

**OFICINA DEL COMISIONADO DE ASUNTOS MUNICIPALES  
ÁREA DE ASESORAMIENTO, REGLAMENTACIÓN E INTERVENCIÓN FISCAL  
ÁREA DE ARCHIVO DIGITAL**

**MUNICIPIO DE CANOVANAS  
AUDITORÍA 2010-2011  
30 DE JUNIO DE 2011**

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**BASIC FINANCIAL STATEMENTS  
WITH THE ADDITIONAL REPORTS AND INFORMATION REQUIRED BY  
THE  
SINGLE AUDIT ACT  
YEAR ENDED JUNE 30, 2011**



**INDEPENDENT AUDITORS' REPORT**

The Honorable Mayor, Members of the  
Municipal Legislature 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, 2011, which collectively comprise the Municipality's basic financial statements as listed in the table of contents. We have also audited the accompanying statement of revenues and expenditures - budget and actual - budgetary basis - general fund of the municipality for the fiscal year then ended, which is presented as part of the basic financial statements. These financial statements are the responsibility of Municipality's management. Our responsibility is to express opinions 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 Governmental Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 statement presentation. We believe that our audit provides a reasonable basis for our opinions.

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, 2011, 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 addition, in our opinion, the financial statements referred to above present fairly, in all material respects, the budgetary results of the general fund for the fiscal year then ended in conformity with the budgetary (statutory) basis of accounting, as described in Note 1 to the accompanying basic financial statements

In accordance with Government Auditing Standards, we have also issued our report dated February 13, 2012, on our consideration of the Municipality's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

**INDEPENDENT AUDITORS' REPORT (CONTINUED)**

Accounting principles generally accepted in the United States of America require that the management's discussion on pages 13 through 29 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Municipality's financial statements as a whole. The introductory section, combining and individual nonmajor fund financial statements and statistical section, are presented for purposes of additional analysis and are not a required part of the financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and is also not a required part of the financial statements. The combining and individual nonmajor fund financial statements and the schedule of expenditures of federal awards are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole. The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

December 19, 2011  
San Juan, Puerto Rico

Stamp No. 2613248  
was affixed to the  
original report.



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Management's Discussion and Analysis  
Fiscal Year Ended June 30, 2011

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, 2011. 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 \$24,568,259 at June 30, 2011. The Municipality's net assets increased by \$7,245,066 (excess of revenues over expenditures) during the fiscal year ended June 30, 2011.
- The Municipality's assets increased from \$55,687,854 at June 30, 2010 to \$71,130,033 at June 30, 2011, for an increase of \$15,442,179 (28 percent).
- The liabilities of the Municipality increased from \$39,388,685 at June 30, 2010 to \$46,561,774 at June 30, 2011, for an increase of \$7,173,089 (18 percent).
- The revenues of the Municipality increased from \$29,883,751 for the fiscal year ended June 30, 2010 to \$32,826,893 for the fiscal year ended June 30, 2011, an increase of \$2,943,142 (10 percent).
- The Municipality's expenses decreased from \$27,800,867 for the fiscal year ended June 30, 2010 to \$25,581,827 for the fiscal year ended June 30, 2011, for a decrease of \$2,219,040 (8 percent).

***Governmental Funds' Highlights:***

- The total fund balances of governmental funds amounted to \$13,926,712 at June 30, 2011, which increased by \$11,163,591 during fiscal year ended June 30, 2011.
- The total assets of governmental funds increased from \$19,405,844 at June 30, 2010 to \$32,259,059 at June 30, 2011, for an increase of \$12,853,215 (66 percent).
- The governmental fund's total liabilities increased from \$16,642,723 at June 30, 2010 to \$18,332,347 at June 30, 2011, for an increase of \$1,689,624 (10 percent).
- The total revenues of governmental funds increased from \$29,811,604 for the fiscal year ended June 30, 2010 to \$32,826,893 for the fiscal year ended June 30, 2011, for an increase of \$3,015,289 (10 percent).
- The governmental fund's total expenditures decreased from \$34,596,020 for the fiscal year ended June 30, 2010 to \$30,592,326 for the fiscal year ended June 30, 2011, for a decrease of \$4,003,694 (12 percent).
- Other financing sources (uses), net, of governmental funds increased from \$2,475,000 for the fiscal year ended June 30, 2010 to \$7,905,000 for the fiscal year ended June 30, 2011.

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**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, 2011. 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, 2011. 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.

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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, 2011, 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, (2) the statement of revenues, expenditures and changes in fund balances – governmental funds, and (3) the statement of revenues and expenditures-budget and actual-hudgetary basis-general fund. 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.

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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) capital improvements bonds funds, (4) special revenue funds, and (5) 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 three 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 three major governmental funds are: (1) general fund, (2) debt service fund, and (3) capital improvements bond fund.

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**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) Other Supplementary Information**

The basic financial statements are followed by a section of other supplementary information consisting of: (1) combining balance sheet – non-major governmental funds, (2) combining statement of revenues, expenditures and changes in fund balances – non-major governmental funds, (3) budgetary comparison schedule – debt service fund, (4) notes to budgetary comparison schedule – debt service fund, and (5) schedule of capital assets used in the operation of governmental funds, as detailed in the accompanying table of contents.

**FINANCIAL ANALYSIS OF GOVERNMENT-WIDE FINANCIAL STATEMENTS**

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

**Comparative Statement of Net Assets**  
**Governmental Activities (Condensed)**  
**June 30, 2011 and 2010**

<i>Assets:</i>	<u>2011</u>	<u>2010</u>
Current assets	\$ 30,810,183	\$ 18,550,688
Non-current assets:		
Capital assets, net	40,226,305	37,067,017
Other non-current assets	93,545	70,149
Total assets	<u>\$ 71,130,033</u>	<u>\$ 55,687,854</u>
 <i>Liabilities:</i>		
Current liabilities	\$ 14,327,327	\$ 10,226,703
Long-term obligations due within one year	3,292,195	6,200,129
Long-term obligations due after one year	28,942,252	22,961,853
Total liabilities	<u>\$ 46,561,774</u>	<u>\$ 39,388,685</u>
 <i>Net assets:</i>		
Invested in capital assets, net of related debt	\$ 28,408,076	\$ 24,774,788
Restricted for debt service and others	5,300,159	1,697,448
Unrestricted	(9,139,976)	(10,173,067)
Total net assets	<u>\$ 24,568,259</u>	<u>\$ 16,299,169</u>

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At June 30, 2011, the Municipality's current assets, amounting to \$30,810,183, are mainly composed of cash and cash equivalents (\$25,206,242) of which \$19,448,429 are restricted, property taxes receivable, net of allowance for doubtful accounts (\$1,894,394), municipal license taxes receivable (\$423,067), construction excise tax receivable (\$776,169), sales and use taxes receivable (\$223,353), and intergovernmental grants and contributions receivable (\$2,184,788).

The restricted cash of \$19,448,429 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. A portion of property taxes receivable, amounting to \$449,554, represents restricted resources set aside to redeem the bonds of the Municipality in minimum annual or biannual principal and interest payments.

The Municipality's non-current assets, amounting to \$40,319,850 at June 30, 2011, are substantially composed of capital assets, with an aggregate cost basis of \$62,166,284, which are reported net of accumulated depreciation and amortization of \$21,939,979.

During the fiscal year ended June 30, 2011, the assets of the Municipality increased by \$15,442,179 (28 percent) in comparison with the prior fiscal year, principally for the following facts:

- Capital assets increased by \$3,159,288 due to the excess of current year additions (\$4,935,384) over depreciation/amortization expense (\$1,776,096) for the fiscal year ended June 30, 2011. The principal additions to capital assets for the current fiscal year were related to infrastructure (\$2,863,384), and construction in progress (\$1,155,643).
- Property taxes receivable increased by \$382,729. At the same time, the increase in this receivable was caused principally by the increase of \$2,285,896 in property tax revenues during the current fiscal year.
- Cash in fiscal agent increased by \$8,090,676 due to the net effect of new bonds issuance made during the current fiscal year for \$7,905,000 and the current year capital outlays paid with these cash balances.

At June 30, 2011, the Municipality's current liabilities amounting to \$17,619,522 are mainly composed of unearned revenues (\$9,945,659), accounts payable and accrued liabilities (\$1,541,701), intergovernmental payables (\$2,319,812), the portions due within one year of compensated absences (\$1,332,195) and bonds and notes payable (\$1,960,000). Deferred revenues principally consist of unearned 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 \$13,190,661, for a current ratio (current assets to current liabilities) of 1.75 to 1.00.

The Municipality's non-current liabilities, amounting to \$28,942,252 at June 30, 2011, are mainly composed of portions due after one year of bonds payable (\$23,980,000), notes payable (\$2,315,000), and compensated absences (\$2,465,042).

At June 30, 2011, the liabilities of the Municipality increased by \$7,173,089 (18 percent) in comparison with the prior fiscal year, principally for the effect of the following facts:

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- Bonds payable increased by \$5,975,000 due to the effect of new bonds issuance made during the current fiscal year for \$7,905,000, and the current year principal payments of \$1,930,000.
- Unearned revenues had a net increase of \$1,926,180. The increase in unearned revenues was caused principally by the increase of \$2,255,089 in unearned municipal license taxes.

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial statement position. The assets of the Municipality exceeded liabilities by \$24,568,259 at June 30, 2011. The most significant portion of net assets (\$28,408,076) 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 the 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, as capital assets cannot be used to liquidate these liabilities.

Another significant portion of net assets at June 30, 2011, represents resources that are restricted for debt service payments (\$5,190,642) and the operations of state and federally funded programs (\$109,517). The remaining component of total net assets consists of unrestricted negative net assets amounting to (\$9,139,976) at June 30, 2011. These unrestricted net liabilities are the consequence of previous budgets that did not provide sufficient funding for incurred long-term obligations, such as bonds payable, notes payable compensated absences, claims and judgments, 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 increased by \$7,245,066 for the fiscal year ended June 30, 2011. Such increase is principally due to the excess of revenues (\$32,826,893) over expenditures (\$25,581,827) for the fiscal year ended June 30, 2011.

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

**Comparative Statement of Activities**  
**Governmental Activities (Condensed)**  
**Fiscal Years Ended June 30, 2011 and 2010**

	<u>2011</u>	<u>2010</u>
<b>Program revenues:</b>		
Program-specific operating grants and contributions	\$ 1,423,238	\$ 1,684,063
Program-specific capital grants and contributions	4,339,913	3,451,921
Charges for services	428,909	1,347,899
Total program revenues	<u>6,192,060</u>	<u>6,483,883</u>
<b>General revenues:</b>		
Property taxes	12,745,502	10,459,606
Municipal license taxes	6,522,095	5,181,642
Construction excise taxes	1,003,570	1,352,612
Sales and use taxes	2,716,031	2,014,457
Unrestricted grants and contributions	1,303,182	3,413,136
Other general revenues, including interests on deposits	2,344,453	978,415
Total general revenues	<u>26,634,833</u>	<u>23,399,868</u>
Total revenues	<u>32,826,893</u>	<u>29,883,751</u>
<b>Program expenses:</b>		
General government	9,516,512	11,671,576
Urban and economic development	5,407,109	4,275,152
Public safety	876,410	1,005,591
Health and sanitation	5,149,632	5,834,035
Culture, recreation and education	1,492,825	1,336,229
Public housing and welfare	2,055,987	2,628,963
Interest on long-term obligations	1,083,352	1,049,321
Total expenses	<u>25,581,827</u>	<u>27,800,867</u>
<b>Net increase (decrease) in net assets</b>	<u>7,245,066</u>	<u>2,082,884</u>
<b>Net assets, at beginning of fiscal year</b>	<u>16,299,169</u>	<u>14,216,285</u>
<b>Prior period adjustments</b>	<u>1,024,024</u>	<u>-</u>
<b>Net assets at beginning of fiscal year, as restated</b>	<u>17,323,193</u>	<u>14,216,285</u>
<b>Net assets, at end of fiscal year</b>	<u>\$ 24,568,259</u>	<u>\$ 16,299,169</u>

As previously mentioned, the Municipality's net assets increased \$7,245,066 during the current fiscal year. Approximately 70 percent (\$22,987,198) of the Municipality's total revenues for the current fiscal year came from taxes (property taxes, municipal license taxes, construction excise taxes and sales and use

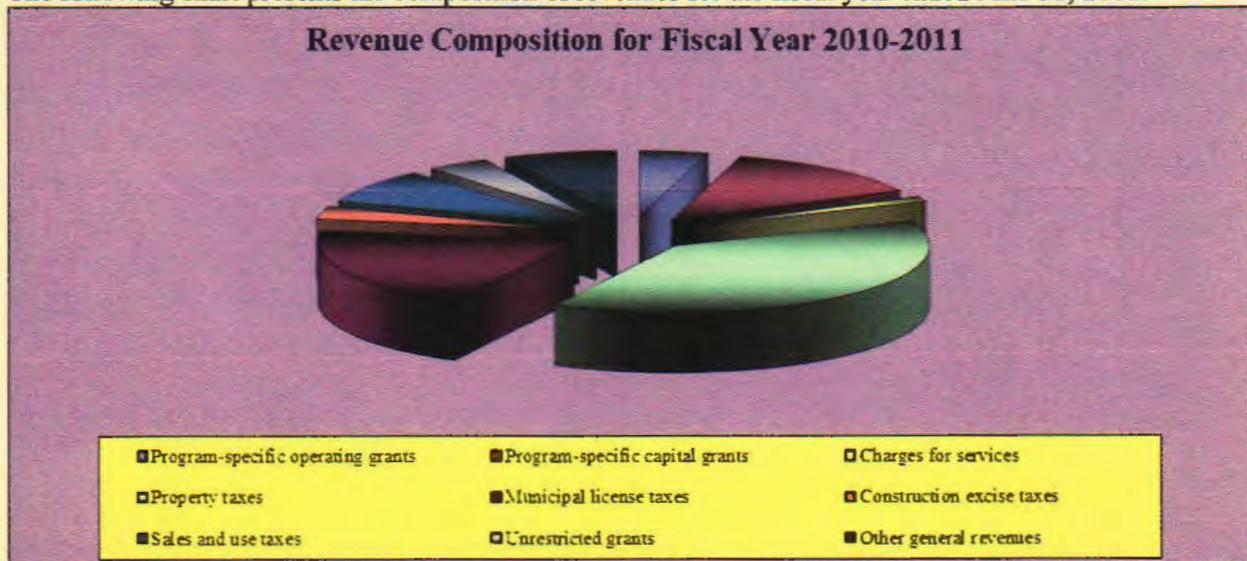
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taxes), while 22 percent (\$7,066,333) resulted from restricted and unrestricted capital and operating grants and contributions.

