

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

MUNICIPIO DE SAN SEBASTIAN
AUDITORIA 2005-2006
30 DE JUNIO DE 2006

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

**BASIC FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED
JUNE 30, 2006**

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
BASICS FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

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BASIC FINANCIAL STATEMENTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

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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, 2006, 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, 2006. 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, 2006, 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 9, 2006, 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 9, 2006

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**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

Our discussion and analysis of the Municipality of San Sebastian "the Municipality" financial performance provides an overview of the Municipality's financial activities for the fiscal year ended June 30, 2006. 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 2006 by \$12,093,354 (net assets), of which \$21,271,747 represents investment in capital assets (net of accumulated depreciation, and related debt), \$2,044,567 represents restricted assets for debt services and unrestricted fund balance (\$11,222,960).
- The Municipality's total net assets increased by \$2,333,550 from prior year restated balance.
- At the end of the current fiscal year, the Municipality's governmental funds reported combined ending fund balances of \$1,143,906 an increase of \$ 672,167 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 \$991,854. 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 \$483,347 and the net effect on sale of capital asset of \$857,500, related transfer in of 183,784 and transfer out of \$532,777.
- On a budgetary basis, actual revenues exceeded actual expenditures by \$641,050.
- The investment in capital assets, net of related debt, for this year is \$836,019.

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.

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

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.

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.

Reporting the Municipality's Most Significant Funds

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, 2006 was \$2,333,550.

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

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

**Table 1
Net Assets
Governmental Activities**

	2006	2005 as restated	Increase (Decrease)	%
Current and other assets	\$5,314,224	\$5,202,597	\$111,627	2.15%
Capital assets	30,776,747	30,705,728	71,019	0.23%
Total Assets	<u>\$36,090,971</u>	<u>\$35,908,325</u>	<u>\$182,646</u>	<u>0.51%</u>
Other liabilities	\$5,647,595	\$6,280,835	(\$633,240)	-10.08%
Long term debt outstanding	18,350,022	19,867,686	(1,517,664)	-7.64%
Total liabilities	<u>\$23,997,617</u>	<u>\$26,148,521</u>	<u>(\$2,150,904)</u>	<u>-8.23%</u>
Net Assets				
Investment in Capital Assets, net of related debt	\$21,271,747	\$20,435,728	\$836,019	4.09%
Restricted for:				
Debt services	2,044,567	1,905,681	138,886	7.29%
Unrestricted	-11,222,960	-12,581,605	1,358,645	-10.80%
Total net assets	<u>\$12,093,354</u>	<u>\$9,759,804</u>	<u>\$2,333,550</u>	<u>23.91%</u>

Governmental Activities

Revenues for the Municipality's governmental activities increase by \$167,705 or 1% and total expenses increased by \$763,928 or 4%. The increase in revenues was mainly due to net effect of an increase of \$253,344 in charges for services, \$351,095 in grants and contributions not restricted to specific programs, a reduction of \$471,170 in operating grand contributions and a decrease of \$180,221 in miscellaneous income. Increase in expenses is directly related to net effect an increase of \$1,392,879 in public works, \$237,319 in general government and decrease of \$729,188 in health and welfare.

