

OFICINA DEL COMISIONADO DE ASUNTOS MUNICIPALES
AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL
AREA DE ARCHIVO DIGITAL

MUNICIPIO DE LARES
AUDITORIA 2004-2005
30 DE JUNIO DE 2005

RECIBO DEL COMISIONADO

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES**

**BASIC FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED
JUNE 30, 2005**

ORTIZ, RODRIGUEZ, RIVERA & CO.

CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

Suite 152, PO Box 70250, San Juan, P.R. 00936-7250 • Phone (787) 756-8524, Fax (787) 274-0562

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
BASIC FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

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INDEPENDENT AUDITORS' REPORT

To the Honorable Mayor and
Municipal Legislature
Municipality of Lares
Lares, 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 Lares, as of and for the year ended June 30, 2005, which collectively comprise the Municipality's basic financial statements, as listed in the table of contents. These financial statements are the responsibility of the Municipality's management. Our responsibility is to express opinions on these financial statements based on our audit.

We 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 statement presentation. We believe that our audit provides a reasonable basis for our opinions.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated December 2, 2005, on our consideration of the Municipality's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance

and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 3 through 13 and the Budgetary Comparison Schedule - General Fund on pages 33 and 34 are not a required parts of the basic financial statements, 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 inquires 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, Local Governments, and Non-Profit Organizations*, and is also not a required part of the basic financial statements of the Municipality. The schedule of expenditures of federal awards has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Ortiz, Rodriguez, Rivera & Co

San Juan, Puerto Rico
December 2, 2005

The stamp 2101419 was affixed
to the original of this report.



Commonwealth of Puerto Rico
MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

The following discussion and analysis of the Municipality of Lares' financial performance provides an overview of the Municipality's financial activities for the fiscal year ended June 30, 2005. Please read it in conjunction with the financial statements which follow this section.

FINANCIAL HIGHLIGHTS

Highlights for Government-wide Financial Statements

The government-wide financial statements report information about the Municipality as a whole using the economic resources measurement focus and accrual basis of accounting:

- The assets of the Municipality, on a government-wide basis, exceeded its liabilities at the close of fiscal year 2005 by \$8,610,347 (net assets).
- Revenues increased by \$1,980,117 (14.2%) and expenses increased \$660,071 (4.5%) in comparison with year 2004, as restated.
- Net change in net assets amounted to \$487,361, an increase of 157% with respect to prior year (2004) net change.

Highlights for Fund Financial Statements

The fund financial statements provide detailed information about the Municipality's most significant funds using the current financial resources measurement focus and modified accrual basis of accounting:

- At the close of the current fiscal year, the Municipality's governmental funds reported combined ending fund balances of \$1,610,108, a decrease of \$1,551,745 in comparison with the prior year.
- The General Fund reported an excess of expenditures and other financing uses over revenues of \$2,218,313 and an unreserved (deficit) fund balance of (\$4,733,044). Unreserved (deficit) fund balances increased by (\$2,435,359) from prior year.

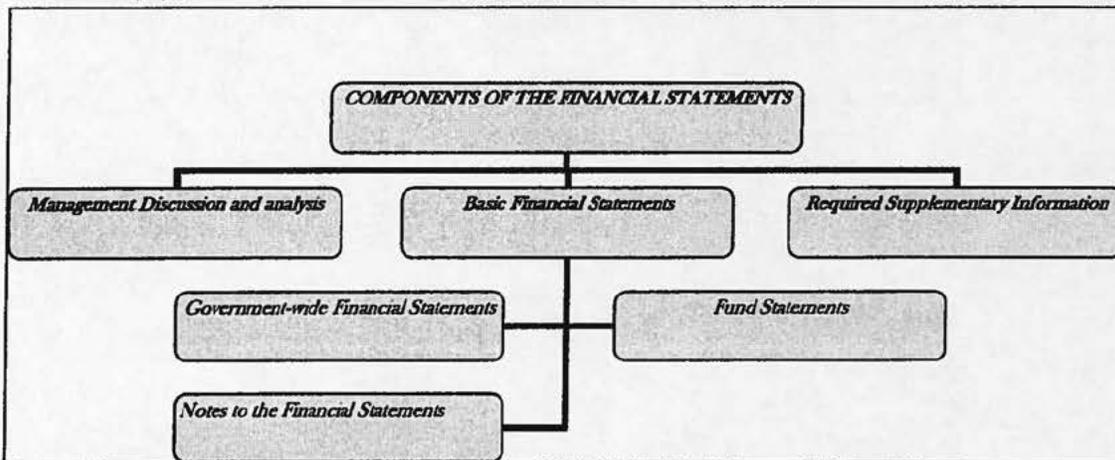
General Financial Highlights

- The investment in net capital assets as of June 30, 2005 was \$7,672,500 (net of related debt).
- Long term debt general obligations decreased to \$289,000, approximately 11.6% with respect to prior year balance.
- Other long term debts increases and net reductions from payments amounted to \$443,896 and \$185,983, respectively.
- On a budgetary basis, actual expenditures exceeded actual revenues by \$2,569,240.
- Revenues decrease was mainly due to over estimate of \$513,065 in construction taxes and \$978,246 in other revenues that the Municipality does not included as an amendment to the budget.

Commonwealth of Puerto Rico
MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

OVERVIEW OF THE FINANCIAL STATEMENTS

The Municipality's basic financial statements comprise three components: (1) management discussion and analysis (presented here), (2) basic financial statements, and (3) required supplementary information.



The Municipality's basic financial statements consist of two kinds of statements, each with a different view of the Municipality's finances. The government-wide financial statements provide both long-term and short-term information about the Municipality's overall financial status. The fund financial statements focus on major aspects of the Municipality's operations, reporting those operations in more detail than the government-wide statements:

Basic Financial Statements

- **Government-Wide Financial Statements**

The government-wide statements report information about the Municipality as a whole using accounting methods similar to those used by private-sector businesses. They are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. The first government-wide statement – the *Statement of Net Assets* – presents information on all of the Municipality's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in the Municipality's net assets are an indicator of whether its financial health is improving or deteriorating. Other non-financial factors such as the condition of the Municipality's roads and other infrastructure may need to be considered to assess the overall health of the Municipality. The second statement – the *Statement of Activities* – presents information showing how the net assets changed during the year. All of the current year's revenues and expenses are taken into account in the statement of activities regardless of when cash is received or paid.

The government-wide statements reports as governmental activities the Municipality's basic services such as public safety, public works, health and sanitation, culture and recreation, solid waste disposal, human services and welfare, and community development; education and general administration. These activities

Commonwealth of Puerto Rico
MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

are primarily financed through property taxes, other local taxes and intergovernmental revenues. Included in the governmental activities are the governmental funds.

- ***Fund Financial Statements***

The fund financial statements provide more detailed information about the Municipality's most significant funds. Funds are accounting devices that the Municipality uses to keep track of specific sources of funding and spending for particular purposes. Some funds are required by Federal and Commonwealth regulations, as well by bond covenants.

The Municipality's basic services are included in governmental funds, which are used to account for essentially the same functions reported as governmental activities in the government-wide statements. However, unlike the government-wide statements, the governmental funds are prepared using the flow of current financial resources measurement focus and the modified accrual basis of accounting. Under this approach the financial statements focus on near-term inflows and outflows of external resources, as well on balances of expendable resources available at year end. Consequently, the governmental fund statements provide a detailed short-term view that helps the reader determine whether there are more or fewer financial resources that can be spent in the near future to finance the Municipality's programs. Because this information does not encompass the additional long-term focus of the government-wide statements, additional information is provided on a subsequent page that explains the relationship (or differences) between the government-wide and fund statements.

The governmental fund statements focus on major funds. The Municipality's major funds are the general fund (which accounts for the main operating activities of the Municipality) and funds that complies with a minimum criterion (percentage of the assets, liabilities, revenues or expenditures). Funds that do not comply with this criterion are grouped and presented in a single column as other governmental funds.

- ***Notes to the financial statements***

Provides integral information needed to explain the basis for the numbers used within the Basic Financial Statements and provide more detailed data.

Required supplementary information

Provides additional information to better understand the financial position of the Municipality and contains the Budgetary Comparison Schedule for the General Fund.

Commonwealth of Puerto Rico
MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE

Net Assets

The following table presents a summary of the Statements of Net Assets as of June 30, 2005 and 2004:

| Table 1 | | |
|---|----------------------------|----------------------------|
| Statement of Net Assets | | |
| As of June 30, | | |
| | 2005 | 2004 |
| Current and non-current assets..... | \$ 7,471,020 | \$ 5,699,014 |
| Capital assets (As Restated)..... | <u>9,878,500</u> | <u>8,607,566</u> |
| Total Assets | <u>17,349,520</u> | <u>14,306,580</u> |
| Current liabilities | 3,664,123 | 1,010,031 |
| Deferred revenues..... | 756,086 | 410,380 |
| Long-term liabilities..... | <u>4,318,656</u> | <u>4,763,183</u> |
| Total Liabilities | <u>8,739,173</u> | <u>6,183,594</u> |
| Net Assets: | | |
| Investment in capital assets, Net of Related Debt (As Restated)..... | 7,672,500 | 6,237,566 |
| Restricted | 5,019,023 | 6,591,539 |
| Unrestricted (As Restated) | <u>(4,081,176)</u> | <u>(4,706,119)</u> |
| Total Net Assets | <u>\$ 8,610,347</u> | <u>\$ 8,122,986</u> |

Net assets (assets over liabilities) may serve over time as a useful indicator of a government's financial position. Net assets for the year increased 6% with respect to prior year as restated. The most significant change was an increased in restricted assets of \$1,572,516.

The largest portion of the Municipality's net assets reflects its investment in capital assets (e.g., land, buildings, equipment, and infrastructure) for \$7,672,500; total capital assets (\$13,238,867) less accumulated depreciation (\$3,360,367) and less any related outstanding debt (\$2,206,000) used to

acquire those assets. The Municipality uses these assets to provide services to its citizens and consequently, these assets are not available for future spending. The resources needed to repay the debt related to these capital assets must be provided from other sources, because capital assets are not generally liquidated for the purpose of retiring debt.

Restricted net assets represent resources that are subject to external restrictions on how they may be used.

Unrestricted net assets are the part of the net assets that can be used to finance day-to-day operations without constrains established by debt covenants, enabling legislation or other legal requirements.

As of June 30, 2005 the Municipality presented unrestricted (deficit) net assets of (\$4,081,176). This balance was affected by long term obligations such as compensated absences \$1,318,656 and other debts for the amount of \$718,419 for which the Municipality did not provide funding in previous budgets. Historically, such obligations have been budgeted on a pay as you go basis without providing funding for their future liquidation.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

Changes in net assets

The following table summarizes the changes in net assets for the years ended June 30, 2005 and 2004:

