

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

**MUNICIPIO DE NAGUABO
AUDITORÍA 2009-2010
30 DE JUNIO DE 2010**

MUNICIPALITY OF NAGUABO

**Basic Financial Statements,
Notes to Basic Financial Statements and
Required Supplemental Schedule**

Fiscal Year Ended June 30, 2010

**MUNICIPALITY OF NAGUABO
COMMONWEATH OF PUERTO RICO**

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Independent Auditors' Report

The Honorable Mayor, Members of the
Municipal Legislature and People of
the 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 of the Commonwealth of Puerto Rico (the "Municipality"), as of and for the year ended June 30, 2010, which collectively comprise the Municipality's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Municipality's management. Our responsibility is to express opinions on these financial statements based on our audit.

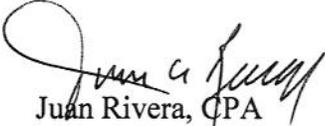
We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and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

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Naguabo of the Commonwealth of Puerto Rico, as of June 30, 2010, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Audit Standards*, we have also issued our report dated December 27, 2010 on our consideration of the Government's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreement and other matters. The purpose of that report is to describe the scope of our testing of internal control over a financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting compliance. That report is an integral part of an audit performed in accordance with *Government Audit Standards* and should be considered in assessing the results of our audit.

The *Management's Discussion and Analysis* and the *Budgetary Comparison Schedule* on page 3 through 16 and 63 through 63 are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Municipality of Naguabo of the Commonwealth of Puerto Rico basic financial statements. The introductory section, combining and individual non-major fund financial statements, and statistical section are presented for purposes of additional analysis and are not a required part of the basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is also not a required part of the basic financial statements of Municipality of Naguabo of the Commonwealth of Puerto Rico, the combining and individual non-major fund financial statements and the schedule of expenditures of federal awards have been subjected to the auditing procedure applied in the audit of the basic financial statements and in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and accordingly we express no opinion on them.


Juan Rivera, CPA
License 2214

December 27, 2010
Toa Baja, Puerto Rico



Stamp No 2579457 of the Puerto Rico Society of Certified Public Accountants was affixed to the record copy of this report.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Management's Discussion and Analysis
June 30, 2010

As management of the Municipality of Naguabo (the Municipality), we offer readers the following discussion and analysis of the Municipality's financial activities reported in the accompanying basic financial statements for the fiscal year ended June 30, 2010. We encourage readers to consider the information presented here in conjunction with additional information that is furnished in the accompanying financial statements, which follow this narrative.

FINANCIAL HIGHLIGHTS

Government-Wide Highlights:

- The Municipality's assets amounted to \$50,544,348 at June 30, 2010, of which \$41,777,236 consist of capital assets (net of accumulated depreciation and amortization of \$9,165,395), \$5,951,544 consist of cash (of which \$1,940,276 are restricted for specific purposes), and \$2,815,568 consist of accounts receivable.
- The Municipality's liabilities amounted to \$14,334,598 at June 30, 2010, of which \$6,818,109 consist of bonds and notes payable, \$6,151,241 consist of accounts payable and accrued liabilities, \$600,565 consist of accrued compensated absences.
- The Municipality's assets exceeded its liabilities (net assets/surplus) by \$36,209,751 at June 30, 2010.
- The Municipality's revenues amounted to \$13,319,177 for the fiscal year ended June 30, 2010, of which \$8,556,957 arose from taxes, \$4,394,166 arose from intergovernmental grants and contributions, \$17,949 arose from interests on deposits, \$83,678 arose from miscellaneous revenue streams and \$266,427 arose from charges from services.
- The Municipality's expenses amounted to \$10,170,867 for the fiscal year ended June 30, 2010, of which \$8,141,279 were incurred in providing direct services and benefits to citizens in relation to urban and economic development, health and sanitation, public safety, public housing and welfare, culture, recreation and education. In addition, the Municipality incurred \$142,138 of its total expenses, in interests related to its long-term obligations, and \$1,887,454 in general government activities to support the Municipality's functions and programs. The Municipality's expenses include depreciation in the amount of \$1,036,081 for the fiscal year ended June 30, 2010.
- The Municipality's net assets increased by \$3,148,310 during the fiscal year ended June 30, 2010.

Governmental Funds' Highlights:

- The total fund balance of governmental funds amounted to \$848,525 at June 30, 2010, of which \$7,473,065 is either restricted, assigned or non-spendable, while \$6,624,540 represents an unassigned deficit.
- The total fund balances of governmental funds increased by \$1,021,521 during the fiscal year ended June 30, 2010.

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OVERVIEW OF THE BASIC FINANCIAL STATEMENTS

The purpose of financial reporting is to provide external users of basic financial statements with information that will help them to make decisions or draw conclusions about the Municipality. There are many external parties that use the basic financial statements of the Municipality; however, these parties do not always have the same specific objectives. In order to address the needs of as many parties as reasonably possible, the Municipality, in accordance with required financial reporting standards, presents this Management's Discussion and Analysis (MD&A) as an introduction to the accompanying basic financial statements. This narrative represents an overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2010. Because this MD&A is designed to focus on the current year activities, resulting changes and currently known facts, we encourage readers to consider the information presented in this MD&A in conjunction with the additional information furnished in the accompanying basic financial statements.

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

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

a) Government-wide Financial Statements

The GWFS are composed of: (1) the statements of net assets (SNA) and (2) the statement of activities (SA). These financial statements can be found immediately following this MD&A. GWFS are designed to provide readers with a broad overview of the Municipality's operations as a whole in a manner similar to private-sector business. These statements provide short-term and long-term information about the Municipality's financial position, which assist the Municipality's management to determine the economic condition at June 30, 2010. The GWFS are prepared using methods that are similar to those used by most private businesses.

1. Statement of Net Assets

The purpose of SNA is to attempt to report all assets owned and all liabilities owed by the Municipality. The Municipality reports of all of its assets when it acquires ownership over the assets and reports all of its liabilities when they are incurred. For example, the Municipality reports buildings and infrastructure as assets, even though they are not available to pay the obligations incurred by the Municipality. On the other hand, the Municipality reports liabilities, such as claims and judgments, bonds and notes payable, obligations under capital leases, compensated absences and certain accounts payable and

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accrued liabilities, even though these liabilities might not be paid until several fiscal years into the future.

The difference between the Municipality's total assets and total liabilities reported in SNA is presented as *Net Assets*, which is similar to the total owners' equity reported by a commercial enterprise in its financial statements. Although the purpose of the Municipality is not to accumulate net assets, as this amount increases or decreases over time, such amount represents a useful indicator of whether the financial position of the Municipality is either improving or deteriorating, respectively.

2. Statement of Activities

The SA presents information showing how the Municipality's net assets changed during the fiscal year ended June 30, 2010, by presenting all of the Municipality's revenues and expenses. As previously discussed, the items reported in SA are measured in a manner similar to the approach used by a commercial enterprise in that revenues are recognized when earned or established criteria are satisfied, and expenses are recorded when incurred by the Municipality. Consequently, revenues are reported even when they may not be collected for several months after the end of the fiscal year and expenses are recorded even though they may not have used cash during the current year.

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

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

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

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

b) *Governmental Fund Financial Statements*

The Municipality's GFFS consist of: (1) the Balance Sheet – Governmental Funds and (2) the Statement of Revenues, Expenditures and Changes in Fund Balances – Governmental Funds. These financial statements report the financial position and results of operations of the

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Municipality's governmental funds, with an emphasis on the Municipality's major governmental funds.

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Municipality, like most other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Each fund is considered an independent fiscal entity accounted for within a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenue, and expenditures. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with legal, financial and contractual provisions.

Governmental funds are used to account for all of the services provided by the Municipality. These funds are used to account for essentially the same functions reported as governmental activities in the GWFS. Unlike GWFS, the focus of GFFS is directed to specific activities of the Municipality rather than the Municipality as a whole; therefore, GFFS report the Municipality's operations in more detail than the GWFS.

GFFS provide a detailed short-term view of the Municipality's finances that assist in determining whether there will be adequate financial resources available to meet the current needs of the Municipality, which is, evaluating the Municipality's near-term financing requirements. For financial reporting purposes, the Municipality classifies its governmental funds within the following types: (1) General Fund, (2) Debt Service Fund, (3) Special Revenue Funds, (4) Capital Projects Funds and (5) Permanent Funds.

GFFS are prepared on an accounting basis that is significantly different from that used to prepare GWFS. In general, GFFS focus on near-term inflows and outflows of expendable financial resources, consequently, generally measure and account for cash and other assets that can easily be converted to cash. For example, amounts reported on the balance sheet include capital assets within a very short period of time, but do not include capital assets such as land and buildings. Governmental fund liabilities generally include amounts that normally are going to be paid within a very short period after the end of the fiscal year. The difference between a fund's total assets and total liabilities is reported as the fund balance, and generally indicates the amount that can be used to finance the next fiscal year's activities. Likewise, the operating statement for governmental funds reports only those revenues and expenditures that were collected in cash or paid with cash, respectively, during the current fiscal year or very shortly after the end of the fiscal year.

Because the focus of GFFS is narrower than that of the GWFS, it is useful to compare the fund information presented for governmental funds with similar information presented for governmental activities in the GWFS. By doing so, readers may better understand the long-term impact of the Municipality's near-term financial decisions. Both the governmental funds' balance sheet and the governmental funds' statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate the comparison between governmental funds and the governmental activities reported in the government-wide financial statements.

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The Municipality has four major governmental funds. Each major fund is presented in a separate column in the governmental funds' balance sheet and the governmental funds' statement of revenues, expenditures and changes in fund balances. The three major governmental funds are: (1) General Fund, (2) Debt Service Fund, and (3) Capital Improvements Bonds Fund.

c) Notes to Basic Financial Statements

The NBFS provide additional information that is essential for a full understanding of the data provided in the GWFS and GFFS. The NBFS can be found immediately following the basic financial statements.

d) Other Supplementary Information

The basic financial statements are followed by a section of other supplementary information consisting of: (1) Budgetary Comparison Schedule – General Fund and the Schedule of Expenditures of Federal Awards.

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FINANCIAL ANALYSIS OF GOVERNMENT-WIDE FINANCIAL STATEMENTS

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

Comparative Statement of Net Assets
Governmental Activities (Condensed)
June 30, 2010 and 2009

<i>Assets:</i>	<u>2010</u>	<u>2009</u>
Current assets	\$ 8,767,112	\$ 8,902,505
Non-current assets:		
Capital assets, net	41,777,236	41,523,269
Total assets	<u>50,544,348</u>	<u>50,425,774</u>
<i>Liabilities:</i>		
Current liabilities	5,781,437	8,617,897
Long-term obligations due within one year	1,779,913	1,885,412
Long-term obligations due after one year	5,638,761	7,022,901
Total liabilities	<u>13,200,111</u>	<u>17,526,210</u>
<i>Net assets:</i>		
Invested in capital assets, net of related debt	39,261,452	37,788,379
Restricted for debt service and others	5,189,753	4,841,562
Unrestricted	(8,241,454)	(9,730,377)
Total net assets	<u>\$ 36,209,751</u>	<u>\$ 32,899,564</u>

At June 30, 2010, the Municipality's current assets, amounting to \$7,144,522, are mainly composed of cash and cash equivalents (\$5,951,544), and accounts receivable (\$2,815,568), net of reserve for doubtful accounts.

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

The Municipality's non-current assets, amounting to \$41,777,236 at June 30, 2010, are substantially composed of capital assets, with a cost basis of \$50,942,631, which are reported net of accumulated depreciation and amortization of \$9,165,395.

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At June 30, 2010, the Municipality's current liabilities amounting to \$8,695,837 are mainly composed of accounts payable and accrued liabilities, and the portions due within one year of bonds and notes payable, claims and judgments and compensated absences.

The Municipality's non-current liabilities, amounting to \$5,638,761 at June 30, 2010, are mainly composed of portions due after one year of bonds and notes payable and compensated absences.

