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AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL

AREA DE ARCHIVO DIGITAL

MUNICIPIO DE CATAÑO

AUDITORIA 2004-2005

30 DE JUNIO DE 2005

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DE ASUNTOS MUNICIPALES

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO**

SINGLE AUDIT REPORT

Fiscal Year Ended

June 30, 2005

**BASIC FINANCIAL STATEMENTS AND
SUPPLEMENTAL SCHEDULE**

With Independent Auditors' Report Thereon

June 30, 2005

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
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Management's Discussion and Analysis
Fiscal Year Ended June 30, 2005



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

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

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

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

On July 1, 2004, the Municipality recorded various significant prior-period adjustments to account for certain unrecorded accounts receivable, accounts payable, accrued liabilities, deferred revenues, inter-fund balances, long-term obligations, and other assets not previously reported in the basic financial statements issued for the fiscal year ended June 30, 2004. The Municipality's basic financial statements for the fiscal year ended June 30, 2004 have not been reissued to account for the aforementioned prior-period adjustments; therefore, the accompanying financial statements are not comparable to the basic financial statements previously issued for the fiscal year ended June 30, 2004.

In accordance with Government Auditing Standards we have also issued our report dated December 19, 2005, on our consideration of the Municipality of Cataño of the Commonwealth of Puerto Rico internal control over financial reporting and on our test of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

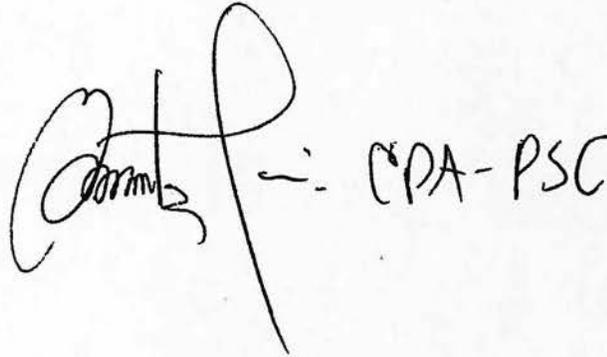
The accompanying Management's Discussion and Analysis and the Budgetary Comparison Schedule are not required parts of the basic financial statements referred to above, but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied

certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Municipality's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States and Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements of the Municipality. The schedule of expenditures and federal awards have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

December 19, 2005
Toa Alta, Puerto Rico

Stamp No. 2023458
affixed to the original
report.

A handwritten signature in black ink, followed by the text "CPA-PSC" written in a similar style.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Management's Discussion and Analysis
Fiscal Year Ended June 30, 2005

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

FINANCIAL HIGHLIGHTS

Government-Wide Highlights:

- The Municipality's assets amounted to \$166,379,616 at June 30, 2005, of which \$88,616,065 (53%) consist of capital assets (net of accumulated depreciation and amortization of \$23,079,448), \$66,940,270 (40%) consist of cash and cash equivalents (of which \$52,665,907 are restricted for specific purposes), \$7,848,373 (5%) consist of accounts receivable (net of reserve for doubtful accounts of \$33,185,276), and \$2,440,000 (2%) consist of other assets.
- The Municipality's liabilities amounted to \$94,513,730 at June 30, 2005, of which \$64,705,418 (68%) consist of bonds and notes payable, \$10,472,006 (11%) consist of accounts payable and accrued liabilities, \$5,536,985 (6%) consist of accrued compensated absences, \$10,877,752 (12%) consist of other assets, \$2,618,408 (3%) consist of accrued legal claims and judgments, and \$303,161 consist of obligations under capital leases.
- The Municipality's assets exceeded its liabilities (net assets/surplus) by \$71,865,886 at June 30, 2005.
- The Municipality's revenues amounted to \$41,722,166 for the fiscal year ended June 30, 2005, of which \$31,834,581 (76%) arose from taxes, 4,122,469 (10%) arose from intergovernmental grants and contributions, \$2,328,159 (6%) arose from interests on deposits, and \$3,436,957 (8%) arose from charges from services, miscellaneous revenues and special items.
- The Municipality's expenses amounted to \$55,725,165 for the fiscal year ended June 30, 2005, of which \$35,755,130 (64%) were incurred in providing direct services and benefits to citizens in relation to urban and economic development, health and sanitation, public safety, public housing and welfare, culture, recreation and education. In addition, the Municipality incurred in \$3,235,842 (6%) of its total expenses, in interests related to its long-term obligations, and \$16,734,193 (30%) in general government activities to support the Municipality's functions and programs. The Municipality's expenses include depreciation and amortization of capital assets in the amount of \$3,777,789 for the fiscal year ended June 30, 2005.
- The Municipality's net assets decreased by \$14,002,999 during the fiscal year ended June 30, 2005.

Governmental Funds' Highlights:

- The total fund balances of governmental funds amounted to \$49,952,435 at June 30, 2005, of which \$46,766,011 (93%) are reserved for capital projects, debt service, encumbrances and other specific purposes, while \$3,186,424 (7%) remained unreserved and available for unrestricted uses.

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- The fund balances of governmental funds decreased by \$10,097,120 during the fiscal year ended June 30, 2005.

OVERVIEW OF THE BASIC FINANCIAL STATEMENTS

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

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

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

a) Government-wide Financial Statements

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

1. Statement of Net Assets

The purpose of SNA is to attempt to report all assets owned and all liabilities owed by the Municipality. The Municipality reports of all of its assets when it acquires ownership over the assets and reports all of its liabilities when they are incurred. For example, the Municipality reports buildings and infrastructure as assets, even though they are not available to pay the obligations incurred by the Municipality. On the other hand, the Municipality reports liabilities, such as claims and judgments, bonds and notes payable, obligations under capital leases, compensated absences and certain accounts payable and accrued liabilities, 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, 2005, by presenting all of the Municipality's revenues and expenses. As previously discussed, the items reported in SA are measured in a manner similar to the approach used by a commercial enterprise in that revenues are recognized when earned or established criteria are satisfied, and expenses are recorded when incurred by the Municipality. Consequently, revenues are reported even when they may not be collected for several months after the end of the fiscal year and expenses are recorded even though they may not have used cash during the current year.

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

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

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

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

b) Governmental Fund Financial Statements

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

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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) special revenue funds, (4) capital projects funds and (5) permanent 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 four 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 four major governmental funds are: (1) general fund, (2) debt service fund, (3) bond issuance fund, and (4) works and permanent improvements 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) budgetary comparison schedule – general fund and (2) budgetary comparison schedule - debt service fund.

FINANCIAL ANALYSIS OF GOVERNMENT-WIDE FINANCIAL STATEMENTS

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

Condensed Statement of Net Assets
Governmental Activities
June 30, 2005

Assets:	
Current assets	\$ 75,043,807
Non-current assets:	
Capital assets, net	88,616,065
Other non-current assets	2,719,744
Total assets	\$ 166,379,616
 Liabilities:	
Current liabilities, excluding long-term obligations	21,349,758
Long-term obligations:	
Due within one year	9,448,114
Due after one year	63,715,858
Total liabilities	94,513,730
 Net assets (deficit):	
Invested in capital assets, net of related debt	\$ 61,171,541
Restricted	16,276,748
Unrestricted	(5,582,403)
Total net assets	\$ 71,865,886

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At June 30, 2005, the Municipality's current assets, amounting to \$75,043,807, are mainly composed of restricted cash and cash equivalents (\$66,940,270), property taxes receivable, net of reserve for doubtful accounts (\$6,548,728), and other receivables (\$1,299,645).

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

The Municipality's non-current assets, amounting to \$91,335,809 at June 30, 2005, are substantially composed of capital assets, with a cost basis of \$111,695,113, which are reported net of accumulated depreciation and amortization of \$23,079,448.

At June 30, 2005, the Municipality's current liabilities amounting to \$30,797,872 are mainly composed of unearned revenues (\$10,877,752), accounts payable and accrued liabilities (\$10,472,006), and the portions due within one year of compensated absences (\$3,502,280), bonds and notes payable (\$3,205,599) and legal claims and judgments (\$2,618,408). Unearned revenues principally consist of unearned revenues associated with municipal license taxes and intergovernmental grants and contributions related to state and federally funded grant programs.

The Municipality's non-current liabilities, amounting to \$63,715,858 at June 30, 2005, are mainly composed of portions due after one year of bonds and notes payable (\$61,499,819) and compensated absences (\$2,034,705).

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial position. The assets of the Municipality exceeded liabilities by \$71,865,886 at June 30, 2005. The most significant portion of net assets (\$61,171,541) reflects the Municipality's investment in capital assets (e.g. land, buildings, machinery, equipment, furniture, fixtures, infrastructure, etc.), net of all related debt still outstanding that was issued to acquire, construct or improve those assets. The Municipality uses these capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although the Municipality's investment in capital assets is reported net of the outstanding related debt, the resources needed to repay that debt must be provided by other sources, since capital assets cannot be used to liquidate these liabilities.

Another significant portion of net assets (\$15,849,100) at June 30, 2005, represents resources that are restricted for debt service payments.

The remaining component of total net assets consists of unrestricted net liabilities amounting to (\$5,582,403) at June 30, 2005. These unrestricted net liabilities are the consequence of previous budgets that did not provide sufficient funding for incurred long-term obligations, such as bonds and notes payable, compensated absences, claims and judgments, certain obligations under capital leases, etc. Historically, a significant portion of such obligations has been budgeted on a pay-as-you-go basis.

The total net assets of the Municipality decreased by \$14,002,999 for the fiscal year ended June 30, 2005. Such increase is due to the excess of total expenses (\$55,725,165, including depreciation and amortization of capital assets of \$3,777,789) over revenues (\$41,722,166) for the fiscal year ended June 30, 2005.

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Fiscal Year Ended June 30, 2005

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

Condensed Statement of Activities
Governmental Activities
Fiscal Year Ended June 30, 2005

Program revenues:	
Program-specific operating grants and contributions	\$ 1,613,562
Program-specific capital grants and contributions	601,176
Charges for services	1,030,129
Total program revenues	<u>\$ 3,244,867</u>
General revenues:	
Property taxes	20,407,227
Municipal license taxes	10,364,582
Construction excise taxes	1,062,772
Unrestricted grants and contributions	1,907,731
Other general revenues (various sources)	3,936,290
Total general revenues	<u>37,678,602</u>
Special item - legal judgment and settlement with	
Puerto Rico Electric Power Authority	<u>798,697</u>
Total revenues	<u>41,722,166</u>
Program expenses:	
General government	16,734,193
Urban and economic development	13,090,120
Health and sanitation	7,060,797
Public safety	6,045,241
Public housing and welfare	5,838,640
Culture, recreation and education	3,720,332
Interest on long-term obligations	3,235,842
Total expenses	<u>55,725,165</u>
Net decrease in net assets	<u>(14,002,999)</u>
Net assets, at beginning of fiscal year	106,619,701
Prior-period adjustments	<u>(20,750,816)</u>
Net assets, at beginning of fiscal year, as restated	85,868,885
Net assets, at end of fiscal year	<u>\$ 92,616,702</u>

As previously mentioned, the Municipality's net assets decreased by \$14,002,999 (16%) during the current fiscal year. Approximately 76% (\$31,834,581) of the Municipality's total revenues for the current fiscal year came from property, municipal license and construction excise taxes, while 10% (\$4,122,469) resulted from restricted and unrestricted capital and operating grants and contributions. Charges for

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services and other revenues, amounting to \$5,765,116, provided 14% of the total revenues for the current fiscal year.

The Municipality's expenses cover a wide range of services. The largest expenses of the Municipality for the fiscal year ended June 30, 2005 were related to: (1) general administrating and operating costs (\$16,734,193), which were classified as "general government" and accounted for 30% of total expenses, (2) public housing and welfare (\$5,838,640), which accounted for 10% percent of total expenses, (3) health and sanitation (\$7,060,797), which accounted for 13% of total expenses, (4) urban and economic development (\$13,090,120), which accounted for 24% of total expenses, (5) public safety (\$6,045,241), which accounted for 11% of total expenses, (6) culture, recreation and education (\$3,720,332), which accounted for 6% of total expenses, and (7) interest on long-term obligations (\$3,235,842), which accounted for 5% of total expenses. These expenses include depreciation and amortization of capital assets and deferred charges in the amounts of \$3,777,789 and \$22,762, respectively, for the fiscal year ended June 30, 2005.

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, 2005, the total assets of governmental funds amounted to \$76,671,819, which consisted principally of: (1) cash and cash equivalents of \$66,940,270 (87%), (2) tax receivables, net of reserve for doubtful accounts, of \$6,548,728 (9%), and (3) intergovernmental, accrued interests and other receivables of \$3,182,821 (4%). Such assets include cash, cash equivalents and receivables in the amount of \$53,286,418 (69%) that are restricted for debt service, capital projects, encumbrances and other specific purposes.

At June 30, 2005, the total liabilities of governmental funds amounted to \$26,719,384, which consisted principally of: (1) deferred revenues of \$13,473,556 (50%), (2) accounts payable and accrued liabilities of \$7,377,175 (28%) and matured bonds and interests due and payable of \$3,985,477 (15%).

The total fund balances of governmental funds amounted to \$49,952,435 at June 30, 2005, of which \$46,766,011 (93%) are reserved for capital projects, debt service, encumbrances and other specific purposes, while \$3,186,424 (7%) remained unreserved and available for unrestricted uses. The fund balances of governmental funds decreased by \$10,097,120 during the fiscal year ended June 30, 2005.