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

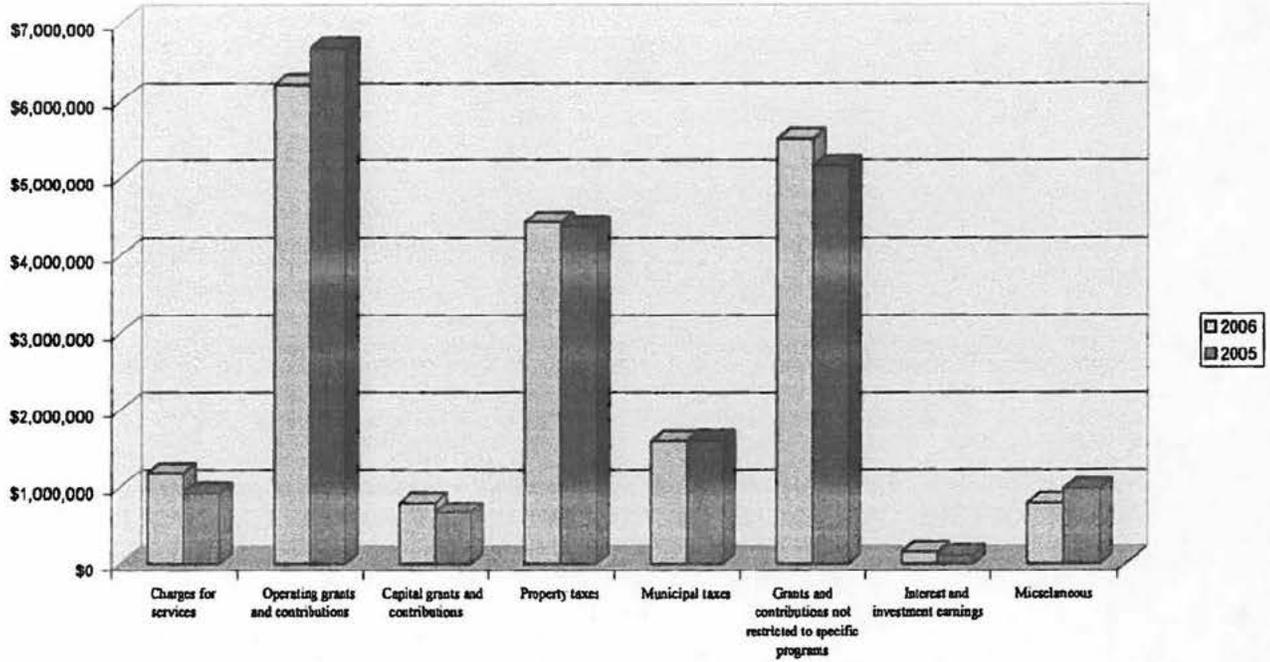
The following table summarizes the changes in net assets for the fiscal years ended 2006 and 2005:

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

	2006	% of Total	2005 as restated	Change	% of Change
Revenues:					
Program revenues:					
Charges for services	\$1,176,100	6%	\$922,756	\$ 253,344	27%
Operating grants and contributions	6,206,915	30%	6,678,085	(471,170)	-7%
Capital grants and contributions	794,052	4%	669,250	124,802	19%
General revenues:					
Property taxes	4,424,398	21%	4,369,472	54,926	1%
Municipal taxes	1,599,011	8%	1,608,789	(9,778)	-1%
Grants and contributions not restricted to specific programs	5,505,701	27%	5,154,606	351,095	7%
Interest and investment earnings	153,237	1%	108,530	44,707	41%
Miscellaneous	797,846	4%	978,067	(180,221)	-18%
Total revenues	20,657,260	100%	20,489,555	167,705	1%
Expenses:					
General government	5,529,894	28%	5,292,575	237,319	4%
Public safety	1,007,847	5%	1,020,945	(13,098)	-1%
Public works	4,241,301	22%	2,848,422	1,392,879	49%
Culture	320,761	2%	382,941	(62,180)	-16%
Recreation	399,543	2%	441,204	(41,661)	-9%
Health and welfare	6,124,626	31%	6,853,814	(729,188)	-11%
Depreciation	1,205,834	6%	1,190,889	14,945	1%
Interest on long-term debt	625,009	3%	660,097	(35,088)	-5%
Total expenses	19,454,815	100%	18,690,887	763,928	4%
Increase(decrease) in net assets	1,202,445		1,798,668	(596,223)	-33%
Special items:					
Gain on sale of capital assets	659,692			659,692	
Increase in net assets	1,862,137		1,798,668	63,469	4%
Net assets at beginning of year					
as restated	10,231,217		7,961,136	2,270,081.00	29%
Net assets end of year	<u>\$12,093,354</u>		<u>\$9,759,804</u>	<u>\$2,333,550</u>	24%