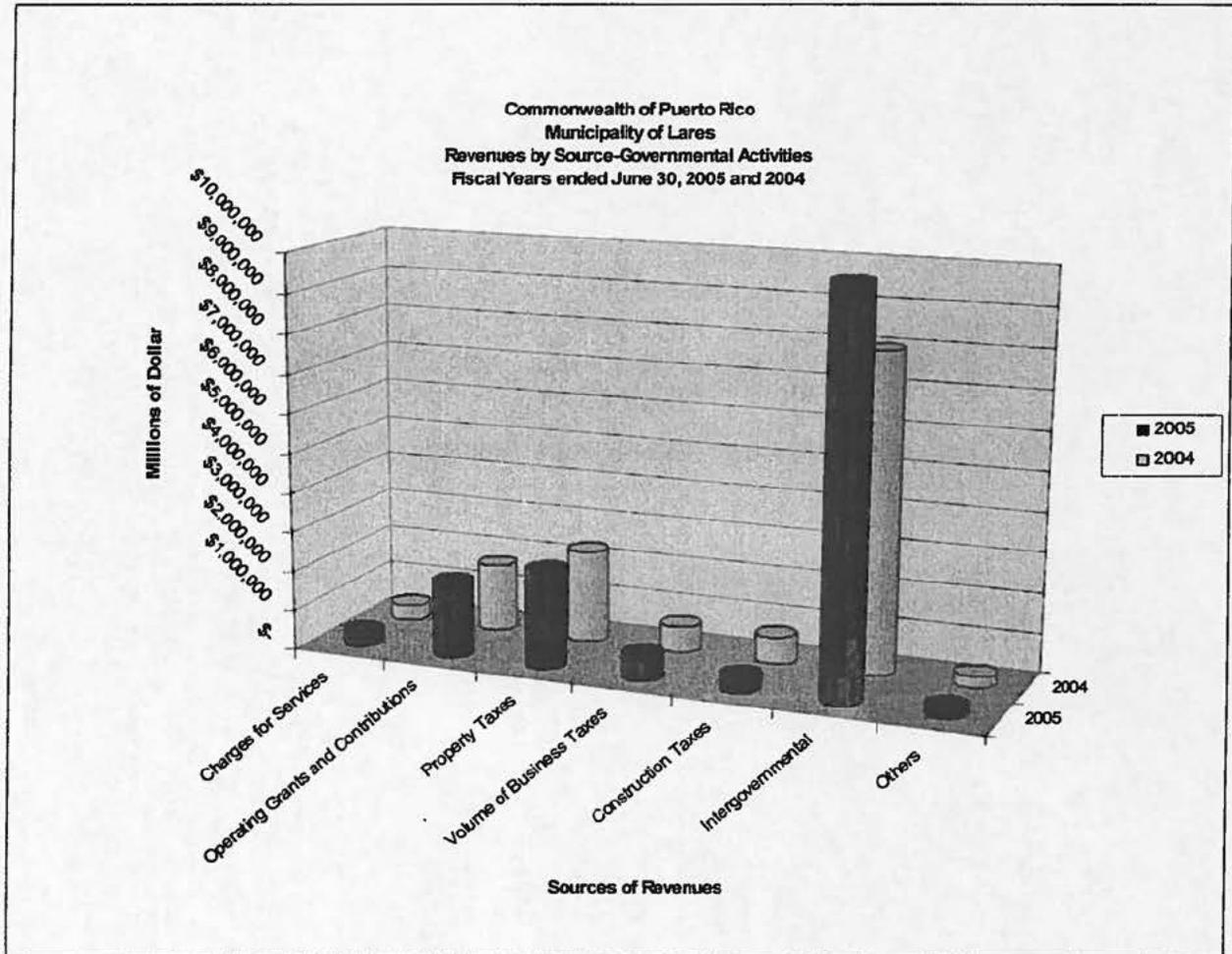
| Table 2 | | |
|---|----------------------------|----------------------------|
| Changes in Net Assets | | |
| For Fiscal Years Ending June 30, | | |
| | 2005 | 2004 |
| Revenues: | | |
| Program Revenues: | | |
| Charges for Services..... | \$ 381,065 | \$ 380,485 |
| Operating Grants and Contributions.... | 1,890,614 | 1,713,073 |
| General Revenues: | | |
| Property Taxes..... | 2,456,674 | 2,320,295 |
| Volume of Business Taxes..... | 640,433 | 649,056 |
| Construction Taxes..... | 391,935 | 667,710 |
| Intergovernmental..... | 9,966,130 | 8,009,010 |
| Other General Revenues..... | <u>262,507</u> | <u>269,612</u> |
| Total revenues | <u>15,989,358</u> | <u>14,009,241</u> |
| Expenses: | | |
| General Administration..... | 6,814,218 | 7,053,626 |
| Public Safety..... | 1,063,718 | 770,003 |
| Public Works..... | 1,915,655 | 1,587,590 |
| Culture and Recreation..... | 724,341 | 713,773 |
| Health and Sanitation..... | 1,315,436 | 1,049,959 |
| Solid Waste Disposal..... | 215,202 | 295,585 |
| Human Services and Welfare..... | 1,958,059 | 1,131,989 |
| Urban Development..... | 1,142,594 | 2,381,923 |
| Education..... | 216,133 | - |
| Interest Costs..... | <u>136,641</u> | <u>153,063</u> |
| Total expenses | <u>15,501,997</u> | <u>14,841,926</u> |
| Changes in net assets | 487,361 | (832,685) |
| Net assets – beginning, as Restated*..... | <u>8,122,986</u> | <u>8,955,671</u> |
| Net assets – ending | <u>\$ 8,610,347</u> | <u>\$ 8,122,986</u> |

Prior Period Adjustment to capital assets is (\$212,842), long-term debts (\$422,495) and others for \$50,601.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

Figure 1 presents revenues comparison by sources of the governmental activities during the past two years:

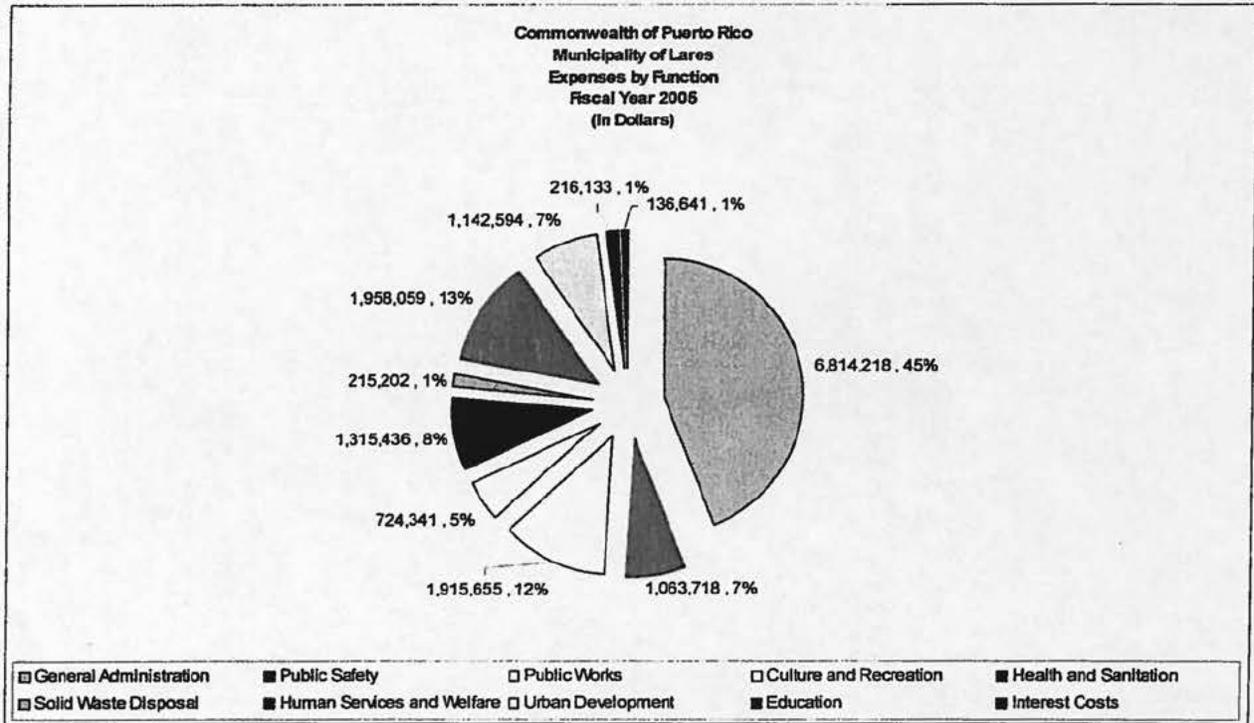
FIGURE 1



Commonwealth of Puerto Rico
MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

Figure 2 presents expenses by function of the governmental activities during the fiscal year 2004-2005:

FIGURE 2



Approximately 62.4% of the Municipality's revenues came from intergovernmental, 11.9% from grants and contributions, 15.4% from property taxes, and 10.3% from other sources. The Municipality's expenses cover a range of services. The largest expenses are general administration with 44%, public works with 12.4%, human services and welfare with 12.7%, health and sanitation with 8.5%, and urban development with 7.4%. Program revenues of the Municipality covered 14.7% of total expenses.

With respect to prior year, revenues increased by approximately \$1,980,000 or 14.2%, principally on intergovernmental.

Expenses increased 4.5% or \$660,071 in comparison with 2004 year. Significant increases were registered on benefits to employees, and donations and services incurred for the benefit of the community. Also, increases were on Public works and Health and Sanitation due to additional capital assets maintenance and other non-capitalize costs.

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MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

The following table focuses on the cost of each of the Municipality's largest functions/programs as well as each functions/program's net cost (total cost less fees generated by the programs and program-specific intergovernmental aid):

TABLE 3

| Net Cost of Municipality's Governmental Activities | | | | |
|---|-------------------------------|---------------------|-----------------------------|---------------------|
| Fiscal years ended June 30, | | | | |
| Functions/Programs | Total Cost of Services | | Net Cost of Services | |
| | 2005 | 2004 | 2005 | 2004 |
| General Administration | \$ 6,814,218 | \$ 7,053,626 | \$ 6,433,153 | \$ 6,673,141 |
| Public Safety | 1,063,718 | 770,003 | 1,063,718 | 770,003 |
| Public Works | 1,915,655 | 1,587,590 | 1,915,655 | 1,587,590 |
| Health and Sanitation | 1,315,436 | 754,374 | 1,315,436 | 754,374 |
| Human Services and Welfare | 1,958,059 | 1,131,989 | 1,601,004 | 633,272 |
| Urban Development | 1,142,594 | 2,381,923 | 390,965 | 1,167,567 |
| Others | 1,292,317 | 1,162,421 | 510,387 | 1,162,421 |
| | <u>\$15,501,997</u> | <u>\$14,841,926</u> | <u>\$13,230,318</u> | <u>\$12,748,368</u> |

Some of the cost of governmental activities in 2005 was paid by those who directly benefited from the programs (\$381,065) and other governments and organizations that subsidized certain programs with grants and contributions (\$1,890,614). The \$13,230,318 net cost of services was substantially covered by other general revenues including property, volume of business license taxes and intergovernmental.

FINANCIAL ANALYSIS OF THE MUNICIPALITY'S FUNDS

Governmental funds

The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows and balances of resources available for spending. Such information is useful in assessing the Municipality's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a Municipality's net resources available at the end of a fiscal year. For the Fiscal year ended June 30, 2005, the governmental funds reported combined ending fund balances of \$1,610,108, a net decrease of \$1,551,745 in comparison with the prior year. This decrease was caused primarily by a net change in the general fund of \$2,218,313 and in non-major funds corresponding to the uses of prior years fund balance of \$503,776. Of total combined fund balances, (\$4,369,098) constitutes unreserved (deficit) fund balance of general fund which was financed by the used of state assignments fund. The remainder of fund balance is reserved to indicate that is not available for new spending.

The general fund is the operating fund of the Municipality. Unreserved (deficit) fund balance of the general fund represents approximately 108% of total ending general fund balance (deficit). For the year ended June 30, 2005, the fund balance (deficit) of the general fund increased by \$2,218,313 when compared with the prior year. The principal component of the net decreases is a excess of expenditures over revenues.

GENERAL FUND BUDGETARY HIGHLIGHTS

The general fund original budget for the fiscal period 2004-2005 presented an increase of 4.2% with respect to prior year budget. During the fiscal year budget revenues were increased by \$121,225 due to \$121,225 of a revision of original estimate of intergovernmental revenues. The Municipality does not included as an amendment to the budget the reduction on projected revenues in volume of business taxes, construction taxes and other revenues. Budget expenditures were amended during the year in accordance with addition intergovernmental revenues and functions estimates.

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MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

A negative variance of \$2,569,240 between revised budget and actual expenditures was due mainly to reduction in revenues as explain in the preceding paragraph and excess of expenditures in some functions. The Municipality reported more expenditures than appropriations in those functions for payments to purchase of supplies, and professional and nonprofessional services.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital assets

At the end of the fiscal year, the Municipality has invested \$9,878,500 (net of accumulated depreciation) in a broad range of capital assets, including buildings, land, construction in progress and equipment. This amount represents a net increase of \$1,270,934 or over 14.8% from the prior year, as restated.

TABLE 4

| Capital Assets, net As of June 30, | | |
|---|--------------------------------|-------------------------------|
| | Governmental Activities | |
| | 2005 | (As restated) 2004 |
| Non-depreciable assets: | | |
| Land | \$ 2,150,134 | \$ 2,150,134 |
| Construction in progress | 1,110,022 | 311,361 |
| Depreciable assets: | | |
| Buildings | 5,180,551 | 5,303,351 |
| Equipment and Vehicles | 737,057 | 213,246 |
| Furniture and Fixtures | 24,782 | 30,970 |
| Heavy Equipment | 406,471 | 324,450 |
| Infrastructure | 269,483 | 274,054 |
| Total | \$ 9,878,500 | \$ 8,607,566 |