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Fiscal Year Ended June 30, 2005

Condensed Balance Sheet - Governmental Funds
June 30, 2005

Assets:	
Total assets - major governmental funds	\$ 72,462,824
Total assets - other governmental funds	4,208,995
Combined total assets	\$ 76,671,819
Liabilities:	
Total liabilities - major governmental funds	24,289,677
Total liabilities - other governmental funds	2,429,707
Combined total liabilities	26,719,384
Fund balances:	
Reserved - major governmental funds	44,986,723
Reserved - other governmental funds	1,779,288
Unreserved - major governmental funds	3,186,424
Combined total fund balances	49,952,435
Total liabilities and fund balances	\$ 76,671,819

Major Governmental Funds

General fund (GF) – The GF is the principal operating fund of the Municipality. The GF's total assets amounted to \$22,516,391 at June 30, 2005. Such assets consist principally of: (1) unrestricted cash and cash equivalents (\$14,274,363), (2) property, municipal license and construction excise tax receivables (\$5,928,217), and (3) short-term and long-term amounts due from other funds (\$1,883,176).

The GF's total liabilities amounted to \$17,597,766 at June 30, 2005. Such liabilities are composed mainly of: (1) deferred revenues (\$12,227,708), and (2) accounts payable and accrued liabilities, including amounts due to other governments (\$5,370,058), which include a book overdraft of cash in the amount of \$3,414,616.

At the end of the current fiscal year, unreserved fund balance of the GF amounted to \$3,186,424, while total fund balance reached \$4,918,625. As a measure of the GF's liquidity it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance represents 7% of the total GF's expenditures, while total fund balance represents 11% of that same amount.

Debt service fund (DSF)- The DSF's total assets amounted to \$19,941,709 at June 30, 2005, which consist mainly of restricted cash in fiscal agent (\$19,283,625) and restricted property taxes receivable, net of reserve for doubtful accounts (\$620,511). The DSF's total liabilities amounted to \$17,597,766 at June 30, 2005, which are mainly composed of: (1) matured bonds due and payable (\$2,545,000), and (2) matured interest due and payable (\$1,440,477). At the end of the current fiscal year, DSF's total and reserved fund balance reached \$15,849,100.

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Bond issuance fund (BIF)- The BIF's total assets amounted to \$28,844,210 at June 30, 2005, which consist mainly of restricted cash in fiscal agent (\$28,768,893). The BIF's total liabilities amounted to \$1,438,788 at June 30, 2005, which are composed of: (1) amounts due to general fund (\$974,457), and (2) accounts payable and accrued liabilities (\$464,331). At the end of the current fiscal year, DSF's total and reserved fund balance reached \$27,405,422.

Works and permanent improvements fund (WPIF)- The WPIF's total assets amounted to \$1,160,514 at June 30, 2005, which consist of restricted cash in commercial banks (\$28,768,893). The WPIF's total liabilities amounted to \$1,160,514 at June 30, 2005, which are composed mainly of accounts payable and accrued liabilities (\$1,071,878). At the end of the current fiscal year, the WPIF had no total or reserved fund balances.

Other governmental funds (OGF)- The OGF's total assets amounted to \$4,208,995 at June 30, 2005, which consist mainly of restricted cash and cash equivalents (\$3,452,875) and receivables from intergovernmental grants and contributions (\$755,373). The OGF's total liabilities amounted to \$2,429,707 at June 30, 2005, which are mainly composed of deferred revenues (\$1,245,848) and short-term and long-term amounts due to other funds (\$712,951). At the end of the current fiscal year, OGF's total reserved fund balance reached \$1,779,288.

Analysis of Operating Results of Governmental Funds

Major Governmental Funds

General fund – The total fund balance of the GF decreased by \$10,444,889 (68%) during current fiscal year. Total revenues, expenditures, other financing sources (net) and special items amounted to \$35,080,484, \$46,808,171, \$484,101 and \$798,697, respectively, for the fiscal year ended June 30, 2005.

Approximately 83% (\$29,051,661) of the GF's total revenues for the current fiscal year came from property, municipal license and construction excise taxes, while 6% (\$1,949,045) resulted from intergovernmental grants and contributions. Interest revenues, charges for services and miscellaneous revenues, amounting to \$4,079,778, provided 11% of the total revenues for the current fiscal year.

The largest expenses of the GF for the fiscal year ended June 30, 2005 were related to: (1) general administrating and operating costs (\$14,336,142), which were classified as "general government" and accounted for 30% of total expenses, (2) public housing and welfare (\$4,917,863), which accounted for 11% percent of total expenses, (3) health and sanitation (\$5,397,871), which accounted for 12% of total expenses, (4) urban and economic development (\$12,515,230), which accounted for 27% of total expenses, (5) public safety (\$5,692,558), which accounted for 12% of total expenses, (6) culture, recreation and education (\$2,759,527), which accounted for 6% of total expenses, and (7) principal and interest on long-term obligations (\$930,733), which accounted for 2% of total expenses.

Debt service fund (DSF) – The total fund balance of the DSF decreased by \$1,799,018 (10%) during current fiscal year. Total revenues, expenditures and other financing uses (net) amounted to \$3,776,509, \$5,281,269 and \$294,258, respectively, for the fiscal year ended June 30, 2005.

Approximately 92% (\$3,464,263) of DSF's total revenues for the current fiscal year came from restricted property taxes. DSF's total expenditures for the current fiscal year came from principal and interests on bonds payable (\$5,281,269).

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Management's Discussion and Analysis
Fiscal Year Ended June 30, 2005

Bond issuance fund (BIF)- The total fund balance of the BIF increased by \$9,290,250 (51%) during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to \$550,354, \$2,879,750 and \$11,619,646, respectively, for the fiscal year ended June 30, 2005.

BIF's total revenues for the current fiscal year came from interests on deposits. BIF's total expenditures for the current fiscal year came from capital outlays, while other financing sources (net) arose principally from the issuance of two new bond series during fiscal year 2004-2005 (\$12,170,000).

Works and permanent improvements fund (WPIF)- The total fund balance of the WPIF decreased by \$4,239,210 (100%) during current fiscal year. Total expenditures and other financing sources (net) amounted to \$6,695,190 and \$2,455,980, respectively, for the fiscal year ended June 30, 2005.

WPIF's total expenditures for the current fiscal year came from capital outlays, while other financing sources (net) arose principally from transfers among funds.

Other governmental funds (OGF) – The total fund balance of the OGF decreased by \$2,904,253 (62%) during current fiscal year. Total revenues, expenditures and other financing uses (net) amounted to \$2,235,140, \$3,043,924 and \$2,095,469, respectively, for the fiscal year ended June 30, 2005. Approximately 99% (\$2,214,738) of OGF's total revenues for the current fiscal year came from intergovernmental grants.

BUDGETARY HIGHLIGHTS

a) General Fund

The original budget of the general fund for the fiscal year ended June 30, 2005 amounted to \$46,815,933. Over the course of the fiscal year, the Municipality revised the GF's budget in order to include increases and decreases in revenues that were identified during the course of the fiscal year based on current developments that positively affected the Municipality's finances. The laws and regulations of the Commonwealth mandate a balanced budget.

The total actual revenues (budgetary basis) of the general fund for the fiscal year ended June 30, 2005 were \$38,836,901, which is 17% (\$7,979,032) less than the budgeted revenues. In addition, the total actual expenditures (budgetary basis) of the general fund for the fiscal year ended June 30, 2005 were \$52,375,357, which is 12% (\$5,559,424) higher than the budgeted expenditures.

CAPITAL ASSETS AND DEBT ADMINISTRATION

a) Capital Assets

The Municipality has invested \$111,695,513 in capital assets used in governmental activities, which have an accumulated depreciation and amortization of \$23,079,448 at June 30, 2005. The net capital assets increased during the current fiscal year due to the current fiscal year's capital additions (\$10,658,806), which were partially offset by the depreciation and amortization expense (\$3,777,789) for the same period.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Management's Discussion and Analysis
Fiscal Year Ended June 30, 2005

Approximately 41% percent of the total capital additions made to capital assets during the fiscal year ended June 30, 2005 were related to construction in progress (\$4,404,556). Other capital additions for the fiscal year ended June 30, 2005 were the following:

Land improvements	\$ 575,072
Buildings, structures and improvements	1,398,726
Infrastructure	2,685,944
Machinery, equipment, furniture and fixtures	728,792
Licensed vehicles	854,702
Licensed vehicles	11,014
Other capital additions for the fiscal year ended June 30, 2005	\$ 6,254,250

b) Debt Administration

The Municipality finances a significant portion of its construction activities through bond and note issuances, and through state and federal grants. The proceeds from bond issuances designated for construction activities are committed in its entirety for such purposes and cannot be used for any other purposes.

At June 30, 2005, the Municipality's total bonded debt amounted to \$56,190,000, consisting of bonds payable. Such debt is backed by the full faith and credit of the Municipality. The following is a summary of the debt activity for the fiscal year ended June 30, 2005:

- Bonds payable increased by 24% (\$10,340,000) due to the issuance of two new bond series amounting to \$12,170,000, which increased the debt. However, such increase was partially reduced by the total principal payments on bonds (\$1,830,000) made during the current fiscal year. The proceeds of the two new bond issuances are being used to acquire machinery and equipment and to perform construction and major capital improvement activities within the Municipality.
- The Municipality has also certain outstanding notes payable due to CRIM (\$7,372,498) and the Federal Emergency Management Agency (\$1,142,920). Such notes payable decreased by \$283,219 during the current fiscal year mainly due to the principal payments made during the same period.

REQUEST FOR INFORMATION

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

**Basic Financial Statements,
Notes to Basic Financial Statements, Required Supplemental
Schedule
and Other Supplemental Information
Fiscal Year Ended June 30, 2005**

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

Assets		<u>Governmental activities</u>
Current assets:		
Cash in commercial banks, including cash equivalents of \$13,200,000		\$ 14,274,363
Accounts receivable, net of reserve for doubtful accounts of \$29,241,549:		
Taxes:		
Property taxes	\$ 2,989,583	
Municipal license taxes	1,167,403	
Construction excise taxes	1,771,231	
Accrued interest on deposits	152,263	
Intergovernmental grants and contributions	1,141,309	
Other	<u>6,073</u>	
Total accounts receivable		7,227,862
Inventories and other current assets		255,164
Restricted assets:		
Cash in commercial banks	\$ 3,658,231	
Cash in fiscal agent	48,107,676	
Cash equivalents in commercial banks	900,000	
Property tax receivable, net of reserve for doubtful accounts of \$3,943,727	<u>620,511</u>	
Total restricted assets		<u>53,286,418</u>
Total current assets		<u>75,043,807</u>
Non-current assets:		
Capital assets, at cost:		
Depreciable capital assets	\$98,749,070	
Non-depreciable capital assets	<u>12,946,443</u>	
Total capital assets, at cost	111,695,513	
Less: accumulated depreciation and amortization	<u>(23,079,448)</u>	
Total capital assets, net of accumulated depreciation and amortization		88,616,065
Deferred charges, net of accumulated amortization of \$168,253		279,744
Other assets - works of art not used in the operations of governmental funds		<u>2,440,000</u>
Total non-current assets		<u>91,335,809</u>
Total assets		<u>\$ 166,379,616</u>

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

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

Liabilities and net assets	Governmental activities
Current liabilities (due within one year):	
Accounts payable and accrued liabilities:	
Trade payables, including book overdraft of \$3,414,616	\$ 7,343,370
Intergovernmental payables	1,645,164
Accrued interests on bonds and notes payable	<u>1,483,472</u>
Total accounts payable and accrued liabilities	\$ 10,472,006
Unearned revenues	10,877,752
Current portion of long-term obligations:	
Bonds payable	\$ 2,545,000
Notes payable	660,599
Obligation under capital leases	121,827
Compensated absences	3,502,280
Claims and judgments	<u>2,618,408</u>
Total current portion of long-term obligations	<u>9,448,114</u>
Total current liabilities	<u>30,797,872</u>
Non-current liabilities, excluding current portion (due in more than one year) :	
Bonds payable	53,645,000
Notes payable	7,854,819
Obligation under capital leases	181,334
Compensated absences	<u>2,034,705</u>
Total non-current liabilities	<u>63,715,858</u>
Total liabilities	<u>94,513,730</u>
Net assets (liabilities):	
Invested in capital assets, net of related debt	<u>61,171,541</u>
Restricted for:	
Debt service	\$ 15,849,100
Capital projects	182,108
Other specified purposes	<u>245,540</u>
Total restricted net assets	<u>16,276,748</u>
Unrestricted net liabilities	<u>(5,582,403)</u>
Total net assets	<u>\$ 71,865,886</u>

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Statement of Activities
Fiscal Year Ended June 30, 2005

Functions/programs	Expenses, including depreciation expense of \$3,777,789	Program revenues		Net (expenses) and changes in net assets
		Charges for services	Program -- specific operating grants and contributions	
Governmental activities:				
General government	\$16,734,193	364,896	-	-(16,369,297)
Urban and economic development	13,090,120	-	32	-(13,090,088)
Health and sanitation	7,060,797	665,233	261,933	-(6,133,631)
Public safety	6,045,241	-	22,946	-(6,022,295)
Public housing and welfare	5,838,640	-	1,101,033	-(4,136,431)
Culture, recreation and education	3,720,332	-	227,618	-(3,492,714)
Interest on long-term obligations	3,235,842	-	-	-(3,235,842)
Total governmental activities	<u>\$55,725,165</u>	<u>1,030,129</u>	<u>1,613,562</u>	<u>-(52,480,298)</u>
General revenues:				
Taxes:				
Property taxes				\$ 20,407,227
Municipal license taxes				10,364,582
Construction excise taxes				1,062,772
Total tax revenues				<u>31,834,581</u>
Intergovernmental grants and contributions, not restricted to specific programs				1,907,731
Interest on deposits				2,328,159
Miscellaneous				1,608,131
Total general revenues				<u>37,678,602</u>
Special item - proceeds from legal judgment and settlement with Puerto Rico Electric Power Authority				<u>798,697</u>
Net change in net assets				<u>-(14,002,999)</u>
Net assets at beginning of fiscal year				106,619,701
Prior-period adjustments				(20,750,816)
Net assets at the beginning of fiscal year, as restated				<u>85,868,885</u>
Net assets at end of fiscal year				<u>\$ 71,865,886</u>