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

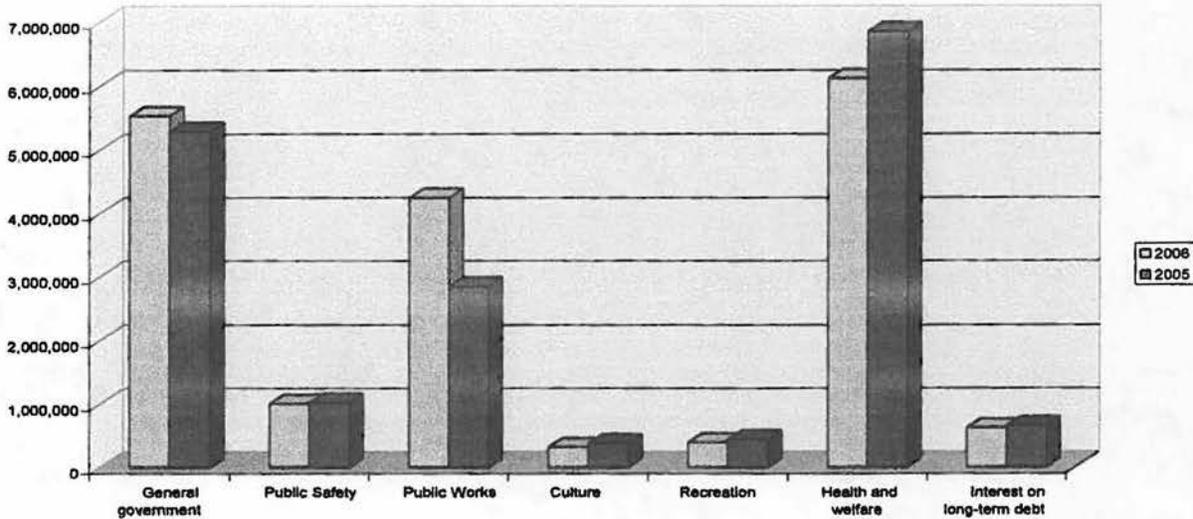
**Municipality of San Sebastian
Governmental Activities - Revenues by Sources
Fiscal Years Ended June 30, 2006 and 2005**



Approximately 30% of the Municipality's revenues came from operating and contributions, 27% from grant and contributions not restricted operating and capital grants and 21% from property taxes. Based on our analysis in Table 2, revenues increased approximately by 1% in comparison with fiscal year 2005. The most significant change, considering it's participation in total revenues, is an increase of 27% in charges for services due to an increases in the student transportation contract amount with the Department of Education and an increase of constructions municipality tax rate, 7% in grants and contributions not restricted to specific programs due to an increase in the Authority of Electric Energy contributions and a reduction of 7% in operating grand contributions related to federals programs reductions.

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

**Municipality of San Sebastian
Governmental Activities - Expenditure by Function
Fiscal Years Ended June 30, 2006 and 2005**



The Municipality's principal expenses are health and welfare benefits provided to citizens, which approximately represents a 31% of total expenses reported for the fiscal year ended June 30, 2006, general government represents a 28% and public work a 21% related to federal programs. The increase of 49% of public works is due to an investment in construction of capital assets. The decrease of 11% of health and welfare was related to a federal's programs reduction. Program revenues of the Municipality covered 42% of total expenses.

Expenses increased 4% in comparison with previous year. This includes the net effect of the following events: an increase in public work and general government, a decrease in health and welfare due to a decrease 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, 2006, the governmental funds reported combined ending fund balances of \$1,143,906 a net increase of \$672,167 in comparison with the prior year. From total combined fund balances, \$(1,173,619) constitutes unreserved fund balance. The remaining fund balance is not available for new spending.

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

Investment in capital assets for governmental activities as of June 30, 2006, amounted to \$30,776,747 (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.

Capital assets as of June 30, 2006 and 2005 follow:

Table 3

Capital Assets, net As of June 30,	Governmental Activities	
	2006	2005 (as restated)
Non-depreciable assets:		
Land	\$2,159,416	\$2,159,416
Construction in progress	-0-	1,946,498
Depreciable assets:		
Buildings and improvements	24,808,509	24,469,539
Furniture and mixtures	251,693	200,927
Vehicles, machinery and equipment	596,568	944,090
Infrastructures	2,960,561	985,258
Total	\$30,776,747	\$30,705,728

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

- \$ 2,020,995 of a Barandillo Bridge in Culebrina River.
- \$524,945 in the Improvements to Softball Park and Basketball Facilities.