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial position. The assets of the Municipality exceeded liabilities by \$36,209,751 at June 30, 2010. The most significant portion of net assets (\$39,261,452) reflects the Municipality's investment in capital assets (e.g. land, buildings, machinery, equipment, furniture, fixtures, infrastructure, etc.), net of all related debt still outstanding that was issued to acquire, construct or improve those assets. The Municipality uses these capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although the Municipality's investment in capital assets is reported net of the outstanding related debt, the resources needed to repay that debt must be provided by other sources, since capital assets cannot be used to liquidate these liabilities.

Another significant portion of net assets (\$2,723,941) at June 30, 2010, represents resources that are restricted for capital project.

The remaining component of total net assets consists of unrestricted net liabilities amounting to \$8,241,454 at June 30, 2010. These unrestricted net liabilities are the consequence of previous budgets that did not provide sufficient funding for incurred long-term obligations, such as bonds and notes payable, compensated absences, claims and judgments, certain obligations under capital leases, etc. Historically, a significant portion of such obligations has been budgeted on a pay-as-you-go basis.

The total net assets of the Municipality increased by \$3,148,310 for the fiscal year ended June 30, 2010.

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

Comparative Statement of Activities
Governmental Activities (Condensed)
Fiscal Years Ended June 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Program revenues:		
Program-specific operating grants and contributions	\$ 2,705,085	\$ 826,453
Program-specific capital grants and contributions	360,000	1,514,168
Charges for services	266,427	303,029
Total program revenues	<u>3,331,512</u>	<u>2,643,650</u>
General revenues:		
Property taxes	6,502,682	5,966,450
Municipal license taxes	989,016	887,486
Construction excise taxes	456,644	670,220
Sales and use taxes	608,615	588,398
Unrestricted grants and contributions	1,329,081	1,523,247
Other general revenues, including interests on deposits	101,627	329,207
Total general revenues	<u>9,987,665</u>	<u>9,965,008</u>
Total revenues	<u>13,319,177</u>	<u>12,608,658</u>
Program expenses:		
General government	1,887,454	1,148,085
Urban and economic development	1,861,951	3,362,134
Public safety	1,120,291	2,387,182
Health and sanitation	2,588,752	3,176,856
Culture, recreation and education	1,020,254	1,364,634
Public housing and welfare	1,550,031	1,503,045
Interest on long-term obligations	142,134	237,293
Total expenses	<u>10,170,867</u>	<u>13,179,229</u>
Net increase (decrease) in net assets	3,148,310	(570,571)
Net assets, at beginning of fiscal year	33,434,563	33,237,183
Prior-period adjustments	(373,122)	232,952
Net assets, at end of fiscal year	<u>\$ 36,209,751</u>	<u>\$ 32,899,564</u>

As previously mentioned the Municipality's net assets increased by \$3,148,310 during the current fiscal year. Approximately \$8,556,957 of the Municipality's total revenues for the current fiscal year came from property, municipal license, construction excise taxes and sales and use taxes. Grants, contributions and charges for services (program revenues) amounting to (\$4,660,593),

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provided 35% of the total revenues for the current fiscal year. Interests on deposits and miscellaneous revenues provided the remaining 1% of total revenues.

The Municipality's expenses cover a wide range of services. The largest expenses of the Municipality for the fiscal year ended June 30, 2010 were related to: (1) urban and economic development (\$1,861,951), (2) health and sanitation (\$2,588,752), (3) public housing and welfare (\$1,550,031), (4) public safety (\$1,120,291), (5) culture, recreation and education (\$1,020,254), (6) general administrating and operating costs (\$1,887,454), which were classified as "general government", and (7) interest on long-term obligations (\$142,134). These expenses include depreciation and amortization of capital assets and deferred charges in the amounts of \$9,165,395 for the fiscal year ended June 30, 2010.

FINANCIAL ANALYSIS OF GOVERNMENTAL FUNDS

Analysis of Financial Position of Governmental Funds

As discussed earlier, the Municipality uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows, and balances of expendable resources. Such information is useful in assessing the Municipality's compliance with finance-related legal requirements. Specifically, unreserved fund balance may serve as a useful measure of the Municipality's net resources available for spending at the end of the fiscal year.

At June 30, 2010, the total assets of governmental funds amounted to \$10,144,786, which consisted principally of: (1) cash of \$5,951,544 (2) accounts receivable, \$2,777,568 net of reserve for doubtful accounts, and (3) inter-fund receivables of \$1,360,674. Such assets are restricted for debt service, capital projects, encumbrances and other specific purposes.

At June 30, 2010, the total liabilities of governmental funds amounted to \$9,296,261, which consisted principally of: (1) deferred revenues of \$1,143,789 (2) accounts payable and accrued liabilities of \$6,072,442 (3) inter-fund payables \$1,377,674 and (4) matured bonds and interests due and payable of \$702,356.

The fund balances of governmental funds increased by \$1,021,521 during the fiscal year ended June 30, 2010.

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Condensed Balance Sheet - Governmental Funds
June 30, 2010 and 2009

	2010	2009
Assets:		
Total assets - major governmental funds	\$ 7,714,835	\$ 8,066,922
Total assets - other governmental funds	2,429,951	2,127,486
Combined total assets	10,144,786	10,194,408
Liabilities:		
Total liabilities - major governmental funds	8,252,231	9,811,306
Total liabilities - other governmental funds	1,044,030	694,958
Combined total liabilities	9,296,261	10,506,264
Fund balances:		
Reserved - major governmental funds	6,087,144	3,664,128
Reserved - other governmental funds	1,385,921	1,432,528
Unreserved – all governmental funds	(6,624,540)	(5,408,512)
Combined total fund balances	848,525	(311,856)
Total liabilities and fund balances	\$ 10,144,786	\$ 10,194,408

Major Governmental Funds

General fund (GF) – The GF is the principal operating fund of the Municipality. The GF's total assets amounted to \$2,692,253 at June 30, 2010. Such assets consist principally of: (1) cash (\$39,818), (2) property, municipal license, construction excise tax, and sales and use tax receivables (\$919,047), and (3) short-term and long-term amounts due from other funds (\$566,441).

The GF's total liabilities amounted to \$7,232,439 at June 30, 2010. Such liabilities are composed mainly of: (1) account payable and accrued liabilities (5,616,029), (2) deferred revenues (\$988,088), and (3) short-term and long-term amounts due to other funds (\$628,322).

At the end of the current fiscal year, unassigned fund deficit of the GF amounted to \$6,625,702, while total fund deficit amounted to \$4,540,186.

Debt service fund (DSF) – The DSF's total assets amounted to \$1,803,718 at June 30, 2010, which consist mainly of restricted cash in fiscal agent (\$1,549,783) and receivables from intergovernmental grants contributions (\$31,610). The DSF's total liabilities amounted to \$702,384 at June 30, 2010, which is mainly composed of: (1) matured bonds due and payable (\$645,000), and (2) matured interest due and payable (\$57,356). At the end of the current fiscal year, DSF's total reserved fund balance reached \$1,101,334.

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Capital improvements fund (CIBF) - The CIBF's total assets amounted to \$3,218,864 at June 30, 2010, which consist mainly of cash (\$2,436,181), and amounts due from other funds (\$782,341). The CIBF's total liabilities amounted to \$317,408 at June 30, 2010, which is composed of: (1) accounts payable and accrued liabilities (\$18,156), and (2) amounts due to other governmental funds (\$299,252). At the end of the current fiscal year, CIBF's total and reserved fund balance reached \$2,901,456.

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COMMONWEALTH OF PUERTO RICO
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Analysis of Operating Results of Governmental Funds

**Condensed Statement of Revenues, Expenditures and
Changes in Fund Balances - Governmental Funds (Condensed)
Fiscal Years Ended June 30, 2010 and 2009**

	2010	2009 as restated,
<i>Revenues:</i>		
Total revenues - major governmental funds	\$ 10,509,683	\$ 12,657,224
Total revenues - other governmental funds	2,430,389	2,864,958
Combined total revenues	12,940,072	15,522,182
<i>Expenditures:</i>		
Total expenditures - major governmental funds	8,972,833	12,814,587
Total expenditures - other governmental funds	2,481,231	3,067,743
Combined total expenditures	12,588,551	15,882,330
<i>Excess of expenditures over revenues</i>	351,521	(360,148)
<i>Other financing sources, net:</i>		
Other financing sources, net - major governmental funds	665,765	946,697
Other financing sources, net - other governmental funds	4,235	758,303
Combined other financing sources, net	670,000	1,705,000
<i>Excess of revenues and other financing sources over expenditures and other financing uses</i>	1,021,521	1,344,852
<i>Fund balances, at beginning of fiscal year</i>	(311,857)	(1,612,603)
<i>Prior-period adjustments</i>	138,861	(44,105)
<i>Fund balances, at end of fiscal year</i>	\$ 848,525	\$ (311,856)

Major Governmental Funds

General fund – The total fund balance of the GF increase by \$867,967 during current fiscal year.

Approximately \$7,636,6285 of the GF's total revenues for the current fiscal year came from property, municipal license, construction excise taxes and sales and use taxes, while (\$1,329,081) resulted from intergovernmental grants and contributions.

COMMONWEALTH OF PUERTO RICO
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Management's Discussion and Analysis
June 30, 2010

The largest expenses of the GF for the fiscal year ended June 30, 2010 were related to: (1) health and sanitation (\$2,444,691), (2) urban and economic development (\$1,500,026), (3) public housing and welfare (\$590,064), (4) public safety (\$1,071,854), (5) general expenditures (\$1,843,644), which were classified as "general government", (6) culture, recreation and education (\$632,717), and (7) principal and interest obligations (\$66,520).

Debt service fund (DSF) – The total fund balance of the DSF increased by \$82,383 during current fiscal year. Approximately 61% (\$570,099) of DSF's total revenues for the current fiscal year came from restricted property taxes. DSF's total expenditures for the current fiscal year came from principal and interests (\$954,126). Other financing sources amounted to \$99,808, from transfers.

Capital improvements fund (CIBF) – The total fund balance of the CIBF increased by \$117,777 during current fiscal year. CIBF's total revenues for the current fiscal year came from intergovernmental grant and contributions and miscellaneous revenues amounting to \$366,392. CIBF's total expenditures for the current fiscal year came principally from capital outlays (\$892,373). Other financing sources amounted to \$663,608 mainly from proceeds from issuance of bonds and transfers.

CAPITAL ASSETS AND DEBT ADMINISTRATION

a) Capital Assets

The Municipality has invested \$50,942,631 in capital assets used in governmental activities, which have an accumulated depreciation and amortization of \$9,165,395 at June 30, 2010. The net capital assets increased during the current fiscal year due to the current fiscal year's capital additions (\$1,802,032), which were partially offset by the depreciation and amortization expense.

b) Debt Administration

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

At June 30, 2010, the Municipality's total bond debt amounted to \$6,048,000 consisting of bonds payable. Such debt is backed by the full faith and credit of the Municipality. The Municipality has also certain outstanding notes payable. Such notes payable also decreased during the current fiscal year mainly due to the principal payments made during the same period.

REQUEST FOR INFORMATION

This financial report is designed to provide a general overview of the Municipality's finances for all of the Municipality's citizens, taxpayers, customers, investors and creditors. This financial report seeks to demonstrate the Municipality's accountability for the money it receives.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Management's Discussion and Analysis
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Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Municipality of Naguabo, Department of Finance.