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

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

	<u>Major governmental funds</u>					<u>Total governmental funds</u>
	<u>General fund</u>	<u>Debt service fund</u>	<u>Bonds issuance fund</u>	<u>Works and permanent improvements fund</u>	<u>Other governmental funds</u>	
Assets						
Cash in commercial banks	\$ 1,074,363					\$ 1,074,363
Cash equivalents in commercial banks	13,200,000					13,200,000
Accounts receivable, net of reserve for doubtful accounts of \$29,241,549:						
Taxes:						
Property taxes	2,989,583					2,989,583
Municipal license taxes	1,167,403					1,167,403
Construction excise taxes	1,771,231					1,771,231
Accrued interest on deposits	38,626	37,573	75,317		747	152,263
Intergovernmental grants and contributions	385,936				755,373	1,141,309
Due from other funds	1,830,676					1,830,676
Advances from other funds	52,500					52,500
Other	6,073					6,073
Restricted assets:						
Cash in commercial banks				1,160,514	2,497,717	3,658,231
Cash in fiscal agent		19,283,625	28,768,893		55,158	48,107,676
Cash equivalents in commercial banks					900,000	900,000
Property taxes receivable, net of reserve for doubtful accounts of \$3,943,727						
		<u>620,511</u>				<u>620,511</u>
Total assets	<u>\$ 22,516,391</u>	<u>19,941,709</u>	<u>28,844,210</u>	<u>1,160,514</u>	<u>4,208,995</u>	<u>\$ 76,671,819</u>
Liabilities						
Accounts payable and accrued liabilities:						
Trade payables, including book overdraft of \$3,414,616	\$ 4,808,118		464,331	1,071,878	470,908	\$ 6,815,235
Intergovernmental payables	561,940					561,940
Due to other governmental funds		107,132	974,457	88,636	660,451	1,830,676
Advances to other funds					52,500	52,500
Deferred revenues:						
Unearned revenues	9,643,735				1,234,017	10,877,752
Earned but unavailable revenues	2,583,973				11,831	2,595,804
Matured bonds due and payable		2,545,000				2,545,000
Matured interest due and payable		1,440,477				1,440,477
Total liabilities	<u>17,597,766</u>	<u>4,092,609</u>	<u>1,438,788</u>	<u>1,160,514</u>	<u>2,429,707</u>	<u>26,719,384</u>
Fund balances						
Reserved for:						
Encumbrances	1,679,701					1,679,701
Debt service		15,849,100				15,849,100
Capital projects			27,405,422		1,545,580	28,951,002
Advances among funds	52,500					52,500
Other specified purposes					233,708	233,708
Unreserved	<u>3,186,424</u>					<u>3,186,424</u>
Total fund balances	<u>4,918,625</u>	<u>15,849,100</u>	<u>27,405,422</u>	<u>1,779,288</u>		<u>49,952,435</u>
Total liabilities and fund balances	<u>\$ 22,516,391</u>	<u>19,941,709</u>	<u>28,844,210</u>	<u>1,160,514</u>	<u>4,208,995</u>	<u>\$ 76,671,819</u>

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

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

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

Total fund balances reported in the balance sheet – governmental funds	\$49,952,435
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.	255,164
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 \$19,524,344 at June 30, 2005.	88,616,065
Other assets (consisting of works of art) not 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 those assets at June 30, 2005.	2,440,000
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, 2005 (municipal licenses, intergovernmental grants and contributions and charges for services).	2,595,804
Debt issued by the Municipality has associated costs (debt issuance 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 \$168,253.	279,744
The following liabilities are not due (mature) in the current fiscal year, therefore, are not reported in the governmental funds at June 30, 2005:	
Bonds payable	(53,645,000)
Notes payable	(8,515,418)
Obligation under capital leases	(303,161)
Compensated absences	(5,536,985)
Claims and judgments	(2,415,408)
Accounts payable and accrued liabilities, including amounts due to other governments	(1,857,354)
Net assets – governmental activities, as reported in the statement of net assets	\$71,865,886

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

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

	Major governmental funds					Total governmental funds
	General fund	Debt service fund	Bond issuance fund	Works and permanent improvements fund	Other governmental funds	
Revenues:						
Taxes:						
Property taxes	\$ 17,826,151	3,464,263				\$ 21,290,414
Municipal license taxes	10,314,833					10,314,833
Construction excise taxes	910,677					910,677
Total tax revenues	<u>29,051,661</u>	<u>3,464,263</u>				<u>32,515,924</u>
Intergovernmental grants and contributions	1,949,045				2,214,738	4,163,783
Interest on deposits	1,447,789	312,246	550,354		17,770	2,328,159
Charges for services	1,023,858				2,632	1,026,490
Miscellaneous	1,608,131					1,608,131
Total revenues	<u>35,080,484</u>	<u>3,776,509</u>	<u>550,354</u>		<u>2,235,140</u>	<u>41,642,487</u>
Expenditures:						
Current:						
General government	14,336,142		48,867			14,385,009
Urban and economic development	12,515,230				3,066	12,518,296
Health and sanitation	5,397,871				1,130,985	6,528,856
Public safety	5,692,558				23,314	5,715,872
Public housing and welfare	4,917,863				783,504	5,701,367
Culture, recreation and education	2,759,527				228,569	2,988,096
Debt service:						
Principal	428,917	2,545,000				2,973,917
Interest	501,816	2,736,269				3,238,085
Capital outlays	258,247		2,830,883	6,695,190	874,486	10,658,806
Total expenditures	<u>46,808,171</u>	<u>5,281,269</u>	<u>2,879,750</u>	<u>6,695,190</u>	<u>3,043,924</u>	<u>64,708,304</u>
Expenditures over revenues	<u>(11,727,687)</u>	<u>(1,504,760)</u>	<u>(2,329,396)</u>	<u>(6,695,190)</u>	<u>(808,784)</u>	<u>(23,065,817)</u>
Other financing sources (uses):						
Transfers-in from other funds	3,777,433			5,147,551	680,206	9,605,190
Transfers-out to other funds	(3,293,332)	(294,258)	(550,354)	(2,691,571)	(2,775,675)	(9,605,190)
Proceeds from issuance of bonds			12,170,000			12,170,000
Total other financing sources (uses), net	<u>484,101</u>	<u>(294,258)</u>	<u>11,619,646</u>	<u>2,455,980</u>	<u>(2,095,469)</u>	<u>12,170,000</u>
Special item - proceeds from legal judgment and settlement with Puerto Rico Electric Power Authority						
	<u>798,697</u>					<u>798,697</u>
Net change in fund balances	<u>(10,444,889)</u>	<u>(1,799,018)</u>	<u>9,290,250</u>	<u>(4,239,210)</u>	<u>(2,904,253)</u>	<u>(10,097,120)</u>
Fund balance at beginning of fiscal year	19,897,809	16,506,633	18,497,272		987,280	55,388,994
Prior-period adjustments	(4,034,295)	1,141,485	(382,100)	4,239,210	3,696,261	4,660,561
Fund balance at beginning of fiscal year, as restated	<u>15,363,514</u>	<u>17,648,118</u>	<u>18,115,172</u>	<u>4,239,210</u>	<u>4,683,541</u>	<u>60,049,555</u>
Fund balance at end of fiscal year	<u>\$ 4,918,625</u>	<u>15,849,100</u>	<u>27,405,422</u>		<u>1,779,288</u>	<u>\$ 49,952,435</u>

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

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

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

Total net change in fund balances reported in the statement of revenues, expenditures and changes in fund balances – governmental funds	\$ (10,097,120)
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Add (Deduct):

The following revenues recorded in the statement of activities do not necessarily provide current financial resources, therefore, sometimes are deferred in the governmental funds. This is the net change in deferred revenues of the following revenue items, which are measurable but not available at fiscal year end:

Property taxes	(883,187)
Municipal license taxes	49,749
Construction excise taxes	152,095
Intergovernmental grants and contributions	(41,314)
Charges for services	3,639

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 (\$10,658,806) exceeded depreciation and amortization expense (\$3,777,789) for the fiscal year ended June 30, 2005.	2,973,917
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Repayment of principal of long-term obligations is reported as an expenditure in the governmental funds, however, the repayment reduces long-term liabilities in the statement of net assets.	2,973,917
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Certain accrued interest expense reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	(2,243)
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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.	(22,762)
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Some expenses reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	(862,356)
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Generally, inventory and other current assets are recorded as expenditures in the governmental funds when paid rather than capitalized as an asset. However, these assets are capitalized in the statement of net assets. This amount represents the net change in these assets for the current fiscal year.	16,466
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Proceeds from issuance of bonds provide current financial resources to governmental funds, but issuing such debt increases long-term liabilities in the statement of net assets.	(12,170,000)
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Net decrease in net assets, as reported in statement of activities	<u>\$ (14,002,099)</u>
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The accompanying notes to the basic financial statements are an integral part to this statement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

1. Summary of Significant Accounting Policies

The Municipality of Cataño (the Municipality) is a local municipal government constituted in 1927 in the Commonwealth of Puerto Rico (the Commonwealth). The Municipality has full legislative, fiscal and all other governmental powers and responsibilities expressly assigned by Public Act No. 81 of August 30, 1991, as amended, known as *Autonomous Municipalities Act of the Commonwealth of Puerto Rico* (Act No. 81). The Municipality is one of seventy-eight municipalities legally separated from the Commonwealth's government.

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

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

a) Financial Reporting Model

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

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

RSI consists of: (1) a Management's Discussion and Analysis (MD&A), (2) a budgetary comparison schedule – general fund and (3) a budgetary comparison schedule – debt service fund. RSI is information presented along with, but separate from, the Municipality's basic financial statements.

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

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Other supplementary information presented in this report for purposes of additional analysis consists of a budgetary comparison schedule – debt service fund.

b) *Financial Reporting Entity*

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

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

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

On July 1, 2004, 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.

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

c) Government-wide Financial Statements

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

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

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

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

- **Invested in capital assets, net of related debt** – This net asset category consists of capital assets, net of accumulated depreciation and amortization, reduced by the outstanding balances of bonds payable, notes payable and other debts that are attributed to the acquisition, construction or improvement of those assets. For the purposes of determining the outstanding debt attributed to capital assets, the total long-term debt related to the acquisition, construction or improvement of capital assets has been reduced by any related unspent debt proceeds and any related unamortized debt issuance costs.
- **Restricted net assets** – This net asset category consists of net resources restricted by external parties (such as creditors, grantors, contributors, laws or regulations of other governments, etc.), or net assets for which constraints are imposed by constitutional provisions or enabling legislation. Enabling legislation consists of legislation that authorizes the Municipality to assess, levy, charge or otherwise mandate payment of resources (from external resource providers). Enabling legislation establishes restrictions if it includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation.

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

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

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

- (1) **Debt service** – Represent net resources available to cover future debt service payments of bonds and notes payable.
 - (2) **Capital projects** – Represent net resources available to finance the acquisition, construction or improvement of major capital assets under contracts and other commitments.
 - (3) **Other specified purposes** – Represent net resources available from certain federal and state grants, which have been set aside to carry out several programs.
- **Unrestricted net liabilities** – This category consists of the excess of liabilities over related assets (accumulated deficit) that are neither externally nor legally restricted, neither invested in capital assets. However, assets reported within unrestricted net liabilities often are designated to indicate that management does not consider them to be available for general operations. Assets reported within this category often have constraints that are imposed by management but can be removed or modified.

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

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

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

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General government:

- Municipal legislature
- Mayor's office
- Department of finance
- Department of planning and budget
- Department of human resources
- Department of legal services
- Department of municipal secretary
- Department of internal audit
- Department of public relations
- Center for governmental operations

Urban and economic development:

- Department of public works
- Department of public terminals and convention center
- Market Square

Public safety:

- Department of emergency management – civil defense
- Department of municipal police
- Department of private police

Health and sanitation:

- Department of recycling services
- Eulalia Kuilan diagnostic and treatment center

Culture, recreation and education:

- Department of sports and recreation
- Juana Matos multi-service center
- Cultural center
- La Esperanza recreational facilities
- Schooling director
- Alberto Dávila library

Public housing and welfare:

- Department of public housing
- Department of federal programs
- Wilson Ramos elderly center
- Department of citizen affairs

The statement of activities demonstrates the degree to which program revenues offset direct expenses of a given function/program or segments. Direct expenses are those that are clearly identifiable with a specific function, segment or operational unit. This statement reports revenues in three broad categories: (1) program revenues, (2) general revenues and (3) special items.

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

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that contributes to the Municipality's general revenues. The accompanying statement of activities separately reports the following categories of program revenues:

- **Charges for services** – These revenues generally consist of exchange or exchange-like transactions involving charges to customers or applicants who purchase, use or directly benefit from the goods, services or privileges provided, or are otherwise directly affected by the services. These revenues include fees charged for specific services, charges for licenses and permits, and fines and forfeitures, among others.
- **Program-specific operating and capital grants and contributions** – These revenues consist of transactions that are either mandatory or voluntary 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 and construction excise taxes are reported as general revenues. All other nontax revenues (including unrestricted interest on deposits, grants and contributions not restricted for specific programs and miscellaneous revenues) that do not meet the definition of program revenues are classified as general revenues. Resources that are dedicated internally by the Municipality are reported as general revenues rather than as program revenues. All general revenues are reported net of estimated uncollectible amounts, which are recorded as reduction of revenues rather than as expenses.

Special items consist of revenues arising from significant transactions or other events within the control of management that are either unusual in nature or infrequent in occurrence.