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

**MUNICIPALITY OF SAN SEBASTIAN, PUERTO RICO
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE YEAR ENDED JUNE 30, 2006**

Debt

Debt Administration

Long term debt as of June 30, 2006 and 2005 follows:

Table 4

	Outstanding Long-term Debt	
	Fiscal years ended June 30,	
	Governmental Activities	
	2006	2005 (as restated)
Bonds payable	\$ 9,505,000	\$ 10,045,000
Notes payable	1,812,163	1,957,609
CRIM debt repayment plan	307,913	353,991
Landfill obligation	5,607,386	5,833,123
P.R. Health Insurance Administration	770,024	770,024
Compensated absences	1,230,613	1,872,518
Claims and judgments	265,000	265,000
Total	\$ 19,498,099	\$ 21,097,265

At the end of the current fiscal year, the Municipality had a total bonded debt and notes payable outstanding of \$11,317,163. Other obligations include a \$5,607,913 in landfill obligation \$1,230,613 in compensated absences, \$770,024 in P.R. Health Insurance Administration, and \$307,913 in CRIM debt repayment plan. 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 2006-2007 budget. The Municipality applied a conservative approach in development budget estimates. Amounts available for appropriations in the General Fund for the fiscal year 2006 are \$13,107,884, an increase of approximately \$659,250, or 6% with respect to prior year estimates.

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, 2006**

<u>Assets</u>	<u>Governmental Activities</u>	<u>Villa Soigal Project</u>
Cash (Notes 2 and 5)	\$ 2,238,418	\$ 34,390
Cash with fiscal agent (Notes 2 and 5)	2,631,877	
Accounts receivable:		
Municipal license taxes (Note 7)	19,707	
Rent, licenses, and permits	- 36,368	
Other		2,523
Due from other agencies (Note 8)	377,543	
Other assets	10,311	23,980
Restricted deposits		406,309
Capital assets, net (Note 10)	<u>30,776,747</u>	<u>1,937,749</u>
 Total assets	 <u>\$ 36,090,971</u>	 <u>\$ 2,404,951</u>
 <u>Liabilities and Net Assets</u>		
Liabilities		
Accounts payable and accrued liabilities	\$ 1,607,024	\$ 37,837
Due to other agencies (Note 11)	601,866	
Deferred revenues (Note 12):		
Municipal license tax	822,737	
Other	1,138,691	
Accrued interest	329,200	7,777
Noncurrent liabilities (Note 14):		
Due within one year	1,148,077	65,986
Due in more than one year	18,350,022	1,279,931
Total liabilities	<u>23,997,617</u>	<u>1,391,531</u>
Net Assets		
Investment in capital assets, net of related debt	21,271,747	
Restricted for:		
Debt service	2,044,567	
Unrestricted	<u>(11,222,960)</u>	<u>1,013,420</u>
 Total net assets	 <u>\$ 12,093,354</u>	 <u>\$ 1,013,420</u>

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

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
STATEMENT OF ACTIVITIES
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

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 Governmental Activities	Component Unit Villa Soigal Project
Primary Government:						
General government	\$ 5,529,894	\$ 1,176,100	\$ -	\$ -	\$ (4,353,794)	\$ -
Public safety	1,007,847				(1,007,847)	
Public works	4,241,301			794,052	(3,447,249)	
Culture	320,761				(320,761)	
Recreation	399,543				(399,543)	
Health and welfare	6,124,626		6,206,915		82,289	
Depreciation	1,205,834				(1,205,834)	
Interest on long-term debt	625,009				(625,009)	
Total primary government	\$ 19,454,815	\$ 1,176,100	\$ 6,206,915	\$ 794,052	(11,277,748)	-
Component Unit:						
Villa Soigal Project	\$ 592,174	\$ 541,317	\$ -	\$ -		(50,857)
General revenues:						
Property taxes					4,424,398	
Municipal license tax					1,599,011	
Grants and contributions not restricted to specific programs					5,505,701	
Interest and investment earnings					153,237	10,182
Gain on sale of capital assets					659,692	
Miscellaneous					797,846	2,094
Total general revenues					13,139,885	12,276
Change in net assets					1,862,137	(38,581)
Net assets at beginning of year, as restated (Note 21)					10,231,217	1,052,001
Net assets at end of year					\$ 12,093,354	\$ 1,013,420

