

OFICINA DEL COMISIONADO DE ASUNTOS MUNICIPALES

AREA DE ASESORAMIENTO, REGLAMENTACION E INTERVENCION FISCAL

AREA DE ARCHIVO DIGITAL

MUNICIPIO DE SAN SEBASTIAN
AUDITORIA 2004-2005

30 DE JUNIO DE 2005

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN**

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

ORTIZ, RODRIGUEZ, RIVERA & CO.

CERTIFIED PUBLIC ACCOUNTANTS • VALUE ADDED SERVICES

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

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

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INDEPENDENT AUDITORS' REPORT

To the Honorable Mayor and
Municipal Legislature
Municipality of San Sebastián
San Sebastián, 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 San Sebastián, 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 did not audit the financial statements of Villa Soigal Project, as of June 30, 2005. Those financial statements were audited by other auditors whose report thereon has been furnished to, and our opinion, insofar as it relates to the amounts included for Villa Soigal Project, is based on the report of the other auditors.

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, based on our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the discretely presented component unit, each major fund and the aggregate remaining fund information of the Municipality of San Sebastián as of June 30, 2005, and the respective changes in financial position, thereof and the respective budgetary comparison for the general and debt service funds 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 November 4, 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 10 is 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.

Ortiz, Rodriguez, Rivera & Co.

San Juan, Puerto Rico
November 4, 2005

The stamp 2101435 was affixed
to the original of this report.



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

Our discussion and analysis of the Municipality of San Sebastián financial performance provides an overview of the Municipality's financial activities for the fiscal year ended June 30, 2005. Please read it in conjunction with the financial statements, which begin on page 11.

FINANCIAL HIGHLIGHTS

- The asset of the Municipality, on a government-wide basis, exceeded its liabilities at the end of fiscal year 2005 by \$9,759,804 (net assets), of which \$20,435,728 was invested in capital assets (net of accumulated depreciation, and related debt) and \$1,905,681 was restricted. The unrestricted fund balance has a negative balance of \$12,581,605.
- The Municipality's total net assets increased by \$33,895 from previous year restated balance.
- At the end of the current fiscal year, the Municipality's governmental funds reported combined ending fund balances of \$471,739, an increase of \$13,169 in comparison with the prior year.
- The General Fund, on a current financial resources basis, reported the excess in revenues and other financing sources over expenditures and other financing uses of \$1,647,342. This excess is mainly due to the fact that during the current year the municipality's operation resulted on an excess of revenues over expenditures of \$207,795 and the net effect of a loan of \$2,810,000 and related transfer out of \$1,370,453.
- On a budgetary basis, actual revenues exceeded actual expenditures by \$1,401,580.

USING THIS ANNUAL REPORT

This annual report consists of a series of financial statements. The Statement of Net Assets and the Statement of Activities (on pages 11 through 12) provide information about the activities of the Municipality as a whole and present a long-term view of the Municipality's finances. Fund financial statements start on page 13. For governmental activities, these statements show how these services were financed in the short term as well as what remains for future spending. Fund financial statements report the Municipalities' operations in more detail than the government-wide statements by providing information about the Municipality's most significant funds.

Reporting the Municipality as a Whole

The Statement of Net Assets and the Statement of Activities

The Statement of Net Assets and the Statement of Activities report information about the Municipality as a whole and about its activities. These statements include *all* assets and liabilities using the *accrual basis of accounting*, which is similar to the accounting used by most private-sector companies. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Municipality's *net assets* and related changes. The Municipality's net assets, represents the difference between assets and liabilities therefore we can measure or determine the financial health and/or financial position. The *increases or decreases* in the Municipality's net assets are indicator of whether its *financial health* is improving or deteriorating. However, you will need to consider other non-financial factors, such as, changes in the Municipality's property tax base and the roads' conditions, in order to asses the *overall health* of the Municipality of San Sebastián.

**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

Reporting the Municipality's Most Significant Funds

In the Statement of Net Assets and the Statement of Activities, we showed the Municipality activities as of basic services are reported here, including the municipal police, public works, garbage disposal, public energy and health services, and general administration. Property taxes, municipal license tax, state and federal grants finance most of these activities.

Fund Financial Statements

Our analysis of the Municipality's major funds begins on page 7. The Fund financial statements begin on page 13 and provide detailed information about the most significant funds, not the Municipality as a whole. Certain bond covenant required that the Municipality establish the Debt Service Fund in order to keep a proper accounting for the resources.

The Municipality's basic services are reported in the governmental funds, that uses an accounting approach which focus on how money was received and disbursed and the balances left at year-end that are available for spending. These funds were reported using an accounting method called *modified accrual* accounting, which measures cash and all other *financial* assets that can readily be converted to cash. The governmental fund statements provide a detailed *short-term view* of the Municipality's general government operations and the basic services it provides.

Governmental fund information helps you to determine whether there are more or fewer financial resources that can be spent in the near future to finance the Municipality's programs. We describe the relationship (or differences) between governmental activities (reported in the Statement of Net Assets and the Statement of Activities) and governmental funds in reconciliation on pages 15 and 17 of this report.

THE MUNICIPALITY AS A WHOLE

The change in fund balance during the year ended June 30, 2005 was \$33,895.

Our analysis below focuses on the net assets and changes in net assets (Table 1) of the Municipality's governmental activities.

**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

Table 1

Net Assets

Governmental Activities

	2005	2004 as restated	Change	%
Current and other assets	\$5,202,597	\$6,559,041	(\$1,356,444)	-20.68%
Capital assets	30,705,728	28,968,707	1,737,021	6.00%
Total Assets	<u>\$35,908,325</u>	<u>\$35,527,748</u>	<u>\$380,577</u>	<u>1.07%</u>
Other liabilities	\$6,280,835	\$8,898,517	(\$2,617,682)	-29.42%
Long term debt outstanding	19,867,686	16,903,322	2,964,364	17.54%
Total liabilities	<u>\$26,148,521</u>	<u>\$25,801,839</u>	<u>\$346,682</u>	<u>1.34%</u>
Net Assets				
Investment in Capital Assets, net of related debt	\$20,435,728	\$21,113,707	(\$677,979)	-3.21%
Restricted for:				
Debt services	1,905,681	1,988,783	(83,102)	-4.18%
Unrestricted	(12,581,605)	(13,376,581)	794,976	-5.94%
Total net assets	<u>\$9,759,804</u>	<u>\$9,725,909</u>	<u>\$33,895</u>	<u>0.35%</u>

Governmental Activities

Revenues for the Municipality's governmental activities decrease by \$2,139,590 or 9% and total expenses decreased by \$576,129 or 3%. The decrease in revenues was mainly due to a reduction of \$3,411,688 in grants and contributions not restricted to specific programs. Decrease in expenses is directly related to the decrease in revenues.

**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

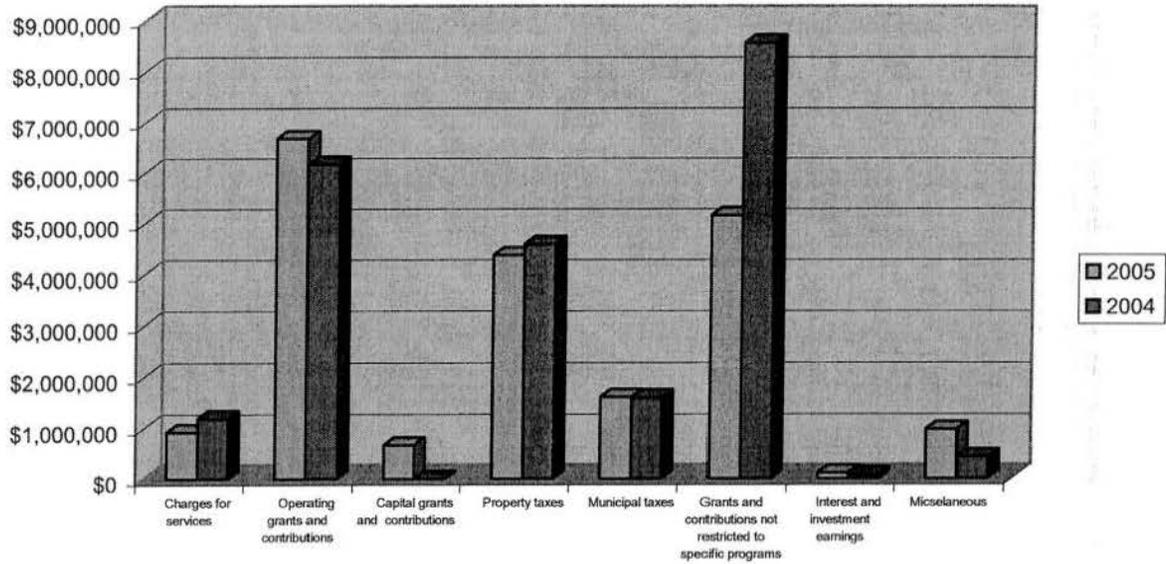
The following table summarizes the changes in net assets for the fiscal years ended 2005 and 2004:

**Table 2
Changes in Net Assets
Governmental Activities**

	2005	%of Total	2004 as restated	Change	% of Change
Revenues:					
Program revenues:					
Charges for services	\$922,756	4.50%	\$1,194,145	\$ (271,389)	-22.73%
Operating grants and contributions	6,678,085	32.59%	6,168,972	509,113	8.25%
Capital grants and contributions	669,250	3.27%	-	669,250	
General revenues:					
Property taxes	4,369,472	21.33%	4,585,805	(216,333)	-4.72%
Municipal taxes	1,608,789	7.85%	1,599,888	8,901	0.56%
Grants and contributions not restricted to specific programs	5,154,606	25.16%	8,566,294	(3,411,688)	-39.83%
Interest and investment earnings	108,530	0.53%	81,081	27,449	33.85%
Miscellaneous	978,067	4.77%	432,960	545,107	125.90%
Total revenues	20,489,555	100%	22,629,145	(2,139,590)	-9.46%
Expenses:					
General government	5,292,575	28.32%	6,537,077	(1,244,502)	-19.04%
Public safety	1,020,945	5.46%	997,212	23,733	2.38%
Public works	2,848,422	15.24%	3,340,939	(492,517)	-14.74%
Culture	382,941	2.05%	397,694	(14,753)	-3.71%
Recreation	441,204	2.36%	433,555	7,649	1.76%
Health and welfare	6,853,814	36.67%	5,156,258	1,697,556	32.92%
Depreciation	1,190,889	6.37%	1,865,129	(674,240)	-36.15%
Interest on long-term debt	660,097	3.53%	539,152	120,945	22.43%
Total expenses	18,690,887	100%	19,267,016	(576,129)	-2.99%
Increase(decrease) in net assets	1,798,668		3,362,129	(1,563,461)	-46.50%
Special items:					
Loss on disposition of asset	-		-5,544	5,544	-100.00%
Increase in net assets	1,798,668		3,356,585	2,664,432	79.38%
Net assets at beginning of year					
as restated	7,961,136		6,369,324	1,695,653	26.62%
Net assets end of year	<u>\$9,759,804</u>		<u>\$9,725,909</u>	<u>\$4,360,085</u>	44.83%

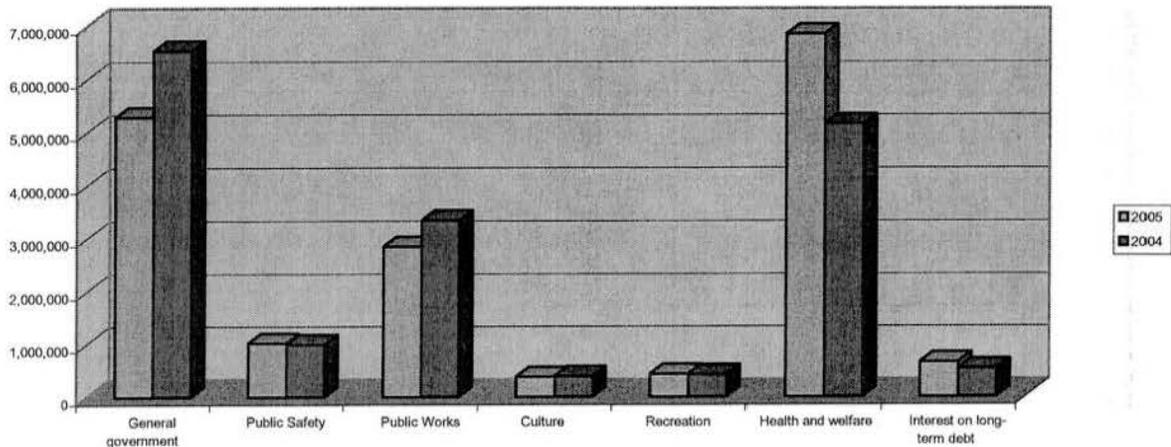
**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

**Municipality of San Sebastian
Governmental Activities - Revenues by Sources
Fiscal Years Ended June 30, 2005 and 2004**



Approximately 32% of the Municipality's revenues came from operating and contributions, 25% from grant and contributions not restricted operating and capital grants and 11% from property taxes. Based on our analysis in Table 2, revenues decreased by 9% in comparison with fiscal year 2004. The most significant change, considering it's participation in total revenues, is a decrease of 39% in grants and contributions not restricted to specific programs.

**Municipality of San Sebastian
Governmental Activities - Expenditure by Function
Fiscal Years Ended June 30, 2005 and 2004**



**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

The Municipality's principal expenses are health and welfare, which approximately represents a 36% of total expenses reported for the fiscal year ended June 30, 2005. General government represent a 28% and public work a 15%. Program revenues of the Municipality covered 45% of total expenses.

Expenses decreased 3% in comparison with previous year. This includes the net effect of the following events: a decrease in general government and public work (vehicles and equipment's repair and maintenance) mainly due to the direct effect of the decrease in revenues and the implementation of relevant internal controls in the Public Work Agency, a decrease in depreciation expense of \$674,240 due to various vehicles and equipment fully depreciated during last year and an increase of \$1,697,556 in health and welfare due to a increase in the Community Development Block Grant.

THE MUNICIPALITY'S FUND

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

For the fiscal year ended June 30, 2005, the governmental funds reported combined ending fund balances of \$471,739 a net increase of \$13,169 in comparison with the prior year. From total combined fund balances, \$(1,806,046) constitutes unreserved fund balance. The remaining fund balance is not available for new spending.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

Investment in capital assets for governmental activities as of June 30, 2005, amounted to \$30,705,728 (net of accumulated depreciation). This investment in capital assets includes land, buildings, improvements, vehicles, machinery and equipment, park facilities, roads, bridges and construction in progress.

**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

Capital assets as of June 30, 2005 and 2004 follow:

Table 3

**Capital Assets, net
As of June 30,**

	Governmental Activities	
	2005	2004 (as restated)
Non-depreciable assets:		
Land	\$2,159,416	\$2,237,416
Construction in progress	1,946,498	2,266,937
Depreciable assets:		
Buildings and improvements	\$24,469,539	\$22,819,400
Furniture and fixtures	200,927	230,977
Vehicules, machinery and equipment	944,090	403,237
Infrastructures	985,258	1,010,740
Total	\$30,705,728	\$28,968,707

Significant capital projects underway in construction in progress included the following:

Improvements to Softball Park	\$ 422,228
Improvements to Basketball Facilities	\$ 188,450
Barandillo Bridge	\$ 1,335,818

This year's major capital assets additions (approximately) included:

- \$1,232,414 of a Bridge in Culebrina River.
- \$502,510 in the Municipality's Management Emergency Agency.

More detailed information about the Municipality's capital assets and future projects is presented in Note 10 to the financial statements.

**MUNICIPALITY OF SAN SEBASTIÁN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2005**

Debt

Debt Administration

Long term debt as of June 30, 2005 and 2004 follows:

Table 4

	Outstanding Long-term Debt	
	Fiscal years ended June 30,	
	Governmental Activities	
	2005	2004 (as restated)
Bonds payable	\$10,270,000	\$7,855,000
Notes payable	1,957,609	2,084,388
Obligation under capital Lease	-	271,912
Landfill obligation	5,833,123	6,048,111
P.R. Department of Treasury	-	1,152,665
P.R. Health Insurance Administration	770,024	770,024
Compensated absences	1,872,518	1,947,730
Claims and judgments	265,000	-
Total	\$ 20,968,274	\$ 20,129,830

At the end of the current fiscal year, the Municipality had a total bonded debt and notes payable outstanding of \$12,227,609. Other obligations include a \$1,872,518 in compensated absences, \$770,024 in P.R. Health Insurance Administration, and \$5,833,123 in landfill obligation. Compensated absences are paid when due.

More detailed information about the Municipality's long-term liabilities is presented in Note 14 to the financial statements.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET

The Municipality's selected and appointed officials considered many factors when setting the fiscal year 2005-2006 budget. The Municipality applied a conservative approach in development budget estimates. Amounts available for appropriations in the General Fund for the fiscal year 2005 are \$12,706,131, an increase of approximately \$192,369 or 2% with respect to prior year estimates. Expenditures and negative fund balance are expected to rise accordingly to the increase of revenues from the sale of unused properties.

CONTACTING FINANCE DIRECTOR

This financial report is design to provide our citizens, taxpayers and customers and creditors with a general overview of the Municipality finances and to show accountability for the money it receives. If you have any questions about this report or need any additional information contact the Finance Department at the Municipality of San Sebastián, PO Box 1603, San Sebastián, P.R. 00685.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
STATEMENT OF NET ASSETS
JUNE 30, 2005**

<u>Assets</u>	<u>Governmental Activities</u>	<u>Villa Soigal Project</u>
Cash (Notes 2 and 5)	\$ 1,982,021	\$ 27,666
Cash with fiscal agent (Notes 2 and 5)	2,929,297	
Accounts receivables:		
Municipal license taxes (Note 7)	61,217	
Rent, licenses, and permits	156,233	
Other		641
Due from other agencies (Note 8)	73,829	
Other assets		23,980
Restricted deposits		379,462
Capital assets, net (Note 10)	<u>30,705,728</u>	<u>2,066,381</u>
 Total assets	 <u>\$ 35,908,325</u>	 <u>\$ 2,498,130</u>
 <u>Liabilities and Net Assets</u>		
Liabilities		
Accounts payable and accrued liabilities	\$ 1,981,081	\$ 30,138
Due to other agencies (Note 11)	769,306	
Deferred revenues (Note 12):		
Municipal license tax	718,058	
Federal government	123,722	
Other	1,138,691	
Accrued interest	449,389	8,387
Noncurrent liabilities (Note 14):		
Due within one year	1,100,588	59,548
Due in more than one year	19,867,686	1,348,056
Total liabilities	<u>26,148,521</u>	<u>1,446,129</u>
Net Assets		
Investment in capital assets, net of related debt	20,435,728	
Restricted for:		
Debt service	1,905,681	
Unrestricted	<u>(12,581,605)</u>	<u>1,052,001</u>
 Total net assets	 <u>\$ 9,759,804</u>	 <u>\$ 1,052,001</u>

The accompanying notes are an integral part of these basic financial statements.