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Statement of Net Assets
June 30, 2010

Assets		Governmental activities
Current assets:		
Cash in commercial banks	\$	4,011,268
Cash in fiscal agent		1,940,276
Accounts receivable		
Taxes:		
Property taxes	\$	562,384
Municipal license taxes		217,364
Construction excise taxes		159,312
Sales and use taxes		54,268
Intergovernmental grants and contributions		1,641,124
Other receivables		181,116
Total accounts receivable		<u>2,815,568</u>
Total current assets		<u>8,767,112</u>
Non-current assets:		
Capital assets, at cost:		
Depreciable capital assets	\$	29,247,918
Non-depreciable capital assets		21,694,713
Total capital assets, at cost		<u>50,942,631</u>
Less: accumulated depreciation and amortization		<u>(9,165,395)</u>
Total capital assets, net of accumulated depreciation and amortization		<u>41,777,236</u>
Total non-current assets		<u>41,777,236</u>
Total assets	\$	<u><u>50,544,348</u></u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Statement of Net Assets (concluded)
June 30, 2010

Liabilities and net assets

Current liabilities (due within one year):

Accounts payable and accrued liabilities:

Trade payables and accrued liabilities	\$	4,068,165
Intergovernmental payables		2,004,277
Deferred revenues		764,683
Accrued interests on bonds and notes payable		78,799

Total accounts payable and accrued liabilities		\$ 6,915,924
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Current portion of long-term obligations:

Bonds payable	\$	723,900
Notes payable		106,669
Compensated absences		600,565
Claims and judgments		348,779

Total current portion of long-term obligations		1,779,913
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Total current liabilities		8,695,837
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**Non-current liabilities, excluding current portion
(due in more than one year) :**

Bonds payable	\$	5,324,100
Notes payable		314,661

Total non-current liabilities		5,638,761
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Total liabilities		14,334,598
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Net assets (liabilities):

Invested in capital assets, net of related debt		39,261,452
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Restricted for:

Debt service	\$	1,079,891
Capital projects		2,723,941
Grants and contributions		1,385,921

Total restricted net assets		5,189,753
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Unrestricted		(8,241,454)
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Total net assets	\$	36,209,751
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The accompanying notes to the basic financial statements are an integral part of this statement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Statement of Activities
Fiscal Year Ended June 30, 2010

Functions/programs	Expenses, including depreciation and amortization \$1,036,080	Program revenues		Net expenses and changes in net assets	
		Charges for services	Program – specific operating grants and contributions		Program – specific capital grants and contributions
Governmental activities:					
General government	\$ 1,887,454	175,718	2,705,085	-	\$ 993,349
Urban and economic development	1,861,951	-	-	360,000	(1,501,951)
Health and sanitation	2,588,752	-	-	-	(2,588,752)
Public safety	1,120,291	-	-	-	(1,120,291)
Public housing and welfare	1,550,031	90,709	-	-	(1,459,322)
Culture, recreation and education	1,020,254	-	-	-	(1,020,254)
Interests on long-term obligations	142,134	-	-	-	(142,134)
Total governmental activities	<u>\$ 10,170,867</u>	<u>266,427</u>	<u>2,705,085</u>	<u>360,000</u>	<u>(6,839,355)</u>
General revenues:					
Taxes:					
Property taxes					\$ 6,502,682
Municipal license taxes					989,016
Construction excise taxes					456,644
Sales and use taxes					608,615
Total tax revenues					<u>8,556,957</u>
Intergovernmental grants and contributions, not restricted to specific programs					1,329,081
Miscellaneous					101,627
Total general revenues					<u>9,987,665</u>
Net increase in net assets					<u>3,148,310</u>
Net assets at beginning of fiscal year					33,434,563
Prior-period adjustments					(373,122)
Net assets at the beginning of fiscal year, as restated					<u>33,061,441</u>
Net assets at end of fiscal year					<u>\$ 36,209,751</u>

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Balance Sheet – Governmental Funds
June 30, 2010

Assets	Major governmental funds				Total governmental funds
	General fund	Capital improvements fund	Debt service fund	Other governmental funds	
Cash in commercial banks	\$ 34,008	2,258,666	-	1,718,594	\$ 4,011,268
Cash in fiscal agent	5,810	177,515	1,549,783	207,168	1,940,276
Accounts receivable:					
Taxes:					
Property taxes	488,103	-	74,281	-	562,384
Municipal license taxes	217,364	-	-	-	217,364
Construction excise taxes	159,312	-	-	-	159,312
Sales and use taxes	54,268	-	-	-	54,268
Intergovernmental grants and contributions	1,134,487	-	31,610	475,027	1,641,124
Due from other funds	566,441	782,341	-	11,892	1,360,674
Advances from other funds	-	-	-	17,000	17,000
Accrued interests on deposits	3	342	87	-	432
Other receivables	32,457	-	147,957	270	180,684
Total assets	<u>2,692,253</u>	<u>3,218,864</u>	<u>1,803,718</u>	<u>2,429,951</u>	<u>10,144,786</u>
Liabilities					
Accounts payable and accrued liabilities	3,611,752	18,156	-	438,257	4,068,165
Intergovernmental payables	2,004,277	-	-	-	2,004,277
Deferred revenues	988,088	-	-	155,701	1,143,789
Liabilities related to restricted assets:					
Due to other funds	628,322	299,252	28	450,072	1,377,674
Matured bonds due and payable	-	-	645,000	-	645,000
Matured interest due and payable	-	-	57,356	-	57,356
Total liabilities	<u>7,232,439</u>	<u>317,408</u>	<u>702,384</u>	<u>1,044,030</u>	<u>9,296,261</u>
Fund balances (deficits)					
Nonspendable	-	-	-	17,000	17,000
Restricted	-	2,901,456	1,101,334	1,367,759	5,370,549
Assigned	2,085,516	-	-	-	2,085,516
Unassigned	(6,625,702)	-	-	1,162	(6,624,540)
Total fund balances (deficits)	<u>(4,540,186)</u>	<u>2,901,456</u>	<u>1,101,334</u>	<u>1,385,921</u>	<u>848,525</u>
Total liabilities and fund balances (deficits)	<u>\$ 2,692,253</u>	<u>3,218,864</u>	<u>1,803,718</u>	<u>2,429,951</u>	<u>\$ 10,144,786</u>

The accompanying notes are an integral part of this statement.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO**

Statement of Revenues, Expenditures and Changes in Fund Balances (Deficits) – Governmental Funds
Fiscal Year Ended June 30, 2010

	Major governmental funds			Other governmental funds	Total governmental funds
	General fund	Capital improvements fund	Debt service fund		
Revenues:					
Taxes:					
Property taxes	\$ 5,932,583	-	570,099	-	\$ 6,502,682
Municipal license taxes	798,098	-	-	-	798,098
Construction excise taxes	297,332	-	-	-	297,332
Sales and use taxes	608,615	-	-	-	608,615
Total tax revenues	7,636,628	-	570,099	-	8,206,727
Intergovernmental grants and contributions	1,329,081	360,000	365,405	2,339,680	4,394,166
Interests on deposits	10,360	6,392	1,197	-	17,949
Charges for services	146,843	-	-	90,709	237,552
Miscellaneous	83,678	-	-	-	83,678
Total revenues	9,206,590	366,392	936,701	2,430,389	12,940,072
Expenditures:					
Current:					
General government	1,843,644	-	-	-	1,843,644
Urban and economic development	1,500,026	19,850	-	298,265	1,818,141
Health and sanitation	2,444,691	-	-	100,251	2,544,942
Public safety	1,071,854	-	-	4,627	1,076,481
Public housing and welfare	590,064	-	-	916,157	1,506,221
Culture, recreation and education	632,717	-	-	343,727	976,444
Debt service:					
Principal	46,515	-	849,900	-	896,415
Interests	20,005	-	104,226	-	124,231
Capital outlays	91,455	892,373	-	818,204	1,802,032
Total expenditures	8,240,971	912,223	954,126	2,481,231	12,588,551
Revenues over (under) expenditures	965,619	(545,831)	(17,425)	(50,842)	351,521
Other financing sources (uses):					
Proceeds from issuance of bonds	-	670,000	-	-	670,000
Transfers from other funds	122,146	-	100,354	119,444	341,944
Transfers to other funds	(219,798)	(6,392)	(545)	(115,209)	(341,944)
Total other financing sources (uses), net	(97,652)	663,608	99,809	4,235	670,000
Net increase in fund balances (deficits)	867,967	117,777	82,384	(46,607)	1,021,521
Fund balance (deficit), at beginning of year	(5,408,153)	2,783,679	880,089	1,432,528	(311,857)
Prior-period adjustments	-	-	138,861	-	138,861
Fund balance (deficit) at beginning of fiscal year, as restated	(5,408,153)	2,783,679	1,018,950	1,432,528	(172,996)
Fund balance (deficit), at end of year	\$ (4,540,186)	2,901,456	1,101,334	1,385,921	\$ 848,525

The accompanying notes are an integral part of this statement.

OK [Signature]
24/05/2010

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
 Reconciliation of the Balance Sheet – Governmental Funds to Statement of Net Assets
 Fiscal Year Ended June 30, 2010

The amounts of governmental activities reported in the statement of net assets and the balance sheet – governmental

Total fund balances reported in the balance sheet – governmental funds	\$ 848,525
Add (Deduct):	

Capital assets used in governmental activities are not considered available financial resources at fiscal year-end, therefore, are not reported in the governmental funds. This is the carrying amount of capital assets, net of accumulated depreciation and amortization of \$9,165,395 at June 30, 2010.	41,777,236
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Net change in deferred revenues of earned but unavailable revenues at June 30, 2010.	379,106
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The following liabilities are not due (mature) in the current fiscal year, therefore, are not reported in the governmental funds at June 30, 2010:

Bonds payable	(5,403,000)
Notes payable	(421,330)
Claims and judgments	(348,779)
Compensated absences	(600,565)
Accrued interests and others	(21,442)
	(12,723,116)

Net assets – governmental activities, as reported in the statement of net assets	\$ 36,209,751
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The accompanying notes are an integral part of this statement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO

Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances
(Deficits) – Governmental Funds to Statement of Activities
Fiscal Year Ended June 30, 2010

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

Total net increase in fund balances reported in the accompanying statement of revenues, expenditures and changes in fund balances – governmental funds	\$	1,021,521
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Add (Deduct):

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

Municipal licenses		190,918
Construction excise taxes		159,312
Charges for service		28,876

Governmental funds report capital outlays as expenditures. However in the statement of activities the cost of those assets is capitalized and allocated over their estimated useful lives as depreciation and amortization expense. This is the amount by which capital outlay expenditures (\$1,802,032) exceeded depreciation and amortization expense (\$1,036,080) for the fiscal year ended June 30, 2010.

765,952

Repayment of principal of bonds payable is reported as an expenditure in the governmental funds, however, the repayment reduces the bonds payable liability in the statement of net assets.

896,415

The issuance of bonds payable is reported as other financing sources in the governmental funds, however, such issuances of bonds increase the long-term liability in the statement of net assets.

(670,000)

Certain accrued interest expense reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.

(17,907)

Certain operating expenses reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds. This is the net change in payables associated with those type

773,223

Net increase in net assets, as reported in the accompanying statement of activities

\$ 3,148,310

The accompanying notes are an integral part to this statement.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Notes to Financial Statements
June 30, 2010

1. Summary of Significant Accounting Policies

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

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

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

a) Financial Reporting Model

The accompanying basic financial statements present the financial position and the results of operations of the Municipality as a whole, and its various governmental funds as of and for the fiscal year ended June 30, 2010, in conformity with Accounting Principles Generally Accepted in the United States of America (GAAP), as prescribed by the Governmental Accounting Standards Board (GASB).

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

RSI consist of: (1) a Management's Discussion and Analysis (MD&A) and (2) a Budgetary Comparison Schedule – General Fund. RSI is information presented along with, but separate from, the Municipality's basic financial statements.

MD&A is a narrative report that introduces the accompanying basic financial statements and provides an analytical overview of the Municipality's financial activities for the fiscal year ended June 30, 2010, based on the Municipality's knowledge of the transactions, events and conditions reflected in the basic financial statements. The MD&A also highlights certain key fiscal policies that control the Municipality's operations.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Notes to Financial Statements
June 30, 2010

Other supplementary information presented in this report for purposes of additional analysis consists of a Budgetary Comparison Schedule – Debt Service Fund.

