

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

**MUNICIPIO DE LUQUILLO
AUDITORÍA 2012-2013
30 DE JUNIO DE 2013**

14-04-0090



DIV. SERVICIOS GENERALES
OCAM
14 APR -4 PM 1:41

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO**

***BASIC FINANCIAL STATEMENTS, REQUIRED SUPPLEMENTARY
INFORMATION AND INDEPENDENT
AUDITORS' REPORT
(WITH ADDITIONAL REPORTS REQUIRED
UNDER THE OMB CIRCULAR A-133)***

***AS OF AND FOR THE FISCAL YEAR ENDED
JUNE 30, 2013***



***Hon. Jesús Marquez Rodríguez
Mayor***

***Mr. Ismael Ortíz
Finance Director***

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO**

TABLE OF CONTENTS

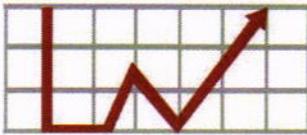
| | <u>Page</u> |
|---|-------------|
| <u>FINANCIAL SECTION</u> | |
| Independent Auditors' Report | 1-3 |
| Management's Discussion and Analysis | 4-13 |
| Basic Financial Statements: | |
| Government-wide Financial Statements: | |
| Statement of Net Position | 14 |
| Statement of Activities | 15 |
| Fund Financial Statements: | |
| Balance Sheet - Governmental Funds | 16 |
| Reconciliation of the Balance Sheet of Governmental Funds to the Statement of Net Position | 17 |
| Statement of Revenues, Expenditures and Changes in Fund Balances (deficit) - Governmental Funds | 18 |
| Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances (deficit) of Governmental Funds to the Statement of Activities | 19 |
| Notes to the Basic Financial Statements | 20-53 |
| Required Supplementary Information: | |
| Budgetary Comparison Schedule - General Fund | 54 |
| Notes to Required Supplementary Information - Budgetary Comparison Schedule - General Fund | 55-56 |
| Supplementary Information: | |
| Financial Data Schedule | 57-58 |
| Notes to Supplementary Information - Financial Data Schedule | 59 |
| <u>SINGLE AUDIT SECTION</u> | |
| Supplementary Information: | |
| Schedule of Expenditures of Federal Awards | 60 |
| Notes to Schedule of Expenditures of Federal Awards | 61 |
| Independent Auditor's Report on Internal Control Over Financial Reporting And On Compliance And Other Matters Based On An Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> | 62-63 |
| Independent Auditor's Report On Compliance For Each Major Federal Program And On Internal Control Over Compliance In Accordance With OMB Circular A-133 | 64-66 |
| Schedule of Findings and Questioned Costs | 67 |
| Schedule of Status of Prior Years Audit Findings and Questioned Costs | 68-69 |

FINANCIAL SECTION

11 APR -1 6M 1:32

DIA: SERVICIOS GENERALES
OCAM

INDEPENDENT AUDITORS' REPORT



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Member of:

- American Institute of Certified Public Accountants
- Puerto Rico Society of Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

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

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Luquillo, Puerto Rico (Municipality), as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the Municipality's basic financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

INDEPENDENT AUDITORS' REPORT (CONTINUED)

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's as of June 30, 2013, and the respective changes in financial position, thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 4 through 13 and Budgetary Comparison information on page 54, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Municipality of Luquillo basic financial statements. The accompanying supplementary information – Financial Data Schedules shown in pages 57 and 58 are presented for purposes of additional analysis as required by the U.S. Department of Housing and Urban Development, Office of the Inspector General, and is not a required part of the financial statements. The accompanying supplementary information – Schedule of Expenditures of Federal Awards shown in pages 60 and 61 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.

The Financial Data Schedules and the Schedule of Expenditures of Federal Awards are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Financial Data Schedules and the Schedule of Expenditures of Federal Awards are fairly stated in all material respects in relation to the basic financial statements as a whole.



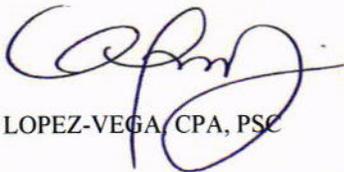
López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

INDEPENDENT AUDITORS' REPORT (CONTINUED)

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, we have also issued our report dated March 30, 2014, on our consideration of the Municipality's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards in considering Municipality's internal control over financial reporting and compliance.



LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
March 30, 2014

Stamp No. 2675799 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

MANAGEMENT'S DISCUSSION AND ANALYSIS

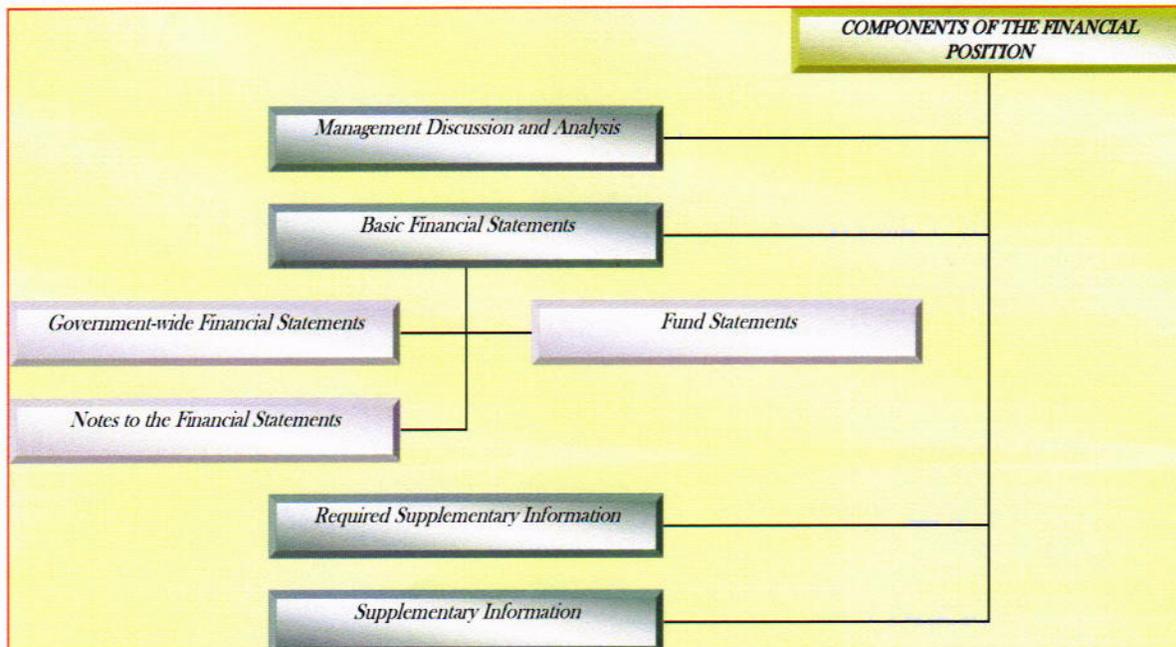
The discussion and analysis of the Municipality of Luquillo's financial performance provides an overall review of the Municipality's financial activities for the year ended June 30, 2013. The intent of this discussion and analysis is to look at the Municipality's financial performance as a whole; this section should be read in conjunction with the basic financial statements to obtain a better understanding of the financial position and the results of operations of the Municipality. Our analysis follows this section.

FINANCIAL HIGHLIGHTS

- The assets of the Municipality, on a government-wide basis, exceeded its liabilities at the close of fiscal year 2013 by \$38,244,938 (net position), an increase of 4% in comparison with 2012. Of this amount, the Municipality presented an unrestricted net position (deficit) of \$(1,088,698).
- Revenues increased 10% and expenses increased 19% when compared with fiscal year 2012. Net position increased \$1,770,050 in 2013.
- A negative net change in the fund balances of the Municipality's governmental funds of \$(5,676,630) in the fiscal year 2013 resulted in reported ending fund balances of \$7,240,505.
- For the fiscal year 2013, the General Fund reported an excess of revenues and other financing sources over expenditures and other financing uses of \$509,158. The unassigned fund balance amounts to \$704,735 for an increase of 121% as compared to 2012.
- The investment in capital assets as of June 30, 2013 was \$47,806,365 (net of depreciation).
- Long-term debt (total primary government) decreased to \$20,306,320 or approximately 6% with respect to the prior year.
- On a budgetary basis, actual revenues exceeded actual expenditures by \$390,068.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Municipality's financial report comprises four components: (1) management's discussion and analysis (presented here), (2) basic financial statements, (3) required supplementary information and (4) other 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 position* presents all of the reporting entity's non-fiduciary assets, deferred outflows, liabilities and deferred inflows, with the difference reported as net position. Over time, increases or decreases in the Municipality's net position are an indicator of whether its financial health is improving or deteriorating. Other non-financial factors such as the condition of the Municipality's capital assets 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 position 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 report as governmental activities the Municipality's basic services such as public works and sanitation, public safety, culture and recreation, housing, welfare, and community development, education and general administration. These activities 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 as 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 as on balances of spendable 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 comply with a minimum criterion that is, a percentage of the assets and deferred outflows; liabilities and deferred inflows; revenues or expenditures or based on the Municipality's official's criteria if the fund is particularly important to financial statement users. Funds that do not comply with this criterion are grouped and presented in a single column as other governmental funds.

- *Notes to financial statements*

The basic financial statements also include notes to explain information in the financial statements and provide more detailed data.

Required supplementary information

The statements and notes are followed by the required supplementary information that contains the budgetary comparison schedule for the General Fund.

Supplementary information

The supplementary information also includes a financial data schedule containing financial information of the Section 8 Housing Choice Voucher Program administered by the Municipality.

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE

Net Position

The following table presents a summary of the Statements of Net Position as of June 30, 2013 and 2012:

TABLE 1

*Summary Statement of Net Position
As of June 30,*

| | Governmental Activities | |
|----------------------------------|-------------------------|----------------------|
| | 2013 | 2012 |
| Assets | | |
| Current and other assets | \$ 13,721,269 | \$ 16,649,101 |
| Capital assets | 47,806,365 | 42,882,979 |
| Total assets | \$ 61,527,634 | \$ 59,532,080 |
| Liabilities | | |
| Current and other liabilities | 4,555,230 | 3,612,700 |
| Long-term liabilities | 18,727,466 | 19,444,492 |
| Total liabilities | 23,282,696 | 23,057,192 |
| Net Position | | |
| Net investment in capital assets | 31,842,870 | 27,712,985 |
| Restricted | 7,490,766 | 12,551,837 |
| Unrestricted (deficit) | (1,088,698) | (3,789,934) |
| Total net position | \$ 38,244,938 | \$ 36,474,888 |

Net position (difference of non-fiduciary assets, deferred outflows versus liabilities and deferred inflows) serve as a useful indicator of a government's financial position. Over time, increases or decreases in the Municipality's net position is one indicator of whether its financial health is improving or deteriorating. At June 30, 2013, assets exceeded its liabilities by \$38,244,938. Of this amount, \$(1,088,698) represents unrestricted net position (deficit). This deficit primarily arises from long-term obligations such as compensated absences, debts to CRIM, among other debts, 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. In addition, operational loans and certain general obligation bonds do not have a related capital asset to be reported as net investment in capital assets. Therefore, they are reported as part of the unrestricted net position section. Restricted net position represents resources that are subject to external restrictions on how they may be used. Net position reported an increase of 5% with respect to fiscal period 2012.

The largest portion of the Municipality's net position reflects its investment in capital assets (land, buildings, equipment, and infrastructure) less accumulated depreciation and less any related outstanding debt 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.

Changes in net position

The following **Table 2** summarizes the changes in net position for the fiscal years ended 2013 and 2012:

| <i>Summary of Changes in Net Position As of June 30,</i> | | |
|--|--------------------------------|----------------------|
| | Governmental Activities | |
| | 2013 | 2012 |
| Program revenues: | | |
| Fees, fines and charges for services | \$ 1,837,902 | \$ 2,025,109 |
| Operating grants and contributions | 3,975,343 | 2,868,666 |
| Capital grants and contributions | 1,014,167 | 1,344,998 |
| General revenues: | | |
| Property taxes | 4,001,942 | 3,521,980 |
| Municipal license taxes | 942,679 | 930,536 |
| Sales and use taxes | 1,678,818 | 1,389,039 |
| Grants and contributions not restricted to specific programs | 3,994,003 | 3,741,413 |
| Interest | 313,784 | 168,772 |
| Other | 427,045 | 408,869 |
| Total revenues | 18,185,683 | 16,399,382 |
| Expenses: | | |
| General government | 7,516,323 | 5,504,587 |
| Public works and sanitation | 4,410,592 | 1,596,614 |
| Public safety | 362,600 | 88,151 |
| Culture and recreation | 1,206,629 | 3,273,573 |
| Health | 323,878 | 1,879,861 |
| Housing, welfare and community development | 2,060,113 | 888,425 |
| Education | 3,160 | 5,550 |
| Interest on long term debt | 532,338 | 464,050 |
| Total expenses | 16,415,633 | 13,700,811 |
| Change in net position | 1,770,050 | 2,698,571 |
| Net position-beginning of year | 36,474,888 | 33,776,317 |
| Net position-end of year | \$ 38,244,938 | \$ 36,474,888 |

The three major sources of revenues of the Municipality in fiscal year 2013 are: unrestricted grants and contributions, property taxes and operating grants, each with 22% of total revenues. Revenues increase 11% due mainly to an increase of 86%, 39% and 21% in interest income, operating grants and sales and use taxes, respectively. The following **Figure 1** illustrates the revenue comparison between 2013 and 2012:

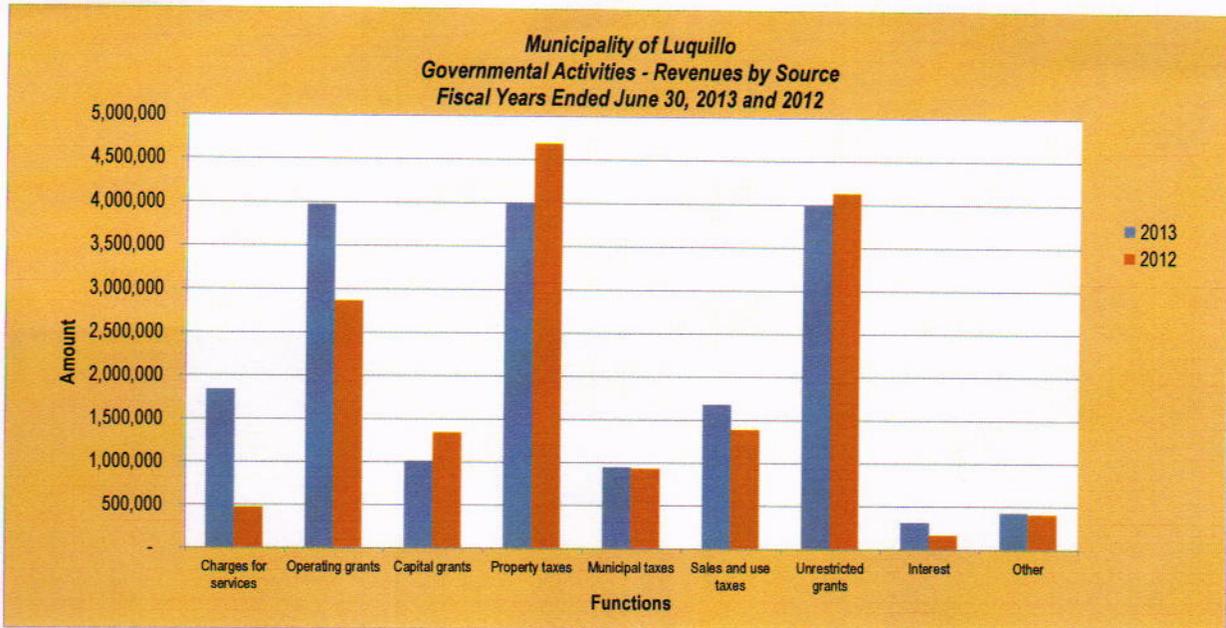
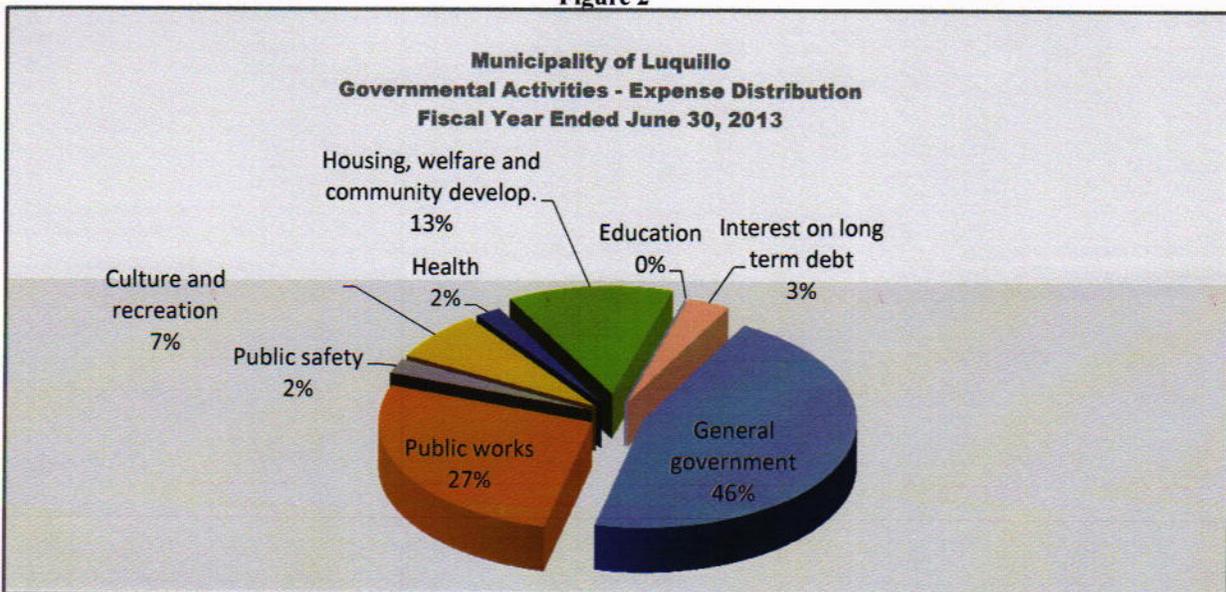


Figure 2



The Municipality's expenses cover a range of services. **Figure 2** illustrate the distribution of expenses in fiscal year 2013. As disclosed, the largest governmental activities expenses are general government with 46% and public works and sanitation with 27%. Total expenses increased 20% when compared with fiscal year 2012.

