

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

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

OFIC. DEL COMISIONADO
DE ASUNTOS MUNICIPALES

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS**

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

ORTIZ, RODRIGUEZ, RIVERA & CO.

CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

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

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

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Management Consulting
Services Division

INDEPENDENT AUDITORS' REPORT

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

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

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

In accordance with *Government Auditing Standards*, we have also issued our report dated December 30, 2005, on our consideration of the Municipality's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and

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

The Management's Discussion and Analysis on pages 3 through 6 and Budgetary Comparison for General Fund on pages 47 and 48 are not a required part of the basic financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

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

San Juan, Puerto Rico
December 30, 2005

Ortiz, Rodriguez, Rivera & Co.

The stamp 2115830 was affixed
to the original of this report.



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
MANAGEMENT'S DISCUSSION AND ANALYSIS**

Management of the Municipality of Quebradillas (the "Municipality") provides this Management's Discussion and Analysis of the Municipality's basic financial statements as an overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2005. We encourage readers to consider the information presented here in conjunction with the additional information that we have furnished in the accompanying basic financial statements.

USING THIS ANNUAL REPORT

This annual report consists of a series of new financial statements with a change in the focus from previous financial statements. The new focus is on both the Municipality as a whole (government-wide) and the major individual funds. Both perspectives (government-wide and major fund) allow the user to address relevant questions, broaden a basis for comparison (year to year or government to government) and enhance the Municipality's accountability.

FINANCIAL HIGHLIGHTS

- The Municipality net assets decreased by \$1,597,570.
- In the fund financial statements, general fund balances increased by \$96,344..
- Long term debt increased by \$2,358,500.

GOVERNMENT-WIDE-FINANCIAL STATEMENT

The government-wide financial statements are designed to provide readers with a broad overview of the Municipality's operations and finance 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 the end of the fiscal year. These financial statements are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This basically means that these financial statements follow methods that are similar to those used by most businesses. They take into account all revenues and expenses connected with the fiscal year ended June 30, 2005 even if cash involved have not been received or paid. The government-wide financial statements include: (1) the statements of net assets and (2) the statement of activities.

Statement of Net Assets

The statement of net assets presents all of the Municipality's assets and liabilities, with the difference between these two items reported as "net assets" (equity). Over time, increases or decreases in the net assets may serve as a useful indicator of whether the financial position of the Municipality is either improving or deteriorating.

Statement of Activities

The statement of activities presents information showing how the Municipality's net assets changed during the fiscal year ended June 30, 2005. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods (such as

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
MANAGEMENT'S DISCUSSION AND ANALYSIS**

uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenues for each function of the Municipality.

Both of the above mentioned financial statements present all the governmental activities of the Municipality, which consist mostly by taxes and intergovernmental revenues (such as federal grants). Most services provided by the Municipality fall into this category, including culture and education, general government, health and sanitation, public safety, public housing and welfare, etc.

Fund Financial Statements

The Fund Financial Statements provide detailed information about the Municipality's most significant funds, not the Municipality as a whole. The Municipality has only one kind of fund, which is the governmental fund.

Governmental funds are used to account for essentially the same functions reported as governmental activities in the Government Wide Financial Statements. However, unlike the Government Wide Financial Statements, Government Fund Financial Statements focus on near term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information is useful in evaluating the Municipality's near term financial requirements.

Because the focus of governmental funds is narrower than that of the government wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government wide financial statements. By doing so, users of the basic financial statements may better understand the long-term impact of the Municipality's near term financial decisions. Both of the Governmental Fund Balance Sheet and the Governmental Fund Statement of Revenues, Expenditures and Changes in Fund Balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

**Condensed Statement of Net Assets
June 30, 2005 and 2004**

	<u>2005</u>	<u>2004</u>
Assets:		
Current assets	\$ 3,571,404	\$ 2,125,751
Non-current assets:		
Capital assets, net	<u>15,767,104</u>	<u>15,944,490</u>
Total assets	<u>\$ 19,338,508</u>	<u>\$ 18,070,241</u>
Liabilities:		
Current liabilities	\$ 8,366,666	\$ 7,820,154
Non-current liabilities - long-term liabilities		
due after one year	<u>8,648,032</u>	<u>6,328,707</u>
Total liabilities	<u>\$ 17,014,698</u>	<u>\$ 14,148,861</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
MANAGEMENT'S DISCUSSION AND ANALYSIS**

	<u>2005</u>	<u>2004</u>
<i>Net assets:</i>		
Invested in capital assets, net of related debt	10,206,084	11,663,406
Restricted	1,728,244	1,346,775
Unrestricted	<u>(9,710,518)</u>	<u>(9,088,801)</u>
Total net assets	<u>\$ 2,223,810</u>	<u>\$ 3,921,380</u>

FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE

Net Assets

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial position. In the case of the Municipality, assets exceeded liabilities by \$2,323,810 at June 30, 2005.

As previously discussed, by far the largest portion of the Municipality's net assets reflect its investment in capital assets (e.g., land, buildings, machinery, equipment and all other property), less any related debt used to acquire those assets that is still outstanding. The Municipality uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. The following is a condensed presentation of the Municipality's financial position and results of operations, as reported in the government-wide financial statements:

CHANGES IN NET ASSETS

The Municipality's net assets decreased by \$1,597,570. Approximately 64 percent of the municipality total revenue came from grants and contributions, including federal aid, while 35 percent resulted from taxes. The municipality's expenses cover a range of service. The largest expenses for were for general government and public works. In future years, when prior-years information is available, a comparative analysis of government-wide data will be presented.

FINANCIAL ANALYSIS OF THE MUNICIPALITY'S INDIVIDUAL FUNDS

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

Governmental Funds

The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows, and balances of spend able resources. Such information is useful in assessing the Municipality's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
MANAGEMENT'S DISCUSSION AND ANALYSIS**

As of the end of the current fiscal year, the Municipality's governmental funds reported combined deficiency (\$3,078,195) a decrease of \$1,213,145 in comparison with the prior year. There are reservations of fund balance amounting to \$302,596. This is the fund balance that is not available for new spending because it has already been committed to pay debt service.

The general fund is included within the governmental funds; it is the operating fund of the Municipality. As of June 30, 2005, the general fund has a deficiency of \$5,541,771.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The Municipality's investment in capital assets as of June 30, 2005, amounts to \$21 million, net of accumulated depreciation of \$5 million, leaving a net book value of \$16 million. This investment in capital assets includes land, buildings, improvements, equipment construction in progress.

The Municipality finances a significant portion of its construction activities through bond issuances. 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.

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 is intended to demonstrate the Municipality's accountability for the money it receives. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Municipality of Quebradillas, Department of Finance, P.O. 1544, Quebradillas, Puerto Rico, 00678.

Commonwealth of Puerto Rico
Municipality of Quebradillas
Statement of Net Assets
June 30, 2005

<u>Assets</u>	<u>Governmental Activities</u>
Current assets:	
Cash	\$ 188,158
Accounts receivable, net of allowance for doubtful accounts:	
Taxes:	
Property taxes	52,658
Municipal license taxes	5,478
Accrued interest	12
Intergovernmental	1,058,401
Federal Financial Assistance	37,918
Restricted assets:	
Cash with commercial bank	615,099
Cash with fiscal agent	1,613,680
Total current assets	3,571,404
Noncurrent assets:	
Capital assets, net of accumulated depreciation and amortization of \$5,351,833	15,767,104
Total assets	\$ 19,338,508
<u>Liabilities and Net Assets</u>	
Current liabilities (due within one year):	
Accounts payable	\$ 1,260,586
Accrued liabilities	163,269
Intergovernmental payables	4,641,483
Deferred revenues	673,077
Accrued interest	533,209
Current portion of long-term obligations:	
Bonds payable	343,100
Notes Payables	40,355
Compensated absences	519,495
Claims and judgments	517,100
Total current liabilities	8,691,674
Noncurrent liabilities (due in more than one year):	
Bonds payable	6,716,200
Notes Payables	888,024
Compensated absences	718,800
Total noncurrent liabilities	8,323,024
Total liabilities	17,014,698
Net assets:	
Invested in capital assets, net of related debt	10,306,084
Restricted for:	
Debt service	\$ 302,596
Other specified purposes	1,425,648
Total restricted net assets	1,728,244
Unrestricted net assets	(9,710,518)
Total net assets	2,323,810
Total liabilities and net assets	\$ 19,338,508

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

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Commonwealth of Puerto Rico
Municipality of Quebradillas
Statement of Activities
For the Fiscal Year Ended June 30, 2005

Functions/programs	Expenses	Program Revenues Operating grants and contributions	Net Expenses and Charges in Net Assets
Governmental activities:			
General government	\$ 5,367,589	\$ 1,074,709	\$ (4,292,880)
Urban and economic development	114,364	-	(114,364)
Public safety	937,834	-	(937,834)
Environmental control	921,975	-	(921,975)
Highway and streets	1,087,214	-	(1,087,214)
Health and sanitation	630,590	-	(630,590)
Culture, recreation and education	201,237	171,222	(30,015)
Public housing and welfare	1,206,159	671,791	(534,368)
Interest on long-term obligation	676,186	-	(676,186)
Total governmental activities	\$ 11,143,148	\$ 1,917,722	\$ (9,225,426)
General Revenues:			
Taxes:			
Property taxes			2,446,594
Municipal license taxes			442,016
Construction excise taxes			218,890
Total taxes			3,107,500
Intergovernmental			3,741,855
Unrestricted investments earnings			4,733
Miscellaneous			773,768
Total general revenues			7,627,856
		Net changes in net assets	(1,597,570)
		Net changes at beginning of the year restated	3,921,380
		Net assets at the end of the year	\$ 2,323,810

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Commonwealth of Puerto Rico
Municipality of Quebradillas
Balance Sheet - Governmental Funds
June 30, 2005