There was an increase of \$5,162,182 when the operating results for the current fiscal year are compared to those of the prior fiscal year. This occurred because, although the total expenses decreased by \$2,219,040 the total revenues increased by \$2,943,142 (10 percent) during the current fiscal year. The most significant fluctuations among the current fiscal year revenues and those of the prior fiscal year were as follows:

- Property tax revenues increased \$2,285,896 because during the fiscal year the Municipality made significant collections in comparison with prior fiscal year.
- Intergovernmental grants and contributions decreased \$1,482,787 due to less federal and state funding awards received principally for economic recovery and development.

The following chart presents the composition of revenues for the fiscal year ended June 30, 2011:



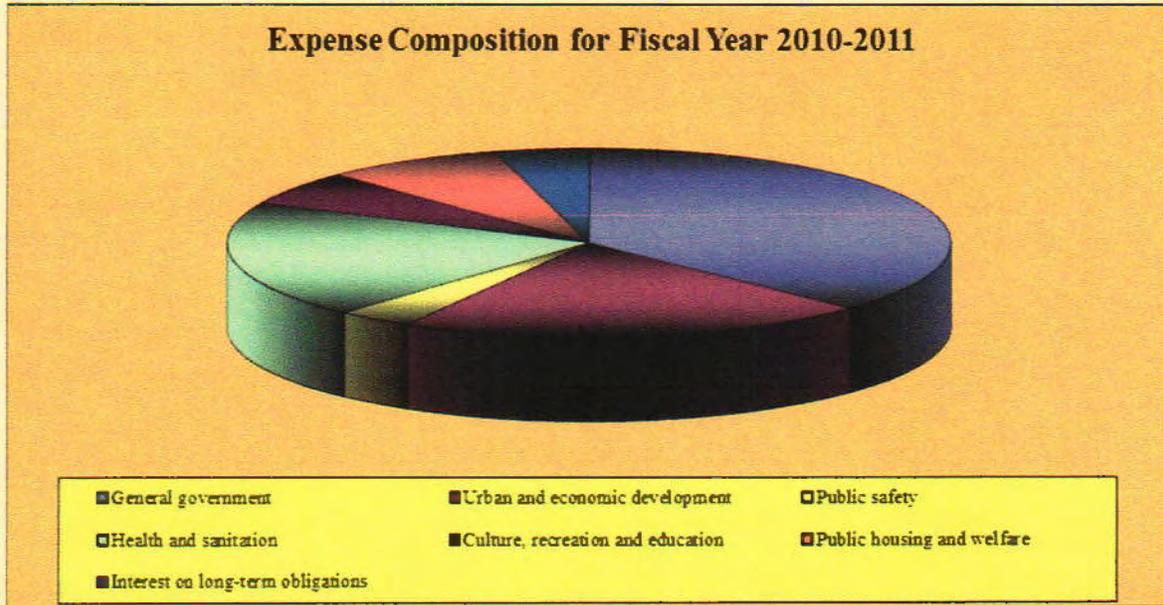
The Municipality's expenses cover a wide range of services. The largest expenses of the Municipality for the fiscal year ended June 30, 2011 were related to: (1) general administrating and operating costs (\$9,516,512), which were classified as "general government", (2) urban and economic development (\$5,407,109), (3) health and sanitation (\$5,149,632), (4) public housing and welfare (\$2,055,987), (5) culture, recreation and education (\$1,492,825), and (6) public safety (\$876,410).

As previously mentioned, the Municipality's expenses decreased from \$27,800,867 for the fiscal year ended June 30, 2010 to \$25,581,827 for the fiscal year ended June 30, 2011, for decrease of \$2,219,040. The most significant fluctuations between the current fiscal year's expenses and those of the prior fiscal year occurred in the general government expenses, which decreased \$2,155,064, and urban and economic development expenses, which increased \$1,131,957.

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The following chart presents the composition of expenses for the fiscal year ended June 30, 2011:



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**Condensed Balance Sheet - Governmental Funds**  
**June 30, 2011 and 2010**

	<u>2011</u>	<u>2010</u>
<i>Assets:</i>		
Total assets - major governmental funds	\$ 28,710,849	\$ 16,037,963
Total assets - other governmental funds	3,548,210	3,367,881
Combined total assets	<u>32,259,059</u>	<u>19,405,844</u>
<i>Liabilities:</i>		
Total liabilities - major governmental funds	14,893,654	13,387,671
Total liabilities - other governmental funds	3,438,693	3,255,052
Combined total liabilities	<u>18,332,347</u>	<u>16,642,723</u>
<i>Fund balances:</i>		
Reserved - major governmental funds	14,713,338	7,321,904
Reserved - other governmental funds	109,517	112,829
Unreserved - major governmental funds	(896,143)	(4,671,612)
Combined total fund balances	<u>13,926,712</u>	<u>2,763,121</u>
<i>Total liabilities and fund balances</i>	<u>\$ 32,259,059</u>	<u>\$ 19,405,844</u>

**FINANCIAL ANALYSIS OF GOVERNMENTAL FUNDS**

*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, 2011, the total assets of governmental funds increased \$12,853,215 (66 percent) in comparison with the prior fiscal year principally for the increase of \$8,090,676 in cash in fiscal agent. At June 30, 2011, the total liabilities of governmental funds increased \$1,689,624 in comparison with the prior fiscal year.

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.

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF CANÓVANAS**  
Management's Discussion and Analysis  
Fiscal Year Ended June 30, 2011

At the end of the current fiscal year, total unreserved fund deficits of governmental funds amounted to \$896,143 (general fund only), while total fund balance reached \$13,926,712. The total fund balances increased by \$10,139,567 during the current fiscal year. The following is a detailed financial analysis of the Municipality's governmental funds:

**Major Governmental Funds**

**General fund (GF)** – The GF is the principal operating fund of the Municipality. The GF's total assets amounted to \$12,334,861 at June 30, 2011. Such assets consist principally of: (1) unrestricted and restricted cash and cash equivalents (\$5,983,268), (2) taxes receivable (\$2,867,429), (3) intergovernmental grants and contributions receivable (\$2,042,008), and (4) short-term and long-term amounts due from other funds (\$1,441,943).

The GF's total liabilities amounted to \$12,440,593 at June 30, 2011. Such liabilities are composed mainly of: (1) deferred revenues (\$9,268,350), and (2) accounts payable and accrued liabilities, including amounts due to other governments (\$3,172,243).

At the end of the current fiscal year, unreserved fund deficit of the GF amounted to \$896,143, while total fund deficit reached \$105,732.

**Debt service fund (DSF)** – The DSF's total assets amounted to \$7,346,092 at June 30, 2011, which consists mainly of restricted cash in fiscal agent (\$6,853,394) and restricted property taxes receivable (\$449,554). The DSF's total liabilities amounted to \$2,155,450 at June 30, 2011, which are mainly composed of: (1) matured bonds due and payable (\$1,930,000), and (2) matured interest due and payable (\$520,155). At the end of the current fiscal year, the DSF's total and reserved fund balance reached \$5,190,642.

**Capital improvements bond fund (CIBF)** – The CIBF's total assets amounted to \$9,029,896 at June 30, 2011, which consists mainly of restricted cash in fiscal agent in the amount of \$8,988,226. The CIBF's total liabilities amounted to \$297,611 at June 30, 2011, which are composed of accounts payable and accrued liabilities (\$216,902), and short-term and long-term amounts due to other funds (\$80,709). At the end of the current fiscal year, the CIBF's total and reserved fund balance reached \$8,732,285.

**Other governmental funds (OGF)** – The OGF's total assets amounted to \$3,548,210 at June 30, 2011, which consist mainly of restricted cash (\$3,381,354), receivables from intergovernmental grants and contributions (\$100,038), and short-term and long-term amounts due from other funds (\$66,818). The OGF's total liabilities amounted to \$3,438,693 at June 30, 2011, which are mainly composed of deferred revenues (\$1,683,272) accounts payable and accrued liabilities (\$327,664) and short-term and long-term amounts due to other funds (\$1,427,757). At the end of the current fiscal year, OGF's total fund balance reached \$109,517.

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COMMONWEALTH OF PUERTO RICO  
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Fiscal Year Ended June 30, 2011

**Condensed Statement of Revenues, Expenditures and  
Changes in Fund Balances - Governmental Funds (Condensed)  
Fiscal Years Ended June 30, 2011 and 2010**

	<u>2011</u>	<u>2010</u>
<i>Revenues:</i>		
Total revenues - major governmental funds	\$ 27,661,281	\$ 24,667,481
Total revenues - other governmental funds	5,165,612	5,144,123
Combined total revenues	<u>32,826,893</u>	<u>29,811,604</u>
<i>Expenditures:</i>		
Total expenditures - major governmental funds	25,097,334	29,042,680
Total expenditures - other governmental funds	5,494,992	5,553,340
Combined total expenditures	<u>30,592,326</u>	<u>34,596,020</u>
<i>Excess of expenditures over revenues</i>	<u>2,234,567</u>	<u>(4,784,416)</u>
<i>Other financing sources, net:</i>		
Proceeds from issuance of bonds	7,905,000	2,475,000
Other financing uses, net - major governmental funds	(326,068)	(393,485)
Other financing sources, net - other governmental funds	326,068	393,485
Combined other financing sources (uses), net	<u>7,905,000</u>	<u>2,475,000</u>
<i>Excess (deficiency) of revenues and other financing     sources over (under) expenditures and other financing uses</i>	<u>10,139,567</u>	<u>(2,309,416)</u>
<i>Fund balance, at beginning of fiscal year</i>	2,763,121	5,072,537
<i>Prior period adjustments</i>	1,024,024	-
<i>Fund balance at beginning of fiscal year, as restated</i>	<u>3,787,145</u>	<u>5,072,537</u>
<i>Fund balance, at end of fiscal year</i>	<u>\$ 13,926,712</u>	<u>\$ 2,763,121</u>

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COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS  
Management's Discussion and Analysis  
Fiscal Year Ended June 30, 2011

**Analysis of Operating Results of Governmental Funds**

**Major Governmental Funds**

**General fund** – The total fund balance of the GF increased \$3,402,038 during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to \$22,275,694, \$20,612,940 and \$1,739,284, respectively, for the fiscal year ended June 30, 2011.

Approximately 83 percent (\$18,454,181) of the GF's total revenues for the current fiscal year came from taxes, while 6 percent (\$1,303,182) resulted from intergovernmental grants and contributions.

During the current fiscal year, there was an excess of revenues and other financing sources over expenditures and other financing uses of \$3,402,038 in the general fund, while in prior fiscal year there was a deficiency of revenues and other financing sources under expenditures and other financing uses of \$453,140.

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

- Intergovernmental grants and contributions decreased \$2,109,954 due to less federal and state funding awards received principally for economic recovery and development.
- Sales and use taxes revenues increased \$701,574 as the municipality made significant collections in comparison with prior year.
- Municipal license taxes revenues increased \$1,312,374 mainly due to an increase in property taxes receivable and additional collections efforts done in current year.

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 \$2,361,562 and urban and economic development which increased by \$807,613.

**Debt service fund (DSF)** – The total fund balance of the DSF increased \$2,581,999 during current fiscal year. Total revenues, expenditures and other financing uses (net) amounted to \$5,141,260, \$2,556,082 and \$3,179, respectively, for the fiscal year ended June 30, 2011.

Approximately 88 percent (\$4,533,017) of DSF's total revenues for the current fiscal year came from restricted property taxes. There was an increase of \$2,340,030 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 mainly, because revenues increased \$3,048,292 and debt service expenditures decreased \$707,125 during the current fiscal year.

**Capital improvements bond fund (CIBF)** – The total fund balance of the CIBF increased \$4,158,842 during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to \$244,327, \$1,928,312 and \$5,842,827 respectively, for the fiscal year ended June 30, 2011. The other financing sources of \$5,842,827 for the current fiscal year came principally from new bonds issued (\$6,070,000).

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF CANÓVANAS**  
Management's Discussion and Analysis  
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**Other governmental funds (OGF)** – The total fund balance of the OGF decreased by \$3,312 during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to \$5,165,612, \$5,494,992 and \$326,068, respectively, for the fiscal year ended June 30, 2011.

Approximately 99 percent (\$5,159,531) of OGF's total revenues for the current fiscal year came from intergovernmental grants. There was an increase of \$21,489 in the OGF's total revenues (mainly on intergovernmental grants), while total expenditures decreased by \$58,348 mainly on public housing and welfare which decreased \$444,923. Other financing sources (net) decreased by \$67,417.

### **BUDGETARY HIGHLIGHTS OF GENERAL FUND**

The original and final approved budget of the general fund for the fiscal year ended June 30, 2011 amounted to \$24,728,504. Accordingly, there were no changes between the original and the final approved budgets for the fiscal year ended June 30, 2011.

The total actual revenues (budgetary basis) of the general fund for the fiscal year ended June 30, 2011 were \$22,135,308, which is 10 percent (\$2,593,196) less than the budgeted revenues. In addition, the total actual expenditures (budgetary basis) of the general fund for the fiscal year ended June 30, 2011 were \$21,605,246, which is 14 percent (\$3,546,320) less than the budgeted expenditures. The most significant fluctuations in actual revenues (budgetary basis) occurred with construction excise tax revenues which were \$3,185,468 less than their respective budgeted amounts. The most significant fluctuations in actual disbursements (budgetary basis) occurred with general government costs which were \$2,838,359 less than their respective budgeted amounts.

The unfavorable variance in construction excise tax revenues were caused by several construction projects that were rescheduled by the respective developers due to the current economic outlook in Puerto Rico; consequently, the respective excise taxes were not collected at June 30, 2011. The favorable variance of \$2,838,359 in general government expenditures were mainly due to the implementation of cost reduction strategies by management during the current fiscal year.

### **CAPITAL ASSETS AND DEBT ADMINISTRATION**

#### **Capital Assets**

The Municipality has invested \$62,166,284 in capital assets used in governmental activities, which have an accumulated depreciation and amortization of \$21,939,979 at June 30, 2011. Capital assets increased \$3,159,288 during the current fiscal year due to the excess of current year additions (\$4,935,384) over depreciation/amortization expense (\$1,776,096) for the fiscal year ended June 30, 2011. The principal additions to capital assets for the current fiscal year were related to infrastructure (\$2,863,384) and construction in progress (\$1,155,643). The capital additions to construction in progress were principally related to the repaving of streets and roads, the construction of the sports complex at San Isidro, and improvements to buildings and structures.

We encourage readers to consider the information presented here in conjunction with more detailed capital assets information furnished in Note 7 to accompanying financial statements.

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF CANÓVANAS**  
Management's Discussion and Analysis  
Fiscal Year Ended June 30, 2011

**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, 2011, the Municipality's total bonded debt amounted to \$25,615,000, consisting of bonds payable. Such debt is backed by the full faith and credit of the Municipality. The Municipality's legal debt margin amounted to \$6,310,550 at the current fiscal year-end.