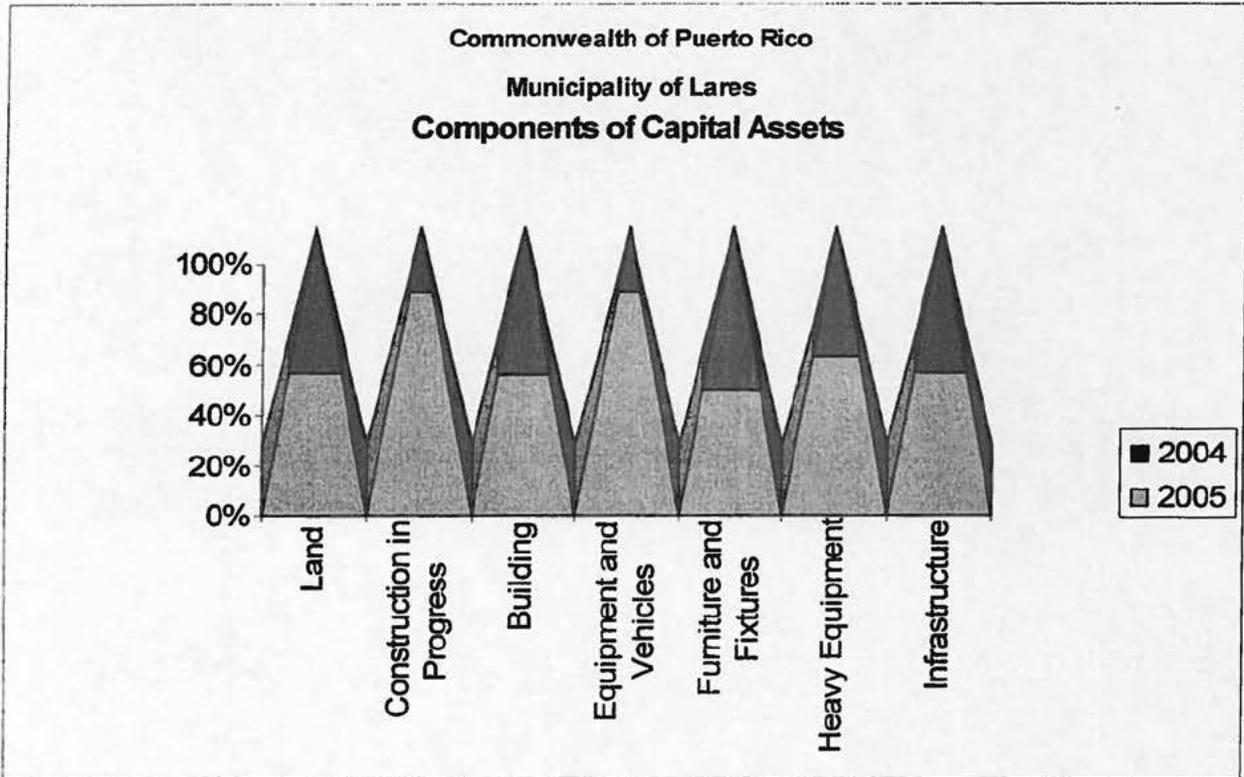
The Municipality acquired a total of \$1,699,764 of capital assets during the fiscal year 2004-2005 as follows:

- Construction in Progress – \$798,661 – The principal projects are the following:
 - Feliu Méndez Coliseum (\$402,070)
 - Piletas Gym (\$42,011)
 - Castañer Fire Station (\$195,914)
 - Infrastructure (\$71,644)
- Acquisition of Equipment and Vehicles – \$901,103

Other projects related to repair and maintenance of roads (not capitalized) was developed during the year 2005.

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MUNICIPALITY OF LARES, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

FIGURE 3



Long term debt

At year-end, the Municipality had \$2,206,000 in general obligation bonds, a decrease of 11.6% with respect to prior year. The following is a summary of the Municipality's outstanding debt as of June 30, 2005 and 2004:

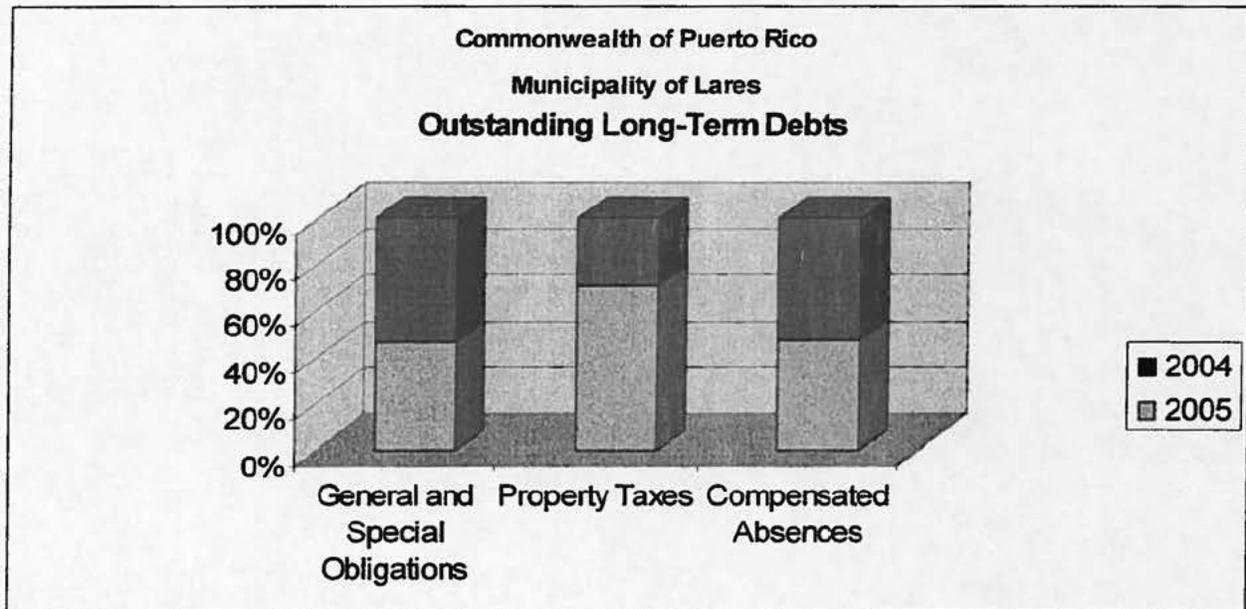
TABLE 5

| Outstanding Long-term Debt As of June 30, | | |
|--|--------------------------------|---------------------|
| | Governmental Activities | |
| | 2005 | 2004 |
| General Obligation Bonds | \$ 2,206,000 | \$ 2,495,000 |
| Property Taxes – MRCC | 718,419 | 295,924 |
| Compensated Absences | 1,394,237 | 1,558,819 |
| Total | \$ 4,318,656 | \$ 4,349,743 |

The decrease in the others debts is due to recognition of advance property taxes, and decrease in compensated absences. More detailed information about the Municipality's long term liabilities is presented in Note 6 and 7 to the financial statements.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
 FOR THE FISCAL YEAR ENDED JUNE 30, 2005

FIGURE 4



ECONOMIC FACTORS AND NEXT YEAR'S BUDGET

The Municipality's selected and appointed officials considered many factors when setting the fiscal year 2005-2006 budget. One of these factors is the economy. Among economic areas considered are the population growth estimates, personal income, housing statistics and unemployment rates. The Municipality's unemployment rate now stands at 11.8%, which compares with the Commonwealth rate of 10.6%.

The Municipality applied a conservative approach in development budget estimates. Amounts available for appropriations in the General Fund for the fiscal year 2006 are \$10.4 million, similar of the fiscal year 2005. A reduction on property taxes estimate and the closure of a big manufacturing industry reduced the possible increases in revenues for year 2006. Budgeted expenditures are expected to stabilize accordingly to the projected revenues. Among planned projects, this budget may be adjusted in accordance with economic injection projected when the construction project promoted by the Municipality and others private projects were develop during the year.

CONTACTING THE MUNICIPALITY'S FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, and creditors with a general overview of the Municipality's finances and to demonstrate the Municipality's accountability for the money it receives. If you have questions about this report or need additional information, contact the Municipality's Finance Department at [(787) 897-2300] or P.O. Box 395, Lares, Puerto Rico 00669.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

STATEMENT OF NET ASSETS

JUNE 30, 2005

| | <u>GOVERNMENTAL ACTIVITIES</u> |
|---|------------------------------------|
| ASSETS: | |
| Cash and Investments..... | \$ 4,436,964 |
| Cash with Fiscal Agent..... | 229,474 |
| Receivables (net): | |
| Property Taxes | 28,896 |
| Federal Grants..... | 1,707,811 |
| Due from Governments | <u>1,067,875</u> |
| Capital Assets (Note 5): | |
| Land, Improvements, and Construction in Progress..... | 3,260,156 |
| Other Capital Assets, [Net of Depreciation]..... | <u>6,618,344</u> |
| Total Capital Assets..... | <u>9,878,500</u> |
| TOTAL ASSETS..... | <u>17,349,520</u> |
| LIABILITIES: | |
| Accounts Payable and Accrued Expenses..... | 3,605,123 |
| Accrued Interest | 59,308 |
| Deferred Revenue | 756,086 |
| Long-Term Liabilities (Note 6): | |
| Due within One Year | 860,931 |
| Due in More than One Year..... | <u>3,457,725</u> |
| Total Liabilities..... | <u>8,739,173</u> |
| NET ASSETS | |
| Invested in Capital Assets, Net of Related Debt..... | 7,672,500 |
| Restricted for: | |
| Debt Service | 166,466 |
| Community Development Projects..... | 1,534,344 |
| Other Purposes..... | 3,318,213 |
| Unrestricted | <u>(4,081,176)</u> |
| TOTAL NET ASSETS | <u>\$ 8,610,347</u> |

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

STATEMENT OF ACTIVITIES

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

| FUNCTIONS/PROGRAMS | EXPENSES | PROGRAM REVENUES | | | NET (EXPENSE) REVENUE (SEE NEXT PAGE) |
|---|---------------------|-------------------------|--|--|---|
| | | CHARGES FOR SERVICES | OPERATING GRANTS AND CONTRIBUTIONS | CAPITAL GRANTS AND CONTRIBUTIONS | |
| Governmental Activities: | | | | | |
| Mayor and Municipal Legislature | \$ 548,008 | \$ - | \$ - | \$ - | (\$ 548,008) |
| General Government | 6,266,210 | 381,065 | - | - | (5,885,145) |
| Public Safety | 1,063,718 | - | - | - | (1,063,718) |
| Public Works | 1,915,655 | - | - | - | (1,915,655) |
| Culture and Recreation | 724,341 | - | - | - | (724,341) |
| Sanitation | 1,315,436 | - | - | - | (1,315,436) |
| Solid Waste Disposal | 215,202 | - | - | - | (215,202) |
| Human Services and Welfare | 1,958,059 | - | 357,055 | - | (1,601,004) |
| Urban Development | 1,142,594 | - | 1,533,559 | - | 390,965 |
| Public Instruction | 216,133 | - | - | - | (216,133) |
| Interest on Long-Term Debt | 136,641 | - | - | - | (136,641) |
| Total Governmental Activities | \$15,501,997 | \$ 381,065 | \$ 1,890,614 | \$ - | (13,230,318) |
| General Revenues: | | | | | |
| Taxes: | | | | | |
| Property Taxes, levied for General Purposes | | | | | 1,969,697 |
| Property Taxes, levied for Debt Service | | | | | 486,977 |
| Volume of Business Taxes | | | | | 640,433 |
| Construction Tax | | | | | 391,935 |
| Intergovernmental | | | | | 9,966,130 |
| Rent | | | | | 89,170 |
| Miscellaneous | | | | | 173,337 |
| Total General Revenues | | | | | 13,717,679 |
| CHANGE IN NET ASSETS | | | | | 487,361 |
| Net Assets – Beginning of Year, as Restated (Note 13) | | | | | 8,122,986 |
| NET ASSETS – ENDING OF YEAR | | | | | \$ 8,610,347 |

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

BALANCE SHEET – GOVERNMENTAL FUNDS

JUNE 30, 2005

| | GENERAL | STATE ASSIGNMENTS FUND | SBGP FUND | OTHER GOVERNMENTAL FUNDS | TOTAL GOVERNMENTAL FUNDS |
|---|---------------------|------------------------------|---------------------|--------------------------------|--------------------------------|
| ASSETS | | | | | |
| Cash and Investments (Note 2) | \$ - | \$ 3,151,860 | \$ 190,201 | \$ 1,094,903 | \$ 4,436,964 |
| Cash with Fiscal Agent..... | 5,298 | - | - | 224,176 | 229,474 |
| Receivables | | | | | |
| Property Taxes..... | - | - | - | 28,896 | 28,896 |
| Federal Grants..... | - | - | 1,579,273 | 128,538 | 1,707,811 |
| Due from Other Funds..... | 1,007,356 | 2,961,347 | - | 439,363 | 4,408,066 |
| Due from Governmental Units..... | 114,060 | - | - | 953,815 | 1,067,875 |
| Others..... | - | - | - | - | - |
| Total Assets..... | \$ 1,126,714 | \$ 6,113,207 | \$ 1,769,474 | \$ 2,869,691 | \$11,879,086 |
| LIABILITIES AND FUND BALANCES | | | | | |
| Liabilities: | | | | | |
| Accounts Payable | \$ 1,093,640 | \$ 246,301 | \$ 235,130 | \$ 1,801,646 | \$ 3,376,717 |
| Accrued Interest..... | - | - | - | 59,308 | 59,308 |
| Due to Governmental Units..... | 363,406 | - | - | - | 363,406 |
| Due to Other Funds..... | 3,398,122 | 2,588 | - | 1,007,356 | 4,408,066 |
| Deferred Revenues: | | | | | |
| Volume of Business Tax..... | 526,584 | - | - | - | 526,584 |
| Intergovernmental Deferred Revenue..... | 114,060 | - | - | - | 114,060 |
| Federal Grants..... | - | - | 1,419,456 | 1,381 | 1,420,837 |
| Total Liabilities..... | 5,495,812 | 248,889 | 1,654,586 | 2,869,691 | 10,268,978 |
| Fund Balances (Deficit): | | | | | |
| Reserve For: | | | | | |
| Encumbrances..... | 358,648 | - | - | - | 358,648 |
| Debt Service..... | - | - | - | 31,466 | 31,466 |
| Other Purposes..... | 5,298 | - | - | - | 5,298 |
| Unreserved (Deficit)..... | (4,733,044) | 5,864,318 | 114,888 | (31,466) | 1,214,696 |
| Total Fund Balances (Deficit)..... | (4,369,098) | 5,864,318 | 114,888 | - | 1,610,108 |
| TOTAL LIABILITIES AND FUND BALANCES..... | \$ 1,126,714 | \$ 6,113,207 | \$ 1,769,474 | \$ 2,869,691 | \$11,879,086 |