	Major Funds			Other Governmental Funds	Total Governmental Funds
	General Fund	Debt Service Fund	\$2,135m Serial Bonds		
Assets					
Cash	\$ 188,159	\$ -	\$ -	\$ 529,968	\$ 718,127
Receivable, net of allowance for uncollectible accounts:					
Taxes:					
Property Taxes	52,658				52,658
Municipal license taxes	5,478				5,478
Due from other funds	248,423			1,194,390	1,442,813
Due from governmental entities	708,984			273,584	982,568
Due from federal financial assistance				37,918	37,918
Other				12	12
Restricted assets:					
Cash with fiscal agent		894,252	719,429	85,131	1,698,812
Total assets	<u>\$ 1,203,702</u>	<u>\$ 894,252</u>	<u>\$ 719,429</u>	<u>\$ 2,121,003</u>	<u>\$ 4,938,386</u>
Liabilities					
Account payable	\$ 608,457	\$ -	\$ -	\$ 59,095	\$ 667,552
Due to other funds	1,194,391			248,422	1,442,813
Due to governmental entities	4,641,483				4,641,483
Deferred revenues	301,142				301,142
Deferred intergovernmental revenues				2,130	2,130
Deferred federal financial assistance				369,805	369,805
Matured bonds due and payable		591,656			591,656
Total liabilities	<u>6,745,473</u>	<u>591,656</u>	<u>-</u>	<u>679,452</u>	<u>8,016,581</u>
Fund Balance					
Reserved for:					
Debt service		302,596			302,596
Other specified purpose				1,441,551	1,441,551
Unreserved	(5,541,771)		719,429		(4,822,342)
Total fund balance	<u>(5,541,771)</u>	<u>302,596</u>	<u>719,429</u>	<u>1,441,551</u>	<u>(3,078,195)</u>
Total liabilities and fund balance	<u>\$ 1,203,702</u>	<u>\$ 894,252</u>	<u>\$ 719,429</u>	<u>\$ 2,121,003</u>	<u>\$ 4,938,386</u>

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

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Commonwealth of Puerto Rico
Municipality of Quebradillas
 Reconciliation of the Balance Sheets-Governmental Funds
 to the Statements of Net Assets
 June 30, 2005

Governmental activities amounts reported in the statements of net assets and the balance sheet-governmental funds are different because:

Aggregate fund balance reported in the balance sheets - governmental funds	\$ (3,078,196)
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Add (Deduct):

Capital assets used in governmental activities are not financial resources, therefore are not reported in the governmental funds	15,767,104
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Deferred revenues in the governmental funds that are recognized as revenues in the statements of activities	75,833
---	--------

The following liabilities are not due(mature) in the current period, therefore are not reported in the governmental funds:

Accounts payable and accrued liabilities and interest	(593,035)
Note payable with Treasury Department	(930,732)
Accrued Christmas bouns	(163,269)
Bonds and notes payables	(6,998,500)
Compensated absences	(1,238,295)
Claims and judgments	<u>(517,100)</u>

Governmental activities net assets reported in statements of net assets	<u><u>\$ 2,323,810</u></u>
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The accompanying notes to the basic financial statements are an integral part of this statement.

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Commonwealth of Puerto Rico
Municipality of Quebradillas
Statement of Revenues, Expenditures and Changes in Fund Balance - Governmental Funds
For Fiscal Year Ended June 30, 2005

	Major Funds			Other Governmental Funds	Total Governmental Funds
	General Fund	Debt Service Fund	\$2,135m Serial Bonds		
Revenues:					
Taxes:					
Property taxes	\$ 2,028,847	\$ 417,747	\$ -	\$ -	\$ 2,446,594
Volume of business tax	442,016				442,016
License, permits and fines	218,890				218,890
Intergovernmental grants and contributions:					
State contributions	3,312,801			382,681	3,695,482
Federal government				1,964,095	1,964,095
Investment earnings	4,503			230	4,733
Miscellaneous	49,866			4,473	54,339
Total revenues	6,056,923	417,747	-	2,351,479	8,826,149
Expenditures					
General:					
General government	3,379,230	-		1,207,467	4,586,697
Urban and economic	30,194				30,194
Public safety	897,784			3,575	901,359
Environmental control	876,962			123	877,085
Health and sanitation	630,590				630,590
Highway and streets	846,007			241,207	1,087,214
Culture, recreation and education	219,273				219,273
Public housing and welfare	498,854			693,275	1,192,129
Debt service					
Principal	35,715	322,300			358,015
Interest	41,709	276,463			318,172
Total expenditures	7,456,318	598,763	-	2,145,647	10,200,728
Excess (deficiency) of revenues over (under) expenditures	(1,399,395)	(181,016)	-	205,832	(i,374,579)
Other financing sources (uses):					
Proceeds from issuance long term debt			2,135,000	452,725	2,587,725
Transfer-in from other funds	1,873,882	222,130		156,010	2,252,022
Transfer-out to other funds	(378,141)	(5,585)	(1,415,571)	(452,725)	(2,252,022)
Total other financing sources (uses), net	1,495,741	216,545	719,429	156,010	2,587,725
Excess (deficiency) of revenues and other financing sources over (under) expenditures and other financing uses	96,346	35,529	719,429	361,842	1,213,146
Fund Balance at beginning of year	(5,638,117)	267,067	-	1,079,709	(4,291,341)
Fund balance at end of year	\$ (5,541,771)	\$ 302,596	\$ 719,429	\$ 1,441,551	\$ (3,078,195)

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

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Commonwealth of Puerto Rico
Municipality of Quebradillas

Reconciliation of Statement of Revenues, Expenditures and Changes
in Fund Balance - Governmental Funds to the Statements of Activities
June 30, 2005

Governmental activities amounts reported in the statement of activities and the statement of Revenues, expenditures and changes in fund balances - governmental funds are different because:

Net change in fund balances reported in statement of revenue, expenditures and change in fund balances - govermental funds	\$ 1,213,146
--	--------------

Add(deduct):

The following revenues recorded in the statement of activities do not provide current financial resources, therefore are deferred in the governmental funds:

Christmas Bonus	78,158
-----------------	--------

Long terms obligation recognized as other Financial resource in govermental fund and as a liability in the Statement of Net Assets.	(1,868,297)
---	-------------

Governmental funds report capital outlays as expenditures. However in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation and amortization expenses. This the amount by which capital outlays exceeded depreciation and amortization expenses.	(177,510)
---	-----------

Some expenses reported in the statements of activities do not requiere the use of current financial resources, therefore are not reported as expenditures in the govermental funds.	<u>(843,067)</u>
---	------------------

Net changes in net assets reported in statements of activities	<u><u>\$ (1,597,570)</u></u>
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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
Notes to Basic Financial Statements
June 30, 2005

1. Summary of Significant Accounting Policies

The Municipality of Quebradillas (the Municipality) is a local municipal government located in Puerto Rico and constituted with full legislative, fiscal and all other governmental powers and responsibilities not expressly assigned to the government of the Commonwealth of Puerto Rico (the Commonwealth).

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

The Municipality assumes responsibility for providing services related to public housing, welfare, public safety, health, sanitation, education, culture, recreation, urban and economic development, and many other general and administrative duties.

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 year ended June 30, 2005 in conformity with the generally accepted accounting principles of the United States of America, as prescribed by the Governmental Accounting Standards Board (GASB).

a) Financial Reporting Model

In June 1999, the GASB issued Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis - for State and Local Governments* (GASB No. 34). This statement establishes financial reporting requirements for state and local governments. The Municipality adopted the provisions of GASB No. 34 as well as other statements referred to below as of July 1, 2002. These statements require the reporting of financial information and restructure much of the information that governments have reported in the past. Reporting standards for financial statements have been significantly affected compared to those issued in prior years.

According to the financial reporting model established by GASB No. 34, the minimum required financial statement presentation applicable to the Municipality is composed of the following elements: (1) Government-Wide Financial Statements (GWFS), (2) Fund Financial Statements, (3) Notes to Basic Financial Statements, and (4) Required Supplementary Information (RSI).

The RSI is a set of reports and information reported along with, but separate from, the Municipality's basic financial statements. In the accompanying basic financial statements, the required RSI is composed of the following elements: (1) Management Discussion and Analysis (MD&A) and, (2) Budgetary Schedule Comparison – General Fund.

The 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 year ended June 30, 2005, based on the Municipality's knowledge of the transactions, events and conditions

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reflected in the basic financial statements. The MD&A also highlights certain key fiscal policies that control the Municipality's operations.

As previously mentioned, other statements and interpretations were required in conjunction with GASB No. 34. Therefore, the Municipality has also adopted the following pronouncements at July 1, 2002: (1) GASB Statement No. 33 - *Accounting and Financial Reporting for Nonexchange Transactions*, (2) GASB Statement No. 37 - *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, (3) GASB Statement No. 38 - *Certain Financial Statement Note Disclosures*, and, (4) GASB Interpretation No. 6 - *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*.

GASB No. 34 also requires that the accounting for all governmental activities reported in the GWFS be based on applicable pronouncements issued by the Financial Accounting Standards Board (FASB) and its predecessor bodies, such as the Accounting Principles Board (APB), issued on or before November 30, 1989, provided those pronouncements do not conflict with or contradict GASB pronouncements. Accordingly, simultaneously with the adoption of GASB No. 34, the Municipality also adopted the following pronouncements: (1) APB Opinion No. 20 - *Accounting Changes*, (2) APB Opinion No. 21 - *Interest on Receivables and Payables*, (3) FASB Statement No. 5 - *Accounting for Contingencies*, and (4) FASB Statement No. 16 - *Prior Period Adjustments*. The Municipality has elected not to apply all Statements and Interpretations issued by FASB after November 30, 1989, in accordance with GASB No. 20.

b) Financial Reporting Entity

The accompanying basic financial statements include all departments, agencies and municipal entities that: (1) are under the legal and administrative control of the Mayor, and (2) whose funds are under the legal custody and control of the Municipality's Finance Director, as prescribed by Law No. 81 of August 30, 1991, as amended, known as the *Autonomous Municipalities Act of the Commonwealth of Puerto Rico*.

The Municipality's management has considered all potential component units 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 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), has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) 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.

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 as of June 30, 2005.

The GASB issued its Statement No. 39, *Determining Whether Certain Organizations are Component Units* (GASB No. 39). This statement is effective for the Municipality's next fiscal

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year and amended the provisions of GASB No. 14 to provide additional guidance to determine whether certain organizations for which the Municipality is not financially accountable should be reported as component units based on the nature and significance of their relationship with the Municipality. Generally, GASB No. 39 will require reporting, as a discretely presented component unit, an organization that raises and holds economic resources for the direct benefit of a governmental entity. Such organizations are legally separate, tax-exempt entities that meet all of the three specific criteria that address benefit, entitlement or access, and significance.

c) *Government-Wide Financial Statements*

The accompanying government-wide financial statements (GWFS) are composed of: (1) the statement of net assets and (2) the statement of activities. These financial statements do not report fund information but rather report information of all of the Municipality's non-fiduciary governmental activities. These statements are aimed at presenting a broad overview of the Municipality's finances while reporting its financial position and results of operations as a whole, using methods that are similar to those used by most private businesses.