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, and (2) the statement of revenues, expenditures and changes in fund balances – governmental funds.

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

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

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

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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. During the fiscal year ended June 30, 2005, the financial activity accounted for in the debt service fund was specifically related to bonds payable.

The outstanding balance of general long-term debts for which debt service payments do not involve the advance accumulation of resources (such as notes payable, obligations under capital leases, accrued compensated absences, accrued legal claims and judgments and the federal cost disallowances) are only accounted for in the accompanying statement of net assets. The debt service payments of such debts are generally accounted for as debt service – principal and debt service – interest expenditures in the general fund, except for certain notes payable to HUD (see note 9), which are accounted for in the HUD Section 108 capital project fund

- **Special revenue funds** – The special revenue funds are 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 project funds). The uses and limitations of each special revenue fund are specified by municipal ordinances or federal and state statutes. However, resources restricted to expenditure for purposes normally financed from the general fund are reported in the Municipality's general fund provided that all applicable legal requirements are appropriately satisfied. In this case, a special revenue fund to account for such kind of transactions will be used only if legally mandated.
- **Capital projects funds** – Capital projects funds are 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. Significant capital outlays financed from proceeds of general obligation, public improvement or special obligation bonds accounted for also in the capital projects funds.

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

The focus of the GFFS is on major governmental funds, which generally represent the Municipality's most important funds. Accordingly, the Municipality is required to segregate governmental funds between major and 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 always considered a major governmental fund for financial reporting purposes. In addition, any other governmental fund is classified as a major governmental fund in the GFFS if its total assets, liabilities, revenues or expenditures of that individual governmental fund are at least 10 percent of the corresponding element total (assets, liabilities, revenues or expenditures) for all governmental funds. For the purposes of applying the aforementioned major fund criteria, no eliminations of 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, (3) the bond issuance fund and (4) the works and permanent improvements fund.

The bond issuance fund is a major capital projects fund used to account for the receipts and disbursements of the proceeds arising from the issuance of general obligation and permanent improvement serial bonds used in the acquisition, construction or improvement of major capital facilities and assets.

The works and permanent improvements fund is a major capital projects fund used to account for financial resources that are self-restricted by the Municipality for use in the acquisition, construction or improvement of major capital facilities and assets.

The accompanying GFFS are accompanied by other statements and 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 additional rules and limitations detailed below, revenues (including interest on deposits) are generally recorded when earned and expenses are generally recorded when a liability is incurred, regardless of the timing of related cash flows.

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

All revenues, expenses, gains, losses and assets resulting from 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

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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 nongovernmental entities, including individuals, other than assessments on exchange transactions, receivables are generally recorded in the period when an enforceable legal claim has arisen. Property taxes and municipal license are generally recorded as revenues (net of amounts considered not collectible) in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted.

Government-mandated 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.

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 (unearned) 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

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

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

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

All revenues, expenses, gains, losses and assets resulting from 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 generally recorded in the fiscal year when an enforceable legal claim has arisen while property tax and municipal license tax revenues (net of amounts considered not collectible) are also generally recorded in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted. Receivables and revenues from federal and state grants and contributions, donations and entitlements are also generally recorded when all eligibility requirements imposed by the provider have been met (generally, as qualifying reimbursable expenditures are incurred).

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

Pursuant to the provisions of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements* (GASBI No. 6), in the absence of an explicit requirement (i.e., the absence of an applicable modification, discussed below) the Municipality generally accrues a governmental fund liability and an expenditure (including salaries, professional services, supplies, utilities, etc.) in the period in which the government incurs the liability, to the extent that these liabilities are normally expected to be liquidated in a timely manner and in full with current available financial resources. GASBI No. 6 modified the recognition criteria for certain expenditures and liabilities reported under the modified accrual basis of accounting prior to GASB No. 34, and clarified a number of situations in which the Municipality should distinguish between governmental fund liabilities and general long-term liabilities. Therefore, the accompanying balance sheet – governmental funds generally

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reflects assets that will be converted into cash to satisfy current liabilities. Long-term assets and those assets that will not be converted into cash to satisfy current liabilities are generally not accounted for in the accompanying balance sheet – governmental funds. At the same time, long-term liabilities (generally, those unmatured that will not require the use of current financial resources to pay them) are not accounted for in the accompanying balance sheet – governmental funds.

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

- Principal and interest on bonds payable are recorded when they mature (when payment is due), except for principal and interest due on July 1, 2005, which have been recorded as governmental fund liabilities at June 30, 2005, which is the date when resources are available in the debt service funds (generally, June 30).
- Notes payable, obligations under capital leases, compensated absences, amounts subject to accrued claims and judgments under litigation are recorded only when they mature (when payment is due).
- Certain accounts payable, intergovernmental payables and other accrued liabilities not due and payable or not normally expected to be liquidated in full and in a timely manner with available and expendable financial resources are recorded in the accompanying statement of net assets. Such liabilities are recorded in the governmental funds when they mature.
- Executory purchase orders and contracts are recorded as a reservation of fund balance in the GFFS.

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

f) Stewardship, Compliance and Accountability

Budgetary Control

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

The Mayor must submit, for each fiscal year commencing on July 1, an annual budgetary resolution project (the Project) to the Commissioner of Municipal Affairs of the Commonwealth (the Commissioner) and the Municipal Legislature no later than the immediately preceding May 10 and May 15, respectively. The Commissioner preliminarily verifies that the Project complies

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with all the applicable laws and regulations and may provide comments and suggestions to the Mayor on or before the immediately preceding June 13.

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

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

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

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

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

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

Budgetary Accounting

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

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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 budgetary comparison schedule – general fund and the budgetary comparison schedule – debt service fund provide information about the general and debt service funds' original budgets, its amendments, and the actual results of operations of such major governmental funds under the budgetary basis of accounting for the fiscal year ended June 30, 2005. Further details of the Municipality's budgetary control at the legal level may be obtained from the Budgetary Liquidation Report for the fiscal year ended June 30, 2005, which is prepared by the Municipality's Department of Finance. Copies of that report may be obtained by writing to the Municipality's Director of Finance.

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 and debt service funds' budgetary bases and GAAP actual amounts are presented at the bottom of the respective budgetary comparison schedules.

g) *Unrestricted and Restricted Deposits*

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

The Municipality follows the practice of pooling cash. The balance in the pooled cash account is available to meet current operating requirements and any unrestricted excess, if any, is invested in certificates of deposit with commercial banks. Any deficiency in the pooled cash account is assumed by the general fund and covered through future budgetary appropriations. At June 30, 2005, the deficiency in the pooled cash account amounted to \$3,414,616, which has been recorded within trade accounts payable and accrued liabilities. However, no resources have been provided by the general fund for such purposes at June 30, 2005.

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

Cash in fiscal agent in the debt service fund consists of cash related to property tax collections amounting to \$19,283,625 which are restricted for the payment of the Municipality's debt service, as required by law. Cash in fiscal agent in the bond issuance fund, amounting to \$28,768,893, consists of unspent proceeds of bonds, which are restricted for the acquisition, construction or improvement of capital assets. Cash with fiscal agent recorded in the non-major governmental funds consists of the balance of interest and non-interest bearing accounts amounting to \$55,158, which are restricted for the acquisition, construction or improvement of major capital assets.

Restricted cash in commercial banks of the works and permanent improvements fund, amounting to \$1,160,514, represents the balance of interest and non-interest bearing accounts restricted to finance the acquisition, construction or improvement of major capital assets. Restricted cash in commercial banks for other governmental funds, amounting to \$2,497,717, represents the balance of interest and non-interest bearing accounts restricted to finance the operations of certain federal and state funded programs.

Restricted cash equivalents consist of certificates of deposit with original maturities of three months or less, amounting to \$900,000 at June 30, 2005, which arose from grants and contributions from the Legislature of the Commonwealth of Puerto Rico to finance the operations of certain programs and activities, including the acquisition, construction or improvement of major capital assets.

h) Unrestricted and Restricted Accounts and Notes Receivable

Accounts receivable consist of all revenues earned but not collected at June 30, 2005. These accounts receivables are stated net of estimated reserved for doubtful 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."

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 expenses. Generally, inventories are capitalized (consumption method) and stated at cost using the first-in, first-out method (FIFO) in the GWFS. Inventories and other current assets in the GFFS are generally recorded as expenditures (purchase method) when purchased (paid) rather than capitalized as an asset.

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j) Deferred Charges

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

k) Capital Assets

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

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

In the statement of net assets, all capital assets are recorded at cost or estimated historical cost if actual cost was unavailable, except for donated capital assets, which are recorded at their estimated fair value at the date of donation. Estimated historical costs based on deflated current costs were used to value a significant portion of the infrastructure constructed or acquired prior to June 30, 2003 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, 2003 as well as, construction in progress, machinery and equipment and licensed vehicles acquired prior or after such date.

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

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

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	<u>Years</u>
Land improvements	20
Buildings, structures and building improvements	30 to 50
Infrastructure	20 to 50
Motor vehicles	5
Furniture, fixtures, machinery and equipment, excluding those held under capital leases	5 to 20
Office and medical equipment held under capital leases	3 to 5

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

l) *Deferred Revenues*

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

- Potential revenue does not meet both the “measurable” and “available” criteria for revenue recognition in the current period (reported as “*earned but unavailable revenue*” in the accompanying balance sheet-governmental funds). As previously discussed, available is defined as due (or past due) at June 30, 2005 and collected within 90 days (60 days for property taxes) thereafter to pay obligations due at June 30. In subsequent periods, when both criteria (measurable and available) 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 (reported as “*unearned revenue*” in the accompanying balance sheet-governmental funds). 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 (reported as “*unearned revenue*” in the accompanying statement of net assets). No “*earned but unavailable revenue*” is accounted for in the accompanying statement of net assets.

m) *Compensated Absences*

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

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

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

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

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

n) Long-term Debt

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

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

In the GWFS debt issuance costs have been capitalized and reported as deferred charges, which are being amortized under the straight-line method over the life of the debt. In the GFFS, such costs are recorded as expenditures as incurred.

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

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

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

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

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

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

p) Accounting for Pension Costs

For the purpose of applying the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers* (GASB No. 27), the Commonwealth is considered to be the sponsor of the Employees' Retirement System of the Government of the

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Commonwealth of Puerto Rico (formerly Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities) (ERS) and System 2000, a multi-employer cost-sharing defined benefit pension plan and a hybrid defined contribution plan, respectively, in which the employees of the Municipality participate. The Municipality is considered a participant, and not a sponsor, of these retirement systems since the majority of the participants in the aforementioned pension trust funds are employees of the Commonwealth and the basic financial statements of such retirement systems are part of the financial reporting entity of the Commonwealth. Accordingly, no portion of the net pension obligation (NPO) related to ERS has been allocated to the Municipality in the accompanying basic financial statements. The basic financial statements of the Commonwealth report the total amount of the net pension obligation of ERS, including any amount that may correspond to the Municipality.

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

q) Risk Management

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

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 applicable at June 30, 2005 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.

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The Municipality also obtains medical insurance coverage from several health insurance companies for its employees. Different health insurance coverage and premium options are negotiated each year by the Department of Treasury on behalf of the Municipality. The current insurance policies have not been canceled or terminated at June 30, 2005. Premiums are paid on a monthly basis directly to the insurance company. In the past three years, the Municipality has not settled claims that exceeded insurance coverage.

r) Reservations of Fund Balances

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

- **Encumbrances** – Represent reservations of fund balances for commitments related to unperformed (executory) contracts for goods or services (future expenditures under purchase orders, contracts and other commitments). These committed amounts represent reservations of unexpired appropriations and generally will become liabilities in future fiscal years as the goods or services are received.
- **Debt service** – Represent fund balances available and restricted 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 that are restricted for the acquisition, construction or improvement of major capital assets under contracts and other commitments. These amounts are accounted for in the capital projects funds.
- **Advances among 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, 2005.
- **Other specified purposes** – Represent financial resources set aside for use in federal and state grant programs.

s) Inter-fund Activities

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

- **Inter-fund loans** – Represent resources (assets) provided by one governmental fund to other governmental fund with a requirement and commitment for repayment (reimbursement), 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, inter-fund receivables/payables are reduced to their estimated realizable (settlement) value, and the portion of the inter-fund loan that is not expected to be repaid is reported as a “*transfer-in*” from the governmental fund that provided the loan.

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

t) Use of Estimates

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

u) Future Adoption of Accounting Pronouncements

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

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

In June 2005, GASB issued its Statement No. 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions* (GASB No. 45). This Statement

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establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities/assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local government employers. The requirements of this statement are effective for the Municipality's fiscal year commencing on July 1, 2007.

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

2. Deposits

The Municipality maintains its deposits in various commercial banks located in Puerto Rico and the Government Development Bank for Puerto Rico (GDB). Proceeds from bonds and funds related to certain 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, the Municipality has adopted, as its custodial and credit risk policy, the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico*. Accordingly, the Municipality invests only in obligations of the Commonwealth, obligations of the United States of America, certificates of deposit, commercial paper, bankers' acceptances, or in pools of obligations of the municipalities of Puerto Rico, which are managed by GDB. According to the aforementioned investment guidelines, the Municipality does not invest in marketable securities or any other types of investments for which credit risk exposure may be significant. 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, 2005.
- **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 investments in its investment portfolio at June 30, 2005, (2) limiting the weighted average maturity of its investments to three months or less, and (3) keeping most of its bank deposits in interests bearing accounts generating interests at prevailing market rates. At June 30, 2005, the Municipality's investment in certificates of deposit are recorded at cost, which approximates their fair value. Therefore, the Municipality's management has concluded that at June 30, 2005, the interest rate risk associated with the Municipality's cash and cash equivalents is considered low.
- **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

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Insurance Corporation (FDIC) generally up to a maximum of \$100,000 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 with GDB are uninsured and uncollateralized. However, no losses related to defaults by GDB on deposit transactions have been incurred by the Municipality through June 30, 2005. Therefore, the Municipality's management has concluded that at June 30, 2005, the custodial credit risk associated with the Municipality's cash and cash equivalents is considered low.

