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AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL
AREA DE ARCHIVO DIGITAL

MUNICIPIO DE NAGUABO
AUDITORIA 2003-2004
30 DE JUNIO DE 2004

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

BASIC FINANCIAL STATEMENTS

FISCAL YEAR ENDED JUNE 30, 2004

(WITH THE ADDITIONAL REPORTS AND
INFORMATION REQUIRED BY
THE GOVERNMENT AUDITING STANDARDS AND
OMB CIRCULAR A-133)

naguabo

2004

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO
BASIC FINANCIAL STATEMENTS
JUNE 30, 2004
(WITH THE ADDITIONAL REPORTS AND INFORMATION
REQUIRED BY THE GOVERNMENT AUDITING STANDARDS
AND OMB CIRCULAR A-133)

TABLE OF CONTENTS

	<u>Pages</u>
PART I – Financial:	
Independent Auditors' Report	1
Management's Discussion and Analysis.....	3
Basic Financial Statements:	
Governmental-Wide Statements:	
Statement of Net Assets	12
Statement of Activities	13
Governmental Funds Statements:	
Balance Sheet	14
Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets	15
Statement of Revenues, Expenditures and Changes in Fund Balance	16
Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balance of Governmental Funds to the Statement of Activities.....	17
Notes to the Basic Financial Statements.....	20
Required Supplementary Information:	
Budgetary Comparison Schedule – General Fund	38
Notes to Required Supplementary Information.....	39
PART II – Schedule of Expenditures of Federal Awards and Reports on Compliance and Internal Control in accordance with Government Auditing Standards and the requirements of OMB Circular A-133	
Schedule of Expenditures of Federal Awards	41
Notes to Schedule of Expenditures of Federal Awards.....	43
Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based upon the Audit Performed in Accordance with Government Auditing Standards	45

TABLE OF CONTENTS

	<u>Pages</u>
Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards	47
PART III – Findings and Questioned Costs:	
Schedule of Findings and Questioned Costs	49
Summary Schedule of Prior Audit Findings	62

PART I
FINANCIAL



MENDOZA & RAMOS
Contadores Públicos Autorizados, C.S.P.

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INDEPENDENT AUDITORS' REPORT

**To the Honorable Mayor and
Members of the Municipal Legislature
Municipality of Naguabo
Naguabo, Puerto Rico**

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Naguabo, Puerto Rico (Municipality), as of and for the year ended June 30, 2004, which collectively comprise the Municipality's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Municipality's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality, as of June 30, 2004, and the respective changes in financial position, where applicable, thereof for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis and budgetary comparison information on pages 3 through 11 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

INDEPENDENT AUDITORS' REPORT

Page 2

As described in Notes 20 and 39, during the fiscal year 2002-2003, the Municipality has implemented a new financial reporting model, as required by GASB Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments: Omnibus*, GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, and GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements* as of July 1, 2002.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 24, 2004 on our consideration of the Municipality's internal control structure over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Mendoza & Ramos
MENDOZA & RAMOS

CERTIFIED PUBLIC ACCOUNTANTS, C.S.P.

Guayama, Puerto Rico
January 27, 2005

Stamp number 2026977 was
affixed to the original of this
report.



COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

The management of Municipality of Naguabo, Puerto Rico (Municipality) offers this narrative overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2004. The new reporting model required by Governmental Accounting Standards Board Statement No. 34 was implemented during fiscal 2003. The financial statements associated with it are described in the following narrative as well as in the Notes to Financial Statements.

The Management's Discussion and Analysis (MD&A) is designed to focus on the current year activities, resulting changes and currently known facts, and much of the information is comparable to prior year. We encourage readers to consider this information with the Municipality's basic financial statements that follow.

FINANCIAL HIGHLIGHTS

The following are key financial highlights for the fiscal year:

- ❖ The *net assets* of the Municipality exceeded its liabilities at June 30, 2004 by \$15.6 million and at June 30, 2003 by \$8.3 million.
- ❖ The Municipality's total net assets increased by \$7.3 million during 2004 and \$623 thousand during 2003.
- ❖ As of June 30, 2004, the Municipality's governmental funds reported combined ending deficit fund balances of \$1.1 million, a decrease of \$40 thousand from the prior year.
- ❖ At June 30, 2004, unreserved (deficit) fund balance for the General Fund was \$2.7 million. The Municipality's total bonded debt increased by \$729 thousand during the fiscal year by new issuance of \$865 thousand for operational purposes.
- ❖ The Municipality's capital assets inventory was finished and net adjustment of \$7.0 million during this year's operations, including infrastructure capital assets inventory of \$4.4 million. Capital assets as of June 30, 2004 are \$21.5 million.
- ❖ The investment in capital assets for this year is \$19.0 million.
- ❖ Loans principal payments were \$136 thousand and \$350 thousand in 2004 and 2003, respectively.

OVERVIEW OF THE BASIC FINANCIAL STATEMENTS

This annual report consists of three components: 1) Management's Discussion and Analysis (this section) 2) Basic Financial Statements and 3) Required Supplementary Information. In light of the fact that this is a very different presentation from the pre-GASB Statement Number 34 model, the following graphic is provided for your review (Figure A-1 on next page). The Basic Financial Statements include two kinds of statements that present different views of the Municipality as follow:

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Government-wide Statements (Reporting the Municipality as Whole)

The Statement of Net Assets and Statement of Activities are two financial statements that report information about the Municipality, as a whole, and about its activities similar to a private-sector business. These statements provide both short-term and long-term information about the Municipality's economic condition at the end of the fiscal year. These statements include all assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The government-wide financial statements include two statements:

The Statement of Net Assets (page 12) presents all the Municipality's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets is an indicator of whether the Municipality's financial position is improving or deteriorating.

The Statement of Activities (page 13) presents information showing how the Municipality's net assets change during the most recent fiscal year. All the changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods.

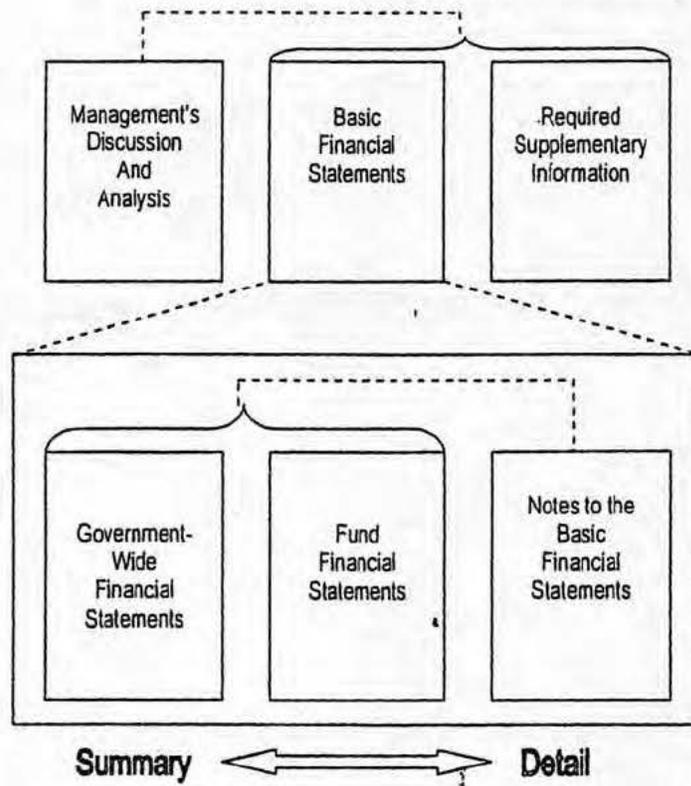
Fund Financial Statements (Reporting the Municipality's Major Funds)

Traditional users of governmental financial statements will find the Fund Financial Statements presentation more familiar. The focus is on Major Funds, rather than (the previous financial reporting model's) fund types. The Major Fund presentation is presented on a sources and uses of liquid resources basis. This is the manner in which the financial plan (the budget) is typically developed. The fund financial statements begin on page 14 and provide detailed information about the Major Individual Funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts the Municipality uses to keep track of specific sources of funding and spending for a particular purpose. The Municipality's funds are all included in Governmental Funds.

The flow and availability of liquid resources is a clear and appropriate focus of any analysis of a government. Funds are established for various purposes and the Fund Financial Statements allows the demonstration of sources and uses and/or budgeting compliance associated therewith (beginning on page 14).

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Figure A-1
Required Component of
Municipality of Naguabo Annual Financial Report



The Municipality's basic services are reported in the government fund financial statements. The government funds are reported using an accounting method called *modified accrual* accounting, which measures cash and all other *financial assets* that can readily be converted into cash. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions.

Notes to the Basic Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Other Information

In addition to the basic financial statements and accompanying notes, this report also presents certain required supplementary information containing budget to actual comparisons for the general.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

GOVERNMENT-WIDE FINANCIAL ANALYSIS

Governmental Net Assets

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the Municipality, assets exceeded liabilities by \$15.6 million as of June 30, 2004 versus \$8.3 million as of June 30, 2003. Our analysis below focuses on the net assets (Table 1) and changes in net assets of the Municipality's governmental activities.

	2004	2003
Current and non-current assets	\$ 4,386,964	\$ 4,037,357
Capital assets	<u>21,496,284</u>	<u>14,098,690</u>
Total Assets	<u>25,883,248</u>	<u>18,136,047</u>
Current liabilities	2,654,356	1,721,167
Deferred revenues	469,100	556,945
Long-term liabilities	<u>7,110,782</u>	<u>7,514,119</u>
Total Liabilities	<u>10,234,238</u>	<u>9,792,231</u>
Net Assets:		
Investment in capital assets	19,064,284	11,940,690
Restricted	4,260,856	3,391,055
Unrestricted (Deficit)	<u>(7,676,130)</u>	<u>(6,987,929)</u>
Total Net Assets	<u>\$15,649,010</u>	<u>\$ 8,343,816</u>

The largest portion of the Municipality's net assets reflects its investment in capital assets (e.g. land, buildings, machinery and equipment) less any related debt used to acquire those assets still outstanding. These capital assets are used to provide services to citizens; consequently these assets are not available for future spending. It should also be noted that the resources required to repay the related debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

An additional portion of the Municipality's net assets represents resources that are subject to external restrictions on how they may be used. The remaining balance of unrestricted net assets may be used to meet the Municipality's ongoing obligations to citizens and creditors.

Total Net Assets of the Municipality's governmental activities were \$15.6 million. *Unrestricted (Deficit) Net Assets*, the part of net assets that can be used to finance day-to-day operations without constraints established by debt covenants, enabling legislation or other legal requirements was approximately \$7.7 million at June 30, 2004.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Governmental Activities

Governmental activities increased the Municipality's net assets by \$8.3 million. Key elements of this increase are as follows: the Municipality's governmental activities had net expenses of \$10.8 million. However, these services are intended to be primarily funded by taxes, as opposed to charges for services and grants, and those taxes and other general revenues did exceed net expenses by \$7.3 million, including donated capital assets of \$6.6 million.