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

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

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

The adoption of GASB 55 and GASB 56 did not have retroactive cumulative effects affecting the accompanying financial statements as of July 1, 2008, and have not affected the financial positions and the results of operations reported as of and for the fiscal year ended June 30, 2010. Accordingly, the accompanying GFFS have not reported any retroactive restatements or reclassifications of fund equities as of July 1, 2008.

b) *Financial Reporting Entity*

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

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Notes to Financial Statements
June 30, 2010

On July 1, 2004, the Municipality adopted the provisions of GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units – an Amendment of GASB Statement No. 14* (GASB No. 39). GASB No. 39 states that certain organizations for which a primary government is not financially accountable nevertheless warrant inclusion as part of the financial reporting entity because of the nature and significance of their relationship with the primary government, including their ongoing financial support of the primary government and its other component units.

According to GASB No. 39, a legally separate, tax-exempt organization should be reported as a discretely presented component unit of a reporting entity if all of the following criteria are met:

The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.

The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.

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

In addition, GASB No. 39 states that other organizations should be evaluated as potential component units if they are closely related to, or financially integrated with, the primary government. Such types of entities may be presented as either blended or discretely presented component units, depending upon how they meet the criteria for each specified in GASB No. 14.

The Municipality's management has concluded that, based on the aforementioned criteria, there are no legally separate entities or organizations that should be reported as component units of the Municipality for the fiscal year ended June 30, 2010.

c) *Government-wide Financial Statements*

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

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Notes to Financial Statements
June 30, 2010

all resources available for that purpose. It focuses on the Municipality's principal operating objective, which is to provide services to its citizens.

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

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

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

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

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

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

COMMONWEALTH OF PUERTO RICO
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Notes to Financial Statements
June 30, 2010

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

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

The accompanying statement of activities presents the Municipality's results of operations by showing, how the Municipality's net assets or liabilities changed during the fiscal year ended June 30, 2010, using a net (expense) revenue format. This statement presents the cost of each function/program as well as the extent to which each of the Municipality's functions, programs or other services either contributes to or draws from the Municipality's general revenues (such as property taxes, municipal license taxes, construction excise taxes, etc.).

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

General government:

- Municipal legislature
- Mayor's office
- Department of Finance
- Department of Planning and Budget
- Department of Human Resources
- Department of Municipal Secretary
- Department of Internal Audit
- Department of Public Relations

Urban and economic development:

- Department of Public Works

COMMONWEALTH OF PUERTO RICO
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Department of Territorial Ordering
Department of Building Conservation

Public safety:

Department of Emergency Management – Civil Defense
Department of Municipal Police

Health and sanitation:

Department of Health

Culture, recreation and education:

Department of Sports and Recreation
Department of Tourism
Department of Education

Public housing and welfare:

Department of Public Housing
Department of Federal Programs
Department of Citizen Affairs

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

Program revenues are generated directly from a program itself or may come from parties outside the Municipality's taxpayers or citizens. In the statement of activities, program revenues reduce the costs (expenses) of the function/program to arrive at: (1) the net cost of the function/program that must be financed from the Municipality's general revenues or (2) the net program revenue that contributes to the Municipality's general revenues. The accompanying statement of activities separately reports the following categories of program revenues:

- **Charges for services** – These revenues generally consist of exchange or exchange-like transactions involving charges to customers or applicants who purchase, use or directly benefit from the goods, services or privileges provided, or are otherwise directly affected by the services. These revenues include fees charged for specific services, charges for licenses and permits, and fines and forfeitures, among others.
- **Program-specific operating and capital grants and contributions** – These revenues consist of transactions that are either mandatory or voluntary non-exchange transactions with other governments, organizations, or individuals that restrict the resources for use in a particular program. Operating grants and contributions consist of resources that are required to be used to finance the costs of operating a specific program or can be used either for operating or capital purposes of a specific program. Capital grants and contributions consist of revenues or resources that are restricted for capital purposes – to purchase, construct or renovate capital assets associated with

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a specific program. Restricted operating and capital grants and contributions are program revenues because they are specifically attributable to a program and reduce the net expense of that program to the Municipality. They are reported net of estimated uncollectible amounts.

General revenues are the default category for revenues. It includes all revenues and gains that do not meet the definition of program revenues. Property taxes, municipal license taxes and construction excise taxes are reported as general revenues. All other non-tax revenues (including unrestricted interest on deposits, grants and contributions not restricted for specific programs and miscellaneous revenues) that do not meet the definition of program revenues are classified as general revenues. Resources that are dedicated internally by the Municipality are reported as general revenues rather than as program revenues. All general revenues are reported net of estimated uncollectible amounts, which are recorded as reduction of revenues rather than as expenses.

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

The *general government* function/program reported in the accompanying statement of activities includes expenses that are, in essence, indirect or costs of other functions/programs of the Municipality. Even though some of these costs have been charged to certain funds in the GFFS as indirect cost allocations permitted under some federal programs, the Municipality has reported these indirect costs as direct expenses of the general government function. Accordingly, the Municipality generally does not allocate general government (indirect) costs to other functions.

The effects of all inter-fund governmental activities (revenues, expenditures and other financing sources/uses among governmental funds) have been removed from the accompanying statements of net assets and activities.

The Municipality classifies all of its activities as governmental activities in the accompanying GWFS. These are activities generally financed through taxes, intergovernmental revenues and other non-exchange revenues that can be used to support the Municipality's programs or services. These governmental activities are also generally reported in the GFFS.

The Municipality has no fiduciary activities, which are those in which the Municipality would be holding or managing net assets for specific individuals or other external parties in accordance with trust agreements or other custodial arrangements. In addition, the Municipality has no operations or activities that are financed and operated in a manner similar to private business enterprises, where the costs of providing goods or services to the general public (expenses, including depreciation) is financed primarily through user charges; or where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

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d) Governmental Fund Financial Statements

A fund is a fiscal and accounting entity consisting of a self-balancing set of accounts used to record assets, liabilities and residual equities, deficits or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with GAAP and/or special regulations, restrictions or limitations.

The accompanying GFFS are composed of: (1) the balance sheet – governmental funds, and (2) the statement of revenues, expenditures and changes in fund balances – governmental funds.

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

The accompanying GFFS segregate governmental funds according to their intended purpose and are used in demonstrating compliance with legal, financial and contractual provisions. The minimum number of governmental funds is maintained consistent with legal and self-imposed managerial requirements established by the Municipality. On July 1, 2009, the Municipality adopted the provisions of GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* (GASB 54), which modified the interpretations of certain terms within the definition of the special revenue funds and the types of activities the Municipality may choose to report in those funds. GASB 54 also clarified the capital projects fund type definition for better alignment with the needs of preparers and users. Definitions of other governmental fund types also were also modified for clarity and consistency.

Pursuant to the provisions set forth by GASB 54, the Municipality reported the following governmental funds in the accompanying GFFS

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

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payments are legally mandated to be accounted for in a debt service fund and/or (2) bonds payable or any general long-term debt for which the Municipality is being accumulating financial resources in advance to pay principal and interest payments maturing in future years. During the fiscal year ended June 30, 2010, the financial activity accounted for in the debt service fund was specifically related to bonds and notes payable.

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

- ***Special revenue funds*** – The special revenue funds are non-major governmental funds, as defined below, used by the Municipality to account for revenues derived from grants, contributions or other revenue sources that are either self-restricted by the Municipality or legally restricted by outside parties for use in specific purposes (except for revenues that are earmarked for expenditures in major capital projects which are accounted for in the capital project funds). The uses and limitations of each special revenue fund are specified by municipal ordinances or federal and state statutes. However, resources restricted to expenditure for purposes normally financed from the general fund are reported in the Municipality's general fund provided that all applicable legal requirements are appropriately satisfied. In this case, a special revenue fund to account for such kind of transactions will be used only if legally mandated.
- ***Capital projects funds*** – Capital projects funds are non-major governmental funds, as defined below, used to account for the financial resources used for the acquisition, construction or improvement of major capital facilities and other assets. Significant capital outlays financed from proceeds of general obligation, public improvement or special obligation bonds accounted for also in the capital projects funds. The use of the capital projects funds has been reserved only for major capital acquisitions, construction or improvement activities that would distort financial resources trend data if not reported separately from the other Municipality's operating activities. The routine purchases of minor capitalize assets (such as furniture, office equipment, vehicles and other minor capital assets or improvements) have been reported in the governmental fund from which financial resources were used for the payment.

The focus of the GFFS is on major governmental funds, which generally represent the Municipality's most important funds. Accordingly, the Municipality is required to segregate governmental funds between major and non-major categories within the GFFS. Major individual governmental funds are reported individually as separate columns in the GFFS, while data from all non-major governmental funds are aggregated into a single column, regardless of fund type.

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By definition, the Municipality's general fund is always considered a major governmental fund for financial reporting purposes. In addition, any other governmental fund is classified as a major governmental fund in the GFFS if its total assets, liabilities, revenues or expenditures of that individual governmental fund are at least 10 percent of the corresponding element total (assets, liabilities, revenues or expenditures) for all governmental funds. For the purposes of applying the aforementioned major fund criteria, no eliminations of inter-fund balances have been made. Total revenues for these purposes means all revenues, including operating and non-operating revenues (net of allowances for uncollectible accounts), except for other financing sources. Total Expenditures for these purposes mean all expenditures, including operating and non-operating expenditures, except for other financing uses.

Based on the aforementioned criteria, the Municipality's major governmental funds reported in the accompanying GFFS are: (1) the general fund, (2) the debt service fund, and (3) the capital improvements fund.

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

The accompanying GFFS are accompanied by other statements and schedules required by GAAP: (1) the reconciliation of the balance sheet – governmental funds to the statement of net assets, and (2) the reconciliation of the statement of revenues, expenditures and changes in fund balances – governmental funds to the statement of activities.

e) Measurement Focus and Basis of Accounting

Government-wide financial statements – The accompanying GWFS are prepared using the economic resources measurement focus and the accrual basis of accounting. Subject to the additional rules and limitations detailed below, revenues (including interest on deposits) are generally recorded when earned and expenses are generally recorded when a liability is incurred, regardless of the timing of related cash flows.

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

All revenues, expenses, gains, losses and assets resulting from non-exchange transactions are recorded using the criteria set forth by GASB Statement No. 33, *Accounting and Financial Reporting for Non-exchange Transactions* (GASB No. 33). GASB No. 33 established accounting and reporting standards for non-exchange transactions involving

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cash and financial or capital resources (for example, most taxes, grants and private donations). In a non-exchange transaction, the Municipality gives (or receives) value without directly receiving (or giving) equal value in return. This is different from an exchange transaction, in which each party receives and gives up essentially equal values. According to GASB No. 33, the Municipality groups its non-exchange transactions into the following four classes in the accompanying basic financial statements: (a) derived tax revenues, (b) imposed non-exchange revenues, (c) government mandated non-exchange transactions, and (d) voluntary non-exchange transactions.

In the case of derived tax revenue transactions, which result from assessments the Municipality places on exchange transactions, receivables and revenues are recorded when the underlying exchange has occurred.

In the case of imposed non-exchange revenue transactions (such as property taxes and municipal license taxes), which result from assessments made by the Municipality on nongovernmental entities, including individuals, other than assessments on exchange transactions, receivables are generally recorded in the period when an enforceable legal claim has arisen. Property taxes and municipal license are generally recorded as revenues (net of amounts considered not collectible) in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted.

Government-mandated non-exchange transactions (such as grants and contributions) result when a government at one level (such as the federal or state government) provides resources to the Municipality and the provider government requires the Municipality to use those resources for a specific purpose or purposes established in the provider's enabling legislation. In these type of transactions, receivables and revenues are generally recorded when all eligibility requirements imposed by the provider have been met. For the majority of grants, the Municipality must expend resources on the specific purpose or project before the provider reimburses any amounts. Revenue is, therefore, generally recognized as qualifying reimbursable expenditures are incurred.