The following is a summary of the debt activity for the fiscal year ended June 30, 2011:

- Bonds payable increased by \$5,975,000 due to the net effect of new bonds issued for \$7,905,000 and principal payments of \$1,930,000 made during the current fiscal year.
- Notes payable decreased by \$546,789 due to the net effect of the debt service principal payments made during the current fiscal year.

We encourage readers to consider the information presented here in conjunction with more detailed long-term debt information furnished in Note 9 to the accompanying financial statements.

**ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES**

The territory of Canóvanas covers an area of approximately 33 square miles. Canóvanas is a municipality with a population density of 1,701 habitants per square mile. Canóvanas is characterized by being the economic integration center of the Region since it is considered the principal source of jobs and services of commercial, educational and health nature in the Region.

From the industrial perspective, Canóvanas accounts for 17 percent of the manufacturing jobs, 25 percent of the finance-related jobs and 21 percent of the service-related jobs in the Region.

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.

The economy of the Municipality is closely linked to the economy of the Commonwealth of Puerto Rico, which ultimately is greatly affected by the condition of the United States of America. Direct investment, exports, transfer payments, interest rates, inflation, and tourist expenditures are exogenous variables that are affected by the economy of the United States of America.

Puerto Rico, including the Municipality, has a diversified economy with manufacturing and services industries comprising its principal sectors. Manufacturing is the largest economic sector in terms of gross domestic product. Manufacturing in Puerto Rico is now more diversified than during the early phases of its industrial development between 1950 and 1980, and includes several industries less prone to business cycles. In the last three decades, industrial development in the Municipality has tended to be more capital intensive and more dependent on skilled labor.

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF CANÓVANAS**  
**Management's Discussion and Analysis**  
**Fiscal Year Ended June 30, 2011**

The Municipality has established policies and programs directed at developing the manufacturing and services industries. Selective tax exemptions and other incentives have stimulated domestic and foreign investment. Infrastructure expansion and modernization have been, to a large extent, financed by bonds issued by the Municipality and certain grants from the U.S. Department of Housing and Urban Development and the Federal Emergency Management Agency. Economic progress has been aided by significant increases in the levels of education and occupational skills of the population of the Municipality.

**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. 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 945, Canóvanas, Puerto Rico, 00729.

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**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF CANÓVANAS**  
Statement of Net Assets  
June 30, 2011

<b>Assets</b>	<b>Governmental activities</b>
<b>Current assets:</b>	
Cash in commercial banks, including cash equivalents of \$1,000,000	\$ 5,757,813
Account receivable, net of allowance for doubtful accounts	
Taxes:	
Property tax	\$ 1,444,840
Municipal license tax	423,067
Construction excise tax	776,169
Sales and use tax	223,353
Intergovernmental grants and contributions	2,042,008
Miscellaneous receivable	213
Total accounts receivable	4,909,650
Inventories and other current assets	59,885
<b>Restricted assets:</b>	
Cash in commercial banks	\$ 3,295,013
Cash in fiscal agent	16,153,416
Accounts receivable:	
Property taxes receivable, net of allowance for doubtful accounts	449,554
Accrued interests on deposits	42,072
Intergovernmental grants and contributions receivable	142,780
Total restricted assets	20,082,835
Total current assets	30,810,183
<b>Non-current assets:</b>	
Capital assets, at cost:	
Depreciable capital assets	\$ 59,251,893
Non-depreciable capital assets	2,914,391
Total capital assets, at cost	62,166,284
Less: accumulated depreciation and amortization	(21,939,979)
Total capital assets, net	40,226,305
Deferred charges, net of accumulated amortization of \$116,883	93,545
Total non-current assets	40,319,850
Total assets	\$ 71,130,033

*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, 2011

**Liabilities and net assets**

		<u>Governmental activities</u>
<b>Current liabilities (due within one year):</b>		
Accounts payable and accrued liabilities	\$ 997,135	
Intergovernmental payables	2,319,812	
Total accounts payable and accrued liabilities		\$ 3,316,947
Unearned revenues		8,262,387
Liabilities related to restricted assets:		
Accounts payable and accrued liabilities	\$ 544,566	
Accrued interests on bonds payable	520,155	
Unearned revenues	1,683,272	
Current portion of bonds payable	1,635,000	
Total current liabilities related to restricted assets:		4,382,993
Current portion of long-term obligations:		
Notes payable	\$ 325,000	
Compensated absences	1,332,195	
Total current portion of long-term obligations		1,657,195
Total current liabilities		<u>17,619,522</u>
<b>Non-current liabilities, excluding current portion (due in more than one year) :</b>		
Liabilities related to restricted assets - bonds payable		23,980,000
Notes payable		2,315,000
Compensated absences		2,465,042
Reserve for federal cost disallowances		182,210
Total non-current liabilities		<u>28,942,252</u>
Total liabilities		<u>46,561,774</u>
<b>Net assets:</b>		
Invested in capital assets, net of related debt		<u>28,408,076</u>
Restricted for:		
Debt service	\$ 5,190,642	
Federal and state funded programs	109,517	
Total restricted net assets		<u>5,300,159</u>
Unrestricted		<u>(9,139,976)</u>
Total net assets		<u>\$ 24,568,259</u>

*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  
Fiscal Year Ended June 30, 2011

<u>Functions/programs</u>	<u>Expenses, including depreciation expense of</u> \$ 1,776,096	<u>Program revenues</u>		<u>Net revenues (expenses) and changes in net assets</u>	
		<u>Charges for services</u>	<u>Program – specific operating grants and contributions</u>		<u>Program – specific capital grants and contributions</u>
<i>Governmental activities:</i>					
General government	\$ 9,516,512	428,909	-	-	\$ (9,087,603)
Urban and economic development	5,407,109	-	-	4,339,913	(1,067,196)
Health and sanitation	5,149,632	-	-	-	(5,149,632)
Public safety	876,410	-	-	-	(876,410)
Public housing and welfare	2,055,987	-	1,423,238	-	(632,749)
Culture, recreation and education	1,492,825	-	-	-	(1,492,825)
Interest on long-term obligations	1,083,352	-	-	-	(1,083,352)
Total governmental activities	<u>\$ 25,581,827</u>	<u>428,909</u>	<u>1,423,238</u>	<u>4,339,913</u>	<u>(19,389,767)</u>
<b>General revenues:</b>					
Taxes:					
Property taxes					\$ 12,745,502
Municipal license taxes					6,522,095
Construction excise taxes					1,003,570
Sales and use taxes					2,716,031
Total tax revenues					<u>22,987,198</u>
Intergovernmental grants and contributions, not restricted to specific programs					1,303,182
Interests on deposits					524,346
Miscellaneous					1,820,107
Total general revenues					<u>26,634,833</u>
Net increase in net assets					<u>7,245,066</u>
Net assets at beginning of fiscal year					16,299,169
Prior period adjustment					1,024,024
Net assets at beginning of fiscal year, as restated					<u>17,323,193</u>
Net assets at end of fiscal year					<u>\$ 24,568,259</u>

*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, 2011

Assets	Major governmental funds			Other governmental funds	Total governmental funds
	General fund	Debt service fund	Capital improvements bonds fund		
Cash and cash equivalents in commercial banks, including cash equivalents of \$1,000,000	\$ 5,757,813	-	-	-	\$ 5,757,813
Accounts receivable, net of allowance for doubtful accounts:					
Taxes:					
Property taxes	1,444,840	-	-	-	1,444,840
Municipal license taxes	423,067	-	-	-	423,067
Construction excise taxes	776,169	-	-	-	776,169
Sales and use taxes	223,353	-	-	-	223,353
Intergovernmental grants and contributions	2,042,008	-	-	-	2,042,008
Due and advances from other funds	1,441,943	-	-	66,818	1,508,761
Miscellaneous receivable	213	-	-	-	213
Restricted assets:					
Cash in commercial banks	-	-	-	3,295,013	3,295,013
Cash in fiscal agent	225,455	6,853,394	8,988,226	86,341	16,153,416
Accounts receivable:					
Property taxes receivable, net of reserve for doubtful accounts	-	-	-	-	-
Accrued interests on deposits	-	449,554	-	-	449,554
Intergovernmental grants and contributions	-	402	41,670	-	42,072
Intergovernmental grants and contributions	-	42,742	-	100,038	142,780
Total assets	\$ 12,334,861	7,346,092	9,029,896	3,548,210	\$ 32,259,059
<b>Liabilities</b>					
Accounts payable and accrued liabilities	852,431	-	-	-	852,431
Intergovernmental payables	2,319,812	-	-	-	2,319,812
Deferred revenues	9,268,350	-	-	-	9,268,350
Liabilities related to restricted assets:					
Accounts payable and accrued liabilities	-	-	216,902	327,664	544,566
Due and advances to other funds	-	295	80,709	1,427,757	1,508,761
Deferred revenues	-	-	-	1,683,272	1,683,272
Matured bonds due and payable	-	1,635,000	-	-	1,635,000
Matured interests due and payable	-	520,155	-	-	520,155
Total liabilities	12,440,593	2,155,450	297,611	3,438,693	18,332,347
<b>Fund balances (deficits)</b>					
Assigned	790,411	-	-	-	790,411
Restricted	-	5,190,642	8,732,285	176,335	14,099,262
Unassigned	(896,143)	-	-	(66,818)	(962,961)
Total fund balances (deficits)	(105,732)	5,190,642	8,732,285	109,517	13,926,712
Total liabilities and fund balances (deficits)	\$ 12,334,861	7,346,092	9,029,896	3,548,210	\$ 32,259,059

*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, 2011

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 combined fund balances reported in the balance sheet – governmental funds	\$ 13,926,712
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.	59,885
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Capital assets used in governmental activities are not considered available financial resources at fiscal year-end, therefore, are not reported in the governmental funds. This is the carrying amount of capital assets, net of accumulated depreciation and amortization of \$21,939,979 at June 30, 2011.	40,226,305
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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, 2011 (Note 8).	2,640,963
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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 of \$116,883 at June 30, 2011.	93,545
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The following liabilities are not due (mature) in the current fiscal year, therefore, are not reported in the governmental funds at June 30, 2011 (see note 9):

Bonds payable	(25,615,000)
Notes payable	(2,640,000)
Compensated absences	(3,797,237)
Reserve for federal cost disallowances	(182,210)
Accrued employees' Christmas bonuses	(144,704)
	(32,379,151)

Net assets – governmental activities, as reported in the statement of net assets	\$ 24,568,259
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*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**  
**Fiscal Year Ended June 30, 2011**

	<u>Major governmental funds</u>				<b>Total governmental funds</b>
	<b>General fund</b>	<b>Debt service fund</b>	<b>Capital improvements bonds fund</b>	<b>Other governmental funds</b>	
<b>Revenues:</b>					
Taxes:					
Property taxes	\$ 8,212,485	4,533,017	-	-	\$ 12,745,502
Municipal license taxes	6,522,095	-	-	-	6,522,095
Construction excise taxes	1,003,570	-	-	-	1,003,570
Sales and use taxes	2,716,031	-	-	-	2,716,031
<b>Total tax revenues</b>	<b>18,454,181</b>	<b>4,533,017</b>	<b>-</b>	<b>-</b>	<b>22,987,198</b>
Charges for services	422,889	-	-	6,020	428,909
Intergovernmental grants and contributions	1,303,182	603,620	-	5,159,531	7,066,333
Interests on deposits	275,395	4,623	244,327	1	524,346
Miscellaneous	1,820,047	-	-	60	1,820,107
<b>Total revenues</b>	<b>22,275,694</b>	<b>5,141,260</b>	<b>244,327</b>	<b>5,165,612</b>	<b>32,826,893</b>
<b>Expenditures:</b>					
Current:					
General government	9,009,369	-	-	-	9,009,369
Urban and economic development	2,820,717	-	44,145	1,349,001	4,213,863
Public safety	852,094	-	-	-	852,094
Health and sanitation	5,018,685	-	-	-	5,018,685
Culture, recreation and education	1,209,800	-	-	-	1,209,800
Public housing and welfare	1,011,478	-	-	1,063,743	2,075,221
Debt service:					
Debt issue costs	8,503	-	23,315	-	31,818
Principal	222,740	1,635,000	-	305,000	2,162,740
Interests	84,063	921,082	-	78,207	1,083,352
Capital outlays	375,491	-	1,860,852	2,699,041	4,935,384
<b>Total expenditures</b>	<b>20,612,940</b>	<b>2,556,082</b>	<b>1,928,312</b>	<b>5,494,992</b>	<b>30,592,326</b>
Excess (deficiency) of revenues over (under) expenditures	1,662,754	2,585,178	(1,683,985)	(329,380)	2,234,567
<b>Other financing sources (uses):</b>					
Proceeds from issuance of bonds	1,835,000	-	6,070,000	-	7,905,000
Transfers from other funds	2,130,615	-	-	413,806	2,544,421
Transfers to other funds	(2,226,331)	(3,179)	(227,173)	(87,738)	(2,544,421)
<b>Total other financing sources (uses), net</b>	<b>1,739,284</b>	<b>(3,179)</b>	<b>5,842,827</b>	<b>326,068</b>	<b>7,905,000</b>
<b>Net increase (decrease) in     fund balances (deficit)</b>	<b>3,402,038</b>	<b>2,581,999</b>	<b>4,158,842</b>	<b>(3,312)</b>	<b>10,139,567</b>
<b>Fund balance (deficit) at beginning of fiscal year</b>	<b>(3,507,770)</b>	<b>1,584,619</b>	<b>4,573,443</b>	<b>112,829</b>	<b>2,763,121</b>
<b>Prior-period adjustments</b>	<b>-</b>	<b>1,024,024</b>	<b>-</b>	<b>-</b>	<b>1,024,024</b>
<b>Fund balance (deficit) at beginning of fiscal year as restated</b>	<b>(3,507,770)</b>	<b>2,608,643</b>	<b>4,573,443</b>	<b>112,829</b>	<b>3,787,145</b>
<b>Fund balance (deficit) at end of year</b>	<b>\$ (105,732)</b>	<b>5,190,642</b>	<b>8,732,285</b>	<b>109,517</b>	<b>\$ 13,926,712</b>

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

**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  
 Fiscal Year Ended June 30, 2011

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:

Net change in fund balances (deficits) reported in the statement of revenues, expenditures and changes in fund balances – governmental funds	\$ 10,139,567
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Add (Deduct):

The following revenue streams 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 June 30, 2011:

Property tax	76,098
Municipal license tax	(1,149)
Construction excise tax	678,000

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 (\$4,935,384) exceeded depreciation expense of capital assets (\$1,776,096) for the fiscal year ended June 30, 2011.	3,159,288
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Proceeds form issuance of bonds are reported as other financing sources in the governmental funds, however, such proceeds increase long-term liabilities in the statement of net assets.	(7,905,000)
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Repayment of principal of long-term obligations is reported as expenditure in the governmental funds, however, the repayment reduces long-term liabilities in the statement of net assets.	2,162,740
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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.	(8,422)
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Other reconciling items, net of certain expenses recorded in the statement of activities that do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	(1,056,056)
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Net increase in net assets, as reported in the statement of activities	\$ <u>7,245,066</u>
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*The accompanying notes to the basic financial statements are an integral part of this statement.*