See accompanying Notes to Basic Financial Statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO**

**RECONCILIATION OF THE GOVERNMENTAL FUNDS BALANCE SHEET
TO THE STATEMENT OF NET ASSETS**

JUNE 30, 2005

Total Fund Balances – Governmental Funds (Page 16)..... \$ 1,610,108

Amounts reported for Governmental Activities in the Statement of Net Assets (Page 14) are different because:

Capital Assets used in governmental activities are not financial resources and therefore are not reported in the funds. In the current period, these amounts are:

| | | |
|--------------------------------------|--------------------|-----------|
| Non Depreciable Capital Assets | \$ 3,260,156 | |
| Depreciable Capital Assets | 9,704,449 | |
| Infrastructure Assets | 274,262 | |
| Accumulated Depreciation | <u>(3,360,367)</u> | |
| Total Capital Assets | | 9,878,500 |

Some of the Municipality's revenues will be collected after year-end but are not available soon enough to pay for the current period's expenditures and therefore are deferred in the funds:

| | | |
|-------------------------------------|----------------|-----------|
| SBGP | 1,419,456 | |
| Christmas Bonus Reimbursement | <u>114,060</u> | |
| Total Long-Term Liabilities | | 1,533,516 |

Some liabilities are not due and payable in the current period and therefore are not reported in the funds. Those liabilities consist of:

| | | |
|-----------------------------------|----------------|--------------------|
| General Obligations Bonds | 2,071,000 | |
| Compensated Absences | 1,394,237 | |
| Christmas Bonus | 228,121 | |
| Property Tax Advances | <u>718,419</u> | |
| Total Long-Term Liabilities | | <u>(4,411,777)</u> |

Total Net Assets of Governmental Activities (Page 14)..... \$ 8,610,347

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE (DEFICIT) –
GOVERNMENTAL FUNDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

| | GENERAL | STATE ASSIGNMENTS FUND | SBGP FUND | OTHER GOVERNMENTAL FUNDS | TOTAL GOVERNMENTAL FUNDS |
|---|------------------------------|------------------------------|--------------------------|--------------------------------|--------------------------------|
| REVENUES | | | | | |
| Property Taxes..... | \$ 1,969,697 | \$ - | \$ - | \$ 486,977 | \$ 2,456,674 |
| Volume of Business Taxes..... | 640,433 | - | - | - | 640,433 |
| Federal Assistances..... | - | - | 1,230,853 | 357,055 | 1,587,908 |
| Intergovernmental..... | 4,923,280 | 2,457,433 | - | 2,587,302 | 9,968,015 |
| Licenses and Permits..... | 391,935 | - | - | - | 391,935 |
| Rent..... | 89,170 | - | - | - | 89,170 |
| Miscellaneous..... | 493,254 | - | - | 61,148 | 554,402 |
| Total Revenues..... | <u>8,507,769</u> | <u>2,457,433</u> | <u>1,230,853</u> | <u>3,492,482</u> | <u>15,688,537</u> |
| EXPENDITURES | | | | | |
| Current: | | | | | |
| Mayor and Municipal Legislature..... | 544,684 | - | - | - | 544,684 |
| General Government..... | 3,830,669 | 384,108 | 81,019 | 1,932,610 | 6,228,406 |
| Public Safety..... | 896,851 | - | - | 159,475 | 1,056,326 |
| Public Works..... | 1,728,840 | - | - | 9,041 | 1,737,881 |
| Culture and Recreation..... | 709,314 | - | - | - | 709,314 |
| Solid Waste Disposal..... | 194,023 | - | - | 21,179 | 215,202 |
| Health and Sanitation..... | 1,313,700 | - | - | 250 | 1,313,950 |
| Public Instruction..... | - | - | - | 216,133 | 216,133 |
| Human Services and Welfare..... | 684,141 | 814,252 | - | 454,892 | 1,953,285 |
| Urban Development..... | 26,226 | 72,624 | 1,140,759 | 80,916 | 1,320,525 |
| Capital Outlay..... | 429,937 | 12,859 | 1,858 | 1,009,593 | 1,454,247 |
| Debt Service: | | | | | |
| Principal..... | 9,779 | - | - | 299,000 | 308,779 |
| Interest and Other Charges..... | 44,909 | - | - | 136,641 | 181,550 |
| Total Expenditures..... | <u>10,413,073</u> | <u>1,283,843</u> | <u>1,223,636</u> | <u>4,319,730</u> | <u>17,240,282</u> |
| OTHER FINANCING SOURCES (USES) | | | | | |
| Transfers – In..... | - | - | - | 323,472 | 323,472 |
| Transfers – Out..... | (313,009) | (10,463) | - | - | (323,472) |
| Total Other Financing Sources and Uses..... | <u>(313,009)</u> | <u>(10,463)</u> | <u>-</u> | <u>323,472</u> | <u>-</u> |
| Net Change in Fund Balances..... | (2,218,313) | 1,163,127 | 7,217 | (503,776) | (1,551,745) |
| Fund Balance (Deficit) – Beginning..... | (2,150,785) | 4,701,191 | 107,671 | 503,776 | 3,161,853 |
| FUND BALANCES (DEFICIT) – ENDING | <u>(\$ 4,369,098)</u> | <u>\$ 5,864,318</u> | <u>\$ 114,888</u> | <u>\$ -</u> | <u>\$ 1,610,108</u> |

Handwritten signature in blue ink, possibly "Ortiz Rodriguez" or similar, over the ending fund balance figures.

See accompanying Notes to Basic Financial Statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO**

**RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES
IN FUND BALANCE OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES**

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

Net Change in Fund Balances – Total Governmental Funds (Page 18) (\$ 1,551,745)

Amounts reported for Governmental Activities in the Statement of Activities (Page 15)
are different because:

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 and reported
as depreciation expense. In the current period, these amounts are:

| | | |
|----------------------------|------------------|-----------|
| Capital Assets | \$ 1,699,764 | |
| Depreciation Expense | <u>(428,830)</u> | |
| Total Capital Assets | | 1,270,934 |

Revenues in the Statement of Activities that do not provide current financial resources are
not reported as revenues in the funds:

| | |
|---|---------|
| Community Development Block Grant | 302,706 |
|---|---------|

| | |
|--|---------|
| Repayment of long-term principal is expenditure in the governmental funds, but the repayment reduces Long-Term Liabilities in the Statement of Net Assets. In the current year the repayments were. | 308,779 |
|--|---------|

| | |
|--|----------------|
| Some expenses reported in the Statement of Activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds. These activities consist of decrease in Compensated Absences | <u>156,687</u> |
|--|----------------|

Change in Net Assets of Governmental Activities (Page 15) \$ 487,361

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO
NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The **Municipality of Lares, Puerto Rico (Municipality)** was founded in the year 1827, and operates as a governmental unit of the Commonwealth of Puerto Rico, under Law Number 81 of August 30, 1991, known as "Autonomous Municipalities Law of the Commonwealth of Puerto Rico". The governmental system of the **Municipality** is composed of the executive and legislative bodies. The Mayor is the Chief Executive Officer and is elected every four years in the general elections of the Commonwealth of Puerto Rico. The legislative body consists of 14 Legislators also elected in the general elections of Puerto Rico for a four-year period.

The **Municipality** provides services such as: health, public works, sanitation, aids and services to low-income and elderly citizens, public safety, housing and urban development, culture and recreation, planning, zoning and other general and administrative services.

The accounting policies of the **Municipality** conform to accounting principles generally accepted in the United States of America (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). The GASB is the standard-setting body for governmental accounting and financial reporting. The GASB periodically updates its codification of the existing Governmental Accounting and Financial Reporting Standards which, along with subsequent GASB pronouncements (Statements and Interpretations) constitutes GAAP for governmental units. The following is a summary of the more significant of such policies.

A. Financial Reporting Entity

The accompanying basic financial statements include all departments and organizations units whose funds are under the custody and control of the **Municipality**. In evaluating the **Municipality** as a reporting entity, management has addressed all the potential component units. The decision to include a potential component unit in the reporting entity was made by applying the provisions of GASBS No. 14.

The basic criteria for including a potential component unit within the reporting entity, is if potential component units are financially accountable and other organizations for which the nature and significance of their relationship with the entity are such that exclusion would cause the **Municipality's** financial statements to be misleading or incomplete. The GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) 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**.

The relative importance of each criterion must be evaluated in light of specific circumstances in order to determine which components units are to be included as part of the reporting entity. Our specific evaluations of the criteria applicable to the **Municipality** indicate no organizations meet the criteria to be included as component units. Accordingly, these basic financial statements present only the **Municipality** as the reporting entity.

These financial statements present the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the **Municipality**, as of June 30, 2005, and the respective changes in financial position, where applicable, thereof for the fiscal year then ended.

B. Financial Statement Presentation

The basic financial statements include both government-wide (based on the **Municipality** as a whole) and fund financial statements. While the previous financial reporting model emphasized fund types (the total of all funds of a particular type), in the new financial model the focus is on either the **Municipality** as a whole, or major individual funds (within the basic financial statements). Both the government-wide and fund financial statements (within the basic financial statements) categorize primary activities as either governmental or business type.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continuation)

Government-wide Financial Statements

The government-wide financial statements (the *Statement of Net Assets* and the *Statement of Activities*) report information of all the activities of the **Municipality**. For most part, the effect of interfund activity has been removed from these government-wide financial statements. Governmental activities are normally supported by taxes and intergovernmental revenues. Business-type activities, which rely to a significant extent on fees and charges for support, are not reported since the Municipality don't have such activities.

The focus of the *Statement of Net Assets* is designed to be similar to bottom line results for the Municipality and its governmental activities. This statement, for the first time, combines and consolidates governmental fund's current financial resources (short-term spendable resources) with capital assets and long-term obligations.

The *Statement of Net Assets* presents the reporting entities' assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- Invested in Capital Assets, Net of Related Debt – These consists of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets.
- Restricted Net Assets – These result when constraints placed on net assets use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation.
- Unrestricted Net Assets – These consist of net assets which do not meet the definition of the two preceding categories. Unrestricted net assets often are designated, to indicate that management does not consider them to be available for general operations. Unrestricted net assets often have constraints on resources that are imposed by management, but can be removed or modified.

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

The *Statement of Activities* demonstrates the degree to which the direct expenses of a given function or segment is offset by program revenues. *Direct expenses* are those that are clearly identifiable with a specific function or segment. *Program revenues* include 1) charges to customers or applicants who purchase, use or directly benefit from goods, services, or privileges provided by a given function or segment, and 2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Taxes and other items not properly included among program revenues are reported instead as *general revenues*.

Governmental Fund Financial Statements

The fund financial statements (the *Balance Sheet*, the *Statement of Revenues, Expenditures, and Changes in Fund Balance Net Assets*) are, in substance, very similar to the financial statements presented in the previous financial reporting model. Emphasis here is on the major funds in the governmental category. Non-major funds are summarized into a single column.

Traditional users of governmental financial statements will find the Fund Financial Statements presentation more familiar. The focus is on Major Funds, rather than the previous financial model's fund types. This is the manner in which these funds are normally budgeted. This presentation deemed most appropriate to (a) demonstrate legal and covenant compliance, (b) demonstrate the source and use of liquid resources, and (c) demonstrate how the Municipality's actual experience conforms to the budgeted fiscal plan.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continuation)

Since the governmental fund statements are presented in different measurement focus and basis of accounting than the government-wide statements, reconciliation is presented and separate explanation for each differences.

The Municipality reports its financial position (Balance Sheet) and results of operations (Statement of Revenues, Expenditures and Changes in Fund Balance) in funds, which are considered separate accounting entities. The operations of each fund are accounted for within a set of self-balancing accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with legal, financial, and contractual provisions.

C. Measurement Focus and Basis of Accounting

Government-wide Financial Statements

The government-wide financial statements (the Statement of Net Assets and the Statement of Activities) are reported using the *economic resources measurement focus* and the *accrual basis of accounting*. Revenue is recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grant and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Governmental Fund Financial Statements

The governmental fund financial statements are reported using the *current financial resources measurement focus* and the *modified accrual basis of accounting*. Revenues are recorded when susceptible to accrual; as soon enough thereafter to pay liabilities of the current period. For this purposes, the government considers revenues to be available if they are collected within sixty (60) days of the end of the current period.

In applying the "susceptible to accrual" concept to intergovernmental revenues (federal grants) pursuant to GASBS No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* (the Municipality may act as either provider or recipient), the provider should recognize liabilities and expenses and the recipient should recognize receivables and revenue when the applicable eligibility requirements including time requirements, are met. Resources transmitted before the eligibility requirements are met should, under most circumstances, be reported as advances by the provider and deferred revenue by the recipient.