The Statement of Activities reports revenues and expenses in a format that focus on the net cost of each function of the Municipality. Both the gross and net cost of the function, which is otherwise being supported by the general government revenues, is compared to the revenues generated directly by the function. This Statement reduces gross direct expenses, including depreciation, by related program revenues, operating and capital grants, and contributions. The following **Table 3** discloses the 2013 expenses net of program revenue and the general revenues available to finance remaining costs:

TABLE 3

| Expenses Net of Program Revenues-Governmental Activities | |
|---|---------------------|
| Fiscal Year ended June 30, 2013 | |
| Net expenses | 2013 |
| General government | \$ (4,960,167) |
| Public works and sanitation | (2,925,425) |
| Public safety | (170,669) |
| Culture and recreation | (1,181,836) |
| Health | (323,878) |
| Housing, welfare and community development | 500,028 |
| Education | 6,064 |
| Interest on long term debt | (532,338) |
| Total expenses, net of program revenues | (9,588,221) |
| General revenues | |
| Taxes | 6,623,439 |
| Grants and contributions not restricted to specific programs | 3,994,003 |
| Interest and other | 740,829 |
| Total general revenues | 11,358,271 |
| Change in net position | \$ 1,770,050 |

Expenses of governmental activities not covered by program revenues were finally covered by other general revenues.

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, unassigned fund balance may serve as a useful measure of a Municipality's net resources available at the end of a fiscal year as they represent the portion of fund balance which has not yet been limited to use for a particular purpose by either an external party.

Governmental funds (Continued)

For the fiscal year ended June 30, 2013, the governmental funds reported ending fund balances of \$7,240,505, a net decrease of \$5,676,630 or 44% due to a significant amount of funds expended from bonds and notes for capital projects in 2013. Of the total fund balances, \$(678,787) or (9%) constitutes unrestricted fund balance, of which \$(1,281,251) are unassigned funds with a net deficit. The remaining fund balance is nonspendable or restricted to indicate that is not available for new spending.

The general fund is the operating fund of the Municipality. The fund balance of the general fund represents approximately 19% of total ending fund balances. Of the total fund balance 50% is nonspendable or restricted, committed or assigned mainly for capital outlays, public works, and general government purposes. The remaining of the unrestricted fund balance of \$704,735 is unassigned fund balance, which represents 50% of the total fund balance of the general fund. Unassigned fund balance increased 121% with respect to the prior year.

During the fiscal year the fund balances of the general fund increased by \$509,158. The main sources of revenues of the general fund in fiscal year 2013 are: intergovernmental subsidies from the Commonwealth with 40%, taxes (property taxes, sales and use taxes and municipal license taxes) with 38%, and charges for services with 10%. Revenues increased 2% in comparison to 2012 due to increases in taxes, intergovernmental revenues and charges for services. The largest expenditures of the general fund are general government with 61% and public works and sanitation with 23%. Expenditures decreased 4%.

GENERAL FUND BUDGETARY HIGHLIGHTS

The general fund original budget for the fiscal year 2012-2013 presented a 6% increase with respect to the prior year budget. It was amended by transfers from other special accounts for a total amount of \$ 784,816. Actual revenues exceeded revised budgeted revenues by \$208,191 (net). The Municipality also reported a positive variance of \$181,877 between revised budgeted appropriations and actual expenditures. Actual revenues exceeded actual expenditures by \$390,068.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital assets

At the end of the fiscal year, the Municipality has invested \$47,806,365 (net of accumulated depreciation) in a broad range of capital assets, including buildings, parks, roads, bridges, land, furniture, works of art and equipment. This amount represents a net increase of 11% over the prior year. The following **Table 4** discloses the capital assets balances as of June 30, 2013 and 2012:

Capital assets (Continued)

TABLE 4

| <i>Capital Assets, net As of June 30,</i> | | | |
|---|-------------------------|----------------------|--|
| | Governmental Activities | | |
| | 2013 | 2012 | |
| Non-depreciable assets: | | | |
| Land | \$ 10,462,413 | \$ 10,462,413 | |
| Construction in progress | 4,105,738 | 11,873,279 | |
| Depreciable assets (net): | | | |
| Buildings and buildings improvements | 20,787,907 | 11,419,349 | |
| Infrastructure | 7,460,169 | 4,328,404 | |
| Infrastructure Improvements | 3,652,418 | 3,515,080 | |
| Equipment | 308,717 | 145,492 | |
| Furniture | 14,218 | 17,278 | |
| Works of Art | 810 | 966 | |
| Computers | 81,129 | 109,656 | |
| Vehicles | 932,846 | 1,011,062 | |
| Total | \$ 47,806,365 | \$ 42,882,979 | |

The Municipality's major capital projects that were still in construction and the related cost as of June 30, 2013 are as follows:

- "Facilidades Deportivas Brisas del Mar" - \$1,845,291
- "Remodelación Centro de Arte y Cultura" - \$633,949
- "CDT Luquillo" - \$516,359

With respect to 2012 there was a significant decrease in construction in progress. During the fiscal year 2012-2013 the Municipality completed and transferred various projects to building improvements, infrastructure, and equipment including: (1) "Estadio Joaquin Robles" amounting \$5,385,582 and "Pista Atlética Tartan" amounting \$3,400,825, that were transferred to Buildings and building improvements; (2) "Sistema de Cámaras y Vigilancia" for a total cost of \$226,515 finished and transferred to the Equipment function and "Repavimentación del Sector Hacienda Caribali" with a total cost of \$916,691 transferred to the Infrastructure function.

More detailed information about the Municipality's capital assets is presented in Note F to the financial statements.

Long-term debt

The following is a summary of the Municipality's outstanding debt as of June 30, 2013 and 2012:

TABLE 5

| <i>Outstanding Long-term Debt</i> <i>Fiscal years ended June 30,</i> | | | |
|---|--------------------------------|----------------------|--|
| | Governmental Activities | | |
| | 2013 | 2012 | |
| General and special obligation bonds and notes | \$ 17,820,000 | \$ 19,085,000 | |
| Note payable to CRIM – property tax doubtful accounts | 173,892 | 183,046 | |
| Payable to CRIM – Property Tax 1998-99 and 1999-2000 (Law 42) | 477,171 | 489,536 | |
| Payable to CRIM – Prior Year Property Tax Debt | - | 38,902 | |
| Payable to PREPA | 464,712 | 429,261 | |
| Compensated absences | 1,250,392 | 1,071,444 | |
| Christmas bonus payable | 120,153 | 122,555 | |
| Total | \$ 20,306,320 | \$ 21,419,744 | |

At year-end, the Municipality had outstanding \$20,306,320 in general and special bonds and notes, a decrease with respect to the prior year of \$1,113,424 because of repayment of debt. The Municipality has no significant change with respect to other long-term debts (other than general obligation bonds and notes) with respect to 2012 year.

More detailed information about the Municipality's long-term liabilities is presented in Note G of the financial statements.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET

The Municipality's officials considered certain factors when establishing the fiscal year's 2013-2014 budget. One of these factors is the economy. Among economic areas considered are the estimates for the growth or decline in population, personal income, housing statistics and unemployment rates. The Municipality's unemployment rate at June 2013 stands at 14.9%, and the Commonwealth rate stands at 13.8%.

For year 2013-2014 the Municipality applied a conservative approach in the development of budget estimates. Amount available for appropriations in the General Fund are \$9,191,173,934 an increase of approximately 4% with respect to prior year estimates. Budgeted expenditures are expected to rise according to the increase of budgeted revenues. If these estimates are realized, the Municipality's budgetary general fund balance is expected to increase modestly by the close of the 2013-2014 fiscal year. In addition to the general fund estimated budget the Municipality plans to submit to the Federal and Commonwealth government fund proposals for welfare and community development as well as permanent capital improvements and public works.

As more fully described in Note R of the basic financial statements the Commonwealth of Puerto Rico is facing a financial crisis due to limited liquidity, general fund deficit, a sizeable amount of debt, an underfunded government pension system and an economy recession since 2006. As a result of these matters, credit ratings agencies have been consistently downgrading the Commonwealth's and certain public corporation's general obligation bonds ratings.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET (Continued)

In order to address these matters the Commonwealth began to make legislation to reform its governmental pension system, provide liquidity to the Governmental Development Bank of Puerto Rico ("GDB"), its fiscal agent, and strength sinking funds to assess financial markets. The Commonwealth estimates that these corrective actions, along others to be implemented, will have a positive impact on the Commonwealth itself, GDB, the municipalities and its citizens. Among other actions on January 24, 2014 the Commonwealth approved Act No. 18 and 19. Those Act's provides for the restructuring and creation of financing structures from sales and use tax sources to guarantee and pay municipal long term debt issuances. As a result of this legislation the municipalities of Puerto Rico may improve its credit capacity along with maintaining sufficient resources for operations.

On February 4, 2014, February 7, 2014 and February 11, 2014 Standard & Poor's Ratings Services ("S&P"), Moody's Investors Service ("Moody's") and Fitch Ratings ("Fitch") respectively, lowered its ratings on the Commonwealth of Puerto Rico's general obligation (GO) debt and other of its instrumentalities such as GDB, ERS and COFINA. The downgrades follow S&P's, Moody's and Fitch's evaluation of liquidity and access to markets. It is the opinion of the Municipality's management that the corrective actions taken and to be taken in current and fiscal periods thereafter will lower the impact of this decision and cause a positive turnaround on the Commonwealth's and the Municipality's finances.

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 any questions about this report or need any additional information contact the Finance Department at the Municipality of Luquillo at P.O. Box 1012, Luquillo, Puerto Rico 00773.

BASIC FINANCIAL STATEMENTS

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
STATEMENT OF NET POSITION
JUNE 30, 2013**

| | Governmental Activities |
|--|------------------------------------|
| <u>ASSETS</u> | |
| Cash and cash equivalents | \$ 1,535,685 |
| Receivables, net: | |
| Sales and use taxes | 54,411 |
| Municipal license taxes | 6,117 |
| Others | 338,319 |
| Due from: | |
| Commonwealth Government | 1,564,229 |
| Federal Government | 562,264 |
| Restricted assets: | |
| Cash and cash equivalents | 1,259,529 |
| Cash with fiscal agent | 8,400,715 |
| Capital assets: | |
| Land and construction in progress | 14,568,151 |
| Other capital assets, net | 33,238,214 |
| Total capital assets, net | 47,806,365 |
| Total assets | 61,527,634 |
| <u>LIABILITIES</u> | |
| Accounts payable and accrued liabilities | 1,945,871 |
| Interest payable | 390,273 |
| Due to: | |
| Commonwealth Government | 42,370 |
| Unearned revenues: | |
| Municipal License taxes | 597,862 |
| Long-term liabilities: | |
| Due within one year | 1,578,854 |
| Due in more than one year | 18,727,466 |
| Total liabilities | 23,282,696 |
| <u>NET POSITION</u> | |
| Net investment in capital assets | 31,842,870 |
| Restricted for: | |
| Debt service | 4,921,786 |
| Capital Projects | 1,130,566 |
| Other specified purposes | 1,438,414 |
| Unrestricted | (1,088,698) |
| Total net position | \$ 38,244,938 |

The accompanying notes are an integral part of this statement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
STATEMENT OF ACTIVITIES
FISCAL YEAR ENDED JUNE 30, 2013

| Functions | Expenses | Program Revenues | | | Net (Expenses) Revenues and Change in Net Position |
|-----------------------------------|----------------------|--|--|--|--|
| | | Fees, Fines and Charges for services | Operating Grants and Contributions | Capital Grants and Contributions | |
| Governmental Activities: | | | | | |
| General government | \$ 7,516,323 | \$ 1,837,902 | \$ 718,254 | \$ - | \$ (4,960,167) |
| Public works and sanitation | 4,410,592 | - | 471,000 | 1,014,167 | (2,925,425) |
| Public safety | 362,600 | - | 191,931 | - | (170,669) |
| Culture and recreation | 1,206,629 | - | 24,793 | - | (1,181,836) |
| Health | 323,878 | - | - | - | (323,878) |
| Welfare and community development | 2,060,113 | - | 2,560,141 | - | 500,028 |
| Education | 3,160 | - | 9,224 | - | 6,064 |
| Interest on long-term debt | 532,338 | - | - | - | (532,338) |
| Total | \$ 16,415,633 | \$ 1,837,902 | \$ 3,975,343 | \$ 1,014,167 | (9,588,221) |

General revenues :

| | |
|--|-------------------|
| Taxes: | |
| Property taxes | 4,001,942 |
| Municipal license taxes | 942,679 |
| Sales and use taxes | 1,678,818 |
| Grants contributions not restricted to specific programs | 3,994,003 |
| Interest | 313,784 |
| Other | 427,045 |
| Total general revenues: | <u>11,358,271</u> |

Change in net position

| | |
|-------------------------------------|----------------------|
| Net position-beginning, as restated | 1,770,050 |
| Net position-ending | 36,474,888 |
| | <u>\$ 38,244,938</u> |

The accompanying notes are an integral part of this statement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
BALANCE SHEET -
GOVERNMENTAL FUNDS
JUNE 30, 2013

| | Major Funds | | | | | Total Governmental Funds |
|---|---------------------|---|---|---|-------------------------|--------------------------------|
| | General | Special Revenue Fund - State and Local Grants | Special Revenue Fund - Other Federal Grants | Capital Project Fund - State and Local Grants | Debt Service Fund | |
| Assets | | | | | | |
| Cash and cash equivalents | \$ 1,535,685 | \$ - | \$ - | \$ - | \$ - | \$ 1,535,685 |
| Receivables, net | - | - | - | - | - | - |
| Sales and use taxes | 54,411 | - | - | - | - | 54,411 |
| License taxes | 6,117 | - | - | - | - | 6,117 |
| Other | - | - | - | 338,319 | - | 338,319 |
| Due from: | | | | | | |
| Commonwealth Government | 841,399 | 332,573 | - | - | 390,257 | 1,564,229 |
| Federal Government | - | - | 562,264 | - | - | 562,264 |
| Other funds | 850,352 | - | - | - | - | 850,352 |
| Advances to other funds | 83,538 | - | - | - | - | 83,538 |
| Restricted assets: | | | | | | |
| Cash and cash equivalents | - | 521,112 | 417,934 | 243,541 | - | 1,259,529 |
| Cash with fiscal agent | - | 3,483 | 21,616 | 3,770,424 | 4,605,192 | 8,400,715 |
| Total assets | \$ 3,371,502 | \$ 857,168 | \$ 1,001,814 | \$ 4,352,284 | \$ 4,995,449 | \$ 14,655,159 |
| Liabilities Deferred Inflows of Resources and Fund Balances (deficit) | | | | | | |
| Liabilities: | | | | | | |
| Accounts payable and accrued liabilities | \$ 492,249 | \$ - | \$ 405,913 | \$ 1,044,053 | \$ - | \$ 1,945,871 |
| Matured bonds and interest payable | - | - | - | - | 1,364,654 | 1,364,654 |
| Due to: | | | | | | |
| Commonwealth Government | 42,370 | - | - | - | - | 42,370 |
| Other funds | - | 309,097 | 214,589 | 321,160 | - | 850,352 |
| Advances from other funds | - | - | 83,538 | - | - | 83,538 |
| Unearned revenues | - | - | - | - | - | - |
| Municipal License taxes | 597,862 | - | - | - | - | 597,862 |
| Total liabilities | \$ 1,132,481 | \$ 309,097 | \$ 704,040 | \$ 1,365,213 | \$ 1,364,654 | \$ 4,884,647 |
| Deferred Inflow of Resources | | | | | | |
| Unavailable revenues - Commonwealth Government Funds | 841,399 | 326,918 | - | 338,319 | 283,823 | 1,790,459 |
| Unavailable revenues - Federal grants | - | - | 739,548 | - | - | 739,548 |
| Total deferred inflow of resources | \$ 841,399 | \$ 326,918 | \$ 739,548 | \$ 338,319 | \$ 283,823 | \$ 2,530,007 |
| Fund Balances (deficit): | | | | | | |
| Nonspendable | 83,538 | - | - | - | - | 83,538 |
| Restricted | 6,885 | 618,284 | 22,908 | 3,772,924 | 3,346,972 | 7,835,753 |
| Committed | 412,943 | - | - | - | - | 412,943 |
| Assigned | 189,521 | - | - | - | - | 189,521 |
| Unassigned | 704,735 | (397,131) | (464,682) | (1,124,172) | - | (1,281,251) |
| Total fund balances (deficit) | \$ 1,397,622 | \$ 221,153 | \$ (441,774) | \$ 2,048,752 | \$ 3,346,972 | \$ 7,240,505 |
| Total liabilities, deferred inflows of resources and fund balances (deficit) | \$ 3,371,502 | \$ 857,168 | \$ 1,001,814 | \$ 4,352,284 | \$ 4,995,449 | \$ 14,655,159 |

The accompanying notes are an integral part of this statement.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
RECONCILIATION OF THE BALANCE SHEET OF GOVERNMENTAL FUNDS
TO THE STATEMENT OF NET POSITION
JUNE 30, 2013**

Total governmental fund balances: **\$ 7,240,505**

Amounts reported for governmental activities in the Statement of Net Position are different because:

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds: 47,806,365

Other assets are not available to pay current-period expenditures and, therefore, are reported as deferred inflows of resources in the funds:

| | | |
|---|-----------|-----------|
| Due from Commonwealth Government: | | |
| Christmas bonus reimbursement | \$ 60,077 | |
| Property taxes- General Fund | 316,609 | |
| Property taxes- Debt Service Fund | 283,823 | |
| P.R. Electric Power Authority (PREPA) | 464,712 | |
| P.R. Department of Labor - Law No. 52 | 326,917 | |
| P.R. Department of Transportation and Public Works (DTOP) | 338,319 | 1,790,457 |
| Due from Federal Government: | | |
| Federal grant - CDBG | 431,746 | |
| Federal grant - Disaster Grants-Public Assistance | 224,244 | |
| Federal grant - Edward Byrne (JAG) | 23,629 | |
| Federal grants - others | 59,931 | 739,550 |

Interest liabilities are not due and payable in the current period and, therefore, are not reported in the funds (619)