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

The accompanying statement of net assets provides short-term and long-term information about the Municipality's financial position and condition by presenting all of the Municipality's assets and liabilities, with the difference between these two items reported as "net assets" (equity) or "net liabilities" (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, including infrastructure; and discloses legal and contractual restrictions on resources.

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

- **Invested in Capital Assets, Net of Related Debt** – These consist of capital assets, net of accumulated depreciation and amortization and reduced by the outstanding balances of bonds, notes and any other debt 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 have been reduced by any related unspent debt proceeds and any related unamortized debt issuance costs.
- **Restricted Net Assets** – These consist of net assets 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

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legislation. Enabling legislation is defined as legislation that authorizes the Municipality to assess, levy, charge, or otherwise mandates 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 is intended to identify 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.

- **Unrestricted Net Assets** – These consist of net assets that are neither externally or legally restricted, nor invested in capital assets. However, unrestricted net assets often are designated to indicate that management does not consider them to be available for general operations. Unrestricted net assets often have constraints on resources that are imposed by management, but can be removed or modified.

When both restricted and unrestricted resources are available for use, 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 results of the Municipality's operations by showing how the Municipality's net assets changed during the year ended June 30, 2005, using the net (expense) revenue format. This statement presents the cost of each function/program as well as the extent to which each of the Municipality's functions, programs, or other services either contributes to or draws from the Municipality's general revenues (such as property taxes, municipal license taxes, construction excise taxes, etc.).

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

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General government:

Municipal legislature
Mayor's office
Department of finance
Department of human resources
Department of municipal secretary
Department of internal audit
Department of federal programs
Department of public relations

Urban and Economic Development:

Department of public works

Public Safety:

Department of civil defense
Police Department

Health and Sanitation

Department of sanitation

Culture, Recreation and Education:

Department of recreation and sports

Welfare:

Center for the elderly

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

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

- **Charges for services** – These generally consist of exchange or exchange-like transactions involving charges to customers or applicants who purchase, use, or directly

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benefit from the goods, services, or privileges provided, or are otherwise directly affected by the services. These include fees charged for specific services, charges for licenses and permits, and fines and forfeitures, among others.

- **Program-specific capital and operating grants and contributions** – These 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. Capital grants and contributions consist of capital assets or resources that are restricted for capital purposes – to purchase, construct, or renovate capital assets associated with a specific program.
- **Program-specific capital and operating grants and contributions (Cont.)** -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. Restricted capital and operating 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 investment earnings, grants and contributions and special items, among others) 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.

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

The effects of all interfund governmental activities (revenues, expenditures and other financing sources/uses among 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 governmental fund financial statements.

The accompanying GWFS do not report fiduciary activities, which are those in which the Municipality would be holding or managing net assets for specific individuals or other external

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parties in accordance with trust agreements or other custodial arrangements. In addition, the Municipality has no significant 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 is financed primarily through user charges.

Accordingly, the accompanying GWFS do not report fiduciary nor business-type activities.

d) *Governmental Fund Financial Statements*

The accompanying governmental fund financial statements (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 of operations of the Municipality's governmental funds by presenting sources, uses, and balances of current financial resources. These financial statements often have a budgetary orientation and focus primarily on: (1) the Municipality's major 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 year have complied with public decisions concerning the raising and spending of public moneys in short term (usually one budgetary cycle or one year).

Each governmental fund is considered an independent fiscal entity accounted for within a set of self-balancing accounts that comprise its assets, liabilities, fund equity or deficit, revenue, and expenditures. The accompanying GFFS segregate governmental funds according to their intended purpose and are used in demonstrating compliance with legal, financial and contractual provisions. The minimum number of governmental funds is maintained consistent with legal and self-imposed managerial requirements established by the Municipality. For financial reporting purposes, the Municipality classifies its governmental funds within the following categories:

- ***General Fund*** – The general fund is the Municipality's chief operating and major 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 type. 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 fund other than the general fund.
- ***Special Revenue Funds*** – The special revenue funds are major and non-major funds used by the Municipality to account for revenues derived from grants or other revenue sources (other than major capital projects) that are either self-restricted by the Municipality or legally restricted by outside parties for use in specific purposes. 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.

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- **Debt Service Fund**– The debt service fund is a major 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 and notes for which debt service payments are legally mandated to be accounted for in a debt service fund, and/or (2) general long-term debt for which the Municipality is accumulating financial resources in advance, to pay principal and interest payments maturing in future years. General long-term debts for which debt service payments do not involve the advance accumulation of resources (such as capital leases, compensated absences, claims and judgments, notes payable to CRIM and federal government, federal cost disallowances, and solid waste landfill closure and post-closure costs, among others) are accounted for in the general fund. Long-term debt's principal and accrued interests due on July 1 of the following fiscal year are accounted for as fund liabilities in the debt service fund at June 30, if resources are available at June 30 for its payment.
- **Capital Project Funds** – Capital project funds are non-major funds, as defined below, used to account for the financial resources used in the acquisition or construction of major capital facilities, other assets and permanent improvements. Significant capital outlays financed from general obligation bond proceeds are also accounted for in the capital project funds.

The use of the capital project funds has been reserved for major capital acquisitions or construction activities that would distort financial resource trend data if not reported separately from the other Municipality's operating activities. The routine purchases of minor capitalizable assets (such as vehicles and other minor capital assets) have been reported in the fund from which financial resources were used for the purchase.

The Municipality was required to report governmental fund financial statements that presented a single aggregated column for each fund type. Each column presented the combined total of all funds of a particular type. Fund types are still reported in certain cases, but they are no longer the focus of the accompanying governmental fund financial statements. Under GASB No. 34, the focus of the governmental fund financial statements is on major funds, which generally represent the Municipality's most important funds. Accordingly, the Municipality is required to segregate governmental funds among major and non-major categories within the governmental fund financial statements. Major individual governmental funds are reported as individually as separate columns in the governmental fund financial statements, while data from all non-major governmental funds are aggregated into a single column, regardless of fund type.

By definition, the Municipality's general fund is always considered a major governmental fund for financial reporting purposes. In addition, any other fund is considered a major fund for financial reporting purposes 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 interfund balances have been made. Total revenues for these purposes means all revenues, including operating and non-operating revenues (net of allowances), except for other financing sources. Total expenditures for these purposes means all expenditures, including operating and non-operating expenditures, except for other financing uses.

As previously discussed, the Municipality has no assets held in a trustee or agency capacity for others, nor has significant operations or activities that are financed and operated in a similar manner

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to private business enterprises, where the costs of providing goods or services to the general public is financed primarily through user charges. As a result, the Municipality does not report fiduciary nor proprietary funds in the accompanying basic financial statements.

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 investment earnings) 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 fees for licenses and permits, 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), which the Municipality adopted on July 1, 2002. GASB No. 33 established accounting and reporting standards for non-exchange transactions involving cash and financial or capital resources (for example, most taxes, grants and private donations). In a non-exchange transaction, the Municipality gives (or receives) value without directly receiving (or giving) equal value in return. This is different from an exchange transaction, in which each party receives and gives up essentially equal values. According to GASB No. 33, the Municipality groups its non-exchange transactions into the following four classes in the accompanying basic financial statements: (a) derived tax revenues, (b) imposed non-exchange revenues; (b) government mandated non-exchange transactions; and (c) voluntary non-exchange transactions.

In the case of derived tax revenue transactions (such as municipal license taxes), which result from assessments the Municipality places on exchange transactions, receivables and revenues are recorded when the underlying exchange has occurred (that generally is, when the taxpayers' net sales or revenues subject to tax take place).

In the case of imposed non-exchange revenue transactions (such as property 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 are generally recorded as revenues (net of amounts considered not collectible) in the period when resources are required to be used or the first period that the use of the resources is permitted.

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Government-mandated non-exchange transactions (such as federal and state grants and contributions) result when a government at one level (such as the federal or state government) provides resources to another government (such as the Municipality), and the provider government requires the recipient government 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, resources must be expended by the Municipality on the specific purpose or project before the provider reimburses any amounts. Revenue is, therefore, generally recognized as qualifying reimbursable expenditures when incurred.

Voluntary non-exchange transactions (such as donations and certain grants and entitlements) result from legislative or contractual agreements, other than exchanges, entered into willingly 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.

Receipts of any type of revenue sources collected in advance for use in the following period are recorded as deferred revenues.

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.

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 with brief explanations 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 and the modified accrual basis of accounting. 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 year or soon enough thereafter to pay liabilities of the current year. For this purpose, the Municipality considers most revenues to be available if collected within 90 days after June 30, 2005, except for property taxes for which the availability period is 60 days.

Revenue sources not meeting these availability criteria or collected in advance are recorded as deferred revenues at June 30, 2005. The principal revenue sources considered susceptible to accrual include property taxes, municipal license taxes, intergovernmental grants and contributions, and investment earnings. These principal revenue sources meet the measurability and availability criteria in the accompanying GFFS.

In a similar manner to the GWFS, but subject to and limited by the availability criteria discussed above, 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, fees for licenses and permits, 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 using the previously discussed criteria set forth by GASB No. 33, but subject to and limited

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by the availability criteria discussed above. Accordingly, municipal license tax receivables and revenues are generally recorded when the underlying exchange has occurred. Property tax receivables are also generally recorded in the period when an enforceable legal claim has arisen while property tax revenues (net of amounts considered not collectible) are also generally recorded in the period when resources are required to be used or the first period 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).

Investment earnings are recorded when earned only if collected within 90 days after year-end since they would be considered both measurable and available.

Pursuant to the provisions of GASB No. 6, expenditures and related liabilities are generally recorded in the accompanying governmental fund financial statements in the accounting period in which the liability is incurred, as under the accrual basis of accounting, but only to the extent that they are normally expected to be liquidated with expendable financial resources.

Governmental Fund Financial Statements

Modifications to the accrual basis of accounting include:

- Employees' accumulated vacation, sick leave and compensatory time (compensated absences) is recorded as expenditure when utilized. The amount of the unpaid compensated absences has been reported only in the GWFS.
- Principal and interest on bonds and notes payable are recorded when they mature (when payment is due), except for principal and interest due in July 1 of the following fiscal year, which are recorded when resources are available in the debt service funds (generally June 30).
- Obligations under capital leases, solid waste landfill closure and post closure care costs, amounts subject to judgments under litigation and other long-term obligations are recorded only when they mature (when the payment is due).
- Accounts payable and accrued liabilities not expected to be liquidated with available financial resources are recorded in the government-wide financial statements but not in the governmental funds.
- Executory purchase orders and contracts are recorded as a reservation of fund balance.