There are essentially two types of revenue. For the majority of grants, moneys must be expended by the Municipality on the specific purpose or project before any amounts will be reimbursed. Revenue is, therefore, recognized as expenditures are incurred to the extent available. For the other revenue, moneys are virtually unrestricted and are generally revocable only for failure to comply with prescribed compliance requirements. These resources are reflected as revenue at the time of receipt or earlier if the susceptible to accrual criteria is met.

Expenditures are generally recognized when the related liability is incurred, as under accrual accounting. The exceptions to this general rule are the compensated absences and claims and judgments, if any, that are recorded only when payment is due.

Property taxes, volume of business taxes, licenses and permits, and interest associated with the current fiscal period are all considered to be susceptible to accrual and so have been recognized as revenues of the current fiscal period. All other revenue items are considered to be measurable and available only when cash is received by the Municipality.

The Municipality reports the following major fund:

General Fund – This is the general operating fund of the Municipality. It is used to account for all financial resources, except those required to be accounted for in another fund.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continuation)

C. Measurement Focus and Basis of Accounting (continuation)

State Assignment Fund – This is the fund used to account for all the transactions of the State Assignment by Legislature Resolutions. The primary objectives of these assignments is the development of projects on communities, not-for-profit organizations, purchase of equipment and indirect assignment to persons of low and moderate income.

SBGP Fund – This is the fund used to account for all the transactions of the State Block Grant Program. The primary objectives of this program is the development of viable communities by providing decent housing, a suitable living environment and expanded economic opportunities, principally for persons of low and moderate income.

The non-major funds are combined in a single column in the fund financial statements.

D. Budgetary Data

The Municipality's annually adopts the Budget Resolution for all operating funds of the Municipality except for certain restricted accounts Special Revenue Funds. Budgetary control is legally maintained at the fund level. The budget is prepared using the modified accrual basis of accounting with encumbrance included as budgetary basis expenditures. The Municipality's Budget Resolution provides transfer authority (1) to the Mayor and the Management and Budget Director, within and between departments and funds, as long as the total budget of the Municipality (net of interfund transfers) is not increased; (2) to the Management and Budget Director to implement grant budgets as the grant applications are accepted by the Municipality; and (3) to the Management and Budget Director to amend (re-appropriate) each new year's budget, to the extent of outstanding encumbrances, and/or unexpended project/grant appropriations at year end. Municipality's Legislature action is required for (1) use of the budgeted Legislature contingency, and (2) the approval of a supplemental appropriation(s). During the year, several supplemental appropriations were necessary.

The budget columns (original and final budgets) of the Budgetary Comparison – General Fund reflect the original budget and the amended budget (which have been adjusted for legally authorized revisions of the annual budgets during the year). Appropriations, except remaining project appropriations, encumbrances, and unexpended grant appropriations, lapse at the end of each fiscal year. Amendments to the budget, including transfers, require the approval of the Municipal Legislature. All encumbrance appropriations in the operating budget lapse at the end of the fiscal year.

Since the budgetary basis differs from accounting principles generally accepted in the United States of America (GAAP), actual amounts for the General Fund in the accompanying Budgetary Comparison Schedule, is presented on the budgetary basis to enhance comparability.

The principal differences between the budgetary and GAAP bases are the following:

1. Encumbrances are recorded as expenditures under the budgetary basis and as a reserve of fund balances under GAAP.
2. Payments of encumbrances of prior year are recorded as expenditures under GAAP but not under the budgetary basis.
3. Interfund transactions of the General Funds are not included in the budgetary basis.
4. Certain accrued liabilities and other debts are not included in the budgetary basis.
5. Certain revenues susceptible to accrual, i.e., both measurable and available, are not included in the budgetary data.

The special funds of the Special Revenue Fund have not been included in the budgetary comparison because balances are not budgeted. Also the budget prepared for the Federal Financial Awards Programs included in the Capital Projects and Special Revenue

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continuation)

D. Budgetary Data (continuation)

Funds is based on a program period which is not necessarily the same fiscal year. Accordingly, it's not practical to present an annual comparison of budget for such programs.

E. Cash and Investment

The Director of Finance of the Municipality is responsible for investing the available resources in certificates of deposit and other short-term investments. Investments are made from the available combined funds of the Municipality and, accordingly, it is not practical to disclose certificates of deposit and other short-term investments individually by fund in the combined financial statements. Interest earned on certificates of deposit and other short-term investments are recognized as revenue in the General Fund. Cash in the Special Revenue, Debt Service and Capital Project Funds are restricted; accordingly, resources available were not used for pool investments.

Cash with fiscal agent represents property tax collections retained by the Municipal Revenues Collection Center and undisbursed proceeds of certain bonds, loans or grants which are maintained in a cash custodian account by the Government Development Bank of the Commonwealth of Puerto Rico.

Cash balance recognized in the Debt Service Fund is restricted for the payment of the Municipality's obligations, and others are restricted for specific projects, such as the acquisition or construction of permanent improvements. This sinking fund is maintained by the Governmental Development Bank of Puerto Rico, agency which acts as the insurer and payer of the Municipality's bonds and notes issued in accordance with law.

F. Receivable

Receivable are stated nets of estimated allowances for uncollectible accounts, which are determined upon past collection experience and current economic conditions. Receivable from Federal Government represents amounts owed to the Municipality for reimbursement of expenditures incurred pursuant to federally funded programs.

G. Inventories

The General, Special Revenue and Capital Project Funds, purchases office and printing supplies, gasoline, oil and other expendable supplies held for consumption. The cost of purchases is recorded as expenditure in the appropriate fund and the inventory is not recorded in the basic financial statements.

H. Capital Assets

Property, plant and equipment purchased or acquired is carried at historical cost or estimated historical cost. Contributed assets are recorded at fair market value as of the date received. The Municipality's capitalization levels are \$500 on personal property. For improvements other than buildings, the capital outlay must be greater than \$10,000, extend the estimated useful life for ten years, and be greater than 10% of the original cost of the asset. Other costs incurred for repairs and maintenance is expensed as incurred.

Depreciation on all assets is provided on the straight-line basis over the following estimated useful lives: (See Table 1)

| TABLE 1 | |
|----------------------------|-------|
| CAPITAL ASSETS | YEARS |
| Buildings and Improvements | 50 |
| Infrastructure | 60 |
| Heavy Equipment | 10 |
| Furniture and Fixtures | 5 |
| Equipment and Vehicles | 5-10 |

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continuation)

I. Compensated Absences

The Municipality accrues accumulated unpaid vacation and sick leave and associated employee-related costs when earned (or estimated to be earned) by the employee. The Municipality's employees are granted 30 days of vacations and 18 days of sick leave annually. Vacations may be accumulated up to a maximum of sixty (60) days and sick leave up to a maximum of ninety (90) days. In the event of employee resignation, the employee is paid for accumulated vacation days up to the maximum allowed. Separation from employment prior to use of all or part of the sick leave terminates all rights for compensation, except for employees with ten years of service who are entitled to sick leave pay up to the maximum allowed. The Municipality accrued a liability for compensated absences, which meet the following criteria:

1. The Municipality's obligation relating to employee's rights to receive compensation for future absences is attributable to employee's services already rendered.
2. The obligation relates to rights that vest or accumulate.
3. Payment of the compensation is probable.
4. The amount can be reasonably estimated.

In accordance with the above criteria and requirements as established by GASBS No. 16; the Municipality has accrued a liability for compensated absences, which has been earned but not taken by Municipality's employees. For the government-wide statements, the current portion is the amount estimated to be used in the following year. For the governmental funds statements, all of the compensated absences are considered long-term and therefore, are not a fund liability and represents a reconciling item between the fund level and government-wide presentations (see Note 6).

The following is a summary of changes in the balance of Compensated Absences for the fiscal year ended June 30, 2005 (Table 2).

| BALANCE JULY 1, 2004 | NEW ISSUES | RETIREMENTS AND CURRENT MATURITIES | BALANCE JUNE 30, 2005 | CURRENT PORTION | LONG-TERM PORTION |
|----------------------------|---------------|--|-----------------------------|--------------------|----------------------|
| \$1,558,819 | \$ - | \$ 164,582 | \$1,394,237 | \$ 605,537 | \$ 788,700 |

J. Insurance

The Municipality has insurance coverage for its public facilities, primarily to provide protection from catastrophic losses. Also, principal officials of the Municipality are covered under various surety bonds. The Secretary of the Treasury Department of the Commonwealth of Puerto Rico is the agent commissioned to place all of the Municipality's insurance coverage. Corresponding premiums payable are withheld by the Municipal Revenue Collection Center from quarterly advances of annual property tax and subsidy sent to the Municipality.

K. Interfund Transactions

Interfund transactions are reflected as loans, reimbursements or transfers. Loans are reported as receivables and payables as appropriate and are subject to elimination upon consolidation. Reimbursements occur when one fund incurs a cost, charges the appropriate benefiting fund and reduces its related cost as a reimbursement. All other interfund transactions are treated as transfers. Transfers between governmental or proprietary funds are netted as part of the reconciliation to the government-wide columnar presentation. The Municipality has the following types of transactions among funds:

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NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continuation)

K. Interfund Transactions (continuation)

Interfund Transfers – Legally required transfers that are reported when incurred as transfers-in by the recipient fund and as transfers-out by the disbursing fund, with receivables and payables presented as amounts due to and due from other funds. Advances between funds are also presented as amounts due to and due from other funds. However, these transfers and related amounts receivables and payables are considered internal balances and activities that have been eliminated in the government-wide financial statements.

L. Reservations of Fund Balance – Governmental Funds

The governmental fund financial statements present fund balance reserves for those portions of fund balance (1) not available for appropriation for expenditures or (2) legally segregated for a specific future use. The reserves for related assets such as inventories and prepayments are examples of the former. Reserves for debt service and other specific purposes are examples of the latter.

M. Claims and Judgments

The estimated amount of the liability for claims and judgments, if any, which is due on demand, such as from adjudicated or settled claims, is recorded in the General Fund. The Long-Term Liabilities includes an amount estimated as a contingent liability or liabilities with a fixed or expected due date, which will require future available financial resources for its payment.

N. Use of Estimates

The preparation of the basic financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the basic financial statements and the reported revenue and expenses during the reporting period. Actual result could differ from those estimates.

NOTE 2 CASH AND CASH EQUIVALENTS

The Municipality's cash and cash equivalents at year-end were entirely covered by the Federal Deposit Insurance Corporation (FDIC) coverage, up to a maximum of \$100,000 in each bank, and the excess by collateral provided by the banks and held by the Department of the Treasury pursuant the applicable laws and regulations. Cash with fiscal agent is maintained in interest bearing accounts in the Government Development Bank of Puerto Rico, which are unsecured and uncollateralized.

Puerto Rico laws authorize governmental entities to invest in direct obligations or obligations guaranteed by the federal government or the Commonwealth of Puerto Rico. The Municipality is also allowed to invest in bank acceptances, other bank obligations and certificates of deposit in financial institutions authorized to do business under the federal and Commonwealth laws.

During the year, the Municipality did not invest its funds in short-term certificates of deposit.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 3 INTERFUND TRANSFER AND BALANCES

A. INTERFUND TRANSFERS

Transfers are indicative of funding for capital projects (See Table 3).

| INTERFUND TRANSFERS WITHIN THE GOVERNMENTAL FUNDS | | | TABLE 3 |
|---|-------------|------------------|--------------------------|
| SOURCES | TRANSFER TO | AMOUNT | PURPOSE |
| General Fund | Other Funds | \$313,009 | Specific Project Funding |
| State Assignments | Other Funds | <u>10,463</u> | Specific Project Funding |
| TOTAL | | <u>\$323,472</u> | |

B. INTERFUND RECEIVABLE AND PAYABLE BALANCES

Interfund receivables and payables at June 30, 2005 are summarized as follows (See Table 4):

| INTERFUND RECEIVABLE | INTERFUND PAYABLE | TABLE 4 AMOUNT |
|----------------------|-------------------|--------------------|
| General Fund | Other Funds | \$1,007,356 |
| Other Funds | General Fund | 436,775 |
| State Assignments | General Fund | 2,961,347 |
| Other Funds | State Assignments | <u>2,588</u> |
| TOTAL | | <u>\$4,408,066</u> |

NOTE 4 DUE TO OTHER GOVERNMENTAL UNITS

As of June 30, 2005, balance due to other governmental units of the General Fund for services rendered to the Municipality, consists of the following: (See Table 5)

| TABLE 5 | AMOUNT |
|--|-------------------|
| Water and Sewer Authority..... | \$ 44,668 |
| General Service Administration | 174,234 |
| Department of the Treasury | 40,129 |
| Municipality of Moca | 74,640 |
| Municipal Revenue Collection Center..... | <u>29,735</u> |
| Total Due to Governmental Units..... | <u>\$ 363,406</u> |