Long-term liabilities, including bonds payable, are not due and payable in the current period and, therefore, are not reported in the funds:

| | | |
|---|--------------|--------------|
| General obligation bonds and notes | (16,845,000) | |
| Note payable to CRIM-Law No. 146 | (173,892) | |
| Note payable to CRIM-Ley 42 | (477,171) | |
| Compensated absences | (1,250,392) | |
| Christmas Bonus | (120,153) | |
| Debt payable to P.R. Electric Power Authority | (464,712) | (19,331,320) |

Net assets of governmental activities: **\$ 38,244,938**

The accompanying notes are an integral part of these statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES (DEFICIT) -
GOVERNMENTAL FUNDS
FISCAL YEAR ENDED JUNE 30, 2013

| | Major Funds | | | | | | | Total Governmental Funds |
|--|---------------------|----------------------------------|--------------------------------|----------------------------------|----------------------------------|-------------------------|--------------------------------|--------------------------------|
| | General | Special Revenue | | Capital Project | | Debt Service Fund | Other Governmental Funds | |
| | | Fund - State and Local Grants | Fund - Other Federal Grants | Fund - State and Local Grants | Fund - State and Local Grants | | | |
| Revenues: | | | | | | | | |
| Taxes: | | | | | | | | |
| Property taxes | \$ 2,248,568 | \$ - | \$ - | \$ - | \$ 1,152,941 | \$ - | \$ - | \$ 3,401,509 |
| Municipal license taxes | 942,679 | - | - | - | - | - | - | 942,679 |
| Sales and use taxes | 617,049 | - | - | - | 1,061,769 | - | - | 1,678,818 |
| Intergovernmental: | | | | | | | | |
| Commonwealth Government | 3,995,203 | 682,326 | - | 680,758 | - | - | - | 5,358,287 |
| Federal Government | - | - | 2,006,034 | - | - | - | 424,245 | 2,430,279 |
| Fees, fines and charges for services | 1,802,452 | - | - | - | - | - | - | 1,802,452 |
| Interest | 462 | 57 | - | 309,523 | - | - | - | 313,784 |
| Other | 420,725 | 6,320 | - | - | 3,742 | - | - | 427,045 |
| Total revenues | 10,027,138 | 688,703 | 2,006,034 | 990,281 | 2,218,452 | 424,245 | - | 16,354,853 |
| Expenditures: | | | | | | | | |
| Current: | | | | | | | | |
| General government | 5,709,270 | 313,009 | - | - | - | - | - | 6,022,279 |
| Public works and sanitation | 2,122,156 | 419,951 | 160,821 | 4,971,066 | - | - | - | 7,673,994 |
| Public Safety | 170,525 | - | 179,609 | - | - | - | - | 350,134 |
| Culture and recreation | 400,458 | 21,842 | - | 1,827,093 | - | - | - | 2,249,393 |
| Health | 323,878 | - | - | - | - | - | - | 323,878 |
| Welfare and community development | 698,466 | - | 2,001,508 | - | - | - | 484,474 | 3,184,448 |
| Education | - | 17,483 | - | - | - | - | - | 17,483 |
| Debt Service: | | | | | | | | |
| Principal | - | - | - | - | 1,020,000 | - | - | 1,020,000 |
| Interest | - | - | - | - | 785,645 | - | - | 785,645 |
| Total expenditures | 9,424,753 | 772,285 | 2,341,938 | 6,798,159 | 1,805,645 | 484,474 | - | 21,627,254 |
| Excess (deficiency) of revenues over expenditures | 602,385 | (83,582) | (335,904) | (5,807,878) | 412,807 | (60,229) | - | (5,272,401) |
| Other financing sources (uses): | | | | | | | | |
| Payment of PREPA debt | (404,229) | - | - | - | - | - | - | (404,229) |
| Transfers in | 311,002 | - | - | - | - | - | - | 311,002 |
| Transfers (out) | - | (57) | - | (309,523) | (1,422) | - | - | (311,002) |
| Total other financing resources (uses) | (93,227) | (57) | - | (309,523) | (1,422) | - | - | (404,229) |
| Net change in fund balances (deficit) | 509,158 | (83,639) | (335,904) | (6,117,401) | 411,385 | (60,229) | - | (5,676,630) |
| Fund balances (deficit) at beginning of year, as restated | 888,464 | 304,792 | (105,870) | 8,766,153 | 2,935,587 | 128,009 | - | 12,917,135 |
| Fund balances (deficit) at end of year | \$ 1,397,622 | \$ 221,153 | \$ (441,774) | \$ 2,648,752 | \$ 3,346,972 | \$ 67,780 | \$ - | \$ 7,240,505 |

Handwritten signature and date: 5/22/2013

The accompanying notes are an integral part of this statement.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
RECONCILIATION OF STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND
BALANCES (DEFICIT) OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES
FISCAL YEAR ENDED JUNE 30, 2013**

| | | |
|--|--------------------|-------------------------|
| Net change in fund balances (deficit) - total governmental funds: | \$ | (5,676,630) |
| <p>Amounts reported for governmental activities in the Statement of Activities are different because:</p> | | |
| <p>Governmental funds reports capital assets outlays as expenditures. However, in the Statement Activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense:</p> | | |
| Expenditures for capital assets | \$ 6,881,965 | |
| Less: current year depreciation | <u>(1,547,872)</u> | 5,334,093 |
| <p>Revenues in the Statement of Activities that do not provide current financial resources are not reported as revenues in the funds:</p> | | |
| Christmas bonus reimbursement (current year) | 60,077 | |
| Property Taxes CRIM Final Liquidation - General Fund | 316,610 | |
| Property taxes-Debt Service Fund | 283,823 | |
| P.R. Electric Power Authority (PREPA) | 293,121 | |
| Puerto Rico State Agency for Emergency and Disaster Management | 21,616 | |
| P.R. Department of Labor - Law No. 52 | 171,058 | |
| P.R. Department of Transportation and Public Works (DTOP) | 338,319 | |
| Federal Grants- FEMA Irene Storm | 224,244 | |
| Federal grant - CDBG | 378,968 | |
| Federal grant - Other | <u>61,940</u> | 2,149,776 |
| <p>Revenues reported in funds which are not reported as revenues in the Statement of Activities:</p> | | |
| Christmas bonus reimbursement (prior year) | 61,278 | |
| P.R. Electric Power Authority (PREPA) | <u>686,931</u> | (748,209) |
| <p>Governmental funds only report the proceeds received in the disposal of assets. In the Statement of Activities, a gain or loss is reported for each disposal. Thus, the change in net position differs from the change in fund balance by the cost of the disposed asset:</p> | | |
| | | (410,711) |
| <p>Expenditures reported in funds which are not reported as expenses in the Statement of Activities:</p> | | |
| Matured bonds principal payments (net change) | | (245,000) |
| <p>Repayment of long term debt is an expenditure in the governmental funds, but reduces long-term liabilities in the Statement of Net Position:</p> | | |
| General obligation bonds and notes | 1,265,000 | |
| Other long term liabilities | <u>710,252</u> | 1,975,252 |
| <p>Some expenses reported in the Statement of Activities do not require the use of current financial resources and therefore are not reported as expenditures:</p> | | |
| <p>expenditures in the governmental funds:</p> | | |
| Compensated absences | (301,995) | |
| Christmas bonus | (120,153) | |
| Debt payment to P.R. Electric Power Authority | (439,680) | |
| Accrued interest (net change) | <u>253,307</u> | <u>(608,521)</u> |
| Change in net assets of governmental activities: | \$ | <u>1,770,050</u> |

The accompanying notes are an integral part of these statements.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Municipality of Luquillo was founded in 1797. The Municipality is governed by the executive and the legislative branch elected for a four year term during the general elections in Puerto Rico. The Mayor is the executive officer and the legislative branch consists of twelve (12) members of the Municipal Legislature. The Municipality engages in comprehensive range of services to the community such as: general government administration, public works, health, environmental control, education, public security, welfare, housing, community development and culture and recreation activities.

The financial statements of the Municipality have been prepared in accordance with accounting principles generally accepted in the United States as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the standard-setting body for governmental accounting and financial reporting. The GASB periodically updates its existing Governmental Accounting and Financial Reporting Standards, which, along with subsequent GASB pronouncements (Statements and Interpretations), constitutes GAAP for governmental units.

1. *Financial reporting entity*

The financial reporting entity included in this report consists of the financial statements of the Municipality of Luquillo (primary government) and organizations for which the primary government is financially accountable. In addition, the primary government may determine, through exercise of management's professional judgment, that the inclusion of an organization that does not meet the financial accountability criteria is necessary in order to prevent the reporting entity's financial statements from being misleading. Other entities should be evaluated as potential component units if they are closely related to, or financially integrated with, the primary government. It is a matter of professional judgment to determine whether the nature and the significance of a potential component unit's relationship with the primary government warrant inclusion in the reporting entity. An entity should be considered a component unit if meets any of the following three conditions:

- a. The primary government appoints a voting majority of the entity's governing body, and either:
 - A financial benefit/ burden exist between the primary government and the entity or
 - The primary government can impose its will on the entity.
- b. The entity is fiscally dependent on the primary government and there is a financial benefit/burden between the primary government and the entity.
- c. It would be necessary to include the entity as a component unit since the primary government's financial statements would be misleading without it.

In addition, "*Special criteria*" apply when evaluating a legally separate, tax-exempt organization as potential component unit. Specifically, such entities must be treated as component units if they meet all of the following criteria:

- a. The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
- b. The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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

Legally separate, tax-exempt organizations that do not meet the above *special criteria* should still be included as a component unit if the financial statements of the primary government would be misleading without them.

There are two methods of presentation of the component unit in the financial statements: (a) *blending* the financial data of the component units' balances and transactions and (b) *discrete* presentation of the component unit's financial data. When a component unit functions as an integral part of the primary government, its data is *blended* with those of the primary government ("*blended component units*"). That is, the component unit's funds are treated just as though they were funds of the primary government with one exception: the general fund. Component units should be reported as *blended* if meets any of the following criteria:

- a. The component unit's governing body is substantively the same as the governing body of the primary government and there is either:
 - A financial benefit/ burden exist between the primary government and the entity or
 - Management of the primary government has operational responsibility for the primary government.
- b. The component unit provides services entirely, or almost entirely, to the primary government or otherwise exclusively, or almost exclusively, benefits the primary government.
- c. The component unit's debt is expected to be paid by the primary government.

Otherwise, the component unit should be presented as discrete. Those component units does not function as an integral part of the primary government and its data is presented discretely (separately) from the data of the primary government ("*discretely component units*"). Legally separate, tax-exempt organizations that meet the *special criteria* should be included as *discretely component units*.

Based on the above criteria there are no potential component units which should be included as part of the financial statements.

2. Basis of presentation, measurement focus and basis of accounting

The financial report of the Municipality consists of the Management's Discussion and Analysis (MD&A), basic financial statements and required supplementary information other than the MD&A. Following is a summary presentation of each, including the measurement focus and basis of accounting. Measurement focus is a term used to describe *which* transactions are recorded within the various financial statements. Basis of accounting refers to *when* transactions are recorded regardless of the measurement focus:

Management's Discussion and Analysis

This consists of a narrative introduction and analytical overview of the Municipality's financial activities. This analysis is similar to analysis the private sector provides in their annual reports.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Basic financial statements

Basic financial statements include both government-wide and fund financial statements. Both levels of statements categorize primary activities as governmental type, which are primarily supported by taxes and intergovernmental revenues.

Government-wide statements

The government-wide statements consist of a Statement of Net Position and a Statement of Activities. These statements are prepared using the economic resources measurement focus, which refers to the reporting of all of the net position available to the governmental unit for the purpose of providing goods and services to the public. The statements are reported on the accrual basis of accounting. Revenues are recognized in the period earned and expenses recognized in the period in which the associated liability is incurred. Fiduciary activities, if any, whose resources are not available to finance government programs, are excluded from the government-wide statements. The effect of inter-fund activities is eliminated.

The Statement of Net Position presents all of the reporting entity's non-fiduciary assets, deferred outflows, liabilities and deferred inflows, with the difference reported as net position. The Statement of Activities reports revenues and expenses in a format that focus on the net cost of each function of the Municipality. Both the gross and net cost of the function, which is otherwise being supported by the general government revenues, is compared to the revenues generated directly by the function. This Statement reduces gross direct expenses, including depreciation, by related program revenues, operating and capital grants, and contributions. Direct expenses are those that are clearly identifiable with a specific function. As a policy, indirect expenses are not allocated in the Statement of Activities. Program revenues must be directly associated with the function.

The types of transactions included as program revenues are: charges for services, fees, licenses and permits; operating grants which include operating-specific and discretionary (either operating or capital) grants; and capital grants which are capital-specific grants. Internally dedicated resources are reported as general revenues rather than as program revenues. Likewise, general revenues include all taxes. Property taxes (imposed nonexchange transactions) are recognized as revenues in the year for which they are levied and municipal license taxes and sales and use taxes (derived tax revenues) when the underlying exchange has occurred and time requirements are met. Revenues on both operating and capital grants are recognized when all eligibility requirements (including time requirements) imposed by the provider have been met. For certain expenditure-driven grants, revenue is recognized after allowable expenditures are incurred.

The Municipality reports unearned revenues in the government-wide statements. Unearned revenues arise when resources are received before the Municipality has a legal claim to them (such as advances of derived tax revenues) or before applicable eligibility requirements are met (in case of certain federal expenditure-driven grants if resources are received before allowable expenditures are incurred). In subsequent periods, when the Municipality has a legal claim to the resources, the liability for unearned revenues is removed from the statement of net position and the revenue is recognized.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Fund Statements

The financial transactions of the Municipality are recorded in individual funds, each of which are considered an independent fiscal entity. Each fund is accounted for by providing a separate set of self-balancing accounts that comprise its assets, deferred outflows, liabilities, deferred inflows, fund equity, revenues and expenditures. Funds are segregated according to their intended purpose which helps management in demonstrating compliance with legal, financial and contractual provisions. Governmental Funds are those through which most governmental functions of the Municipality are financed. The governmental fund statements include a Balance Sheet and a Statement of Revenues, Expenditures and Changes in Fund Balances with one column for the general fund, one for each major fund and one column combining all non-major governmental funds. Major funds are determined based on a minimum criterion, that is, a percentage of the assets and deferred outflows; liabilities and deferred inflows; revenues or expenditures or based on the Municipality's official's criteria if the fund is particularly important to financial statement users (Special Revenue Fund – Other Federal Awards).

The Municipality reports the following major governmental funds:

General Fund: This is the operating fund of the Municipality and is used to account for and report all financial resources not accounted for and reported in another fund.

Special Revenue Fund – State and Local Grants: This fund is used to account for and report revenue sources from Commonwealth agencies and Legislature that are restricted or committed for specific purposes which include, among others, acquisition of capital assets, public works, welfare and other community development projects.

Special Revenue Fund – Other Federal Grants: This fund is used to account for and report revenue sources from Federal agencies that are restricted or committed for specific purposes which include, among others, acquisition of capital assets, public works, welfare and other community development projects.

Capital Project's Fund – State and Local Grants: This fund is used to account for and report revenue sources from Commonwealth agencies and Legislature and proceeds from issuance of long-term debt that are restricted, committed or assigned for to expenditure for capital outlays, including acquisition, development and improvement of capital assets.

Debt Service Fund: This fund is used to account for and report financial resources that are restricted, committed, or assigned to expenditures for principal and interest. This fund accounts for the resources of three individual funds including the "CAE Fund" (sinking fund which accounts for the 2% of property taxes collected by the CRIM, and the "Municipal Redemption Fund" (.2% of the .5% from sales and use taxes will be deposited in GDB to finance loans to Municipalities).

The governmental fund financial statements are accounted for using the current financial resources measurement focus and the modified accrual basis of accounting. Under this method of accounting, revenues are recognized when they are susceptible to accrual (i.e. both measurable and available). Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Municipality considers revenues to be available if they are collected within 60 days of the end of the current fiscal period.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Revenues susceptible to accrual include property taxes, recognized as revenues in the year for which they are levied; municipal license taxes and sales and use taxes, recognized when the underlying exchange has occurred and time requirements are met; and interest. In applying the susceptible to accrual concept to intergovernmental revenues, revenues are recognized when all eligibility requirements (including time requirements) imposed by the provider have been met and revenue becomes available. There are, however, essentially two types of these revenues. In the first case, on expenditure-driven grants, monies must be expended on the specific project or purpose (eligibility requirement), before any amounts are paid to the Municipality. Revenue is, therefore, recognized as expenditures are incurred to the extent available. In the other cases, monies are virtually unrestricted and are generally revocable only for failure to comply with prescribed compliance requirements. In these cases revenues are recognized as the time of receipt or earlier if the susceptible to accrual criteria is met. Licenses and permits, charges for services, rent, fines and miscellaneous revenues are generally recorded as revenues when received or are recognized earlier if the susceptible to accrual criteria is met.

The Municipality reports unearned revenues in the governmental funds statements. Unearned revenues arise when resources are received before the Municipality has a legal claim to them (such as advances of derived tax revenues) or before applicable eligibility requirements are met (in case of certain federal expenditure-driven grants if resources are received before allowable expenditures are incurred). In subsequent periods, when the Municipality has a legal claim to the resources, the liability for unearned revenues is removed from the balance sheet and the revenue is recognized.

Expenditures are generally recognized when the related liability is incurred as under accrual basis of accounting. Certain exceptions to this fundamental concept include the following: (1) payments of principal and interest on general long-term debt, which are recorded as expenditures when due, except for principal and interest due on July 1 (in this case amounts are recorded as liabilities and expenditures on June 30 since amounts have been accumulated or transferred to the debt service fund before July 1 payments are made) and (2) vested compensated absences, claims and judgments and special termination benefits which are recorded as expenditures only to the extent that they are expected to be liquidated with expendable financial resources (in the government-wide statements the expense and related accrual liability for long-term portions of debt must be included).

Since the governmental fund statements are presented on a different measurement focus and basis of accounting than the government-wide statements, reconciliation is necessary to explain the adjustments needed to transform the fund financial statements into the government-wide statements. This reconciliation is part of the financial statements.

Notes to Financial Statements

The notes to financial statements provide information that is essential to a user's understanding of the basic financial statements.