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, 2006**

<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)	\$ 1,574,521	\$ 158,210	\$ 53,959	\$ -	\$ -	\$ 451,728	\$ 2,238,418
Cash with fiscal agent (Notes 2 and 5)	4,709			2,044,567	307,618	274,983	2,631,877
Accounts receivable:							
Municipal license taxes (Note 7)	19,707						19,707
Rent, licences, and permits	36,368						36,368
Due from agencies (Note 8)	377,543						377,543
Due from other funds (Note 9)	235,134		100			246,391	481,625
Other assets		9,503	808				10,311
Total assets	\$ 2,247,982	\$ 167,713	\$ 54,867	\$ 2,044,567	\$ 307,618	\$ 973,102	\$ 5,795,849

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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, 2006**

<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	\$ 576,753	\$ 271,107	\$ 95,355	\$ -	\$ 345,785	\$ 318,024	\$ 1,607,024
Due to other agencies (Note 11)	601,866						601,866
Due to other funds (Note 9)	246,491	27,180	1,504			206,450	481,625
Deferred revenues (Note 12):							
Municipal license tax	822,737						822,737
Other						1,138,691	1,138,691
Total liabilities	<u>2,247,847</u>	<u>298,287</u>	<u>96,859</u>	<u>-</u>	<u>345,785</u>	<u>1,663,165</u>	<u>4,651,943</u>
Fund Balance (Deficiency)							
Reserved for:							
Encumbrances	157,843				115,115		272,958
Debt service				2,044,567			2,044,567
Unreserved fund balance (deficiency)	(157,708)	(130,574)	(41,992)		(153,282)	(690,063)	(1,173,619)
Total fund balance (deficiency)	<u>135</u>	<u>(130,574)</u>	<u>(41,992)</u>	<u>2,044,567</u>	<u>(38,167)</u>	<u>(690,063)</u>	<u>1,143,906</u>
Total liabilities and fund balance (deficiency)	<u>\$ 2,247,982</u>	<u>\$ 167,713</u>	<u>\$ 54,867</u>	<u>\$ 2,044,567</u>	<u>\$ 307,618</u>	<u>\$ 973,102</u>	<u>\$ 5,795,849</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, 2006**

Total fund balances - governmental funds	\$ 1,143,906
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	30,776,747
• Some liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds. (Note 4)	<u>(19,827,299)</u>
Net assets of governmental activities	<u>\$ 12,093,354</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
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES (DEFICIT) - GOVERNMENTAL (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

	General	HUD Programs	HHS Program	Debt Service	Capital Projects	Other Governmental Funds	Total Governmental Funds
REVENUES							
Property taxes (Note 6)	\$ 3,395,298	\$ -	\$ -	\$ 1,029,100	\$ -	\$ -	\$ 4,424,398
Municipal license taxes (Note 7)	1,599,011						1,599,011
Licenses and permits	605,153						605,153
Charges for service and rents	570,947						570,947
Intergovernmental revenues (Note 13):							
Federal grants and contributions		1,907,828	3,436,099			962,988	6,206,915
State contributions	5,505,701					794,052	6,299,753
Interest, fines, and penalties	61,247			57,137	4,135	30,718	153,237
Other revenues	342,974				307,618	147,254	797,846
Total revenues	12,080,331	1,807,828	3,436,099	1,086,237	311,753	1,935,012	20,657,260
EXPENDITURES							
General government	6,171,799						6,171,799
Public safety	1,007,847						1,007,847
Public works	2,988,901						2,988,901
Culture	320,761						320,761
Recreation	399,543						399,543
Health and welfare	708,133	1,938,402	3,478,091				6,124,626
Capital outlays					1,433,592	1,519,206	2,952,798
Debt service:							
Principal retirement				731,524			731,524
Interest and other				697,548			697,548
Total expenditures	11,596,984	1,938,402	3,478,091	1,429,070	1,433,592	1,519,206	21,395,345
Excess (deficiency) of revenues over (under) expenditures	483,347	(130,574)	(41,992)	(342,833)	(1,121,839)	415,806	(738,085)
OTHER FINANCING SOURCES (USES)							
Extraordinary item: proceed on sale on asset	857,500						857,500
Transfers in	183,784			532,777	1,347,684	379	2,064,624
Transfers out	(532,777)			(51,058)	(115,168)	(1,365,821)	(2,064,624)
Total other financing sources (uses)	508,507	-	-	481,719	1,232,516	(1,365,242)	857,500
Excess (deficiency) of revenues and other sources over expenditures and other uses	991,854	(130,574)	(41,992)	138,886	110,677	(949,436)	119,415
FUND BALANCES (DEFICIT) AT BEGINNING OF YEAR, AS RESTATED (Note 21)							
	(991,719)	-	-	1,905,681	(148,844)	259,373	1,024,491
FUND BALANCES (DEFICIT) AT END OF YEAR							
	\$ 135	\$ (130,574)	\$ (41,992)	\$ 2,044,567	\$ (38,167)	\$ (690,063)	\$ 1,143,906