Liabilities outside the bounds of these exceptions or modifications are reported as governmental fund liabilities when incurred (including salaries, professional services, supplies, utilities, etc.) since these liabilities normally are paid in a timely manner and in full from current financial resources.

The measurement focus of the GFFS is on decreases in 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 not recognized in the accompanying GFFS.

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Under the new financial reporting model established by GASB No. 34, all general capital assets and the unmatured long-term liabilities (determined using the modified accrual basis of accounting) are no longer reported in account groups within the governmental fund balance sheet but are now incorporated into the GWFS.

f) Stewardship, Compliance and Accountability

Budgetary Control

According to the Autonomous Municipalities Act of the Commonwealth of Puerto Rico, the Mayor and its Administrative Cabinet prepare each fiscal year an annual budget for the Municipality's general fund and debt service fund. Such legally adopted budget is based on expected expenditures by program and estimated resources by source for both funds. The annual budget is developed using elements of performance-based program budgeting and zero-based budgeting, and includes an estimate of revenues and other resources for the ensuing fiscal year under laws and regulations existing at the time the budget is prepared.

The Mayor must submit an annual budgetary resolution project (the project) to the Commissioner of Municipal Affairs of Puerto Rico (the Commissioner) and the Municipal Legislature no later than each 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 each June 13.

The Municipal Legislature has 10 business days up to no later than June 13 to discuss and approve the project with modifications. The Municipal Legislature may amend the budget 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 approve 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 budget. The Mayor may also veto the budget in its entirety and return it to the Municipal Legislature with his objections. If the project is rejected by the Mayor, 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 a budget is not adopted prior to the end of the deadlines referred to above, the annual budget for the preceding fiscal year, as approved by the Legislature and the Mayor, is automatically renewed for the ensuing fiscal year until the Municipal Legislature and the Mayor approve a new budget. This permits the Municipality to continue making payments for its operations and other purposes until the new budget is approved.

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

For day to day management control, expenditures plus encumbrances may not exceed budgeted amounts at the expenditure-type level of each cost center (activity within a program within a fund).

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The Mayor may transfer unencumbered appropriations within programs within funds. Appropriation control is by program within a fund. The Municipal Legislature may transfer amounts among programs within and between funds.

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 budget is prepared under the budgetary basis of accounting, which is not in accordance with GAAP.

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

Under the budgetary basis of accounting, 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 year after the end of the fiscal year. Amounts required to settle claims and judgments against the Municipality, and certain other liabilities, are not recognized until they are encumbered or otherwise processed for payment. Unencumbered appropriations and encumbrances lapse at 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.

g) Unrestricted and Restricted Deposits

The Municipality's deposits are composed of cash on hand and demand deposits in commercial banks and the Government Development Bank for Puerto Rico (GDB), a governmental bank and a major component unit of the Commonwealth, who is statutorily designated as fiscal agent of the Municipality.

The Municipality follows the practice of pooling cash. The balance in the pooled cash account is available to meet current operating requirements and any excess is invested in certificates of deposit with original maturities of more than three months.

Under the laws and regulations of the Commonwealth, public funds deposited by the Municipality in commercial banks must be fully collateralized for the amounts deposited in excess of the federal depository insurance generally provided by the Federal Deposits Insurance Corporation (FDIC). All securities pledged as collateral are held in the Municipality's name by agents designated by the Secretary of the Treasury of the Commonwealth.

Restricted cash for major special revenue and capital projects funds, represent the balance of interest and noninterest bearing accounts restricted to finance the operations of federal and state funded

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programs and the acquisition, construction and improvement of major capital improvements, respectively.

Restricted cash in other governmental funds represents: (1) resources restricted to finance the operations of federal and state funded programs, and (2) resources restricted for the acquisition, construction and improvements of capital improvements.

h) Accounts Receivable

In the accompanying GWFS, receivables consist of all revenues earned but not collected at June 30, 2005. Major receivable balances for the governmental activities include municipal license taxes, property taxes and intergovernmental receivables.

Tax receivables in the general fund represent uncollected property taxes and municipal license taxes. Tax receivables in the debt service fund consist of uncollected property taxes which are restricted for the payment of the Municipality's debt service, as established by law.

Intergovernmental receivables are mainly composed of amounts owed to the Municipality for reimbursement of expenditures incurred pursuant to state and federally funded programs (recorded in the special revenue fund).

These accounts receivables are stated net of estimated allowances for uncollectible accounts, which are determined, based upon past collection experience, historical trends, current economic conditions and the periodic aging of accounts receivable.

Activity between 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 interfund loans) or "advances to/from other funds" (i.e., the non-current portion of interfund loans). All other outstanding balances between funds are reported as "due to/from other funds." Advances between funds, as reported in the GFFS, are offset by a fund balance reserve account in applicable governmental funds to indicate that they are not available for appropriation and are not expendable available financial resources.

i) Cash equivalents

Cash equivalents are composed of certificates of deposit with original maturities of less than three months. Investments are held with commercial banks and are recorded at cost (which approximates fair value).

j) Deferred Charges

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

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k) Capital Assets

Capital assets used in governmental activities include land and land improvements, buildings, structures and building improvements, machinery and equipment, furniture and fixtures, licensed vehicles, construction in progress, and infrastructure. These assets are capitalized and reported in the accompanying GWFS. Infrastructure assets are generally immovable in nature and include roads, bridges, streets and sidewalks, drainage systems and other similar assets. The Municipality has no collection of works of art or historical treasures.

The Municipality defines capital assets as assets with an individual cost of \$500 or more at the date of acquisition or construction, and with a 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 expenditures.

Major outlays for capital assets and improvements are capitalized in the GWFS 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	50
Infrastructure	20 to 50
Motor vehicles	8
Furniture and fixtures	5 to 20
Machinery and equipment, excluding those held under capital leases	5 to 20

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

l) Deferred Revenues

The Municipality reports deferred revenue on its GFFS and GWFS. In the GFFS, deferred revenue arises when:

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- Potential revenue does not meet both the “measurable” and “available” criteria for revenue recognition in the current period. As previously discussed, available is defined as due (or past due) at June 30, and collected within 90 days thereafter to pay obligations due at June 30, or;
- Resources are received by the Municipality before it has a legal claim to them. In subsequent periods, when the revenue recognition criterion is met, or when the Municipality has a legal claim to the resources, 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.

m) Compensated Absences

Compensated absences are accounted for under the provisions of Statement No. 16, *Accounting for Compensated Absences*, issued by 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 government-wide statement of net assets is limited to leave that: (1) is attributable to services already rendered on or before June 30, 2005, and (2) is not contingent on a specific event (such as illness) that is outside the control of the Municipality and the employee. The liability for compensated absences, include 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, Medicare taxes, employer contributions to the employees’ retirement systems and others). 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 year). Employees accumulate sick leave at a rate of 1.5 days per month (18 days per year). Compensatory time is accumulated by employees at a rate of 1.5 times the overtime worked. All vacation and sick leave days accumulated by employees in excess of 60 days and 90 days, respectively, are paid to employees each year if not consumed, as required by law. In the case of compensatory time, the excess of 240 hours is paid to employees each year, if not consumed.

Upon termination of employment, an employee receives compensation for all accumulated unpaid regular vacation leave at the current rate. In the case of sick leave, if the employee terminates his or her employment with the Municipality before reaching 10 years of services, such regular sick leave days is not paid to the employee. After 10 years of services any sick leave balance is paid to the employee. Accumulated vacation time is fully vested to the employees 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 if they have matured, for example, as a result of employee resignations and retirements.

n) Long-term Debt

The long-term liabilities reported in the GWFS include the Municipality’s general obligation and public improvements bonds, long-term notes, obligation under capital leases, compensated absences, and legal claims and judgments.

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All long-term debt to be repaid from governmental resources is reported as liabilities in the government-wide statement of net assets, except for principal and interest payment on bonds due in July 1 of the following fiscal year, which is recorded in the GFFS when resources are available in the debt service fund (generally at June 30). In the GFFS, long-term debt is generally not reported as liabilities. The face amount of the debt issued is reported as other financing sources.

In the GWFS debt issuance costs are reported as deferred charges and are amortized under the straight-line method over the life of the debt while in the GFFS are recognized as expenditures as during the current period.

The note discount is amortized over the life of the note using the effective interest method. Amortization of the note discount is recorded as part of interest expense in the statement of activities. In the GFFS, note discounts are recognized as other financing uses during the current period.

o) 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*, the Commonwealth of Puerto Rico is considered to be the sponsor of the Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities (ERS) and System 2000, the two retirement systems in which the employees of the Municipality participate. Accordingly, the Municipality is considered a participant and not a sponsor of these retirement systems since substantially all of the participants in the aforementioned pension trust funds are part of the financial reporting entity of the Commonwealth of Puerto Rico. Accordingly, no portion of the net pension obligation (NPO) related to ERS and System 2000 has been allocated to the Municipality in the accompanying basic financial statements. The basic financial statements of the Commonwealth of Puerto Rico accounts for the total amount of the net pension obligation of ERS and System 2000, including any amount that may be allocated to the Municipality.

The Municipality accounts for pension costs from the stand point 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. In the GFFS the statutory contributions and the related liability are accounted for under the modified accrual basis of accounting while in the GWFS, are recorded under the accrual basis of accounting.

p) 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 on behalf of all of municipalities of Puerto Rico. The Department of Treasury pays the insurance premiums on behalf of the Municipality and then is reimbursed each year through monthly equal payments deducted from the Municipality's gross property tax collections made by the Municipal Revenue Collection Center (known as "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 (known as "AACA", by its Spanish Acronyms), a component unit of the Commonwealth. This insurance is compulsory for all licensed vehicles used on public roads and

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highways in Puerto Rico. The annual premium is \$35 per licensed motor vehicle, which is paid directly to AACA.

The Municipality provides workers' compensation insurance coverage to its employees through the State Insurance Fund Corporation, 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 provides unemployment compensation, non-occupational disability, and drivers' insurance coverage to its employees through various insurance programs administered by the Commonwealth's Department of Labor and Human Resources (DOL). These insurance programs cover workers against unemployment and provide supplementary insurance coverage for temporary disability, or death because of work or employment-related accidents or because of illness suffered as a consequence of their employment. Unemployment compensation, non-occupational disability and drivers' insurance premiums are paid directly to DOL on a quarterly basis.