The cost of all governmental activities this year was \$50.5 million. Table 2 presents the cost of each of the Municipality's largest programs. A visual description are presented in Graphs 1 and 2)

Table 2

**Changes in Net Assets
For Fiscal Years Ending June 30,**

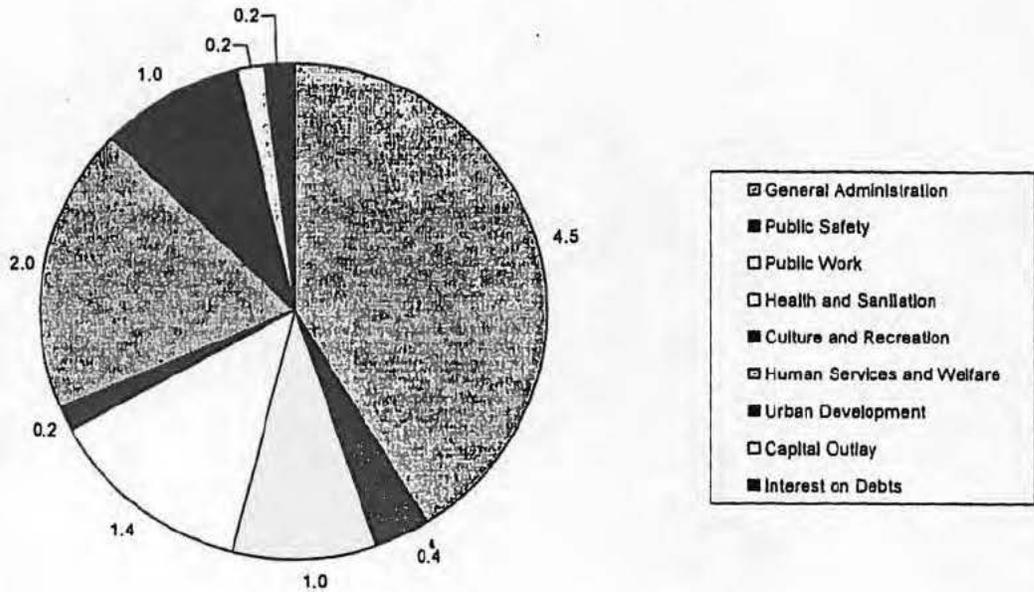
	2004	2003
Revenues:		
Program Revenues:		
Operating Grants and Contributions	\$ 3,351,381	\$ 3,908,256
Capital Grants and Contributions....	72,162	643,198
General Revenues:		
Property Taxes	2,235,583	1,837,318
Volume of Business Taxes.....	718,902	667,204
Construction Taxes	411,000	387,432
Intergovernmental.....	11,011,266	4,429,130
Other General Revenues	<u>358,723</u>	<u>238,084</u>
Total revenues.....	<u>18,159,017</u>	<u>12,108,628</u>
Expenses:		
General Administration.....	4,458,200	5,389,900
Public Safety	449,393	411,172
Public Works.....	981,744	845,910
Health and Sanitation.....	1,428,620	980,605
Culture and Recreation.....	164,893	184,623
Human Services and Welfare	1,989,100	1,763,421
Urban Development	997,084	1,751,070
Capital Outlay	173,359	-
Interest Costs.....	<u>211,430</u>	<u>148,477</u>
Total expenses.....	<u>10,853,823</u>	<u>11,485,208</u>
Changes in net assets.....	7,305,194	623,420
Net assets – beginning, as Restated* ..	<u>8,343,816</u>	<u>14,753,648</u>
Net assets – ending.....	<u>\$15,649,010</u>	<u>\$15,377,068</u>

Prior Period Adjustment to capital assets is \$7.1 million and \$84 thousand for long-term debts.

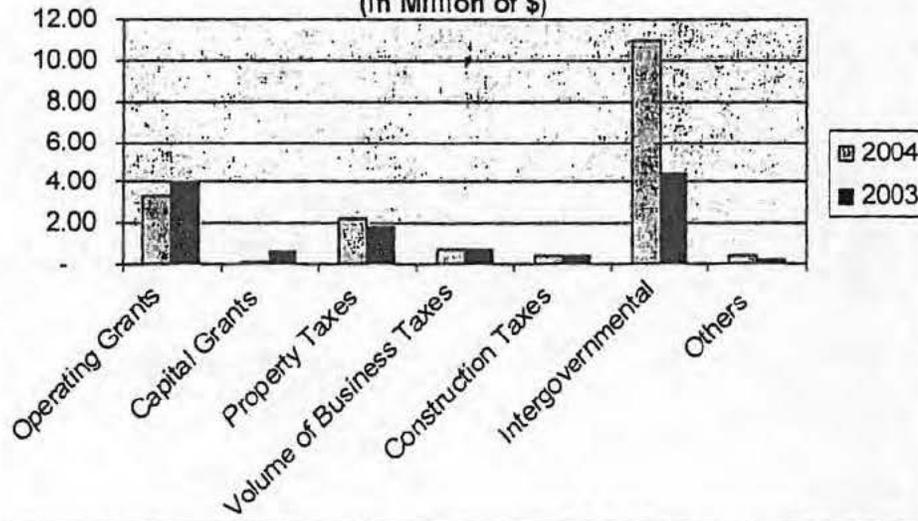
COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

GRAPH 1
Municipality of Naguabo, Puerto Rico
2004 Expenses By Functions
(In Million of \$)



GRAPH 2
Municipality of Naguabo, Puerto Rico
Revenues by Category
(In Million of \$)



COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

FINANCIAL ANALYSIS OF THE GOVERNMENT'S FUNDS

As noted earlier, the Municipality uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the Municipality's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of its fiscal year. At June 30, 2004, the Municipality's governmental funds reported combined ending fund balances (deficit) of (\$1.1) million, an increase of (\$725) thousand from the prior year.

Approximately (\$3.1) million constitutes unreserved (deficit) fund balance. The remainder of the balance is reserved to indicate that it is not available for new spending because it has already been committed (1) to liquidate prior year obligations (\$.3 million), (2) to pay debt service (\$.6 million), or (3) for other restricted purposes (\$1.1 million).

The general fund is the chief operating fund of the Municipality. At June 30, 2004, unreserved (deficit) fund balance of the general fund was (\$2.8) million and total fund balance was (\$1.1) million. As a measure of the general fund's liquidity, the total fund balance represents 32 percent of total general fund expenditures and transfers out.

BUDGETARY HIGHLIGHTS

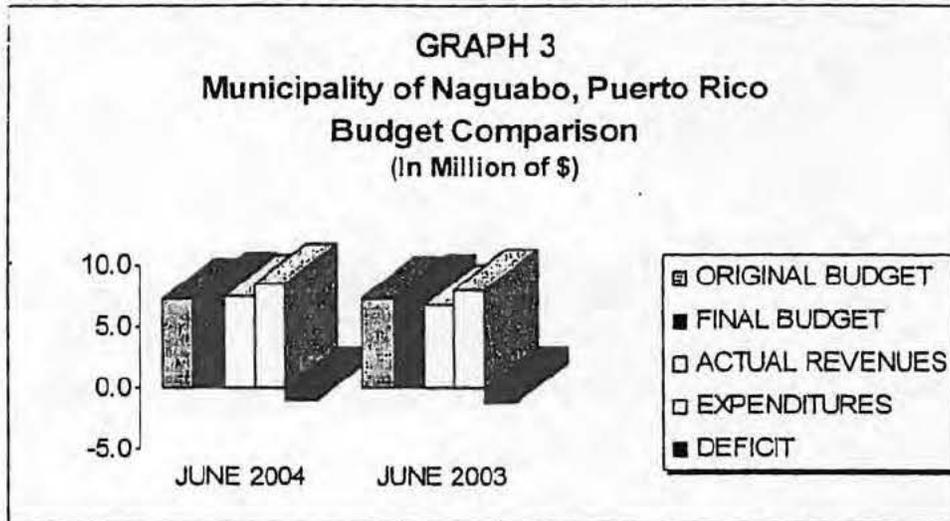
Budget and actual comparison schedules are provided in the *Basic Financial Statements* for the General Fund. The *Budgetary Comparison Schedule* of the General Fund shows the original adopted budgets, the final revised budget, actual results, and variance between the final budget and actual results for the general and major special revenue funds (see Graph 3).

After the original budget is approved, it may be revised for a variety of reasons such as unforeseen circumstances and other unanticipated revenues. Differences between the original 2004 budget and the final amended budget for the General Fund were relatively minor and can be summarized as follows:

- ❖ Revenues primarily decreased from collections of intergovernmental revenues, which resulted in a deficiency of \$220,000; and licenses and permits by \$66,000; but other miscellaneous revenues increase by \$115,000. As a result, the Municipality culminated its year end operations with a \$165,000 deficit in Municipal collections during the year.
- ❖ Expenditures increase in some functions, principally for solid waste, resulting in an excess of \$597,000.
- ❖ The original budget was amended to increase and decrease appropriation for expenditures.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004



CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

The Municipality's investment in capital assets for its governmental type activities as of June 30, 2004 amounted to \$21.5 million (net of accumulated depreciation). This investment in capital assets includes land, buildings, improvements, machinery and equipment, parks, roads, and bridges. The total increase in the Municipality's investment in capital assets for the current fiscal year was \$7.4 million.

Major capital asset events during the fiscal year included the inventory of infrastructure for the amount of \$4.2 million (net of depreciation) and other capital assets for \$17.3 million (net of depreciation). Additions during the fiscal year was principally for donation of capital assets from State Government, for the construction of the buildings, new vehicles and purchases of machinery and equipment, necessary to provides services to our citizens. Table 3 present the major classes of capital assets.

Table 3
Municipality of Naguabo's Capital Assets
(Net of depreciation, In Million)

Land.....	\$ 7.1
Construction in Progress.....	2.4
Buildings	6.8
Infrastructure.....	4.1
Motor Vehicles6
Machinery and Equipment5
Total Capital Assets	<u>\$21.5</u>

COMMONWEALTH OF PUERTO-RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Long-Term Debts

At June 30, 2004 the Municipality had total of \$7.1 million in general obligations and others outstanding debts, as shown in Table 4. Of this amount, \$5.0 million comprises debt backed by the full faith and credit of the government and \$2.1 million is other obligations.

General Obligations	\$2.9
Special Notes.....	2.1
Others	<u>2.1</u>
Total Capital Assets	<u>\$7.1</u>

The Municipality is required to limit the amount of general obligation debt to 10% of the total assessment of property located within the Municipality in order for the bonds to be repaid with the proceeds of property taxes restricted for debt services. Other obligations include accrued vacation and sick leave, and advance property taxes. More detailed information about the Municipality's long-term liabilities is presented in the notes to the financial statements. The Municipality continues to meet its financial needs through prudent use of its revenues and creative debt financing

programs.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES

Local, national and international economic factors influence the Municipality's revenues. Positive economic growth is correlated with increased revenues from property taxes, volume of business taxes, charges for services, as well as state and federal grants. Economic growth in the local economy may be measured by a variety of indicators such as employment growth, unemployment, new construction, assessed valuation, and other revenues.

All of these factors were considered in preparing the Municipality's budget for the 2005 fiscal year. Some cost reductions helped fund improvements of existing facilities, public safety and works, economic development initiatives and human service improvements.