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

617,719
 857,500
 1,599,011
 605,153
 570,947
 1,907,828
 3,436,099
 5,505,701
 61,247
 342,974
 12,080,331
 6,171,799
 1,007,847
 2,988,901
 320,761
 399,543
 708,133
 1,938,402
 3,478,091
 731,524
 697,548
 11,596,984
 483,347
 857,500
 183,784
 (532,777)
 508,507
 991,854
 (130,574)
 (41,992)
 138,886
 110,677
 (949,436)
 119,415
 (991,719)
 -
 -
 1,905,681
 (148,844)
 259,373
 1,024,491
 \$ 135
 \$ (130,574)
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 \$ 2,044,567
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 \$ (690,063)
 \$ 1,143,906

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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, 2006**

Net change in fund balances - total governmental funds \$ 119,415

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. 2,952,798
- 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. (1,205,834)
- Gain on sale of land are reported as revenue in the governmental fund (857,500)
- Gain from sale of land is reported in the statement of activities, but do not require the use of current financial sources 659,692
- 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. 731,524
- Change in accrued interest expense which does not require the use of current financial resources. 72,537
- 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. (610,495)

Changes in net assets of governmental activities \$ 1,862,137

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, 2006**

	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	\$ 3,395,216	\$ 3,395,216	\$ 3,405,728	\$ 10,512	\$ 881,599	\$ 881,599	\$ 1,029,100	\$ 147,501
Municipal license taxes	1,750,000	1,750,000	1,733,624	(16,376)				
Licenses and permits	806,500	806,500	605,153	(201,347)				
Charges for service and rents	613,000	613,000	593,015	(19,985)				
Intergovernmental revenues:								
State contributions	5,321,927	5,170,760	5,139,543	(31,217)				
Interest, fines and penalties	166,494	166,494	170,489	3,995			57,137	57,137
Other revenues	652,995	652,995	1,079,528	426,533				
Total revenues	12,706,132	12,554,965	12,727,080	172,115	881,599	881,599	1,086,237	204,638
EXPENDITURES								
General government	6,598,971	6,837,878	6,586,693	251,185				
Public safety	1,172,847	1,030,840	1,010,050	20,790				
Public works	3,265,377	3,181,252	3,058,693	122,559				
Culture	453,014	334,937	321,512	13,425				
Recreation	465,079	419,214	400,949	18,265				
Health and welfare	750,844	750,844	708,133	42,711				
Debt service:								
Principal				-	435,000	435,000	731,524	(296,524)
Interest				-	446,599	446,599	697,546	(250,947)
Total expenditures	12,706,132	12,554,965	12,086,030	468,935	881,599	881,599	1,429,070	(547,471)
Excess (deficiency) of revenues over (under) expenditures	\$ -	\$ -	\$ 641,050	\$ 641,050	\$ -	\$ -	\$ (342,833)	\$ (342,833)

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, 2006**

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, 2006**

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, 2006**

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, 2006**

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, 2006**

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, 2006**

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, 2006**

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, 2006**

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, 2006 amounted to approximately \$329,000. The current insurance policies have not been cancelled or terminated. The CRIM also deducted approximately \$358,000 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, 2006**

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>
45	Accounting and Financial Reporting for Employers for Post-employment Benefits Other than Pensions	2007-08
48	Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues	2007-08

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

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

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

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, 2006 representing the original and the amended budget.