**COMMONWEALTH OF PUERTO RICO**  
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Statement of Revenues and Expenditures –  
Budget and Actual – Budgetary Basis – General Fund  
Fiscal Year Ended June 30, 2011

	Budgeted amounts		Actual amounts (budgetary basis-Note 1)	Variance with final budget-over (under)
	Original	Final		
<b>Revenues:</b>				
Taxes:				
Property taxes	\$ 8,423,881	8,423,881	8,212,486	\$ (211,395)
Municipal license taxes	6,042,000	6,042,000	7,092,536	1,050,536
Construction excise taxes	4,090,868	4,090,868	905,400	(3,185,468)
Sales and use taxes	2,980,100	2,980,100	2,547,480	(432,620)
Total tax revenues	21,536,849	21,536,849	18,757,902	(2,778,947)
Charges for services	201,000	201,000	422,889	221,889
Intergovernmental grants and contributions	1,975,772	1,975,772	1,302,732	(673,040)
Interests on deposits	406,883	406,883	249,341	(157,542)
Miscellaneous	608,000	608,000	1,402,444	794,444
Total revenues	24,728,504	24,728,504	22,135,308	(2,593,196)
<b>Expenditures:</b>				
Current:				
General government	13,669,924	14,957,128	12,118,769	2,838,359
Urban and economic development	2,640,120	2,480,466	2,125,269	355,197
Public safety	952,683	750,598	663,485	87,113
Health and sanitation	5,295,666	5,224,882	4,389,993	834,889
Culture, recreation and education	1,083,995	929,310	895,453	33,857
Public housing and welfare	1,086,116	809,182	760,001	49,181
Debt service:				
Principal	-	-	222,740	(222,740)
Interests	-	-	54,045	(54,045)
Capital outlays	-	-	375,491	(375,491)
Total expenditures	24,728,504	25,151,566	21,605,246	3,546,320
Deficiency of revenue under expenditures	-	(423,062)	530,062	953,124
<b>Other financing sources (uses):</b>				
Prior year's budgetary cash surplus readjustment	-	423,062	-	(423,062)
Transfers from other funds	-	-	2,130,615	2,130,615
Transfers to other funds	-	-	(413,806)	(413,806)
Total other financing sources (uses), net	-	423,062	1,716,809	1,293,747
Deficiency of revenues and other financing sources under expenditures and other financing uses	\$ -	-	2,246,871	\$ 2,246,871

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

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF CANÓVANAS**  
Notes to Basic Financial Statements  
Fiscal Year Ended June 30, 2011

**I. Background Information and 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, 2011, 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, 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, 2011, 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 non-major governmental fund financial statements, (2)

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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.

On July 1, 2005, the Municipality adopted the provisions of Statement No. 44, *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1* (GASB No. 44). This statement amended 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). Accordingly, the statistical section of this Comprehensive Annual Financial Report has been modified to present more 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.

On March 2009, the Municipality adopted the provisions of GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments* (GASB 55), and GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* (GASB 56).

GASB 55 incorporated the hierarchy of generally accepted accounting principles (GAAP) for state and local governments into the Governmental Accounting Standards Board's (GASB) authoritative literature. The requirements in this Statement codify all GAAP for state and local governments so that they derive from a single source.

GASB 56 incorporated into the Governmental Accounting Standards Board's (GASB) authoritative literature certain accounting and financial reporting guidance presented in the American Institute of Certified Public Accountants' Statements on Auditing Standards. This Statement addressed three issues not included in the authoritative literature that establishes *accounting* principles – related party transactions, going concern considerations, and subsequent events.

The adoption of GASB 55 and GASB 56 did not have retroactive cumulative effects affecting the accompanying financial statements as of July 1, 2010, and have not affected the financial positions and the results of operations reported as of and for the fiscal year ended June 30, 2011. Accordingly, the accompanying GFFS have not reported any retroactive restatements or reclassifications of fund equities as of July 1, 2010.

**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

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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, 2011.

**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.

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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 net liabilities. 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 all long-term debt that is specifically attributed to the acquisition, construction or improvement of those assets (capital-related debt), regardless of the type of debt.

For the purposes of determining the outstanding debt attributed to capital assets, only the total long-term debt related to the acquisition, construction or improvement of capital assets has been considered in the computation, which is further reduced by any related unspent debt proceeds. Accordingly, all non-capital long-term debts (such as a portion of bonds and notes payable) has been excluded from the computation since were originally issued for certain purposes other than the acquisition, construction or improvement of capital assets.

In addition, for the purposes of determining the outstanding debt attributed to capital assets, the following items are excluded from the calculation: (1) bond issuance costs, (2) interest payable, (3) accrued interest on deep discount debt and non-capital accrued liabilities (e.g. compensated absences, claims and judgments, etc.), and (5) debt used to finance capital acquisitions by parties outside the Municipality. Furthermore, the computation of net assets invested in capital assets, net of related debt, excludes inter-fund loans and other financial assets.

- **Restricted net assets** – This net asset category consists of net resources restricted by external parties (such as debt covenants, 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.

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On July 1, 2005, the Municipality adopted the provisions of Statement No. 46, *Net Assets Restricted by Enabling Legislation* (GASB No. 46). This Statement requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. This Statement clarified that a legally enforceable enabling legislation restriction is one that a party external to the Municipality (such as citizens, public interest groups, or the judiciary) can compel the Municipality to honor. This Statement states that the legal enforceability of an enabling legislation should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if the Municipality has other cause for consideration. Although the determination that a particular restriction is not legally enforceable may cause the Municipality to review the enforceability of other restrictions, it should not necessarily lead the Municipality to the same conclusion for all enabling legislation restrictions.

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 as of June 30, 2011:

- (1) **Debt service** – Represent net resources available to cover future debt service payments of bonds payable.
  - (2) **Federal and state funded programs** – Represent net resources available from certain federal and state grants, which have been set aside to carry out several programs.
- **Unrestricted net assets** – Generally, this category consists of the excess of assets over related liabilities that are neither externally nor legally restricted, neither invested in capital assets. However, at June 30, 2011, this category has a negative balance of \$9,139,976 because liabilities exceeded the related assets. Generally, the assets recorded within this category 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 changed during the fiscal year ended June 30, 2011, 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

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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 urban development
- Department of conservation and ornate

***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 service to citizens
- Department of elderly services

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.

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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 reports the following categories of program revenues for the fiscal year ended June 30, 2011:

- **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 non-exchange 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, sales and use taxes and construction excise taxes are reported as general revenues. All other non-tax 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 inter-fund 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

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other non-exchange 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, (2) the statement of revenues, expenditures and changes in fund balances – governmental funds and (3) the statement of revenues and expenditures – budget and actual – budgetary basis – general fund.

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.

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- **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. Consistently with the prior fiscal years' financial statement presentation, during the fiscal year ended June 30, 2011, 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, and the reserve for 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, which are accounted for in the HUD Section 108 capital projects fund, a non-major governmental fund.

- **Special revenue funds** – The special revenue funds are non-major 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 projects fund). The uses and limitations of each special revenue fund are specified by municipal ordinances or federal and state statutes. However, resources restricted to expenditures 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 major and non-major 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.

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 capitalized 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 non-major categories within the GFFS. Major individual governmental funds are reported individually as separate columns in the GFFS, while data from all non-major governmental funds are aggregated into a single column, regardless of fund type.

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By definition, the Municipality's general fund is considered a major governmental fund for financial reporting purposes. In addition, any other governmental fund would be 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 inter-fund balances have been made. Total revenues for these purposes means all revenues, including operating and non-operating revenues (net of allowances for uncollectible accounts), except for other financing sources. Total expenditures for these purposes mean all expenditures, including operating and non-operating 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, and (3) the capital improvements bond fund.

The capital improvements bond fund is a major capital projects fund used to account for the financial resources arising mainly from bond issuance proceeds used in the acquisition or construction of major capital facilities, other assets and permanent improvements. The most significant transactions of this fund are related to the proceeds on the issuance of bonds.

The Municipality periodically undertakes a comprehensive evaluation of its fund structure to ensure that complies with all aspects that are of importance to users of general purpose external financial reports. Consequently, all superfluous funds and some internal funds currently used by Municipality in the day-to-day accounting procedures have not been reported as individual governmental funds in the accompanying fund financial statements. Accordingly, the accompanying fund financial statements include only the minimum number of funds consistent with legal and operating requirements and, consequently, the following types of similar internal funds have been combined into single funds in the accompanying fund financial statements:

- The various capital improvement bond issues outstanding have been reported as a single major capital projects fund, the capital improvements bond fund.
- Numerous less significant capital project and special revenue funds have been combined into single capital project funds and special revenue funds, respectively.
- Program-specific capital grants and contributions awarded by the Legislature of the Commonwealth of Puerto Rico have been combined into a single major capital projects fund, the legislative joint resolutions fund.

The accompanying GFFS are accompanied by the following schedules required by GAAP: (1) the reconciliation of the balance sheet – governmental funds to the statement of net assets, and (2) 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

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additional rules and limitations detailed below, revenues (including interest on deposits and investments) 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 fees for licenses and permits, 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 non-exchange transactions are recorded using the criteria set forth by GASB Statement No. 33, *Accounting and Financial Reporting for Non-exchange Transactions* (GASB No. 33). GASB No. 33 established accounting and reporting standards for non-exchange transactions involving cash and financial or capital resources (for example, most taxes, grants and private donations). In a non-exchange 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 non-exchange transactions into the following four classes in the accompanying basic financial statements: (a) derived tax revenues, (b) imposed non-exchange revenues, (c) government mandated non-exchange transactions, and (d) voluntary non-exchange 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 non-exchange revenue transactions (such as property taxes and municipal license taxes), which result from assessments made by the Municipality on non-governmental 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 non-exchange 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.

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Voluntary non-exchange 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 non-exchange transactions discussed above. Events that are neither exchange nor non-exchange 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 revenues.

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 generally considers most revenues (municipal licenses taxes, construction excise taxes, sales and use taxes, interests on deposit, intergovernmental grants and contributions and certain charges for services) to be available if collected within 90 days after June 30, 2011, 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 revenues at June 30, 2011.

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 revenues (see note 8).

In a manner similar to the GWFS, but subject to and limited by the availability criteria discussed above, 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, fees for licenses and permits, 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 non-exchange transactions are recorded in a similar manner to the GWFS, using the previously discussed criteria set forth by GASB No. 33 for non-exchange transactions, but subject to and limited by the availability criteria discussed above. Accordingly, property tax and municipal license tax receivables are also

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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 for expenditure-driven grants).

Interest on deposits are recorded when earned as these revenues are considered both measurable and available at June 30, 2011.

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 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 only 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 and notes payable are recorded when they mature (when payment is due), except for principal and interest of bonds due on July 1, 2011, which are recorded as governmental fund liabilities at June 30, 2011 which is the date when resources were available in the debt service fund.
- Obligations under capital leases, compensated absences, and the reserve for federal cost disallowances are recorded only when they mature (when payment is due).
- Certain accrued liabilities not due and payable (unmatured) 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.

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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 the fiscal year commencing on the next 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 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 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 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.

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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 functions/program level (general government, urban and economic development, public safety, health and sanitation, culture, recreation and education, and public housing and welfare, capital outlays, principal expenditures, interest expenditures, etc.) within the general and debt service funds, respectively.

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, 2011. 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, 2010, 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 at P.O. Box 1612, Canóvanas, Puerto Rico 00729-1612.

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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:

Revenues and other financing sources over expenditures and other financing uses- budgetary basis – general fund	\$ 2,246,871
Timing difference - net effect of current year encumbrances recorded as expenditures for budgetary purpose versus prior year encumbrances recorded as current year expenditures for GAAP purpose	35,328
<i>Basis of accounting differences:</i>	
Net increase in property taxes receivable	76,098
Net increase in construction excise taxes receivable	776,169
Net increase in municipal license taxes receivable	421,918
Net increase in sales and use taxes receivable	168,551
Net increase in intergovernmental receivables	53,672
Net increase in accrued interest receivable	213
Net decrease in miscellaneous receivables	(205,955)
Net increase in due and advances from other funds	623,558
Net increase in deferred revenues	(1,728,300)
Net decrease in accounts payable and accrued liabilities	716,895
Net decrease in intergovernmental payables and accrued liabilities	193,128
Net decrease in due/advances to other funds	23,892
Revenues and other financing sources over expenditures and other financing uses –general fund– GAAP basis	\$ 3,402,038

**g) Unrestricted and Restricted Deposits**

The Municipality's deposits at June 30, 2011 are composed of: (1) demand deposits in commercial banks (2) demand deposits in the Government Development Bank for Puerto Rico (GDB, fiscal agent) and (3) cash equivalents consisting of certificates of deposits in commercial banks of \$5,757,813, with original maturities of three months or less. Cash equivalents are recorded at amortized cost, which approximates fair value.

The Municipality follows the practice of pooling cash. At June 30, 2011, the pool cash account has balance of \$192,383 of which \$543,636 which have been recorded in within the non-major capital project funds and the non-major special revenue funds, respectively. The remaining balance negative of \$344,587 has been recorded within accounts payable in the general fund.

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

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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 debt service funds includes property tax collections amounting to \$6,853,394, which are restricted for the payment of the Municipality's debt service, as required by law. Cash with fiscal agent of \$225,455 in the general fund also includes unspent proceeds of bonds that are restricted for the acquisition of certain minor capital assets and the payment of certain accounts payable. Cash with fiscal agent recorded in the capital improvements bonds funds consists of unspent proceeds of bonds and notes and the balance of interests bearing accounts amounting to \$8,988,226, which is restricted for the acquisition, construction, or improvements of major capital assets. Cash with fiscal agent recorded in the non-major governmental funds consists principally of unspent proceeds of bonds and notes and the balance of interest and non-interest bearing accounts amounting to \$86,341 which is restricted for the acquisition, construction, or improvements of major capital assets.

Restricted cash in commercial banks for other governmental funds, amounting to \$3,295,013, represents the balance of interest and non-interest bearing accounts restricted to finance the operations of various 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, 2011. 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 inter-fund loans) or "advances to/from other funds" (i.e. the non-current portion of inter-fund loans), as applicable. All other outstanding balances between funds are reported as "due to/from other funds".