-11-

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Functions/Programs	Expenses	Program Revenues			Net (Expense) Revenue and Changes in Net Assets	
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Primary Government Governmental Activities	Component Unit Villa Soigal Project
Primary Government:						
General government	\$ 5,292,575	\$ 922,756	\$ -	\$ -	\$ (4,369,819)	\$ -
Public safety	1,020,945				(1,020,945)	
Public works	2,848,422			669,250	(2,179,172)	
Culture	382,941				(382,941)	
Recreation	441,204				(441,204)	
Health and welfare	6,853,814		6,678,085		(175,729)	
Depreciation	1,190,889				(1,190,889)	
Interest on long-term debt	660,097				(660,097)	
Total primary government	<u>\$ 18,690,887</u>	<u>\$ 922,756</u>	<u>\$ 6,678,085</u>	<u>\$ 669,250</u>	<u>(10,420,796)</u>	<u>-</u>
Component Unit:						
Villa Soigal Project	<u>\$ 579,648</u>	<u>\$ 526,869</u>	<u>\$ -</u>	<u>\$ -</u>		<u>(52,779)</u>
General revenues:						
Property taxes					4,369,472	
Municipal license tax					1,608,789	
Grants and contributions not restricted to specific programs					5,154,606	
Interest and investment earnings					108,530	6,351
Miscellaneous					978,067	1,490
Total general revenues					<u>12,219,464</u>	<u>7,841</u>
Change in net assets					1,798,668	(44,938)
Net assets at beginning of year, as restated (Note 21)					<u>7,961,136</u>	<u>1,096,939</u>
Net assets at end of year					<u>\$ 9,759,804</u>	<u>\$ 1,052,001</u>

The accompanying notes are an integral part of these basic financial statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
BALANCE SHEET-GOVERNMENTAL FUNDS
JUNE 30, 2005**

<u>Assets</u>	<u>General</u>	<u>HUD Programs</u>	<u>HHS Program</u>	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Other Governmental Funds</u>	<u>Total Governmental Funds</u>
Cash (Notes 2 and 5)	\$ 1,203,957	\$ 133,661	\$ 266,272	\$ -	\$ -	\$ 378,131	\$ 1,982,021
Cash with fiscal agent (Notes 2 and 5)	4,709			1,905,681		1,018,907	2,929,297
Accounts receivable:							
Municipal license taxes (Note 7)	61,217						61,217
Rent, licences, and permits	156,233						156,233
Due from agencies (Note 8)		50,609	23,220				73,829
Due from other funds (Note 9)	996,651				9,883	1,030,241	2,036,775
Total assets	\$ 2,422,767	\$ 184,270	\$ 289,492	\$ 1,905,681	\$ 9,883	\$ 2,427,279	\$ 7,239,372

The accompanying notes are an integral part of these basic financial statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
BALANCE SHEET-GOVERNMENTAL FUNDS
JUNE 30, 2005**

<u>Liabilities and Fund Balance (Deficiency)</u>	<u>General</u>	<u>HUD Programs</u>	<u>HHS Program</u>	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Other Governmental Funds</u>	<u>Total Governmental Funds</u>
Liabilities							
Account payable and accrued liabilities	\$ 749,736	\$ 18,536	\$ 188,070	\$ -	\$ 851,710	\$ 173,029	\$ 1,981,081
Due to other agencies (Note 11)	769,306						769,306
Due to other funds (Note 9)	1,045,633	42,012	101,422			847,708	2,036,775
Deferred revenues (Note 12):							
Municipal license tax	718,058						718,058
Federal government		123,722					123,722
Other						1,138,691	1,138,691
Total liabilities	<u>3,282,733</u>	<u>184,270</u>	<u>289,492</u>	<u>-</u>	<u>851,710</u>	<u>2,159,428</u>	<u>6,767,633</u>
Fund Balance (Deficiency)							
Reserved for:							
Encumbrances	33,483				70,770	1,575	105,828
Debt service				1,905,681			1,905,681
Restricted for specific purposes						266,276	266,276
Unreserved fund balance (deficiency)	(893,449)				(912,597)		(1,806,046)
Total fund balance (deficiency)	<u>(859,966)</u>	<u>-</u>	<u>-</u>	<u>1,905,681</u>	<u>(841,827)</u>	<u>267,851</u>	<u>471,739</u>
Total liabilities and fund balance	<u>\$ 2,422,767</u>	<u>\$ 184,270</u>	<u>\$ 289,492</u>	<u>\$ 1,905,681</u>	<u>\$ 9,883</u>	<u>\$ 2,427,279</u>	<u>\$ 7,239,372</u>

The accompanying notes are an integral part of these basic financial statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
RECONCILIATION OF THE GOVERNMENTAL FUNDS
BALANCE SHEET TO STATEMENT OF NET ASSETS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Total fund balances - governmental funds \$ 471,739

Amounts reported for governmental activities in the statement of net assets are different because:

- Capital assets, net used in governmental activities are not current financial resources and therefore are not reported in the governmental funds balance sheet 30,705,728

- Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds. **(Note 4)** (21,417,663)

Net assets of governmental activities \$ 9,759,804

The accompanying notes are an integral part of these basic financial statements.

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES (DEFICIT) - GOVERNMENTAL (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

	General	HUD Programs	HHS Program	Debt Service	Capital Projects	Other Governmental Funds	Total Governmental Funds
REVENUES							
Property taxes (Note 6)	\$ 3,540,542	\$ -	\$ -	\$ 828,930	\$ -	\$ -	\$ 4,369,472
Municipal license taxes (Note 7)	1,608,789						1,608,789
Licenses and permits	449,753						449,753
Charges for service and rents	473,003						473,003
Intergovernmental revenues (Note 13):							
Federal grants and contributions		2,292,259	3,477,328			908,498	6,678,085
State contributions	5,154,606					669,250	5,823,856
Interest, fines, and penalties	84,205			24,325			108,530
Other revenues	253,147					724,920	978,067
Total revenues	<u>11,564,045</u>	<u>2,292,259</u>	<u>3,477,328</u>	<u>853,255</u>	<u>-</u>	<u>2,302,668</u>	<u>20,489,555</u>
EXPENDITURES							
General government	5,754,416					804,727	6,559,143
Public safety	1,020,945						1,020,945
Public works	3,048,611						3,048,611
Culture	382,941						382,941
Recreation	441,204						441,204
Health and welfare	708,133	2,292,259	3,477,328			376,094	6,853,814
Capital outlays					2,942,709		2,942,709
Debt service:							
Principal retirement				1,600,000			1,600,000
Interest and other				552,270			552,270
Total expenditures	<u>11,356,250</u>	<u>2,292,259</u>	<u>3,477,328</u>	<u>2,152,270</u>	<u>2,942,709</u>	<u>1,180,821</u>	<u>23,401,637</u>
Excess (deficiency) of revenues over (under) expenditures	<u>207,795</u>	<u>-</u>	<u>-</u>	<u>(1,299,015)</u>	<u>(2,942,709)</u>	<u>1,121,847</u>	<u>(2,912,082)</u>
OTHER FINANCING SOURCES (USES)							
Issuance of long-term debt	2,810,000					1,110,000	3,920,000
Transfers in				1,215,913	3,289,745		4,505,658
Transfers out	(1,370,453)					(3,135,205)	(4,505,658)
Total other financing sources (uses)	<u>1,439,547</u>	<u>-</u>	<u>-</u>	<u>1,215,913</u>	<u>3,289,745</u>	<u>(2,025,205)</u>	<u>3,920,000</u>
Excess (deficiency) of revenues and other sources over expenditures and other uses	<u>1,647,342</u>	<u>-</u>	<u>-</u>	<u>(83,102)</u>	<u>347,036</u>	<u>(903,358)</u>	<u>1,007,918</u>
FUND BALANCES (DEFICIT) AT BEGINNING OF YEAR							
	<u>(2,507,308)</u>	<u>-</u>	<u>-</u>	<u>1,988,783</u>	<u>(1,188,863)</u>	<u>1,171,209</u>	<u>(536,179)</u>
FUND BALANCES (DEFICIT) AT END OF YEAR							
	<u>\$ (859,966)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,905,681</u>	<u>\$ (841,827)</u>	<u>\$ 267,851</u>	<u>\$ 471,739</u>

The accompanying notes are an integral part of these basic financial statements.

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES AND
CHANGES IN FUND BALANCES OF GOVERNMENTAL FUNDS TO THE
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

Net change in fund balances - total governmental funds \$ 1,007,918

Amounts reported for governmental activities in the statement of activities are different because:

- Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. 2,942,709
- Depreciation expense on capital assets is reported in the statement of activities, but they do not require the use of current financial resources. Therefore, depreciation expense is not reported as expenditure in governmental funds. (1,190,889)
- Governmental funds report issuance of long-term debt as other financial sources because provides current financial resources. (3,920,000)
- Governmental funds report principal payments on long-term obligations as expenditures, whereas the principal payments reduces the long-term obligations in the statement of activities. 1,600,000
- Change in accrued interest expense which does not require the use of current financial resources. (107,827)
- Some expenses reported in the statement of activities do not require the use of current financial resources; therefore, are not reported as expenditures in governmental funds. 1,466,757

Changes in net assets of governmental activities \$ 1,798,668

The accompanying notes are an integral part of these basic financial statements.