REQUESTS FOR INFORMATION

This financial report is designed to provide a general overview of the Municipality's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional information contact the Municipality's Finance Department at (787) 874-3840.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

STATEMENT OF NET ASSETS

JUNE 30, 2004

	<u>GOVERNMENTAL ACTIVITIES</u>
<u>ASSETS:</u>	
Cash and Investments	\$ 404,578
Cash with Fiscal Agent.....	975,585
Receivables (net):	
Property Taxes	46,223
Federal Grants	2,360,019
Others	<u>600,559</u>
Capital Assets (Note 6):	
Land, Improvements, and Construction in Progress	9,494,846
Other Capital Assets, [Net of Depreciation]	<u>12,001,438</u>
Total Capital Assets.....	<u>21,496,284</u>
TOTAL ASSETS	<u>25,883,248</u>
<u>LIABILITIES:</u>	
Accounts Payable and Accrued Expenses	2,468,955
Accrued Interest.....	40,806
Bank Overdraft	144,595
Deferred Revenue.....	469,100
Long-Term Liabilities (Note 7):	
Due within One Year.....	1,559,835
Due in More than One Year	<u>5,550,947</u>
Total Liabilities.....	<u>10,234,238</u>
NET ASSETS	
Invested in Capital Assets, Net of Related Debt	19,064,284
Restricted for:	
Capital Projects.....	268,317
Debt Service	857,587
Community Development Projects.....	1,960,969
Other Purposes	1,173,983
Unrestricted (Deficit)	<u>(7,676,130)</u>
TOTAL NET ASSETS.....	<u>\$15,649,010</u>

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

STATEMENT OF ACTIVITIES

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

FUNCTIONS/PROGRAMS	EXPENSES	PROGRAM REVENUES			NET (EXPENSE) REVENUE (SEE NEXT PAGE)
		CHARGES FOR SERVICES	OPERATING GRANTS AND CONTRIBUTIONS	CAPITAL GRANTS AND CONTRIBUTIONS	
Governmental Activities:					
Mayor and Municipal Legislature	\$ 785,208	\$ -	\$ -	\$ -	(\$ 785,208)
General Government.....	3,672,992	-	479,358	-	(3,193,634)
Public Safety.....	449,393	-	16,438	-	(432,955)
Public Works	981,744	-	240,886	-	(740,858)
Culture and Recreation	164,893	-	-	-	(164,893)
Health and Sanitation.....	1,428,620	-	3,457	-	(1,425,163)
Human Services and Welfare	1,989,100	-	1,140,294	-	(848,806)
Urban Development.....	997,084	-	1,470,948	72,162	546,026
Capital Outlay.....	173,359	-	-	-	(173,359)
Interest on Long-Term Debt	211,430	-	-	-	(211,430)
Total Governmental Activities	\$10,853,823	\$ -	\$ 3,351,381	\$ 72,162	(7,430,280)
General Revenues:					
Taxes:					
Property Taxes, levied for General Purposes.....					1,738,118
Property Taxes, levied for Debt Service					497,465
Volume of Business Taxes					718,902
Construction Tax.....					411,000
Intergovernmental					11,011,266
Rent					99,012
Miscellaneous.....					259,711
Total General Revenues.....					14,735,474
CHANGE IN NET ASSETS.....					7,305,194
Net Assets – Beginning of Year, as Restate (Note 14) ..					8,343,816
NET ASSETS – ENDING OF YEAR.....					\$15,649,010

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

BALANCE SHEET – GOVERNMENTAL FUNDS

JUNE 30, 2004

	GENERAL	DEBT SERVICE FUND	CDBG FUND	OTHER GOVERNMENTAL FUNDS	TOTAL GOVERNMENTAL FUNDS
ASSETS					
Cash and Investments (Note 1).....	\$ 120,991	\$ -	\$ 99,374	\$ 184,213	\$ 404,578
Cash with Fiscal Agent.....	1,839	899,530	-	74,216	975,585
Receivables:					
Property Taxes.....	46,223	-	-	-	46,223
Federal Grants.....	-	-	1,942,109	417,910	2,360,019
Due from Other Funds.....	255,579	-	-	812,024	1,067,603
Others.....	469,393	-	-	131,166	600,559
Total Assets.....	894,025	899,530	2,041,483	1,619,529	5,454,567
LIABILITIES AND FUND BALANCES					
Liabilities:					
Accounts Payable.....	1,298,215	295,000	50,700	134,312	1,778,227
Accrued Interest.....	-	40,806	-	-	40,806
Bank Overdraft.....	144,595	-	-	-	144,595
Due to Governmental Units.....	985,728	-	-	-	985,728
Due to Other Funds.....	812,024	1,137	29,814	224,628	1,067,603
Deferred Revenues:					
Volume of Business Tax.....	382,494	-	-	-	382,494
Local Grants.....	46,223	-	-	-	46,223
Federal Grants.....	-	-	1,885,972	241,574	2,127,546
Total Liabilities.....	3,669,279	336,943	1,966,486	600,514	6,573,222
Fund Balances:					
Reserve For:					
Encumbrances.....	315,930	-	-	-	315,930
Debt Service.....	-	562,587	-	-	562,587
Other Purposes.....	1,839	-	74,997	1,019,015	1,095,851
Unreserved (Deficit).....	(3,093,023)	-	-	-	(3,093,023)
Total Fund Balances (Deficit).....	(2,775,254)	562,587	74,997	1,019,015	(1,118,655)
TOTAL LIABILITIES AND FUND BALANCES.....	\$ 894,025	\$ 899,530	\$ 2,041,483	\$ 1,619,529	\$ 5,454,567

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

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

JUNE 30, 2004

Total Fund Balances – Governmental Funds (Page 14)..... (\$ 1,118,655)

Amounts reported for Governmental Activities in the Statement of Net Assets (Page 12)
are different because:

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

Non Depreciable Capital Assets.....	\$ 9,494,846	
Depreciable Capital Assets.....	13,523,157	
Accumulated Depreciation.....	<u>(1,521,719)</u>	
Total Capital Assets.....		21,496,284

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

Child Care	154,968	
SBGP.....	1,885,972	
Municipal Revenue Collection Center	<u>46,223</u>	
Total Deferred Revenues		2,087,163

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

General Bonds and Notes Payable	(4,677,000)	
Compensated Absences.....	(1,061,975)	
Claims and Assessments	(49,000)	
Other Long-Term Debts	<u>(1,027,807)</u>	
Total Long-Term Liabilities		<u>(6,815,782)</u>

Total Net Assets of Governmental Activities (Page 12) \$15,649,010

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

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

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

	GENERAL	DEBT SERVICE FUND	CDBG FUND	OTHER GOVERNMENTAL FUNDS	TOTAL GOVERNMENTAL FUNDS
REVENUES					
Property Taxes.....	\$ 1,738,118	\$ 497,465	\$ -	\$ -	\$ 2,235,583
Volume of Business Taxes.....	718,902	-	-	-	718,902
Federal Assistances.....	-	-	675,527	1,260,788	1,936,315
Intergovernmental.....	4,895,868	-	-	1,047,396	5,943,264
Licenses and Permits.....	411,000	-	-	-	411,000
Rent.....	99,012	-	-	-	99,012
Miscellaneous.....	259,711	-	-	-	259,711
Total Revenues.....	8,122,611	497,465	675,527	2,308,184	11,603,787
EXPENDITURES					
Current:					
Mayor and Municipal Legislature.....	784,029	-	-	-	784,029
General Government.....	4,088,299	-	-	322,345	4,410,644
Public Safety.....	424,636	-	-	7,635	432,271
Public Works.....	776,254	-	-	384,961	1,161,215
Culture and Recreation.....	176,091	-	-	-	176,091
Health and Sanitation.....	1,403,907	-	-	25,311	1,429,218
Solid Waste Disposal.....	-	-	-	-	-
Human Services and Welfare.....	702,558	-	-	1,277,070	1,979,628
Urban Development.....	-	-	610,477	716,360	1,326,837
Capital Outlay.....	39,047	-	-	134,312	173,359
Debt Service:					
Principal.....	-	431,000	-	-	431,000
Interest and Other Charges.....	-	211,430	-	-	211,430
Total Expenditures.....	8,394,821	642,430	610,477	2,867,994	12,515,722
OTHER FINANCING SOURCES (USES)					
Proceed of Note.....	865,000	-	-	-	865,000
Transfers – In.....	-	170,313	-	57,052	227,365
Transfers – Out.....	(206,565)	-	-	(20,800)	(227,365)
Total Other Financing Sources and Uses.....	658,435	170,313	-	36,252	865,000
Net Change in Fund Balances.....	386,225	25,348	65,050	(523,558)	(46,935)
Fund Balance (Deficit) – Beginning, as Restated (Note 14).....	(3,161,479)	537,239	9,947	1,542,573	(1,071,720)
FUND BALANCES (DEFICIT) – ENDING.....	(\$ 2,775,254)	\$ 562,587	\$ 74,997	\$ 1,019,015	(\$ 1,118,655)

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

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

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Net Change in Fund Balances – Total Governmental Funds (Page 16) (\$ 46,935)

Amounts reported for Governmental Activities in the Statement of Activities (Page 13)
are different because:

Governmental funds report capital outlays as expenditures. However, in the Statement of
Activities the cost of those assets is allocated over their estimated useful lives and reported
as depreciation expense. In the current period, these amounts are:

Urban Development and Capital Outlay	\$ 1,134,215	
Depreciation Expense.....	<u>(357,362)</u>	
Excess of Capital Outlay over Depreciation Expense		776,853

Revenues in the Statement of Activities that do not provide current financial resources are not reported as revenues in the funds.....		486,055
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Revenues in the Statement of Revenues that correspond to prior year resources are recorded as revenue in the Statement of Activities.....		(551,566)
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Bonds proceeds provide current financial resources to governmental funds, but issuing debt increases Long-Term Liabilities in the Statement of Net Assets. In the current period, proceeds received was.....		(865,000)
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Repayment of long-term principal is expenditure in the governmental funds, but the repayment reduces Long-Term Liabilities in the Statement of Net Assets. In the current year the repayments were.....		971,304
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Some expenses reported in the Statement of Activities do not require the use of current
financial resources and therefore are not reported as expenditures in governmental funds.
These activities consist of

Compensated Absences.....		(86,258)
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Donation of capital assets from outside parties do not provide current financial resources in Governmental Funds are recognized based on the fair value of the donated property in the Government-Wide Financial Statement.....		<u>6,620,741</u>
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Change in Net Assets of Governmental Activities (Page 13) \$ 7,305,194

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Municipality of Naguabo, Puerto Rico (Municipality) was founded in the year 1775, and operates as a governmental unit of the Commonwealth of Puerto Rico, under the Law Number 81 of August 30, 1991, known as "Autonomy Municipalities Law of the Commonwealth of Puerto Rico". The governmental system of the Municipality is composed of the executive and legislative bodies. The Mayor is the Chief Executive Officer and is elected every four years in the general elections of the Commonwealth of Puerto Rico. The legislative body consists of 14 Legislators also elected in the general elections of Puerto Rico for a four-year period.

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

The accounting policies of the Municipality conform to accounting principles generally accepted in the United States of America as applicable to governmental units. The following is a summary of the more significant of such policies.

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

In June 1999, the GASB issued Statement Number 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*. This statement establishes new financial reporting requirements for state and local governments. The Municipality adopted the provisions of GASBS No. 34 as well as other statements referred to below as of July 1, 2002. They require new information and restructure much of the information that governments have presented in the past.