On July 1, 2007, the Municipality adopted the provisions of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* (GASB No. 48). This Statement establishes standards for the measurement, recognition, and display of transactions where governments exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments, generally, a single lump sum. GASB No. 48 provides technical guidance to determine whether this type of transaction should be regarded as a sale or as a collateralized borrowing resulting in a liability. This criteria is used to determine the extent to which a transferor government either retains or relinquishes control over the receivables or future revenues through its continuing involvement with those receivables or future revenues. Accordingly, GASB No. 48 establishes that a transaction will be reported as a collateralized borrowing unless the criteria indicating that a sale has taken place are met. If it is determined that a transaction involving receivables should be reported as a sale, the difference between the carrying value of the receivables and the proceeds should be recognized in the period of the sale in the change statements. If it is determined that a transaction involving future revenues should be reported as a sale, the revenue should be deferred and amortized, except when specific criteria are met. This

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Statement also provides additional guidance for sales of receivables and future revenues within the same financial reporting entity.

GASB No. 48 also provides guidance to be used for recognizing other assets and liabilities arising from a sale of specific receivables or future revenues, including residual interests and recourse provisions. According to the criteria set forth by GASB. No. 48, there were no transactions involving receivables that should be reported as a sale as of and for the fiscal year ended June 30, 2011, therefore, the adoption of GASB No. 48 had no effect in the accompanying basic financial statements.

*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 costs. Generally, inventories are capitalized and stated at cost using the first-in, first-out method (FIFO) in the GWFS. Inventories and prepaid expenses 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, 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 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).

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,

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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:

	<u>Years</u>
Land improvements	20
Buildings, structures and building improvements	30 to 50
Infrastructure	20 to 50
Motor vehicles	8
Furniture and fixtures	5 to 20
Machinery and equipment, excluding those held under capital leases	5 to 20
Machinery and equipment 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.

***1) 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, 2011 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 (unearned 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.

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***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, 2011 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 year) per employee. Employees accumulate regular sick leave at a rate of 1.5 days per month (18 days per 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 year, if not consumed, as required by law. In the case of compensatory time, the excess of 240 hours is paid to employees each 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 federal cost disallowances.

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, 2011 are recorded as governmental fund liabilities in the GFFS (debt service fund) when resources are available in the debt service fund (June 30, 2011). In the GFFS, the face amount of debt issued (gross debt reported) is reported as other financing sources when issued.

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In the GWFS debt issuance costs are 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 recognized 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 FASB (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 or 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

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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 and Post-Employment Benefits**

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 state government of the Commonwealth of Puerto Rico 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 of Puerto Rico and the basic financial statements of such retirement systems are part of the financial reporting entity of the Commonwealth of Puerto Rico.

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.

On July 1, 2007, the Municipality adopted the provisions of GASB Statement No. 50, *Pension Disclosures* (GASB No. 50). This Statement more closely aligns current pension disclosure requirements for governments with those that governments are beginning to implement for retiree health insurance and other post-employment benefits. Specifically, GASB No. 50 amends GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, by requiring:

- Disclosure in the notes to the financial statements of pension plans and certain employer governments of the current funded status of the plan—in other words, the degree to which the actuarial accrued liabilities for benefits are covered by assets that have been set aside to pay the benefits—as of the most recent actuarial valuation date.
- Governments that use the aggregate actuarial cost method to disclose the funded status and present a multi-year schedule of funding progress using the entry age actuarial cost method as a surrogate; these governments previously were not required to provide this information.
- Disclosure by governments participating in multi-employer cost-sharing pension plans of how the contractually required contribution rate is determined.

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB No. 45) establishes standards for the measurement,

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recognition, and display of expense/expenditures and related liabilities/assets of post-employment benefits other than pensions (OPEB), note disclosures, and, if applicable, required supplementary information in the financial reports of state and local government employers. At June 30, 2011, there were no OPEB plans adopted by the Municipality. Accordingly, during the fiscal year ended June 30, 2011, the Municipality did not incur in any post-employment benefits costs other than pensions, therefore, the adoption of GASB No. 45 had no effect in the accompanying basic financial statements.

**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 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.

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, 2011. 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.

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**r) Fund Balances**

On July 1, 2010, the Municipality adopted the provisions of GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* (GASB 54), which enhanced the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied. This statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which the Municipality is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

Pursuant to the provisions of GASB 54, the accompanying GFFS report fund balance amounts that are considered non-spendable since are net resources that cannot be spent readily with cash or are legally or contractually required not to be spent. At June 30, 2011, such fund balances are related to long-term interfund loans receivable recorded in the general fund amounting to \$.

Other fund balances in the accompanying basic financial statements have been reported as restricted, assigned, or unassigned, based on the relative strength of the constraints that control how specific amounts can be spent, as described as follows:

- a. *Restricted* - Represent net resources that can be spent only for the specific purposes stipulated by constitutional provisions, external resource providers (externally imposed by creditors or grantors), or through enabling legislation (that is, legislation that creates a new revenue source and restricts its use). Effectively, restrictions may be changed or lifted only with the consent of resource providers. In the accompanying basic financial statements, restricted fund balances have been reported in the following funds and for the following purposes:
  - *Capital improvements bond fund* – restricted fund balance consist of financial resources to be used only for the acquisition, construction or improvement of capital assets under contracts and other commitments, as approved and financed by the Government Development Bank for Puerto Rico.
  - *Legislative joint resolutions fund* – restricted fund balance consist of financial resources arising from grants and contributions received through resolutions of the Legislature of the Commonwealth of Puerto Rico to be used principally for the acquisition, construction or improvement of capital assets under contracts and other commitments.
  - *Debt service fund* – restricted fund balance consist of financial resources available only to cover future debt service payments (principal and interest) on bonds payable, which are accounted for in the debt service fund, as required by Law.
  - *Community development block grant fund* – restricted fund balance consist of financial resources arising from program-specific capital grants and contributions awarded by the U.S. Department of Housing and Urban Development through the Puerto Rico Office of the Commissioner of

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Municipal Affairs (sub-grantor), which are principally restricted for the acquisition or construction of major capital facilities, other assets and permanent improvements in benefit of low-income and moderate-income communities.

- *Other governmental funds* – restricted fund balance consist of financial resources arising from operating and capital grants and contributions from state and federal grantors that can be spent only for the specific purposes stipulated by the respective external resource providers, or through enabling legislation.
  
- b. *Assigned* – Represent net resources recorded in the general fund intended to be used by the Municipality for specific purposes but do not meet the criteria to be classified as restricted or committed (generally executive orders approved by the Mayor). Intent can be expressed by the Municipal Legislature, the Mayor or by an official or body to which the Municipal Legislature delegates authority in conformity with the Autonomous Municipalities Act of Puerto Rico, as amended. In governmental funds other than the general fund, assigned fund balance represents the remaining amount that is not restricted or committed.

At June 30, 2011 assigned fund balances in the general fund consist of fund balances reserved for encumbrances amounting to \$790,411.

- e. *Unassigned* – Represent the residual classification for the Municipality's general fund and includes all spendable amounts not contained in the other classifications. In other funds, the unassigned classification is used only to report a deficit balance resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned.

Negative fund balance amounts are assigned amounts reduced to the amount that will raise the fund balance to zero. Consequently, negative residual amounts in restricted, committed and assigned fund balance classifications have been reported as unassigned fund balances, when applicable.

The Municipality had no fund balances classified as *committed* at June 30, 2011. Those types of fund balances are generally related to financial resources used for specific purposes, imposed by formal action of the Municipal's highest level of decision making authority (Municipal Legislature through resolutions and ordinances), which would only be changed by a similar law, ordinance or resolution.

The Municipality reports resources constrained to stabilization as a specified purpose (restricted or committed fund balance in the general fund) only if: (1) such resources meet the other criteria for those classifications, as described above and (2) the circumstances or conditions that signal the need for stabilization are identified in sufficient detail and are not expected to occur routinely. However, the Municipality has not entered into any stabilization-like arrangements, nor has set

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aside material financial resources for emergencies and has not established formal minimum fund balance amounts as of and for the fiscal year ended June 30, 2011.

In situations when an expenditure is made for a purpose for which amounts are available in multiple fund balance classifications, the Municipality uses restricted resources first, and then unrestricted resources. Within unrestricted resources, the Municipality generally spends committed resources first, followed by assigned resources, and then unassigned resources when expenditures.

The classification of the Municipality's individual governmental funds among general, debt service, special revenue and capital project fund types used in prior fiscal years for financial reporting purposes was not affected by the implementation of GASB 54. In addition, the financial positions and the results of operations reported in the accompanying GFFS as of and for the fiscal year ended June 30, 2011 have not been affected for this change in accounting principle. Accordingly, the accompanying GFFS have not reported any retroactive restatements or reclassifications of fund equities as of July 1, 2010.

**s) 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.
- **Advances from other funds** – Represent the reservation of financial resources set aside for long-term inter-fund receivables, which are not considered current available financial resources at June 30, 2011.
- **Federal and state funded programs** – Represent financial resources set aside for use in federal and state grant programs.

**t) Inter-fund Activities**

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

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- **Inter-fund 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. Inter-fund 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, inter-fund receivables/payables are reduced to the estimated realizable value and the amount that is not expected to be repaid is reported as an operating transfer from the governmental fund that made the loan.
- **Inter-fund 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. Inter-fund transfers are reported as other financing sources in the governmental fund making transfers and as other financing sources in the governmental fund receiving transfers.
- **Inter-fund 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, inter-fund activity has not been eliminated, as permitted by GAAP.

**u) 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.

**v) Future Adoption of Accounting Pronouncements**

The GASB has issued the following statements that have effective dates after June 30, 2011:

- GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements* (GASB 60). The requirements of this Statement are effective for the fiscal year commencing on July 1, 2011.
- GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34* (GASB 61). The requirements of this Statement are effective for the fiscal year commencing on July 1, 2012.
- GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* (GASB 62). The requirements of this Statement are effective for the fiscal year commencing on July 1, 2012.
- GASB Statement No. 63, *Financial Reporting of Deferred Outflows of resources, Deferred Inflows of Resources, and Net Position* (GASB 63). The requirements of this Statement are effective for the fiscal year commencing on July 1, 2012.

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- GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions – an amendment of ASB Statement No. 53* (GASB 64). The requirements of this Statement are effective for the fiscal year commencing on July 1, 2011.

The impact of these statements on the Municipality's basic financial statements has not yet been determined.

## 2. Deposits

The Municipality maintains its deposits in various commercial banks located in Puerto Rico and the Government Development Bank for Puerto Rico (GDB). Proceeds from all bonds and the funds related to certain federal grant awards are required by law to be held with GDB.

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, and (4) foreign exchange exposure.

- **Credit risk** – This is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. In compliance with the laws and regulations of the Commonwealth of Puerto Rico, the Municipality has adopted, as its custodial credit risk policy, the *Statement of Uniform Investment Guidelines for the Municipalities of the Commonwealth of Puerto Rico, issued by the Government Development Bank for Puerto Rico* as promulgated by Law No. 113 of August 3, 1995. Accordingly, the Municipality is only allowed to invest in obligations of the Commonwealth of Puerto Rico, 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. According to the aforementioned investment guidelines, the Municipality is not allowed to invest in marketable securities or any other type of investments (debt securities) for which credit risk exposure may be significant. Consequently, at June 30, 2011 and for the fiscal year then ended, the Municipality invested only in certificates of deposit in commercial banks, which are insured by the Federal Deposit Insurance Corporation (FDIC), generally up to a maximum of \$100,000 per depositor. No investments in debt or equity securities were made during the fiscal year ended June 30, 2011. Therefore, the Municipality's management has concluded that the credit risk related to any possible loss related to defaults by commercial banks on the Municipality's deposits is considered low at June 30, 2011.
- **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: (1) not including debt or equity investments in its investments portfolio at June 30, 2011, (2) limiting the weighted average maturity of its investments in certificates of deposit to periods of three months or less and (3) keeping most of its banks deposits and certificates of deposit in interest bearing accounts generating interest at prevailing market rates. At June 30, 2011, the interest rate risk associated with the Municipality's cash and cash equivalent is considered low since the investment portfolio of

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the Municipality consists of certificates of deposit and do not include debt securities or any type of investments that could be affected by changes in interest rates.

- **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. Pursuant to the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico*, the balances deposited in commercial banks by the Municipality are insured by the Federal Deposit Insurance Corporation (FDIC), generally up to a maximum of \$250,000 per depositor. In addition, public funds deposited in commercial banks by the Municipality are 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 of GDB, amounting to \$8,988,226 at June 30, 2011, are uninsured and uncollateralized. However, no losses related to defaults by GDB on deposit transactions have been incurred by the Municipality through June 30, 2011. It is management’s policy to only maintain deposits in banks affiliated to FDIC to minimize the custodial credit risk, except for GDB. Therefore, the Municipality’s management has concluded that at June 30, 2011, the custodial credit risk associated with the Municipality’s cash and cash equivalents is considered low.
  
- **Foreign exchange risk** – This is the risk that changes in exchange rates will adversely affect the value of an investment or a deposit. According to the aforementioned investment guidelines, adopted by the Municipality, the Municipality is prevented from investing in foreign securities or any other types of investments for which foreign exchange risk exposure may be significant. Accordingly, management has concluded that the foreign exchange risk related to the Municipality’s deposits is considered low at June 30, 2011.

Cash and cash equivalents at June 30, 2011, are classified in the accompanying balance sheet – governmental funds as follows:

	<b>Major governmental funds</b>				<b>Total</b>
	<b>General fund</b>	<b>Debt service fund</b>	<b>Capital improvements bond fund</b>	<b>Other governmental funds</b>	
<b>Unrestricted:</b>					
Cash in commercial banks	\$ 4,757,813	-	-	-	\$ 4,757,813
Cash equivalents in commercial banks	1,000,000	-	-	-	1,000,000
<b>Total unrestricted deposits</b>	<b>5,757,813</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>5,757,813</b>
<b>Restricted:</b>					
Cash in commercial banks	-	-	-	3,295,013	3,295,013
Cash in GDB, as fiscal agent	225,455	6,853,394	8,988,226	86,341	16,153,416
Cash equivalents in commercial banks	-	-	-	-	-
<b>Total restricted deposits</b>	<b>225,455</b>	<b>6,853,394</b>	<b>8,988,226</b>	<b>3,381,354</b>	<b>19,448,429</b>
<b>Total carrying amount of deposits</b>	<b>\$ 5,983,268</b>	<b>6,853,394</b>	<b>8,988,226</b>	<b>3,381,354</b>	<b>\$ 25,206,242</b>

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**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, 2011, 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 assess the corresponding municipal license tax by declaring the volume of business through a tax return to be filed every April 15, based on the actual volume of business (revenues) generated in the preceding calendar year. Taxpayers with a sales volume of \$3 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 amounted to \$423,067 at June 30, 2011. Unearned (deferred) municipal license tax revenues recorded in the accompanying GWFS and the general fund amounted to \$6,522,095 respectively at June 30, 2011. Earned but unavailable municipal license tax revenues amounting to \$423,067 have been recorded in the general fund within deferred revenues at June 30, 2011.