Voluntary non-exchange transactions (such as donations and certain grants and entitlements) result from legislative or contractual agreements, other than exchanges, willingly entered into by two or more parties. In these types of transactions, receivables and revenues are generally accounted for in the same manner as government-mandated non-exchange transactions discussed above. Events that are neither exchange nor non-exchange transactions are recorded when it is probable that a loss has been incurred and the amount of loss is reasonably estimable.

Receipts of any type of revenue sources collected in advance for use in the following fiscal year are recorded as deferred (unearned) revenues.

According to GASB No. 34, all general capital assets and the un-matured long-term liabilities are recorded only in the accompanying statement of net assets. The measurement focus and the basis of accounting used in the accompanying GWFS differ significantly from the measurement focus and basis of accounting used in the preparation of the accompanying GFFS. Therefore, the accompanying GFFS include reconciliations,

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as detailed in the accompanying table of contents, to better identify the relationship between the GWFS and the GFFS.

Governmental fund financial statements – The accompanying GFFS are reported using the current financial resources measurement focus (flow of current financial resources) and the modified accrual basis of accounting. Accordingly, the accompanying statement of revenues, expenditures and changes in fund balances – governmental funds, reports changes in the amount of financial resources available in the near future as a result of transactions and events of the fiscal year reported. Therefore, revenues are generally recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current fiscal year or soon enough thereafter to pay liabilities of the current fiscal year. For this purpose, the Municipality considers most revenues to be available if collected within 90 days after June 30, 2010, except for property taxes for which the availability period is 60 days. Revenue sources not meeting this availability criterion or collected in advance are recorded as deferred (unavailable) revenues at June 30, 2010.

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

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

All revenues, expenses, gains, losses and assets resulting from non-exchange transactions are recorded in a similar manner to the GWFS, using the previously discussed criteria set forth by GASB No. 33 for non-exchange transactions, but subject to and limited by the availability criteria discussed above. Accordingly, property tax and municipal license tax receivables are also generally recorded in the fiscal year when an enforceable legal claim has arisen while property tax and municipal license tax revenues (net of amounts considered not collectible) are also generally recorded in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted. Receivables and revenues from federal and state grants and contributions, donations and entitlements are also generally recorded when all eligibility requirements imposed by the provider have been met (generally, as qualifying reimbursable expenditures are incurred).

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

Pursuant to the provisions of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements* (GASBI No. 6), in the absence of an explicit requirement (i.e., the absence of an

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applicable modification, discussed below) the Municipality generally accrues a governmental fund liability and an expenditure (including salaries, professional services, supplies, utilities, etc.) in the period in which the government incurs the liability, to the extent that these liabilities are normally expected to be liquidated in a timely manner and in full with current available financial resources. GASBI No. 6 modified the recognition criteria for certain expenditures and liabilities reported under the modified accrual basis of accounting prior to GASB No. 34, and clarified a number of situations in which the Municipality should distinguish between governmental fund liabilities and general long-term liabilities. Therefore, the accompanying balance sheet – governmental funds generally reflects assets that will be converted into cash to satisfy current liabilities. Long-term assets and those assets that will not be converted into cash to satisfy current liabilities are generally not accounted for in the accompanying balance sheet – governmental funds. At the same time, long-term liabilities (generally, those un-matured that will not require the use of current financial resources to pay them) are not accounted for in the accompanying balance sheet – governmental funds.

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

- Principal and interest on bonds payable are recorded when they mature (when payment is due), except for principal and interest due on July 1, 2010, which have been recorded as governmental fund liabilities at June 30, 2010, which is the date when resources are available in the debt service funds (generally, June 30).
- Notes payable and compensated absences are recorded only when they mature (when payment is due).
- Certain accounts payable, intergovernmental payables and other accrued liabilities not due and payable or not normally expected to be liquidated in full and in a timely manner with available and expendable financial resources are recorded in the accompanying statement of net assets. Such liabilities are recorded in the governmental funds when they mature.
- Executory purchase orders and contracts are recorded as a reservation of fund balance in the GFFS.

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

f) Stewardship, Compliance and Accountability

Budgetary Control

According to Act No. 81, the Mayor and its Administrative Cabinet prepare annual budgets each fiscal year for the Municipality's general fund and debt service fund. Such legally adopted budgets are based on expected expenditures by program and estimated

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resources by source. The annual budgets are developed using elements of performance-based program budgeting and zero-based budgeting, and include estimates of revenues and other resources for the ensuing fiscal year under laws and regulations existing at the time the budgets are prepared.

The Mayor must submit, for each fiscal year commencing on July 1, an annual budgetary resolution project (the Project) to the Commissioner of Municipal Affairs of the Commonwealth (the Commissioner) and the Municipal Legislature no later than the immediately preceding May 10 and May 15, respectively. The Commissioner preliminarily verifies that the Project complies with all the applicable laws and regulations and may provide comments and suggestions to the Mayor on or before the immediately preceding June 13.

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

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

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

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

The legal level of budgetary control (i.e., the level at which expenditures may not legally exceed appropriation) is at the function/program level (general government, urban and

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economic development, public safety, health and sanitation, culture, recreation and education, and public housing and welfare) within a fund.

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

Budgetary Accounting

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

According to the budgetary basis of accounting, revenue is generally recorded when cash is received. Short-term and long-term borrowings may be used to finance budgetary excess of expenditures over revenues.

The Municipality uses encumbrance accounting to record the full amount of purchase orders, contracts and other commitments of appropriated resources as deductions from the appropriation prior to actual expenditure. In the governmental funds, encumbrance accounting is a significant aspect of budgetary control. Accordingly, expenditures are generally recorded when the related expenditure is incurred or encumbered. Available appropriations and encumbrances are established to lapse one fiscal year after the end of the fiscal year. Amounts required settling claims and judgments against the Municipality, and certain other liabilities, are not recognized until they are encumbered or otherwise processed for payment. Unencumbered appropriations and encumbrances lapse at fiscal year-end. Other appropriations, mainly capital projects appropriations, are continuing accounts for which the Municipal Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending.

The accompanying Budgetary Comparison Schedule – General Fund provides information about the general fund's original budget, its amendments, and the actual results of operations of such major governmental fund under the budgetary basis of accounting for the fiscal year ended June 30, 2010. Further details of the Municipality's budgetary control at the legal level may be obtained from the Budgetary Liquidation Report for the fiscal year ended June 30, 2010, which is prepared by the Municipality's Department of Finance. Copies of that report may be obtained by writing to the Municipality's Director of Finance.

Because accounting principles applied for the purposes of the developing data on a budgetary basis differ significantly from those used to present the governmental fund financial statements in conformity with GAAP, a reconciliation of the differences between the general and debt service funds' budgetary bases and GAAP actual amounts are presented at the bottom of the respective budgetary comparison schedules.

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g) *Unrestricted and Restricted Deposits*

The Municipality's deposits are composed of: (1) cash on hand, (2) demand deposits in commercial banks, and (3) demand deposits in the Government Development Bank for Puerto Rico (fiscal agent).

Under the laws and regulations of the Commonwealth, public funds deposited by the Municipality in commercial banks must be fully collateralized for the amounts deposited in excess of the federal depository insurance generally provided by the Federal Deposits Insurance Corporation (FDIC). Agents designated by the Commonwealth's Secretary of the Treasury, but not in the Municipality's name hold all securities pledged as collateral. Cash in fiscal agent in the debt service fund consists of cash related to property tax collections amounting to \$1,549,783, which is restricted for the payment of the Municipality's debt service, as required by law. Cash in fiscal agent in the capital improvements fund, amounting to \$177,515 consists of unspent proceeds of bonds, which are restricted for the acquisition, construction or improvement of capital assets.

Restricted cash in commercial banks recorded in other governmental funds, amounting to \$1,718,594 represents mainly the balance of interest and non-interest bearing accounts restricted to finance the operations of certain federal and state funded programs.

The Municipality follows the practice of pooling cash among governmental funds. The total balance of pooled cash accounts amounted to \$3,716,698 at June 30, 2010. Of such amount, \$3,194,646 has been recorded in the general fund as an excess of checks over bank balances (within accounts payable) at June 30, 2010, while the remaining positive balances have been recorded as cash within the remaining major and non-major governmental funds.

h) *Unrestricted and Restricted Accounts Receivable*

Accounts receivable consist of all revenues earned but not collected at June 30, 2010. These accounts receivables are stated net of estimated reserved for doubtful accounts, which are determined based upon past collection experience, historical trends, current economic conditions and the periodic aging of accounts receivable.

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

i) *Capital Assets*

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

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nature and include roads, bridges, streets and sidewalks, drainage systems and other similar assets.

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

In the statement of net assets, all capital assets are recorded at cost or estimated historical cost if actual cost was unavailable, except for donated capital assets, which are recorded at their estimated fair value at the date of donation. Estimated historical costs based on deflated current costs were used to value a significant portion of the infrastructure constructed or acquired prior to June 30, 2003 and certain lands, buildings, structures and building improvements. The method used to deflate the current costs with an approximate price index was used only in the case of certain items for which the historical cost documentation was not available. Actual historical costs were used to value the infrastructure acquired or constructed after June 30, 2003 as well as, construction in progress, machinery and equipment and licensed vehicles acquired prior or after such date.

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

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

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

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

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j) *Deferred Revenues*

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

- Potential revenue does not meet both the “measurable” and “available” criteria for revenue recognition in the current period (reported as “*earned but unavailable revenue*” in the accompanying balance sheet-governmental funds). As previously discussed, available is defined as due (or past due) at June 30, 2010 and collected within 90 days (60 days for property taxes) thereafter to pay obligations due at June 30. In subsequent periods, when both criteria (measurable and available) are met, the liability for deferred revenue is removed and revenue is recognized.
- The Municipality receives resources before it has a legal claim to them (reported as “*unearned revenue*” in the accompanying balance sheet-governmental funds). In subsequent periods, when the revenue recognition criterion is met, the liability for deferred revenue is removed and revenue is recognized.

Deferred revenues at the government-wide level arise only when the Municipality receives resources before it has a legal claim to them (reported as “*unearned revenue*” in the accompanying statement of net assets). No “*earned but unavailable revenue*” is accounted for in the accompanying statement of net assets.

k) *Compensated Absences*

Compensated absences are accounted for under the provisions of Statement No. 16, *Accounting for Compensated Absences*, issued by GASB (GASB No. 16). Compensated absences include paid time off made available to employees in connection with vacation, sick leave and compensatory time. The liability for compensated absences recorded in the accompanying statement of net assets is limited to leave that: (1) is attributable to services already rendered on or before June 30, 2010 and (2) is not contingent on a specific event that is outside the control of the Municipality and the employee (such as illness). Compensated absences that relate to future services or are contingent on a specific event outside the control of the employer or the employee are accounted for in the period when those services are rendered or those events take place.

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

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

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

After 10 years of services, any regular sick leave balance is paid to the employee. Accumulated vacation time is fully vested to the employee at any time.

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

l) Long-term Debt

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

All long-term debt to be repaid from governmental resources is reported as liabilities in the accompanying statement of net assets. Principal and interest payments on bonds due on July 1, 2010 have been recorded as governmental fund liabilities in the GFFS when resources were available in the debt service fund (June 30, 2010). In the GFFS, the face amount of debt issued (gross debt reported) is reported as other financing sources when issued.