Comparability with reports issued in prior years is affected. With the implementation of GASBS No. 34, the Municipality has prepared required supplementary information titled *Management's Discussion and Analysis*, which precedes the basic financial statements.

As previously mentioned, other GASB Statements and Interpretations were required to be implemented in conjunction with GASBS No. 34. Therefore, the Municipality has implemented the following GASB Statements in the fiscal year 2002-2003: GASBS No. 37, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments: Omnibus*, GASBS No. 38, *Certain Financial Statement Note Disclosures*, GASB No. 41, *Budgetary Comparison Schedules - Perspective Differences*, and GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*.

The accompanying basic financial statements present the financial position and the results of operations of the Municipality and its various funds and fund types, and the cash flows of the proprietary funds. The basic financial statements are presented as of June 30, 2004, and for the fiscal year then ended. The more significant of these accounting policies are described below and, where appropriate, subsequent pronouncements will be referenced.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

A. Financial Reporting Entity

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

The basic criteria for including a potential component unit within the reporting entity is if potential component units are financially accountable and other organizations for which the nature and significance of their relationship with the entity are such that exclusion would cause the Municipality's financial statements to be misleading or incomplete. The GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) ability of the Municipality to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on the Municipality.

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

These financial statements present the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality, as of June 30, 2003, and the respective changes in financial position, where applicable, thereof for the fiscal year then ended.

B. Measurement Focus and Basis of Accounting

Government-wide Financial Statements

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

Governmental Fund Financial Statements

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recorded when susceptible to accrual; as soon as it is both measurable and available. "Available" means collectible within the current period or soon enough thereafter, normally within sixty (60) days, to be used to pay liabilities of the current period. Expenditures are generally recognized when the related liability is incurred.

The exception to this general rule is the principal and interest on general obligation long-term debt and compensated absences, if any, are recognized when due.

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

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

- Employee's vested annual vacation and sick leave is recorded as expenditure when utilized. The amount of accumulated annual vacation and sick leave unpaid at June 30, 2003, has been reported only in the government-wide financial statements.

C. Financial Statement Presentation

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

Government-wide Financial Statements

The government-wide financial statements (the Statement of Net Assets and the Statement of Activities) report information of all the activities of the Municipality. For most part, the effect of interfund activity has been removed from these government-wide financial statements. Governmental activities, which normally are supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support.

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

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

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

The Statement of Activities is focused on both the gross and net costs per functional category. The statement reduces gross expenses (including depreciation) by related program revenues, operating and capital grants. This is intended to summarize and simplify the user's analysis of cost of various governmental services.

Governmental Fund Financial Statements

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

Traditional users of governmental financial statements will find the Fund Financial Statements presentation more familiar. The focus is on Major Funds, rather than the previous financial model's fund types. The Governmental Major Fund Statements are presented on current financial resources and modified accrual basis of accounting.

This is the manner in which these funds are normally budgeted. This presentation deemed most appropriate to (a) demonstrate legal and covenant compliance, (b) demonstrate the source and use of liquid resources, and (c) demonstrate how the Municipality's actual experience conforms to the budgeted fiscal plan.

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

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

The new model as defined in GASBS No. 34 established criteria (percentage of the assets, liabilities, revenues, or expenditures/expenses of either fund category in the governmental fund) for the determination of major funds. The non-major funds are combined in a single column in the fund financial statements. The Municipality reports the following major fund:

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

Debt Service Fund – This is used to account for the accumulation of resources for, and the payment of long-term debt principal and interests

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

GASBS No. 34 eliminates the presentation of Account Groups, but provides for these records to be maintained and incorporates the information into the Governmental column in the government-wide Statement of Net Assets.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

D. Budgetary Data

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

The budget columns (original and final budgets) of the Budgetary Comparison – General Fund reflect the original budget and the amended budget (which have been adjusted for legally authorized revisions of the annual budgets during the year). Appropriations, except remaining project appropriations, encumbrances, and unexpended grant appropriations, lapse at the end of each fiscal year.

Amendments to the budget, including transfers, require the approval of the Municipal Legislature. Unencumbered appropriations lapse at the end of the next fiscal year. The Municipality follows these procedures, in accordance with law, in order to establish the budgetary data reflected in the basic financial statements:

1. Prior of May 15 of each fiscal year, the Mayor submits to the Municipal Legislature a proposed budget for the fiscal year commencing the following July 1 in addition of a budget message.
2. The budget document is available for public inspection prior to its approval by the Municipal Legislature.
3. The Commissioner of Municipal Affairs examines the budget to verify if it complied with the law's standards and sends it to the Mayor for any comments or recommendation before the limited date establishes by the Law.
4. Prior to June 13, the annual budget is legally enacted through passage of the annual appropriation ordinance.
5. If a budget is not adopted prior to the end of the end of the fiscal year, the annual budget for the preceding fiscal year, as approved by the Municipal Legislature and the Mayor, is automatically renewed for the ensuing fiscal year until a new budget is approved. This permits the Municipality to continue making payments for its operating and other expenses until the new budget is approved.
6. Subsequent to the enactment of the annual appropriation ordinance, the Municipal Legislature has the authority to make necessary amendments made during the fiscal year and are reflected in the budget information included in the Budgetary Comparison Schedule – General Fund.

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

1. Encumbrances are recorded as expenditures under the budgetary basis and as a reserve of fund balances under GAAP.
2. The non-exonerated portion of the property tax advances are presented as revenue in the budgetary basis and as other financing sources under GAAP (See Note 9).
3. Interfund transactions of the General and Special Revenue Funds are not included in the budgetary basis.
4. Certain accrued liabilities and other debts are not included in the budgetary basis.
5. Certain revenues susceptible to accrual, i.e., both measurable and available, are not included in the budgetary data.

All encumbrance appropriations in the operating budget lapse at the end of the fiscal year. Property taxes collected during the current year by the Municipal Revenue Collection Center (Fiscal Agent) are presented as revenues in the accounting basis but are not considered in the budgetary schedule.

The special funds of the Special Revenue Fund have not been included in the budgetary comparison because balances are not budgeted. Also the budget prepared for the Federal Finance Awards Programs included in the Capital Projects and Special Revenue Funds is based on a program period which is not necessarily a year. Accordingly, it's not practical to present an annual comparison of budget for such programs.

E. Cash, Cash Equivalent and Investment

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

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

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

F. Receivables

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

G. Inventories

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

H. Capital Assets

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

Depreciation on all assets is provided on the straight-line basis over the following estimated useful lives:

<u>Capital Assets</u>	<u>Years</u>
Buildings	50
Improvement Other Than Buildings	50
Infrastructure	10-50
Vehicles	5
Machinery and Equipment	5-10

I. Compensated Absences

The Municipality accrues accumulated unpaid vacation and sick leave and associated employee-related costs when earned (or estimated to be earned) by the employee. The Municipality's employees are granted 30 days of vacations and 18 days of sick leave annually. Vacations may be accumulated up to a maximum of sixty (60) days and sick leave up to a maximum of ninety (90) days. In the event of employee resignation, the employee is paid for accumulated vacation days up to the maximum allowed.

Separation from employment prior to use of all or part of the sick leave terminates all rights for compensation, except for employees with ten years of service who are entitled to sick leave pay up to the maximum allowed. The Municipality accrued a liability for compensated absences, which meet the following criteria:

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

not a fund liability and represents a reconciling item between the fund level and government-wide presentations (see Note 7 on page X).

The following is a summary of changes in the balance of Compensated Absences for the fiscal year ended.

BALANCE JULY 1, 2003	NEW ISSUES	RETIREMENTS AND CURRENT MATURATES	BALANCE JUNE 30, 2004	CURRENT PORTION	LONG-TERM PORTION
<u>\$ 975.717</u>	<u>\$ 86.258</u>	<u>\$ -</u>	<u>\$1,061.975</u>	<u>\$ 818.042</u>	<u>\$ 243.933</u>

J. Insurance

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

K. Interfund Transactions

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

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

L. Reservations of Fund Balance – Governmental Funds

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

Encumbrance – Represent future expenditures under purchases orders, contracts and other commitments issued for goods and services not received at year-end. Where the appropriations lapse at year-end these will be honored during subsequent year. Encumbrances constitute the equivalent of expenditures for budgetary purposes and, accordingly, are reported with expenditures in the budgetary comparison schedule.

Debt Service – Represents net assets available to finance future debt service payments.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

Fund Deficit in the General Fund is primarily attributable to decrease in revenues. The deficit is expected to decrease in the future as a result of a plan to reduce expenditures, obtain additional sources of revenues, and appropriation in annual budget as require by State Municipal Law.

M. Claims and Judgments

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

N. Use of Estimates

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

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS

Investments consist of certificates of deposit. The Municipality's cash, cash equivalent and investments at year-end were entirely covered by the Federal Deposit Insurance Corporation (FDIC) coverage, up to a maximum of \$100,000 in each bank, and the excess by collateral provided by the banks and held by the Department of the Treasury pursuant the applicable laws and regulations. Cash with fiscal agent is maintained in interest bearing accounts in the Government Development Bank of Puerto Rico and is not collateralized.

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

NOTE 3: OTHERS RECEIVABLES

As of June 30, 2004, the amount of \$469,393 corresponds to Puerto Rico Electric Power Authority legal case settlement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

NOTE 4: INTERFUND TRANSFER AND BALANCES

A. INTERFUND TRANSFERS

Transfers are indicative of funding for capital projects or debt service, and subsidies of various operations.

INTERFUND TRANSFERS WITHIN THE GOVERNMENTAL FUNDS

Sources	Transfer To	Amount	Purpose
General Fund	Debt Services Fund	\$ 170,313	Debt payment.
General Fund	Other Govern Funds	36,252	Capital projects
Other Gov. Funds- Special Rev.	Other Govern Funds- Capital	<u>20,800</u>	Capital projects
	Total	<u>\$ 227,365</u>	

B. INTERFUND RECEIVABLE AND PAYABLE BALANCES

Interfund receivables and payables at are summarized as follows:

Interfund Receivable	Interfund Payable	Amount
Other Govern Fund	General Fund	\$ 812,024
General Fund	Other Govern Fund	224,628
General Fund	SBGP	29,814
General Fund	Debt Service Fund	<u>1,137</u>
TOTAL		<u>\$1,067,603</u>

NOTE 5: DUE TO OTHER GOVERNMENTAL UNITS

As of June 30, 2004 , balance due to other governmental units of the General Fund for services rendered to the Municipality, consists of the following:

	Amount
Water Company	\$ 165,918
Municipality of Fajardo.....	100,000
Department of Treasury.....	515,637
General Service Administration.....	9,592
Retirement System Administration	177,759
AEELA.....	<u>16,822</u>
Total Due to Governmental Units	<u>\$985,728</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

NOTE 6: CAPITAL ASSETS

Capital Assets activities for the fiscal year ended is as follows:

DESCRIPTION	BALANCE JULY 1, 2003	ADJUSTMENTS	ADDITIONS	RETIREMENTS	BALANCE JUNE 30, 2004
Non-Depreciable Capital Assets:					
Land.....	\$ -	\$ 504,467	\$ 6,620,741	\$ -	\$ 7,125,208
Construction in Progress.....	-	2,039,955	329,683	-	2,369,638
Total Non-Depreciable Capital Assets.....	-	2,544,422	6,950,424	-	9,494,846
Depreciable Capital Assets:					
Buildings.....	21,059,000	(14,187,955)	232,315	-	7,103,360
Infrastructure.....	-	4,406,073	-	-	4,406,073
Motor Vehicles.....	-	967,131	352,039	-	1,319,170
Machinery and Equipment.....	157,396	316,980	220,178	-	694,554
Total Depreciable Capital Assets.....	21,216,396	(8,497,771)	804,532	-	13,523,157
Less Accumulated Depreciation:					
Buildings.....	-	(213,868)	(132,929)	-	(346,797)
Infrastructure.....	-	(176,243)	(66,091)	-	(242,334)
Motor Vehicles.....	-	(605,385)	(95,419)	-	(700,804)
Machinery and Equipment.....	-	(168,861)	(62,923)	-	(231,784)
Total Accumulated Depreciation.....	-	(1,164,357)	(357,362)	-	(1,521,719)
Total Depreciable Capital Assets (Net)....	21,216,396	(9,662,128)	447,170	-	12,001,438
CAPITAL ASSETS, NET.....	\$21,216,396	(\$ 7,117,706)	\$ 7,397,594	\$ -	\$21,496,284

Depreciation expenses were charged to governmental functions/programs as follows:

	AMOUNT
Mayor and Municipal Legislature.....	\$ 2,389
General Government.....	187,029
Public Safety.....	19,922
Public Works.....	44,744
Health and Sanitation.....	612
Culture and Recreation.....	1,607
Human Services and Welfare.....	11,232
Urban Development.....	89,827
Total Depreciation Expenses.....	<u>\$ 357,362</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

NOTE 7: GENERAL LONG-TERM DEBTS

A. GENERAL AND SPECIAL OBLIGATIONS

The principal long-term obligations of the Municipality are general obligations bonds and special notes issued to finance the construction and improvements of public facilities and purchase of equipment. The Municipality's obligations long-term debt retirements are appropriated and paid from resources accumulated in the Debt Service Fund (See Note 8). The special obligations long-term notes retirements are paid through retention made by the Municipal Revenue Collection Center from monthly advance of annual property tax and subsidy send to the Municipality.

General obligations bonds and notes payable as of, are comprised of the following individual issues:

<u>DESCRIPTION</u>	<u>AMOUNT</u>
<i>General Obligations Bonds:</i>	
\$100,000, Series 2002, for construction purposes, payable in semiannual installments ranging from \$15,000 to \$25,000, excluding variable interests from 5.0% to 8.0%, through July 1, 2006	\$ 65,000
\$370,000, Series 2002, for construction purposes, payable in semiannual installments ranging from \$15,000 to \$45,000, excluding variable interest from 5.0% to 8.0%, through July 1, 2016	340,000
\$415,000, Series 1991, for construction purposes, payable in semiannual installments ranging from \$15,000 to \$50,000, excluding variable interest from 4.37% to 6.36%, through July 1, 2006	130,000
\$320,000, Series 1997, for construction purposes, payable in semiannual installments ranging from \$20,000 to \$45,000 excluding variable interest from 6.71% to 7.0%, through July 1, 2007	160,000
\$620,000, Series 1999, for construction purposes, payable in semiannual installments ranging from \$70,000 to \$110,000, excluding variable interest from 5.62% to 6.0%, through July 1, 2005	210,000
\$514,000, Series 2000, for construction purposes, payable in semiannual installments ranging from \$16,000 to \$39,000, excluding interest at 4.5%, through July 1, 2005 (Water and Waste Disposal).....	444,000
\$576,000, Series 2000, for construction purposes, payable in semiannual installments ranging from \$14,000 to \$39,000, excluding interest at 4.5%, through July 1, 2023	

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

(Water and Waste Disposal).....	501,000
\$200,000, Series 2000, for construction purposes, payable in semiannual installments ranging from \$20,000 to \$35,000, excluding variable interest from 7.08% to 7.5%, through July 1, 2007	\$ 100,000
\$590,000, Series 2001, for construction purposes, payable in semiannual installments ranging from \$40,000 to \$80,000, excluding interests at 8.0%, through July 1, 2010	455,000
\$239,000, Series 2000, payable in annual installments ranging from \$6,000 to \$10,000, interests from 4.50%, until year 2014 (Water and Waste Disposal).....	227,000
\$285,000, Series 2003, payable in annual installments ranging from \$5,000 to \$25,000, variable interests from 5.00% to 6.30%, until year 2006	<u>280,000</u>
Total General Obligations Bonds.....	<u>2,912,000</u>
<i>Special Obligations Notes:</i>	
\$400,000 Note from Lottery Fund, for operational purposes, payable in annual installments ranging from \$40,000 to \$80,000, excluding interests at 8.0%, through July 1, 2010	300,000
\$865,000, Special Obligation Bond, payable in annual installments ranging from \$60,000 to \$110,000, excluding interests at 6%, through July 1, 2013	805,000
\$990,000, Special Obligation Bond, payable in annual installments ranging from \$15,000 to \$75,000, variable interests from 5.00% to 6.30%.....	<u>955,000</u>
Total Special Obligations Notes.....	<u>2,060,000</u>
Total General and Special Obligations.....	<u>\$4,972,000</u>

The Municipality's general obligations long-term note retirements are appropriated and paid from resources accumulated in the debt service fund (see Note 8). The special obligations long-term notes retirements are paid through retention made by the Municipal Revenue Collection Center from monthly advance of annual property tax and subsidy sent to the Municipality.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

The annual requirements to amortize the general and special obligations outstanding as of are as follows:

YEAR ENDING JUNE 30,	PRINCIPAL PAYMENT	INTEREST PAYMENT	TOTAL PAYMENT
2005	\$ 439,000	\$ 259,500	\$ 698,500
2006	480,000	262,923	742,923
2007	402,000	238,634	640,634
2008	315,000	216,659	531,659
2009	282,000	197,345	479,345
2010-2014	1,325,000	706,412	2,031,412
2015-2019	809,000	388,163	1,197,163
2020-2024	608,000	190,830	798,830
2025-2029	<u>312,000</u>	<u>30,668</u>	<u>342,668</u>
TOTAL	<u>\$4,972,000</u>	<u>\$2,491,134</u>	<u>\$7,463,134</u>

B. OTHER LONG-TERM DEBTS

The following is a summary of long-term debts for the year ended June 30, 2004:

DESCRIPTION	BALANCE JULY 1, 2003	NEW ISSUES	RETIREMENTS AND ADJUSTMENT	BALANCE JUNE 30, 2004
Property Tax Advance	\$ 210,945	\$ -	\$ 17,399	\$ 193,546
Property Tax-Treasury	165,442	-	20,681	144,761
Unemployment.....	65,266	-	27,194	38,072
Unemployment-Federal Prog.....	47,116	-	23,558	23,558
Solid Waste Disposal	220,000	-	220,000	-
Water and Sewer Authority.....	148,880	-	148,880	-
Social Security	158,068	-	19,800	138,268
Income Tax Withheld.....	471,717	-	58,200	413,517
Income Tax Withheld.....	418,216	-	418,216	-
Claims and Assessments	390,121	-	341,121	49,000
P.R. Land Authority	84,085	-	8,000	76,085
Compensated Absences.....	<u>975,717</u>	<u>86,258</u>	<u>-</u>	<u>1,061,975</u>
TOTAL.....	<u>\$3,355,573</u>	<u>\$ 86,258</u>	<u>\$1,303,049</u>	<u>\$2,138,782</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO**

NOTES TO THE FINANCIAL STATEMENTS

C. CHANGES IN GENERAL LONG-TERM DEBTS

The following is a summary of changes in long-term debts for the year ended June 30, 2004:

DESCRIPTION	BALANCE JULY 1, 2003	NEW ISSUES	RETIREMENTS AND ADJUSTMENT	BALANCE JUNE 30, 2004	AMOUNTS DUE WITHIN ONE YEAR	AMOUNTS DUE AFTER NEXT YEAR
General.....	\$2,953,000	\$ -	\$ 41,000	\$2,912,000	\$ 339,000	\$2,573,000
Special.....	1,290,000	865,000	95,000	2,060,000	100,000	1,960,000
Other Debts.....	<u>3,355,573</u>	<u>86,258</u>	<u>1,303,049</u>	<u>2,138,782</u>	<u>1,120,835</u>	<u>1,017,947</u>
TOTAL.....	<u>\$7,598,573</u>	<u>\$ 951,258</u>	<u>\$1,439,049</u>	<u>\$7,667,510</u>	<u>\$1,559,835</u>	<u>\$5,550,947</u>

NOTE 8: DEBT RETIREMENT

Revenues of the debt service fund consists of the ad-valorem property taxes which are recognized as revenue when collected from taxpayers and reported by the Municipal Revenue Collection Center of the Commonwealth of Puerto Rico to the Municipality (See Note 9).

These property taxes are accumulated by the Municipal Revenue Collection Center in costs of the general obligations bonds issued by the Municipality (See Note 7). Payments are made to the Government Development Bank of the Commonwealth of Puerto Rico from such accumulated funds by the Municipal Revenue Collection Center of Puerto Rico.

NOTE 9: PROPERTY TAXES

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

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

The tax rate per annum is 7.85% for real property and 5.88% for personal property of which 1.03% of both belong to the Commonwealth of Puerto Rico and 6.82% and 4.85%, respectively, belongs to the Municipality. From the portion belonging to the Municipality, 5.72% and 3.75%, respectively, represents the Municipality's basic tax rate that is appropriated for general purposes and therefore accounted for through the general fund.

The remaining portion belonging to the Municipality of 1.50% represents the ad-valorem property taxes withheld by the Municipal Revenue Collection Center of the Commonwealth of Puerto Rico and restricted for debt service, which is accounted for through the debt service fund (See Note 8). The Municipality has reached the maximum statutory tax rate limit for the basic tax while there is no limitation for the ad-valorem tax rate.

The Commonwealth of Puerto Rico grants complete real property tax exoneration on the first \$15,000 has assessed valuation on residential units occupied by their owners. However, the Municipality receives the full amount levied, except for residential units assessed at less than \$3,500 on which a complete exemption is granted.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO**

NOTES TO THE FINANCIAL STATEMENTS

The Municipal Revenue Collection Center, instead of the property taxpayer, becomes the source of payment in these cases.

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

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

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

NOTE 10: VOLUME OF BUSINESS TAX

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

- a. 1.50% for financial institutions and savings and loan associations.
- b. 0.50% for all other organizations.

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

NOTE 11: INTERGOVERNMENTAL REVENUES

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

NOTE 12: EMPLOYEE'S RETIREMENT PLAN

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

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

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

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

Law Number 305 of September 24, 1999, amends the Act Number 447 that establish a savings program. All employees active in the system as of December 31, 1999 may elect to transfer from defined contribution programs to the new savings program (a defined contribution plan). Employees in the savings program may now contribute from a minimum of 8.275% up to a maximum of 10% of their monthly salary, and will invest in an account which will either: (a) earn a fixed rate based on the two-year Constant Maturity Treasury Note or (b) earn a rate equal to 75% of the return of the System's investment portfolio (net of management fees), or (c) earn a combination of both alternatives.

If at time of retirement accumulated benefits amount to \$10,000 or less may elect to receive a lump sum distribution up to the accumulated benefits. Under the new program the retirement age is reduced from 65 to 60 for those employees who joined the current plan on or after April 1, 1990.