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
STATEMENT OF REVENUES AND EXPENDITURES - GENERAL BUDGET AND DEBT SERVICE FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

	General Fund				Debt Service Fund			
	Budgeted Amounts		Actual	Variance with Final Budget- Positive (Negative)	Budgeted Amounts		Actual	Variance with Final Budget- Positive (Negative)
	Original	Final			Original	Final		
REVENUES								
Property taxes	\$ 3,720,977	\$ 3,720,977	\$ 3,540,542	\$ (180,435)	\$ 1,037,425	\$ 1,037,425	\$ 828,930	\$ (208,495)
Municipal license taxes	1,955,000	1,955,000	1,534,891	(420,109)				
Licenses and permits	770,000	770,000	338,457	(431,543)				
Charges for service and rents	785,000	785,000	480,101	(304,899)				
Intergovernmental revenues:								
State contributions	4,124,494	4,128,684	4,945,301	816,617				
Interest, fines and penalties	200,000	200,000	84,205	(115,795)				
Other revenues	958,290	958,290	253,147	(705,143)				
Total revenues	<u>12,513,761</u>	<u>12,517,951</u>	<u>11,176,644</u>	<u>(1,341,307)</u>	<u>1,037,425</u>	<u>1,037,425</u>	<u>828,930</u>	<u>(208,495)</u>
EXPENDITURES								
General government	6,681,529	9,591,103	6,988,883	2,602,220				
Public safety	1,137,123	1,093,675	1,020,945	72,730				
Public works	3,103,503	3,083,713	3,042,958	40,755				
Culture	412,470	390,474	382,941	7,533				
Health and welfare	708,133	708,133	708,133	-				
Recreation	471,003	460,853	441,204	19,649				
Education								
Debt service:								
Principal					655,610	655,610	1,600,000	(944,390)
Interest					381,815	381,815	552,270	(170,455)
Total expenditures	<u>12,513,761</u>	<u>15,327,951</u>	<u>12,585,064</u>	<u>2,742,887</u>	<u>1,037,425</u>	<u>1,037,425</u>	<u>2,152,270</u>	<u>(1,114,845)</u>
OTHER FINANCING SOURCES								
Proceeds from long-term debt		2,810,000	2,810,000					
Excess (deficiency) of revenues over (under) expenditures	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,401,580</u>	<u>\$ 1,401,580</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (1,323,340)</u>	<u>\$ (1,323,340)</u>

The accompanying notes are an integral part of these basic financial statements.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

1. ORGANIZATION

The Municipality of San Sebastián, Puerto Rico (Municipality) was founded in 1752. The Municipality is a political legal entity with full legislative and administrative faculties in every affair of municipal character, with perpetual succession existence and legal identity, separate and independent from the central government of the Commonwealth of Puerto Rico. The Municipality provides a full range of services including: public safety, public works, culture, recreation, health and welfare, education and other miscellaneous services.

The Municipal Government comprises the executive and legislative branches. The executive power is exercised by the Mayor and the legislative by the Municipal Assembly, which has 14 members. The members of these branches are elected every four years in the Puerto Rico general elections.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the Municipality have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applicable to governmental entities. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The financial information of the Municipality is presented in this report as follows:

- Management's Discussion and Analysis - Introduces the basic financial statements and provides an analytical overview of the Municipality's financial activities.
- Government - Wide Financial Statements - The reporting model includes financial statements prepared using full accrual of accounting for all of the government's activities. This approach includes not just current assets and liabilities, but also capital assets and long-term liabilities (such as buildings and infrastructure, including bridges and roads, and general obligation debt).
- Statement of Net Assets - The statement of net assets is designed to display the financial position of the Municipality, including capital assets and infrastructure.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

The net assets of the Municipality will be broken down into three categories; invested in capital assets, net of related debt; restricted; and unrestricted.

- **Statement of Program Activities** - The government - wide statement of activities report expenses and revenues in a format that focuses on the cost of each of the government's functions. The expense of individual functions is compared to the revenues generated directly by the function.
- **Budgetary comparison schedules** - Demonstrating compliance with the adopted budget is an important component of a government's accountability to the public. Under the new reporting model, the Municipality will continue to provide budgetary comparison information in their financial statements. An important change, however, is a requirement to add the government's original budget to the current comparison of final budget and actual results.

The following is a summary of the more significant policies.

a. Reporting Entity

In evaluating how to define the Municipality for financial reporting purposes, management has considered all potential component units. The decision to include a potential component unit in the reporting entity was made by applying the provisions of Statement No. 14, "The Financial Reporting Entity," of the GASB. The basic, but not the only criterion for including a potential component unit within the reporting entity is if elected officials of a primary government appoints a voting majority of the entity's governing body, and if either one of the following conditions exist: the primary government can impose its will on the other entity or the potential exists for the other entity to (1) provide specific financial benefits to or (2) impose specific financial burdens on the primary government. A second criterion used in evaluating potential component units is if the nature and significance of the relationship between the entity and a primary government are such that to exclude the entity from the financial reporting entity would render the financial statements misleading or incomplete. GAAP details two methods of presentation: blending the financial data of the component units' balances and transactions in a manner similar to the presentation of the Municipality's balances and transactions or discrete presentation of the component units' financial data in columns separate from the Municipality's balances and transactions.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

The Villa Soigal Project is included in the basic financial statements as a discretely component unit because of the nature of the services they provide and the Municipality's ability to impose its will

Villa Soigal Project is a 120-unit multi-family housing project owned by the Municipality as authorized transfer from the Special Trustee for the Liquidation of the Accounts of the Puerto Rico Urban Renewal and Housing Corporation. The Project is operated under Section 515 of USDA, Rural Development (USDA-RD) and regulated by the U. S. Department of Housing and Urban Development (HUD) with respect to rental charges and operating methods. The project is also subject to Section 8 Housing Assistance Payments agreements with HUD, and a significant portion of the Project's rental income is received from HUD. Also, the Project is financed by a Mortgage of Section 515 Direct Loan.

b. Government-Wide and Fund Financial Statements

The government-wide financial statements (i.e., the statement of net assets and the statement of changes in net assets) report information on all the activities of the Municipality. For the most part, the effect of interfund activity has been removed from these statements. Governmental activities are supported mainly by taxes and intergovernmental revenues.

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

The fund financial statements segregate transactions related to certain functions or activities in separate funds in order to aid financial management and to demonstrate legal compliance. These statements present each major fund as a separate column on the fund financial statements; all non-major funds are aggregated and presented in a single column.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

c. Measurement Focus, Basis of Accounting and Financial Statement Presentation

The government-wide financial statements are reported using the *economic resources measurement focus and the accrual basis of accounting*. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Property taxes are recognized as revenues in the year for which they are levied. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Governmental fund financial statements are reported using the *current financial resources measurement focus and the modified accrual basis of accounting*. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the government considers revenues to be available if they are collected within the current period or soon enough thereafter. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures, as well as expenditures related to compensated absences and claims and judgments, are recorded only when payment is due.

Property taxes, franchise taxes, licenses, and interest associated with the current fiscal period are all considered to be susceptible to accrual and so have been recognized as revenues of the current fiscal period. Only the portion of special assessments receivable due within the current fiscal period is considered to be susceptible to accrual as revenue of the current period. All other revenue items are considered to be measurable and available only when cash is received by the government.

The Municipality reports the following major governmental funds:

1) General Fund

This is the operating fund of the Municipality and accounts for all financial resources, except those required to be accounted for in another fund.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

2) Housing and Urban Development Programs (HUD Programs)

This fund account for revenue sources for the development of viable urban communities, decent housing, suitable living environment, rental assistance to help very low-income families afford decent, safe and sanitary housing by encouraging property owners to rehabilitate substandard housing and lease the units with rental subsidies to low-income family.

3) Health and Human Services Programs (HHS Programs)

This fund account for revenue sources to provide essential human services such as health insurance for elderly and low-income people, improving maternal and infant health, pre-school education and services, prevent child abuse and domestic violence and medical and social science research including the prevention of outbreak of infections disease and immunization services.

4) Debt Service Fund

This fund is used to account for the resources accumulated and payments made for principal and interest on long-term general obligation debt of governmental funds.

5) Capital Projects Fund

This fund is used to account for the financial resources used for the acquisition and construction of major capital facilities, financed with the proceeds of general obligation bonds.

Private-section standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in the government-wide financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board.

As a general rule the effect of interfund activity has been eliminated from the government-wide financial statements.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

Amounts reported as *program revenues* include 1) charges to customers or applicants for goods, services, licenses, permits, or privileges provided, 2) operating grants and contributions, and 3) capital grants and contributions, including special assessments. Internally dedicated resources are reported as *general revenues* rather than as program revenues. Likewise, general revenues include all taxes.

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

d. Cash and Cash with Fiscal Agent

The Municipality's Finance Director is responsible for investing available resources. The Municipality is restricted by law to invest only in savings accounts with banks qualified as a depository of public funds by the Puerto Rico Treasury Department (PRTD) or in instruments of the Government Development Bank for Puerto Rico (GDB).