The Municipality also provides medical insurance coverage to all employees. The current insurance policies have not been canceled or terminated at June 30, 2005. In the past three years, the Municipality has not settled claims that exceeded insurance coverage.

q) Reservations of Fund Balances

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

- **Encumbrances** – Represent future expenditures under purchase orders, contracts and other commitments. These committed amounts represent reservations of unexpired appropriations and generally will become liabilities in future periods as the goods or services are received.
- **Capital Projects** – Represent the reservation of amounts to be used for future expenditures for capital projects under contracts and other commitments. These committed amounts generally will become liabilities in future periods as the projects are completed.
- **Debt Service** – Represent fund balances available to finance future debt service payments.
- **Other Specified Purposes** – Represents resources set aside for use under federal and state grant programs accounted for in special revenue funds.

r) Interfund Transactions

Permanent reallocations of resources between the Municipality's funds are classified as interfund transfers. The Municipality has the following types of transactions recorded among funds in the GFFS:

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- **Operating Transfers** – Represent legally required transfers that are reported when incurred as “operating transfers-in” by the recipient fund and as “operating transfer-out” by the disbursing fund.
- **Intra-Entity Transactions** – Represent transfers between the funds of the Municipality that are reported as interfund transfers with receivables and payables presented as amounts due to and due from other funds.
- **Advances** – Represent the amounts advanced among the funds of the Municipality, which are not considered to be currently available financial resources.

s) 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 and 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.

2. Deposits and Investments

The Municipality maintains its deposits of cash with various commercial banks located in Puerto Rico and GDB. The balances deposited in commercial banks are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to a maximum of \$100,000 per depositor.

Under the laws and regulations of the Commonwealth, public funds deposited in commercial banks must be fully collateralized for the amounts deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury’s agents in the Municipality’s name.

Pursuant to the Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico, the Municipality may invest 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, among others.

3. Municipal License Taxes

The Municipality is authorized by law to impose and collect municipal license taxes on all trade or business activities operated by any natural or legal person within the territorial area of Quebradillas. This is a self-assessed tax based on the business volume in gross sales. The Municipality establishes the applicable tax rates. At June 30, 2005, the municipal tax rates imposed by the Municipality were 1.50% for financing institutions and 0.50% for any other taxpayers. Any taxpayers that have been granted with partial tax exemptions under any of the incentive tax laws of the Commonwealth ultimately pay municipal license taxes at reduced tax rates, generally between 60% and 90% under standard rates.

Each taxpayer must assess his/her corresponding municipal license tax by declaring his/her volume of business through a tax return every April 15 based on the actual volume of business generated in the preceding calendar year. Taxpayers with a sales volume of \$1 million or more must include audited financial statements with their returns. 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. The first installment of the tax covers the six-month period ended December 31, subsequent to the filing date of the declaration, while

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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% discount is granted automatically on the tax amount due. Any municipal license taxes collected in advance (that is, pertaining to a future period) are recorded as deferred revenues.

4. Property Taxes

The Municipality is authorized by law to impose and collect personal and real property taxes. Under the laws and regulations of the Commonwealth, personal property taxes can be imposed to any natural or legal person that at January 1 of each year is engaged in trade or business and is the owner of personal property used in trade or business.

Personal property taxes are self-assessed by taxpayers every year generally using the book value of personal property assets owned by the taxpayer at January 1 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 was 6.28% (of which taxpayers pay 6.08% and 0.20% is reimbursed by the Department of Treasury) at June 30, 2005. 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 at 1957 market prices. The total real property tax rate in force was 8.28% (of which 8.08% is paid by taxpayers and 0.20% is also reimbursed by the Department of Treasury) at June 30, 2005.

Residential real property occupied by its owner is exempt by law from property taxes on the first \$15,000 of the assessed value (at 1957 market prices). For such exempt amounts, the Department of Treasury assumes payment of the basic tax (4%) to the Municipality, except for property assessed of less than \$3,500 (at 1957 market prices), for which no payment is made.

CRIM is responsible for the billing and collections of real and personal property taxes on behalf of the Municipality. Prior to the beginning of each fiscal year, CRIM informs the Municipality of the estimated amount of property tax expected to be collected for the ensuing fiscal year. Throughout the year, CRIM advances funds to the Municipality based on the initial estimated collections. CRIM is required by law to prepare a settlement statement on a fiscal year basis, whereby a comparison is made between the amounts advanced to the Municipality and amounts actually collected from taxpayers. This settlement has to be completed on a preliminary basis not later than December 31. If CRIM remits to the Municipality property tax advances, which are less than the tax actually collected, an additional property tax receivable is recorded at June 30. However, if advances exceed the amount actually collected by CRIM, an intergovernmental payable is recorded at June 30.

Law No. 83 of August 30, 1991, as amended, provides for the levy of an annual special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation. Such special tax is levied by the Commonwealth but is collected by CRIM. Collections of this special tax are remitted to the Commonwealth's debt service fund for payment of debt service on general obligations of the Commonwealth.

In addition, 1.25% of the total personal and real property taxes collected by CRIM is restricted for the Municipality's debt service requirements and is retained by GDB for such purposes.

The Additional Lottery System of the Commonwealth (the "Additional Lottery") is an operational unit reported as an enterprise fund of the Commonwealth, which currently operates several betting

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alternatives to the citizens of Puerto Rico. The Additional Lottery is required every year to distribute a portion of its excess of revenues over expenses as follows:

- i. Thirty five percent (35%) 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.
- ii. An additional amount not exceeding \$16 million, on an annual basis, is distributed to the Municipal Equalization Fund, provided it is within the 35% corresponding to the municipalities of the Commonwealth.
- iii. Resources will be assigned to the Health Insurance Administration, a component unit of the Commonwealth.

5. Interfund Receivables, Payables and Transfers

The composition of interfund balances at June 30, 2005 and for the year then ended is as follows:

<u>Due/advances to:</u>	<u>Due/advances from:</u>		
	<u>General Fund</u>	<u>Other Nonmajor Funds</u>	<u>Total Governmental Funds</u>
Major funds:			
General fund	\$ -	\$ 1,194,391	\$ 1,194,391
Nonmajor funds:			
SBGP	33,720		33,720
Section 8	12,439		12,439
Food Programs	561		561
Joint Resolution	161,934		161,934
Law 52	39,671		39,671
Serial Bonds \$ 505 M	13		13
Serial Bonds \$ 1,010 M	49		49
Serial Bonds \$ 570 M	35		35
Total	<u>\$ 248,422</u>	<u>\$ 1,194,391</u>	<u>\$ 1,442,813</u>

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Interfund receivables and payables represent the pending settlements of the aforementioned transfers, which are considered by management to be fully realizable at June 30, 2005.

Transfer to:	Transfer from:			
	Major Funds			Total Governmental Funds
	General Fund	Debt Service Fund	Nonmajor Funds	
General fund	\$ -	\$ 222,130	\$ 156,010	\$ 378,140
Serial Bonds \$ 2,135 M	1,415,572	-	-	1,415,572
Serial Bonds \$ 455 M	452,725	-	-	452,725
Debt services fund	5,585	-	-	5,585
Total	\$ 1,873,882	\$ 222,130	\$ 156,010	\$ 2,252,022

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6. Intergovernmental Receivables and Payables

Intergovernmental receivables and payables recorded in the accompanying GWFS and GFFS at June 30, 2005 are as follows:

	<u>Mayor Funds</u>	<u>Other governmental Funds</u>	<u>Total Governmental Funds</u>	<u>Statement of net assets</u>
<i>Intergovernmental receivable:</i>				
<i>Grant and Contributions:</i>				
Ley 52 program fund	\$ -	\$ 38,576	\$ 38,576	\$ 38,576
Food Programs	-	5,290	5,290	5,290
Puerto Rico Treasury Department (Joint Resolution)	-	197,765	197,765	197,765
Puerto Rico Treasury Department (Reimbursement of Christmas bonus)	-	-	-	75,833
Puerto Rico Electric Power Authority	708,984	-	708,984	708,984
Child Care	-	31,953	31,953	31,953
item - general fund	-	-	-	-
Total intergovernmental receivable	<u>\$ 708,984</u>	<u>\$ 273,584</u>	<u>\$ 982,568</u>	<u>\$ 1,058,401</u>
<i>Intergovernmental payable:</i>				
Internal Revenues Service (Social Security)	\$ 897,006	\$ -	\$ 897,006	\$ 897,006
General Service Administration of the Commonwealth of Puerto Rico	128,855	-	128,855	128,855
Employees Retirement System of the Government of Puerto Rico and Its Instrumentalities	978,236	-	978,236	978,236
Puerto Rico Department of Labor	401,914	-	401,914	401,914
Puerto Rico Treasury Department (General fund)	56,600	-	56,600	56,600
Puerto Rico Aqueduct and Sewer Authority	183,955	-	183,955	183,955
Puerto Rico Electric Power Authority	751,261	-	751,261	751,261
CRIM Liquidation 2003--2004	16,585	-	16,585	16,585
Puerto Rico Treasury Department (Property)	43,739	-	43,739	43,739
Puerto Rico Treasury Department (Patronal)	257,714	-	257,714	257,714
CRIM	55,047	-	55,047	55,047
Puerto Rico Treasury Department (Income Tax)	864,301	-	864,301	864,301
Puerto Rico Department of Labor (Chauffeurs)	6,270	-	6,270	6,270
Total intergovernmental payable	<u>\$ 4,641,483</u>	<u>\$ -</u>	<u>\$ 4,641,483</u>	<u>\$ 4,641,483</u>

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7. Capital Assets

Capital assets activity for the year ended June 30, 2005 is as follows:

	Balance at June 30, 2004	Additions, depreciation, and amortization expense	Balance at June 30, 2005
Capital assets, not subject to depreciation and amortization:			
Land	\$ 160,000	\$ -	\$ 160,000
Construction in progress	9,905,503	99,400	10,004,903
Total cost basis of capital assets, not subject to depreciation and amortization	10,065,503	99,400	10,164,903
Capital assets, subject to depreciation and amortization:			
Land improvements	818,027		818,027
Buildings, structures and building improvements	5,202,516		5,202,516
Infrastructure	2,670,333		2,670,333
Other machinery and equipment	320,002	3,657	323,659
Licensed vehicles	1,939,499		1,939,499
Total cost basis of capital assets, subject to depreciation and amortization	10,950,377	3,657	10,954,034
Total cost of capital assets	21,015,880	103,057	21,118,937
Accumulated depreciation and amortization:			
Land improvements	512,460	25,132	537,592
Buildings, structures and building improvements	1,317,506	99,400	1,416,906
Infrastructure	1,615,464	42,200	1,657,664
Other machinery and equipment	162,411	15,125	177,536
Licensed vehicles	1,463,425	98,710	1,562,135
Total accumulated depreciation and amortization	5,071,266	280,567	5,351,833
Net capital assets	\$ 15,944,614	\$ (177,510)	\$ 15,767,104