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

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

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

All employees that do not elect to transfer for the new program, and who at the time of employment are 55 years old or less are eligible to participate in the System. Pension benefits for participants with 30 years of service are as follows (See Table 10)

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

YEARS OF SERVICE	PARTICIPANT'S AGE	PENSION BENEFITS
30 or more	55 or less	65% of the average of the three years of highest salary during the employee's service period.
30 or more	58 or more	75% of the average of the three years of highest salary during the employee's service period.
30 or more	65 or more	75% of the average of the three years of highest salary during the employee's service period (employees started working after April 1, 1990).

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

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

Contributions in 2004 and prior years were made based on percentages established by the law. Such percentage has not been based on actuarial studies, as required by accounting principles generally accepted in the United States of America. An actuarial compilation of the annual contribution applicable to the Municipality has not been prepared. Accordingly, the accounts by which the actual contributions differ from the required actuarial contributions are not known.

The total pension expenditures recorded in the category of administration for the Fiscal Year Ended June 30, 2004 was approximately \$184,228. All employees who at the time of employment are 55 years old or less are eligible to participate in the System. No benefit is payable if the participant receives a refund of his accumulated contributions.

The historical trend information regarding the accumulation of assets and pension benefit obligation in the ERS is not available. For the ten-year trend information, refer to the separately issued financial statements of the ERS as of and for the fiscal year ended June 30, 2004. The P.R. Retirement Plan Administration provides additional information of the ERS. They issue a publicly available financial report that includes financial statements and required supplementary information for ERS, as a component unit of the Commonwealth of Puerto Rico. That report may be obtained by writing to the Administration at PO Box 42003, Minillas Station, San Juan, PR 00940.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

NOTE 13: CONTINGENCIES

A. CLAIMS AND JUDGMENTS

The municipality is a defendant in various lawsuits alleging damages and losses from alleged improper application of policies and negligence in the ordinary course of municipality's activities. Management did not made provision for these legal claims for the year ended in June 30, 2004.

B. FEDERAL GRANTS

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

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

NOTE 14: ACCOUNTING CHANGES, CHANGES IN REPORTING ENTITY AND RESTATEMENTS

During fiscal year 2002-2003, the Municipality implemented several new accounting standards and an interpretation issued by GASB. As part of the implementation of the new standards, during the current fiscal year 2003-2004 the Municipality continued the documentation of capital assets not previously reported and the inventory of infrastructure.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE FINANCIAL STATEMENTS

The following reconciles the June 30, 2003 Fund Balance/Net Assets, as previously reported to Beginning Fund Balance/Net Assets, as restated July 1, 2003.

FUND BALANCE RESTATED

	GENERAL FUND	OTHER GOVERNMENTAL FUND
Fund Balance, as Reported		
June 30, 2003.....	(\$2,308,649)	\$1,368,032
Adjustment to Due to/Due From.....	(174,541)	174,541
Adjustment to Due to Other Governmental Units	(68,275)	-
Reclassification of Long-Term Debt...	<u>(610,016)</u>	<u>-</u>
Beginning Fund Balance, as Restated, July 1, 2003	<u>(\$3,161,479)</u>	<u>\$1,542,573</u>

NET ASSETS RESTATED

	NET ASSETS
Net Assets, as previously reported	
June 30, 2003.....	\$15,377,068
Adjustment to Long-Term Debt.....	84,454
Adjustment to Capital Assets.....	<u>(7,117,706)</u>
Beginning Net Assets, as Restated, July 1, 2003	<u>\$ 8,343,816</u>

NOTE 15: FUTURE ADOPTION OF ACCOUNTING PRONOUNCEMENT

The Governmental Accounting Standards Board (GASB) issued GASBS No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which is effective for fiscal year beginning after December 15, 2004. Early application is encouraged. The Municipality has not adopted the requirement of this statement. Other two pronouncements are issued (GASBS Nos. 43 and 44), but do not apply to the Municipality.

END OF NOTES

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

REQUIRED SUPPLEMENTARY INFORMATION
BUDGETARY COMPARISON SCHEDULE – GENERAL FUND

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

	BUDGET AMOUNTS		ACTUAL AMOUNTS (BUDGETARY BASIS) (SEE NOTE A)	VARIANCE WITH FINAL BUDGET POSITIVE (NEGATIVE)
	ORIGINAL	FINAL		
BUDGETARY FUND BALANCE (DEFICIT), JULY 1, 2003	<u>(\$ 3,153,423)</u>	<u>(\$ 3,153,423)</u>	<u>(\$ 3,153,423)</u>	<u>\$ -</u>
Resources (Inflows):				
Property Taxes	1,368,753	1,738,118	1,738,118	-
Volume of Business Taxes.....	715,600	715,600	718,902	3,302
Intergovernmental Revenues.....	4,511,475	4,511,476	4,291,442	(220,034)
License and Permits	476,875	476,875	411,000	(65,875)
Rent.....	96,400	96,400	99,012	2,612
Miscellaneous	<u>144,763</u>	<u>144,763</u>	<u>259,711</u>	<u>114,948</u>
Total Resources (Inflows).....	<u>7,313,866</u>	<u>7,683,232</u>	<u>7,518,185</u>	<u>(165,047)</u>
Amounts Available for Appropriation	<u>(4,160,443)</u>	<u>(4,529,809)</u>	<u>(4,364,762)</u>	<u>(165,047)</u>
Charges to Appropriations (Outflows):				
Mayor and Municipal Legislature	866,391	848,730	855,577	(6,847)
General Government.....	3,300,909	3,676,422	3,879,905	(203,483)
Public Safety	475,912	432,123	432,268	(145)
Public Works.....	778,022	812,849	812,264	585
Health and Sanitation.....	823,353	809,075	1,405,709	(596,634)
Culture and Recreation.....	223,461	177,100	177,011	89
Human Services and Welfare.....	682,439	716,801	717,345	(544)
Capital Outlay	39,804	39,819	39,047	772
Transfer to Other Funds.....	<u>123,575</u>	<u>170,313</u>	<u>170,313</u>	<u>-</u>
Total Charges to Appropriations.....	<u>7,313,866</u>	<u>7,683,232</u>	<u>8,489,439</u>	<u>(806,207)</u>
BUDGETARY FUND BALANCE (DEFICIT), JUNE 30, 2004	<u>(\$ 3,153,423)</u>	<u>(\$ 3,153,423)</u>	<u>(\$ 4,124,677)</u>	<u>(\$ 971,254)</u>

See accompanying Notes to Required Supplementary Information.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

REQUIRED SUPPLEMENTARY INFORMATION
BUDGETARY COMPARISON SCHEDULE – GENERAL FUND

NOTE REQUIRED SUPPLEMENTARY INFORMATION

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

	<u>GENERAL FUND</u>
Sources/Inflows of Resources:	
Actual Amounts (Budgetary Basis) "Available for Appropriation" from the Budgetary Comparison Schedule (See Page 18).....	\$ 4,364,762
Difference – Budget to GAAP:	
The Fund Balance (Deficit) at the Beginning of Year is a budgetary resource but is not a Current-Year Revenue for financial reporting purposes.	3,153,423
Proceed from Claim is not a current year inflow of budgetary resources but are revenues for financial reporting purpose.....	469,393
Revenues non-budget.....	<u>135,033</u>
Total Revenues as Reported on the Statement of Governmental Funds Revenues, Expenditures and Changes in Fund Balance (See Page 16).....	<u>\$ 8,122,611</u>
Uses/Outflows of Resources:	
Actual Amounts (Budgetary Basis) "Total Charges to Appropriation" from the Budgetary Comparison Schedule (See Page 18).....	\$ 8,489,439
Difference – Budget to GAAP:	
Encumbrances for supplies and equipment ordered but not received are reported in the year the order is placed for budgetary reporting purposes.	(185,195)
Prior-Year Expenditures are not outflows of budgetary resources but are <i>expenditures</i> for financial reporting purposes.	135,711
Transfers to other funds are outflows of budgetary resources but are not expenditures for financial reporting purposes.	(170,313)
Expenditures non-budget.....	<u>125,179</u>
Total Expenditures as Reported on the Statement of Governmental Funds Revenues, Expenditures and Changes in Fund Balance (See Page 16).....	<u>\$ 8,394,821</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

REQUIRED SUPPLEMENTARY INFORMATION
BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

NOTE REQUIRED SUPPLEMENTARY INFORMATION

NOTE B: Explanation of Differences between Budgetary Fund Balance and GAAP Fund Balance

Budgetary Fund Balance (Deficit), June 30, 2004 (See Page 18).....	(\$ 4,124,677)
Timing Differences:	
Net Change in Encumbrances	(314,432)
Reserved Fund Balance.....	1,839
Non-budgetary Items	479,247
Proceed of Bonds	<u>865,000</u>
Fund Balance (Deficit) (See Page 14)	<u>(\$ 3,093,023)</u>

END OF THIS SECTION

PART II

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
AND REPORTS ON COMPLIANCE AND INTERNAL CONTROL
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS
AND THE REQUIREMENTS OF OMB CIRCULAR A-133**

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

FEDERAL GRANTOR / PASS THROUGH GRANTOR / PROGRAM OR CLUSTER TITLE	FEDERAL CFDA NUMBER	PASS-THROUGH ENTITY IDENTIFYING NUMBER	FEDERAL EXPENDITURES
U.S. Department of Agriculture:			
Water and Waste Disposal Loans and Grants	10.770		\$ 276,430
Pass-Through Department of Education:			
Child and Adult Care Food Program	10.558	N/A	<u>11,479</u>
Total U.S. Department of Agriculture.....			<u>287,909</u>
U.S. Department of Commerce:			
Economic Adjustment Assistance.....	11.307		<u>7,731</u>
U.S. Department of Housing and Urban Development:			
Section 8 Housing Choice Vouchers (Cluster)	14.871	RQ047V00014	606,602
Pass-Through State – Office of the Commissioner of Municipal Affairs			
Community Development Block Grant (CDBG)...	14.219	03-AB-FC-47 02-AB-FC-47 01-FD-FC-47 98-FD-47 97-FD-47	<u>610,477</u>
Total U.S. Department of Housing and Urban Development			<u>1,217,079</u>
U.S. Health and Human Services:			
Pass-Through Administration of Children and Families:			
Child Care and Development Block Grant	93.575	N/A	<u>448,126</u>
U.S. Department of Transportation:			
Pass-Through State – Highway Authority:			
Non-Urbanized Area Formula Program, Section 5311.....	20.509	PR-18-X017-53(1) PR-18-X017-53(2)	<u>134,312</u>
Subtotal Expenditures of Federal Awards (Balance Carry Forward).....			2,095,157

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

FEDERAL GRANTOR / PASS THROUGH GRANTOR / PROGRAM OR CLUSTER TITLE	FEDERAL CFDA NUMBER	PASS-THROUGH ENTITY IDENTIFYING NUMBER	FEDERAL EXPENDITURES
Subtotal of Expenditures of Federal Awards (Balance Brought Forward)			<u>\$ 2,095,157</u>
U.S. Federal Emergency Management Agency (FEMA):			
Pass-Through State – Office of Governor Authorized Representative (GAR):			
Public Assistant Grants	83.544	N/A	<u>202,761</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS			<u>\$2,297,918</u>

The accompanying Notes to Schedule of Expenditures of Federal Awards are an integral of this Schedule.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

NOTE 1 GENERAL

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activities of the Municipality of Naguabo, Puerto Rico. The information in this Schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this Schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements. The Municipality reporting entity is defined in Note (1) (A) to the basic financial statements. All federal financial awards received directly from federal agency as well as federal financial awards passed through other government agencies are included on the Schedule.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

NOTE 3 FEDERAL CFDA NUMBER

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

NOTE 4 PASS-THROUGH GRANTOR'S NUMBER

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

NOTE 5 LOAN OUTSTANDING

The Municipality of Naguabo, Puerto Rico had the following outstanding balance at June 30, 2004 for Water and Waste Disposal Loans Programs. For these loans the grantor does not impose continuing compliance requirements, as described on the OMB Circular A-133. Therefore, the prior year balances are not considered expenditures on the Schedule of

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Expenditures of Federal Awards. The amount presented in the Schedule, represent federal expenditures according to modified accrual basis of accounting (see Note 2).