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO**

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 5 CAPITAL ASSETS

Capital Assets activities for the fiscal year ended June 30, 2005 was as follows (See Table 6)

| TABLE 6 | BALANCE JULY 1, 2004 | ADJUSTMENTS | ADDITIONS | RETIREMENTS | BALANCE JUNE 30, 2005 |
|--|----------------------------|----------------------------|---------------------------|--------------------|-----------------------------|
| DESCRIPTION | | | | | |
| Non-Depreciable Capital Assets: | | | | | |
| Land..... | \$2,150,134 | \$ - | \$ - | \$ - | \$2,150,134 |
| Construction in Progress | <u>311,361</u> | <u>-</u> | <u>798,661</u> | <u>-</u> | <u>1,110,022</u> |
| Total Non-Depreciable Capital Assets..... | <u>2,461,495</u> | <u>-</u> | <u>798,661</u> | <u>-</u> | <u>3,260,156</u> |
| Depreciable Capital Assets: | | | | | |
| Buildings and Buildings Improvements.... | 6,139,998 | - | - | - | 6,139,998 |
| Equipment and Vehicles..... | 1,898,597 | - | 743,386 | - | 2,641,983 |
| Furniture and Fixtures..... | 96,423 | - | - | - | 96,423 |
| Heavy Equipment | 668,328 | - | 157,717 | - | 826,045 |
| Infrastructure..... | <u>274,262</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>274,262</u> |
| Total Depreciable Capital Assets | <u>9,077,608</u> | <u>-</u> | <u>901,103</u> | <u>-</u> | <u>9,978,711</u> |
| Less Accumulated Depreciation: | | | | | |
| Buildings and Buildings Improvements.... | (663,805) | (202,842) | (122,800) | - | (959,447) |
| Equipment and Vehicles..... | (1,685,351) | - | (219,575) | - | (1,904,926) |
| Furniture and Fixtures..... | (65,453) | - | (6,188) | - | (71,641) |
| Heavy Equipment | (343,878) | - | (75,696) | - | (419,574) |
| Infrastructure..... | <u>(208)</u> | <u>-</u> | <u>(4,571)</u> | <u>-</u> | <u>(4,779)</u> |
| Total Accumulated Depreciation..... | <u>(2,728,695)</u> | <u>(202,842)</u> | <u>(428,830)</u> | <u>-</u> | <u>(3,360,367)</u> |
| Total Depreciable Capital Assets (Net) ... | <u>6,348,913</u> | <u>(202,842)</u> | <u>472,273</u> | <u>-</u> | <u>6,618,344</u> |
| CAPITAL ASSETS, NET | <u>\$8,810,408</u> | <u>(\$ 202,842)</u> | <u>\$1,270,934</u> | <u>\$ -</u> | <u>\$9,878,500</u> |

Depreciation expenses were charged to governmental functions/programs as follows: (See Table 7)

| TABLE 7 | AMOUNT |
|--------------------------------------|--------------------------|
| General Government | \$ 161,457 |
| Mayor and Legislature | 3,324 |
| Public Safety | 7,392 |
| Public Works and Transportation..... | 177,774 |
| Culture..... | 15,027 |
| Sanitation | 1,486 |
| Health and Welfare | 4,774 |
| Urban Development..... | <u>57,596</u> |
| Total Depreciation Expenses | <u>\$ 428,830</u> |

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 6 GENERAL LONG-TERM DEBTS

A. GENERAL OBLIGATIONS BONDS

The principal long-term obligations of the Municipality are general obligations bonds and special notes issued to finance the construction and improvements of public facilities and purchase of equipment. The Municipality's obligations long-term debt retirements are appropriated and paid from resources accumulated in the Debt Service Fund (See Note 7).

General obligations bonds as of June 30, 2005, are comprised of the following individual issues:

| DESCRIPTION | AMOUNT |
|---|---------------------------|
| General Obligations Bonds: | |
| \$750,000, Series 2002, for purchase of land, payable in annual installments ranging from \$5,000 to \$65,000, excluding interests at 8%, through July 1, 2026 | \$ 725,000 |
| \$300,000, Series 1982, for improvement to the water system, payable in annual installments ranging from \$4,000 to \$20,000, excluding interests at 5%, through January 1, 2007 | 39,000 |
| \$1,045,000, Series 1994, for construction purposes, payable in annual installments ranging from \$10,000 to \$90,000, excluding variable interests from 6% to 8%, through July 1, 2022 | 940,000 |
| \$1,020,000, Series 1992, for construction purposes, payable in annual installments ranging from \$30,000 to \$115,000, excluding interests at 7.5%, through July 1, 2007 | 315,000 |
| \$435,000, Series 2000, for construction purposes, payable in annual installments ranging from \$53,000 to \$72,000, excluding interests at 5%, through January 1, 2007 (Community Facilities Loans Program)..... | 140,000 |
| \$148,000, Series 2000, for construction purposes, payable in annual installments ranging from \$19,000 to \$24,000, excluding interests at 4.375%, through January 1, 2007 (Water & Waste Disposal Loans & Grants) | <u>47,000</u> |
| Total General Obligations Bonds | <u>\$2,206,000</u> |

The annual requirements to amortize the general obligations outstanding as of June 30, 2005 are as follows (See Table 8):

| YEAR ENDING JUNE 30, | PRINCIPAL PAYMENT | INTEREST PAYMENT | TABLE 8 TOTAL PAYMENT |
|-------------------------|---------------------------|---------------------------|-----------------------------|
| 2006 | \$ 245,000 | \$ 125,257 | \$ 370,257 |
| 2007 | 261,000 | 110,717 | 371,717 |
| 2008 | 160,000 | 94,824 | 254,824 |
| 2009 | 45,000 | 88,255 | 133,255 |
| 2010 | 55,000 | 85,689 | 140,689 |
| 2011-2015 | 325,000 | 379,805 | 704,805 |
| 2016-2020 | 495,000 | 263,263 | 758,263 |
| 2021-2025 | 495,000 | 96,092 | 591,092 |
| 2026 | <u>125,000</u> | <u>7,140</u> | <u>132,140</u> |
| TOTAL | <u>\$2,206,000</u> | <u>\$1,251,043</u> | <u>\$3,457,043</u> |

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO**

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 6 GENERAL LONG-TERM DEBTS (continuation)

B. OTHER LONG-TERM DEBTS

Following are the Other Long-Term Debts (See Table 9):

| TABLE 9 | BALANCE JULY 1, 2004 | NEW ISSUES | RETIREMENTS AND ADJUSTMENT | BALANCE JUNE 30, 2005 |
|---------------------------|----------------------------|-------------------|----------------------------------|-----------------------------|
| DESCRIPTION | | | | |
| Property Taxes – MRCC ... | \$ 295,924 | \$ 443,896 | \$ 21,401 | \$ 718,419 |
| Compensated Absences. ... | 1,558,819 | - | 164,582 | 1,394,237 |
| TOTAL | <u>\$1,854,743</u> | <u>\$ 443,896</u> | <u>\$ 185,983</u> | <u>\$2,112,656</u> |

C. CHANGES IN GENERAL LONG-TERM DEBTS

The following is a summary of changes in long-term debts for the year ended June 30, 2005 (See Table 10):

| TABLE 10 | BALANCE JULY 1, 2004 | NEW ISSUES | RETIREMENTS AND ADJUSTMENT | BALANCE JUNE 30, 2005 | AMOUNTS DUE WITHIN ONE YEAR | AMOUNTS DUE AFTER NEXT YEAR |
|--------------------|----------------------------|-------------------|----------------------------------|-----------------------------|-----------------------------------|-----------------------------------|
| DESCRIPTION | | | | | | |
| General | \$2,495,000 | \$ - | \$ 289,000 | \$2,206,000 | \$ 245,000 | \$1,961,000 |
| Others Debts | <u>1,854,743</u> | <u>443,896</u> | <u>185,983</u> | <u>2,112,656</u> | <u>615,931</u> | <u>1,496,725</u> |
| TOTAL | <u>\$4,349,743</u> | <u>\$ 443,896</u> | <u>\$ 474,983</u> | <u>\$4,318,656</u> | <u>\$ 860,931</u> | <u>\$3,457,725</u> |

NOTE 7 DEBT RETIREMENT

Revenues of the debt service fund consists of the ad-valorem property taxes which are recognized as revenue when collected from taxpayers and reported by the Municipal Revenue Collection Center of the Commonwealth of Puerto Rico to the **Municipality** (See Note 6).

These property taxes are accumulated by the Municipal Revenue Collection Center in costs of the general obligations bonds issued by the **Municipality** (See Note 6). Payments are made to the Government Development Bank of the Commonwealth of Puerto Rico from such accumulated funds by the Municipal Revenue Collection Center of Puerto Rico.

NOTE 8 PROPERTY TAXES

The Municipal Revenue Collection Center of the Commonwealth of Puerto Rico is responsible for the assessment of all real and personal property located within the **Municipality** and for the levy, administration and collection of the corresponding tax contribution.

The property tax contribution is levied each year over the appraised value of the property at the beginning of the calendar year. The real property assessment is based on the current value existing in the year 1957 and the personal property at the current value at the date of the assessment.

The tax rate per annum is 7.83% for real property and 5.83% for personal property of which 1.03% of both belong to the Commonwealth of Puerto Rico and 6.80% and 4.80%, respectively, belongs to the **Municipality**. From the portion belonging to the **Municipality**, 5.55% and 3.55%, respectively, represents the **Municipality's** basic tax rate that is appropriated for general purposes and therefore accounted for through the General Fund. The remaining portion belonging to the **Municipality** of 1.25% represents the ad-valorem property taxes withheld by the Municipal Revenue Collection Center of the Commonwealth of Puerto Rico and restricted for debt service, which is accounted for through the Debt Service Fund (See Note 7).

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MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 8 PROPERTY TAXES (continuation)

The **Municipality** has not reached the maximum statutory tax rate limit for the basic tax while there is no limitation for the ad-valorem tax rate.

The Commonwealth of Puerto Rico grants complete real property tax exoneration on the first \$15,000 assessed valuation on residential units occupied by their owners. However, the **Municipality** receives the full amount levied, except for residential units assessed at less than \$3,500 on which a complete exemption is granted. The Municipal Revenue Collection Center, instead of the property taxpayer, becomes the source of payment in these cases.

The **Municipality** grants a complete exemption from personal property taxes up to an assessment value of \$50,000 to retailers with an annual net sales volume of less than \$150,000. The Municipal Revenue Collection Center advances to the **Municipality**, on monthly payments, 100% of the contribution assessed over property for each fiscal year. In accordance to Law, these advances will be contributions by the Municipal Revenue Collection Center from taxpayers. The Municipal Revenue Collection Center periodically informs to the **Municipality** the amounts collected from taxpayers and applied to outstanding advances.

The **Municipality** records as revenue in the general fund the property tax contribution when received from monthly advances from Municipal Revenue Collection Center.

Due to the fact that collections of property tax are applied to the advances of property tax paid by the Municipal Revenue Collection Center, the amortization of the advance at end of year was not available due to that is in process of verification by external auditors.

NOTE 9 VOLUME OF BUSINESS TAX

The volume of business tax is levied each year based on the prior year's gross revenues for all commercial and industrial organizations doing business in the **Municipality** and which are not totally or partially exempt from this tax under the Industrial Incentives Laws of the Commonwealth of Puerto Rico. All taxpayers are required to file their declarations by April 23 of each year. The tax rates are as follows:

- a. 1.50% for financial institutions and savings and loan associations.
- b. 0.30% for all other organizations.

Taxes are payable in two equal semi-annual installments on July 1 and January 1 following the date of levy. If they are paid with declaration, the taxpayer is granted a 5% of discount. Collections of taxes during current fiscal year, applicable to the next fiscal year, are recorded as deferred revenues in the General Fund.

NOTE 10 INTERGOVERNMENTAL REVENUES

Intergovernmental revenues consist primarily of funds received from the Commonwealth of Puerto Rico, "in lieu of tax" payments from the quasi-public corporation, Puerto Rico Electric Power Authority, and federal financial assistance received from federal government.

Grants and subsidies received from the Commonwealth of Puerto Rico and federal agencies include, among others, a general subsidy for urban development and capital improvements. Intergovernmental revenues are accounted for through the General Fund except for those directly related to urban development and capital improvements, which are accounted for through the Special Revenue and the Capital Project Funds. Federal Financial Assistance is recorded in the Special Revenue Fund.

COMMONWEALTH OF PUERTO RICO
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NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 11 EMPLOYEE'S RETIREMENT PLAN

The Employee's Retirement System of the Government of Puerto Rico and its instrumentality (ERS) is the administrator of a cost-sharing multiple-employer retirement system established by the Commonwealth of Puerto Rico. The ERS was created under the Act 447, approved on May 15, 1951, as amended, and became effective on January 1, 1952. ERS covers all regular employees of the Commonwealth of Puerto Rico and its instrumentality and of certain municipalities and components units not covered by their own retirement systems.

Participation is mandatory except for members of the Legislature, Government Secretaries, Head of Agencies and Public Instrumentality, Assistants of the Governor, the Comptroller of the Puerto Rico, Gubernatorial Board and Committee appointees and Experimental Service Station employees. ERS provides retirement, death and disability benefits. Disability retirement benefits are available to members for occupational and non-occupational disabilities. Retirement benefits depend upon age at retirement and number of years of credited service. Benefits vest after ten years of plan participation.

The **Municipality** adopted the requirements of GASBS No. 25 for all the career employees that are covered under the Commonwealth of Puerto Rico Employee's Retirement System, a multiple-employer public employee retirement system, established by State Laws.