Cash with fiscal agent in the capital projects fund consists of unused proceeds from appropriations from the Legislature of Puerto Rico, for the payment of current liabilities, and bonds and notes issued for the acquisition and construction of major capital improvements. Cash with fiscal agent in the debt service fund represents special additional property tax collections retained by the Commonwealth of Puerto Rico and restricted for the payment of the Municipality's debt service, as established by law.

e. Interfund Receivables and Payables

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.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

f. Capital Assets

Capital assets, which include property, plant, equipment, and infrastructure (which is normally immovable and of value only to the Municipality, such as roads, bridges, streets sidewalks, and drainage system), are reported in the applicable governmental or component units columns in the government-wide financial statements.

Capital assets purchased or acquired are carried at historical cost or estimated historical cost. Contributed assets are recorded at fair market value as of the date donated. Additions, improvements and other capital outlays that significantly extend the useful life of an asset are capitalized. Other costs incurred for repairs and maintenance are expensed as incurred. Depreciation in capital assets is calculated on the straight-line basis over the following estimated useful lives:

	<u>Useful Life</u>
Infrastructure	25-50 years
Buildings and building improvements	20-50 years
Furniture and fixtures	5-10 years
Vehicles and equipment	5-20 years

g. Reservation of Fund Balance

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

1) Encumbrances

Represent future expenditures under purchase orders, contracts and other commitments. These committed amounts generally will become liabilities in future periods as the goods or services are received.

2) Debt Service

Represents net assets available to finance future debt service payments.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

3) Capital Projects Fund

Represents the reservation of amounts to be used for future expenditures for capital projects under contracts and other commitments. The committed amounts generally will become liabilities in future periods as the projects are completed.

h. Risk Financing

The Municipality carries insurance to cover casualty, theft, tort claims and other losses. Insurance policies are negotiated by the Puerto Rico Treasury Department and costs are allocated among all the municipalities of Puerto Rico. Cost of insurance allocated to the Municipality and deducted from the gross property tax collections by the Municipal Revenue Collection Center (the "CRIM") for the year ended June 30, 2005 amounted to approximately \$278,000. The current insurance policies have not been cancelled or terminated. The CRIM also deducted approximately \$348,000 for workers compensation insurance covering all municipal employees.

i. Compensated Absences

Employees are entitled to 30 days vacations leave and 18 days sick leave per year. Sick leave is recorded as an expenditure in the year paid. Employees are entitled to payment of unused sick leave upon retirement if have been employed for at least 10 years in the municipal government. On July 1997, state Law 152 supra amended the Article 12.016, Section b (2) of the Municipal Law, authorizing the Municipality to pay any excess of vacations and sick leave accumulated over the maximum previously permitted by law. Calculations must be made until December 31 of every year. Excess of sick leave must be paid until March 31 next every natural year. Excess of vacations can be paid after July 1 of every fiscal year.

j. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures/expenses during the reporting period. The most significant estimates consist of the contribution received from the Puerto Rico Electric Power Authority and the Municipal Revenue Collection Center caused by the delay of the notification of the actual revenues and expenditures to the presented in the financial statements of the agencies mentioned above.

k. Future Adoption of Accounting Pronouncements

The Governmental Accounting Standards Board (GASB) has issued the following statements that the Municipality has not yet adopted:

<u>Statement Number</u>	<u>Statement Name</u>	<u>Adoption Required in Fiscal Year</u>
43	Financial Reporting for Post-employment Benefit Other than Pension Plans	2005-06
44	Economic Condition Reporting: The Statistical Section - an amendment on NCGA Statement I	2005-06
45	Accounting and Financial Reporting for Employers for Post-employment Benefits Other than Pensions	2008-09
46	Net Assets Restricted by Enabling Legislation - an amendment of GASB Statement No. 34.	2005-06
47	Accounting for Termination Benefits	2005-06

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

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

3. STEWARDSHIP, COMPLIANCE AND ACCOUNTABILITY

a. Budgetary Control

The Municipality's annual budget is prepared on the budgetary basis of accounting, which is not in accordance with GAAP, and represents departmental appropriations recommended by the Mayor and approved by the Municipal Legislature prior to the beginning of the fiscal year. Amendments to the budget require the approval of the Municipal Legislature. Transfers of appropriations within the budget, known as Mayor's Resolutions, do not require the approval of the Municipal Legislature.

The Municipality prepares its annual budget including the operations of the general and the debt service funds.

Revenues and Expenditures - Budget and Actual (Budgetary Basis), accordingly, includes only the operations of the general and the debt service funds. The amounts budgeted under the Special Revenue Fund were excluded since they are received and expended over a period of time which generally exceeds the current year.

For budgetary purposes, encumbrance accounting is used. The encumbrances (i.e., purchase orders, contracts) are considered expenditures when incurred. For GAAP reporting purposes, encumbrances outstanding at year-end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be honored during the subsequent year.

The unencumbered balance of any appropriation at the end of the fiscal year will lapse at the end of such fiscal year. Other appropriations, mainly capital project appropriations, are continuing accounts for which the Municipal Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending.

The annual budget is presented in the Combined Statement of Revenues and Expenditures - Budget and Actual (Budgetary Basis) is the budget ordinance to June 30, 2005 representing the original and the amended budget.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

b. Budget/GAAP Reconciliation

The following schedule presents comparisons of the legally adopted budget with actual data on a budget basis. Because accounting principles applied for purposes of developing data on a budget basis differ significantly from those used to present financial statements in conformity with GAAP, a reconciliation of entity and timing differences in the excess of revenues over expenditures for the year ended June 30, 2005 is presented below for the general and debt service funds:

	<u>General</u>	<u>Debt Service</u>
Excess of revenues (expenditures) over (under) revenues (expenditures) and other financing sources - budgetary basis	\$1,401,580	(\$1,323,340)
Timing differences:		
Prior year encumbrances recorded as current year expenditures for GAAP basis	(1,289)	-
Current year encumbrances recorded as expenditures on the budgetary basis-	33,843	
Basis of accounting differences:		
Net increase in receivables	(318,443)	-
Net increase in accounts payable and other liabilities	(223,140)	-
Entity differences:		
Non-budgeted revenues	<u>754,791</u>	<u>24,325</u>
Excess of revenues (expenditures) over revenues (expenditures) and other financing sources - GAAP basis	<u>\$1,647,342</u>	<u>(\$1,299,015)</u>

c. Legal Compliance

The legal level of budgetary control is at the individual department level for general fund expenditures, and principal and interest due for the debt service fund.

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4. RECONCILIATION OF GOVERNMENT-WIDE AND FUND FINANCIAL STATEMENTS

The governmental fund balance sheet includes a reconciliation between fund balance-governmental funds and net assets of governmental activities as reported in the government-wide statement of net assets. One element of that reconciliation explains that some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds. The details of the approximately \$21.4 million difference are as follows:

Bonds payable	\$10,270,000
Landfill obligation	5,833,123
Notes payable	1,957,609
Compensated absences	1,872,518
Other long-term liabilities	770,024
Accrued interest payable	449,389
Claims and judgments	<u>265,000</u>
 Net adjustment to reduce fund balance governmental funds to arrive at net assets of governmental activities	 <u>\$21,417,663</u>

5. DEPOSITS - CUSTODIAL CREDIT RISK

Custodial credit risk is the risk that in the event of a bank failure, the government's deposits may not be returned to it. Under Puerto Rico statutes, public funds deposited in commercial banks must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of Puerto Rico. In addition, the Municipality maintains deposits with the Government Development Bank for Puerto Rico (GDB).

The deposits at GDB of approximately \$1.8 million that are restricted principally for capital projects, and the \$1.9 million in the debt service fund are unsecured and uncollateralized, as no collateral is required to be carried by governmental banks.

The Municipality maintains its deposits in banks located at Puerto Rico. All kind of deposit is guaranteed by the Federal Deposit Insurance Corporation (FDIC) up to \$100,000.

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The excess is covered by collateral provided by banks and held by the Treasury Department of the Commonwealth of Puerto Rico pursuant to applicable laws and regulations.

6. PROPERTY TAXES

The Municipal Revenues Collection Center (CRIM) of the Commonwealth of Puerto Rico is responsible by law for the assessment, levy and collection of all real and personal property taxes. The tax on personal property is self assessed by the taxpayer. The assessment is made in a return which must be filed with the CRIM by May 15 of each year. The tax on real property is assessed by the CRIM. The assessment is made as of January 1 of each year and is based on estimated current values of the property as of year 1957. The tax on personal property must be paid in full together with the return on or before May 15. The tax on real property is due in two equal installments in July 1 and January 1, following the assessment date.

The rates are 8.08% for real property and 6.08% for personal property. The composition is as follows:

	<u>Real</u>	<u>Personal</u>
Basic property	6.00%	4.00%
Additional special property - state	1.03%	1.03%
Additional special property - municipal	1.25%	1.25%
Discounts made by state to tax payer	< .20% >	< .20% >
	<u>8.08%</u>	<u>6.08%</u>

The Municipality's basic property tax rate represents the portion which is appropriated for general purposes and accounted for in the general fund.

The "Additional special property tax - municipal" is restricted for debt service and retained by GDB for such purposes and it is recorded as revenue in the Debt Service Fund when collected by the CRIM and reported to the Municipality.

The "Additional special property tax - state" is collected by the CRIM for the payment of principal and interest of general obligation bonds and certain other obligations issued by the state government.