**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 market prices).

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 (lien; levy date) and reporting such taxable value through a personal property tax return filed on May 15 (due date and collection date) subsequent to the assessment date. The total personal property tax rate in force at June 30, 2010 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 every January 1 (lien; levy date) and is based on estimated current values of the property, deflated to 1957 market prices. Real property taxes are due and collectible on January 1 and July of every fiscal year. The total real property tax rate in force at June 30, 2011 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).

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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.

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 1.40 percent that is restricted for the Municipality's debt service requirements on bonds. Such amounts are recorded in the Municipality's debt service fund.

The composition of property taxes receivable and the related deferred revenue is as follows at June 30, 2011:

	<b>General fund</b>	<b>Debt service fund</b>	<b>Total</b>
Gross property taxes receivable	\$ 1,444,840	449,554	\$ 1,894,394
Deferred (earned and unavailable) property tax revenues in GFFS	\$ 1,444,840	-	\$ 1,444,840

**5. Sales and Use Taxes**

The Municipality imposes a sales and usage tax within the territorial limits of the Municipality pursuant to the Internal Revenue Code of the Government of Puerto Rico. This is a self-assessed tax consisting of one and a half percent (1.5%) on the sale price of a taxable item or on the purchase price of all usage, storage or consumption of a taxable item, as defined in the Puerto Rico Internal Revenue Code, as amended. The tax is assessed and collected on a monthly basis through a tax return filed by each business classified as tax withholding agent.

The sales and use tax revenues amounted to \$223,353 for the fiscal year ended June 30, 2011, which has been recorded in the general fund since is available for general operating purposes.

**6. Construction Excise Taxes**

The Municipality imposes and collects municipal construction excise taxes to most natural and legal persons and any governmental instrumentality that carry out activities related to construction, expansion, major repairs, relocations, alterations and other types of permanent improvements to residential, commercial and industrial buildings and structures within the territorial area of the Municipality. The tax is also applicable to infrastructure projects, the installation of machinery, equipment and fixtures, and other types of construction-related activities.

The construction excise tax generally is a self-assessed tax imposed over the cost of the project, net of certain exemptions such as the costs associated with the acquisition of land, project design and other engineering fees, licenses and permits, legal and accounting fees, and most marketing and advertising costs. The tax is paid by the taxpayer at the beginning of the project.

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All single-family residential construction projects not related to housing development projects, condominiums, or any similar projects, are partially exempt from construction excise taxes. In addition, a portion of all single-family residential improvement projects are exempt from construction excise taxes. All projects carried out on buildings and structures classified as historical treasures by the Puerto Rico Planning Board have an in the tax rate applicable to construction excise taxes.

Construction excise tax revenues amounted to \$776,169 for the fiscal year ended June 30, 2011, which has been recorded in the general fund since is available for general operating purposes.

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**7. Intergovernmental Receivables and Payables**

Intergovernmental receivables and payables recorded in the accompanying GWFS and GFFS are as follows at June 30, 2011:

	<b>Major governmental funds</b>	<b>Other governmental funds</b>	<b>Total governmental funds</b>	<b>Statement of net assets</b>
<i>Intergovernmental receivables:</i>				
U.S. Department of Housing and Urban Development - capital project funds	\$ -	66,906	66,906	\$ 66,906
U.S. Department of Health and Human Services - special revenue funds	-	33,132	33,132	33,132
Government Development Bank of Puerto Rico - debt service fund	42,742	-	42,742	42,742
Puerto Rico Treasury Department - general fund - Christmas bonus reimbursement program	144,704	-	144,704	144,704
Puerto Rico Energy and Power Authority	1,897,304	-	1,897,304	1,897,304
Total intergovernmental receivables	<u>\$ 2,084,750</u>	<u>100,038</u>	<u>2,184,788</u>	<u>\$ 2,184,788</u>

	<b>Major governmental funds</b>	<b>Other governmental funds</b>	<b>Total governmental funds</b>	<b>Statement of net assets</b>
<i>Intergovernmental payables:</i>				
Payroll withholdings and employer's contributions - general fund:				
Employees' Association of the Government of Puerto Rico	\$ 52,256	-	52,256	\$ 52,256
Employees' Retirement System of the Government of Puerto Rico	145,820	-	145,820	145,820
Puerto Rico Treasury Department	169,261	-	169,261	169,261
Puerto Rico Department of Labor	18,529	-	18,529	18,529
Utilities - general fund:				
Puerto Rico Water and Sewer Authority	36,642	-	36,642	36,642
Puerto Rico Electric and Power Authority	1,897,304	-	1,897,304	1,897,304
Total intergovernmental payables	<u>\$ 2,319,812</u>	<u>-</u>	<u>2,319,812</u>	<u>\$ 2,319,812</u>

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**8. Inter-fund Transactions**

The composition of inter-fund balances at June 30, 2011 and for the fiscal year then ended is as follows:

<b>Due/advances to:</b>	<b>Due/advances from:</b>		
	<b>Major governmental funds</b>		
	<b>General fund</b>	<b>Other governmental funds</b>	<b>Total governmental funds</b>
<b>Major governmental funds:</b>			
General fund	\$ -	-	\$ -
Debt service fund	295	-	295
Capital improvements bond fund	80,709	-	80,709
<b>Other governmental funds:</b>			
Special revenue funds	1,268,228	-	1,268,228
Capital project funds	92,711	-	92,711
<b>Total</b>	<b>\$ 1,441,943</b>	<b>-</b>	<b>\$ 1,441,943</b>

<b>Transfers out:</b>	<b>Transfers in:</b>		
	<b>Major governmental funds</b>		
	<b>General fund</b>	<b>Other governmental funds</b>	<b>Total governmental funds</b>
<b>Major governmental funds:</b>			
General fund	\$ 1,812,525	-	\$ 1,812,525
Debt service fund	3,179	-	3,179
Capital improvements bond fund	227,173	-	227,173
<b>Other governmental funds:</b>			
Special revenue funds	7,088	19,964	27,052
Capital project funds	80,650	393,842	474,492
<b>Total</b>	<b>\$ 2,130,615</b>	<b>413,806</b>	<b>\$ 2,544,421</b>

The principal purposes of inter-fund receivables and payables are:

- Recognize in the general fund the outstanding balance of the loans granted to non-major capital project and special revenue funds (\$1,360,939) to temporarily cover the payroll and other operating costs of several federally and state funded programs.

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The principal purposes of inter-fund transfers are to:

- Make a routinary transfer of interest income, amounting to \$3,179 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.

Inter-fund receivables and payables represent the pending settlements of the aforementioned transfers, which are considered by management to be fully realizable at June 30, 2011.

At June 30, 2011, the general fund reported advances (long-term inter-fund receivables) from non-major special revenue funds and major capital project funds amounting to \$665,664 and \$85,708, respectively. These advances among governmental funds have been reported at June 30, 2011 within due and advances from other funds and are not expected to be repaid within one year after year-end. Accordingly, at June 30, 2011, the general fund reported a reservation of fund balance amounting to \$ to properly disclose the portion of inter-fund receivables that are considered current available financial resources at June 30, 2011.

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**9. Capital Assets**

Capital assets activity for the fiscal year ended June 30, 2011 is as follows:

	Balance at 30-Jun-10	Capital outlays/ additions	Reclassifications	Balance at 30-Jun-11
<u>Cost basis:</u>				
Cost basis of capital assets, not subject to depreciation and amortization:				
Infrastructure land	\$ 1,611,480	-	-	\$ 1,611,480
Construction in progress	631,411	1,155,643	(484,143)	1,302,911
Total cost basis of capital assets, not subject to depreciation and amortization	<u>2,242,891</u>	<u>1,155,643</u>	<u>(484,143)</u>	<u>2,914,391</u>
Cost basis of capital assets, subject to depreciation and amortization:				
Building, structures and building improvements	22,120,769	534,666	484,143	23,139,578
Infrastructure	19,323,082	2,863,384	-	22,186,466
Land Improvements	2,210,091	-	-	2,210,091
Licensed vehicles	7,353,222	28,200	-	7,381,422
Furniture, fixtures, machinery and equipment	3,775,600	353,491	-	4,129,091
Machinery and equipment held under capital leases	205,245	-	-	205,245
Total cost basis of capital assets subject to depreciation and amortization	<u>54,988,009</u>	<u>3,779,741</u>	<u>484,143</u>	<u>59,251,893</u>
Total cost basis of capital assets subject	<u>\$ 57,230,900</u>	<u>4,935,384</u>	<u>-</u>	<u>\$ 62,166,284</u>
	Balance at 30-Jun-10	Depreciation expense	Reclassification	Balance at 30-Jun-11
<u>Accumulated depreciation:</u>				
Buildings, structures and building improvements	\$ 4,754,258	448,258	-	\$ 5,202,516
Infrastructure	5,749,136	705,806	-	6,454,942
Land Improvements	1,606,018	71,023	-	1,677,041
Licensed vehicles	6,195,105	341,075	-	6,536,180
Furniture, fixtures, machinery and equipment	1,654,121	209,934	-	1,864,055
Machinery and equipment held under capital leases	205,245	-	-	205,245
Total accumulated depreciation	<u>20,163,883</u>	<u>1,776,096</u>	<u>-</u>	<u>21,939,979</u>
Capital assets, net	<u>\$ 37,067,017</u>	<u>3,159,288</u>	<u>-</u>	<u>\$ 40,226,305</u>

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Depreciation expense was charged to functions in the accompanying government-wide statement of activities as follows for the fiscal year ended June 30, 2011:

General government	\$	162,652
Public safety		58,774
Public housing and welfare		12,771
Health and sanitation		48,323
Urban and economic development		1,183,807
Culture, recreation and education		309,769
Total depreciation and amortization expense	\$	<u>1,776,096</u>

At June 30, 2011, the estimated aggregate replacement cost of the Municipality's capital assets amounted to approximately \$62 million.

**10. Deferred Revenues**

At June 30, 2011, deferred revenues recorded in the GWFS and the GFFS are as follows:

	Major governmental funds		Total governmental funds	Statement of net assets
	General fund	Other governmental funds		
<i>Earned and unavailable revenues:</i>				
Property tax	\$ 1,444,840	-	1,444,840	\$ -
Construction excise tax	678,000	-	678,000	-
Intergovernmental grants and contributions	144,704	-	144,704	-
Total earned and unavailable revenues	2,267,544	-	2,267,544	-
<i>Unearned revenues:</i>				
Property taxes	-	-	-	1,261,581
Municipal licenses	7,000,806	-	7,000,806	7,000,806
Intergovernmental grants and contributions	-	1,683,272	1,683,272	1,683,272
Total unearned revenues	7,000,806	1,683,272	8,684,078	9,945,659
Total deferred revenues	\$ 9,268,350	1,683,272	10,951,622	\$ 9,945,659

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**11. Long-Term Obligations**

The general long-term debt activity for the fiscal year ended June 30, 2011 is as follows:

	<b>Balance at beginning of fiscal year</b>	<b>Borrowings and other Increases</b>	<b>Payments or deductions</b>	<b>Balance at end of fiscal year</b>	<b>Balance due within one year</b>
Bonds payable	\$ 19,640,000	7,905,000	(1,930,000)	25,615,000	\$ 1,635,000
Notes payable:					
Municipal Revenue Collection Center	241,789		(241,789)		
U.S. Department of Housing (HUD) and urban development	2,945,000		(305,000)	2,640,000	325,000
Reserve for federal cost disallowances	182,210			182,210	
Compensated absences	3,121,071	3,797,237	(3,121,071)	3,797,237	1,332,195
<b>Total</b>	<b>\$ 26,130,070</b>	<b>11,702,237</b>	<b>(5,597,860)</b>	<b>32,234,447</b>	<b>\$ 3,292,195</b>

Historically, the general fund has been used to liquidate certain notes payable, compensated absences, obligations under capital leases, federal cost disallowances and any other long-term liabilities other than bonds, except for notes payable to HUD, which have been recorded in the non-major capital project funds.

**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 of Puerto Rico 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 are issued, the revenues of the debt service fund should be sufficient to cover the projected debt service requirement. The Municipality's available legal debt margin amounted to \$6.3 million at June 30, 2011, as published by the Government Development Bank for Puerto Rico.

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***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 of Puerto Rico provide that the Municipality's public debt will constitute a first claim on the available revenue of the Municipality. Public debt includes bonds and bond anticipation notes. 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, 2011:

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	<b>Outstanding amount</b>
<b><u>Public Improvement Bonds:</u></b>	
2005 serial bonds for the acquisition of major capital assets, original amount of \$3,115,000, due in annual principal installments ranging from \$145,000 to \$285,000; plus interests due in semiannually installments at variable rates (4.38% at June 30, 2011) through July 1, 2019	\$ 2,135,000
2009 serial bonds for the acquisition of major capital assets, original amount of \$1,450,000, due in annual principal installments ranging from \$165,000 to \$260,000; plus interests due in semiannually installments at variable rates (4.75% at June 30, 2011) through July 1, 2015	1,110,000
2009 serial bonds for the acquisition of major capital assets, original amount of \$4,990,000, due in annual principal installments ranging from \$75,000 to \$420,000; plus interests due in semiannually installments at variable rates (4.75% at June 30, 2011) through July 1, 2033	4,835,000
Total public improvements bonds	\$ 8,080,000

	<b>Outstanding amount</b>
<b><u>General Obligation Bonds:</u></b>	
2001 serial bonds for the acquisition of major capital assets, original amount of \$5,500,000, due in annual principal installments ranging from \$75,000 to \$475,000; plus interests due in semiannually installments at variable rates (4.10% at June 30, 2011) through July 1, 2026	4,560,000
2004 serial bonds for working capital and the payment of past due accounts payable to suppliers, original amount of \$1,435,000, due in annual principal installments ranging from \$175,000 to \$235,000; plus interests due in semiannually installments at variable rates (4.38% at June 30, 2011) through July 1, 2011	235,000
2007 serial bonds for working capital and the payment of accounts payable to suppliers, original amount of \$1,560,000, due in annual principal installments ranging from \$110,000 to \$215,000; plus interests due in semiannually installments at variable rates (2.43% at June 30, 2011) through July 1, 2016	1,070,000

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2009 serial bonds for working capital and the payment of accounts payable to suppliers, original amount of \$1,845,000, due in annual principal installments ranging from \$130,000 to \$255,000; plus interests due in semiannually installments at variable rates (4.75% at June 30, 2011) through July 1, 2018	1,575,000
2010 special obligation note for \$2,475,000 as per resolution 13 serial 2009-2010, guaranteed with sales and use tax funds, due in annual principal installments of \$285,000; plus interests due in semiannually installments at variable rates through July 1, 2016	2,190,000
2011 serial bonds for working capital and the payment of accounts payable to suppliers, original amount of \$1,835,000, due in annual principal installments ranging from \$130,000 to \$255,000; plus interests due in semiannually installments at variable rates (4.75% at June 30, 2011) through July 1, 2018	1,835,000
2011 serial bonds for working capital and the payment of accounts payable to suppliers, original amount of \$6,070,000, due in annual principal installments ranging from \$130,000 to \$255,000; plus interests due in semiannually installments at variable rates (4.75% at June 30, 2011) through July 1, 2018	6,070,000
Total general obligation bonds	17,535,000
Total bonds payable	\$ 25,615,000

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
2012	1,150,000	973,919	2,123,919
2013	1,260,000	912,785	2,172,785
2014	1,609,000	1,158,480	2,767,480
2015	1,585,000	1,141,200	2,726,200
2016	1,710,000	1,184,675	2,894,675
2017-2021	5,106,000	5,001,116	10,107,116
2022-2025	5,020,000	3,756,789	8,776,789
2026-2030	5,415,000	2,338,445	7,753,445
2031-2035	2,760,000	959,853	3,719,853
<b>Totals</b>	<b>\$ 25,615,000</b>	<b>17,427,262</b>	<b>\$ 43,042,262</b>

At June 30, 2011, accrued interest payable on bonds amounted to \$520,155. Interest expense and interest paid on bonds amounted to \$1,083,352 and \$921,082, respectively, for the fiscal year ended June 30, 2011.