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

Non-interest bearing notes payable are accounted for under the provisions of Opinion No. 21, *Interest on Receivables and Payables*, issued by the Accounting Principles Board (APB No. 21). According to APB No. 21, the Municipality has recorded such notes at present value with an imputed interest rate that approximates the rate that would have been used, using the same terms and conditions, if it had been negotiated by an independent lender. In the accompanying statement of net assets, such notes payable are reported net of the applicable unamortized discount, which is the difference between the present value and the face amount of the notes. The discount is amortized over the life of the notes using the effective interest method. Amortization of the notes discount is recorded as part of interest expense in the statement of activities. In the GFFS, notes discount is recognized as other financing uses during the current period.

m) Accounting for Pension Costs

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

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

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

n) Risk Management

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

The Municipality carries insurance coverage for death and bodily injuries caused by automobile accidents. This insurance is obtained through the Automobile Accidents Compensation Administration (ACAA), a component unit of the Commonwealth. This insurance is compulsory for all licensed vehicles used on public roads and highways in Puerto Rico. The annual premium applicable at June 30, 2010 is \$35 per licensed motor vehicle, which is paid directly to ACAA.

The Municipality obtains workers' compensation insurance coverage through the State Insurance Fund Corporation (SIFC), a component unit of the Commonwealth. This insurance covers workers against injuries, disability or death because of work or employment-related accidents, or because of illness suffered as a consequence of their employment. Workers' compensation insurance premiums are also paid through monthly deductions made by CRIM from the Municipality's gross property tax collections.

The Municipality obtains unemployment compensation, non-occupational disability, and drivers' insurance coverage for its employees through various insurance programs administered by the Commonwealth's Department of Labor and Human Resources (DOL). These insurance programs cover workers against unemployment and provide supplementary insurance coverage for temporary disability, or death because of work or

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employment-related accidents or because of illness suffered as a consequence of their employment. Unemployment compensation, non-occupational disability and drivers' insurance premiums are paid directly to DOL on a cost reimbursement basis.

The Municipality also obtains medical insurance coverage from several health insurance companies for its employees. Different health insurance coverage and premium options are negotiated each year by the Department of Treasury on behalf of the Municipality. The current insurance policies have not been canceled or terminated at June 30, 2010. Premiums are paid on a monthly basis directly to the insurance company. In the past three years, the Municipality has not settled claims that exceeded insurance coverage.

o) Fund Balances

On July 1, 2009, the Municipality adopted the provisions of GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* (GASB 54), which enhanced the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied. This statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which the Municipality is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

Pursuant to the provisions of GASB 54, the accompanying GFFS report fund balance amounts that are considered nonspendable, such as fund balance associated with inventories. Other fund balances have been reported as restricted, committed, assigned, and unassigned, based on the relative strength of the constraints that control how specific amounts can be spent, as described as follows:

- a. *Nonspendable* - Represent resources that cannot be spent readily with cash or are legally or contractually required not to be spent, including but not limited to inventories, prepaid items, and long term balances of interfund loans and accounts receivable.
- b. *Restricted* - Represent resources that can be spent only for the specific purposes stipulated by constitutional provisions, external resource providers (externally imposed by creditors or grantors), or through enabling legislation (that is, legislation that creates a new revenue source and restricts its use). Effectively, restrictions may be changed or lifted only with the consent of resource providers.
- c. *Committed* - Represent resources used for specific purposes, imposed by formal action of the Municipal's highest level of decision making authority (Municipal Legislature through resolutions and ordinances) and can only be changed by a similar law, ordinance or resolution.
- d. *Assigned* - Represent resources intended to be used by the Municipality for specific purposes but do not meet the criteria to be classified as restricted or committed (generally executive orders approved by the Mayor). Intent can be expressed by the Municipal Legislature, the

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Mayor or by an official or body to which the Municipal Legislature delegates authority in conformity with the Autonomous Municipalities Act of Puerto Rico, as amended. In governmental funds other than the general fund, assigned fund balance represents the remaining amount that is not restricted or committed.

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

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

The Municipality reports resources constrained to stabilization as a specified purpose (restricted or committed fund balance in the general fund) only if: (1) such resources meet the other criteria for those classifications, as described above and (2) the circumstances or conditions that signal the need for stabilization are identified in sufficient detail and are not expected to occur routinely. However, the Municipality has not entered into any stabilization-like arrangements, nor has set aside material financial resources for emergencies and has not established formal minimum fund balance amounts as of and for the fiscal year ended June 30, 2010.

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

The classification of the Municipality's individual governmental funds among general, debt service, special revenue and capital project fund types used in prior fiscal years for financial reporting purposes was not affected by the implementation of GASB 54. In addition, the financial positions and the results of operations reported in the accompanying GFFS as of and for the fiscal year ended June 30, 2010 have not been affected for this change in accounting principle. Accordingly, the accompanying GFFS have not reported any retroactive restatements or reclassifications of fund equities as of July 1, 2009.

p) *Inter-fund Activities*

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

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- **Inter-fund loans** – Represent resources (assets) provided by one governmental fund to other governmental fund with a requirement and commitment for repayment (reimbursement), which are recorded as “*due from*” in the lender governmental fund and “*due to*” in the borrower governmental fund. Inter-fund receivables, which are not considered to be currently available financial resources, are reported as “*advances*”. For amounts not expected to be collected, inter-fund receivables/payables are reduced to their estimated realizable (settlement) value, and the portion of the inter-fund loan that is not expected to be repaid is reported as a “*transfer-in*” from the governmental fund that provided the loan.
- **Inter-fund transfers (transfers-in/(out))** – Represent flows of assets (permanent reallocation of financial resources among governmental funds) without equivalent flows of assets in return and without a requirement for repayment. Transfers are reported as “*other financing uses*” in the governmental fund making transfers and as “*other financing sources*” in the governmental fund receiving transfers.
- **Inter-fund reimbursements** – Represent repayments (reimbursements) from the governmental fund responsible for particular expenditures or expenses to the governmental fund that initially paid for them.

In the GFFS, inter-fund activity has not been eliminated, as permitted by GAAP.

q) Use of Estimates

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

r) Future adoption of accounting pronouncements

The GASB has issued the following statements that have effective dates after June 30, 2010:

- a. GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, which is effective for periods beginning after June 15, 2009.
- b. GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which is effective for periods beginning after June 15, 2009.
- c. GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which is effective for periods beginning after June 15, 2009.

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

2. Deposits

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

On July 1, 2005, the Municipality adopted the provisions of GASB Statement No. 40 (GASB No. 40), *Deposit and Investment Risk Disclosure, an Amendment to GASB Statement No. 3*. This statement requires that state and local governments disclose essential risk information about deposits and investments. The disclosure requirements cover four main areas: (1) credit risk, (2) interest rate risk, (3) custodial credit risk, and (4) foreign exchange exposure.

- **Credit risk** – This is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. In compliance with the laws and regulations of the Commonwealth, the Municipality has adopted, as its custodial and credit risk policy, the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico*. Accordingly, the Municipality invests only in obligations of the Commonwealth, obligations of the United States of America, certificates of deposit, commercial paper, bankers' acceptances, or in pools of obligations of the municipalities of Puerto Rico, which are managed by GDB. According to the aforementioned investment guidelines, the Municipality does not invest in marketable securities or any other types of investments for which credit risk exposure may be significant. Therefore, the Municipality's management has concluded that the credit risk related to any possible loss related to defaults by commercial banks on the Municipality's deposits are considered low at June 30, 2010.
- **Interest rate risk** – This is the risk that changes in interest rates of debt investments will adversely affect the fair value of an investment. The Municipality manages its exposure to declines in fair values by: (1) not including debt investments in its investment portfolio at June 30, 2010, (2) limiting the weighted average maturity of its investments to three months or less, and (3) keeping most of its bank deposits in interests bearing accounts generating interests at prevailing market rates. At June 30, 2010, the Municipality's cash balances are recorded at cost, which approximates their fair value. Therefore, the Municipality's management has concluded that at June 30, 2010, the interest rate risk associated with the Municipality's cash and cash equivalents is considered low.
- **Custodial credit risk** – In the case of deposits, this is the risk that in the event of a bank failure, the Municipality's deposits may not be recovered. Pursuant to the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico* the balances deposited in commercial banks by the Municipality are insured by the Federal Deposit Insurance Corporation (FDIC) generally up to a maximum of \$100,000 per depositor. In addition, public funds deposited in commercial banks by the Municipality are fully collateralized for the amounts deposited in excess of the federal depository insurance. All securities pledged as

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collateral are held, in the Municipality's name, by the agents of the Commonwealth's Secretary of Treasury. Deposits with GDB are uninsured and uncollateralized. However, no losses related to defaults by GDB on deposit transactions have been incurred by the Municipality through June 30, 2010. Therefore, the Municipality's management has concluded that at June 30, 2010, the custodial credit risk associated with the Municipality's cash is considered low.

- **Foreign exchange risk** – The risk that changes in exchange rates will adversely affect the value of an investment or a deposit. According to the aforementioned investment guidelines, the Municipality is prevented from investing in foreign securities or any other types of investments for which foreign exchange risk exposure may be significant. Accordingly, management has concluded that the foreign exchange risk related to the Municipality's deposits is considered low at June 30, 2010.

3. Municipal License Taxes

The Municipality is authorized by Act No. 81 to impose and collect municipal license taxes to any natural or legal person having trade or business activities within the territory of Naguabo. This is a self-assessed tax generally based on the business volume of taxpayers, measured by gross revenues. The Municipality establishes the applicable tax rates. At June 30, 2010, the municipal license tax rates imposed by the Municipality were 1.50 percent for financial institutions and 0.50 percent for other types of taxpayers. Any taxpayers that have been granted with a partial tax exemption under any of the tax incentive acts of the Commonwealth ultimately pay municipal license taxes at reduced tax rates, generally between 60 percent and 90 percent under standard rates.

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

Any municipal license taxes collected in advance (that is, pertaining to a future fiscal year) are recorded as unearned revenues in the GWFS and the GFFS. Total municipal license tax receivable amounted to \$217,364 at June 30, 2010. Deferred municipal license tax revenues recorded in the accompanying GWFS and GFFS amounted to \$799,900 and \$773,454, respectively, at June 30, 2010.

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4. Property Taxes

The Municipality is authorized by Act No. 81 to impose and collect property taxes from any natural or legal person that, at January 1 of each calendar year: (1) is engaged in trade or business and is the owner of personal or real property used in trade or business or (2) owns residential real property with a value in excess of \$15,000 (at 1957 estimated market prices). CRIM is responsible for the billings and collections of real and personal property taxes on behalf of the Municipality. Prior to the beginning of each fiscal year, CRIM informs to the Municipality the estimated amount of property tax expected to be collected for the ensuing fiscal year. Throughout the fiscal year, CRIM advances funds to the Municipality based on the initial estimated collection amounts for the fiscal year. CRIM is required by law to prepare a settlement statement on a fiscal year basis, whereby a comparison is made between the amounts advanced to the Municipality and the property tax amounts actually collected from taxpayers on behalf of the Municipality during the fiscal year. This settlement has to be completed on a preliminary basis not later than December 31 following the fiscal year end.

Personal property taxes are self-assessed by taxpayers every year using the book value of personal property assets owned by the taxpayer at January 1 (assessment date) and reporting such taxable value through a personal property tax return filed on May 15 subsequent to the assessment date. The total personal property tax rate in force at June 30, 2008 was 7.03 percent (of which taxpayers pay 6.83 percent and the remaining 0.20 percent is paid by the Department of Treasury, as a subsidy).

Real property taxes are assessed by CRIM. The assessment on real property is made every January 1 and is based on estimated current values of the property, deflated to 1957 market prices. The total real property tax rate in force at June 30, 2008 was 9.03 percent (of which 8.83 percent is paid by taxpayers and the remaining 0.20 percent is also paid by the Department of Treasury, as a subsidy).

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

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

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

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

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

- Thirty five percent of its net earnings (defined as the excess of revenues over expenses less an amount earmarked for the Fund for Rent and Home Improvement Subsidy Program for the Low-Income Qualifying Elderly) is earmarked to the municipalities of the Commonwealth, of which a maximum of \$26 million, on an annual basis, is distributed to the Municipal Equalization Fund held by CRIM to cover operating expenses and permanent improvements of the municipalities.
- An additional amount not exceeding \$16 million, on an annual basis, is distributed to the Municipal Equalization Fund, provided it is within the thirty-five percent corresponding to the municipalities of the Commonwealth. When the accumulated municipal appropriations from the municipalities' Puerto Rico Health Reform are covered up to June 30, 1997, these resources will be assigned to PRHSA.