Required Supplementary Information

Required supplementary information consists of the Budgetary Comparison Schedule – General Fund as required by GASB.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

3. *Deposits and investments*

Cash and cash equivalents consist of cash on hand, demand deposits and short-term investments with original maturities of three months or less from the date of acquisition. Nonnegotiable certificates of deposits with original maturity of more than three months are considered time deposits as required by current standards. The Municipality follows the practice of pooling cash of all funds except for certain Commonwealth's grants, restricted funds generally held by outside custodians and federal grants. Available pooled cash balance beyond immediate needs is invested in certificates of deposits. Cash and cash equivalents related to Commonwealth and Federal grants (including Commonwealth Legislature Resolutions) are restricted since their use is limited by applicable agreements or required by law.

The laws and regulations of the Commonwealth of Puerto Rico authorize the Municipality to invest only in obligations of the Commonwealth, obligations of the United States of America, certificates of deposits, commercial paper, bankers' acceptances, or in pools of obligations of the municipalities of Puerto Rico, which are managed by the Governmental Development Bank for Puerto Rico ("GDB").

4. *Restricted assets*

Restricted assets are liquid assets which have third-party limitations on their use. Cash and cash equivalents related to Commonwealth and Federal grants (including Commonwealth Legislature Resolutions) are restricted since their use is limited by applicable agreements or required by law.

Restricted cash with fiscal agent in the debt service fund consists of the undisbursed balance of property and sales tax collections retained by the Commonwealth of Puerto Rico which are restricted for the repayment of the Municipality's general and special obligation bonds and notes as established by law. Restricted cash with fiscal agent of the other governmental funds represent the undisbursed proceeds of certain bonds, loans or grants which are maintained in a cash custodian account by the GDB or a federal government agency.

5. *Receivables and due from governmental entities*

Receivables are stated net of estimated allowances for uncollectible accounts, which are determined upon past collection experience and current economic conditions. Amounts due from federal government represent amounts owed to the Municipality for the reimbursement of expenditures incurred pursuant to federally funded programs. Amounts reported in the debt service fund represent property and sales tax revenues of current fiscal year collected by the CRIM (property tax) and the Puerto Rico Department of Treasury (sales tax) on the subsequent fiscal year.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

6. Interfund receivables and payables

Activities among funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as either "due from/to other funds" (i.e., the current portion of interfund loans) or "advances to/from other funds" (i.e., the non-current portion of interfund loans). All other outstanding balances among funds are reported as "due from/to other funds".

7. Inventories

The Municipality purchases gasoline, oil and other expendable supplies held for consumption. The cost of those purchases is recorded as expenditure when incurred in the appropriate fund but the year-end inventory is not recorded in the Statement of Net Assets, as management believes is not significant.

8. Capital assets

Capital assets reported in the governmental activities in the Statements of Net Position include property, plant, equipment and infrastructure, (e.g., roads, bridges, sidewalks, and similar items). The Municipality defines capital assets (except for infrastructure assets) as assets that have an individual cost of \$500 or more and have a useful life of one or more years. Infrastructure assets are capitalized based on a percentage of the estimated useful life. The cost of normal maintenance and repairs that do not add to the value of the assets or materially extend assets lives are not capitalized. Major outlays for capital assets and improvements are capitalized as projects are constructed.

Capital assets are capitalized at historical cost or estimated historical cost if historical cost is not available. Donated assets are recorded as capital assets at their estimated fair market value at the date of donation. All capital assets, other than land and construction in progress, are depreciated using the straight-line method over the following useful lives:

| <u>Description</u> | <u>Years</u> |
|--|--------------|
| Buildings and building improvements | 40 |
| Infrastructure and infrastructure improvements | 40 |
| Equipment | 3 to 5 |
| Furniture and Fixtures | 5 |
| Work of Art | 10 |
| Vehicles | 5 |

In accordance with current accounting standards capital assets are reviewed for impairment. Impairment occurs when there is a significant decline in asset service utility due to the occurrence of a prominent event or change in circumstances affecting the asset. Current standards provide guidance for accounting and reporting for impairment and for insurance recoveries.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES- Continued

9. *Deferred outflows/inflows of resources*

In addition to assets, the statement of net position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, deferred outflows of resources, represents a consumption of net position that applies to a future period(s) and so will not be recognized as an outflow of resources (expense/ expenditure) until then.

In addition to liabilities, the statement of financial position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, deferred inflows of resources, represents an acquisition of net position that applies to a future period(s) and so will not be recognized as an inflow of resources (revenue) until that time. The government has only one item, which arises only under a modified accrual basis of accounting that qualifies for reporting in this category. Accordingly, the item, *unavailable revenue*, is reported only in the governmental funds balance sheet. The governmental funds report *unavailable revenue* from one source: unavailable intergovernmental revenues. These amounts are deferred and recognized as an inflow of resources in the period that the amounts become available.

10. *Long-term obligations*

Long-term debt and other long-term obligations, which are reported as liabilities in the governmental activities column in the Statement of Net Position, consist of general and special obligation bonds, liabilities for compensated absences, claims and judgments, and long-term liabilities to other governmental entities. Related bond issuance costs, whenever rise, are reported as current outflows of resources in the Statement of Activities, as required by current standards. Governmental fund types recognize bond issuance costs as expenditures during the current period. Those issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures in the appropriate fund.

11. *Compensated absences*

The Municipality's employees accumulate vacation, sick leave and compensatory time based on continuous service. Compensated absences are recorded as a liability if (1) are earned on the basis of services already performed by employees, (2) it is probable that will be paid (in the form of paid time off, cash payments at termination or retirement, or some other means) and (3) are not contingent on a specific event (such as illness). The compensated absences are accumulated on the basis of 2½ days per month of vacation and 1½ days per month of sick pay and compensatory time up to a maximum of 60 days of vacations and 90 days of sick leave. Upon separation from employment the accumulated vacations are liquidated up to the maximum number of days. Accumulated sick leave, which is accrued based on all vesting amounts for which payment is probable, is liquidated to employees with 10 years or more service up to the maximum number of days.

The accrual of compensated absences includes estimated payments that are related to payroll. The entire compensated absence liability is reported on the government-wide financial statements. For governmental fund financial statements, the current portion of unpaid compensated absences is the amount that is normally expected to be paid using expendable available financial resources. The non-current portion of the liability is not reported.

Pursuant to Law No. 152 of August 20, 1996 effective July 1, 1997 the Municipality is required to pay any excess of vacations and sick leave accumulated over 90 days as of December 31 of each year. Payments should be made on or before March 31 of the following year.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

12. Claims and judgments

The estimated amount of the liability for claims and judgments, which is due on demand, such as from adjudicated or settled claims, is recorded in the general fund when they mature (generally, when payment is due). The accompanying government-wide statements include an amount estimated as a contingent liability or liabilities as incurred.

13. Net position

In the government-wide statements, assets plus deferred outflows of resources less liabilities and deferred inflows of resources equal net position, and should be displayed in three components: net investment in capital assets, restricted, and unrestricted, as follows:

Net investment in capital assets: Consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of bonds, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt also should be included in this component of net position. The portion of the debt or deferred inflows of resources attributable to the unspent debt proceeds is not included in the calculation of net investment in capital assets. Instead, the portion of the debt or deferred inflows of resources is included in the same net position component (restricted or unrestricted) as the unspent amount.

Restricted net position: The restricted component of net position consists of restricted assets (subject to restrictions beyond the Municipality's control) reduced by liabilities and deferred inflows of resources related to those assets. Generally, a liability relates to restricted assets if the asset results from a resource flow that also results in the recognition of a liability or if the liability will be liquidated with the restricted assets reported. Restrictions are externally imposed (by creditors, grantors, contributors, or laws and regulations of other governments) or imposed by the law through constitutional provisions or enabling legislation.

Unrestricted net position: Unrestricted net position is the net amount of the assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of net investment in capital assets or the restricted component of net position. Unrestricted net position is often designated to indicate that management does not consider them to be available for general operations. These types of constraints are internal and management can remove or modify them.

14. Net position flow assumption

Sometimes the government will fund outlays for a particular purpose from both restricted (restricted bond or grant proceeds) and unrestricted resources. In order to calculate the amounts to report as restricted – net position and unrestricted – net position in the government-wide financial statements, a flow assumption must be made about the order in which the resources are considered to be applied. It is the government's policy to consider restricted – net position to have been depleted before unrestricted – net position is applied.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

15. Fund balances

The GASB Statement No. 54 *Fund Balance Reporting and Governmental Fund Type Definitions* (“GASB No. 54”) establishes accounting and reporting standards for all governments that report governmental funds. It also establishes criteria for classifying fund balances into specifically defined classifications and clarifies definitions for governmental fund types. These classifications comprise a hierarchy based primarily on the extent to which the Municipality is bound to observe constraints upon the use of the resources reported. The classifications are as follows:

- | | |
|----------------------|---|
| Nonspendable: | Amounts that cannot be spent because are either (a) not in spendable form or (b) legally or contractually required to be maintained intact. |
| Restricted: | Amounts constrained by external parties (creditors, grantors, contributors, or laws and regulations of other governments), imposed by law through constitutional provisions or by enabling legislation. Enabling legislation authorizes the Municipality to assess, levy, charge or otherwise mandate payment or resources (from external resource providers) and includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation. Legally enforceability means that the Municipality can be compelled by an external party such as citizens, public interest groups, or the judiciary to use resources created by enabling legislation only for the purposes specified by the legislation. |
| Committed: | Amounts that can be used only for the specific purposes pursuant to constraints imposed through formal action (ordinance or resolution) by consent of the government’s highest level of decision-making authority, which in the case of the Municipality is the Mayor and the Municipal Legislature. Those committed amounts cannot be used for any other purposes unless the Mayor and the Municipal Legislature removes or changes the specified use by taking the same type of action (ordinance or resolution) it employed to commit those amounts. Formal action to commits fund balance to a specific purpose should occur prior to the end of the fiscal year, but the amount, if any, which will be subject to the constraint, may be determined in the subsequent period. |
| Assigned: | Amounts that are constrained by the Municipality’s intent to be used for specific purposes, but are neither restricted nor committed. In distinction to committed balances, the authority for making an assignment is not required to be the government’s highest level of decision-making authority, (both the Mayor and the Municipal Legislature). It is the Municipality’s policy that intent can be expressed by the Mayor, the Finance Director (the official to which the Mayor has also delegated the authority to assign amounts) or by any other official or body to which the Mayor delegates. Furthermore, the nature of the actions necessary to remove or modify an assignment is not as prescriptive as it is with committed fund balances. With the exception of the general fund, this is the residual fund balance of the classification of all governmental funds with positive fund balances. Action taken to assign fund balance may be made after year-end. |
| Unassigned: | Is the residual classification for the general fund and includes all spendable amounts not restricted, committed or assigned. The general fund is the only fund that reports a positive unassigned fund balance amount. For all other governmental funds the unassigned classification is used only to report a deficit balance resulting for the overspending for specific purposes for which amounts had been restricted, committed or assigned. |

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

16. Fund balance flow assumptions

Sometimes the government will fund outlays for a particular purpose from both restricted and unrestricted resources (the total of committed, assigned, and unassigned fund balance). In order to calculate the amounts to report as restricted, committed, assigned, and unassigned fund balance in the governmental fund financial statements a flow assumption must be made about the order in which the resources are considered to be applied. It is the government's policy to consider restricted fund balance to have been depleted before using any of the components of unrestricted fund balance. Further, when the components of unrestricted fund balance can be used for the same purpose, committed fund balance is depleted first, followed by assigned fund balance. Unassigned fund balance is applied last.

17. Interfund transactions

The Municipality reports certain transactions as transfers, which are legally required transfers that are reported when incurred as "Transfers-in" by the recipient fund and as "Transfers-out" by the disbursing fund.

18. Risk financing

The Puerto Rico Department of Treasury (PRDT) acts as an agent, obtaining and determining the coverage for the municipalities of Puerto Rico. The coverage for the Municipality of Luquillo consists of professional, public responsibility, property and theft, auto and fidelity bond coverage.

Insurance policies costs are allocated by PRDT among all the municipalities of Puerto Rico. Payment of the Municipality's insurance premiums is monthly deducted from advances of property tax and amounts of municipal equalization fund send to the Municipality by the Municipal Revenue Collection Center (CRIM). Workers compensation insurance is also deducted from the monthly advances by the CRIM. Settled cases have not exceeded insurance coverage for any of the past three years.

19. Use of estimates

The preparation of the basic financial statements in accordance 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 disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

20. Reclassifications

Various reclassifications have been made in the accompanying basic financial statements which affect the comparability with the basic financial statements issued for previous fiscal years.

NOTE A- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

21. Future adoption of accounting pronouncements

The GASB has issued the following statements, which the Municipality has not yet adopted:

- a. **GASB Statement No. 66** “*Technical Corrections—2012—an amendment of GASB Statements No. 10 and No. 62*”. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2012 (fiscal year ended June 30, 2014).
- b. **GASB Statement No. 67** “*Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*”. The provisions of this Statement are effective for financial statements for fiscal years beginning after June 15, 2013 (fiscal year ended June 30, 2014).
- a. **GASB Statement No. 68** “*Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*”. The provisions of this Statement are effective for fiscal years beginning after June 15, 2014 (fiscal year ended June 30, 2015).
- b. **GASB Statement No. 69** “*Government Combinations and Disposals of Government Operations*”. The provisions of this Statement are effective for government combinations and disposals of government operations occurring in financial reporting periods beginning after December 15, 2013, and should be applied on a prospective basis (fiscal year ended June 30, 2015).
- c. **GASB Statement No. 70** “*Accounting and Financial Reporting for Nonexchange Financial Guarantees*”. The provisions of Statement 70 are effective for financial statements for reporting beginning after June 15, 2013 (fiscal year ended June 30, 2015).
- d. **GASB Statement No. 71** “*Pension Transition for Contributions Made Subsequent to the Measurement Date*”. The provisions of this Statement should be applied simultaneously with the provisions of Statement 68 (fiscal year ended June 30, 2015).

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

NOTE B- DEPOSITS

Custodial credit risk on Deposits. This is the risk that in the event of a bank failure, the government’s deposits may not be returned to it. The Municipality maintains cash deposits in commercial and governmental banks located in Puerto Rico. Under Commonwealth of Puerto Rico statutes, public funds deposited in commercial banks must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral by the Municipality are held by the Secretary of Treasury of Puerto Rico in the Municipality’s name.

At year-end, the Municipality’s bank balance of deposits in commercial banks amounting to \$2,795,214 was covered by federal depository insurance or by collateral held by the Secretary of Treasury of Puerto Rico in the Municipality’s name. Deposits in governmental banks (all of which are uninsured and uncollateralized), are exposed to custodial credit risk. At year-end the Municipality’s bank balance in governmental banks amounts to \$8,400,715.

NOTE C- DUE FROM GOVERNMENTAL ENTITIES

Amounts due from governmental entities as of June 30, 2013 follows:

| | <u>Commonwealth Government Funds</u> | <u>Federal Government Funds</u> |
|--|--|---|
| Major fund – General fund: | | |
| P.R. Electric Power Authority (PREPA) | \$ 464,712 | \$ - |
| Municipal Revenue Collection Center (CRIM)- property taxes and intergovernmental subsidy(general fund) | 316,610 | - |
| P.R. Department of Treasury – Christmas bonus reimbursement | 60,077 | - |
| Major fund – Debt service fund: | | |
| Municipal Revenue Collection Center (CRIM) – property taxes | 304,350 | - |
| P.R. Department of Treasury – sales and use taxes-Municipal Redemption Fund | 85,907 | - |
| Major fund – Special Revenue State & Local Grants: | | |
| P.R. Department of Labor- Law No. 52 | 332,573 | - |
| Major fund- Special Revenue Other Federal Grants: | | |
| Office of Commissioner of Municipal Affairs-CDBG | - | 465,161 |
| P.R. Office of Ombudsman Administration (OAP)-OAP-Special Program for the Aging- Title III Part B & NSIP | - | 35,121 |
| P.R. Department of Justice - Edward Byrne Memorial Assistance Grant Program (JAG-CMEI) | - | 23,629 |
| P.R. Traffic Safety Commission - State & Community Highway Safety Program | - | 11,401 |
| Others | - | 26,952 |
| | <u>\$ 1,564,229</u> | <u>\$ 562,264</u> |

Certain amounts are recorded as deferred inflows of resources in the governmental funds statements since they are not available as required by current standards. See related note H.

NOTE D- INTERFUND TRANSACTIONS

1. Due from/to other funds

Amounts due/from to other funds in the general fund represent advances to other funds to finance payroll, payroll taxes and other expenditures, as follows:

| <u>Receivable Fund</u> | <u>Payable Funds</u> | <u>Amount</u> |
|------------------------|--|---------------|
| General Fund | Major Funds: | |
| | Special Revenue Federal- (CDBG) | \$ 59,248 |
| | Special Revenue Federal- Special Program for the Aging- Title III & NSIP | 71,157 |
| | Special Revenue Federal- JAGCMEI | 34,076 |
| | Special Revenue Federal- Other | 50,108 |
| | Special Revenue State & Local- Law No. 52 | 304,416 |

NOTE D- INTERFUND TRANSACTIONS - Continued

| <u>Receivable Fund</u> | <u>Payable Funds</u> | <u>Amount</u> |
|------------------------|--|-------------------|
| | Capital Project State & Local- Law No. 212 | 300,624 |
| | Capital Project State & Local- Permanent Improvements | 20,536 |
| | Capital Project State & Local- Other | 4,681 |
| | <u>Other Governmental Funds:</u> | |
| | Special Revenue State & Local- NMF- Section 8 HCVP | 5,506 |
| | | <u>\$ 850,352</u> |

2. Transfers in (out)

Transfers among individual funds were made for operational purposes. Transfers include interest earned on restricted cash with fiscal agent in the debt service fund and bonds and notes included in the Capital Project Fund – State and Local Grants which is transferred to the general fund.