- **Foreign exchange risk** – The risk that changes in exchange rates will adversely affect the value of an investment or a deposit. According to the aforementioned investment guidelines, 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, 2005.

	Major governmental funds					Total governmental funds
	General fund	Debt service fund	Bond issuance fund	Works and permanent improvements fund	Other governmental funds	
Unrestricted:						
Cash in commercial banks	\$ 1,074,363					\$ 1,074,363
Cash equivalents in commercial banks	13,200,000					13,200,000
Total unrestricted deposits	<u>14,274,363</u>					<u>14,274,363</u>
Restricted:						
Cash in commercial banks				1,160,514	2,497,717	3,658,231
Cash in GDB, as fiscal agent		19,283,625	28,768,893		55,158	48,107,676
Cash equivalents in commercial banks					900,000	900,000
Total restricted deposits		<u>19,283,625</u>	<u>28,768,893</u>	<u>1,160,514</u>	<u>3,452,875</u>	<u>52,665,907</u>
Total carrying amount of deposits	<u>\$ 14,274,363</u>	<u>19,283,625</u>	<u>28,768,893</u>	<u>1,160,514</u>	<u>3,452,875</u>	<u>\$ 66,940,270</u>
Excess of checks drawn over bank balance (book overdraft) - recorded within accounts payable and accrued liabilities	<u>\$ 3,414,616</u>					<u>\$ 3,414,616</u>

3. Municipal License Tax

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 Cataño. This is a self-assessed tax generally based on the business volume of taxpayers, measured by gross revenues. The Municipality establishes the applicable tax rates. At June 30, 2005, the municipal license tax rates imposed by the Municipality were 1.50 percent for financial institutions and 0.50 percent for other types of taxpayers. Any taxpayers that have been granted with a partial tax exemption under any of the tax incentive acts of the Commonwealth ultimately pay municipal license taxes at reduced tax rates, generally between 60 percent and 90 percent under standard rates.

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

Any municipal license taxes collected in advance (that is, pertaining to a future fiscal year) are recorded as unearned revenues in the GWFS and the GFFS. Total municipal license tax receivable, net of its reserve for doubtful accounts of \$8,975,367, amounted to \$1,167,403 at June 30, 2005. Unearned municipal license tax revenues recorded in the accompanying GWFS and GFFS amounted to \$9,643,735 at June 30, 2005.

4. Property Taxes

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

CRIM is responsible for the billings and collections of real and personal property taxes on behalf of the Municipality. Prior to the beginning of each fiscal year, CRIM informs to the Municipality the estimated amount of property tax expected to be collected for the ensuing fiscal year. Throughout the fiscal year, CRIM advances funds to the Municipality based on the initial estimated collection amounts for the fiscal year. CRIM is required by law to prepare a settlement statement on a fiscal year basis, whereby a comparison is made between the amounts advanced to the Municipality and the property tax amounts actually collected from taxpayers on behalf of the Municipality during the fiscal year. This settlement has to be completed on a preliminary basis not later than December 31 following the fiscal year end. If in any given fiscal year, CRIM remits to the Municipality property tax advances that are less than the property taxes actually collected, on behalf of the Municipality, an intergovernmental receivable is recorded at June 30 in the Municipality's basic financial statements. However, if advances exceed the amount actually collected by CRIM, an intergovernmental payable is recorded at June 30. For the fiscal year ended June 30, 2005, the property tax advances remitted by CRIM to the Municipality exceeded the actual property tax collections by \$802,308, which are recorded within intergovernmental payables in the accompanying GWFS.

Personal property taxes are self-assessed by taxpayers every year using the book value of personal property assets owned by the taxpayer at January 1 (assessment date) and reporting such taxable value through a personal property tax return filed on May 15 subsequent to the assessment date. The total personal property tax rate in force at June 30, 2005 was 7.03 percent (of which taxpayers pay 6.83 percent and the remaining 0.20 percent is paid by the Department of Treasury, as a subsidy).

Real property taxes are assessed by CRIM. The assessment on real property is made every January 1 and is based on estimated current values of the property, deflated to 1957 market prices. The total

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real property tax rate in force at June 30, 2005 was 9.03 percent (of which 8.83 percent is paid by taxpayers and the remaining 0.20 percent is also paid by the Department of Treasury, as a subsidy).

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

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

In addition, included within the total personal and real property tax rates of 6.83 percent and 8.83 percent, respectively, there is a portion of the tax rate in the amount of 2.00 percent that is restricted for the Municipality's debt service requirements on bonds. Such amounts are recorded in the Municipality's debt service fund.

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

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

- Thirty five percent of its net earnings (defined as the excess of revenues over expenses less an amount earmarked for the Fund for Rent and Home Improvement Subsidy Program for the Low-Income Qualifying Elderly) is earmarked to the municipalities of the Commonwealth, of which a maximum of \$26 million, on an annual basis, is distributed to the Municipal Equalization Fund held by CRIM to cover operating expenses and permanent improvements of the municipalities.
- An additional amount not exceeding \$16 million, on an annual basis, is distributed to the Municipal Equalization Fund, provided it is within the thirty-five percent corresponding to the municipalities of the Commonwealth. When the accumulated municipal appropriations from the

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municipalities' Puerto Rico Health Reform are covered up to June 30, 1997, these resources will be assigned to PRHSA.

At June 30, 2005, property taxes receivable recorded in the general and debt service fund amounted to \$2,989,583 and \$620,511, respectively, net of a reserve for doubtful accounts of \$19,000,637 and \$3,943,727, respectively.

5. Intergovernmental Receivables and Payables

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

	<u>Major governmental funds</u>	<u>Other governmental funds</u>	<u>Total governmental funds</u>	<u>Statement of net assets</u>
<i>Intergovernmental receivables:</i>				
Grants and contributions:				
U.S. Department of Health and Human Services- Child care and development block grant fund	\$ -	21,341	21,341	\$ 21,341
U.S. Department of Education – Even start program	-	110,205	110,205	110,205
U.S. Department of Housing and Urban Development (HUD)-State block grant program fund	-	99,434	99,434	99,434
Puerto Rico Department of Recreation and Sports	-	52,500	52,500	52,500
Legislature of the Commonwealth of Puerto Rico	-	469,543	469,543	469,543
Puerto Rico Office of Women Affairs	-	2,350	2,350	2,350
Puerto Rico Treasury Department – general fund	274,403	-	274,403	274,403
Puerto Rico Electric Power Authority - general fund	111,533	-	111,533	111,533
Total intergovernmental receivables	\$ 385,936	755,373	1,141,309	\$1,141,309
<i>Intergovernmental payables:</i>				
CRIM - Excess of property tax advances over collections	\$ -	-	-	\$ 802,308
Payroll withholdings (general fund):				
U.S. Department of Treasury - Internal Revenue Service	-	-	-	4,458
Association of Employees of Commonwealth of Puerto Rico	70,939	-	70,939	70,939
Puerto Rico Treasury Department	250,624	-	250,624	250,624
State Insurance Fund Corporation	191,494	-	191,494	193,508
Employees Retirement System of the Government of the Commonwealth of Puerto Rico	-	-	-	256,019
Puerto Rico Department of Labor	-	-	-	4,183
Utilities (general fund):				
Puerto Rico Aqueduct and Sewer Authority	-	-	-	14,242
Puerto Rico Electric Power Authority	927	-	927	927
Municipality of Toa Baja, Commonwealth of Puerto Rico	35,648	-	35,648	35,648
Miscellaneous - General Services Administration	12,308	-	12,308	12,308
Total intergovernmental payables	\$ 561,940	-	561,940	\$1,645,164

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- Recognize in the general fund the outstanding balance of the loans granted to the bond issuance fund (\$974,457) to temporarily cover the acquisition, construction and permanent improvements of capital assets.
- Recognize in the general fund the outstanding balance of the loans granted to nonmajor capital project funds (\$532,315) and special revenue funds (\$180,636) to temporarily cover the acquisition, construction and permanent improvements of capital assets and to cover the payroll and other operating costs of several federally and state funded programs.
- Recognize in the general fund the interests earned by the deposits of the debt service fund during the quarter ended June 30, 2005 (\$107,132), which were transferred to the general fund subsequently in July 2005.

The principal purposes of inter-fund transfers are to:

- Make a routinary transfer of interest income, amounting to \$294,258, from the debt service fund to the general fund, as permitted by law. This interest income is generated by the debt service fund's deposits and is transferred on a quarterly basis to the general fund.
- Make a routinary transfer of interest income amounting to \$550,354, from the bond issuance fund to the general fund. This interest income is generated by the unspent proceeds of bonds recorded in the bond issuance fund and is transferred on a monthly basis, as permitted by law.
- Make a non-routinary transfer of cash from the general fund and various non-major governmental fund, amounting to \$5,147,551, as capital contributions to the works and permanent improvements fund to cover the costs of the acquisition, construction and improvement of capital assets.
- Make a non-routinary transfer of excess cash, amounting to \$2,691,571, from the works and permanent improvements fund 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, 2005.

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7. Capital Assets

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

	<u>Cost Basis at beginning of fiscal year, as restated</u>	<u>Additions (capital outlays)</u>	<u>Reclassification of completed works and permanent improvement projects</u>	<u>Cost Basis at end of fiscal year</u>
Governmental activities:				
<i>Cost basis:</i>				
Capital assets, not being depreciated/amortized:				
Land	\$ 9,156,887	-	-	\$ 9,156,887
Construction in progress	4,784,059	4,404,556	(5,399,059)	3,789,556
Total capital assets, not being depreciated/amortized	<u>13,940,946</u>	<u>4,404,556</u>	<u>(5,399,059)</u>	<u>12,946,443</u>
Capital assets, being depreciated/amortized:				
Land improvements	33,059,339	575,072	3,855,429	37,489,840
Buildings, structures, and improvements	32,673,789	1,398,726	472,058	34,544,573
Infrastructure	14,209,681	2,685,944	1,071,572	17,967,197
Machinery and equipment, and furniture and fixtures	4,772,159	728,792	-	5,500,951
Office and medical equipment under capital leases	720,225	-	-	720,225
Licensed vehicles	1,519,399	854,702	-	2,374,101
Licensed software	141,169	11,014	-	152,183
Total capital assets, being depreciated/amortized	<u>87,095,761</u>	<u>6,254,250</u>	<u>5,399,059</u>	<u>98,749,070</u>
Total cost basis of capital assets	<u>\$101,036,707</u>	<u>10,658,806</u>	<u>-</u>	<u>\$111,695,513</u>
	<u>Accumulated depreciation/ amortization at beginning of fiscal year, as restated</u>	<u>Depreciation and amortization expense</u>	<u>Reclassification of completed works and permanent improvement projects</u>	<u>Accumulated depreciation/ amortization at end of fiscal year</u>
Accumulated depreciation and amortization:				
Land improvements	\$ 4,259,224	1,428,601	-	\$ 5,687,825
Buildings, structures, and improvements	8,106,496	1,104,902	-	9,211,398
Infrastructure	2,363,754	355,342	-	2,719,096
Machinery and equipment, and furniture and fixtures	3,354,399	419,035	-	3,773,434
Office and medical equipment under capital leases	303,346	145,151	-	448,497
Licensed vehicles	840,595	295,416	-	1,136,011
Licensed software	73,845	29,342	-	103,187
Total accumulated depreciation and amortization	<u>19,301,659</u>	<u>3,777,789</u>	<u>-</u>	<u>23,079,448</u>
Net capital assets	<u>\$ 81,735,048</u>	<u>6,881,017</u>	<u>-</u>	<u>\$ 88,616,065</u>

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Depreciation and amortization expense for the fiscal year ended June 30, 2005 was charged to functions/programs in the accompanying statement of activities as follows:

Governmental activities:	
General government	\$ 2,386,581
Public safety	177,645
Economic and urban development	421,746
Health and sanitation	205,692
Public housing and welfare	1,563
Culture, recreation, and education	584,562
Total depreciation and amortization expense	<u>\$ 3,777,789</u>

8. Deferred Revenues

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

	<u>General fund</u>	<u>Nonmajor special revenue funds</u>	<u>Nonmajor capital project funds</u>	<u>Total governmental funds</u>	<u>Statement of net assets</u>
<i>Measurable but not available revenues:</i>					
Municipal licenses	\$ 420,733	-	-	420,733	\$ -
Construction excise taxes	1,771,231	-	-	1,771,231	-
Charges for services	6,073	-	-	6,073	-
Intergovernmental grants and contributions	<u>385,936</u>	<u>11,831</u>	<u>-</u>	<u>397,767</u>	<u>-</u>
Total measurable but not available revenue	<u>2,583,973</u>	<u>11,831</u>	<u>-</u>	<u>2,595,804</u>	<u>-</u>
<i>Unearned revenues:</i>					
Municipal licenses	9,643,735	-	-	9,643,735	9,643,735
Intergovernmental grants and contributions	<u> </u>	<u>285,249</u>	<u>948,768</u>	<u>1,234,017</u>	<u>1,234,017</u>
Total unearned revenues	<u>9,643,735</u>	<u>285,249</u>	<u>948,768</u>	<u>10,877,752</u>	<u>10,877,752</u>
Total deferred revenues	<u>\$12,227,708</u>	<u>297,080</u>	<u>948,768</u>	<u>13,473,556</u>	<u>\$10,877,752</u>

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9. Long-Term Obligations

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

	<u>Balance at beginning of fiscal year, as restated</u>	<u>Borrowings or additions</u>	<u>Payments or deductions</u>	<u>Balance at end of fiscal year</u>	<u>Balance due within one year</u>
Bonds payable:					
General obligation serial bonds	\$35,290,000	12,170,000	(1,195,000)	46,265,000	\$1,860,000
Public improvement serial bonds	10,560,000	-	(635,000)	9,925,000	685,000
Notes payable:					
Federal Emergency Management Agency	1,142,920	-	-	1,142,920	558,474
CRIM: Public Act No. 146 of October 11, 2001	731,579	-	(187,222)	544,357	-
Public Act No. 42 of January 26, 2000	6,924,138	-	(95,997)	6,828,141	102,125
Obligation under capital leases	448,859	-	(145,698)	303,161	121,827
Compensated absences	5,505,953	3,394,137	(3,363,105)	5,536,985	3,502,280
Claims and judgments	2,548,551	450,256	(380,399)	2,618,408	2,618,408
Total	<u>\$63,152,000</u>	<u>16,014,393</u>	<u>(6,002,421)</u>	<u>73,163,972</u>	<u>\$ 9,448,114</u>

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

a) Debt Limitation

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

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

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.

