then following exceptions were noted during our examination:	NONE
	(a) In one project there was no evidence that employee interviews were performed during the period. (Project - Mejoras al Parque de Pelota y Construcción Cancha de baloncesto, Barrio San Isidro	

Program	Findings/Noncompliance Recommendations	Questioned Cost
	(b) One project file was not available for examination. (Project - Construcción de Aceras, Barrio La Central	
	Criteria:	
	According to HUD Handbook:	
	Contractor weekly payrolls and other basic records should be reviewed during routine compliance enforcement activity on every construction project. Submitted payrolls shall be examined to assure compliance with the labor standards. Also, a preconstruction conference must be held to explain labor standards.	
	Recommendation:	
	The Municipality should establish procedures to ascertain that all documents submitted by the contractor are reviewed and approved on a timely basis to ensure compliance with labor standards.	
FEMA 1247 CFDA No.83.544	**05-23 FEDERAL CASH MANAGEMENT SYSTEM**	
	Statement of Condition:	
	The Municipality has not established effective cash management procedures. The program had an average cash balance of $36,340, during the fiscal year. There were months which reported balances as high as $36,675, at the end of each month.	NONE
	Criteria:	
	Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.	
	Recommendation:	
	In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	

Program	Findings/Noncompliance Recommendations	Questioned Cost
Pass-through the Puerto Rico Elderly Commission Food Distribution CFDA No.10.558	**05-23 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program had an average cash balance of $175,409, during the fiscal year. There were months which reported balances as high as $216,939, at the end of each month.	NONE
	Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.	
	Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	
Passed through the Puerto Rico Elderly Commission	**05-25 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $20,218, during the fiscal year.	NONE
	Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.	
	Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	
	Total Questioned Costs	$ -

Estado Libre Asociado de Puerto Rico

Gobierno Municipal de Canóvanas

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Canóvanas PR 00729-1612
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Miguel A. Jiménez Carrión
Vicealcalde

November 17, 2005

Benítez-Jaime, CPA-PSC
Certified Public Accountants and
Business Consultants
P O Box 191503
San Juan, Puerto Rico, 00919-1503

Dear Auditors:

We have received the Schedule of Findings and Questioned Costs, included in the Single Audit Report of the Municipality of Canovanas for the year ended June 30, 2005.

Although we have already discussed the above mentioned findings, (Financial Statements and Federal Awards) we are in the process of gathering all the relevant information and preparing the related responses. In order to comply with OMB Circular A-133 after completing this task we are going to issue our corrective actions taken on all prior audit findings and our responses to the current findings directly to the grantors and required government agencies.

Cordially,

Miguel A. Jiménez Carrión
Vice-Mayor

Lilliam Rodríguez García
Finance Director

Annette Ortiz Flores
External Resources Director

¡Trabajando para nuestra gente, de hoy y del futuro!

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Summary schedule of prior years audit findings
Fiscal Year 2003-2004
June 30, 2005

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance and Internal Control Based on the Audit of the General Purpose Financial Statements for Performed in Accordance with Government Auditing Standards for the Fiscal Year ended June 30, 2004. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2004-2005).

NR - Not resolved yet. Finding repeated in fiscal year 2004-2005.

Finding Number	Title	Corrective Action Taken
04-1	Accounting System	NR
04-2	Cash and Bank accounts	NR
04-3	Long-term debt	NR
04-4	Bidding Procedures	FR
04-5	Interfund transactions	NR
04-6	Accounts payable and encumbrances	NR
04-7	Cash management	NR
04-8	Municipal license tax	NR
04-9	Disbursement test	NR
04-10	Personnel files and related payroll procedures	NR
04-11	Cash receipts test	NR
04-12	Inactive and unnecessary funds and inactive bank accounts	NR

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Summary schedule of prior years audit findings
Fiscal Year 2003-2004
June 30, 2005

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in accordance with OMB Circular A-133 for the Fiscal Year ended June 30, 2004. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2004-2005).

NR - Not resolved yet. Finding repeated in fiscal year 2004-2005.

Finding Number	Title	Corrective Action Taken
04-13	Federal Cash Management System	NR
04-14	Federal Cash Management System	NR
04-15	Federal Cash Management System	NR
04-16	Financial Reporting	NR
04-17	Financial Reporting	NR
04-18	Federal Management System	NR
04-19	Inadequate Documentation of Participants Files	NR
04-20	Federal Cash Management System	NR
04-21	Financial Reporting	FR
04-22	Davis-Bacon Act	NR
04-23	Federal Cash Management System	NR
04-24	Federal Cash Management System	NR
04-25	Federal Cash Management System	NR

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Summary schedule of prior years audit findings
Fiscal Year 2002-2003
June 30, 2005

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance and Internal Control Based on the Audit of the General Purpose Financial Statements for Performed in Accordance with Government Auditing Standards for the Fiscal Year ended June 30, 2003. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2004-2005).

NR - Not resolved yet. Finding repeated in fiscal year 2004-2005.

Finding Number	Title	Corrective Action Taken
03-1	Accounting System	NR
03-2	Cash and Bank accounts	NR
03-3	Long-term debt	NR
03-4	Internal Audit Department	FR
03-5	Bidding Procedures	FR
03-6	Interfund transactions	NR
03-7	Accounts payable and encumbrances	NR
03-8	Cash management	NR
03-9	Municipal license tax	NR
03-10	Disbursement test	NR
03-11	Personnel files and related payroll procedures	NR
03-12	Cash receipts test	NR
03-13	Inactive and unnecessary funds and inactive bank accounts	NR
03-14	Interest and overdraft charges incurred	NR

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CANÓVANAS
Summary schedule of prior years audit findings
Fiscal Year 2002-2003
June 30, 2005

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in accordance with OMB Circular A-133 for the Fiscal Year ended June 30, 2003. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2004-2005).

NR - Not resolved yet. Finding repeated in fiscal year 2004-2005.

Finding Number	Title	Corrective Action Taken
03-15	Federal Cash Management System	NR
03-16	Federal Reporting	FR
03-17	Reporting Requirements	FR
03-18	Federal Management System	NR
03-19	Federal Management System	NR
03-20	Inadequate Documentation of Providers Files	FR
03-21	Inadequate Documentation of Participants Files	FR
03-22	Federal Management System	NR
03-23	Inadequate Documentation of Participant Files	NR
03-24	Davis-Bacon Act	NR
03-25	Davis-Bacon Act	NR
03-26	Federal Management System	NR
03-27	Federal Management System	NR
03-28	Federal Management System	NR