NOTE E- FUND BALANCE

1. Fund balance classifications

The governmental fund balance classifications and amounts at June 30, 2013 are shown in the following table:

| | General | Special Revenue Fund - State and Local Grants | Special Revenue Fund - Other Federal Grants | Capital Project Fund - State and Local Grants | Debt Service Fund | Other Governmental Funds | Total Governmental Funds |
|---|---------------------|---|---|---|---------------------|--------------------------|--------------------------|
| Nonspendable: | | | | | | | |
| Advances to other funds | \$ 83,538 | - | - | - | - | - | \$ 83,538 |
| | <u>83,538</u> | | | | | | <u>83,538</u> |
| Restricted: | | | | | | | |
| General public works and sanitation | - | 97,905 | - | 468,620 | - | - | 566,525 |
| Public safety | - | 66,512 | - | - | - | - | 66,512 |
| Sports, culture and recreation | 6,885 | 143,961 | - | 22,912 | - | - | 173,758 |
| Housing, welfare and community develop. | - | 225,771 | 22,908 | 88,474 | - | 67,780 | 404,933 |
| Education | - | 50,400 | - | 38,245 | - | - | 88,645 |
| Debt service | - | - | - | - | 3,346,972 | - | 3,346,972 |
| Capital outlays | - | - | - | 3,154,673 | - | - | 3,154,673 |
| General government and other purposes | - | 33,735 | - | - | - | - | 33,735 |
| | <u>6,885</u> | <u>618,284</u> | <u>22,908</u> | <u>3,772,924</u> | <u>3,346,972</u> | <u>67,780</u> | <u>7,835,753</u> |
| Committed: | | | | | | | |
| General government and other purposes | 412,943 | - | - | - | - | - | 412,943 |
| | <u>412,943</u> | | | | | | <u>412,943</u> |
| Assigned: | | | | | | | |
| General public works and sanitation | 34,606 | - | - | - | - | - | 34,606 |
| Public safety | 1,459 | - | - | - | - | - | 1,459 |
| Sports, culture and recreation | 3,957 | - | - | - | - | - | 3,957 |
| Housing, welfare and community develop. | 13,527 | - | - | - | - | - | 13,527 |
| General government and other purposes | 135,972 | - | - | - | - | - | 135,972 |
| | <u>189,521</u> | | | | | | <u>189,521</u> |
| Unassigned | 704,735 | (397,131) | (464,682) | (1,124,172) | - | - | (1,281,250) |
| | <u>\$ 1,397,622</u> | <u>\$ 221,153</u> | <u>\$ (441,774)</u> | <u>\$ 2,648,752</u> | <u>\$ 3,346,972</u> | <u>\$ 67,780</u> | <u>\$ 7,240,505</u> |

NOTE E- FUND BALANCE – Continued

2. Fund balance deficits

Certain special funds included in the fund statements disclosed fund balance deficits. The most significant balances follows:

| <u>Funds</u> | <u>Amount</u> |
|---|---------------|
| <u>Major Fund: Special Revenue – State and Local</u> | |
| <u>Grants:</u> | |
| FEMA - Loan | \$ 34,349 |
| Transit Program | 23,880 |
| P.R. Department of Labor – Law No. 52 | 293,835 |
| <u>Major Fund: Special Revenue – Other Federal Grants:</u> | |
| Community Development Block Grant Program | 429,652 |
| Edward Byrne Memorial Assistance Grant Program (JAG-CMEI) | 29,629 |
| State & Community Highway Safety Program | 11,401 |
| <u>Major Fund: Capital Projects – State and Local</u> | |
| <u>Grants:</u> | |
| Mitigation - Loan | 30,173 |
| Rural Development Corporation (CDR)-30771 | 204,272 |
| Commonwealth Legislature Resolutions | 334,180 |
| Rural Development Corporation (CDR)-98 | 78,124 |
| Citizens Participation | 39,560 |
| Law 212 | 338,318 |

The deficits result (1) from the recognition of deferred inflows of resources for unavailable revenues. As required by current standards, the Municipality recorded intergovernmental revenues for reimbursement (expenditure-driven grants) on fund statements when all applicable eligibility requirements have been met and the resources are available and (2) certain funds with cash shortfalls or without sufficient resources to cover their costs.

NOTE F- CAPITAL ASSETS

Capital assets and depreciation activity as of and for the year ended June 30, 2013 is as follows:

| | Balance July 1, 2012, as restated | Increases | Decreases | Balance June 30, 2013 |
|--|---|----------------------|----------------------|--------------------------|
| Governmental activities: | | | | |
| Capital assets, not being depreciated: | | | | |
| Land | \$ 10,462,413 | \$ - | - | \$ 10,462,413 |
| Construction in progress | 11,873,279 | 3,663,257 | 11,430,798 | 4,105,738 |
| Total capital assets not being depreciated: | <u>22,335,692</u> | <u>3,663,257</u> | <u>11,430,798</u> | <u>14,568,151</u> |
| Capital assets, being depreciated: | | | | |
| Building | 11,946,952 | - | - | 11,946,952 |
| Building Improvements | 4,680,854 | 9,977,820 | - | 14,658,674 |
| Infrastructure | 6,997,408 | 3,312,471 | - | 10,309,879 |
| Infrastructure Improvements | 5,189,875 | 480,934 | - | 5,670,809 |
| Equipment | 2,589,093 | 264,866 | - | 2,853,959 |
| Furniture & Fixture | 621,035 | 4,428 | - | 625,463 |
| Work of Art | 1,960 | - | - | 1,960 |
| Computer Equipment | 542,293 | 31,554 | - | 573,847 |
| Vehicles, machinery and equipment | 3,316,065 | 204,008 | 39,246 | 3,480,827 |
| Total capital assets being depreciated | <u>35,885,535</u> | <u>14,276,081</u> | <u>39,246</u> | <u>50,122,370</u> |
| Less accumulated depreciation for: | | | | |
| Building | (4,570,244) | (298,674) | - | (4,868,918) |
| Building improvements | (638,213) | (310,588) | - | (948,801) |
| Infrastructure | (2,669,004) | (180,706) | - | (2,849,710) |
| Infrastructure Improvements | (1,674,795) | (343,596) | - | (2,018,391) |
| Equipment | (2,443,601) | (101,641) | - | (2,545,242) |
| Furniture & Fixture | (603,757) | (7,489) | - | (611,246) |
| Work of Art | (994) | (156) | - | (1,150) |
| Computer Equipment | (432,637) | (60,081) | - | (492,718) |
| Vehicles, machinery and equipment | (2,305,003) | (244,941) | (1,963) | (2,547,981) |
| Total accumulated depreciation | <u>(15,338,248)</u> | <u>(1,547,872)</u> | <u>(1,963)</u> | <u>(16,884,157)</u> |
| Total capital assets being depreciated, net | <u>20,547,287</u> | <u>12,728,209</u> | <u>37,283</u> | <u>33,238,213</u> |
| Governmental activities capital assets, net | <u>\$ 42,882,979</u> | <u>\$ 16,391,466</u> | <u>\$ 11,468,081</u> | <u>\$ 47,806,364</u> |

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

| | |
|--|---------------------|
| Governmental activities: | |
| General government | \$ 302,644 |
| Public works and sanitation | 522,987 |
| Public safety | 60,397 |
| Culture and recreation | 374,177 |
| Welfare and community development | 220,051 |
| Health | 64,293 |
| Education | 3,323 |
| Total depreciation expense, governmental activities | <u>\$ 1,547,872</u> |

NOTE G- LONG-TERM DEBT

1. Summary of long-term debt activity

The following summarizes activity in long-term debt for the fiscal year ended June 30, 2013:

| | Balance at July 1, 2012, as restated | Increases | Decreases | Balance at June 30, 2013 | Due within one year |
|---|--|-------------------|---------------------|-----------------------------|------------------------|
| General, Special Obligations Bonds and Notes | \$ 19,085,000 | \$ - | \$ 1,265,000 | \$ 17,820,000 | \$ 982,000 |
| Note payable to CRIM- Law No. 42 | 489,536 | - | 12,365 | 477,171 | 13,142 |
| Note payable to CRIM- financing of delinquent accounts (Law No. 146) | 183,046 | - | 9,154 | 173,892 | 9,154 |
| Compensated absences | 1,071,444 | 301,995 | 123,047 | 1,250,392 | 136,254 |
| Christmas Bonus | 122,555 | 120,153 | 122,555 | 120,153 | 120,153 |
| Payable to CRIM- property tax advances | 38,902 | - | 38,902 | - | - |
| Payable to PREPA | 429,261 | 439,680 | 404,229 | 464,712 | 318,151 |
| | <u>\$ 21,419,744</u> | <u>\$ 861,828</u> | <u>\$ 1,975,252</u> | <u>\$ 20,306,320</u> | <u>\$ 1,578,854</u> |

2. General and special obligation bonds and notes

The Municipality's outstanding general and special obligation bonds and notes at June 30, 2013 amount to \$17,820,000. All these bonds are serviced by the Governmental Development Bank of Puerto Rico (GDB) maturing at various dates. As required by law, the Commonwealth Government is obligated to collect property taxes for payment of principal and interest on bonds and notes. In addition, .2% of the .5% municipal sales and use tax collected by the P.R. Department of Treasury is deposited in a "Municipal Redemption Fund" to finance loans to Municipalities subject to restrictions imposed by law. Debt service funds has been established for the bonds and notes at GDB with the proceeds of those property and sales and use taxes, whereby sufficient funds must be set aside in order to cover the projected debt service requirement, before any new bonds are issued.

Principal and interest payments on long term debt are made through CAE sinking fund except general and special obligation bonds and note \$3,165,000, \$395,000, \$245,000, \$890,000, \$770,000 and \$2,785,000 which are made through the "Municipal Redemption Fund (IVU)". A detail of the general and special obligation bonds and notes as of June 30, 2013 follows:

| | <u>Outstanding Amount</u> |
|--|-------------------------------|
| 2000 general obligation bonds of \$460,000 due in annual installments of \$25,000 to \$75,000 through January 1, 2014; bearing interest at rates ranging from 2.70% to 7.81% (4.50% at June 30, 2013) | \$ 95,000 |
| 2003 general obligation bonds of \$4,430,000 due in annual installments of \$75,000 to \$345,000 through January 1, 2027; bearing interest at rates ranging from 4.17% to 5.31% (4.36% at June 30, 2013) | 3,415,000 |
| 2007 general obligation notes of \$1,125,000 due in annual installments of \$200,000 through July 1, 2014; bearing interest at rates ranging from 6.48% to 7.50% (7.50% at June 30, 2013) | 200,000 |

NOTE G- LONG-TERM DEBT- Continued

| | <u>Outstanding Amount</u> |
|--|-------------------------------|
| 2008 general obligation bonds of \$2,645,000 due in annual installments of \$55,000 to \$220,000 through January 1, 2038; bearing interest at rates ranging from 1.53% to 7.50% (1.53% at June 30, 2013) | 2,425,000 |
| 2010 general obligation notes of \$50,000 due in annual installments of \$7,000 to \$8,000 through January 1, 2017; bearing an interest at rate of 4.13%. | 30,000 |
| 2011 general obligation notes of \$1,210,000 due in annual installments of \$160,000 to \$215,000 through July 1, 2017; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 930,000 |
| 2011 general obligation bonds of \$1,195,000 due in annual installments of \$55,000 to \$130,000 through July 1, 2025; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 1,100,000 |
| 2012 general obligation notes of \$305,000 due in annual installments of \$35,000 to \$55,000 through July 1, 2018; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 270,000 |
| 2012 general obligation bonds of \$1,510,000 due in annual installments of \$60,000 to \$160,000 through July 1, 2026; bearing interest at rates ranging from 6.0% to 7.50% (6.00% at June 30, 2013) | 1,455,000 |
| 2008 special obligation note of \$3,165,000 due in annual installments of \$60,000 to \$270,000 through July 1, 2032; bearing interest at rates ranging from 1.53 to 7.50% (1.53% at June 30, 2013) | 2,965,000 |
| 2012 special obligation note of \$395,000 due in annual installments of \$50,000 to \$70,000 through July 1, 2018; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 350,000 |
| 2012 special obligation bonds of \$245,000 due in annual installments of \$20,000 to \$35,000 through July 1, 2021; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 230,000 |
| 2012 special obligation bonds of \$890,000 due in annual installments of \$20,000 to \$85,000 through July 1, 2031; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 870,000 |
| 2013 special obligation bonds of \$770,000 due in annual installments of \$30,000 to \$85,000 through July 1, 2026; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 740,000 |
| 2012 special obligation bonds of \$2,785,000 due in annual installments of \$45,000 to \$230,000 through July 2, 2036; bearing interest at rates ranging from 6.00% to 7.50% (6.00% at June 30, 2013) | 2,745,000 |
| | <u>\$ 17,820,000</u> |

NOTE G- LONG-TERM DEBT- Continued

The annual requirement to amortize general and special obligation bonds and notes as of June 30, 2013 follows:

| <u>June 30,</u> | <u>Principal</u> | <u>Interest</u> |
|-----------------|----------------------|----------------------|
| 2014 | \$ 982,000 | \$ 779,718 |
| 2015 | 837,000 | 986,694 |
| 2016 | 858,000 | 1,112,152 |
| 2017 | 928,000 | 1,052,053 |
| 2018 | 995,000 | 987,415 |
| 2019-2023 | 4,190,000 | 4,022,372 |
| 2024-2028 | 5,020,000 | 2,430,237 |
| 2029-2033 | 3,180,000 | 1,049,625 |
| 2034-2038 | 830,000 | 161,250 |
| Totals | <u>\$ 17,820,000</u> | <u>\$ 12,581,516</u> |

3. Other long-term liabilities

Outstanding
Amount

Note payable to CRIM (Law No. 42) – Law No. 42 of January 26, 2000 (as amended by Law No. 146 of October 11, 2001 and Law No. 172 of August 11, 2002) was enacted to authorize the CRIM to obtain a special loan in the form of a line of credit from the Governmental Development Bank of Puerto Rico (GDB) to finance a debt the municipalities of Puerto Rico owe to CRIM for excess property tax advances as of June 30, 2000. Principal and interest payments are financed through .48% of the net increase of subsidy provided by the Commonwealth of Puerto Rico’s general fund. Amounts are retained from advances of property tax and amounts of municipal equalization fund sent to the Municipality by the CRIM. Law No.42 was amended by Law no. 146 to extend from 10 to 30 years the financing period and by Law No. 172 to extend the debt period to June 30, 2001. On July 1, 2002 the Municipality entered into the financing agreement with the CRIM for a total amount of \$576,023, bearing interest at 6.18% and due on July 1, 2032. Debt service requirements in future years are as follows:

\$ 477,171

| <u>June 30,</u> | <u>Principal</u> | <u>Interest</u> |
|-----------------|-------------------|-------------------|
| 2014 | \$ 13,142 | \$ 29,325 |
| 2015 | 13,967 | 28,499 |
| 2016 | 14,845 | 27,622 |
| 2017 | 15,778 | 26,689 |
| 2018 | 16,769 | 25,697 |
| 2019-2023 | 101,038 | 111,294 |
| 2024-2028 | 137,028 | 75,304 |
| 2029-2032 | 164,604 | 26,495 |
| Totals | <u>\$ 477,171</u> | <u>\$ 350,925</u> |

NOTE G- LONG-TERM DEBT- Continued

**Outstanding
Amount**

Note payable to CRIM (Financing of delinquent accounts)– On March 27, 2002 the Municipality entered into a financing agreement with CRIM to finance delinquent property tax accounts sold to private investors, under the provision of Law No. 146 of October 11, 2001. The agreement is in the form of a non-revolving line of credit bearing interest of 6.5% for the first five years and variable for the next twenty-five years at 125 points over London Interbank Offered Rate (LIBOR) and is due on December 1, 2032. As described in Law No. 146, interest payments for the first five years were financed through .48% of the net increase of subsidy provided by the Commonwealth of Puerto Rico’s general fund. Also, during the first five years any collection from those delinquent accounts was credited to the loan principal. After the five year period the loan outstanding balance of \$228,834 was restructured for a twenty-five-year period. Debt service requirements in future years are as follows:

173,892

| June 30, | Principal | Interest |
|-----------|------------|-----------|
| 2014 | \$ 9,152 | \$ 4,354 |
| 2015 | 9,152 | 4,125 |
| 2016 | 9,152 | 3,896 |
| 2017 | 9,152 | 3,667 |
| 2018 | 9,152 | 3,438 |
| 2019-2023 | 45,762 | 13,750 |
| 2024-2028 | 45,762 | 8,021 |
| 2029-2032 | 36,608 | 2,292 |
| Totals | \$ 173,892 | \$ 43,543 |

NOTE G- LONG-TERM DEBT – Continued

| | <u>Outstanding Amount</u> |
|--|-------------------------------|
| Compensated absences – includes accrued vacations, sick leave benefits and other benefits with similar characteristics such as compensatory time; represents the Municipality’s commitment to fund such costs from future operations. The amount is paid with unrestricted funds | 1,250,392 |
| Christmas Bonus – represents the accrued portion corresponding to fiscal year 2013 of the Christmas bonus to be paid in December 2013. | 120,153 |
| Payable to PREPA – As required by Act No. 83 of May 2, 1941 the Puerto Rico Electric Power Authority (“PREPA”) should annually pay to the Municipalities of Puerto Rico a contribution in lieu of tax (“CELI”) based on certain requirements as specified by the mentioned Act. The amount of CELI obligation is used by the Municipalities to finance the annual electric utility expense payment to PREPA. For fiscal year 2011-2012 the Municipality’s annual energy charges amounts to \$1,135,234 but the CELI obligation amounted to \$695,554. The excess amount of \$439,680 was recorded as a payable and a receivable for the same amount and will be amortized over a three-year period. As of June 30, 2013 the outstanding amount of \$464,712 includes the unamortized balances of \$293,121 and \$171,591 from fiscal years 2012 and 2011 respectively and is recognized by the Municipality as a receivable and a liability to PREPA. Debt service requirements in future years are as follows: | 464,712 |

| <u>June 30</u> | <u>Principal</u> |
|----------------|-------------------|
| 2014 | \$ 318,151 |
| 2015 | 146,561 |
| Totals | <u>\$ 464,712</u> |

NOTE H- DEFERRED INFLOWS OF RESOURCES – GOVERNMENTAL FUNDS

As required by current standards, revenues and other governmental fund financial resources should be recognized in the accounting period in which they become both measurable and available. When an asset is recorded in governmental fund’s financial statements but the revenue is not available, the Municipality should report a deferred inflow of resources until such time as the revenue becomes available. A detail of these balances follows:

NOTE H- DEFERRED INFLOWS OF RESOURCES – GOVERNMENTAL FUNDS - Continued

| | <u>Commonwealth Government Funds</u> | <u>Federal Grants</u> |
|---|--|---------------------------|
| <u>Major fund – General fund:</u> | | |
| P.R. Electric Power Authority (PREPA) | \$ 464,712 | \$ - |
| Municipal Revenue Collection Center (CRIM)- property taxes and intergovernmental subsidy(general fund) | 316,610 | - |
| P.R. Department of Treasury – Christmas bonus reimbursement | 60,077 | - |
| <u>Major fund – Debt service fund:</u> | | |
| Municipal Revenue Collection Center (CRIM) – property taxes | 283,823 | - |
| <u>Major fund – Special Revenue State & Local:</u> | | |
| P.R. Department of Labor- Law No. 52 | 326,918 | - |
| <u>Major fund- Capital Project State & Local:</u> | | |
| P.R. Department of Transportation & Public Works (Law 212) | 338,319 | - |
| <u>Major fund- Special Revenue Other Federal:</u> | | |
| Office of Commissioner of Municipal Affairs-CDBG | - | 431,746 |
| P.R. Office of Ombudsman Administration- NSIP | - | 10,162 |
| P.R. Traffic Safety Commission - State & Community Highway Safety Program | - | 11,401 |
| P.R. Department of Justice- Edward Byrne Memorial Assistance Grant Program (JAG-CMEI) | - | 23,629 |
| P.R. Governor’s Office (GAR)- Disasters Grants- Public Assistance (Irene Storm) | - | 224,244 |
| P.R. Governor’s Office (GAR)- Disasters Grants- Public Assistance (Jeanne Storm) | - | 21,616 |
| Other | - | 16,750 |
| | <u>\$ 1,790,459</u> | <u>\$ 739,548</u> |

NOTE I – PROPERTY TAXES

The Municipal Revenue Collection Center (CRIM) of the Commonwealth of Puerto Rico is responsible for the assessment, collection and distribution of real and personal property taxes. The tax on personal property is self-assessed by the taxpayer. The assessment is made on a return, which must be filed with the CRIM by May 15 of each year and is based on the current value at the date of the assessment. Real property is assessed by the CRIM. The tax is general assessed on January 1 on all taxable property located within the Municipality and is based on the current value existing in the year 1957. For personal property the tax is due with the return filed on or before May 15. Taxes on real property may be paid on two equal installments, July 1st and January 1st. Total tax rates in force as of June 30, 2013 are 7.03% for personal property and 9.03% for real property. The distribution of these rates follows:

| <u>Description</u> | <u>Personal Property</u> | <u>Real Property</u> |
|--|------------------------------|--------------------------|
| Basic property tax rate, which is appropriated for general purposes and accounted in the Municipality’s general fund: | 4.00% | 6.00% |
| Percent that belongs to the Commonwealth’s debt service fund: | 1.03% | 1.03% |
| Percent that belongs to the Municipality’s debt service fund: | 2.00% | 2.00% |
| Total tax rate: | 7.03% | 9.03% |
| Discount granted by law to the taxpayers but reimbursed to the Municipality by the P.R. Treasury Department: | (.20%) | (.20%) |
| Total percent to be paid by taxpayers: | <u>6.83%</u> | <u>8.83%</u> |

NOTE I – PROPERTY TAXES - Continued

Residential real property occupied by its owner is exempt by law from property taxes on the first \$15,000 of the assessed value. For such exempted amounts, the Puerto Rico Department of Treasury assumes payment of the basic tax to the Municipality, except for residential units assessed at less than \$3,500 on which a complete exemption is granted. Revenue related to exempt property is recorded in the General Fund. The Municipality grants a complete exemption from personal property taxes up to an assessment value of \$50,000 to retailers with annual net sales of less than \$150,000.

The CRIM advances funds to the Municipality based on an estimate of special governmental subsidies and the property taxes to be levied and which are collected in subsequent periods. This distribution includes advances of property tax and amounts of municipal equalization fund from the Commonwealth government. The CRIM is required by law to prepare a settlement statement on a fiscal year basis, whereby a comparison is made between the amounts advanced to the Municipality and amounts actually collected from taxpayers. The CRIM prepares a preliminary settlement not later than three months after fiscal year-end and a final settlement not later than six months after fiscal year-end. If actual collections exceed the advances a receivable from CRIM is recorded. However, if advances exceed actual collections, a payable to CRIM is recorded. A receivable of \$316,610 from the final settlement of fiscal 2012-2013 was recorded as deferred inflows of resources since is not available are required by current standards.

NOTE J – MUNICIPAL LICENSE TAXES

Municipal License taxes are assessed annually by the Municipality to all organizations or entities subject to the tax doing business in the Municipality's location except for entities totally or partially exempt pursuant to certain Commonwealth's statutes. This tax is based generally on volume of business or gross sales as shown in a tax return that should be submitted on or before April 15.

During the fiscal year ended June 30, 2013, the tax rates were as follows:

- Financial business – 1.50% of gross revenues
- Other organizations - .50% of gross revenues

The tax is due in two equal installments on July 1 and January 1 of each fiscal year. Tax revenue is recognized at that moment by the Municipality. A discount of 5% is allowed when full payment is made on or before April 15. Municipal license taxes collected prior to June 30 but pertaining to the next fiscal year in the amount of \$597,862 is recorded as unearned revenues.

NOTE K – SALES AND USE TAXES

On July 4, 2006, the Commonwealth Legislature approved Act No. 117 ("Act 117") which amends the Puerto Rico Internal Revenue Code of 1994 to provide, among other things, for a sale and use tax of 5.5% to be imposed by the Commonwealth Government. Act 117 also authorizes each municipal government to impose a municipal sale and use tax of 1.5%. This municipal sales and use tax has in general the same tax base and limitations (except for unprocessed foods) as those provided by the Commonwealth's sales and use tax. The Municipal Legislature approved the imposition of the municipal sales and use tax, effective on November 15, 2006.

On July 29, 2007, the Commonwealth Legislature approved Act No. 80 ("Act 80") which amends Act No. 117 of July 4, 2006 to impose to all the Municipalities of Puerto Rico a uniform municipal sales and use tax of 1.5%. Effective August 1, 2007 1% of the 1.5% is collected by the Municipalities and the remaining .5% of the 1.5% is collected by the Puerto Rico Department of Treasury (PRDT).

NOTE K – SALES AND USE TAXES - Continued

The amount collected by the PRDT, (.5% of the 1.5%) is deposited in accounts or special funds in the Governmental Development Bank of Puerto Rico (“GDB”), subject to restrictions imposed and distributed as follows:

- a. .2% of the .5% will be deposited in a Municipal Development Fund to be distributed among all the municipalities in accordance with a formula created by the Act,
- b. .2% of the .5% will be deposited in a Municipal Redemption Fund to finance loans to Municipalities and,
- c. .1% of the .5% will be deposited in a Municipal Improvement Fund to finance capital improvement projects; these funds will be distributed based on legislation from the Commonwealth’s Legislature

The Municipal Legislature approved a municipal ordinance to conform to dispositions of Act 80. Effective January 1, 2011 the Commonwealth of Puerto Rico adopted a new Internal Revenue Code (“2011 PR Code”). Subtitle D (Sections 4010 to 4070) of the 2011 PR Code incorporates the dispositions applicable to the sales and use tax. As stated by Section 4050 the Municipalities may use the sales and use tax proceeds to finance solid waste, recycling, capital projects, health and public safety programs as well as any other activity that promotes sound public administration.

Individuals, organizations and entities subject to collect the municipal sales and use tax must file a tax return to the PRDT. The tax is due the 10th day of each month based on tax collected in the preceding month. The Municipality recorded as revenue \$617,049 in the general fund and \$1,061,769 in the debt service fund corresponding to the Municipal Redemption Fund.

A total \$54,411 sales and use tax receivable from PRDT represents the tax collected on June by individuals, organizations and entities but reported and paid to the Municipality by the PRDT on or before July 10, net of uncollectible accounts; \$85,907 represents the amount of “Municipal Redemption Fund” collected on June by individuals, organizations and entities but paid by the PRDT subsequent to June 30.

On June 30, 2013, the Commonwealth approved Act No. 40 which among other things, reduces the municipal sales and use tax from 1.5% to 1% and increasing the Commonwealth sales and use tax from 5.5% to 6% effective December 1, 2013. This Act was subsequently amended to change this effective date from December 1, 2013 to February 1, 2014. In addition, subsequent to June 30, 2013 the Commonwealth approved Act No. 18 and 19 of January 24, 2014 for the restructuring and creation of financing structures from sales and use tax sources to guarantee and pay municipal long term debt issuances.

NOTE L – INTERGOVERNMENTAL REVENUES AND FEES, FINES AND CHARGES FOR SERVICES - GENERAL FUND

- I. Intergovernmental revenues in the General Fund are comprised of the following:

| | <u>Amount</u> |
|---|---------------------|
| Amount of municipal subsidies and equalization fund sent by CRIM | \$ 3,890,156 |
| Reimbursement from Commonwealth Government of Christmas Bonus expenditure | 105,047 |
| | <u>\$ 3,995,203</u> |

NOTE L – INTERGOVERNMENTAL REVENUES AND FEES, FINES AND CHARGES FOR SERVICES - GENERAL FUND - Continued

2. Fees, fines and charges for services revenues reported in the general fund are comprised of the following:

| | <u>Amount</u> |
|---|---------------------|
| Compensation in lieu of tax from the Puerto Rico Electric Power Authority (PREPA) | \$ 1,409,566 |
| Construction excise tax | 282,263 |
| Rental income | 61,085 |
| Licenses and permits | 20,914 |
| Fines | 7,005 |
| Other | 21,619 |
| | <u>\$ 1,802,452</u> |

NOTE M – RETIREMENT PLAN

1. Plan description

As of June 30, 2013 regular employees of the Municipality contribute to a cost-sharing multiple employer defined benefit retirement plan administered by the Employee's Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS). ERS covers all regular full-time public employees working for the central government, the municipalities of Puerto Rico and certain public corporations not having their own retirement systems. The system provides retirement pensions, death, and disability benefits. Retirement benefits depend upon age at retirement and number of years of credited service. Disability retirement benefits are available to members of occupational and non-occupational disabilities. Benefits vest after ten years of plan participation.

The system operate under *Act 447, approved on May 15, 1951* effective on January 1, 1952 and *Act 1 of February 16, 1990* for employees that entered as participants of the Plan starting April 1, 1990 and ending December 31, 1999. Retirement benefits are determined by the application of stipulated benefit ratios to the member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by ERS. The annuity, for which a plan member is eligible, is limited to a minimum of \$200 per month and a maximum of 75% of the average compensation. ERS issues a publicly financial report that includes financial statements and required supplementary information of the Plan, which may be obtained from the ERS. *Act No. 305 of September 24, 1999* amended *Act No. 447 of 1951* and *Act 1 of February 16, 1990* to establish a new pension program (System 2000). The new pension program became effective on January 1, 2000. Employees participating in the current system as of December 31, 1999 may elect either to stay in the defined benefit plan or transfer to the new program. Persons joining the government on or after January 1, 2000 will only be allowed to become members of the new program.

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. There will be a pool of pension assets, which will be invested by the System, together with those of the current defined benefit plan. Benefits at retirement age will not be guaranteed by the State government and will be subjected to the total accumulated balance of the savings account. The annuity will be based on a formula, which assumes that each year the employee's contribution (with a minimum of 8.275% of the employee's salary up to a maximum of 10%) will be invested in an account which will either: (1) earn a fixed rate based on the two-year Constant Maturity Treasury Note or, (2) earn a rate equal to 75% of the return of the System's investment portfolio (net of management fees), or (3) earn a combination of both alternatives. If the savings accounts balance is \$10,000 or less at time of retirement, the balance will be distributed by the System to the participant as a lump sum.

NOTE M – RETIREMENT PLAN - Continued

Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability pensions have not been granted under the new program. The employer contributions (11.275% of the employee's salary) will be used to fund the current plan. Under System 2000 the retirement age is reduced from 65 years to 60 for those employees who joined the current plan on or after April 1, 1990.

2. Funding policy

The Act 447, as amended, is the authority under which obligations to contribute to the Plan by the Plan members, employers and other contributing entities are established or may be amended. Plan members are required to contribute 5.775% of gross salary up to \$6,600 plus 8.275% of gross salary in excess of \$6,600 except for the Mayor or employee under a supplementation plan, which contributes 8.275% of gross salary. As of June 30, 2012, the ERS has an unfunded actuarial accrued liability of approximately \$26.4 billion. In the opinion of management if measures are not implemented to deal with this situation, the ERS's net assets will be exhausted by the fiscal year 2015. In order to address this issue, among other measures, on July 6, 2011 (effective July 1, 2011) the Commonwealth Legislature approved Act No. 116 increasing the employers' contributions rate from 9.275% to 10.275% of employee compensation for fiscal year 2012, an additional 1% annually for each of the next four years, and 1.25% annually for each of the five years thereafter, reaching an aggregate contribution rate of 20.525% effective July 1, 2020. The purpose of this Act is to provide cash flow and strength the System to adequately cover administrative expenses and payment of benefits.

The Municipality is required to contribute 11.275% of gross salary for fiscal year 2013. As stated in the Act, percent increases applicable to municipalities for fiscal years 2011-2012, 2012-2013 y 2013-2014 would be financed through the Commonwealth's budget approved by the Commonwealth's Legislature. The Municipality's actual contribution for the current and the previous two fiscal years, which is equal to the required contribution, follows:

| <u>Fiscal year ended:</u> | <u>Law No. 447</u> | <u>System 2000</u> |
|---------------------------|--------------------|--------------------|
| 2013 | <u>\$ 123,559</u> | <u>\$ 98,249</u> |
| 2012 | <u>\$ 132,535</u> | <u>\$ 88,304</u> |
| 2011 | <u>\$ 154,844</u> | <u>\$ 89,577</u> |

In order to address its unfunded liability and rescue the System from insolvency, on April 4, 2013 the Commonwealth of Puerto Rico enacted Act No. 3 of 2013, representing a comprehensive reform of the ERS.

NOTE N – POSTEMPLOYMENT BENEFITS

In addition to the pension benefits described in Note M, as of June 30, 2013 the Municipality is required to cover annually the 3% increase in the retirement plan of its retired employees, as required by Commonwealth's laws. Also, the Municipality is required to finance costs related to the application of certain "Special Laws" issued by the Commonwealth Government. Those Special Laws granted increases in pensions and other benefits to retired employees of the Municipality such as medicines bonus, Christmas bonus and death benefits. For the fiscal year 2013, costs related to these postemployment benefits amounted to \$84,630. These benefits are recorded as expenditures in the general fund.

NOTE O – COMMITMENTS

1. Construction

As of June 30, 2013, the Municipality has commitments of \$1,047,079 for design, construction, improvements or renovation of certain municipal facilities.

2. Encumbrances

The Municipality has encumbrances outstanding which represent the estimated amount of expenditures required to complete contracts, purchase orders and other commitments in process of completion at fiscal year-end. Outstanding encumbrances as of June 30, 2013 in the general fund represent unassigned amounts that are encumbered and are classified by management as assigned fund balance. Purpose classification follows:

| <u>Purpose</u> | <u>General Fund- assigned fund balance</u> |
|-----------------------------------|--|
| General government | \$ 135,972 |
| Public works and sanitation | 34,606 |
| Public Safety | 1,459 |
| Sports, culture and recreation | 3,957 |
| Welfare and community development | 13,527 |
| | <u>\$ 189,521</u> |

Fund balance of major and other governmental funds (special revenue, capital project and debt service funds) is classified as restricted, some or all of which may be encumbered. Encumbrances of restricted fund balance are not reported separately from this classification because the encumbrance does not further restrict the purpose for which the resources may be used.

NOTE P – CONTINGENCIES

1. Federal and Commonwealth Grants

Projects financed by the Federal and Commonwealth Grants are subject to audits by grantors and other governmental agencies in order to determine that the expenditures comply with the conditions of such grants. It is the Municipality's opinion that no additional material unrecorded liabilities will arise from audits previously performed or to perform.

2. Litigations

The Municipality is, at present, a defendant in a number of legal matters that arise in the ordinary course of the Municipality's activities. There are cases whereby the Municipality is a defendant or codefendant that will be covered by insurance, certain cases whereby the legal counsel has not determined an outcome and other cases that would not be covered by insurance. However, it is the opinion of the Municipality and the legal counsel that based on their experience, such actions and the potential liabilities will not impair the Municipality's financial position.