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Residential real property occupied by its owner is exempt by law from the payment of property taxes on the first \$15,000 of the assessed value. For such exempted amounts, the Department of Treasury assumes payment of the basic tax to the Municipality, except for property assessed at less than \$3,500, for which no payment is made. Revenue related to the basic tax on exempt property is recorded in the General Fund when payments are received from the CRIM.

Complete exemption from personal property taxes up to an assessment of \$50,000 is granted to merchants with an annual volume of net sales less than \$150,000.

Prior to the beginning of each fiscal year, the CRIM informs the Municipality of the estimated amount of property tax expected to be collected for the ensuing fiscal year. Throughout the year, the CRIM advances funds to the Municipality based on the initial estimated collections. The CRIM is required by law to prepare a settlement statement on a fiscal year basis, whereby a comparison is made between the amounts advanced to the Municipality and amounts actually collected from taxpayers. This settlement has to be completed on a preliminary basis not later than three months after fiscal year-end, and a final settlement made not later than six months after year end. If the CRIM remits to the Municipality property tax advances, which are less than the tax actually collected, a receivable from the CRIM is recorded at June 30. However, if advances exceed the amount actually collected by the CRIM, a payable to the CRIM is recorded at June 30.

Currently, the Municipality has received the preliminary settlement from CRIM related to fiscal year 2004-05, but not the final settlement as the six months period after fiscal year end, provided by law to CRIM to issue this, has not yet expired. Management believes, based in part on the experience from prior years, that when received, the final settlement from CRIM will not show a significant difference from the preliminary settlement and that such difference, if any, will not have a material effect on the financial condition of the Municipality.

Based on the preliminary settlement already received, during the year ended June 30, 2005, the amount collected from taxpayers and charges by CRIM of approximately \$4.4 million, less than the advances received by the Municipality for the same period by approximately \$47,000. Such amount is presented as intergovernmental payable in the general fund in the basic financial statements. (See Note 11).

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7. MUNICIPAL LICENSE TAX

Municipal License Tax receivables are recorded in the fiscal year in which payment is due and, accordingly, represent taxes which are due and uncollected at June 30, 2005. The annual Municipal License Tax is determined based on the gross income of all commerce and industrial organizations who have operations in the Municipality of San Sebastián, and are not totally or partially exempt under the Industrial Incentive Law of Puerto Rico.

An annual return of business volume should be filed on or before April 15 of each year and payable in two equal installments due on July 1 and January 1. A discount of 5% is allowed when full payment is made on or before April 15. The rates of municipal license in the Municipality of San Sebastián, are as follows:

Savings and loans associations	= 1.00%
Financial institutions	= 1.50%
Other organizations:	
Up to \$500,000	= .40%
Over \$500,000	= .50%

The amounts collected in advance are recorded as deferred revenues in the General Fund. The Municipality invoiced and collected in advance during the current year approximately \$718,000, corresponding to the next fiscal year municipal license.

8. DUE FROM OTHER AGENCIES

Represents grants and contributions due from federal agencies as follows:

U.S. Department of Housing and Urban Development	\$50,609
U.S. Department of Health and Human Services	<u>23,220</u>
 Total	 <u>\$73,829</u>

**COMMONWEALTH OF PUERTO RICO
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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

9. INTERFUND TRANSACTIONS

a. Due From/To Other Funds:

The due from and due to other fund balances as of June 30, 2005, are as follows:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Amount</u>
Other Governmental Funds	General	\$1,030,241
General	Other Governmental Funds	853,217
General	HHS Programs	101,422
General	HUD Programs	42,012
Capital Projects	Other Governmental Funds	<u>9,883</u>
Total		<u>\$2,036,775</u>

The balance of \$853,217 due from the other governmental funds to the general fund represents advances for various construction projects.

All remaining balances resulted from the time lag between the dates that (1) interfund goods and services are provided or reimbursable expenditures occur, (2) transactions are recorded in the accounting system, and (3) payments between funds are made.

b. Interfund Transfers:

Interfund transfers for the year ended June 30, 2005 consisted of the following:

<u>Transfer In</u>	<u>Transfer Out</u>	<u>Amount</u>
Capital Projects	Other Governmental Funds	\$3,135,205
Debt Service	General	1,215,913
Capital projects	General	<u>154,540</u>
Total		<u>\$4,505,658</u>

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The transfer from other governmental funds to the capital projects fund of \$3.1 million, represents monies received for the construction of various construction projects, which were received through other governmental funds.

Remaining transfers are used to (1) move revenues from the fund that statute or budget revenues to collect them to the fund that statute or budget requires to expend them, (2) move receipts restricted to debt service from the fund collection the receipts to the debt service fund as debt service payments become due, and (3) use unrestricted revenues collected in the general fund to finance various programs accounted for in other funds in accordance with budgetary authorizations.

10. CAPITAL ASSETS

Capital asset activity for the Municipality for the year ended June 30, 2005 was as follows:

Primary Government	Balance July 1, 2004	Increases	Decreases	Balance June 30, 2005
Governmental Activities:				
Capital assets, not being depreciated:				
Land	\$ 2,237,416	\$ -	\$ 78,000	\$ 2,159,416
Construction in progress	2,266,937	1,414,486	1,734,925	1,946,498
Total capital assets, not being depreciated	<u>4,504,353</u>	<u>1,414,486</u>	<u>1,812,925</u>	<u>4,105,914</u>
Capital assets, being depreciated:				
Buildings and building improvements	25,958,381	2,294,290		28,252,671
Furniture and fixtures	1,335,445	78,921		1,414,366
Vehicles and equipment	4,573,577	953,138		5,526,715
Infrastructure	1,274,124	-	-	1,274,124
Total capital assets, being depreciated	<u>33,141,527</u>	<u>3,326,349</u>	<u>-</u>	<u>36,467,876</u>
Less accumulated depreciation for:				
Buildings and building improvements	3,138,981	644,151		3,783,132
Furnitures and fixtures	1,104,468	108,971		1,213,439
Vehicles and equipment	4,170,340	412,285		4,582,625
Infrastructure	263,384	25,482		288,866
Total accumulated depreciation	<u>8,677,173</u>	<u>1,190,889</u>	<u>-</u>	<u>9,868,062</u>
Total capital assets, being depreciated, net	<u>24,464,354</u>	<u>2,135,460</u>	<u>-</u>	<u>26,599,814</u>
Governmental activities capital assets, net	<u>\$ 28,968,707</u>	<u>\$ 3,549,946</u>	<u>\$ 1,812,925</u>	<u>\$ 30,705,728</u>

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NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
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Capital asset activity for Villa Soigal Project, a discretely presented component unit, for the year ended June 30, 2005 was as follows:

<u>Component Unit- Villa Soigal Project</u>	<u>Balance July 1, 2004</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2005</u>
Capital assets, not being depreciated:				
Land	\$ 58,350	\$ -	\$ -	\$ 58,350
Total capital assets, not being depreciated	<u>58,350</u>	<u>-</u>	<u>-</u>	<u>58,350</u>
Capital assets, being depreciated:				
Land improvements	739,624			739,624
Buildings and building improvements	3,566,155	1,800		3,567,955
Building equipment	415,676	2,606		418,282
Furniture and fixtures	32,982			32,982
Equipment	9,898			9,898
Total capital assets, being depreciated	<u>4,764,335</u>	<u>4,406</u>	<u>-</u>	<u>4,768,741</u>
Less accumulated depreciation for:				
Land improvements	412,958	18,490		431,448
Buildings and building improvements	1,971,222	86,801		2,058,023
Building equipment	201,327	29,535		230,862
Furnitures and fixtures	30,828	234		31,062
Equipment	9,065	250		9,315
Total accumulated depreciation	<u>2,625,400</u>	<u>135,310</u>	<u>-</u>	<u>2,760,710</u>
Total capital assets, being depreciated, net	<u>2,138,935</u>	<u>(130,904)</u>	<u>-</u>	<u>2,008,031</u>
Villa Soigal Project capital assets, net	<u>\$ 2,197,285</u>	<u>\$ (130,904)</u>	<u>\$ -</u>	<u>\$ 2,066,381</u>

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11. DUE TO OTHER AGENCIES

Due to other agencies at June 30, 2005 are as follows:

Puerto Rico Treasury Department	\$ 228,201
Retirement System Administration	223,224
Municipal Revenues Collection Center	47,243
Puerto Rico Water and Sewer Authority	18,766
U. S. Internal Revenue Services	52,761
Municipality of Moca	162,000
Puerto Rico Labor Department	9,102
Puerto Rico Land Authority	10,224
Puerto Rico General Services Administration	<u>17,785</u>
	<u>\$ 769,306</u>

12. DEFERRED REVENUES

a. Municipal License Tax

The deferred revenues of approximately \$718,000 in the general fund related to municipal license tax collected in fiscal year 2004-05 that will be earned in fiscal year 2005-06.

b. Federal Government

The deferred revenues presented as federal government represents the portion of federal grants received for which qualifying expenditures have not been incurred. The amounts were determined taking into consideration the specific years of the grant. The balance of approximately \$124,000 in the HUD Programs is related to the Section 8 Housing Choice Voucher.

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13. INTERGOVERNMENTAL REVENUES

Intergovernmental revenues in the general and capital projects funds consist mainly of collections from the Commonwealth of Puerto Rico and the CRIM, payments in lieu of taxes from the Puerto Rico Electric Power Authority and federal financial assistance received from the federal government.