According to sections 103 and 148 to 150 of the U.S. Internal Revenue Code and sections 1.148 to 1.150 of the U.S. Treasury Regulation, the Municipality's the tax-exempt bonds are subject to the arbitrage rebate requirements. At June 30, 2011, the Municipality had no federal arbitrage liability on bonds since interest income earned from the investment of unspent bond proceeds were made in bank deposits that generate yields lower than the rates applicable to the debt service payments.

**c) Notes Payable to Municipal Revenue Collection Center**

The Municipality entered into a financing agreement of \$2,640,000 with the Municipal Revenue Collection Center (CRIM) through 2011. The notes are payable in monthly installments ranging from \$25,000 to \$28,000, at no interest. This notes have an imputed interest rate of 5.00 percent. The outstanding balance of the notes, net of the unamortized discount of \$0 at June 30, 2011. Amortization of the notes discount amounted to \$0 for the fiscal year ended June 30, 2011, which has been recorded as interest expense in the accompanying statement of activities. The principal maturities and the scheduled amortization of discount are as follows:

Fiscal year ending June 30,	Principal	Discount accretion	Total
2012	\$ -	-	\$ -
<b>Totals</b>	<b>\$ -</b>	<b>-</b>	<b>\$ -</b>

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**d) Notes Payable to U.S. Department of Housing and Urban Development**

The Municipality has a loan guarantee commitment of \$4,770,000 with the U.S. Department of Housing and Urban Development (HUD) pursuant to an application under Section 108 of the Housing and Community Development Act of 1974 (Section 108) for the construction of the Multiples Use Center of the Municipality, which was concluded during the current fiscal year. 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 30<sup>th</sup> of the 5<sup>th</sup> 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 3.82 percent to 6.67 percent. The proceeds and uses of the loan guarantee commitment are accounted for in the Section 108 loan guarantee fund, a capital projects fund. The loan guarantee commitment is repaid through financial resources transferred from the general fund to the Section 108 loan guarantee fund. Principal and interest on these notes are accounted for in the Section 108 loan guarantee fund, a non-major capital projects fund. At June 30, 2011, the outstanding principal balance of the loan guarantee commitment amounted to \$2,640,000. The loan guarantee commitment is subject to various positive, negative and restrictive covenants that the Municipality has complied with at June 30, 2011. The principal and interest maturities on the Section 108 loan guarantee commitment are as follows:

<b>Fiscal year ending June 30,</b>	<b>Principal</b>	<b>Interest</b>	<b>Total</b>
2012	\$ 325,000	144,262	\$ 469,262
2013	335,000	129,672	464,672
2014	240,000	84,304	324,304
2015	240,000	84,304	324,304
2016	175,000	55,749	230,749
2017-2021	857,000	248,827	1,105,827
2022-2025	468,000	77,492	545,492
<b>Totals</b>	<b>\$ 2,640,000</b>	<b>824,610</b>	<b>\$ 3,464,610</b>

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*e) Compensated Absences*

At June 30, 2011, the liability for compensated absences is composed as follows:

	<b>Due within one year</b>	<b>Due after one year</b>	<b>Total</b>
Vacations	\$ 579,948	1,046,437	\$ 1,626,385
Sick leave	752,247	1,418,605	2,170,852
Total	<u>\$ 1,332,195</u>	<u>2,465,042</u>	<u>\$ 3,797,237</u>

**12. 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 and administered by the Retirement Systems Administration of the Commonwealth of Puerto Rico. 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.

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- ***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.

- ***Non-occupational 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.

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- ***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.

***Non-occupational:***

**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.

- ***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.

- ***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 administered by the Retirement Systems Administration of the Commonwealth of Puerto Rico, 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.

**COMMONWEALTH OF PUERTO RICO**  
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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 state government of the Commonwealth of Puerto Rico 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.

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

The Senate and the House of Representatives of the Commonwealth of Puerto Rico have the authority for establishing or amending the contribution requirements of System 2000 by approving the necessary amendments or laws, subject to the final approval of the Governor of the Commonwealth of Puerto Rico.

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.

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Supplementation plan: 8.28 percent of gross salary. This is the only choice available to policemen, firemen and mayors

The contribution requirement to System 2000 is also established by law and is not actuarially determined. These contributions are as follows:

Municipality and other employers: 9.28 percent of applicable payroll

Employees: 5.78 percent of gross salary up to \$6,600 per year, plus 8.28 percent gross salary in excess of \$6,600.

During the fiscal years ended June 30, 2009, 2010 and 2011, the Municipality and the participating employees contributed 100 percent of the required contributions to ERS and System 2000. The combined actual contributions made by the Municipality and its participating employees to ERS and System 2000 (which equal the required contribution amounts) were as follows during the last three fiscal years:

<b>Fiscal year ended June 30,</b>	<b>Employer contributions</b>	<b>Employee contributions</b>
2009	\$ 578,902	\$ 515,381
2010	\$ 668,447	\$ 595,101
2011	\$ 740,895	\$ 658,677

The above actual employer contributions for the fiscal years ended June 30, 2009, 2010, and 2011 include the employer contributions to System 2000 amounting to \$274,287, \$112,026, and \$359,458, respectively. In addition, the above actual employee contributions for the fiscal years ended June 30, 2009, 2010, and 2011 include the employee contributions to System 2000 amounting to \$249,040, \$101,916 and \$316,062, respectively.

The authority under which obligations to contribute to ERS and System 2000 by the plans' members, employers and other contributing entities (i.e., state or municipal contributions) are established or may be amended by law by the House of Representatives, the Senate and the Governor of the Commonwealth of Puerto Rico.

Readers can obtain copies of the audited basic financial statements (GAAP basis) of ERS and System 2000 by writing to Mr. Juan Cancel, Executive Director of the Retirement Systems Administration of the Commonwealth of Puerto Rico (the entity that administers ERS and System 2000) at PO Box 42003, Minillas Station, Santurce, Puerto Rico 00940.

**COMMONWEALTH OF PUERTO RICO**  
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**13. Commitments and Contingencies**

The Municipality is defendant in various legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Public 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 Public 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 judgments.

With respect to pending and threatened litigation, the Municipality has not reported liabilities for awarded or anticipated unfavorable judgments as of June 30, 2011. 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 \$790,411 in the general fund at June 30, 2011. 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.

The Municipality receives financial assistance from the federal Governments of the United States of America and the Commonwealth in the form of grants and entitlements. Receipt of grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal laws and regulations, including the expenditure of resources for eligible purposes. Accordingly, expenditures financed by these programs are subject to financial and compliance audits by the appropriate grantor. Disallowance as a result of these audits may become liabilities of the Municipality. The *"Reports on Compliance and Internal Control in Accordance with Government Auditing Standards and the Requirements of OMB Circular A-133"* for the fiscal year ended June 30, 2010, disclosed various instances of noncompliance with applicable laws and regulations and with internal accounting and administrative controls. If expenditures are disallowed due to noncompliance with grant programs regulations, the Municipality may be required to reimburse the grantor the disallowed amounts. Management believes that the Municipality will be able to comply with the terms of corrective action plans that may be requested by the federal grantors, if any.

On October 4, 2007, the Office of Inspector General (OIG) of the U.S. Department of Housing and Urban Development (HUD) completed an audit of the Community Development Block Grant activities of the Municipality. OIG preliminarily concluded, subject to further discussion and review with the Municipality's management, that the Municipality's financial management system (the System) did not fully comply with the applicable requirements set forth by HUD since allegedly the System: (1) did not support the allow ability of more than \$885,000 in program disbursements, (2) could not account for more than \$501,000 in Block Grant receipts, (3) allowed the use of more than \$23,000 for ineligible program expenditures, and (4) did not disburse Block Grant program funds in a timely manner (cash management).

OIG also concluded that the Municipality's management controls over its housing rehabilitation activities were inadequate since allegedly the Municipality used Block Grant funds for new housing construction and lacked adequate documentation to support program accomplishments. Therefore,

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OIG concluded that the related program expenditures of more than \$36,000 are ineligible, and more than \$324,000 are considered by OIG as unsupported pending to an eligibility determination by HUD.

Furthermore, OIG concluded that the Municipality awarded six contracts totaling more than \$1 million without following all HUD procurement requirements and did not support the reasonableness of more than \$109,000 in Block Grant disbursements and paid more than \$70,000 for excessive expenditures.

OIG recommended that the Director of the San Juan Office of Community Planning and Development require the Municipality to repay more than \$59,000 in ineligible expenditures and \$70,374 in excessive costs. OIG has also recommended that the Municipality must provide all supporting documentation showing the appropriateness and eligibility of more than \$1.82 million in Block Grant disbursements. In addition, OIG has recommended that the Municipality must develop and implement an internal control plan to ensure that the Block Grant Program has: (1) a financial management system that complies with HUD requirements, (2) controls and procedures which ensure that the housing rehabilitation activities meet the program objectives, and (3) procurement procedures which ensure that goods and services are obtained at the most advantageous terms and in a manner providing full and open competition. Finally, OIG recommended that the Municipality must ensure that Block Grant expenditures are properly accounted for, reconciled with HUD's disbursement system, and in compliance with HUD requirements.

As of the issuance date of this Comprehensive Annual Financial Report, OIG's findings, conclusions and recommendations do not necessarily contain final conclusions and are subject to revision based on discussions and further documentation to be provided to OIG by the Municipality's management. Currently, the management of the Municipality is in the process of reviewing the findings, conclusions and recommendations of OIG and anticipates that many of the aforementioned findings will be cleared and will not prevail in the final audit report to be issued by OIG. In addition, the final findings and recommendations arising from this audit are subject to a final determination to be made by HUD.

As a conservative approach, the accompanying basic financial statements include, as part of its long-term obligations, a reserve of \$182,210 for federal cost disallowances to cover any disallowed costs arising from the final determination of HUD over OIG's final audit report. Management believes that any unfavorable outcome in relation to any possible disallowed costs would not be significant, if any.

#### **14. Liquidity and Cash Flows**

During the last five fiscal years, the Municipality's general fund has reported recurring excesses of expenditures over revenues, which have led to significant liquidity and cash flows shortfalls during those fiscal years. Management of the Municipality is currently evaluating different alternatives for the permanent financing of the Municipality's operations, principally to increase its revenue sources and implementing continuous cost reductions policies.

#### **15. Sales and Use Tax System**

On July 1, 2006, the Legislature of the Commonwealth of Puerto Rico approved Law No. 117, known as *Tax Justice Law of Puerto Rico* (Law No. 117). Law No. 117 established a seven percent (7%) sales and use tax to substantially all products and services sold in Puerto Rico, of which 5.5%

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represents a state tax and 1.5% represents a municipal tax pertaining to the Municipality. The state tax was effective for substantially all products and services sold starting November 15, 2006. The municipal tax became effective on April 2007 after the approval of the Municipal Legislature. Municipal sales and use tax revenues recorded in the general fund amounted to \$2,716,031 for the fiscal year ended June 30, 2011. In addition, at June 30, 2010, the municipal sales and use taxes receivable amounted to \$223,353.

On July 29, 2007, the Legislature of the Commonwealth of Puerto Rico approved Law No. 80 (Law No. 80) to amend the provisions of Law No. 117. The amendments made obligatory the implementation of a uniform sales and use tax of 1.5% in all municipalities of Puerto Rico that as of June 30, 2007 had not approved such kind of tax. The total tax rate of 1.5% is divided as 1.00% to be collected by each municipality and 0.5% is collected by the Puerto Rico Treasury Department.

The 0.5% referred to above is being administered by the Government Development Bank for Puerto Rico for the following purposes: (1) 0.2% is deposited in the new "Municipal Debt Service Fund", strictly for granting loans to the municipalities of Puerto Rico, (2) 0.2% for the creation of the "Municipal Development Fund" % to be distributed among all municipalities pursuant to a formula established by Law No. 80, and (3) 0.1% for the creation of the "Permanent Improvements Fund", to be distributed by the Legislature of the Commonwealth of Puerto Rico to carry out public works and permanent improvement projects.