NOTE Q – RESTATEMENT OF FUND BALANCE AND NET POSITION

The following table disclosed the net change in fund balances and net position at beginning of year as previously reported in the financial statements. The beginning balances have been restated as follows:

| Description | Fund Balance | | | | | | Net Position | |
|--|--------------|-----------------------------------|--|-----------------------------------|--------------|--------------------------|----------------------------|--|
| | General | Special Revenue - State and Local | Special Revenue - Other Federal Grants | Capital Project - State and Local | Debt Service | Other Governmental Funds | Government Wide Statements | |
| Fund balance / net position, at beginning of year, as previously reported | \$ 1,646,739 | \$ (497,452) | \$ - | \$ 8,837,350 | \$ 4,267,775 | \$ 120,965 | \$ 34,472,960 | |
| Correction of errors: | - | - | - | - | (1,332,189) | - | - | |
| Understatement of matured bonds and interest payable | - | - | - | - | - | - | - | |
| Net understatement of cash – bonds and notes | - | - | - | 60,294 | - | - | 60,294 | |
| Understatement of due from general fund | 428,364 | - | (170,828) | (257,536) | - | - | - | |
| Understatement of accounts payable – CDBG | - | - | (52,778) | - | - | - | - | |
| Unsupported cash balance | - | - | - | (150,000) | - | - | (150,000) | |
| Understatement of receivable, Federal Government | - | - | 91,007 | - | - | - | 91,007 | |
| Overstatement of due to general fund | (108,351) | - | 97,652 | - | - | 10,700 | - | |
| Understatement of receivable, Federal Government | - | - | (70,923) | - | - | - | (70,923) | |
| Understatement of cash in general fund, overstatement in Legislative Resolutions | 324,153 | - | - | (324,153) | - | - | - | |
| Overstatement of advances from other funds in general fund | (1,402,441) | 802,244 | - | 600,198 | - | (3,656) | (3,656) | |
| Understatement of accounts payable – Section 8 | - | - | - | - | - | - | 155,860 | |
| Overstatement of revenues, Law No. 52 | - | - | - | - | - | - | 508,944 | |
| Overstatement of long-term debts to “CRIM” | - | - | - | - | - | - | (122,555) | |
| Understatement of long-term debts – Christmas Bonus | - | - | - | - | - | - | 61,278 | |
| Understatement of revenues – Christmas Bonus | - | - | - | - | - | - | 880,247 | |
| Overstatement of accounts payable | - | - | - | - | - | - | 274,357 | |
| Net understatement in capital assets | - | - | - | - | - | - | 317,075 | |
| Others | - | - | - | - | - | - | - | |
| Fund balance / net position, at end of year, as restated | \$ 888,464 | \$ 304,792 | \$ (105,870) | \$ 8,766,153 | \$ 2,935,586 | \$ 128,009 | \$ 36,474,888 | |

NOTE R- SUBSEQUENT EVENTS

The Commonwealth of Puerto Rico is facing a financial crisis due to limited liquidity, general fund deficit, a sizeable amount of debt, an underfunded government pension system and an economy recession since 2006. As a result of these matters, credit ratings agencies have been consistently downgrading the Commonwealth's and certain public corporation's general obligation bonds ratings. In order to address these matters the Commonwealth began to make legislation to reform its governmental pension system, provide liquidity to the Governmental Development Bank of Puerto Rico ("GDB"), its fiscal agent, and strength sinking funds to assess financial markets. The Commonwealth estimates that these corrective actions, along others to be implemented, will have a positive impact on the Commonwealth itself, GDB, the municipalities and its citizens:

1. Pension System Reform

In order to address its unfunded liability and rescue the System from insolvency, on April 4, 2013 the Commonwealth of Puerto Rico enacted Act No. 3 of 2013, representing a comprehensive reform of the ERS. Act No. 3 became effective on July 1, 2013 and amends the provisions of the different benefits structures under the ERS, including, but not limited to, the following:

- a. Moves all participants (employees) under the defined benefit pension plans (Act 447 and Act 1) and the defined contribution plan (System 2000) to a new hybrid plan ("New Plan").
- b. For active participants of the contributory defined benefit programs under Act No. 447 of 1951 and Act No. 1 of 1990, all retirement benefits accrued through June 30, 2013 will be frozen, and thereafter, all future benefits will accrue under the New Plan. Participants will receive a pension at retirement age equivalent to what they have accrued under Act 447 and Act 1 up to June 30, 2013, and a supplemental annuity corresponding to contributions made after July 1, 2013.
- c. Participants under System 2000 will no longer receive a lump-sum payment upon retirement, but rather a lifetime annuity calculated at retirement based on a factor that will incorporate the individual's life expectancy and a rate of return.
- d. New participants under the New Plan will receive a lifetime annuity based on the accumulated balance of their individual accounts (employees' contributions plus a return on investment)
- e. Eliminates the possibility of accruing a merit pension (payable once the participant has achieved 30 years of creditable service) after June 30, 2013.
- f. Increases employee contributions from 8.275% to a minimum of 10.000%.
- g. After July 1, 2013 all employers must contribute 12.275% of employee contribution with an additional 1% annually up to June 30, 2016; after July 1, 2016 an additional 1.25% annually for each of the five years thereafter, reaching an aggregate contribution rate of 20.525% effective July 1, 2020. These contributions will be used to increase the System's assets, reduce the actuarial deficit and enable the System to comply with future obligations.

NOTE R – SUBSEQUENT EVENTS - Continued

h. Retirement age will be modified as follows:

- 1) Act 447 regular employees: age 58 to 61,
- 2) Act 447 high risk employees (state and municipal police, firefighters and custody officials): from age 50 to 55 years,
- 3) Act 305 (System 2000) regular employees: age 60 to 65; high risk employees remains the same (55 years).

Act 1 employees will remain the same (65 years for regular employees and 55 for high risk employees. For new employees under the New Plan will retire after 67 years (retirement age will be 67 for regular employees and 58 for high risk employees.

i. Modifies Special Law benefits as follows:

- 1) Reduction in Christmas bonus from \$600 to \$200 (current retirees),
- 2) Elimination of summer bonus of \$100 (current retirees),
- 3) No change in medical plan contribution of up to \$1,200 and medicine bonus of \$100 (current retirees)
- 4) Eliminates Special Law benefits to future retirees.

Employers will contribute \$2,000 per retiree and future retiree (originally under Act 447 and Act 1); the System will benefit from the savings generated between this employer contribution and the Special Law benefits paid out to retirees.

- j. Given these changes to Special Laws, the minimum monthly pension for current retirees was increased from \$400 to \$500.
- k. Disability benefits will be eliminated and substituted for a mandatory disability insurance policy.
- l. Survivor benefits will be modified.

In addition to the previously scheduled measures, the ERS reform plan also assumes an estimated \$140 million incremental contribution from the general fund (1.4% of general fund expenses for fiscal year 2014) to be included in the Commonwealth's proposed budget for the fiscal year 2014 and thereafter. The Commonwealth projects that the combined impact of these measures will allow the retirement system to increase the liquidity and solvency and meet the revised future obligations.

NOTE R – SUBSEQUENT EVENTS - Continued

2. Sales and use taxes – Act No. 18 and 19 of 2014

In order to address the fiscal and credit crisis of the Commonwealth of Puerto Rico, the GDB liquidity and the difficult fiscal situation of the municipalities of Puerto Rico, on January 24, 2014 the Commonwealth approved Act No. 18 and 19. Those Act's provides for the restructuring and creation of financing structures from sales and use tax sources to guarantee and pay municipal long term debt issuances. As a result of this legislation the municipalities of Puerto Rico may improve its credit capacity along with maintaining sufficient resources for operations.

a. Act No. 18 of January 24, 2014

The purpose of this Act is to create a special fund called "Municipal Administration Fund" ("FAM") under custody of the Governmental Development Bank of Puerto Rico ("GDB") that permits the Municipalities to guarantee and pay long term debt and provide funds for its general operations. In addition, this Act improves the financing capacity of the Puerto Rico Sales Tax Financing Corporation ("COFINA"), a Commonwealth fund administered by GDB and the P.R. Secretary of Treasury. The Act includes provisions for municipalities that do not want to be covered by the Act. Special rules apply for those municipalities. The Act is effective on February 1, 2014.

The 6% corresponding to the Commonwealth's sales and use tax will be deposited in COFINA. From these funds during a transitory period from February 1, 2014 to June 30, 2014 the Commonwealth will deposit \$43,440,184 in the FAM to be distributed to the Municipalities as follows:

- .2% will be deposited in a Municipal Development Fund to be distributed to the municipalities,
- .2% will be deposited in a Municipal Redemption Fund to guarantee and repay the municipalities long term debt and,
- .1% will be deposited in a Municipal Improvement Fund to finance capital improvement projects; these funds will be distributed based on legislation from the Commonwealth's Legislature.

After July 1, 2014, the 6% corresponding to the Commonwealth's sales and use tax will be deposited in COFINA. From these funds the Commonwealth will deposit .5% in the FAM. Distribution to municipalities will depend on whether the municipalities signed an agreement to be covered or not covered by the Act's provisions. The Municipality of Luquillo signed the agreement to be covered.

For municipalities covered by the agreement the .5% will be distributed as follows:

- .2% will be deposited in the Municipal Development Fund to be distributed to the municipalities,
- .2% will be deposited in a Municipal Redemption Fund to then be deposited in the municipalities general fund (the municipalities has the option to maintain funds in the Municipal Redemption Fund or to transfer funds from the Municipal Development Fund to increase its debt margin and issue loans to be obtained from financial institutions)
- .1% will be deposited in a Municipal Improvement Fund to finance capital improvement projects; these funds will be distributed based on legislation from the Commonwealth's Legislature.

NOTE R – SUBSEQUENT EVENTS - Continued

For municipalities not covered by the agreement the .5% will be distributed as follows:

- .2% will be deposited in the “Municipal Development Fund”. Section 4 of the Act requires amounts deposited in the Municipal Development Fund of municipalities not covered by the Act to be redistributed to the municipalities covered by the Act,
- .2% will be deposited in a “Municipal Redemption Fund” to guarantee and repay long term debt through any financial institution (each semester the municipalities may transfer to their general fund the funds in excess of debt service requirements),
- .1% will be deposited in a “Municipal Improvement Fund” to finance capital improvement projects; these funds will be distributed based on legislation from the Commonwealth’s Legislature.

b. Act No. 19 of January 24, 2014

The purpose of this Act is to create the “Municipal Finance Corporation” (“COFIN”) a public corporation and a component unit of the Governmental Development Bank of Puerto Rico (“GDB”) which may issue, pay or refinance long-term debt of municipalities. Principal and interest of these bonds and loans will be guaranteed with the municipal sales and use tax (1%). The Act includes provisions for municipalities that do not want to be covered by the Act. Special rules apply for those municipalities. The Act is effective on February 1, 2014.

After July 1, 2014 the 1% corresponding to the municipalities’ sales and use tax will be deposited in COFIN. From these funds COFIN will deposit to the COFIN’s sinking fund the greater of: .3% of the 1% municipal sales and use tax or an Annual Rental Fee (“RFA”). The RFA for fiscal year 2014-2015 will be \$65,541,281 and thereafter will be 1.5% of the RFA of the preceding fiscal period. The excess of the required deposit to the COFIN’s sinking fund (.7% of the 1% of the municipal sales and use tax) will be transferred to the general fund of municipalities covered by the agreement or to the Municipal Redemption Fund as decided by the municipality. Before the transfer of the .7% to the municipalities covered by the Act, COFIN will transfer the 1% municipal sales and use tax to the municipalities not covered by the Act. These municipalities cannot obtain loans guaranteed by COFIN’s sinking fund.

If at any moment the required deposits to the COFIN’s sinking fund were not sufficient to pay the principal and interest of any outstanding obligation, the deficiency will be covered by appropriations of the Commonwealth’s general fund budget.

As stated above the purpose of Act 18 and 19 of 2014 is to provide a financial structure to guarantee and pay long term debt to the municipalities while maintaining adequate cash flows for its operations, as well as provide liquidity to the GDB.

NOTE R – SUBSEQUENT EVENTS - Continued

Notwithstanding the above corrective actions, on February 4, 2014 Standard & Poor's Ratings Services ("S&P") lowered its rating on the Commonwealth of Puerto Rico's general obligation (GO) debt to 'BB+' from 'BBB-' and the Commonwealth's appropriation secured debt and Employee Retirement System (ERS) debt to 'BB'. In addition, S&P downgraded the GDB to 'BB', and the rating remains on CreditWatch with negative implications. S&P have not taken a rating action on sales tax-secured debt of COFINA, but have retained their negative outlook on their COFINA ratings reflecting S&P's view of the economic outlook and that COFINA sales tax is not subject to the prior diversion of revenue for general obligation debt service payments. The downgrades follow S&P's evaluation of liquidity for the Commonwealth, including what they believe is a reduced capacity to access liquidity from GDB. S&P also believe that the Commonwealth's access to liquidity and to the market either through GDB or other means will remain constrained in the medium term. As S&P, the rating is not lower due to the progress the current administration has made in reducing operating deficits and recent success with reform of the public employee and teacher pension systems. They view those reforms as significant which could contribute to a sustainable path to fiscal stability.

In addition, on February 7, 2014 Moody's Investors Service ("Moody's") has downgraded the general obligation (GO) rating of the Commonwealth of Puerto Rico, the Pension funding bonds and GDB senior notes to Ba2 from Baa3. Other ratings that are capped by or linked to the Commonwealth's GO rating were also downgraded two notches, with the exception of the Puerto Rico Aqueduct and Sewer Authority (PRASA) Revenue Bonds, which were downgraded to Ba2 from Ba1. At the same time, Moody's downgraded the Puerto Rico Sales Tax Financing Corporation's (COFINA's) senior-lien bonds to Baa1 from A2 and its junior-lien bonds to Baa2 from A3. The outlooks for ratings on the GO and the related bonds, as well as the COFINA bonds, are negative. Downgrade is based among other Commonwealth's problems in years of deficit financing, pension underfunding, budgetary imbalance and seven years of economic recession. As a result, Commonwealth's debt load and fixed costs are high, its liquidity is narrow, and its market access has become constrained. Moody's recognizes major actions taken to stabilize Commonwealth finances, including significant reform to main pension system, and tax increases to reduce budget deficit.

Furthermore, on February 11, 2014 Fitch Ratings Fitch Ratings has downgraded the ratings, among other instrumentalities, for the Commonwealth general obligation (GO) bonds and ERS pension funding bonds from BB from BBB-. The current action does not affect the ratings that Fitch assigns to bonds issued by COFINA, since those bonds are secured by the Commonwealth's sales and use tax and insulated from the Commonwealth's general credit strain. Fitch reported that recent downgrades have triggered new liquidity requirements and lowered expectations for the market available for the Commonwealth's debt going forward, though there have been no significant negative developments regarding the Commonwealth's finances or economy since November 2013. In addition, the report recognizes that the Commonwealth's management has responded quickly and decisively to challenges that have arisen in recent years and the current administration has made significant progress in addressing longstanding credit issues.

These downgrades may have a significant impact in the economic environment of Puerto Rico and the Commonwealth Government, its instrumentalities and the municipalities in critical areas such as access to markets and liquidity for the current fiscal year and thereafter. It is the opinion of the Commonwealth's and Municipality of Luquillo's management that the corrective actions taken and to be taken in current and fiscal periods thereafter will lower the impact of this decision and cause a positive turnaround on the Commonwealth's and the Municipality's finances.

REQUIRED SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
BUDGETARY COMPARISON SCHEDULE - GENERAL FUND
FISCAL YEAR ENDED JUNE 30, 2013

| | Budgeted Amounts | | Actual Amounts (Budgetary Basis) | Variance with Final Budget Positive (Negative) |
|---|------------------|------------------|-------------------------------------|--|
| | Original | Final | | |
| REVENUES: | | | | |
| Taxes: | | | | |
| Property taxes | \$ 3,188,353 | \$ 3,188,353 | \$ 3,442,370 | \$ 254,017 |
| Municipal license taxes | 741,916 | 931,340 | 969,346 | 38,006 |
| Sales and use taxes | 425,000 | 447,000 | 629,016 | 182,016 |
| Intergovernmental | 2,816,854 | 2,816,854 | 2,801,401 | (15,453) |
| Fees, fines and charges for services | 1,447,991 | 1,459,991 | 1,431,924 | (28,067) |
| Interest | 103,991 | 241,683 | 311,464 | 69,781 |
| Other | 95,000 | 518,700 | 226,591 | (292,109) |
| Total revenues | 8,819,105 | 9,603,921 | 9,812,112 | 208,191 |
| EXPENDITURES: | | | | |
| Current: | | | | |
| General government | 5,433,363 | 5,799,052 | 5,712,612 | 86,440 |
| Public works and sanitation | 1,742,331 | 2,191,349 | 2,128,869 | 62,480 |
| Public safety | 154,058 | 167,876 | 163,773 | 4,103 |
| Culture and recreation | 264,346 | 400,781 | 395,637 | 5,144 |
| Health | 357,127 | 337,117 | 323,878 | 13,239 |
| Welfare and community development | 867,879 | 707,746 | 697,275 | 10,471 |
| Total expenditures | 8,819,105 | 9,603,921 | 9,422,044 | 181,877 |
| Excess of revenues over expenditures | \$ - | \$ - | \$ 390,068 | \$ 390,068 |

The accompanying notes are an integral part of this required supplementary information.

NOTE A – BUDGET PROCESS AND BUDGETARY BASIS OF ACCOUNTING

The Municipal budget is prepared for the General Fund following the requirements of the Autonomous Municipal Law of 1991, as amended. It is developed utilizing elements of performance-based program budgeting and zero-based budgeting and includes estimates of revenues and other sources for ensuing fiscal year under laws existing at the time the budget is prepared.

Budget amendments are approved by the Municipal Legislature. Certain budget transfers within the limitations and restrictions of the Municipal Law can be approved by the Mayor or by the Municipal Legislature. The budget comparison schedule provides information about the original budget, the amended budget and the actual results, under the budgetary basis of accounting.

The budgetary basis of accounting is different from GAAP. Revenues are generally recorded when cash is received and expenditures are generally recorded when the related expenditure is incurred or encumbered. The encumbrances (that is, purchase orders, contracts) are considered expenditures when a commitment is made. On a GAAP basis encumbrances outstanding at year-end are reported in the governmental funds statements as assigned fund balance since they do not constitute expenditures or liabilities while on a budgetary basis encumbrances are recorded as expenditures of the current year. Encumbrance appropriations lapse one year after the end of the fiscal year. Unencumbered appropriations are lapsed at year-end. The legal level of budgetary control (the level at which expenditures may not legally exceed appropriations) is at the function level.

The presentation of the budgetary data excludes other appropriations such as capital projects, debt service and special revenue funds because projects are funded on a multi-year nature, generally requiring several years to complete or effective budgetary control is alternatively achieved through general obligation bond indentures and legal and contractual grant agreement provisions.