The loans outstanding balance were included in the Municipality's Long-Term Liabilities (see Note 7 of the Notes to Basic Financial Statements)

PROGRAM TITLE	FEDERAL CFDA NUMBER	AMOUNT OUTSTANDING
Water and Waste Disposal Loans and Grants	10.770	\$227,000
Water and Waste Disposal Loans and Grants	10.770	501,000
Water and Waste Disposal Loans and Grants	10.770	444,000

NOTE 6 MAJOR PROGRAMS

Major programs are identified in the Summary of Auditor's Results Section of the Schedule of Findings and Questioned Costs.

END OF NOTES



MENDOZA & RAMOS
Contadores Públicos Autorizados, C.S.P.

P.O. Box 35 • Guayama, Puerto Rico 00785 • Telefax 787-864-9271

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED IN
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

**To the Honorable Mayor and
Members of the Municipal Legislature
Municipality of Naguabo
Naguabo, Puerto Rico**

We have audited the basic financial statements of Municipality of Naguabo, Puerto Rico (the "Municipality") as of and for the fiscal year ended June 30, 2004, and have issued report thereon dated January 27, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Municipality's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*, which are described in the accompanying Schedule of Findings and Questioned Costs as items 04-01 to 04-06.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Municipality's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control over financial reporting. We did not note matters involving the internal control over financial reporting and its operation that we consider being reportable conditions. Reportable conditions involve matters coming to our consideration relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Municipality's ability to record, process, summarize and report financial statements.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the basic financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in

INDEPENDENT AUDITORS' REPORT

Page 2

the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

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

Mendoza & Ramos
MENDOZA & RAMOS

CERTIFIED PUBLIC ACCOUNTANTS, C.S.P.

Guayama, Puerto Rico
January 27, 2005

Stamp number 2026978 was
affixed to the original of this
report.





MENDOZA & RAMOS
Contadores Públicos Autorizados, C.S.P.

P.O. Box 35 • Guayama, Puerto Rico 00785 • Telefax 787-864-9271

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

**To the Honorable Mayor and
Members of the Municipal Legislature
Municipality of Naguabo
Naguabo, Puerto Rico**

Compliance

We have audited the compliance of the Municipality of Naguabo, Puerto Rico (the "Municipality") with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the fiscal year ended June 30, 2004. The Municipality's major federal programs are identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts and grants, applicable to each of its major federal programs is the responsibility of the Municipality's management. Our responsibility is to express an opinion on the Municipality's compliance based on our audit.

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

As discussed in the accompanying Schedule of Findings and Questioned Costs listed in the Table of Contents, the Municipality did not comply with the requirements regarding cash management; procurement and suspension and debarment; and applicable special tests and provisions that are applicable to its Section 8 Housing Choice Vouchers and Community Development Block Grants/Small Cities Program. Compliance with such requirements is necessary, in our opinion, for the Municipality to comply with requirements applicable to that program.

INDEPENDENT AUDITORS' REPORT

Page 2

In our opinion, except for the instances of non-compliance identified above, the Municipality complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2004. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying Schedule of Findings and Questioned Costs.

Internal Control Over Compliance

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

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Municipality's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts and grants. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as item 04-01 and 04-06.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However we believe none of the reportable conditions described above to be material weakness.

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

Mendoza & Ramos
MENDOZA & RAMOS

CERTIFIED PUBLIC ACCOUNTANTS, C.S.P.

Guayama, Puerto Rico
January 27, 2005

Stamp number 2026979 was
affixed to the original of this
report



PART III

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

SECTION I – SUMMARY OF AUDITORS' RESULTS

Financial Statements

Type of auditors' report issued: Unqualified Opinion Qualified Opinion
 Adverse Opinion Disclaimer Opinion

Internal control over financial reporting:

• Reportable condition(s) identified? Yes None Reported

• Material weakness(es) identified? Yes No

Noncompliance material to financial statements noted? Yes No

Federal Awards

Internal control over major programs:

• Reportable condition(s) identified? Yes None Reported

• Material weakness (es) identified? Yes No

Type of auditors' report issued on compliance for Major Programs: Unqualified Opinion Qualified Opinion
 Adverse Opinion Disclaimer Opinion

Any audit finding disclosed that are required to be reported in accordance with OMB Circular A-133? Yes No

The Municipality's major programs were: 1

CFDA Number	Name of Federal Program
14.219	Community Development Block Grants / Small Cities Program
14.871	Section 8 Housing Choice Vouchers
93.575	Child Care and Development Block Grant

Dollar threshold used to distinguish between Type A and Type B Programs: \$300,000

Auditee qualified as low-risk auditee? Yes No

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

SECTION II – FINDINGS ON COMPLIANCE AND ON INTERNAL CONTROL OVER COMPLIANCE WITH
REQUIREMENTS APPLICABLE TO FEDERAL PROGRAMS

COMMUNITY DEVELOPMENTY BLOCK GRANT SMALL CITIES PROGRAM - CFDA 14.219

The primary objective of the Community Development Block Grant (CDBG) Small Cities Program is to develop viable urban communities by providing decent housing, a suitable living environment and expanding economic opportunities, principally for persons of low and moderate income.

The following findings and recommendations arise from our tests of compliance and internal control over compliance with the requirements applicable to the CDBG federal financial assistance program.

FINDING NUMBER	04-01
CATEGORY	COMPLIANCE
NONCOMPLIANCE	SUSPENSION AND DEBARMENT
TOPIC SENTENCE	Lack of Controls Over Suspensions and Debarments Requirement
CONDITION	<p>The Municipality does not have procedures in place to verify the status of an entity as to suspensions and debarments when contracting services or procuring goods with federal funds.</p> <p>In testing procurement, suspension and debarments, we were not able to find evidence indicating that the Municipality performs procedures to assure that the individuals and entities that receive contracts are not suspended or debarred from participation if federal programs.</p>
CRITERIA	As stated in 24 CFR 85.20 (a) and (b)(2) fiscal control and accounting As stated in 24 CFR 85.35 grantee and subgrantee must not make any award or permit any award (subgrant or contract) at any tier to any party which is debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549, Debarment and Suspension.
CAUSE	The Municipality has no policies and procedures for the use of the List of Parties Excluded from federal procurement or non-procurement programs to assure that they do not award assistance to listed parties.
EFFECT	As a result of this deficiency, the Municipality could have procured goods or services from organizations and individuals that are suspended or debarred which could result in cost disallowances by the federal awarding agency.
RECOMMENDATION	The Municipality should amend their procurement procedures and include a step to verify whether or not the individual or entity is on the list of parties excluded from federal participation in procurement and nonprocurement programs. The Municipality should also require the entities or individuals to submit a certification stating that they are not suspended or debarred.
QUESTIONED COSTS	None
MANAGEMENT RESPONSE	We'll amend our construction contract model in Secretarial Municipality Office to incorporate the procurement, suspension and debarment clauses for contracts regarding federal funds.

Contact Person: Mr. Héctor E. Machín, Finance Office Director
 Mr. William Vázquez, Municipality Secretary

Tel. 787-874-3040

FINDING NUMBER	04-02
CATEGORY	INTERNAL CONTROLS OVER COMPLIANCE
NONCOMPLIANCE	PROCUREMENT
TOPIC SENTENCE	Deficiencies in the procurement and contracting procedures (Prior Year Finding Number 03-III-07)
CONDITION	<p>In testing procurement procedures followed by the Municipality, we examined annual auctions files regarding municipality streets pavement and repavement and merchant plaza improvements. Our test revealed the following:</p> <ul style="list-style-type: none"> - Contracts are not prepared for each of the pavement or repavement works requested. Instead, at the beginning of the fiscal year, an annual general contract for all pavement or repavement works is granted to the contractor to which the auction was adjudged. Such contracts lack of most of the federal required provisions and did not establish Municipality and contractor's responsibilities nor work description. - Nine out of 18 (50%) auctions bidders were not included on the Municipality's bidders register ("Registro de Licitadores") as required by the Municipalities Law.
CRITERIA	<p>As stated in 24 CFR 85.36(i) a grantee's and subgrantee's contracts must contain, among others, a provision regarding (1) administrative, contractual, or legal remedies in instances where contractors, violate or breach contract terms, and provide for such sanctions and penalties as may be appropriate; (3) compliance with executive order 11246 of September 24, 1965, entitled "Equal Employment Opportunity"; (5) compliance with the Davis Bacon Act; (10) access by the grantee, the subgrantee, the Federal grantor agency, the Comptroller General of the United States or any of their duly authorized representatives to any books, documents, papers, and records of the contractor; (11) retention of all required records for three years after grantees or subgrantees make final payments and all other pending matters are closed; (13) compliance with all applicable environment standards and policies.</p> <p>24 CFR 85.36 (c)(4) grantee and subgrantees will ensure that all prequalified lists of persons, firms, or products which are used in acquiring goods and services are current and include enough qualified sources to ensure maximum open and free competition. As per Chapter VIII, Section 4, of the "Reglamento sobre Normas Básicas para los Municipios de PR", municipalities could maintain a classified bidder's register by goods or services.</p>
CAUSE	The Municipality has not ensured that all contracts granted counts with the required provisions due to the lack of understanding of the applicable Federal regulation. In addition, Municipality's personnel understood that by granting to the contractor an annual general contract for all pavement and repavement works was sufficient to comply with all applicable federal and local laws and regulations.

EFFECT No preparing contracts for services required, or contracts failure to contain all required federal provisions, could expose the Municipality to contractors non compliance with works requested and being liable for contractors non compliance with applicable federal laws and regulations contained within the required provisions.

RECOMMENDATION The Municipality should prepare a contract for each of the works requested to a contractor. In addition, should verify and amend their contracts in order to include all required provisions as required by Federal regulations.

QUESTIONED COSTS NONE

MANAGEMENT RESPONSE The Finance Office Director will ensure that contracts are repared for all pavements or repayments works. Also, said official will supervise more closely the Purchasing Office personnel to ensure that auction bidders are included on the Municipality's bidders register.