14. LONG-TERM DEBTS

Bonds and other long-term liabilities outstanding at June 30, 2005 are as follows:

Bonds

\$3,420,000 series of 1996, payable in annual installments of \$70,000 to \$315,000 until July 1, 2016, interest ranging from 4.7% to 6.875%.	\$2,570,000
\$1,010,000 series of 1996, payable in annual installments of \$20,000 to \$95,000 until July 1, 2015, interest ranging from 4.7% to 6.58%.	735,000
\$1,800,000 series of 1997, payable in annual installments of \$20,000 to \$165,000 until July 1, 2021, interest ranging from 6.69% to 8.00%.	1,600,000
\$1,510,000 series of 2001, payable in annual installments of \$20,000 to \$135,000, until July 1, 2026; interest ranging from 5% to 8%.	1,445,000
\$1,110,000 series of 2005, payable in annual installments of \$50,000 to \$105,000 until July 1, 2019, interest ranging from 3.27% to 5%.	1,110,000
\$2,810,000 series of 2005, payable in annual installments of \$225,000 to \$345,000 until July 1, 2014, interest ranging from 4.5% to 6%.	<u>2,810,000</u>
Total bonds payable	<u>\$10,270,000</u>

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Notes Payable

\$1,010,000 series of 2004, payable in annual installments of \$124,700 to \$174,250 until July 1, 2010, interest rate at 5%. \$ 890,000

Note payable of represents a repayment agreement with GDB and CRIM to repay the excess of property taxes advances from fiscal years up to 2001. The CRIM will retain the principal and interest from the property taxes advances. The amounts retained by CRIM will be remitted to GDB on July 1 of each year through 2032. The repayment agreement is payable in annual aggregate installments of \$81,269 including interest rate of 6.158%. 1,067,609

Total notes payable \$1,957,609

Due to Puerto Rico Health Insurance Administration

Due to the Puerto Rico Health Insurance Administration of \$770,024 represents the municipal contribution related to the Health Care Reform corresponding to the period from December 1, 1995 through June 30, 1997. This balance will be paid through amounts retained by the CRIM from the participation in the Municipal Equalization Fund of the Additional Lottery System.

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The annual debt service requirements for the bonds and notes payable at June 30, 2005, are as follows:

	<i>Bonds Payable</i>		<i>Notes Payable</i>	
	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>
2006	\$ 530,000	\$ 558,282	\$ 145,446	\$ 102,625
2007	565,000	522,668	151,416	99,478
2008	595,000	492,978	162,448	91,446
2009	640,000	461,040	168,544	82,975
2010	675,000	438,485	179,709	74,060
2011-2015	4,095,000	1,584,668	288,754	291,841
2016-2020	2,120,000	560,352	161,053	245,291
2021-2025	795,000	163,493	218,420	187,924
2026-2030	255,000	14,700	296,222	110,123
2031-2035	-	-	185,597	17,575
	<u>\$ 10,270,000</u>	<u>\$ 4,796,666</u>	<u>\$ 1,957,609</u>	<u>\$ 1,303,338</u>

Component Unit

The mortgage payable by the discretely component unit is owed by Villa Soigal Project and consists of a 8% mortgage note, payable in monthly installments of \$13,203, including interest, until 2019, collateralized with land and building.

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The principal maturities of the mortgage in each of the next five years and thereafter are as follows:

<u>Year Ended June 30,</u>	<u>Amount</u>
2006	\$ 59,548
2007	63,955
2008	66,688
2009	73,771
2010	79,231
Thereafter	<u>1,064,411</u>
Total	<u>\$1,407,604</u>

Long-term liability activity for the year ended June 30, 2005 was as follows:

<u>Primary Government</u>	<u>Beginning Balance (As Restated)</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Due within One Year</u>
Governmental Activities:					
Bonds payable	\$ 7,855,000	\$ 3,920,000	\$ 1,505,000	\$ 10,270,000	\$ 530,000
Notes payable	2,084,388		126,779	1,957,609	145,446
Obligations under capital lease	271,912		271,912	-	
Total long-term debt	<u>10,211,300</u>	<u>3,920,000</u>	<u>1,903,691</u>	<u>12,227,609</u>	<u>675,446</u>
Other long-term liabilities:					
Landfill obligation	6,048,111		214,988	5,833,123	225,737
Puerto Rico Treasury Department	1,152,665		1,152,665	-	
Puerto Rico Health Insurance Administration	770,024			770,024	
Compensated absences	1,947,730	132,202	207,414	1,872,518	199,405
Claims and judgments		265,000		265,000	
Total other long-term liabilities	<u>9,918,530</u>	<u>397,202</u>	<u>1,575,067</u>	<u>8,740,665</u>	<u>425,142</u>
Total noncurrent liabilities, governmental activities	<u>\$ 20,129,830</u>	<u>\$ 4,317,202</u>	<u>\$ 3,478,758</u>	<u>\$ 20,968,274</u>	<u>\$ 1,100,588</u>
Component Unit:					
Villa Soigal Project mortgage payable	<u>\$ 1,463,217</u>	<u>\$ -</u>	<u>\$ 55,613</u>	<u>\$ 1,407,604</u>	<u>\$ 59,548</u>

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The beginning balance of long-term debt has been restated to included a liability to the Puerto Rico Health Insurance Administration.

15. RETIREMENT PLAN

a. Plan Description

The Employee's Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS) is the administrator of a cost-sharing multiple-employer retirement system established by the Commonwealth of Puerto Rico. ERS System was created under the Act 447, approved on May 15, 1951, as amended, and became effective on January 1, 1952.

ERS covers all regular employees of the Commonwealth of Puerto Rico and its instrumentalities and of certain municipalities and components units not covered by their own retirements systems.

Participation is mandatory except for members of the Legislature, Government Secretaries, Heads for Agencies and Public Instrumentalities, Assistants to the Governor, the Comptroller of Puerto Rico, Gubernatorial Board and Committee appointees and Experimental Service Station employees.

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

Members who have attained an age of at least fifty-five (55) years and have completed at least twenty-five (25) years of creditable service or members who have attained an age of at least fifty-eight (58) years and have completed at least fifty-eight (58) years and have completed at least ten (10) years of creditable service, are entitled to an annual benefit, payable monthly for life.

The amounts of the annuity shall be one and one-half percent of the average compensation multiplied by the number of years of creditable service up to twenty years, plus 2% of the average compensation multiplied by the number of years of creditable service in excess of twenty years. In no case the annuity will be less than \$200 per month.

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Participants who have completed at least thirty (30) years of creditable service are entitled to receive the Merit Annuity. Participants who have not attained fifty-five (55) years of age will receive 65% of the average compensation or if they have attained fifty-five (55) years of age will receive 75% of the average compensation. Disability retirement benefits are available to members for occupational and non-occupational disability. However, for non-occupational disability a member must have at least ten (10) years of service.

No benefit is payable if the participant receives a refund of his accumulated contributions.

On September 24, 1999, an amendment to Act No. 447 of May 15, 1951, which created ERS, was enacted with the purpose of establishing a new pension program (System 2000). Employees participating in the current system as of December 31, 1999, may elect to stay in the defined benefit plan or transfer to the new program. Persons joining the Municipality on or after January 2000, will only be allowed to become members of System 2000. System 2000 will reduce the retirement age from 65 years to 60 for those employees who joined the current plan on or after April 1, 1990.

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there will be a pool of pension assets, which will be invested by ERS, together with those of the current defined benefit plan. Benefits at retirement age will not be guaranteed by the Commonwealth of Puerto Rico. The annuity will be based on a formula which assumes that each year the employee's contribution (with a minimum of 8.275% of the employee's salary upon to a maximum of 10%) will be invested in an account which will either: (1) earn a fixed rate based on the two-year Constant Maturity Treasury Note or, (2) earn rate equal to 75% of the return of the ERS's investment portfolio (net of management fees), or (3) earn a combination of both alternatives. Participants will receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability pensions will not be granted under System 2000. The employer's contribution (9.275% of the employee's salary) will be used to fund the current plan.

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b. Contribution Requirements

Commonwealth legislation requires employees to contribute 5.775% of gross salary up to \$6,600 plus 8.275% of gross salary in excess of \$6,600. The Municipality's contributions are 9.275% of gross salary. Contributions' requirements are established by law. The actuarially determined contribution requirement and contributions actually made for the year ended June 30, 2005 was approximately \$434,000. The Municipality's payroll for employees covered by ERS was approximately \$4.7 million. The Municipality total payroll for all employees was approximately \$8.5 million.

Additional information on the ERS is provided in its financial statements for the year ended June 30, 2005, a copy of which can be obtained from the ERS, Minillas Station, PO Box 42003, San Juan, PR 00940.

16. RISK MANAGEMENT

The Risk Management Division of the Municipality's Legal Department is responsible of assuring that the Municipality's property is properly insured. Annually, the Risk Management Division compiles the information of all property owned and its respective market value. After evaluating this information, the Risk Management Division submits the data regarding the Municipality's properties to the Area of Public Insurance at the Department of the Treasury of the Commonwealth of Puerto Rico who is responsible for purchasing all property and casualty insurance policies of all municipalities.

17. LEASES

Operating Leases

Leasing Arrangement with the Municipality as Lessor:

- a. The Municipality leases spaces in its Market Place and Transportation center under operating lease agreements with terms ranging from one to five years.
- b. Total income from leases during the year ended June 30, 2005 was approximately \$42,700.

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- c. The Municipality retains title to its leased property. The lessee pays taxes, licenses, insurance, and maintenance costs of the leased assets.