NOTE B - BUDGET TO GAAP RECONCILIATION

The accompanying budgetary comparison schedule presents comparisons of the original and final legally adopted budget with actual data on a budgetary basis. Since accounting principles applied for the purposes of developing data on a budgetary basis differ significantly from those used to present accounting principles generally accepted in the United States, the following budget to GAAP reconciliation is presented:

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
NOTES TO REQUIRED SUPPLEMENTARY INFORMATION -
BUDGETARY COMPARISON SCHEDULE - GENERAL FUND
June 30, 2013

NOTE B - BUDGET TO GAAP RECONCILIATION - Continued

| | |
|---|---------------------------------|
| Excess of revenues and other financing sources over expenditures and other financing uses (budgetary basis): | \$ 390,068 |
| Budget to GAAP differences: | |
| Basis of accounting differences: | |
| Revenues recorded for financial reporting purposes but not in budgetary basis: | 278,009 |
| Revenues recorded in budgetary basis purposes but not in financial reporting: | (156,210) |
| Expenditures recorded in budgetary basis but not for financial reporting purposes: | 87,451 |
| Expenditures recorded for financial reporting purposes but not in budgetary basis: | (98,730) |
| Timing differences: | |
| Current year encumbrances recorded as expenditures for budgetary reporting purposes: | 170,169 |
| Prior year encumbrances recorded as expenditures for financial reporting purposes: | (161,599) |
| Net change in fund balance (GAAP basis): | <u><u>\$ 509,158</u></u> |

SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
SUPPLEMENTARY INFORMATION - FINANCIAL DATA SCHEDULE
BALANCE SHEET AND STATEMENT OF REVENUES AND EXPENSES INFORMATION
JUNE 30, 2013

| Line Item No. | Description | 14.871 |
|-------------------------|--|-------------------------|
| | | Housing Choice Vouchers |
| Balance Sheet | | |
| 111 | Cash - unrestricted | \$ 44,890 |
| 113 | Cash - other restricted | \$ 32,052 |
| 100 | Total cash | \$ 76,942 |
| 150 | Total Current Assets | \$ 76,942 |
| 190 | Total Assets | \$ 76,942 |
| 290 | Total Assets and Deferred Outflow of Resources | \$ 76,942 |
| 333 | Accounts payable - other government | \$ 5,506 |
| 310 | Total Current Liabilities | \$ 5,506 |
| 353 | Non-current liabilities - other | \$ 3,656 |
| 350 | Total Non-current Liabilities | \$ 3,656 |
| 300 | Total Liabilities | \$ 9,162 |
| 400 | Deferred Inflow of Resources | \$ - |
| 508.1 | Net Investment in Capital Assets | \$ - |
| 511.1 | Restricted Net Position | \$ 28,396 |
| 512.1 | Unrestricted Net Position | \$ 39,384 |
| 513 | Total Equity/Net Position | \$ 67,780 |
| 600 | Total Liabilities, Deferred Inflow of Resources and Equity/Net Position | \$ 76,942 |
| Income Statement | | |
| 70600-010 | Housing assistance payments | \$ 366,412 |
| 70600-020 | Ongoing administrative fees earned | \$ 45,946 |
| 70600-070 | Admin fee calculation description | |
| 70600 | HUD PHA operating grants | \$ 412,358 |
| 71400 | Fraud recovery | \$ 646 |
| 71500 | Other revenue | \$ 29,711 |
| 700 | Total Revenue | \$ 442,715 |
| 91100 | Administrative salaries | \$ 66,244 |
| 91900 | Other | \$ 27,314 |
| 91000 | Total Operating - Administrative | \$ 93,558 |
| 96900 | Total Operating Expenses | \$ 93,558 |
| 97000 | Excess Revenue Over Operating Expenses | \$ 349,157 |
| 97300-050 | All Other | \$ 395,978 |
| 97300 | Housing assistance payments | \$ 396,294 |
| 97350 | HAP Portability-in | \$ 8,776 |
| 97400 | Depreciation expense | \$ - |
| 900 | Total Expenses | \$ 498,628 |
| 10000 | Excess (Deficiency) of Revenue Over (Under) Expenses | \$ (55,913) |
| 11030 | Beginning equity | \$ 123,693 |
| 11040-010 | Prior period adjustments and correction of errors - Editable | \$ 2,534.00 |
| 11040 | Prior period adjustments, equity transfers, and correction of errors | \$ 2,534 |
| 11770-001 | Administrative Fee Equity - Beginning Balance | \$ 66,061 |
| 11170-010 | Administrative Fee Revenue | \$ 45,946 |
| 11170-050 | Other Revenue | \$ 29,711 |

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
SUPPLEMENTARY INFORMATION - FINANCIAL DATA SCHEDULE
BALANCE SHEET AND STATEMENT OF REVENUES AND EXPENSES INFORMATION
JUNE 30, 2013

| Line Item No. | Description | 14.871 Housing Choice Vouchers |
|---------------|--|-----------------------------------|
| 11170-051 | Comment For Other Revenue | |
| 11170-060 | Total Admin Fee Revenues | \$ 75,657 |
| 11170-080 | Total Operating Expenses | \$ 93,558 |
| 11170-090 | Depreciation | \$ - |
| 11170-095 | Housing Assistance Portability In | \$ 8,776 |
| 11170-101 | Comment For Other Expense | |
| 11170-110 | Total Expenses | \$ 102,334 |
| 11170-002 | Net Administrative Fee | \$ (26,677) |
| 11170-003 | Administrative Fee Equity - Ending Balance | \$ 39,384 |
| 11170 | Administrative Fee Equity | \$ 39,384 |
| 11180-001 | Housing Assistance Payments Equity - Beginning Balance | \$ 57,632 |
| 11180-010 | Housing Assistance Payments Revenues | \$ 366,412 |
| 11180-015 | Fraud Recovery Revenue | \$ 646 |
| 11180-020 | Other Revenue | \$ - |
| 11180-021 | Comment For Other Revenue | |
| 11180-025 | Investment Income | \$ - |
| 11180-030 | Total HAP Revenues | \$ 367,058 |
| 11180-080 | Housing Assistance Payments | \$ 395,978 |
| 11180-090 | Other Expenses | \$ 316 |
| 11180-091 | Comment For Other Expense | |
| 11180-100 | Total Housing Assistance Payments Expenses | \$ 396,294 |
| 11180-002 | Net Housing Assistance Payments | \$ (29,236) |
| 11180-003 | Housing Assistance Payments Equity - Ending Balance | \$ 28,396 |
| 11180 | Housing Assistance Payments Equity | \$ 28,396 |
| 11190-210 | Total ACC HCV Units | - |
| 11190-220 | Unfunded Units | - |
| 11190-230 | Other Adjustments | - |
| 11190 | Unit Months Available | 828 |
| 11210 | Unit Months Leased | 780 |

The accompanying notes are an integral part of this schedule.

NOTE A – BASIS OF PRESENTATION

The accompanying financial data schedule (FDS) is a trial balance of the Section 8 Housing Choice Voucher Program administered by the Municipality. The FDS was created in order to standardize the financial information reported by Public Housing Authorities (PHA) to the Real Estate Assessment Center (REAC), as required by the Uniform Financial Reporting Standards (UFRS). REAC is the US Department of Housing and Urban Development (HUD) national management center created to assess the condition of HUD owned and assisted properties. The UFRS are rules to implement requirements of 24 CFR, Part 5, Subpart H, for the electronic filing of financial information to HUD.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

In accordance with the guidelines for reporting and attestation requirements of UFRS, the accompanying FDS is included as information supplementary to the financial statements. It is prepared using the accrual basis of accounting, as required by REAC regulations.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF LUQUILLO
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FISCAL YEAR ENDED JUNE 30, 2013**

| <u>Federal Grantor/Pass Through Grantor/Program Title</u> | <u>Federal CFDA Number</u> | <u>Pass-Through Entity Identifying Number</u> | <u>Federal Expenditures</u> |
|--|------------------------------------|---|---------------------------------|
| <u>U.S. Department of Housing and Urban Development</u> | | | |
| Direct programs: | | | |
| Section 8 Housing Choice Vouchers Program | 14.871 | N/A | \$ 412,358 |
| Passed-through programs from: | | | |
| <u>Office of Commissioner of Municipal Affairs:</u> | | | |
| Community Development Block Grants/State's Program and Non-Entitlement Grants in Hawaii | 14.228 | AB - 41, FC - 41 | <u>1,484,636</u> |
| Subtotal U.S. Department of Housing and Urban Development | | | 1,896,994 |
| <u>U.S. Department of Justice</u> | | | |
| Passed-through programs from: | | | |
| <u>P.R. Department of Justice:</u> | | | |
| JAG Program Cluster: | | | |
| Edward Byrne Memorial Justice Assistance Grant Program | 16.738 | 2009-DJ-UCPML-01, 2010-DJ-MLMEI-01 | 179,609 |
| ARRA - Edward Byrne Memorial Justice Assistance Grant (JAG) Program / Grants to States and Territories | 16.803 | 2009-SU-IHLUQ-01 | <u>45,530</u> |
| Total JAG Program Cluster: | | | 225,139 |
| <u>U.S. Department of Transportation</u> | | | |
| Passed-through program from: | | | |
| <u>P.R. Traffic Safety Commission</u> | | | |
| State and Community Highway Safety | 20.500 | 13-06-04 | 43,972 |
| <u>U.S. Department of Energy</u> | | | |
| Passed-through program from: | | | |
| <u>P.R. Energy Affairs Administration:</u> | | | |
| ARRA - Energy Efficiency and Conservation Block Grant Program (EECBG) | 81.128 | FOA-00013-34 | 7,045 |
| <u>U.S. Department of Health and Human Services</u> | | | |
| Passed-through programs from: | | | |
| <u>P. R. Office of Ombudsman Administration (OAP):</u> | | | |
| Aging Cluster: | | | |
| Special Programs for the Aging - Title III Part B - Grants for Supportive Services and Senior Centers | 93.044 | N/A | 141,025 |
| Nutrition Services Incentive Program | 93.053 | N/A | <u>37,931</u> |
| Total Aging Cluster: | | | 178,956 |
| <u>P.R. Department of Family - Families and Children Administration:</u> | | | |
| CCDF Program Cluster: | | | |
| Child Care and Development Block Grant | 93.575 | N/A | 214,067 |
| ARRA - Child Care and Development Block Grant | 93.713 | N/A | <u>27,191</u> |
| Total CCDF Program Cluster: | | | <u>241,258</u> |
| Subtotal U.S. Department of Health and Human Services: | | | 420,214 |
| <u>U.S. Department of Homeland Security</u> | | | |
| Passed-through programs from: | | | |
| <u>P.R. Governor's Office - Governor's Authorized Representative (GAR)</u> | | | |
| Disaster Grants - Public Assistance (Presidentially Declared Disasters) | 97.036 | FEMA -4017-DR-PR, PA I.D. 089-99089-00 | 160,821 |
| Total Expenditures of Federal Awards | | | <u>\$ 2,754,185</u> |

The accompanying notes are an integral part of this schedule.

NOTE A – BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Municipality under programs of the federal government for the year ended June 30, 2013. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments and Nonprofit Organizations*. Therefore, some amounts presented in this schedule may differ from the amounts presented in, or used in the preparation of, the basic financial statements. Because the schedule presents only a selected portion of the operations of the Municipality, it is not intended to and does not present the financial position and changes in net assets of the Municipality.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Expenditures reported on the Schedule are reported on the modified accrual basis of accounting, except for Section 8 Housing Choice Voucher Program (HCV). Expenditures are recognized when the related liability is incurred following the cost principles contained in OMB Circular A-87 *Cost Principles for State, Local and Indian Tribal Governments*, wherein certain types of expenditures are not allowable or are limited as to reimbursement. Expenditures for HCV Program are reported on a statutory basis as required by the U.S. Department of Housing and Urban Development. Such expenditures should equal the net ACC subsidy for the PHA's fiscal period.

The Catalog of Federal Domestic Assistance (CFDA) Number is a program identification number. The first two digits identify the federal department or agency that administers the program and the last three numbers are assigned by numerical sequence.

State or local government redistributions of federal awards to the Municipality, known as "pass-through awards", should be treated by the Municipality as though 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 the identifying number assigned by the pass-through entity for the federal awards received as a sub recipient. Numbers identified as N/A are not applicable and numbers identified as N/AV are not available.

NOTE C – RECONCILIATION OF EXPENDITURES PRESENTED IN THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS TO THE EXPENDITURES PRESENTED IN THE BASIC FINANCIAL STATEMENTS

| Description | Special Revenue – Other Federal Grants | Other Governmental Funds |
|--|--|--------------------------------|
| 14.871 | \$ - | \$ 412,358 |
| 14.228 | 1,484,636 | - |
| 16.738 | 179,609 | - |
| ARRA – 16.803 | 45,530 | - |
| 20.500 | 43,972 | - |
| ARRA – 81.128 | 7,045 | - |
| 93.044 | 141,025 | - |
| 93.053 | 37,931 | - |
| 93.575 | 214,067 | - |
| ARRA – 93.713 | 27,191 | - |
| 97.036 | 160,821 | - |
| Total federal awards expenditures: | 2,341,827 | 412,358 |
| Additional amount recorded as expenditures under modified accrual basis for Section 8 HCV Program: | - | 72,116 |
| Non-federal awards expenditures: | 111 | - |
| Reimbursement of program awards surplus to the federal agency | - | - |
| Total expenditures, fund statements: | \$ 2,341,938 | \$ 484,474 |



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Member of:

- American Institute of Certified Public Accountants
- Puerto Rico Society of Certified Public Accountants

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

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

We have audited, in accordance with the 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, the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of Municipality of Luquillo, as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise Municipality of Luquillo's basic financial statements and have issued our report thereon dated June 30, 2013.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered Municipality of Luquillo's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Municipality of Luquillo's internal control. Accordingly, we do not express an opinion on the effectiveness of Municipality of Luquillo's internal control.

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings and questioned costs, as item 13-01, that we consider to be significant deficiencies.

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

Compliance and Other Matters

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

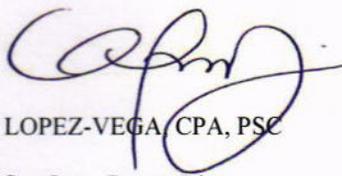
We noted certain other matters that we reported to management of the Municipality of Luquillo in a separate letter dated March 30, 2014.

Municipality of Luquillo's Response to Findings

Municipality of Luquillo's response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. Municipality of Luquillo's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
March 30, 2014

Stamp No.2675800 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.



López
CPA, PSC



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Member of:

- American Institute of Certified Public Accountants
- Puerto Rico Society of Certified Public Accountants

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY
OMB CIRCULAR A-133

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

Report on Compliance for Each Major Federal Program

We have audited Municipality of Luquillo's compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of Municipality of Luquillo's major federal programs for the year ended June 30, 2013. Municipality of Luquillo's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Municipality of Luquillo's major federal programs based on our audit of the types of compliance requirements referred to above. 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 Luquillo's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of Municipality of Luquillo's compliance.

Opinion on Each Major Federal Program

In our opinion, Municipality of Luquillo complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2013.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR
PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY
OMB CIRCULAR A-133 (CONTINUED)

Report on Internal Control Over Compliance

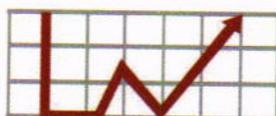
Management of the Municipality of Luquillo is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the Municipality of Luquillo's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Municipality of Luquillo's internal control over compliance.

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

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

We noted certain other matters that we reported to management of the Municipality of Luquillo in a separate letter dated March 30, 2014.

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

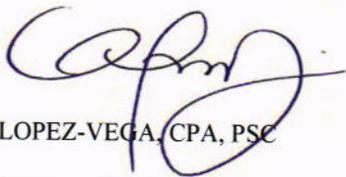


López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR
PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY
OMB CIRCULAR A-133 (CONTINUED)

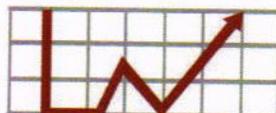
This report is intended solely for the information and use of management and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.



LOPEZ-VEGA, CPA, PSC

San Juan, Puerto Rico
March 30, 2014

Stamp No. 2675801 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.



López-Vega, CPA, PSC

Certified Public Accountants / Management Advisors

Section I - Summary of Auditor's Results

Financial Statements

| | | |
|---|-------------------|---------------|
| Type of auditor's report issued: | Unmodified | |
| Internal control over financial reporting: | | |
| Material weakness identified? | Yes | No X |
| Significant deficiencies identified not considered to be material weaknesses? | Yes X | None reported |
| Noncompliance material to financial statements noted? | Yes | No X |

Federal awards

| | | |
|---|-------------------|------------------------|
| Internal Control over major programs: | | |
| Material weakness identified? | Yes | No X |
| Significant deficiencies identified not considered to be material weaknesses? | Yes | None reported X |
| Type of auditor's report issued on compliance for major programs: | Unmodified | |
| Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)? | Yes | No X |

Identification of major programs:

| <u>CFDA Number</u> | <u>Name of Federal Program or Cluster</u> |
|--------------------|---|
| 14.228 | Community Development Block Grant - State's Program |
| 14.871 | Section 8 Housing Choice Voucher Program |

| | | |
|---|------------------|-------------|
| Dollar threshold used to distinguish between Type A and Type B programs | <u>\$300,000</u> | |
| Auditee qualified as low-risk auditee? | Yes | No X |

Section II – Financial Statements Findings

| | |
|-------------------------------|---|
| Finding Reference | 13-01 |
| Requirement | Financial Reporting – Accounting Records |
| Statement of Condition | <p>During our examination of the Municipality's accounting system, we noted that the Municipality's accounting record for Local, State and Federal funds does not provide modified accrual basis financial statements. Also, the accounting system does not offer subsidiaries to produce government wide financial statements. The computerized system provided by the Office of the Commissioner for Municipal Affairs (OCAM) and manual system maintained by finance department personnel do not provide financial information to generate the basic financial statements since the beginning balances were not properly presented in the accounting system.</p> <p>Therefore, the Municipality's hires the professional services of local accounting firms to perform the required adjustment entries to convert its accounting records from cash basis to modified and then to accrual basis and compile the necessary information as required by GAAP and the Law No. 81.</p> |
| Criteria | <p>Chapter VIII, Article 8.010 of State Act Number 81 of August 30, 1991, states that the Municipality should maintain an effective and updated accounting system.</p> |
| Cause of Condition | <p>The Municipality did not establish effective internal control over the transactions recorded on its accounting records. Also, the accounting data is not summarized in the form of a double-entry General Ledger record.</p> |
| Effect of Condition | <p>The Municipality's accounting system did not provide updated and complete financial information that presents the financial position and the result of operations and the change in fund balances. Such information is necessary to take management decisions.</p> |
| Recommendation | <p>We recommend the Municipality's Management to implement internal control and procedures in order to maintain a double entry accounting system that contains accurate information pertaining to authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, interfund transactions, etc.</p> |

Section II – Financial Statements Findings

Finding Reference **13-01 (Continued)**

Questioned Costs None

**Management Response
and Corrective Action**

The Municipality maintains two set of accounting records; a manual system and a computerized system provided by the Office of the Commissioner for Municipal Affairs (OCAM). Actually, all of the transactions were recorded in both systems, but the manual system is the primary financial record for financial statements preparation purposes at the end of each fiscal year due to the fact that the computerized system real accounts balances carried forward from prior years were affected by accounting errors in the first years of the system operation.

Nevertheless, as part of the corrective action plan, the Commissioner for Municipal Affairs (“OCAM”) consider alternatives to improve the accounting system, including the acquisition of new accounting software, and therefore, we will hope to solve our accounting system condition in a near future.

Implementation Date: Not available at this moment

Responsible Person: Mr. Ismael Ortiz Bonilla
Finance Department Director

14 JUN 2013 6:32 PM
DIA: SERVICIOS GENERALES
OCAM