Contact Person: Mr. Héctor E. Machín, Finance Office Director

Tel. 787-874-3040

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

SECTION 8 HOUSING CHOICE VOUCHERS – CFDA 14.871

The Housing choice Voucher Program (HCVP) provides rental assistance to help very low income families afford decent, safe, and sanitary rental housing. The HCVP is administered by local public housing agencies (PHA's) authorized under State law to operate housing programs within an area or jurisdiction. The PHA accepts the application for rental assistance, selects the applicant for admission, and issues the selected family a voucher confirming the family's eligibility for assistance. The family must then find and lease a dwelling unit suitable to the family's needs and desires in the private rental market. The PHA pays the owner a portion of the rent (a housing assistance payment (HAP)) on behalf of the family.

The following findings and recommendations arise from our tests of compliance and internal control over compliance with the requirements applicable to the Section 8 Housing Choice Vouchers federal financial assistance program.

FINDING NUMBER	04-03
CATEGORY	COMPLIANCE
NONCOMPLIANCE	CASH MANAGEMENT
TOPIC SENTENCE	Non-Compliance with cash management requirement
CONDITION	<p>Section 8 Housing Choice Voucher Program does not have adequate controls over the timing of disbursements once the federal funds are received.</p> <p>During the fiscal year 2003-2004, the Municipality received \$528,158 from Section 8 Housing Choice Vouchers grant funds. In order to determine compliance with cash management requirement, we selected for testing one of the ten remittances received during the fiscal year amounting \$52,217 (10%). The time elapsed between the receipt and the disbursement of such funds was for more than three months.</p> <p>We also noted that during the fiscal year 2003-2004, monthly bank account balance maintained by the Program was between \$36,000 and \$164,000, before next monthly receipt.</p>
CRITERIA	As stated in 24 CFR 85.21 and 31 CFR 205.33, Subpart B, grantees must minimize the time elapsing between the drawdown of Federal funds from the Federal government and their disbursements for Federal program purposes.
CAUSE	Monthly deposits transferred by HUD are supported by an annual contribution contract based on an estimated number of occupied units and annual payments to owners. Due to the non identification of available dwelling units within the Naguabo territory, the Program counts with a number of vouchers much higher than the amount of dwelling units available for rent. Such situation causes that, even when the Program counts with the necessary funds to provide housing assistance, these could not be expended due to the lack of units to be rented.
EFFECT	If the recipient fails to expend those Federal assistance funds within a reasonable period or fails to establish procedures to minimize the time elapsing between cash advances and the disbursements, the Municipality could be adversely affected in the benefits they are entitled to receive in the future.
RECOMMENDATION	The Program should implement adequate internal control procedures which allow the promptly use of federal funds received.
QUESTIONED COSTS	None
MANAGEMENT RESPONSE	The disbursements criticized by the external auditors represents reimbursements made to the Municipality of Naguabo. The practice is that the Municipality incurs the disbursements on behalf of the Federal Programs Office and afterwards, the latter Office reimburses the Municipality when the federal funds are received. To correct the

situation criticized. we'll invoiced on a monthly basis the Federal Programs Office when the Municipality incurs the expenditures and afterwards the Municipality will be reimburse when the federal funds are received. In the past, the invoice process was not done on a timely basis to the Federal Programs Office.

Also, we'll implement a direct deposit system for Section 8 participants. We expect to implement said system effective February, 2005.

Finally, the Finance Office Director will monitor more closely cash management to ensure federal requirements are complied with.

Contact Person: Mr. Héctor E. Machín, Finance Office Director

Tel. 787-874-3040

FINDING NUMBER 04-04
CATEGORY COMPLIANCE
NONCOMPLIANCE SPECIAL TESTS AND PROVISIONS
TOPIC SENTENCE PHA amounts were incorrectly calculated (Prior Year Finding Number 03-III-05)

CONDITION In testing special test and provisions regarding housing assistance payments (HAP), we selected 20 out of 115 Program's participant's files (17%) to corroborate participant income eligibility, total tenant payment (TTP) and housing assistance payment (PHA) amounts. Our test revealed the following:

- In three out of 20 cases (15%), payment standard amounts (PSA) considered as part of HAP determination (HUD Form 50058) were incorrect and not in accordance with what it was established in the Program's administrative plan.
- In one out of 20 cases (5%), family dependents were not considered for purpose of determining TTP and final HAP amount.
- In one out of 20 cases (5%), a member of a family which was over 18 year old was considered as a dependent for purposes of determining HAP amount.
- In two out of 20 files examined (10%), we found income evidence which was not considered for purpose of determining HAP amount.

CRITERIA The foregoing conditions are not in accordance with 24 CFR 982.54(c) and (d)(14) which establishes that the PHA must administer the program in accordance with the PHA administrative plan. The administrative plan must cover PHA policies regarding the process for establishing and revising payment standards, including affordability adjustment.

24 CFR 5.603(d) defined a dependent as a member of the family, other than the family head or spouse, who is under 18 years of age, a person with disability, or is a full-time student.

CAUSE The first condition was due to the Program's personnel use of a non effective HUD fair market rent schedule at the moment of determining payment standard amounts. Income evidence not considered for purpose of determining TTP, HAP and participant's eligibility was due to participant's works instability. Other conditions were due to Program's personnel non intentional misstatements.

EFFECT Selection process from the waiting list could be questioned by legating preference among applicants. Such lack of control, also, could cause that ineligible participants could be admitted into the Program cause costs disallowance.

RECOMMENDATION At the moment of determining HAP and TTP amounts, Program personnel should adhere to the policies and procedures established by HUD approved Program's Administrative Plan.

QUESTIONED COSTS None

MANAGEMENT RESPONSE The Federal Programs Director will supervise more closely the Section 8 Program to ensure the participants accomplish with eligibility procedures.

Contact Person: Mrs. Elizabeth López, Federal Office Director

Tel. 787-874-3040

FINDING NUMBER	04-05
CATEGORY	COMPLIANCE
NONCOMPLIANCE	SPECIAL TESTS AND PROVISIONS
TOPIC SENTENCE	Rent amounts paid were not in accordance with the Program's administrative plan
CONDITION	<p>Rent amounts paid to owners of Section 8 Housing Choice Voucher Program's dwelling units, were not in accordance with Public Housing Authority administrative plan. According to the PHA administrative plan, the amount of rent to be paid to owners should be 90% of the fair market rent based on HUD effective tables.</p> <p>In order to test compliance with such policy, we selected for testing 20 participants/landlords files. In 17 out of 20 (85%) participant files examined, we found that the amounts of rent paid to the owners of the dwelling units were below HUD 90% fair market rent amount.</p>
CRITERIA	<p>The foregoing condition is not in accordance with 24 CFR 982.54(c) and (d)(15) which establishes that the PHA must administer the program in accordance with the PHA administrative plan. The administrative plan must cover PHA policies regarding the method of determining that rent to owner is a reasonable rent (initially and during the term of a HAP contract). In addition, 24 CFR 982.153(b)(13) establishes that in administering the program, the PHA must determine the maximum rent to the owner, and whether the rent is reasonable.</p>
CAUSE	<p>The Program decided not to pay to the owners of the dwelling units an amount of rent higher to the amount expected or requested by them.</p>
EFFECT	<p>The Municipality might be making payments in excess or below the established fair market rent amounts. Also, it could adversely affect the Municipality's ability to be awarded with future grants.</p>
RECOMMENDATION	<p>The Program should adhere to the methods established in the administrative plan regarding reasonable rent determination and rent amounts to be paid to owners. If a different practice is follow, PHA administrative plan should be amended and informed to HUD.</p>
QUESTIONED COSTS	None
MANAGEMENT RESPONSE	<p>Because of the Municipality's current limited financial position we have been unable to comply with this federal requirements. We'll strive to establish a reasonable rent amount based on our available funds.</p>

Contact Person: Mrs. Elizabeth López, Federal Office Director
Mr. Héctor E. Machín, Finance Office Director

Tel. 787-874-3040

FINDING NUMBER 04-06
 CATEGORY INTERNAL CONTROLS OVER COMPLIANCE
 NONCOMPLIANCE ELIGIBILITY
 TOPIC SENTENCE Lack of adequate controls over participants' eligibility evaluation (Prior Year Finding Num. 03-III-04)

CONDITION In testing internal controls over compliance, we selected 20 participants' files from a total of 115 Program participants (17%). Among those implemented procedures, applicants are requested to provide various documents before they are admitted into the Program.

Our test revealed that five out of 20 (40%) participant's files selected for testing does not contain at least one of the following documents:

<u>Documents</u>	<u>Quantity</u>
Negative certification from the PR Unemployment Department	1
Affidavit regarding family composition and income	3
Negative certification from "ASUME"	1

CRITERIA The above condition is not in compliance with 24 CFR 85.20(3); 982.201(e) and 982.516 which establishes that effective controls must be maintained for all grant financed activities. The PHA must receive information verifying that an applicant is eligible within the period of 60 days before the PHA issues a voucher to the applicant.

CAUSE This condition arises because during participant's admission and renewal process, applicants are not providing to the Program with all the required documents. Thereafter, Program personnel are being experiencing difficulties in obtaining those documents which were not provided by the participants before they were admitted or re-evaluated into the Program.

EFFECT Failure to obtain all required documentation as part of participant's eligibility determination may result in the possibility of not preventing, detecting and correcting, on a timely basis, significant instances of noncompliance that may expose the Municipality to cost disallowances.

RECOMMENDATION The Program should obtain all required documents before a participant is admitted or re-evaluated into the Program. They should also conduct periodic monitoring and follow up procedures that allow them to ensure that all required documents are obtained during the admission process and throughout the year.

QUESTIONED COSTS None

MANAGEMENT RESPONSE The Federal Programs Director will supervise more closely the Section 8 Program to ensure participants file are complete with their required documentation.

Contact Person: Mrs. Elizabeth López, Federal Office Director
Mr. Héctor E. Machín, Finance Office Director

Tel. 787-874-3040

END OF SCHEDULE

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO**

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004**

The following schedule contains the finding number, title, questioned costs and status of each of the findings included in the schedule of findings and questioned costs relative to federal awards for the year ended June 30, 2003 as required by OMB Circular A-133.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NAGUABO, PUERTO RICO**

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDING
FOR THE YEAR ENDED JUNE 30, 2004**

FISCAL YEAR	FINDING NUMBER		CFDA NUMBER	QUESTIONED COST	COMMENTS
2003	03-II-01	Reportable Condition Over Capital Assets		NONE	Situation was corrected.
	03-II-02	Reportable Condition Over Bank Account		NONE	Situation was corrected.
	03-III-01	Cash Management – Bank Accounts	11.307 / 10.760	NONE	Situation was corrected.
	03-III-02	Cash Management – Excess Cash Balances	11.307 / 14.228 / 10.760	NONE	Situation was corrected.
	03-III-03	Equipment & Real Property Management	14.228 / 95.575	NONE	Situation was corrected.
	03-III-04	Eligibility Test – Lack of Documentation	14.871	NONE	Situation prevails during this fiscal year. Refer to finding number 04-06.
	03-III-05	Eligibility Test - Evidence of Income	14.871	NONE	Situation prevails during this fiscal year. Refer to finding number 04-04.
	03-III-06	Period of Availability	95.575	NONE	Situation was corrected.
	03-III-07	Procurement and Suspension	11.307	NONE	Situation prevails during this fiscal year. Refer to finding number 04-02.
	03-III-08	Procurement and Suspension and Debarment	95.575	NONE	Situation was corrected.
	03-III-09	Special Test and Provisions	14.871	NONE	Situation was corrected.

END OF SCHEDULE