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Depreciation and amortization expense was charged to functions in the accompanying government-wide statement of activities as follows:

General government	\$	19,640
Public safety		36,474
Urban and economic development		84,170
Health and sanitation		44,891
Public housing and welfare		14,028
Culture, recreation, and education		81,364
Total depreciation and amortization expense	<u>\$</u>	<u>280,567</u>

8. Long-Term Obligations

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

	Balance at June 30, 2004	Borrowings/ additions	Payments/ deductions	Balance at June 30, 2005	Due Within One Year
Bonds payables	\$ 4,963,100	\$ 2,590,000	\$ (493,800)	\$7,059,300	\$ 343,100
Notes payable:					
Puerto Rico Treasury	468,589		(37,417)	431,172	37,417
Puerto Rico Treasury Department (Property Tax advances)	198,533		(2,860)	195,673	2,938
CRIM (Delinquent Acc)	301,534			301,534	
Compensated absences	1,398,522		(160,227)	1,238,295	519,495
Claims and judgments	528,334		(11,234)	517,100	517,100
Total	<u>\$ 7,858,612</u>	<u>\$ 2,590,000</u>	<u>\$ (705,538)</u>	<u>\$ 9,743,074</u>	<u>\$1,420,050</u>

Historically, the general fund has been used to liquidate compensated absences, claims and judgments, and any other long-term liabilities other than long-term debt.

a) Debt Limitation

The Municipality's Legislature is legally authorized to determine 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 notes) are backed by the full faith, credit and taxing power of the Municipality; and

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- Direct obligations are not to be issued by the Municipality if the amount of the principal of, and interest on, such bonds and notes (and on all such 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 notes guaranteed by the Municipality, exceed 10% 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 to be repaid with the proceeds of property taxes restricted for debt service.

In addition, before any new bonds or notes are issued, the revenues of the debt service fund should be sufficient to cover the projected debt service requirement.

b) Bonds Payable

The Municipality issues general obligation and public improvement bonds that can be used to finance the acquisition and construction of capital assets, as well as, to cover certain operating needs.

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

The Municipality levies an annual additional special tax of 1.40% 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 must be set aside to redeem the bonds in minimum annual or biannual principal and interest payments. The proceeds of this special tax are recorded in the debt service fund.

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

<u>General obligation bonds:</u>	<u>Outstanding Amount</u>
1999 serial bonds, original issues amount of \$680,000, due in annual principal installments ranging from \$45,000 to \$95,000; plus interest due in semiannually installments at 8% through July, 1, 2009	\$ 335,000
1999 serial bonds, original issues amount of \$1,010,000, due in annual principal installments ranging from \$70,000 to \$140,000; plus interest due in semiannually installments at rates 8% through July, 1, 2009	550,000
2002 serial bonds, original issues amount of \$570,000, due in annual principal installments ranging from \$10,000 to \$50,000; plus interest due in semiannually installments at rates 5% to 6.5% through July, 1, 2026	530,000

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2002 serial bonds, original issues amount of \$2,000,000, due in annual principal installments ranging from \$20,000 to \$175,000; plus interest due in semiannually installments at rates 7% through July 1, 2026	1,885,000
2002 serial bonds, original issues amount of \$638,800, due in annual principal installments ranging from \$10,700 to \$49,200; plus interest due in semiannual installments at rates 6.5% through July, 1, 2027	604,300
2003 serial bonds issues amount of \$670,000, due in annual principal installments ranging from \$10,000 to \$50,000, plus interest due in semiannual installments at rate 5.0% to 6% through July 1, 2028	645,000
2005 serial bonds issues amount of \$2,135,000, due in annual principal installments ranging from \$65,000 to \$165,000, plus interest due in semiannual installments at rate 5.0% through July 1, 2018	2,070,000
2005 serial bonds issues amount of \$455,000, due in annual principal installments ranging from \$15,000 to \$35,000, plus interest due in semiannual installments at rate 5.0% through July 1, 2024	<u>440,000</u>
Total general municipal obligation bonds	\$ <u>7,059,300</u>

Interest rates on serial bonds subject to variable interest rates are reviewed periodically by Government Development Bank (GDB) and are based on GDB's weighted average rate for its commercial paper program, not to exceed 8%. For financial reporting purposes, the outstanding amounts of bonds represent the total principal to be repaid.

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

Year Ending June 30,	Principal	Interest	Total
2006	\$ 343,100	\$ 359,441	702,541
2007	369,000	361,326	730,326
2008	394,900	323,256	718,156
2009	420,800	304,711	725,511
2010	196,900	284,584	481,484
Years After	5,334,600	2,839,810	8,174,410
Total	<u>\$ 7,059,300</u>	<u>\$ 4,473,128</u>	<u>\$ 11,532,428</u>

c) Notes Payable to Puerto Rico Treasury Department (Social Security)

On May 21, 1999, the Municipality entered into a financing agreement with the Puerto Rico Treasury Department to pay the debt related to social security tax from 1982 to 1986. The original face

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amount of the note was \$936,377, which is due in monthly principal installments of \$5,200, at an implicit interest rate of 6.00% through May 2014. Outstanding balance at June 30, 2005 is net of the unamortized discount. The outstanding principal and interest balances of the note payable amounted to \$433,346 and \$128,632, respectively, at June 30, 2005. The principal and interests maturities are as follows:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 37,417	\$ 24,983	\$ 62,400
2007	39,725	22,675	62,400
2008	42,175	20,225	62,400
2009	44,776	17,624	62,400
2010	47,538	14,862	62,400
Years After	<u>221,715</u>	<u>28,264</u>	<u>249,979</u>
Total	<u>\$ 433,346</u>	<u>\$ 128,633</u>	<u>\$ 561,979</u>

d) Notes Payable to Puerto Rico Treasury Department (Property tax advances)

On July 3 2001, the Municipality entered into a financing agreement with the CRIM to pay the debt related to the excess of property tax advances over collection made by CRIM. The original face amount of the note was \$203,419, which is due in monthly principal installments of \$1,252, at an implicit interest rate of 6.255% through July 2033. Outstanding balance at June 30, 2005 is net of the unamortized discount. The outstanding principal and interest balances of the note payable amounted to \$195,673 and \$211,223, respectively, at June 30, 2005. The principal and interests maturities are as follows:

<u>Year Ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 3,099	\$ 11,925	\$ 15,024
2007	3,291	11,733	15,024
2008	3,494	11,530	15,024
2009	3,710	11,314	15,024
2010	3,663	11,361	15,024
Years after	<u>179,624</u>	<u>152,156</u>	<u>331,780</u>
Total	<u>\$ 196,881</u>	<u>\$ 210,019</u>	<u>\$ 406,900</u>

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e) Payable to CRIM (Delinquent accounts)

On March 19, 2002, the Resolution Num. 36 Serie 2001-2002 was enacted which authorized the Municipality to obtain up to \$301,534, for a term not exceeding 30 years, for the repayment of bonds issued for the sale of delinquent accounts. The repayment agreement bears interest at variable rates (beginning in 6.50% at June 30, 2004). The outstanding principal and accrued interest balances of the note payable to CRIM amounted to \$280,974 and \$388,616, respectively, at June 30, 2005. The principal and interest maturities are as follows:

Year Ending June 30,	Principal	Interest	Total
2006	\$ -	\$ 19,600	\$ 19,600
2007	-	19,600	19,600
2008	-	19,600	19,600
2009	4,979	19,453	24,432
2010	5,312	19,120	24,432
Years after	<u>270,683</u>	<u>291,243</u>	<u>561,926</u>
Total	<u>\$ 280,974</u>	<u>\$ 388,616</u>	<u>\$ 669,590</u>

f) Compensated Absences

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

	Due Within One Year	Due After One Year	Total
Vacation and sick leave	\$ 519,495	\$ 718,800	\$ 1,238,295
Total	<u>\$ 519,495</u>	<u>\$ 718,800</u>	<u>\$ 1,238,295</u>

9. 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"). The ERS is the administrator of a multi-employer (as related to the Municipality's reporting entity) defined pension plan (the "System") established by the Commonwealth. The System was created under Act. No. 447 (the "Act"), approved on May 15, 1951, as amended, and became effective on January 1, 1952. ERS covers all regular employees of the Commonwealth of Puerto Rico and its instrumentalities, the Municipality and other municipalities of the Commonwealth of Puerto Rico.

The System is independent, thus assets may not be transferred to another system or used for any other purpose other than for benefit each system's participants. The System issues publicly available

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financial reports that include basic financial statements and required supplementary information for each of them, including required six-year trend information. Those reports may be obtained by writing to the administrator of the System.

The System provides for retirement, death and disability benefits. Death and disability retirement benefits are available to members for occupational and non-occupational death and disabilities. Retirement benefits depend upon age at retirement and number of years of credited service. Benefits vest after 10 years of plan participation.

Retirement benefits are determined by the application of stipulated benefit ratios to the member's average compensation. Average compensation is computed based on the highest 36 months of compensation recognized by ERS. The annuity, for which a plan member is eligible, is limited to a minimum of \$200 per month and a maximum of 75% of the average compensation.

On September 24, 1999, an amendment to Act No. 447 of May 15, 1951, which created the System, was enacted with the purpose of establishing a new pension program ("System 2000").

System 2000 became effective on January 1, 2000. Employees participating in the current system as of December 31, 1999, had the option to either stay in the defined benefit plan or transfer to the new program. Persons employed on or after January 1, 2000, are only allowed to become members of System 2000.

System 2000 is a hybrid defined contribution plan, also known as cash balance plan. Under this new plan, there is a pool of pension assets, which are invested by the System, together with those of the current defined benefit plan.

a) Plan Description

Benefits at retirement are not guaranteed by the Commonwealth of Puerto Rico or the Municipality. The annuity is based on a formula which assumes that each year the employees' contribution (with a minimum of 8.275 percent of the participant's salary up to a maximum of 10%) will be invested in an account which will either: (1) earn a fixed rate based on the two-year Constant Maturity Treasury Note; (2) earn a rate equal to 75% of the return of ERS's investment portfolio (net of management fees); or (3) earn a combination of both alternatives.

Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability pensions are not being granted under System 2000. The employer's contributions (9.275% of the participant's salary) will be used to fund the current 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.