**16. Fund Balances**

As of June 30 2011, fund balance is comprised of the following:

	General fund	Capital improvements bond fund	Debt service fund	Other governmental funds	Total
<i>Restricted for:</i>					
Federal and state funded programs	\$ -	-	-	101,120	\$ 101,120
Reserved for advances	-	-	-	66,818	66,818
Debt service	-	-	5,190,642	-	5,190,642
Capital projects	-	8,732,285	-	8,397	8,740,682
Urban and economic development	-	-	-	-	-
Public safety	-	-	-	-	-
Public housing and welfare	-	-	-	-	-
Culture, recreation and education	-	-	-	-	-
<i>Assigned for:</i>					
Advance from other funds	790,411	-	-	-	790,411
<i>Encumbrances:</i>					
General government	-	-	-	-	-
Urban and economic development	-	-	-	-	-
Health and sanitation	-	-	-	-	-
Public safety	-	-	-	-	-
Public housing and welfare	-	-	-	-	-
Culture, recreation and education	-	-	-	-	-
<i>Unassigned</i>	(896,143)	-	-	(66,818)	(962,961)
<b>Total fund balances</b>	<b>\$ (105,732)</b>	<b>8,732,285</b>	<b>5,190,642</b>	<b>109,517</b>	<b>\$13,926,712</b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

**YEAR ENDED JUNE 30, 2011**

	<u>CFDA Number</u>	<u>Grantor's Number</u>	<u>Expenditures</u>
<b>US Department of Housing and Urban Development</b>			
Section 8 Housing Voucher	14.871	RQ-46V-07501	\$ 186,798
Housing opportunities for person with AIDS (HOPWA)	14.241	N/A	18,176
Community Development Block Grant Entitlement Grants	14.218	B-09-MC-72-0018	2,373,451
Community Development Block Grant Section 108 Loan Guarantee	14.248	B-99-MC-72-0018	383,206
Homelessness Prevention And Rapid Rehousing Program (ARRA Funded)	14.257	B-09-MC-72-0019	<u>104,772</u>
<i>Total US Department of Housing and Urban Development</i>			<u>3,066,404</u>
<b>US Department of Health And Human Services</b>			
Pass-through of the Department of Family - Child Care and Development Block Grant	93.575	241-2010-000116	543,878
Pass-through of the Department of Family - ARRACHild Care and Development Block Grant	93.713	241-2010-000276	<u>40,719</u>
<i>Total US Department of Health And Human Services</i>			<u>584,597</u>

The accompanying notes are an integral part of this schedule

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

**YEAR ENDED JUNE 30, 2011**

	<b>CFDA Number</b>	<b>Grantor's Number</b>	<b>Expenditures</b>
<b>US Department of Agriculture</b>			
Pass-through of the Puerto Rico Department of Education - Child and Adult Care Food Program - PACNA	10.558	CCC-227	13,942
Pass-through of the Puerto Rico Elderly Commission - Food Distribution-Child and Adult Care Food Program	10.558	N/A	96,868
<i>Total US Department of Agriculture</i>			110,810
<b>US Department of Energy</b>			
Energy Efficiency and Conservation Grant	81.128	DE-EE0002392	154,718
<i>Total US Department of Energy</i>			154,718
<b>Total Federal Assistance</b>			<b>\$ 3,916,528</b>

The accompanying notes are an integral part of this schedule

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

**YEAR ENDED JUNE 30, 2011**

**1. GENERAL**

The accompanying Schedule of Expenditures of Federal Awards presents the federal grant activity of the Municipality of Canóvanas of the Commonwealth of Puerto Rico. The Municipality of Canóvanas reporting entity is defined in Note 1 to the Municipality's basic financial statements.

**2. BASIS OF ACCOUNTING**

The accompanying Schedule of Expenditures of Federal Awards presents the federal grant activity of Municipality of Canóvanas and is presented on the modified accrual basis of accounting. The basis of accounting is the same used to prepare the fund financial statements. The information of this schedule is presented in accordance with the requirements of the OMB Circular A-133, Audit of State, Local Governments, and Non-profit Organizations. Therefore, some amounts presented in this schedule may differ from amounts presented in or used in the preparations of the basic financial statements.

**3. FEDERAL CFDA NUMBER**

The CFDA number included in this schedule are determined based on the program name, review of grant contract information and the Office of Management and Budget's Catalogue of Federal Assistance.

**4. RELATIONSHIP TO THE BASIC FINANCIAL STATEMENTS**

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

Expenditures in the basic financial statements:

Nonmajor governmental funds	\$ 5,494,992
Less: Nonfederal expenditures	<u>(1,578,464)</u>
Total expenditures in the Schedule of Federal Awards	<u>\$ 3,916,528</u>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

**YEAR ENDED JUNE 30, 2011**

**5. 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, 2010, amounted to \$2,640,000.

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

The Honorable Mayor, Members of the  
Municipal Legislature and People of  
the Municipality of Canóvanas  
Canóvanas, Puerto Rico

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Canóvanas of the Commonwealth of Puerto Rico (the "Municipality"), as of and for the year ended June 30, 2011, which collectively comprise the Municipality's basic financial statements and have issued our report thereon dated December 19, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Municipality's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Municipality's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Municipality's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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

**Compliance and Other Matters**

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

This report is intended solely for the information and use of management of the Municipality of Canóvanas and others within the entity, and federal and state awarding agencies and pass-through entities, and is not intended to be and should not be used by anyone other than these specified parties.

*Gonzalez Torres & Co., CPA, PSC*  
GONZALEZ TORRES & CO., CPA PSC

San Juan, Puerto Rico  
February 13, 2012

Stamp No. 2632027 of the Puerto Rico  
Society of Certified Public Accountants  
was affixed to the record copy of this report.



# **GT** GONZÁLEZ TORRES & Co. CSP

Certified Public Accountants and Consultants

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

The Honorable Mayor, Members of the  
Municipal Legislature and People of  
the Municipality of Canóvanas  
Canóvanas, Puerto Rico

### **Compliance**

We have audited the Municipality of Canóvanas of the Commonwealth of Puerto Rico' (the "Municipality")'s compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Municipality's major federal programs for the year ended June 30, 2011. The 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 the Municipality's management. Our responsibility is to express an opinion on the 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 the 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 the Municipality's compliance with those requirements.

In our opinion, the Municipality complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2011. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items 11-01 and 11-02.

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

**Internal Control Over Compliance**

Management of the Municipality 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 the requirements that could have a direct and material effect on a major federal program to determine the auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Municipality's internal control over compliance.

*A deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies as described in the accompanying schedule of findings and questioned costs as items 11-01 and 11-02. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

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

The Municipality's responses to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit the Municipality's responses and, accordingly, we express no opinion on the responses.

This report is intended for the information of the management 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.

*Leonilda Acuña*  
GONZALEZ TORRES & CO., CPA PSC

San Juan, Puerto Rico  
February 13, 2012

Stamp No. 2632028 of the Puerto Rico  
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was affixed to the record copy of this report.



**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS**

**YEAR ENDED JUNE 30, 2011**

**Section I - Summary of Auditors' Results**

**Financial Statements**

Type of auditors' report issued:

**Unqualified**

Internal control over financial reporting:

Material weakness identified? Yes \_\_\_ No X

Significant deficiencies identified not considered to be material weaknesses? Yes \_\_\_ No X

Noncompliance material to financial statements noted? Yes \_\_\_ No X

**Federal awards**

Internal Control over major programs:

Material weakness identified? Yes \_\_\_ No X

Significant deficiencies identified not considered to be material weaknesses? Yes X No \_\_\_

Type of auditors' report issued on compliance for major programs:

**Unqualified**

Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)? Yes X No \_\_\_

**Identification of major program**

<u>CFDA Number</u>	<u>Name of Federal Program or Cluster</u>
14.218	Community Development Block Grant – Entitlements Grants (State Administered Small Cities Program)
14.248	Community Development Block Grant, Section 8 Loan Guarantee

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2011

14.257 Homelessness Prevention and Rapid Rehousing Program  
(ARRA Funds)

93.575 Pass-through of the Department of Family – Child Care  
Development Block Grant

Dollar threshold used to distinguish between Type A and  
Type B programs

\$300,000\*

Auditee qualified as low-risk auditee? Yes \_\_\_ No X

Waive risk criteria under 520 (i) of Circular A-133? Yes \_\_\_ No X

\*Or less amount when ARRA funds were disbursed.

**Section II – Financial Statements Findings**

NONE

**Section III – Federal Award Findings and Questioned Costs**

**FINDING NO. 11-01**

**Federal program:**

CFDA 14.871 SECTION 8 HOUSING CHOICE VOUCHERS

**Category**

Compliance / Internal control

**Compliance requirements**

Eligibility

**Condition found**

As part of our audit we perform an eligibility test for the Section 8 Program that consisted in 30 participants, we found the following:

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)**

**YEAR ENDED JUNE 30, 2011**

The Municipality has established procedures to comply with eligibility requirements. However, in our sample selected to test the compliance with eligibility requirements, we found some instances where the Municipality was not in compliance with such procedures. We found the followings exceptions:

- In two (2) files we did not found the annual inspection for the current year
- In two (2) files we did not found the current utilities invoice
- In three (3) files we did not found the current students certifications
- In four (4) files we did not found the photographs of the family
- In seven (7) files we did not found the letters of personal recommendation

**Criteria**

According to A-133 Compliance Supplement, the PHA must do the following:

- a. As a condition of admission or continued occupancy, require the tenant and other family members to provide necessary information, documentation, and releases for the PHA to verify income eligibility (24 CFR sections 5.230, 5.609, and 982.516).
- b. For both family income examinations and reexaminations, obtain and document in the family file third-party verification of: (1) reported family annual income; (2) the value of assets; (3) expenses related to deductions from annual income; and (4) other factors that affect the determination of adjusted income or income-based rent (24 CFR section 982.516).
- c. Determine income eligibility and calculate the tenant's rent payment using the documentation from third-party verification in accordance with 24 CFR part 5 subpart F (24 CFR section 5.601 *et seq.*) (24 CFR sections 982.201, 982.515, and 982.516).
- d. Select tenants from the HCVP waiting list (see III.N.1, "Special Tests and Provisions – Selection from the Waiting List") (24 CFR sections 982.202 through 982.207).
- e. Reexamine family income and composition at least once every 12 months and adjust the tenant rent and housing assistance payment as necessary using the documentation from third-party verification (24 CFR section 982.516).

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)**

**YEAR ENDED JUNE 30, 2011**

**Effect**

The conditions, if not corrected, could result in material noncompliance with laws and regulations of the Program Requirements.

**Questioned costs**

Undetermined

**Recommendations**

The Municipality should develop a direct supervision and monitoring procedures to assure the compliance with Program requirements.

**Management Response**

We agreed with the findings. We will establish review process and direct supervision to assure that all procedures and documents are completed as established by policies and procedures. As part of these corrective actions, we will create a checklist to verify the information or documents needed to be on file before signing the contract.

**FINDING NO. 11-02**

**Federal programs:**

CFDA 14.218

**COMMUNITY DEVELOPMENT BLOCK  
GRANTS/ENTITLEMENT GRANTS**

CFDA 14.257

**HOMELESSNESS PREVENTION AND RAPID RE-HOUSING  
PROGRAM (HPRP) (RECOVERY ACT FUNDED)**

**Category**

Compliance / Internal control

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)**

**YEAR ENDED JUNE 30, 2011**

**Compliance requirements**

Eligibility

**Condition found**

As part of our audit we perform an eligibility test for the CDBG Program that consisted in 25 participants to each one of the federal program identified. The Municipality's administration have established procedures to assure compliance with eligibility, however, we detected instances of noncompliance with requirements to assure that compliance are documented, we found the following:

- In two (2) files we did not found the property deed
- In one (1) file we did not found the Social Security
- In fourteen (14) files we did not found the birth certificate

**Criteria**

According to A-133 Compliance Supplement for some Federal programs with a large number of people receiving benefits, the non-Federal entity may use a computer system for processing individual eligibility determinations and delivery of benefits. Often these computer systems are complex and will be separate from the non-Federal entity's regular financial accounting system. Typical functions a computer system for eligibility may perform are:

- Perform calculations to assist in determining who is eligible and the amount of benefits
- Pay benefits (e.g., write checks)
- Maintain eligibility records, including information about each individual and benefits paid to or on behalf of the individual (regular payments, refunds, and adjustments)
- Track the period of time during which an individual is eligible to receive benefits, i.e., from the beginning date of eligibility through the date when those benefits stop, generally at the end of a predetermined period, unless there is a redetermination of eligibility
- Perform matches with other computer databases to verify eligibility (e.g., matches to verify earnings or identify individuals who are deceased)

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

**YEAR ENDED JUNE 30, 2011**

- Control who is authorized to approve benefits for eligibles (e.g., an employee may be approving benefits on-line and this process may be controlled by passwords or other access controls)
- Produce exception reports indicating likely errors that need follow-up (e.g., when benefits exceed a certain amount, would not be appropriate for a particular classification of individuals, or are paid more frequently than normal)

**Effect**

This condition, if not corrected, could result in material noncompliance with laws and regulations of the Program

**Questioned costs**

Undetermined

**Recommendations**

The Municipality should carefully review the compliance and documentation with these requirements.

**Management Response**

We agreed with the findings. We will establish review process and direct supervision to assure that all procedures and documents are completed as established by policies and procedures. As part of these corrective actions, we will create a checklist to verify the information or documents needed to be on file before signing the contract.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS AND QUESTIONED  
COSTS**

**YEAR ENDED JUNE 30, 2011**

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 Performed in Accordance with Government Auditing Standards for the Fiscal Year ended June 30, 2010. 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 2010-2011)

NR – Not Resolved Yet. (Finding repeated in fiscal year 2010-2011)\

<b>Original Finding Number</b>	<b>Current Status of Prior Year Audit Financial Statement Findings Part II Findings. (As required by Government Auditing Standards)</b>	<b>Corrective Action Taken</b>
10-01	Deficiencies in the Uniform Accounting System and Other Accounting Records	FR
10-02	Depositing of Cash Receipts in Bank Accounts	FR
10-03	Inactive and Unnecessary Funds and Inactive Bank Accounts	FR
10-04	Deficiencies in Accounting Records of Capital Assets	FR
10-05	Operating Deficit of the General Fund	FR
10-06	Unauthorized use of Next Fiscal Year's Municipal License Revenue	FR
10-07	Payroll and Related Liabilities Procedures	FR

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS**

**SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS AND QUESTIONED  
COSTS (CONTINUED)**

**YEAR ENDED JUNE 30, 2011**

The following schedule contains the finding number, CFDA 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, 2010. 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 2010-2011)

NR – Not Resolved Yet. (Finding repeated in fiscal year 2010-2011)\

<b>Original Finding Number</b>	<b>CFDA No.</b>	<b>Current Status of Prior Year Audit Federal Award Findings Part III Findings. (As required by OMB Circular A-133)</b>	<b>Action</b>
10-08	14.218, 93.575	Federal Financial Reports	FR
10-10	14.218	Davis Bacon Act	FR
10-11	14.218	Earmarking Requirement	FR
10-12	14.218	Procurement, Suspension and Debarment	FR
10-13	14.218	Equipment and Real Property Management	FR
10-14	14.218	Federal Cash Management System	FR
10-15	14.218	Federal Cash Management System	FR
10-16	14.218	Federal Cash Management System	FR
10-17	14.218	Timeliness – Contract Provision	FR
10-18	14.218	Inadequate Documentation of Participant Files (Moderate Housing Rehabilitation Program)	PR
10-19	14.218	Financial Reporting	FR

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF CANÓVANAS

SUMMARY SCHEDULE OF PRIOR YEAR AUDIT FINDINGS AND QUESTIONED  
COSTS (CONTINUED)

YEAR ENDED JUNE 30, 2011

<b>Original Finding Number</b>	<b>CFDA No.</b>	<b>Current Status of Prior Year Audit Federal Award Findings Part III Findings. (As required by OMB Circular A-133)</b>	<b>Action</b>
10-20	14.218	Financial Reporting	FR
10-21	93.575	Period of Availability of Federal Funds	FR
10-22	93.575	Equipment and Real Property Management	FR
10-23	93.713	Financial Reporting	FR
10-24	93.575	Financial Reporting	FR
10-25	93.575	Financial Reporting	FR
10-26	93.575	Financial Reporting	FR
10-27	93.575	Financial Reporting	FR