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

As described in Note 4, the Municipality levies an annual additional special tax of 2.00 percent of the assessed value of personal and real property. The proceeds of this additional special tax are deposited in a sinking fund established at GDB whereby sufficient funds are set aside to redeem the bonds payable of the Municipality in minimum annual or semiannual principal and interest payments. The collections of this special tax are recorded in the Municipality's debt service fund.

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

	<u>Outstanding Amount</u>
<u>General Obligation Bonds:</u>	
2003 serial bonds (face amount of \$845,000) due in annual principal installments ranging from \$145,000 to \$190,000; plus interests due in semiannually installments at variable rates (5.00% at June 30, 2005) through July, 1, 2007	\$ 540,000
2004 serial bonds (face amount of \$1,720,000) due in annual principal installments ranging from \$260,000 to \$315,000; plus interests due in semiannually installments at variable rates (4.37% at June 30, 2005) through July, 1, 2010	1,720,000
2001 serial bonds (face amount of \$7,240,000) due in annual principal installments ranging from \$195,000 to \$715,000; plus interests due in semiannually installments at variable rates (2.89% at June 30, 2005) through July, 1, 2019	6,610,000
2004 serial bonds (face amount \$10,450,000) due in annual principal installments ranging from \$315,000 to \$800,000; plus interests due in semiannually installments at variable rates (4.37% at June 30, 2005) through July, 1, 2024	\$10,450,000
2000 serial bonds (face amount \$11,850,000) due in annual principal installments ranging from \$315,000 to \$1,170,000; plus interests due in semiannually installments at variable rates (2.89% at June 30, 2005) through July 1, 2018	10,425,000
1998 serial bonds (face amount of \$18,825,000) due in annual principal installments ranging from \$260,000 to \$1,635,000; plus interests due in semiannually installments at variable rates (5.42% at June 30, 2005) through July 1, 2022	16,520,000
Total general obligation bonds	<u>46,265,000</u>

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**Outstanding
Amount**

Public Improvement Bonds:

1998 serial bonds (face amount of \$14,520,000) due in annual principal installments ranging from \$315 to \$1,370,000; plus interests due in semiannually installments at variable rates (7.31% at June 30, 2005) through July 1, 2014

9,925,000

Total bonds payable

\$56,190,000

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.

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

Fiscal year ending June 30,	Principal	Interest	Total
2006	\$ 2,545,000	2,964,083	\$ 5,509,083
2007	2,725,000	2,979,258	5,704,258
2008	2,920,000	2,828,615	5,748,615
2009	2,920,000	2,669,697	5,589,697
2010	3,135,000	2,502,037	5,637,037
2011-2015	18,060,000	9,541,846	27,601,846
2016-2020	15,710,000	4,581,038	20,291,038
2021-2025	8,175,000	934,394	9,109,394
Totals	<u>\$ 56,190,000</u>	<u>29,000,968</u>	<u>\$ 85,190,968</u>

At June 30, 2005, accrued interest payable on bonds amounted to \$1,440,477.

c) Notes Payable to Federal Emergency Management Agency

On June 16, 2004, the Office of the Authorized Representative of the Governor of the Commonwealth of Puerto Rico at the Federal Emergency Management Agency and the Federal Emergency Management Agency (FEMA) issued an audit report for the solid waste disposal related to the Hurricane Georges disaster that occurred in 1998. Such report shows \$1,705,660 of ineligible costs, which subsequently were reduced to \$1,204,028. On January 19, 2005, the Municipality entered into a payment plan for \$1,204,028 payable in installment of \$50,187 commencing in July 2005, and twenty-three consecutive installments of \$50,167 through June 16, 2007.

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The note does not bear interests and has an imputed interest rate of 5.50 percent. The outstanding balance of this note, net of the unamortized discount of \$61,108, amounted to \$1,142,920 at June 30, 2005. Annual debt service requirements of maturity for notes payable to FEMA are as follows:

<u>Fiscal year ending June 30,</u>	<u>Principal</u>	<u>Accretion/ amortization of discount</u>	<u>Total</u>
2006	\$ 558,474	43,550	\$ 602,024
2007	584,446	17,558	602,004
Totals	<u>\$ 1,142,920</u>	<u>61,108</u>	<u>\$ 1,204,028</u>

d) Notes Payable to CRIM

The Municipality had the following notes payables to CRIM at June 30, 2005:

- **Public Act No. 146** – On September 24, 2002, CRIM, on behalf of the municipalities of Puerto Rico, entered into a financing agreement with GDB pursuant to the provisions of Public Act No. 146 of October 11, 2001, as amended (Act No. 146). The purpose of this financing agreement was to extinguish in advance certain bonds payable issued by Public Finance Corporation (PFC), a subsidiary of GDB, which were originally issued to pay certain property tax receivables owned by the municipalities of Puerto Rico through 1996, which were acquired by PFC with recourse.

The original face amount of the note allocated by CRIM to the Municipality was \$731,579, for a term not exceeding 30 years. The note bears interest at 6.50 percent during its first five years. Subsequently, from years 6 through 30, the loan shall bear variable interest at a rate of 125 points over the 5-year LIBOR rate, which will be adjusted every five years. During the first five years of the note, commenced on July 1, 2003, the Municipality shall pay only interest, except for a principal payment of \$187,222 made by the Municipality during the fiscal year ended June 30, 2005. At the end of the first five years of the note, the repayment terms and conditions of the note shall be renegotiated to allow the Municipality to pay the outstanding balance of the note in equal installments of principal plus interest, through maturity. Interest payments on this financing agreement are accounted for in the general fund.

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The outstanding principal of the note payable to CRIM amounted to \$544,357, at June 30, 2005. The principal and interest maturities are as follows:

Fiscal year ending June 30,	Principal	Interest	Total
2006	\$ -	41,542	\$ 41,542
2007	-	35,644	35,644
2008	19,960	34,843	54,803
2009	21,774	33,437	55,211
2010	21,774	32,022	53,796
2011-2015	108,870	138,880	247,750
2016-2020	108,870	103,497	212,367
2021-2025	108,870	68,113	176,983
2026-2030	108,870	32,730	141,600
2031-2035	45,369	3,185	48,554
Totals	\$ 544,357	523,893	\$1,068,250

At June 30, 2005, accrued interest payable on notes payable to CRIM under Public Act No. 146 amounted to \$5,674.

- **Public Act No. 42** – The Commonwealth’s Pubic Act No. 42 of January 26, 2000 (Act No. 42) was enacted to authorize CRIM to enter into a financing agreement of up to \$200 million, for a term not exceeding 30 years. The financing agreement authorized CRIM to finance a debt that the municipalities of Puerto Rico had with such entity, which arose from the difference between the yearly final settlements of property tax advances made by CRIM to the municipalities and the actual property tax collections received by CRIM from taxpayers through fiscal year 2000. The amounts that the municipalities will collect from the additional property taxes resulting from the increases in the subsidy from the Commonwealth are assigned through Act No. 42 to repay such note. The increase in this subsidy was the result of Public Act No. 238 of August 15, 1999.

In addition, on December 16, 2002 the Municipality entered into a repayment agreement with GDB and CRIM to pay off the remaining \$7,092,328 of excess of property tax advances from fiscal years 2000, 2001 and other previous fiscal years. CRIM retains the principal and interest from the property tax advances of the Municipality. The amounts retained by CRIM are remitted to GDB on July 1 of each fiscal year through July 1, 2032. The repayment agreement bears interest at variable rates determined by GDB (6.30 percent at June 30, 2005) but not exceeding 8.00 percent. Principal and interest payments on this financing agreement are accounted for in the general fund. The outstanding principal and accrued interest balances of this note amounted to \$6,828,141 and \$35,302, respectively, at June 30, 2005. The principal and interest maturities are as follows:

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Fiscal year Ending June 30,	Principal	Interest	Total
2006	\$ 102,125	41,542	\$ 143,667
2007	108,645	35,644	144,289
2008	115,580	34,843	150,423
2009	122,958	33,437	156,395
2010	130,807	32,022	162,829
2011-2015	790,470	138,880	929,350
2016-2020	1,077,101	103,497	1,180,598
2021-2025	1,467,665	68,113	1,535,778
2026-2030	1,999,854	32,730	2,032,584
2031-2035	912,936	3,185	916,121
Totals	\$6,828,141	523,893	\$7,352,034

e) Lease Obligations

The Municipality is obligated under capital leases with third parties that expire through 2008 for the acquisition of machinery and equipment. At June 30, 2005, the capitalized costs and the related accumulated depreciation of the leased machinery and equipment amounted to \$720,225 and \$448,497, respectively, which are accounted for as capital assets in the accompanying statement of net assets. Amortization charges applicable to capital leases and included within depreciation expense amounted to \$145,151 for the fiscal year ended June 30, 2005. The present value of the future minimum capital lease payments reported in the accompanying statement of net assets is as follows:

	Fiscal year ending June 30,	Amount
	2006	\$ 141,109
	2007	98,479
	2008	64,481
	2009	35,762
		<hr/>
Total future minimum lease payments		339,831
Less: amounts representing future interests at a rate of 8.00%		(36,670)
Present value of minimum lease payments at June 30, 2005		303,161
Less: current portion of obligation under capital leases		(121,827)
Obligation under capital leases, excluding current portion		<hr/> \$ 181,334

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

At June 30, 2005, accrued interest payable on obligations under capital leases amounted to \$2,019.

f) Compensated Absences

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

	<u>Due within one year</u>	<u>Due after one year</u>	<u>Total</u>
Accrued vacations	\$ 1,729,958	749,672	\$ 2,479,630
Accrued sick leave	1,261,415	1,285,033	2,546,448
Accrued compensatory time	510,907	-	510,907
Total compensated absences	<u>\$ 3,502,280</u>	<u>2,034,705</u>	<u>\$ 5,536,985</u>

10. Employees' Retirement Systems

a) Plan Description

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

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

• *Retirement Annuity*

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

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
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June 30, 2005

- ***Merit Annuity***

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

- ***Deferred Retirement Annuity***

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

- ***Coordinated Plan***

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

- (a) \$165 per month, if retired with 55 years of age and 30 years of credited service.
- (b) \$110 per month, if retired with less than 55 years of age and 30 years of credited service.
- (c) All other between \$82 and \$100 per month.
- (d) Disability annuities under the coordinated plan are also adjusted at age 65 and in some cases can be reduced over \$165 per month.

- ***Non-Coordinated Plan***

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

- ***Reversionary Annuity***

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

- ***Occupational Disability Annuity***

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

- ***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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

1.50 percent of the average compensation of the first 20 years of credited services, increased by 2 percent for every additional year of credited service in excess of 20 years.

- ***Death Benefits***

Occupational:

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

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

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.

Post-retirement:

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

- ***Refunds***

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

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

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

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

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

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

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there is a pool of plan assets, which is invested by the System, together with those of the cost-sharing multi-employer defined benefit plan. Neither the Commonwealth nor the Municipality guarantee benefits at retirement age. The annuity is based on a formula which assumes that each fiscal year the employee's contribution (with a minimum of 8.28 percent of the employee's salary up to a maximum of 10 percent) is invested as instructed by the employee in an account which either: (1) earns a fixed rate based on the two-year Constant Maturity Treasury Notes, (2) earns a rate equal to 75 percent of the return of the ERS' investment portfolio (net of management fees), or (3) earns a combination of both alternatives. Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability benefits are not granted under System 2000, rather are provided to those participants that voluntarily elect to participate in a private insurance long-term disability program. The employers' contributions (9.28 percent of the employee's salary) with respect to employees under System 2000 will continue and will be used to fund the cost-sharing multi-employer defined benefit plan.

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

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

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

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

- (a) Increase in minimum monthly pension payments to \$300, effective January 1, 2005.
- (b) Triennial 3 percent increase in all pensions, effective January 1, 2005.
- (c) Increase in widow and/or beneficiaries to 50 percent of the benefit received by the deceased pensioner, effective January 1, 2005.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

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

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

b) Funding Policy

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

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

c) Annual Pension Cost and Net Pension Obligation

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

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

11. Commitments and Contingencies

The Municipality is defendant in various legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended, persons are authorized to sue the Municipality only for causes of actions set forth in said Act to a maximum amount of \$75,000 or \$150,000 if it involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

provided in Act No. 9 of November 26, 1975, as amended, the Municipality may provide its officers and employees with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the payment of such judgment.

With respects to pending or threatened litigation, the Municipality has reported liabilities amounting to \$2,618,408 for awarded or anticipated unfavorable judgments as of June 30, 2005. Management believes that any unfavorable outcome in relation to pending or threatened litigation would not be significant, if any.

The Municipality has reported, outstanding encumbrances amounting to \$1,679,701 in the general fund at June 30, 2005. The Municipality intends to honor these encumbrances, which will continue to be liquidated under the current year's budget during a lapse period that extends into the subsequent fiscal year.