Under the plan, the employees and employer portions are contributed, for which, the employee amount is withheld from salaries. Covered employees are required by Commonwealth statute to contribute 5.775% for the first \$550 of monthly salary plus 8.275% for the excess of this amount, or on the alternative, 8.275% of all salary. The **Municipality** contributes to the system 9.275% of the participating employee's salaries.

Law Number 305 of September 24, 1999, amends the Act Number 447 that establish a savings program. All employees active in the system as of December 31, 1999 may elect to transfer from defined contribution programs to the new savings program (a defined contribution plan). Employees in the savings program may now contribute from a minimum of 8.275% up to a maximum of 10% of their monthly salary, and will be invested in an account which will either: (a) earn a fixed rate based on the two-year Constant Maturity Treasury Note or, (b) earn a rate equal to 75% of the return of the System's investment portfolio (net of management fees), or (c) earn a combination of both alternatives. If at time of retirement accumulated benefits amount to \$10,000 or less may elect to receive a lump sum distribution up to the accumulated benefits. Under the new program the retirement age is reduced from 65 to 60 for those employees who joined the current plan on or after April 1, 1990.

The pension benefit for participants who retire with less than 30 years of service is computed at the rate of 1½% of their average compensation for each year of credit service for the remaining years. The System also provides for death and disability benefits and the assets of the System pertaining to the participant employees.

A variety of significant actuarial assumptions are used to determine the standard measure of the pension benefit obligation and these assumptions are summarized below:

- a. The present value of the future pension payments was computed by using a discount of 9%.
- b. Future pension payments reflect an assumption of a 6% salary increase.

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NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 11 EMPLOYEE'S RETIREMENT PLAN (continuation)

All employees that do not elect to transfer for the new program and who at the time of employment are 55 years old or less are eligible to participate in the System. Pension benefits for participants with 30 years of service are as follows (See Table 11)

| YEARS OF SERVICE | PARTICIPANT'S AGE | PENSION BENEFITS | TABLE 11 |
|------------------|-------------------|--|----------|
| 30 or more | 55 or less | 65% of the average of the three years of highest salary during the employee's service period. | |
| 30 or more | 58 or more | 75% of the average of the three years of highest salary during the employee's service period. | |
| 30 or more | 65 or more | 75% of the average of the three years of highest salary during the employee's service period (employees started working after April 1, | |

The amount of the total pension benefit obligation is based on a standardized measurement established by GASBS No. 27, *Financial Reporting for Defined Benefit Pension Plans and Notes Disclosure for Defined Contributions Plans*. The standardized measurement is the actuarial present value of estimated defined pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee services performed to date. The measure is intended to help users assess the System's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among other public retirement systems. The measure is independent of the actuarial funding method used to determine contributions to the plan.

The membership of retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits, but not yet receiving benefits, and active employees and the distribution of active employees between vested and non-vested is not readily available.

Contributions in 2005 and prior years were made based on percentages established by the law. Such percentage has not been based on actuarial studies, as required by accounting principles generally accepted in the United States of America. An actuarial compilation of the annual contribution applicable to the **Municipality** has not been prepared. Accordingly, the accounts by which the actual contributions differ from the required actuarial contributions are not known.

The total pension expenditures recorded in the category of administration for the Fiscal Year Ended June 30, 2005 was approximately **\$391,230**. All employees who at the time of employment are 55 years old or less are eligible to participate in the System. No benefit is payable if the participant receives a refund of his accumulated contributions.

The historical trend information regarding the accumulation of assets and pension benefit obligation in the ERS is not available. For the ten-year trend information, refer to the separately issued financial statements of the ERS as of and for the fiscal year ended June 30, 2005. The P.R. Retirement Plan Administration provides additional information of the ERS. They issue a publicly available financial report that includes financial statements and required supplementary information for ERS, as a component unit of the Commonwealth of Puerto Rico. That report may be obtained by writing to the Administration at PO Box 42003, Minillas Station, San Juan, PR 00940.

NOTE 12 CONTINGENCIES

A. CLAIMS AND JUDGMENTS

The **Municipality** is, at present, a defendant in a number of legal matters that arise from alleged improper application of policies and negligence in the ordinary course of the **Municipality's** activities. The legal counsel of the **Municipality** has advised that at this stage in the proceedings of lawsuits he cannot offer an opinion as to the probable outcome.

**COMMONWEALTH OF PUERTO RICO
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NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 12 CONTINGENCIES (continuation)

A. CLAIMS AND JUDGMENTS (continuation)

In addition, the **Municipality** is a defendant or co-defendant in several legal proceedings that are in discovery stage. Certain of these claims are covered by insurance. Legal counsel with the information currently available can not determine the final outcome of these claims. Accordingly, the financial statements do not include adjustment, if any, that could result from the resolution of these legal proceeding. However, it has been the **Municipality's** experience that such actions are settled for amounts substantially less than the claimed amounts.

B. FEDERAL GRANTS

In the normal course of operations, the **Municipality** receives grants from various Federal and State agencies. The grant programs are subject to audit by agents of the granting authority, the purpose of which is to ensure compliance with conditions precedent to the granting of funds. Any liability for reimbursement which may arise as the result of these audits is not believed to be material.

NOTE 13 NET ASSETS RESTATEMENT

The following schedules reconcile the June 30, 2004 Net Assets, as previously reported to Beginning Net Assets, as restated, July 1, 2004.

| | NET ASSETS |
|---|--------------------|
| Net Assets, as Previously Reported, At June 30, 2004..... | \$8,697,722 |
| Adjustment to SBGP Revenues | 166,546 |
| Adjustment to Christmas Bonus | (115,945) |
| Adjustment to Accumulated Depreciation | (202,842) |
| Debts not Previously Recognized | <u>(422,495)</u> |
| Beginning Net Assets, as Restated, At July 1, 2004 | <u>\$8,122,986</u> |

NOTE 14 SUBSEQUENT EVENT

On July 28, 2005, The Municipality Legislature, be means of Ordinance Number 1, Series 2005-2006, approved the issuance of \$1,634,000 in special obligation notes form USDA Rural Development for the purchase of equipment.

NOTE 15 FUTURE ADOPTION OF ACCOUNTING PRONOUNCEMENT

The Governmental Accounting Standards Board (GASB) issued GASBS No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which is effective for fiscal year beginning after December 15, 2004; and GASBS No. 46, *Net Assets Restricted by Enabling Legislation*, which is effective for period beginning after June 15, 2005. Early application is encouraged. The Municipality has not adopted the requirement of these statements. The following are other pronouncements issued that does not apply to the Municipality:

GASBS No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (Period beginning after December 15, 2006)

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NOTES TO THE BASIC FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 15 FUTURE ADOPTION OF ACCOUNTING PRONOUNCEMENT (continuation)

GASBS No. 44, *Economic Condition Reporting: The Statistical Section* (Period beginning after June 15, 2005)

GASBS No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefit Other Than Pension* (Period beginning after December 15, 2007)

GASBS No. 47, *Accounting for Termination Benefits* (Period beginning after June 15, 2005)

REQUIRED SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

REQUIRED SUPPLEMENTARY INFORMATION
BUDGETARY COMPARISON SCHEDULE – GENERAL FUND

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

| | BUDGET AMOUNTS | | ACTUAL AMOUNTS (BUDGETARY BASIS) (SEE NOTE A) | VARIANCE WITH FINAL BUDGET |
|--|------------------------------|------------------------------|---|-------------------------------|
| | ORIGINAL | FINAL | | |
| BUDGETARY FUND BALANCE, JULY 1, 2004 | <u>(\$ 1,835,514)</u> | <u>(\$ 1,835,514)</u> | <u>(\$ 1,835,514)</u> | <u>\$ -</u> |
| Resources (Inflows): | | | | |
| Property Taxes | 1,826,054 | 1,826,054 | 1,849,161 | (23,107) |
| Volume of Business Taxes | 725,789 | 725,789 | 640,433 | (85,356) |
| Intergovernmental Revenues | 4,996,657 | 5,117,882 | 4,923,280 | (194,602) |
| License and Permits | 905,000 | 905,000 | 391,935 | (513,065) |
| Rent | 75,000 | 75,000 | 89,170 | 14,170 |
| Miscellaneous | <u>1,471,500</u> | <u>1,471,500</u> | <u>493,254</u> | <u>(978,246)</u> |
| Total Resources (Inflows) | <u>10,000,000</u> | <u>10,121,225</u> | <u>8,387,233</u> | <u>(1,733,992)</u> |
| Amounts Available for Appropriation | <u>8,164,486</u> | <u>8,285,711</u> | <u>6,551,719</u> | <u>(1,733,992)</u> |
| Charges to Appropriations (Outflows): | | | | |
| Mayor and Municipal Legislature | 643,473 | 583,863 | 569,790 | 14,073 |
| General Government | 3,256,685 | 3,542,917 | 3,970,656 | (427,739) |
| Public Safety | 1,001,142 | 903,258 | 896,867 | 6,391 |
| Public Works | 1,793,598 | 1,769,764 | 1,765,612 | 4,152 |
| Sanitation | 1,372,315 | 1,315,310 | 1,313,700 | 1,610 |
| Culture and Recreation | 713,147 | 683,939 | 720,325 | (36,386) |
| Solid Waste Disposal | 150,000 | 261,584 | 261,584 | - |
| Human Services and Welfare | 776,640 | 692,006 | 684,403 | 7,603 |
| Urban Development | 24,000 | 32,000 | 30,171 | 1,829 |
| Capital Outlays | 44,000 | 23,575 | 430,356 | (406,781) |
| Transfer to Other Funds | <u>225,000</u> | <u>313,009</u> | <u>313,009</u> | <u>-</u> |
| Total Charges to Appropriations | <u>10,000,000</u> | <u>10,121,225</u> | <u>10,956,473</u> | <u>(835,248)</u> |
| BUDGETARY FUND BALANCE, JUNE 30, 2005 | <u>(\$ 1,835,514)</u> | <u>(\$ 1,835,514)</u> | <u>(\$ 4,404,754)</u> | <u>(\$ 2,569,240)</u> |

See accompanying Notes to Required Supplementary Information.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

BUDGETARY COMPARISON SCHEDULE – GENERAL FUND
NOTE TO REQUIRED SUPPLEMENTARY INFORMATION

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE A Explanation of Differences between Budgetary Inflows and Outflows and GAAP Revenues and Expenditures

| | <u>GENERAL FUND</u> |
|--|-----------------------|
| Sources/Inflows of Resources: | |
| Actual Amounts (Budgetary Basis) "Available for Appropriation" from the Budgetary Comparison Schedule (See Page 37) | \$ 6,551,719 |
| Difference – Budget to GAAP: | |
| The Fund Balance (Deficit) at the Beginning of Year is a budgetary resource (but is not a Current-Year Revenue for financial reporting purposes) | 1,835,514 |
| Prior-Year Revenue is not inflows of budgetary resources but are <i>revenues</i> for financial reporting purposes..... | <u>120,536</u> |
| Total Revenues as Reported on the Statement of Governmental Funds Revenues, Expenditures and Changes in Fund Balance (See Page 18) | <u>\$ 8,507,769</u> |
| Uses/Outflows of Resources: | |
| Actual Amounts (Budgetary Basis) "Total Charges to Appropriation" from the Budgetary Comparison Schedule (See Page 37) | \$10,956,473 |
| Difference – Budget to GAAP: | |
| Encumbrances for supplies and equipment ordered but not received are reported in the year the order is placed for budgetary reporting purposes. | (295,115) |
| Payments of encumbrances of prior year that are expenditures for financial reporting purposes but are not outflows for budgetary purposes..... | 64,724 |
| Transfers to other funds are outflows of budgetary resources but are not expenditures for financial reporting purposes..... | <u>(313,009)</u> |
| Total Expenditures as Reported on the Statement of Governmental Funds Revenues, Expenditures and Changes in Fund Balance (See Page 18) | <u>\$10,413,073</u> |
| NOTE B Explanation of Differences between Budgetary Fund Balance and GAAP Fund Balance | |
| Budgetary Fund Balance, June 30, 2005 (See Page 37) | (\$ 4,404,754) |
| Timing Differences: | |
| Net Change in Encumbrances | (230,391) |
| Non-budgetary Items | <u>266,047</u> |
| Unreserved Fund Balance (Deficit) (See Page 18) | <u>(\$ 4,369,098)</u> |

PART II

SINGLE AUDIT SECTION

- 39 -

ORTIZ, RODRIGUEZ, RIVERA & CO.

CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO**

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

| FEDERAL GRANTOR / PASS-THROUGH GRANTOR / PROGRAM OR CLUSTER TITLE | FEDERAL CFDA NUMBER | PASS-THROUGH ENTITY IDENTIFYING NUMBER | FEDERAL EXPENDITURES |
|--|---------------------------|--|---------------------------|
| U.S. Department of Housing and Urban Development: | | | |
| Direct Programs: | | | |
| Section 8 Housing Choice Vouchers..... | 14.871 | | \$ 273,200 |
| Indirect Programs: | | | |
| Pass-Through State – Office of the Commissioner of Municipal Affairs: | | | |
| State Block Grant Program (SBGP)..... | 14.228 | 94-FD-37 95-FD-37 01-FD-37 01-FC-37 02-FC-37 02-AB-37 | <u>1,223,636</u> |
| Total U.S. Department of Housing and Urban Development.... | | | <u>1,496,836</u> |
| U.S. Department of Justice: | | | |
| Pass-Through Puerto Rico Department of Justice: | | | |
| Local Law Enforcement Block Grant Program | 16.592 | N/AV | <u>273</u> |
| TOTAL EXPENDITURES OF FEDERAL AWARDS | | | <u>\$1,497,109</u> |

See accompanying Notes to Schedule of Expenditures of Federal Awards.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES, PUERTO RICO

NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

NOTE 1 GENERAL

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activities of the **Municipality of Lares, Puerto Rico**. 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, or used in the preparation of, the general-purpose financial statements. The **Municipality** reporting entity is defined in Note (1) (A) to the general-purpose financial statements. All federal financial awards received directly from federal agency as well as federal financial awards passed through other government agencies are included on the Schedule.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

- A. The accompanying Schedule of Expenditures of Federal Awards is prepared from **Municipality's** accounting records and is not intended to present financial position or the results of operations.
- B. The financial transactions are recorded by the **Municipality** in accordance with the terms and conditions of the grants, which are consistent with accounting principles generally accepted in the United States of America.
- C. Expenditures are recognized in the accounting period in which the liability is incurred, if measurable or when actually paid, whichever occurs first.

NOTE 3 FEDERAL CFDA NUMBER

The CFDA numbers included in this Schedule were determined based on the program name, review of grant contract information and the Office of Management and Budget's Catalogue of Federal Domestic Assistance.

NOTE 4 PASS THROUGH GRANTOR'S NUMBER

State or local government redistribution of federal awards to the **Municipality**, treated as if they were received directly from the federal government. OMB Circular A-133 requires the schedule to include the name of the pass through entity and identifying number assigned by the pass through entity for federal awards received as a subrecipient. Numbers identified as N/A are not available.



ORTIZ, RODRIGUEZ, RIVERA & CO.
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Services Division

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

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

We have audited the financial statements of the governmental activities, each major fund and the aggregate remaining fund information of the Municipality of Lares as of and for the year ended June 30, 2005, which collectively comprise the Municipality of Lares' basic financial statements, and have issued our report thereon dated December 2, 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 *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Municipality of Lares' 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 an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable condition. Reportable condition involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Municipality's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 05-A thru 05-C.

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 reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Municipality of Lares' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect of 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 test disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of Municipality of Lares in a separate letter dated December 2, 2005.

This report is intended solely for the information and use of the management, Commissioner Office of Municipal Affairs, and the 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.

Ortiz, Rodriguez, Rivera & Co

San Juan, Puerto Rico
December 2, 2005

The stamp 2101420 was affixed to the original of this report.





ORTIZ, RODRIGUEZ, RIVERA & CO.
CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

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

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

Compliance

We have audited the compliance of Municipality of Lares 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 of Lares' major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of Municipality of Lares' management. Our responsibility is to express an opinion on Municipality of Lares' 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 of Lares' compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on Municipality of Lares' compliance with those requirements.

In our opinion, Municipality of Lares complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements 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 item 05-1 through 05-3.

Internal Control over Compliance

The management of Municipality of Lares 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 Municipality of Lares' 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.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components do not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the management, Commissioner Office of Municipal Affairs, and the 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.

Ortiz, Rodriguez, Rivera & Co

San Juan, Puerto Rico
December 2, 2005

The stamp 2101421 was affixed
to the original of this report



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

1. SUMMARY OF AUDIT RESULTS

- a. The auditors' report expresses an unqualified opinion on the basic financial statements of the Municipality of Lares.
- b. There were reportable conditions on internal controls over financial reporting.
- c. No instances of noncompliance material to the financial statements of Municipality of Lares were disclosed during the audit.
- d. There were reportable conditions on internal controls over major programs.
- e. The auditor's report on compliance with requirements applicable to federal award programs for Municipality of Lares express an unqualified opinion.
- f. There were audit findings relative to the major federal award programs for the Municipality of Lares.
- g. The program tested as major programs included:
State Block Grant Program - CFDA No. 14.228
- h. The threshold for distinguishing types A and B programs was \$300,000.
- i. Municipality of Lares was determined to be a high risk auditee.

2. FINDINGS - FINANCIAL STATEMENTS AUDIT

05-A: General Fund Deficit

Condition

As of June 30, 2005, the Municipality closed with an accumulated deficit of \$4,369,098. This is the third consecutive year that the Municipality closed its operations reporting a deficit. The current year deficit represents an increase of 49% when compared to prior year operations.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Cause

The deficit is caused by the overestimation of budgeted revenues and by the incurrence of obligations without the proper consideration of current and future available resources. The mayor and the Finance Director did not follow adequate budgeting procedures.

Criteria

Article 7.011(a) of Autonomous Municipal Act (Law 81 of August 30, 1991), as amended, establishes that municipalities with deficits at their closing dates must provide for sufficient resources during the next fiscal year period in order to cover such deficit.

Section 3 of the Revised Regulation over Basic Standards for Municipalities of Puerto Rico (The Regulation) states that special care must be provided for the estimation of future revenues in order to avoid budget appropriations in excess of available resources.

Recommendation

The continuing deficit reported by the Municipality of Lares may harm the basic governmental services provided to its citizens. We strongly recommend that the necessary measures are taken in order to stop this trend. The Municipality must work on increasing actual revenues and/or substantially reducing expenditures.

05-B: Estimated Revenue Shortfall

Condition

As of June 30, 2005, the Municipality did not meet certain projected revenues by significant amounts, causing an increase in its General Fund deficit (see Finding 05-A). The following deficiencies were noted based on our comparison of budgeted revenues versus final operating results:

- a. For volume of business taxes, the Municipality failed to meet its expectations by \$85,356, a 12% budget shortfall.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

- b. For Licenses and Permits revenues, the Municipality failed to meet its expectations by \$513,065, a 57% budget shortfall.
- c. For Miscellaneous revenues, the Municipality failed to meet its expectations by \$978,246, a 66% budget shortfall.

Criteria

Section 3 of the Revised Regulation over Basic Standards for Municipalities of Puerto Rico (The Regulation) states that special care must be provided for the estimation of future revenues in order to avoid budget appropriations in excess of available resources.

Cause

The mayor and the Finance Director did not follow adequate budgeting procedures for establishing reasonable estimates.

Recommendation

The Municipality should revise and amend the budget as current information related to collections of budgeted revenues became available.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

05-C: Unauthorized Transfer of State Special Funds

Condition

The Municipality realized several unauthorized transfers from its special revenue fund accounts to its General Fund during the fiscal year ended on June 30, 2005. These unauthorized transfers are detailed as follows:

| <u>Account Number</u> | <u>Account Name</u> | <u>Transfer Amount</u> | <u>Transfer Date</u> |
|-----------------------|------------------------------|------------------------|----------------------|
| 156-059614 | Plaza del Mercado | \$300,000 | 01-07-05 |
| 156-059614 | Plaza del Mercado | 300,000 | 12-28-04 |
| 156-059614 | Plaza del Mercado | 344,000 | 12-08-04 |
| 156-059614 | Plaza del Mercado | 401,578 | 11-09-04 |
| 156-059606 | Piscina y Gimnasio Municipal | 250,000 | 10-15-04 |
| 156-059606 | Piscina y Gimnasio Municipal | 200,000 | 10-05-04 |

Criteria

Article 8 of the Resource Allocation for the Realization of Permanent Works, Acquisition of Equipment, Purchase of Materials and Other Social Interest Activities Act (Law 179 of August 16, 2002) requires municipalities to utilize funds from state grants only for the intended purpose established by the Joint Resolution of the Puerto Rico Legislature and may not expend these in any activity not specifically and categorically addressed in the legislative grant. The use of funds from state grants in activities other than those mentioned in the Joint Resolution requires the prior approval of the Puerto Rico Legislature.

Cause

The bank transfers were authorized by the Finance Director through letters to bank. These transfers were made to compensate cash deficiency the Municipality was facing to pay current operating obligations. The Mayor and the Finance Director performed these transfers in violation of state law.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Recommendation

We recommend the Municipality refer this case to the appropriate regulatory bodies.

**3. FINDINGS AND QUESTIONED COSTS - MAJOR FEDERAL AWARD PROGRAM
AUDIT**

a. SBGP - CFDA No. 14.228

• **Condition 05-1**

The Municipality' internal control over compliance with the cash management requirements of the federal program is not effective since it is not minimizing the time elapsed between the receipt and final disbursements of funds.

Criteria

The 24CFR 85.20(b)(7) establishes that the federal funds recipient shall adopt the necessary policies and procedures to minimize the time between the receipt of funds and the disbursements for expenditures.

Cause

The Municipality does not keep adequate cash forecasting procedures because the Municipality has requested and received federal funds in excess of its immediate needs.

Effect

The continued occurrence of this condition may expose the Municipality to the assessment of interest cost relating to the excess cash on hand which would be paid from local funds.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Recommendation

The Municipality should modify the cash forecasting process by establishing a system to forecast the cash needs for the next five days, as established by federal regulations. Federal funds should only be requested when they are going to be disbursed immediately after receipt, or within three (3) business days.

Questioned Cost

\$ -0-

● **Condition 05-2**

The Municipality has deficiencies in the execution of property management procedures. During our test of real property and equipment management, we found that the Municipality does not perform a reconciliation of the physical inventory with the accounting records. In addition, equipment acquired during the year is not properly labeled and identified.

Criteria

As per CFR 24, Part 85.32 (4)(d) property records shall be accurately maintained. The records should include, for each item of equipment, a description of the equipment including serial number, an identification number, identification of the grant under which the recipient acquired the equipment, the information needed to calculate the federal share of the equipment, the acquisition date and unit acquisition cost, the location, use and condition of the equipment. In addition, states that every two years, at a minimum, a physical inventory should be conducted and the results should be reconciled with the property records to verify the existence, current utilization, and continued need for the equipment. Any discrepancies between quantities determined by the physical inspection and those shown in the accounting records should be investigated to determine the causes of the differences.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Cause

The Municipality does not maintain accurate records for acquisitions and dispositions for property acquired with federal awards.

Effect

The Municipality is exposed to the risk of possible unauthorized use and disposition of equipment due to the lack of internal controls and adequate property and equipment records. The possible misappropriation of the equipment acquired with federal funds could result in disallowed costs.

Recommendation

The Municipalities' management should determine that proper procedures are in place to ensure that property purchased with federal funds is identified and conduct periodic inventories and follow up an inventory discrepancies. In addition, the Municipality's management should review all dispositions of property to ensure appropriate valuation and reimbursement to federal awarding agencies.

Questioned Cost

\$ -0-

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

● **Condition 05-3**

In order to test the allowability of the disbursements for the fiscal year ended June 30, 2005, we selected 25 disbursements which totaled \$196,686.90 or 16% of the program. The Municipality could not provide adequate supporting documentation in 5 out of the 25 disbursements tested, or 25% of our sample, amounting to \$8,996.28 as follows:

| <u>Check Number</u> | <u>Payee</u> | <u>Date</u> | <u>Amount</u> |
|---------------------|---------------------|-------------|-------------------|
| 2606 | Ferretería Miramar | 08-11-04 | \$ 18.70 |
| 2609 | Comm. Hnos. Barreto | 08-12-04 | 673.83 |
| 2639 | Ferretería René | 10-18-04 | 26.70 |
| 2667 | Ferretería René | 11-12-04 | 2,077.05 |
| 2707 | Super Mix Concrete | 12-03-04 | <u>6,200.00</u> |
| | | | <u>\$8,996.28</u> |

Criteria

As per OMB A-87, to be allowable under federal awards, costs must be adequately documented. In addition, 24 CFR (b) requires that except as otherwise provided, records must be retained for three years starting the day the grantee submits to the awarding agency its expenditure report.

Cause

The Municipality does not keep adequate internal control procedures regarding the filing of documents.

Effect

Failure to maintain adequate accounting records may result in disallowance of costs by the awarding agency.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Recommendation

The Municipality's management should ascertain that adequate source documentation exists to support amounts and items reported as expenditures. The Municipality should also establish a record keeping system to ensure that accounting records and documentation are retained for the time period required by applicable requirements and the provisions of laws, regulations, contracts or grant agreements applicable to the program.

Questioned Cost

\$8,996.28

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF STATUS OF PRIOR YEAR
AUDIT FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

During the current examination, follow-up was given to the findings informed to the Municipality in prior years. It was noted that corrective action has been taken, except for certain conditions that still exist and require further action. These are included in the accompanying Schedule of Prior Year Audits Findings and Questioned Costs.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LARES
SCHEDULE OF STATUS OF PRIOR YEAR
AUDIT FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

| <u>Program</u> | <u>Finding/Noncompliance</u> | <u>Status</u> |
|---|---|-----------------------------|
| State Block Grant Program CFDA No. 14.228 | Condition 2004-6 Construction contracts did not contain certain required clause. | Condition was corrected. |