On August 12, 2000, Act No. 174 was approved to allow certain participants of ERS to be eligible for early retirement upon attaining at least age 55 with 25 years of service, provided they made their election on or before April 1, 2001. Those who elected early retirement under this law will receive monthly benefits of 75% (if 25 or more years of service and age 55, or 30 or more years of service and age 50) or benefits of 65% (if 25 years of service by less than age 55) of their average compensation which is computed based on the highest 36 months of compensation recognized by

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ERS. In the cases, the sponsor contribution with respect to the participants covered until the participants reach the normal retirement age.

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

b) Funding Policy

Contribution requirements are established by law and are as follows:

Municipality and other employers	9.275% of applicable payroll
Employees:	
Hired on or before March 31, 1990	5.775% of monthly gross salary up to \$550
	8.275% of monthly gross salary up to \$550
Hired on or before April 1, 1990	8.275% of monthly gross salary

c) Annual Pension Cost and Net Pension Obligation

The net pension obligation and the annual pension cost of ERS and System 2000 as of and for the year ended June 30, 2002 (most recent data available), which include the employees of the Municipality, the Commonwealth of Puerto Rico and other municipalities, has been recorded in the basic financial statements of the Commonwealth. No allocation of such amounts has been made in the accompanying basic financial statements. The following aggregate annual pension cost and net pension obligation as of and for the year ended June 30, 2002 (most recent data available) which are assumed and accounted for by the

Commonwealth is presented only for the purposes of additional analysis (amounts expressed in thousands):

Annual required contributions	\$ 802,536
Interest on net pension obligation	192,416
Adjustment to annual required employers' contributions	<u>(134,870)</u>
Annual pension cost	860,082
Statutory employers' contributions made	<u>(308,228)</u>
Increase (decrease) in net pension obligation	551,854
Net pension obligation at beginning of year	<u>2,263,722</u>
Net pension obligation at end of year	\$ <u>2,815,576</u>

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The annual required contribution recorded at June 30, 2002 (most recent data available) in the basic financial statements of the Commonwealth was determined by actuarial valuations for the pension plans as described below:

Date of latest actuarial valuation:	July 1, 2001
Actuarial cost method:	Projected unit credit cost
Amortization cost method:	Level percentage of projected payroll
Remaining amortization period:	25 years
Amortization approach:	Closed
Asset valuation method:	Market Value
Actuarial assumptions:	
Inflation	3.50%
Investment rate of return	8.50%
Projected salary increases per annum	5.00%
Cost-of-living adjustments	3.0% every three years

d) Three-Year Trend Information

The three-year trend information is as follows (most recent data available; expressed in thousands):

Annual pension cost (APC):	
Year ended June 30, 2002	\$ 860,082
Year ended June 30, 2001	803,526
Year ended June 30, 2000	768,761
Percentage of APC contributed:	
Year ended June 30, 2002	35.8%
Year ended June 30, 2001	65.6%
Year ended June 30, 2000	35.8%
Net pension obligation:	
Year ended June 30, 2002	\$ 2,815,576
Year ended June 30, 2001	2,263,722
Year ended June 30, 2000	2,010,051

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10. Deferred Revenues

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

	General Fund	Other Governmental Funds	Total Governmental Funds	Statement of Net Assets
Measurable but not available revenues:				
Municipal license taxes	\$ 301,142	\$ -	\$ 301,142	\$ 301,142
Total	<u>301,142</u>	<u>-</u>	<u>301,142</u>	<u>301,142</u>
Unearned revenues:				
Intergovernmental grants and contributions:				
U.S. Department of Health and Human Services:				
Child Care Program	\$ -	\$ 37,533	\$ 37,533	\$ 37,533
Child Care Food Program		2,089	2,089	2,089
U.S. Department of Housing and Urban Development:				
Section 8		120,975	120,975	120,975
UDAG		137,256	137,256	137,256
U.S. Department of Defense				
Other governmental agencies		71,952	71,952	71,952
		2,130	2,130	2,130
Total unearned revenues	<u>-</u>	<u>371,935</u>	<u>371,935</u>	<u>371,935</u>
Total deferred revenues	<u>\$ 301,142</u>	<u>\$ 371,935</u>	<u>\$ 673,077</u>	<u>\$ 673,077</u>

11. Contingencies

a) Contingencies

The Municipality is defendant in numerous claims and legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1995, 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 for any judgment that may be entered against them. There is no limitation on the payment of such judgments. With respect to pending and threatened litigation, the Municipality has reported liabilities amounting to \$517,000 for awarded and anticipated unfavorable judgments at June 30, 2005. This amount was included as a current portion of long term obligation in the accompanying statement of net assets, and represents the amount estimated as a probable liability or a liability with a fixed or expected due date, when will require future available financial resources for its payment. Management believes that the ultimate liability in excess of amounts recorded in the accompanying statement of net assets, if any, would not be material to the basic financial statements taken as a whole.

The Municipality receives financial assistance from the federal government in the form of grants and entitlements. Receipt of grants is generally conditioned upon compliance with terms and conditions

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of the grant agreements and applicable federal laws and regulations, including the expenditure of resources for eligible purposes. Accordingly, expenditures financed by these programs are subject to financial and compliance audits by the appropriate grantor. Disallowance as a result of these audits may become liabilities of the Municipality. The *"Reports on Compliance and Internal Control in Accordance with Government Auditing Standards and the Requirements of OMB Circular A-133"* for the year ended June 30, 2005, disclosed various instances of noncompliance with applicable laws and regulations and with internal accounting and administrative controls. If expenditures are disallowed due to noncompliance with grant programs regulations, the Municipality may be required to reimburse the grantor. Management believes that the Municipality will be able to comply with the terms of corrective action plans that may be requested by the federal grantors, consequently, the accompanying basic financial statements do not include any provision or reserve for possible disallowed costs arising from the federal funds disbursed during fiscal year ended June 30, 2005

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Commonwealth of Puerto Rico
Municipality of Quebradillas
 Budgetary Comparison Schedule - General Fund
 For Fiscal Year Ended June 30, 2005

	Budgeted Amounts		Actual amounts (budgetary basis) (see note 1)	Variance with final budget - over (under)
	Original	Final		
Revenues:				
Property taxes	\$ 1,740,510	\$ 1,740,510	\$ 2,045,432	\$ 304,922
Municipal license taxes	503,500	503,500	446,076	(57,424)
Charges for services	8,000	8,000	4,512	(3,488)
Intergovernmental grants and contributions	4,038,272	4,038,272	3,312,801	(725,471)
Excise taxes	1,060,000	1,060,000	214,831	(845,169)
Investment earnings	10,000	10,000	4,503	(5,497)
Miscellaneous	1,615,800	1,615,800	53,555	(1,562,245)
Total revenues	<u>8,976,082</u>	<u>8,976,082</u>	<u>6,081,710</u>	<u>(2,894,372)</u>
Expenditures:				
Current:				
General government	3,159,680	3,394,638	2,781,125	(613,513)
Urban and economic	1,800,610	1,989,200	846,006	(1,143,194)
Public safety	1,325,607	1,238,414	870,207	(368,207)
Environmental Control	786,880	630,919	357,459	(273,460)
Health and sanitation	630,589	630,589	630,590	1
Culture, recreation and education	429,009	312,398	214,138	(98,260)
Public housing and welfare	843,707	779,924	482,798	(297,126)
Capital outlays	-	-	-	-
Total expenditures	<u>8,976,082</u>	<u>8,976,082</u>	<u>6,182,323</u>	<u>(2,793,759)</u>
Excess (deficiency) of revenues over expenditures	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (100,613)</u>	<u>\$ (100,613)</u>
Explanation of differences:				
Sources/inflows of financial resources:				
Actual amounts (budgetary basis) "available for appropriations" from the budgetary comparison schedule				\$ 6,081,710
Differences - budget basis to GAAP Resources considered revenues for budgetary purposes but are not revenues for financial reporting purposes				(24,787)
Total revenues as reported on the statement of revenues, expenditures and changes in fund balances - governmental funds				<u>\$ 6,056,923</u>
Uses/outflows of financial resources:				
Actual amounts (budgetary basis "total charges to appropriations" from the budgetary comparison schedule				\$ 6,182,323
Differences - budget basis to GAAP Outflows of budgetary resources used for financing expenditures that are not expenditures for budgetary purposes				1,273,997
Total expenditures as reported on the statement of revenues, expenditures and changes in fund balances - governmental funds				<u>\$ 7,456,320</u>

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 Note to Budgetary Comparison Schedule – General Fund
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Excess (deficiency) of revenues and other financing sources over expenditures and other financing sources - budgetary basis	\$	(100,613)
Timing differences:		
Add:		
Current year encumbrance recorded as expenditure for budgetary purpose		(417,099)
Deduct:		
Prior year encumbrance recorded as current year expenditures for GAAP purpose		126,147
Entity differences:		
Non-budgeted expenditures		1,147,849
Basis of accounting differences:		
Net increase in municipal license tax receivable		4,059
Net increase in due from other funds		2,204
Net increase in accounts payable and accrued expenses		(250,791)
Net increase in intergovernmental payables		(383,131)
Net increase in due to other funds		(8,801)
Net increase in deferred volume of business tax		(23,478)
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses (GAAP basis)	<u>\$</u>	<u>96,346</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

<u>Federal Grantor/Program Title</u>	<u>Federal CFDA Number</u>	<u>Federal Disbursements/ Expenditures</u>
U.S. Department of Housing and Urban Development		
Direct Programs		
Section 8 Vouchers	14.871	\$ 359,479
Pass-through Commonwealth of Puerto Rico/ Commissions Office of Municipal Affairs Community Development Block Grant-States Program SBGP	14.228	<u>232,299</u>
Subtotal U.S. Department of HUD		<u>591,778</u>
U.S. Department of Health and Human Services		
Pass-through the Office of Administration for Children and Families Child Care and Development Block Grant	93.575	<u>241,338</u>
Subtotal U.S. Department of HHS		<u>241,338</u>
U.S. Department of Agriculture		
Pass-through Governor's Office of Child Services and Community Development: Child and Adult Care Food Program	10.558	<u>38,450</u>
Subtotal U.S. Department of Agriculture		<u>38,450</u>
U.S. Department of Justice		
Direct Programs:		
Crime Victim Assistance	16.575	<u>63,158</u>
Subtotal U.S. Department of Justice		<u>63,158</u>
U.S. Department of Homeland Security		
Direct Programs:		
Public Assistance Grant	97.036	<u>741,669</u>
Subtotal U.S. Department of Homeland Security		<u>741,669</u>
TOTAL		<u>\$1,676,393</u>

See notes to Schedule of Expenditures of Federal Awards.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF QUEBRADILLAS
NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

1. SIGNIFICANT ACCOUNTING POLICIES

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Municipality of Quebradillas and is presented on the modified accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

2. BASIS OF PRESENTATION

The expenditures of the schedule are included in the Municipality's basic financial statements in the accompanying Statement of Revenues, Expenditures and Changes in Fund Balances-Governmental Funds. The reconciliation of expenditures in the basic financial statements to the Schedule of Expenditures of Federal Awards is as follows:

	<u>Expenditures</u>
Total expenditures per schedule	<u>\$1,676,393</u>
Federal expenditures per basic financial statements include within:	
Federal expenditures included in other governmental funds	<u>\$1,676,393</u>



ORTIZ, RODRIGUEZ, RIVERA & CO.
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Services Division

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

To the Honorable Mayor
and Municipal Legislature
Municipality of Quebradillas
Quebradillas, 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 Quebradillas as of and for the year ended June 30, 2005, which collectively comprise the Municipality of Quebradillas' basic financial statements, and have issued our report thereon dated December 30, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Municipality of Quebradillas' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial

reporting that we have reported to management of Municipality of Quebradillas, in a separate letter dated December 30, 2005.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Municipality of Quebradillas' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect of the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our test disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. However, we noted certain immaterial instances of noncompliance, which we have reported to management of Municipality of Quebradillas in a separate letter dated December 30, 2005.