At June 30, 2005, the Municipality's Child care and development (SENDEC) grant fund, a nonmajor special revenue fund, reported a fund deficit amounting to \$21,341. It is the intention of the Municipality to cover such deficits through future budgetary appropriations of the general fund. However, no resources have been provided by the general fund for such purposes at June 30, 2005.

12. Prior-period Adjustments and Restatements

During the current year the Municipality recorded several prior-period adjustments to account for the correction of several accounting errors and omissions reported in the audited financial statements issued by the Municipality for the fiscal year ended June 30, 2004, and to conform the accompanying basic financial statements to accounting principles generally accepted in the United States of America.

The Municipality's basic financial statements at June 30, 2004 were substantially prepared, substance over form, on the basis of cash receipts and disbursements with certain modifications to the modified accrual basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles. The basic financial statements at June 30, 2004 did not account for substantial amounts of accounts receivable, accounts payable, accrued liabilities, deferred revenues, inter-fund balances, long-term obligations, and other assets. The Municipality's basic financial statements for the fiscal year ended June 30, 2004 have not been reissued to conform with generally accepted accounting principles, therefore, the accompanying financial statements are not comparable to the basic financial statements previously issued for the fiscal year ended June 30, 2004.

The following schedule presents a summary of the prior-period adjustments recorded in the accompanying balance sheet – governmental funds, and reconciles the fund balances, as previously reported by the Municipality at June 30, 2004, to the beginning fund balances in the accompanying basic financial statements, as restated:

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Notes to Basic Financial Statements
June 30, 2005

	<u>Major governmental funds</u>					<u>Total governmental funds</u>
	<u>General fund</u>	<u>Debt service fund</u>	<u>Bond issuance fund</u>	<u>Works and permanent improvements fund</u>	<u>Other governmental funds</u>	
Assets:						
As previously reported in the audited financial statements at June 30, 2004	\$ 32,447,628	20,215,780	18,497,272		1,057,966	\$ 72,218,646
Add/(deduct): prior-period adjustments	<u>3,982,360</u>	<u>640,753</u>	<u>42,723</u>	<u>4,455,990</u>	<u>5,721,915</u>	<u>14,843,741</u>
Total assets at June 30, 2004, as restated	<u>\$ 36,429,988</u>	<u>20,856,533</u>	<u>18,539,995</u>	<u>4,455,990</u>	<u>6,779,881</u>	<u>\$ 87,062,387</u>
Liabilities:						
As previously reported in the audited financial statements at June 30, 2004	\$ 13,049,819	3,709,147			70,686	\$ 16,829,652
Add/(deduct): prior-period adjustments	<u>8,016,655</u>	<u>(500,732)</u>	<u>424,823</u>	<u>216,780</u>	<u>2,025,654</u>	<u>10,183,180</u>
Total liabilities at June 30, 2004, as restated	<u>\$ 21,066,474</u>	<u>3,208,415</u>	<u>424,823</u>	<u>216,780</u>	<u>2,096,340</u>	<u>\$ 27,012,832</u>
Fund balance:						
As previously reported in the audited financial statements at June 30, 2004	\$ 19,397,809	16,506,633	18,497,272		987,280	\$ 55,388,994
Add/(deduct): prior-period adjustments	<u>(4,034,295)</u>	<u>1,141,485</u>	<u>(382,100)</u>	<u>4,239,210</u>	<u>3,696,261</u>	<u>4,660,561</u>
Total fund balance at June 30, 2004, as restated	<u>\$ 15,363,514</u>	<u>17,648,118</u>	<u>18,115,172</u>	<u>4,239,210</u>	<u>4,683,541</u>	<u>\$ 60,049,555</u>

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

Net assets:	
As previously reported in the audited financial statements at June 30, 2004	\$ 106,619,702
Add/(deduct): prior-period adjustments	<u>(20,750,816)</u>
Total net assets at June 30, 2004, as restated	<u>\$ 85,868,886</u>

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

	Original budgeted amounts	Final budgeted amounts	Actual (budgetary basis)	Variance with final budget – over (under)
Revenues:				
Taxes:				
Property taxes	\$17,557,065	17,557,065	17,762,416	\$ 205,351
Municipal license taxes	11,885,503	11,885,503	10,628,115	(1,257,388)
Construction excise taxes	1,935,000	1,935,000	910,677	(1,024,323)
Intergovernmental grants and contributions	1,613,351	1,613,351	1,949,045	335,694
Interest on deposits	1,500,000	1,500,000	1,457,444	(42,556)
Charges for services	341,500	341,500	1,023,858	682,358
Special item - legal judgment and settlement with Puerto Rico Electric Power Authority	-	798,697	798,697	-
Miscellaneous	11,983,514	8,486,299	1,608,131	(6,878,168)
Transfers from other governmental funds	-	2,698,518	2,698,518	-
Total revenues and transfers from other funds	<u>46,815,933</u>	<u>46,815,933</u>	<u>38,836,901</u>	<u>(7,979,032)</u>
Expenditures:				
Current:				
General government	26,306,167	20,684,622	16,281,387	(4,403,235)
Urban and economic development	7,765,608	9,542,733	12,650,148	3,107,415
Health and sanitation	3,532,712	3,235,202	5,639,452	2,404,250
Public safety	3,825,093	3,534,779	5,718,351	2,183,572
Public housing and welfare	2,545,457	2,319,929	4,909,835	2,589,906
Culture, recreation and education	2,840,896	3,022,350	2,699,866	(322,484)
Debt service:				
Principal	-	428,917	428,917	-
Interest	-	501,816	501,816	-
Capital outlays	-	252,253	252,253	-
Transfers to other funds	-	3,293,332	3,293,332	-
Total expenditures and transfers to other funds	<u>\$46,815,933</u>	<u>46,815,933</u>	<u>52,375,357</u>	<u>\$ 5,559,424</u>

Reconciliation of differences:

Sources/inflows of financial resources:

Actual amounts (budgetary basis) "available for appropriations" from from the budgetary comparison schedule	\$ 38,836,901
Differences - budgetary basis to GAAP:	
Transfers from other funds are inflows of budgetary resources but are not revenues for financial reporting purposes	(2,698,518)
Differences in bases of accounting:	
Net increase in tax receivables	551,145
Net decrease in intergovernmental receivables	(112,683)
Net decrease in accrued interests on deposits	(9,655)
Net increase in other receivables	3,639
Net increase in unearned and unavailable revenues	(691,648)
Total revenues and special item reported on the statement of revenues, expenditures and changes in fund balances	<u>\$ 35,879,181</u>

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

Reconciliation of differences (concluded):

Uses/outflows of financial resources:

Actual amounts (budgetary basis) "total charges to appropriations" from the budgetary comparison schedule	\$ 52,375,357
Timing differences:	
Current year encumbrances recorded as expenditures for budgetary purposes	(2,755,781)
Prior year encumbrances recorded as expenditures for GAAP purposes	3,339,122 (3,117,205)
Entity differences - non-budgeted expenditures	
Differences - budgetary basis to GAAP:	
Transfers to other funds are outflows of budgetary resources but are not expenditures for financial reporting purposes	(3,293,332)
Differences in bases of accounting:	
Net increase in accounts payable and accrued liabilities	260,010
Total expenditures reported on the statement of revenues, expenditures and changes in fund balances	<hr style="width: 100%;"/> \$ 46,808,171 <hr style="width: 100%;"/>

See accompanying notes to basic financial statements.

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

	<u>Budgeted amounts</u>		Actual amounts (budgetary basis)	Variance with final budget – over (under)
	<u>Original</u>	<u>Final</u>		
Revenues:				
Property taxes	\$4,255,008	4,255,008	3,464,920	\$ (790,088)
Interest on deposits	294,258	294,258	294,258	-
Total revenues and transfers from other funds	<u>4,549,266</u>	<u>4,549,266</u>	<u>3,759,178</u>	<u>(790,088)</u>
Expenditures:				
Debt service:				
Principal	1,830,000	1,830,000	1,830,000	-
Interest	2,719,266	2,719,266	2,633,360	(85,906)
Transfers to other funds	-	-	227,973	227,973
Total expenditures and transfers to other funds	<u>\$4,549,266</u>	<u>4,549,266</u>	<u>4,691,333</u>	<u>\$ 142,067</u>

Reconciliation of differences:

Sources/inflows of financial resources:

Actual amounts (budgetary basis) "available for appropriations" from the budgetary comparison schedule	\$ 3,759,178
Differences in bases of accounting:	
Net decrease in property tax receivable	(657)
Net increase in accrued interest receivable	17,988
Total revenues reported on the statement of revenues, expenditures and changes in fund balances - governmental funds	<u>\$ 3,776,509</u>

Uses/outflows of financial resources:

Actual amounts (budgetary basis) "total charges to appropriations" from the budgetary comparison schedule	\$ 4,691,333
Differences - budgetary basis to GAAP:	
Transfers to other funds are outflows of budgetary resources but are not expenditures for financial reporting purposes	(227,973)
Differences in bases of accounting:	
Net increase in matured bonds due and payable	715,000
Net increase in matured interest due and payable	102,909
Total expenditures reported on the statement of revenues, expenditures and changes in fund balances - governmental fund	<u>\$ 5,281,269</u>

See accompanying notes to financial statements.

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

<u>Federal Grantor/Program Title</u>	<u>Federal CFDA Number</u>	<u>Pass-Through Grantor's Number</u>	<u>Expenditures</u>
U.S. Department of Housing and Urban Development			
Pass-through State – Commissioner Office of Municipal Affairs Community Development Block Grant- State Program (SBGP)	14.228	N/A*	\$867,276
Total U.S. Department of Housing and Urban Development			<u>867,276</u>
U.S. Department of Health and Human Services			
Passed through the Office of Administration for Children and Families			
Child Care and Development Block Grant	93.575	N/A	138,057
Community Service Block Grant	93.569	N/A	26,206
Total U.S. Department of Health and Human Services			<u>164,263</u>
U.S. Department of Education			
Even Start – State Educational Agencies	84.213	N/A	227,736
Child and Adult Care Food Program	84.999	N/A	22,963
Total U.S. Department of Education			<u>250,699</u>
U.S. Department of Transportation			
Public Transportation for Nonurbanized Areas	20.509	N/A	32
Total U.S. Department of Transportation			<u>32</u>
Total Federal Financial Assistance			<u>\$ 1,282,270</u>

* Major Programs

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

NOTE 1 - GENERAL

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Municipality of Cataño of the Commonwealth of Puerto Rico and is presented on the accrual basis of accounting. The Municipality of Cataño reporting entity is defined in Note 1 to the Municipality's basic financial statements. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Therefore, some amounts presented in this schedule may differ from amounts presented in our used in the preparation of the basic financial statements.

NOTE 2 - RELATIONSHIP TO THE BASIC FINANCIAL STATEMENTS

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

Expenditures in the basic financial statements:

Major Funds	\$ 61,664,380
Nonmajor Governmental Funds	<u>3,043,924</u>
	64,708,304
Less non-federal expenditures	<u>(63,426,034)</u>
Expenditures in the Schedule of Expenditures of Federal Awards	<u>\$ 1,282,270</u>



BENITEZ-JAIME, CPA-PSC

Certified Public Accountants and Business Consultants

COMMONWEALTH OF PUERTO RICO

MUNICIPALITY OF CATAÑO

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

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

We have audited the financial statements of the Municipality of Cataño of the Commonwealth of Puerto Rico as of and for the year ended June 30, 2005, and have issued our report thereon dated December 19, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Governmental Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Municipality of Cataño of the Commonwealth of Puerto Rico financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as items 05-12 thru 05-20.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Municipality's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters, involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Municipality's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 05-01 thru 05-11.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 05-01 to be a material weakness.

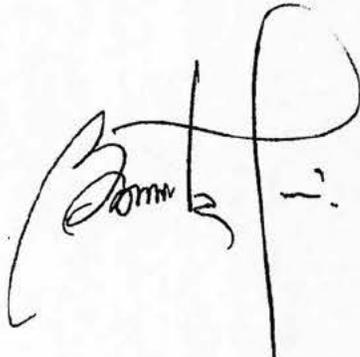
COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO

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

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

Toa Alta, Puerto Rico
December 19, 2005

Stamp No. 2023459
was affixed to the
original report.



CPA - PSC



BENITEZ-JAIME, CPA-PSC

Certified Public Accountants and Business Consultants

COMMONWEALTH OF PUERTO RICO MUNICIPALITY OF CATAÑO

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

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

Compliance

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

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

In our opinion, except for the instances of noncompliance disclosed below, the Municipality of Cataño, Commonwealth of Puerto Rico complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items 05-12 thru 05-20.

Internal Control Over Compliance

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

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO

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

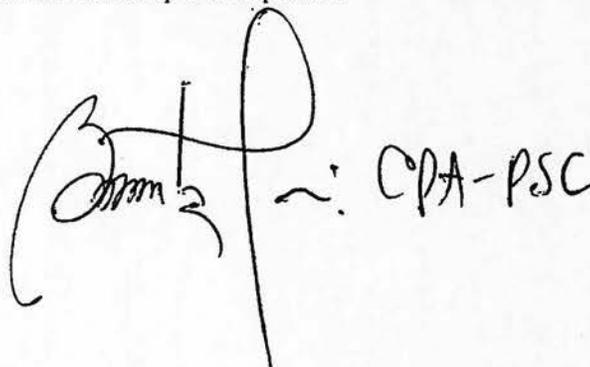
relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Municipality's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 05-01 thru 05-11.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions, and accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 05-01 to be material weakness.

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

Toa Alta, Puerto Rico
December 19, 2005

Stamp No. 2109242
was affixed to the
original report.