At June 30, 2010, property taxes receivable recorded in the general fund and the debt service fund amounted to \$488,103 and \$74,281, respectively, net of a reserve for doubtful accounts.

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5. Inter-Fund Transactions

The composition of inter-fund balances at June 30, 2010 and for the fiscal year then ended is as follows:

Due/advances from:	Due/advances to:				Total governmental funds
	Major governmental funds				
	General fund	Debt service fund	Capital improvement fund	Other governmental funds	
Major governmental funds:					
General fund	\$ -	28	299,252	267,161	\$ 566,441
Capital improvements bond fund	599,430	-	-	182,911	782,341
Other governmental funds	28,892	-	-	-	28,892
Total	\$ 628,322	28	299,252	450,072	\$ 1,377,674

Transfers out:	Transfers in:			
	Major governmental funds			
	General fund	Debt service fund	Other governmental funds	Total governmental funds
Major governmental funds:				
General fund	\$ -	100,354	119,444	\$ 219,798
Debt service fund	545	-	-	545
Capital improvements bond fund	6,392	-	-	6,392
Other governmental funds	115,209	-	-	115,209
Total	\$ 122,146	100,354	119,444	\$ 341,944

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6. Capital Assets

Capital assets activity for the fiscal year ended June 30, 2010:

Governmental Activities:	Balance at beginning of fiscal year, as restated	Reclasifications	Additions	Balance at end of fiscal year
Cost basis:				
Capital asset, not being depreciated:				
Land	\$ 19,200,460	-	233,100	\$ 19,433,560
Construction in progress	2,080,023	-	181,130	2,261,153
Total capital assets, not being depreciated/amortized	<u>21,280,483</u>	<u>-</u>	<u>414,230</u>	<u>21,694,713</u>
Capital assets, being depreciated:				
Buildings, structures, and improvements	21,556,805	-	666,945	22,223,750
Infrastructure	3,646,204	-	20,147	3,666,351
Vehicles, machinery and equipmnet, and furniture and fixtures	2,657,107	(1,500)	700,710	-
Works of art	-	1,500	-	1,500
Total capital assets, not being depreciated/amortized	<u>27,860,116</u>	<u>-</u>	<u>1,387,802</u>	<u>29,247,918</u>
Total cost basis of capital assets	<u>49,140,599</u>	<u>-</u>	<u>1,802,032</u>	<u>50,942,631</u>
	Accumulated Depreciation/ amortization at beginning of fiscal year	Reclasifications	Depreciation and amortization expense	Accumulated Depreciation/ amortization at end of of fiscal year
Accumulated depreciation and amortization:				
Buildings, structures, and improvements	(3,554,100)	-	(742,697)	(4,296,797)
Infrastructure	(2,357,660)	-	-	(2,357,660)
Vehicles, machinery and equipmnet, and furniture and fixtures	(2,217,554)	663	(293,234)	(2,511,451)
Works of art	-	(663)	(150)	513
Total accumulated depreciation and amortization	<u>(8,129,314)</u>	<u>-</u>	<u>(1,036,081)</u>	<u>(9,165,395)</u>
Net capital assets	<u>\$ 41,011,285</u>	<u>-</u>	<u>765,951</u>	<u>\$ 41,777,236</u>

Depreciation and amortization expense for the fiscal year ended June 30, 2010, was charged to fuctions/programs as follows:

Governmental activities:

General government	\$ (172,680)
Public safety	(172,680)
Public works	(172,680)
Culture, recreation and education	(172,680)
Health and welfare	(172,680)
Urban and economic development	<u>(172,680)</u>
Total depreciation and amortization expenses	<u>\$ (1,036,080)</u>

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7. Long-Term Obligations

The general long-term debt activity for the fiscal year ended June 30, 2010 is as follows:

	Balance at beginning of fiscal year, as restated	Borrowings or additions	Payments or deductions	Balance at end of fiscal year	Balance due within one year
Bonds payable	\$ 6,117,900	670,000	(739,900)	6,048,000	\$ 723,900
Notes payable:					
Public Acts No. 42 and 146	279,242	-	(22,676)	256,566	24,630
LIMS Repayment Plan	66,086	-	(23,839)	42,247	23,839
Puerto Rico Treasury Department	122,517	-	-	122,517	58,200
Compensated absences	1,373,789	600,565	1,373,789	600,565	-
Claims and judgments	348,779	-	-	348,779	348,779
Total	<u>\$ 8,308,313</u>	<u>1,270,565</u>	<u>587,374</u>	<u>7,418,674</u>	<u>\$ 1,179,348</u>

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

a) Debt Limitation

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

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

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b) Bonds Payable

The Municipality issues general obligation, special obligation and public improvement bonds to finance the acquisition, construction and improvement of capital assets, as well as, to finance certain operating needs, including the payment to suppliers in certain circumstances.

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

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

For financial reporting purposes, the outstanding balances of bonds represent the total principal to be repaid. Bonds payable is composed as follows at June 30, 2010:

	<u>Outstanding Amount</u>
2001 serial bonds (face amount of \$590,000) due in annual principal installments ranging from \$40,000 to \$80,000; plus interests due in semiannually installments at variable rates (8.00% at June 30, 2010) through July, 1, 2010	\$ 80,000
2002 serial bonds (face amount of \$370,000) due in annual principal installments ranging from \$15,000 to \$45,000; plus interests due in semiannually installments at variable rates (1.28% at June 30, 2010) through July, 1, 2017	225,000
2003 serial bonds (face amount of \$285,000) due in annual principal installments ranging from \$5,000 to \$258,000; plus interests due in semiannually installments at variable rates (4.50% at June 30, 2010) through July 1, 2028	250,000
2005 serial bonds (face amount \$475,000) due in annual principal installments ranging from \$35,000 to \$60,000; plus interests due in semiannually installments at variable rates (1.53% at June 30, 2010) through July 1, 2015	270,000
2005 serial bonds (face amount of \$1,140,000) due in annual principal installments ranging from \$50,000 to \$105,000; plus interests due in semiannually installments at variable rates (1.53% at June 30, 2010)	850,000

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	<u>Outstanding Amount</u>
through July 1, 2020	
1998 serial bonds (face amount of \$576,000) due in annual principal installments ranging from \$14,000 to \$39,000; plus interests due in semiannually installments at variable rates (4.50% at June 30, 2010) through January 1, 2023	385,000
1996 serial bonds (face amount of \$514,000) due in annual principal installments ranging from \$16,000 to \$39,000; plus interests due in semiannually installments at variable rates (4.50% at June 30, 2010) through January 1, 2020	314,000
2000 serial bonds (face amount of \$239,000) due in annual principal installments ranging from \$6,000 to \$17,000; plus interests due in semiannually installments at variable rates (4.50% at June 30, 2010) through January 1, 2025	182,000
2005 serial bonds (face amount of \$153,700) due in annual principal installments ranging from \$19,000 to \$25,100; plus interests due in semiannually installments at variable rates (4.50% at June 30, 2010) through January 1, 2013	72,000
2009 serial bonds (face amount of \$670,000) due in annual principal installments ranging from \$75,000 to \$120,000; plus interests due in semiannually installments at variable rates (1.53% at June 30, 2010) through July 1, 2016	595,000
2009 serial bonds (face amount of \$1,035,000) due in annual principal installments ranging from \$120,000 to \$185,000; plus interests due in semiannually installments at variable rates (4.75% at June 30, 2009) through July 1, 2015	915,000
1997 serial bonds (face amount of \$400,000) due in annual principal installments ranging from \$10,000 to \$40,000; plus interests due in semiannually installments at variable rates (1.53% at June 30, 2010) through July 1, 2016	205,000
2003-2004 serial bonds (face amount of \$865,000) due in annual principal installments ranging from \$60,000 to \$110,000; plus interests due in semiannually installments at variable rates (1.53% at June 30, 2010) through July 1, 2014	410,000
2003 serial bonds (face amount of \$990,000) due in annual principal installments ranging from \$15,000 to \$75,000; plus interests due in semiannually installments at variable rates (1.53% at June 30, 2010) through July 1, 2028	845,000

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Notes to Financial Statements
June 30, 2010

	<u>Outstanding Amount</u>
2008 serial bonds (face amount of \$505,000) due in annual principal installments ranging from \$15,000 to \$80,000; plus interests due in semiannually installments at variable rates (1.54% at June 30, 2010) through January 1, 2016	450,000
Total bonds payable	\$6,048,000

Variable interest rates on serial bonds are reviewed periodically by GDB and are based on the fluctuation of GDB's weighted average rate for its commercial paper program. Under this program, GDB issues commercial paper: (1) in the taxable and tax-exempt markets of the United States of America, (2) in the Eurodollar market, and (3) to corporations having tax exemptions under the Commonwealth's Industrial Incentives Acts and, which qualify for benefits provided by the former Section 936 of the U.S. Internal Revenue Code. Annual debt service requirements of maturity for bonds payable are as follows:

Fiscal year ending June 30,	Principal	Interest	Total
2011	\$ 723,900	193,081	\$ 916,981
2012	683,000	308,364	991,364
2013	727,100	261,162	988,262
2014	740,000	213,988	953,988
2015	682,000	168,173	850,173
2016-2020	1,672,000	420,637	2,092,637
2021-2025	545,000	164,032	709,032
2026-2030	275,000	26,300	301,300
Totals	\$ 6,048,000	1,755,737	\$ 7,803,737

At June 30, 2010, accrued interest payable on bonds amounted to \$78,799.

c) Notes Payable to CRIM

The Municipality had the following notes payables to CRIM at June 30, 2010:

- **Public Acts No. 146 and No. 42** – On September 24, 2002, CRIM, on behalf of the municipalities of Puerto Rico, entered into a financing agreement with GDB pursuant to the provisions of Public Act No. 146 of October 11, 2001, as amended (Act No. 146). The purpose of this financing agreement was to extinguish in

COMMONWEALTH OF PUERTO RICO
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advance certain bonds payable issued by Public Finance Corporation (PFC), a subsidiary of GDB, which were originally issued to pay certain property tax receivables owned by the municipalities of Puerto Rico through 1996, which were acquired by PFC with recourse.

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

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

In addition, on December 16, 2002 the Municipality entered into a repayment agreement with GDB and CRIM to pay off the remaining of excess of property tax advances from fiscal years 2000, 2001 and other previous fiscal years. CRIM retains the principal and interest from the property tax advances of the Municipality. The amounts retained by CRIM are remitted to GDB on July 1 of each fiscal year through July 1, 2032. The repayment agreement bears interest at variable rates determined by GDB (6.30 percent at June 30, 2008) but not exceeding 8.00 percent. Principal and interest payments on this financing agreement are accounted for in the general fund.

The outstanding principal of the notes payable to CRIM amounted to \$256,566, at June 30, 2010.

d) Notes Payable to Land Information Management System (LIMS)

During the fiscal year 2001-2002, the Municipality authorized the CRIM to retain the corresponding portion for the financing project of Land Information Management System-LIMS, contracted by the CRIM. A total of \$215,030 is to be retained in ten years period at an interest rate of 5.95% until November 28, 2011. The outstanding debt balance of the note payable amounted to \$42,247.

COMMONWEALTH OF PUERTO RICO
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June 30, 2010

8. Employees' Retirement Systems

a) Plan Description

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

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

- ***Retirement Annuity***

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

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

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

- ***Merit Annuity***

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

- ***Deferred Retirement Annuity***

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

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- ***Coordinated Plan***

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

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

- ***Non-Coordinated Plan***

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

- ***Reversionary Annuity***

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

- ***Occupational Disability Annuity***

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

- ***Non-occupational Disability Annuity***

A participating employee, totally and permanently disabled for causes not related to his/her occupation and with no less than 10 years of credited service, is eligible for an annuity of 1.50 percent of the average compensation of the first 20 years of credited services, increased by 2 percent for every additional year of credited service in excess of 20 years.