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

San Juan, Puerto Rico
December 30, 2005

Ortiz, Rodriguez, Rivera & Co.

The stamp 2115831 was affixed to the original of this report.





ORTIZ, RODRIGUEZ, RIVERA & CO.

CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

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

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

Compliance

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

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

As described in items 05-1 and 05-4 in the accompanying schedule of findings and questioned costs, the Municipality of Quebradillas did not comply with requirements regarding cash management, allowable costs, reporting, and special test that are applicable to its Section 8 Housing Choice Voucher Program. Compliance with such requirements is necessary, in our opinion, for the Municipality of Quebradillas to comply with requirements applicable to that programs.

In our opinion, except for the noncompliance described in the preceding paragraph, Municipality of Quebradillas complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005.

Internal Control over Compliance

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

We noted certain matters involving in 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 Municipality's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 05-1 to 05-5.

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 caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. 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 weaknesses.

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

San Juan, Puerto Rico
December 30, 2005

Ortiz, Rodriguez, Rivera & Co.

The stamp 2115832 was affixed
to the original of this report.



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

1. SUMMARY OF AUDIT RESULTS

- a. The auditors' report expresses an unqualified opinion on the basic financial statements of the Municipality of Quebradillas.
- b. There were no reportable conditions on internal controls.
- c. No instances of noncompliance material to the financial statements of Municipality of Quebradillas were disclosed during the audit.
- d. There were reportable conditions on internal controls over major programs.
- e. The auditor's report on compliance with requirements applicable to federal award programs for Municipality of Quebradillas express a qualified opinion.
- f. Audit findings relative to the major federal award programs for the Municipality of Quebradillas are reported in number 3 of this schedule.
- g. The programs tested as major programs are:
 - Section 8 Housing Choice Vouchers - CFDA No. 14.871
 - Public Assistance Grant - CFDA No. 97.036
- h. The threshold for distinguishing types A and B programs was \$300,000.
- i. Municipality of Quebradillas was determined to be a high-risk auditee.

2. FINDINGS - FINANCIAL STATEMENTS AUDIT

None.

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

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

a. Section 8 Voucher - CFDA 14.871

• **Condition 05-1**

During the audit, we reviewed 25 participant files. We observed that two of those files do not include evidence of corrections to be realized as result of unit inspection.

Criteria

The 24 CFR 982.406 (3) establishes that the Municipality must not make any housing assistance payments for a dwelling unit that fails to meet the Housing Quality Standard (HQS), unless the owner corrects the defect within the period specified by the Municipality and verified the correction.

Cause

The program does not have an effective control procedures to follow-up the corrections.

Effect

The program of Section 8 do not comply with the requirement of HQS enforcement.

Recommendation

The Municipality should have a HQS control procedure to assure the deficiencies will be corrected on a timely basis.

Questioned Costs

-0-

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

● **Condition 05-2**

The program did not comply with the procedures require for minimizing the time elapsing between the transfer of federal funds and the disbursement by grantees. In addition, the program maintain a high balance in bank.

Criteria

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

Cause

The program does not have an effective control procedures for cash management.

Effect

The program does not comply with the cash management requirement.

Recommendation

The Municipality should establish a control procedures, in order to make disbursements after received the federal funds. In addition, the Municipality should identify the purpose of the balance in bank, in order to avoid a surplus on the bank account.

Questioned Costs

-0-

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

● **Condition 05-3**

Some vouchers of Section 8 program were not available for review.

<u>Date</u>	<u>Payee</u>	<u>Check Number</u>	<u>Amount</u>
09/01/04	Roca Jiménez	5624	\$ 230
10/01/04	José M. Pérez	5721	340
11/30/04	Nereida Nieves	5914	397
02/04/05	Jose Escorlaza	6159	321
03/02/05	Nereida Nieves	6272	397
			<u>\$ 1,685</u>

Criteria

The 24 CFR 982.158 (a) establishes that the Municipality must maintain complete and accurate accounts and other records for the program in accordance with HUD requirements, in a manner that permits a speedy and effective audit.

Cause

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

Effect

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

Recommendation

The Municipality's management should ascertain that adequate source of documentation exists to support amounts and items reported as expenditures. The Municipality should also establish a record keeping system to ensure that

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

accounting records and documentation are retained for the time period required by applicable requirements and the provisions of laws, regulations, contracts or grant agreements applicable to the program.

Questioned Costs

\$1,685

● **Condition 05-4**

During the audit, we observed the Municipality did not submitted any report to the agency, in relation to the disbursements made. Because the large amount of disbursements at least a quarterly report should be submitted to the federal agency. In addition, by the absence of some report, we cannot evaluate if the program used the federal funds into the period of availability.

Criteria

The 44 CFR 206.204 (f) establishes that the grantee is required to submit quarterly financial and progress reports to the RD. The reports should describe the status of those projects on which a final payment of the Federal Share has not been made to the state and outline any problems of circumstances expected to result in noncompliance with the approved grant conditions. The grantees are required to report on all large projects.

Cause

The above situation occurred because the Municipality did not ensure to verify and understand the reporting requirements for this program.

Effect

The continued failure to file the required reports may result in sanctions by the federal grantor, such as grant payment withholdings.

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

Recommendation

The Municipality should verify and become familiar with all administrative requirements applicable to each federal financial assistance program, especially with new grants are received. This can be achieved by obtaining the information applicable to the program from the pass-thru grantor, federal grantor, or the Catalog of Federal Domestic Assistance ("CFDA"), which is available from the federal government.

Questioned Costs

-0-

b. FEMA - CFDA No. 97.036

• **Condition 05-5**

The Municipality did not comply with the procedures required for minimizing the time elapsing between the transfer of federal fund and the disbursement by grantees. In addition, the Municipality maintains a high balance in bank account.

Criteria

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

Cause

The program does not have an effective control procedures for cash management.

Effect

The program does not comply with the cash management requirement.

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

Recommendation

The Municipality should establish a control procedures, in order to make disbursement after received the federal fund. In addition, the Municipality should identify the purpose of the balance in bank, in order to avoid a surplus on the bank account.

Questioned Costs

-0-

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

The Municipality has not prior years audit findings and questioned costs.

CORRECTIVE ACTION PLAN

ORTIZ, RODRIGUEZ, RIVERA & CO.

CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

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



Estado Libre Asociado de Puerto Rico
Gobierno Municipal de Quebradillas
Hon. Heriberto Vélez Vélez
Alcalde

CORRECTIVE ACTION PLAN

December 30, 2005

Cognizant or Oversight Agency for Audit:

Municipality of Quebradillas respectfully submits the following corrective action plan for the year ended June 30, 2005

Name and address of independent public accounting firm: Ortiz, Rodríguez, Rivera & Co., Suite 152, PO Box 70250, San Juan, Puerto Rico 00936-7250.

Audit period: Fiscal year ended June 30, 2005

The findings from the June 30, 2005 schedule of findings and questioned costs are discussed below. The findings are numbered consistently with the numbers assigned in the schedule.

FINDINGS - FEDERAL AWARD PROGRAM AUDITS, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Finding 05-1: Section 8 Voucher - CFDA 14.871

Reportable Condition: See Condition 05-1

Recommendation

The Municipality should have an HQS control procedure to assure the deficiencies will be corrected into the time required.

Action Taken

The Municipality will establish a maintenance control, in the Federal Program Office, in order to give the necessary follow-up to the deficiencies observed on the units inspections. This control will help us to assure the deficiencies will be corrected into the time required.

Finding 05-2: Section 8 Voucher - CFDA 14.871

Reportable Condition: See Condition 05-2

Recommendation

The Municipality should establish control procedures, in order to make disbursement after received the federal fund. In addition, the Municipality should identify the purpose of the balance in bank, in order to avoid a surplus will result on the bank account.

Action Taken

The Municipality will establish control procedures to make the disbursements immediately after received the federal funds. In addition, the balance on bank will be verified to determinate the purpose of them.

Finding 05-3: Section 8 Voucher - CFDA 14.871

Reportable Condition: See Condition 05-3

Recommendation

The Municipality should improve the process of maintaining the records, in order to evidence of accountability will be available for audits.

Action Taken

The Municipality improved the archive's control procedures, in order to avoid this situation in the future.

Finding 05-4: Section 8 Voucher - CFDA 14.871

Reportable Condition: See Condition 05-4

Recommendation

The Municipality should verify all the required requisites with the agency when federal funds are approved.

Action Taken

The Municipality will establish control procedures to evaluate all requirements of the agencies when federal funds are approved, in order to comply with all of them.

Finding 05-5: FEMA - CFDA No. 97.036

Reportable Condition: See Condition 05-5

Recommendation

The Municipality should establish control procedures, in order to make disbursement after received the federal fund. In addition, the Municipality should identify the purpose of the balance in bank, in order to avoid a surplus will result on the bank account.

Action Taken

The Municipality will establish control procedures to make the disbursements immediately after received the federal funds, in order to minimize the time elapsing between the transfer of funds from the agency and disbursements.

If the Cognizant or Oversight Agency for Audit has questions regarding this plan, please call Edna M. Pérez at (787) 895-2840.

Cordially,



Edna M. Pérez
Finance Director