A handwritten signature in black ink, appearing to be "Benitez", followed by the initials "CPA-PSC" written in a similar style.

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

Section I - Summary of Auditors' Results

Financial Statements

Type of auditors' report issued: Unqualified

Internal control over financial reporting:

Material weakness(es) identified? yes no

Reportable condition(s) identified
not considered to be material weakness? yes none reported

Noncompliance material to financial statements noted? yes no

Federal Awards

Internal Control over major programs:

Material weakness(es) identified? yes no

Reportable condition(s) identified
not considered to be material weaknesses? yes none reported

Type of auditor's report issued on compliance

For major programs: Qualified

Any audit findings disclosed that are required
to be reported in accordance with
Circular A-133, Section .510(a)? yes no

Identification of major programs:

CFDA Numbers

Name of Federal Program or Cluster

14.228

Community Development Block Grant – State

Dollar threshold used to distinguish
Between Type A and Type B programs: \$500,000

Auditee qualified as low-risk auditee? yes no

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

Section II - Financial Statement Findings

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

05-1 ACCOUNTING SYSTEM

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

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

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

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

05-2 CASH AND BANK ACCOUNTS

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

- a) Checks totaling \$545,753, as of June 30, 2005, have been outstanding for more than one year. The bank reconciliation are the following:

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

	<u>Account Name</u>	<u>Amount</u>
-	Fondos Especiales	\$ 1,547
-	Emprestito \$11,850,000	<u>544,205</u>
		<u>\$545,753</u>

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

- SENDEC
- SBGP
- CDBG IDIS

RECOMMENDATION:

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

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

05-3 LONG-TERM DEBT

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

RECOMMENDATION:

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

05-4 INTERFUND TRANSACTIONS

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

RECOMMENDATION:

We recommend that adequate control procedures be established to assure proper accountability of interfund transactions. These procedures should be designed to properly segregate cash transferred on a

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

loan basis from cash which represents revenue to the program since these transactions have different accounting treatment for financial statement presentation.

05-5 ACCOUNTS PAYABLE AND ENCUMBRANCES

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

RECOMMENDATION:

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

05-6 CASH MANAGEMENT

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

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

RECOMMENDATION:

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

05-7 MUNICIPAL LICENSE TAX

We selected 40 municipal license taxpayers' files for examination amounting to \$226,132.

The following deficiencies were noted during our test:

- In 12 (30%) municipal license taxpayers files examined amounting to \$10,072, the municipal license issued were not present in file.
- In 4 (10%) municipal license tax payer files amounting to \$6,517, the income section of the volume of business tax return was not properly supported.
- In 1 (2%) the "Modelo #5 – Registro de Patente de Industria y Comercio was not prepared.

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

- In 11 (18%) municipal license taxpayer files selected for examination, the taxpayer did not file the income tax return and there were no evidence of the closing of business operations.

RECOMMENDATION:

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

05-8 DISBURSEMENT TEST

As part of our test of cash disbursements during the year (amounting to approximately \$72 million), we selected 60 disbursement vouchers amounting to \$2,764,517. The following deficiencies were noted during our examination:

- In 3 (5%) disbursement vouchers amounting to \$165,880, we noted that the documents were not mark as paid.
- 3 (5%) disbursements vouchers amounting to \$1,409,920 were not available for examination.

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

RECOMMENDATION:

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

05-9 PERSONNEL FILES AND RELATED PAYROLL PROCEDURES

As part of our internal control tests we selected a sample of 60 employee files. The following exceptions were noted during our examination:

- The current salary paid to one employee amounted to \$5,620 per month. The salary ranges for the municipal employees are established in the Municipality's Retribution and Classification Plan. The approved salary for such position amounted to \$2,879 per month. As a result the employee is receiving a monthly overpayment of \$2,741.

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

RECOMMENDATION:

The Personnel Department should review each employee file and ascertain its compliance to the properly approved Retribution and Classification Plan as approved on fiscal year 1999-2000.

05-10 CASH RECEIPT TEST

As part of our test of cash receipts during the year (amounting to approximately \$67 million), we selected 60 receipts amounting to \$637,333, representing 7% of the total receipts. The following deficiencies were noted during our examination:

The following report was not prepared during the 2004-2005 fiscal year:

- "Modelo 2 – Libro de Caja"

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

RECOMMENDATION:

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

05-11 INACTIVE AND UNNECESSARY FUNDS AND INACTIVE BANK ACCOUNTS

The Municipality is maintaining an excessive number of funds and bank accounts that have been inactive for a long period. The accounting records include over 59 different funds, many of which have been inactive or had insignificant movement on operations during the year under audit.

Also, two bank accounts have been inactive during the current fiscal year. The bank accounts are the following:

- UMTA
- 1999 Reserve Surplus

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

RECOMMENDATION:

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

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

Section III - Federal Award Findings and Questioned Costs

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
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All Programs

GENERAL MATTERS APPLICABLE TO MORE THAN ONE PROGRAM

05-12 ACCOUNTING SYSTEM

Statement of Condition:

The accounting records maintained by the Federal Programs Office are not reconciled with the accounting records maintained for the federal programs by the Municipality's central accounting department. The Municipality has not established procedures for the reconciliation of the transactions on a periodic basis. OMB Circular A-102, 20 (b) (2), requires recipients of federal funds to have a financial management system that provides for the maintenance of accurate, current and complete records of the financial results of the federal program.

NONE

Recommendation:

The Municipality should perform periodic reconciliations between the accounting records held per each federal program and the Finance Department accounting records and reports, in order to provide for an effective detection control within the financial management system.

CSBG
CFDA No. 93.569

05-13 FEDERAL CASH MANAGEMENT SYSTEM

Statement of Condition:

The Municipality has not established effective cash management procedures. The program had an average cash balance of \$40,588, during the fiscal year. There were months which reported balances as high as \$59,193, at the end of the month.

NONE

Criteria:

Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Program's immediate cash needs.

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

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
Child Care CFDA No. 93.575	<p>Recommendation:</p> <p>In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely and possible to the actual disbursements.</p> <p>05-14 FEDERAL CASH MANAGEMENT SYSTEM</p> <p>Statement of Condition:</p> <p>The Municipality has not established effective cash management procedures. The program has an average cash balance of \$10,980, during the fiscal year. There were months which reported balances as high as \$40,495, at the end of the month.</p> <p>Criteria:</p> <p>Federal Regulation required that grantees shall conform to the standards applicable to advances from Federal Agencies. Amounts requested should be limited to the Program's immediate cash needs.</p> <p>Recommendation:</p> <p>In accordance with Federal Regulations, the Municipality should estimate drawdown of Federal funds as closely as possible to the actual disbursements.</p>	NONE
Child and Adult Care Food Program CFDA NO. 84.999	<p>05-15 FEDERAL CASH MANAGEMENT SYSTEM</p> <p>Statement of Condition:</p> <p>The Municipality has not established effective cash management procedures. The program has an average cash balance of \$81,589, during the fiscal year. There were months which reported balances as high as \$86,023, at the end of the month.</p> <p>Criteria:</p> <p>Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.</p>	NONE

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

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
	<p>Recommendation:</p> <p>In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.</p>	
Even Start Program CFDA NO. 84.213	<p>05-16 FEDERAL MANAGEMENT SYSTEM</p> <p>Statement of Condition:</p> <p>The Municipality has not established effective cash management procedures. The program has an average cash balance of \$15,402 during the fiscal year. There were months which reported balances as high as \$47,096, at the end of the month.</p> <p>Criteria:</p> <p>Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.</p> <p>Recommendation:</p> <p>In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.</p>	NONE
School to Work CFDA No. 84.278	<p>05-17 FEDERAL CASH MANAGEMENT SYSTEM</p> <p>Statement of Condition:</p> <p>The Municipality has not established effective cash management procedures. The program has an average cash balance of \$33,401, during the fiscal year. There were months which reported balances as high as \$138,869, at the end of the month.</p>	NONE

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

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
	<p>Criteria:</p> <p>Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.</p> <p>Recommendation:</p> <p>In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.</p>	
SBGP CFDA No. 14.228	<p>05-18 INADEQUATE DOCUMENTATION OF PARTICIPANT FILES</p> <p>Statement of Condition:</p> <p>As part of our test to determine whether the grantee assure that the rehabilitation work is properly completed, we selected a sample of 40 participants. The following documents were not available for examination:</p> <p>a. Income verification not present on file 1 File 3%</p> <p>Criteria:</p> <p>According to 24 CFR, 570.506 the grantee must assure that the work is properly completed. For each residential rehabilitation activity the following records are needed:</p> <p>a) Re-habilitation contract describing the deficiencies in each structure to be corrected.</p> <p>b) An inspection of the rehabilitation work upon completion to assure that it was carried out in accordance with contract specifications.</p> <p>Recommendation:</p> <p>The Municipality must inspect the rehabilitation work upon completion to assure that it is carried out in accordance with the contract specifications.</p>	<p>NONE</p>

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

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
SBGP CFDA 14.228	<p>05-19 DAVIS-BACON ACT</p> <p>Statement of Condition:</p> <p>As part of our audit tests we selected 1 weekly payroll from the following construction projects:</p> <ul style="list-style-type: none">- Reparación de aceras y encintados en varios sectores (98-FD-13-003)- Remodelación Edificio Antigua Casa Alcaldía (00-FD-13-002)- Remodelación de Edificio Programa Aprendamos en Familia (00-FD-13-003)- Construcción área recreativa pasiva bajo Puente (01-FD-13-001)- Mejoras al centro de Convenciones y Terminal carros públicos de Cataño (02-FD-13-001)- Mejoras al Sistema Pluvial en calle Prolongación, La Puntilla (03-AB-13-002)- Repavimentación de calles en sectores La Puntilla, Pueblito y Sector Bajo Costo (03-FC-13-001)- Construcción Centro de Cuido Diurno La Puntilla (97-FD-13-007) <p>Then following exceptions were noted during our examination:</p> <p>(a) In 4 projects the certified payrolls selected for examination did not included the required employees' information. The projects were the following:</p> <ul style="list-style-type: none">-98-FD-13-003-00-FD-13-003-01-FD-13-001-02-FD-13-001 <p>(b) One project file was not available for examination.</p> <ul style="list-style-type: none">-97-FD-13-007	NONE

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

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
	<p>(c) In two projects the pre-construction conference minute was not present on file. The projects were the following:</p> <p style="padding-left: 40px;">-01-FD-13-001 -03-AB-13-002</p> <p>(d) In two project files the weekly payrolls were not certified as required by the federal regulations. The projects were the following:</p> <p style="padding-left: 40px;">-00-FD-13-003 -02-FD-13-001</p> <p>Criteria:</p> <p>According to HUD Handbook:</p> <p>Contractor weekly payrolls and other basic records should be reviewed during routine compliance enforcement activity on every construction project. Submitted payrolls shall be examined to assure compliance with the labor standards. Also, a preconstruction conference must be held to explain labor standards.</p> <p>Recommendation:</p> <p>The Municipality should establish procedures to ascertain that all documents submitted by the contractor are reviewed and approved on a timely basis to ensure compliance with labor standards.</p>	
<p>SBGP CFDA No. 14.228</p>	<p>05-20 EARMARKING REQUIREMENT</p> <p>Statement of Condition:</p> <p>As of June 30, 2005, the Municipality expended less than 70 percent of the funds over a period of up to three years, for activities that benefit low-and moderate-income persons as required by the federal regulation.</p>	<p>NONE</p>

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

<u>Program</u>	<u>Findings/Noncompliance Recommendations</u>	<u>Questioned Cost</u>
	<p>Criteria:</p> <p>According to 24 CFR, 570.506 the grantee must assure that not less than 70 percent of the funds must be used over a period of up to three years, as specified by the grantee in its certification, for activities that benefit low- and moderate-income persons.</p> <p>Recommendation:</p> <p>The Municipality should establish procedures to ascertain that comply with the earmarking requirement in accordance with 24 CFR sections 570.420 and 570.430.</p>	
	Total Questioned Costs	<u>\$ -</u>



Estado Libre Asociado de Puerto Rico
Gobierno Municipal
Cataño, P.R. 00963
Departamento de Finanzas



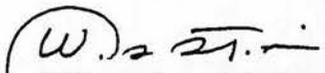
December 19, 2005

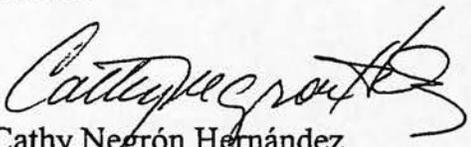
Benitez-Jaime, CPA-PSC
Certified Public Accountants and Business Consultants
PO Box 191503
San Juan, PR 00919-1503

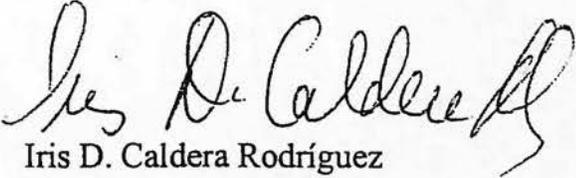
Dear Auditors:

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

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


Hon. Wilson Soto Molina
Mayor


Cathy Negrón Hernández
Finance Director


Iris D. Caldera Rodríguez
Federal Programs Director

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

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

- FR - Fully resolved (indicating the corrective action plan was fully implemented).
- PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2004-2005).
- NR - Not resolved yet. Finding repeated in fiscal year 2004-2005.

<u>Finding Number</u>	<u>Title</u>	<u>Corrective Action Taken</u>
04-1	Cash management	NR
04-2	◦ Cash management	NR

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

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

- FR - Fully resolved (indicating the corrective action plan was fully implemented).
- PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2004-2005).
- NR - Not resolved yet. Finding repeated in fiscal year 2004-2005.

<u>Finding Number</u>	<u>Title</u>	<u>Corrective Action Taken</u>
03-1	Cash Management System	NR