- ***Death Benefits***

Occupational:

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
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June 30, 2010

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

Non-occupational:

Beneficiary – the contributions and interest accumulated as of the date of the death plus an amount equal to the annual compensation at the time of the death.

Post-retirement:

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

- **Refunds**

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

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

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

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

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

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

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

COMMONWEALTH OF PUERTO RICO
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Notes to Financial Statements
June 30, 2010

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

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

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

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

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

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

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

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

COMMONWEALTH OF PUERTO RICO
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Notes to Financial Statements
June 30, 2010

b) Funding Policy

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

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

9. Commitments and Contingencies

The Municipality is defendant in various legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended, persons are authorized to sue the Municipality only for causes of actions set forth in said Act to a maximum amount of \$75,000 or \$150,000 if it involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as provided in Act No. 9 of November 26, 1975, as amended, the Municipality may provide its officers and employees with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the payment of such judgment.

With respects to pending or threatened litigation, the Municipality has reported liabilities amounting to \$348,779 for awarded or anticipated unfavorable judgments as of June 30, 2010. Management believes that any unfavorable outcome in relation to pending or threatened litigation would not be significant, if any.

The Municipality has reported, outstanding encumbrances amounting to \$2,085,516 in the general fund at June 30, 2010. The Municipality intends to honor these encumbrances, which will continue to be liquidated under the current year's budget during a lapse period that extends into the subsequent fiscal year.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
 Budgetary Comparison Schedule-General Fund
 Year Ended June 30, 2010

	Original	Final	basis)	over (under)
Revenues				
Property taxes	\$ 5,738,700	5,738,700	5,800,753	\$ 62,053
Municipal license taxes	967,974	967,974	854,396	(113,578)
Sales and taxes	577,440	577,440	605,306	27,866
Construction excise taxes	694,255	694,255	322,750	(371,505)
Charges for services	126,060	126,060	144,305	18,245
Intergovernmental grants and contributions	1,136,524	1,136,524	1,252,144	115,620
Miscellaneous	399,426	399,426	93,945	(305,481)
Other financing sources	-	-	122,146	122,146
	9,640,379	9,640,379	9,195,745	(444,634)
Expenditures				
Current:				
General government	6,129,472	6,274,479	1,070,428	(5,204,051)
Public Works	1,500,452	1,499,992	1,760,562	260,570
Public safety	840,746	748,734	1,332,390	583,656
Health and welfare	846,428	808,216	2,705,252	1,897,036
Culture, recreation and education	323,281	308,959	893,253	584,294
Public housing and welfare	-	-	850,600	850,600
Other financing uses	-	-	219,798	219,798
Total expenditures and transfers to other funds	\$ 9,640,379	9,640,379	8,832,283	\$ (808,096)

Explanation of Differences:

Sources/inflows of financial resources:

Actual amounts (budgetary basis) "available for appropriations" from the budgetary comparison schedule	9,195,745
Differences - budget basis to GAAP:	
Actual revenues considered revenues for financial reporting purposes but not inflows for budget purposes (net changes in receivables)	(1,489,599)
Transfer in from other governmental funds	(122,146)
Total revenues as reported on the statement of revenues, expenditures and changes in fund balances - governmental funds	<u>7,584,000</u>

Uses/outflows of financial resources:

Actual amounts (budgetary basis) "total charges to appropriations" from the budgetary comparison schedule	8,832,283
Differences - budget basis to GAAP:	
Actual outflow considered expenditures for financial reporting purposes but not expenditures for budget purposes (net change in encumbrances)	(1,506,001)
Transfers out other governmental funds	(219,798)
Total expenditures as reported on the statement of revenues, expenditures and changes in fund balances - governmental funds	<u>7,106,484</u>

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
SCHEDULE OF EXPENDITURE OF FEDERAL AWARD
JUNE 30, 2010

<u>Program Title</u>	Federal CFDA Number	Pass-through Grantor's Number	Expenditures
U.S Department of Housing and Urban Development			
State Block Grant Program (SBGP)	14.228	All year Program	\$934,498
Section 8 Housing Choice Voucher	14.871	All Year Program	837,186
Emergency Shelter Program	14.231		42,993
Pass Through the Commonwealth of PR Municipality of San Juan: Housing Opportunities for Persons with AIDS (HOPWA)	14.241		<u>33,021</u>
Total U.S. Department of Housing and Urban Development:			<u>1,804,705</u>
 U.S. Department of Agriculture			
Child and Adult Care Food Program	10.558		<u>12,916</u>
Total U.S. Department of Agriculture			<u>12,916</u>
 U.S. Department of Health and Human Services			
Child Care – ARRA	97.713		764,000
Child Care and Development Block Grant	93.575		<u>340,283</u>
Total U.S. Department of Health and Human Services			<u>1,104,283</u>
 U.S. Department of Energy (DOE)			
Energy Efficiency	81.128		<u>4,104</u>
Total U.S. Department of Energy			<u>4,104</u>
 Total Federal Financial Assistance			 <u>\$2,205,765</u>

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
NOTES TO
SCHEDULE OF EXPENDITURE OF FEDERAL AWARD
JUNE 30, 2010

1. General

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

2. Relationship to General Purpose Financial Statements

Expenditures of the Federal Awards as reported in the Statement of Revenues, Expenditures and Changes in Fund Balances- Governmental Funds. The reconciliation between the expenditures in the basic financial statements and expenditures in the Schedule of Expenditures of Federal Award is as follows:

Expenditures in the Basis Financial Statements

Non-Major Governmental Funds	-	\$2,481,231
Less: Non-Federal Expenditures	-	<u>275,466</u>
Total Expenditures in the Schedule of Federal Award	-	<u>\$2,205,765</u>


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

To the Honorable Mayor and
the Municipal Assembly
Municipality of Naguabo
Naguabo, Puerto Rico

We have audited the financial statements of the governmental activities, each major fund and the aggregate remaining fund information of the Municipality of Naguabo as of and for the year ended June 30, 2010, which collectively comprise the Municipality of Naguabo basic financial statements and have issued our report thereon dated December 27, 2010. We conducted our audit in accordance with auditing standards generally accepted in United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

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

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Municipality of Naguabo ability to initiate, authorize, record process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Municipality of Naguabo financial statements that is more than inconsequential will not be prevented or detected by Municipality of Naguabo internal control. We consider the deficiencies described in the accompanying schedule of internal control over financial reporting. (2010-1 and 2010-2)

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Municipality of Naguabo internal control.

Our consideration of the internal control over financial reporting was for the limited purpose describe in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that

might be significant deficiencies and accordingly would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However we believe that none of the significant deficiencies described above is a material weakness.

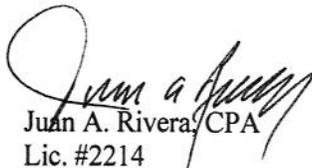
Compliance

As part of obtaining reasonable assurance about whether the Municipality of Naguabo 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 statements amounts. However, providing and opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such as an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as items (2010-1 and 2010-2).

We noted certain matters that we reported to management of Municipality of Naguabo, in a separate letter dated December 27, 2010.

Municipality of Naguabo, response to the findings identified in our audit is described in the accompanying schedule of federal findings and questioned costs. We did not audit Municipality of Naguabo response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, of the Honorable Mayor and The Municipal Assembly of Municipality of Naguabo, others within the entity, and federal awarding agencies and past-through entities and is not intended to be and should not be used by anyone other than these specified parties.


Juan A. Rivera, CPA
Lic. #2214

Toa Baja, Puerto Rico
December 27, 2010



Stamp NO. 2579458 of the Puerto Rico Society of Certified Public Accountants was affixed to the original report.


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

To the Honorable Mayor and
the Municipal Assembly
Municipality of Naguabo
Naguabo, Puerto Rico

We have audited the compliance of Municipality of Naguabo with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each of its major federal programs for the year ended June 30, 2010. The Municipality of Naguabo 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 of Naguabo management. Our responsibility is to express an opinion on the Municipality of Naguabo compliance based on our audit.

Compliance

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in Governmental 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 of Naguabo compliance with those requirements and performing such others procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not include a legal determination of the Municipality of Naguabo compliance with those requirements.

As described in item Section II in the accompanying schedule of findings and questioned costs, the Municipality of Naguabo did not comply with requirements regarding administrative requirements that are applicable to its SBGP Program. Compliance with such requirement is necessary for the Municipality of Naguabo to comply with the federal regulations. Also we want to emphasize that this requirement has not been complied in prior years.

In our opinion, except for the noncompliance described in the preceding paragraph, the Municipality of Naguabo 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, 2010.

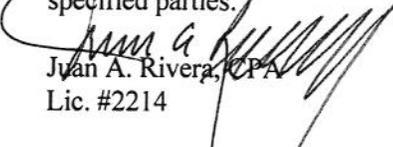
Internal Control over Compliance

The management of the Municipality of Naguabo is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grant applicable to federal programs. In planning and performing our audit, we considered the Municipality of Naguabo 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 of Naguabo 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 in Section II.

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

However, we believe that none of the reportable conditions described above is a material weakness. This report is intended for the information of the audit committee, the Municipality's management, the Department of Housing and Urban Development (Cognizant Agency), and federal awarding agencies and pass-through entities. However, this report is not intended to be and should not be used by anyone other than these specified parties.


Juan A. Rivera, CPA
Lic. #2214

December 27, 2010
Toa Baja, Puerto Rico



Stamp No. 2579459 of the Puerto Rico State Society of Certified Public Accountants was affixed to the original reports

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2010

Section II – Schedule of Financial Statements Findings and Questioned Costs

Finding Number 10-01 - Davis Bacon Act – Department of Labor (DOL)

Required that construction contract in excess of \$2,000 financed by Federal Assistance Funds must be paid wages not less than local prevailing rate.

CRITERIA

The Department of Labor (DOL) (40 USC 2769 to 2769-7) required contractor and subcontractor to submit the Municipality, each week, with certified copy of the payroll.

CAUSE

The Municipality was not aware with the compliance to the contractor or subcontractor federal regulation.

EFFECT

The Municipality is not in compliance with the Federal Regulation.

RECOMMENDATION

The Municipality must establish Operating Procedures to avoid this situation in the future.

AUDITEE RESPONSE

The Federal Director gave instructions to the person in charge of this area, in order to comply with the requirement of Department of Labor (40usc 2769 to 2769-7)

Finding Number 10-2 – Reasonable Rent (Section8)

STATEMENT OF CONDITION

As part of our eligibility test for participants, we selected 11 participants' files. The following deficiency was noted during our examination.

1. In 5 (45.5%) participants, file application forms were not present in the file.

CRITERIA

Most PHA's devise their own application forms that are filled out by the PHA staff during interview with the tenant. The head of the household signs: (a) on or more release forms to allow the PHA to obtain information from third parties; (b) a federally prescribed general release from for employment information and (c) a privacy notice. (24) CFR section 5.212 and 5.230.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 2010

Finding 10-2 (cont)

RECOMMENDATION

The Municipality should determine income eligibility and calculate the tenant rent payment using the documentation from any validate third party in accordance with 24 CFR Part 5 subpart F.

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF NAGUABO
 Schedule of Prior Year Findings and Questioned Costs
 For the Year Ended June 30, 2010

Program	Finding / Compliance	Status
<u>Special Revenue Fund- Non federal</u>	<u>Condition 09-01</u> <u>Special Revenue Fund- Non federal</u> During the performance of our audit procedures the following exceptions were noted: The Municipality did not maintain effective control over commitments over Special Revenue Funds. During the year the Municipality commits in excess, half million dollars (\$500,000) from Special Revenue Funds.	During this year this exception was noted

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