Leasing arrangements with the Municipality as lessee:

The Municipality is obligated under noncancellable operational leases, with periods not longer than one year.

18. MUNICIPAL SOLID WASTE LANDFILL POSTCLOSURE

The Municipality discontinued its landfill operations and ceased to accept solid waste in January 1993. State and Federal laws and regulations require the Municipality to perform certain postclosure procedures on its solid waste landfill after discontinuing of operations and perform certain maintenance and monitoring functions at the landfill site for thirty years. Postclosure care procedures were assumed by Municipality and directed by an external consultant. The closure process was completed in January 17, 1997. The total estimated liability for postclosure care costs has been determined in approximately \$6 million as of June 30, 2005. (See Note 14).

19. CONTINGENCIES

- a. The Municipality receives Federal Grants for specific purposes that are subject to review and audit by the grantor agencies. Although such audits could generate expenditure disallowances under the terms of the grants, management believes that any required reimbursements would not be material.
- b. The Municipality is a defendant and/or co-defendant in various lawsuits which claims for actual damages. Some of these lawsuits are covered by insurance. The Municipality's management and outside counsels believe that is probable that any potential liability that might exist, if any, in excess of the insurance, will not affect significantly the financial position of the Municipality.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

20. COMMITMENTS

The Municipality of San Sebastián has a contract for deposit of solid waste with the Municipality of Moca landfill for \$23,000 monthly renewable each six months.

21. RESTATEMENT

The beginning balance of net assets has been restated to include a payable to the Puerto Rico Health Insurance Administration amounting to \$770,024.

In addition, the beginning fund balance of governmental funds has been restated by approximately \$995,000 to recognize as deferred revenues restricted deposits received in prior year.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
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 (HUD)		
Section 8 - Rental Housing Choice Voucher Program	14.871	\$ 569,259
Pass-through Commissioner Office of Municipal Affairs - Community Development Block Grants/State Program - SBGP	14.228	<u>1,723,000</u>
Subtotal U.S. Department of HUD		<u>2,292,259</u>
U.S. Department of Health and Human Services (HHS)		
Pass through Governor's Office of Child Services and Community Development: Head Start	93.600	3,319,497
Pass through Administration of Families and Children: Child Care and Development Block Grant	93.575	<u>157,831</u>
Subtotal U.S. Department of HHS		<u>3,477,328</u>
U.S. Department of Agriculture		
Pass-through Education Department: Child and Adult Care Food Programs	10.558	<u>376,094</u>
Subtotal U.S. Department of Agriculture		<u>376,094</u>
TOTAL		<u>\$6,145,681</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
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 San Sebastián 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>
Expenditures as per basic financial statements:	
Housing and Urban Development Programs	\$2,292,259
Health and Human Services Programs	3,477,328
Included within other governmental funds	<u>376,094</u>
Total expenditures per schedule of expenditures of federal awards	<u>\$6,145,681</u>



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

To the Honorable Mayor
and Municipal Legislature
Municipality of San Sebastián
San Sebastián, 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 San Sebastián as of and for the year ended June 30, 2005, which collectively comprise the Municipality of San Sebastián's basic financial statements, and have issued our report thereon dated November 4, 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 San Sebastián's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted other matters involving the internal control over financial reporting 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 financial reporting that, in our judgment, could adversely affect Municipality's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 05-A and 05-B.

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 audit may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

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

We noted certain immaterial instances of noncompliance, which we have reported to management of Municipality of San Sebastián in a separate letter dated November 4, 2005.

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

Ortiz, Rodriguez, Rivera & Co

San Juan, Puerto Rico
November 4, 2005

The stamp 2101436 was affixed
to the original of this report.





ORTIZ, RODRIGUEZ, RIVERA & CO.

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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 San Sebastián
San Sebastián, Puerto Rico

Compliance

We have audited the compliance of Municipality of San Sebastián 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 San Sebastián'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 San Sebastián's management. Our responsibility is to express and opinion on Municipality of San Sebastián's compliance based on our audit.

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

In our opinion, Municipality of San Sebastián complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as item 05-1.

Internal Control over Compliance

The management of Municipality of San Sebastián 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 San Sebastián'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.

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

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

San Juan, Puerto Rico
November 4, 2005

The stamp 2101437 was affixed
to the original of this report.



**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
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 San Sebastián.
- b. There were no reportable conditions on internal controls over financial reporting.
- c. No instances of noncompliance material to the financial statements of Municipality of San Sebastián were disclosed during the audit.
- d. There were no 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 San Sebastián.
- f. There were no audit findings relative to the major federal award programs for the Municipality of San Sebastián.
- g. The programs tested as major programs included:

Head Start - CFDA 93.600
- h. The threshold for distinguishing types A and B programs was \$300,000.
- i. Municipality of San Sebastián was determined to be a low-risk auditee.

2. FINDINGS - FINANCIAL STATEMENTS AUDIT

● **Finding 05-A - General Fund Deficit**

As of June 30, 2005, the Municipality closed with an accumulated deficit of \$859,966.

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

Cause

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

Criteria

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

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

Recommendation

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

● **Finding 05-B - Unauthorized Transfer of State Special Funds**

The Municipality realized several unauthorized transfers from its restricted funds to its General Fund during years previous to year ended in June 30, 2005.

Criteria

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

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

use of funds from state grants in activities other than those mentioned in the Joint Resolution requires the prior approval of the Puerto Rico Legislature.

Cause

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

Recommendation

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

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

a. Head Start - CFDA No. 93.600

Condition 05-1

The Municipality's compliance with the administrative requirement to remit interest in excess of \$100 per year on federal fund deposit accounts is not effective. We noted that the program did not remit to the federal grantor and/or pass-through agency the interest income credited to the program cash account as required by federal regulations. The program cash account earned interest income of \$825 for the fiscal year 2004-05.

Criteria

The 45 CFR Section 92.21(I) establishes that grantees and subgrantees should be promptly, but at least quarterly, remit interest earned on advances to the federal agency. The grantee or subgrantee may keep interest amounts up to \$100 per year for administrative expenses.

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

Cause

This occurs because the Municipality has not established internal controls over compliance with the requirement to ensure that any interest earned is promptly remitted to the federal grantor. In addition, another cause for the excess interest earned is the ineffective cash management process of the Municipality because cash requests are made in excess of immediate needs and/or payments are not issued within three days after the receipt of federal funds requirement.

Effect

The continued failure to comply with this requirement may result in the assessment of interests and penalties from the federal grantor on the amounts owed; as well as the determination of additional restrictions on future funding.

Recommendation

The Municipality Program should reimburse the federal grantor this and other amounts owed in previous years as a result of the same instance of noncompliance. In addition, the Municipality should establish and enforce a monitoring procedure within the Program to ensure that interest earned in excess of \$100 is remitted on a quarterly basis.

Questioned Cost

Under \$10,000

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

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

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

<u>Program</u>	<u>Finding/Noncompliance</u>	<u>Status</u>
<p>Head Start Early Head Start CFDA No. 93.600</p>	<p>Condition 03-1</p> <p>The Municipality' internal control over compliance with the cash management requirements of the federal program is not effective since it is not minimizing the time elapsed between the receipt and final disbursements of funds.</p>	<p>Condition was not observed.</p>
<p>Head Start CFDA No. 93.600</p>	<p>Condition 03-2</p> <p>The Municipality did not comply with the requirement of preparing and filing its federal financial reports on a timely basis. During our examination of the Federal Cash Transaction Reports, we noted that the Municipality did not submit on time the quarterly reports.</p>	<p>Condition was not observed.</p>



**COMMONWEALTH OF PUERTO RICO
 MUNICIPALITY OF SAN SEBASTIAN
 CORRECTIVE ACTION PLAN
 FOR DE YEAR ENDED JUNE 30, 2005**

The Municipality of San Sebastian are submits the following corrective action plan for the year ended June 30, 2005:

FINDING OF FINANCIAL STATEMENT AUDIT

Finding	Reportable condition	Recommendation	Action Taken
05-A General Fund Deficit	As of June 30, 2005, the Municipality closed with an accumulated deficit of \$859,966.	The continuing deficit reported by the Municipality may harm the basic governmental services provided to its citizens. We strongly recommend that the necessary measurable be taken in order to stop this trend. The Municipality must work on increasing actual revenues and/or substantially reducing expenditures.	Actually the financial data and operating activities are under the municipality's key personnel in order to identify and analyze of internal control that are relevant to ensure the effectiveness and efficiency of the public resources.
05-B Unauthorized Transfer of State Special Funds	The Municipality realized several unauthorized transfers from its restricted funds to its General Fund during prior fiscal year ended in June 30, 2004.	We recommend the Municipality refer this case to the appropriate regulatory bodies.	We will refer this situation to corresponding regulatory bodies.

FINDING AND QUESTIONED COST

Finding	Reportable condition	Recommendation	Action Taken
a. Head Start – CFDA No 93.600	The municipality's compliance with the administrative requirement to remit interest in excess of \$100 per year on federal fund deposit accounts is not effective.	The Municipality program should reimburse the federal grantor this and other amount owed in previous years as a result of the same instance of noncompliance. In addition, the Program to ensure that interest earned in excess of \$100 is remitted on a quarterly basis.	We will design and establish adequate internal control to minimize interest income and remit to the grantor immediately accumulated interest income generated into the account.

Any questions please contact to Mr. Félix M Irizarry, Finance Director, at (787) 896-2300.

Cordially,


Félix M Irizarry
Finance Director