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

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

and timing differences in the excess of revenues over expenditures for the year ended June 30, 2006 is presented below for the general fund:

	<u>General</u>
Excess of revenues over expenditures - budgetary basis	\$641,050
Timing differences:	
Prior year encumbrances recorded as current year expenditures for GAAP basis	(33,483)
Current year encumbrances recorded as expenditures on the budgetary basis	157,843
Basis of accounting differences:	
Net increase in receivables	216,258
Net increase in accounts payable and other liabilities	340,423
Entity differences:	
Non-budgeted expenditures	(<u>838,744</u>)
Excess of revenues over expenditures - GAAP basis	<u>\$483,347</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.

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

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current period and therefore are not reported in the funds. The details of the approximately \$20 million difference are as follows:

Bonds payable	\$ 9,505,000
Landfill obligation	5,607,386
Notes payable	2,120,076
Compensated absences	1,230,613
Other long-term liabilities	770,024
Accrued interest payable	329,200
Claims and judgments	<u>265,000</u>
 Net adjustment to reduce fund balance governmental funds to arrive at net assets of governmental activities	 <u>\$19,827,299</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 \$2.6 million that are restricted principally for capital projects, and the \$2.0 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.

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.

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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.

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

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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 2005-06, 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, 2006, the amount collected by CRIM exceeded the amount received from CRIM for the same period by approximately \$262,000. Such amount is presented as intergovernmental receivable in the general fund in the basic financial statements due from CRIM. (See Note 8).

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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, 2006. 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 \$823,000, corresponding to the next fiscal year municipal license.

8. DUE FROM OTHER AGENCIES

Represents contributions due from the Municipal Revenues Collection Center and from the Federal Emergency Management Administration.

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9. INTERFUND TRANSACTIONS

a. Due From/To Other Funds:

The due from and due to other fund balances as of June 30, 2006, are as follows:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Amount</u>
General	Other Governmental Funds	\$206,450
General	HHS Programs	1,504
General	HUD Programs	27,180
Other Governmental Funds	General	246,391
HHS Programs	General	<u>100</u>
Total		<u>\$481,625</u>

The balance of \$246,391 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, 2006 consisted of the following:

<u>Transfer In</u>	<u>Transfer Out</u>	<u>Amount</u>
Capital Projects	Other Governmental Funds	\$1,347,684
Debt Service	General	532,777
General	Capital Projects	114,789
Other Governmental	Capital Projects	379
General	Debt Service	51,058
General	Other Governmental Funds	<u>17,937</u>
Total		<u>\$2,064,624</u>

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The transfer from other governmental funds to the capital projects fund of \$1.35 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, 2006 was as follows:

<u>Primary Government</u>	<u>Balance July 1, 2005</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2006</u>
Governmental Activities:				
Capital assets, not being depreciated:				
Land	\$ 2,159,416	\$ 194,480	\$ 194,480	\$ 2,159,416
Construction in progress	1,946,498	806,892	2,753,390	-
Total capital assets, not being depreciated	<u>4,105,914</u>	<u>1,001,372</u>	<u>2,947,870</u>	<u>2,159,416</u>
Capital assets, being depreciated:				
Buildings and building improvements	28,252,671	1,047,395	10,000	29,290,066
Furniture and fixtures	1,414,366	158,289	31,505	1,541,150
Vehicles and equipment	5,526,715			5,526,715
Infrastructure	1,274,124	2,020,995	-	3,295,119
Total capital assets, being depreciated	<u>36,467,876</u>	<u>3,226,679</u>	<u>41,505</u>	<u>39,653,050</u>
Less accumulated depreciation for:				
Buildings and building improvements	3,783,132	698,425		4,481,557
Furnitures and fixtures	1,213,439	114,195	38,177	1,289,457
Vehicles and equipment	4,582,625	347,522		4,930,147
Infrastructure	288,866	45,692		334,558
Total accumulated depreciation	<u>9,868,062</u>	<u>1,205,834</u>	<u>38,177</u>	<u>11,035,719</u>
Total capital assets, being depreciated, net	<u>26,599,814</u>	<u>2,020,845</u>	<u>3,328</u>	<u>28,617,331</u>
Governmental activities capital assets, net	<u>\$ 30,705,728</u>	<u>\$ 3,022,217</u>	<u>\$ 2,951,198</u>	<u>\$ 30,776,747</u>

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Capital asset activity for Villa Soigal Project, a discretely presented component unit, for the year ended June 30, 2006 was as follows:

<u>Component Unit- Villa Soigal Project</u>	<u>Balance July 1, 2005</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2006</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	3,567,955			3,567,955
Building equipment	418,282	6,530	5,268	430,080
Furniture and fixtures	32,982	373		33,355
Equipment	9,898			9,898
Total capital assets, being depreciated	<u>4,768,741</u>	<u>6,903</u>	<u>5,268</u>	<u>4,780,912</u>
Less accumulated depreciation for:				
Land improvements	431,448	18,490		449,938
Buildings and building improvements	2,058,023	86,844		2,144,867
Building equipment	230,862	29,718	5,268	265,848
Furnitures and fixtures	31,062	233		31,295
Equipment	9,315	250		9,565
Total accumulated depreciation	<u>2,760,710</u>	<u>135,535</u>	<u>5,268</u>	<u>2,901,513</u>
Total capital assets, being depreciated, net	<u>2,008,031</u>	<u>(128,632)</u>	<u>-</u>	<u>1,879,399</u>
Villa Soigal Project capital assets, net	<u>\$ 2,066,381</u>	<u>\$ (128,632)</u>	<u>\$ -</u>	<u>\$ 1,937,749</u>

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11. DUE TO OTHER AGENCIES

Due to other agencies at June 30, 2006 are as follows:

Puerto Rico Treasury Department	\$ 178,895
Retirement System Administration	88,324
Municipal Revenues Collection Center	47,243
Puerto Rico Water and Sewer Authority	31,775
U. S. Internal Revenue Services	53,074
Municipality of Moca	175,000
Puerto Rico Labor Department	5,030
Puerto Rico Land Authority	4,260
Puerto Rico General Services Administration	<u>18,265</u>
	<u>\$ 601,866</u>

12. DEFERRED REVENUES

Municipal License Tax

The deferred revenues of approximately \$823,000 in the general fund related to municipal license tax collected in fiscal year 2005-06 that will be earned in fiscal year 2006-07.

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.

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14. LONG-TERM DEBTS

Bonds and other long-term liabilities outstanding at June 30, 2006 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%.	\$2,435,000
\$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%.	690,000
\$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%.	1,550,000
\$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%.	1,420,000
\$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%.	1,060,000
\$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>2,350,000</u>
Total bonds payable	<u>\$9,505,000</u>

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%.	\$ 760,000
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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%.

\$1,052,163

Note payable to CRIM (LIMS) - On June 27, 2001, the Municipality entered into a financing agreement with the CRIM in the amount of \$495,559 for the payment of the Municipality's share of the cost of a management information system (LIMS) acquired by the CRIM for the management of taxpayer's properties located in Puerto Rico. The note is payable in semiannual installments of \$33,232 including interest of 5.95% and is due on November 28, 2011. Amount is financed with unrestricted funds through withholdings from the advances of property tax and amounts of municipal equalization fund sent to the Municipality by the Municipal Revenue Collection Center (CRIM).

307,913

Total notes payable

\$2,120,076

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, 2006, are as follows:

	<u><i>Bonds Payable</i></u>		<u><i>Notes Payable</i></u>	
	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>
2007	\$ 575,000	\$ 512,632	\$ 200,276	\$ 112,377
2008	610,000	483,157	214,258	102,517
2009	650,000	451,338	223,483	92,088
2010	690,000	448,675	237,966	80,922
2011	735,000	406,106	252,722	68,837
2012-2016	3,710,000	1,301,984	158,487	281,090
2017-2021	1,715,000	444,837	171,173	235,172
2022-2026	685,000	120,103	232,144	174,200
2027-2031	135,000	3,780	314,834	91,511
2032-2036	-	-	114,733	7,171
	<u>\$ 9,505,000</u>	<u>\$ 4,172,612</u>	<u>\$ 2,120,076</u>	<u>\$ 1,245,885</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>
2007	\$ 65,986
2008	71,462
2009	77,394
2010	83,817
2011	90,774
Thereafter	<u>956,484</u>
Total	<u>\$1,345,917</u>

Long-term liability activity for the year ended June 30, 2006 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	\$ 10,045,000		\$ 540,000	\$ 9,505,000	\$ 575,000
Notes payable	1,957,609		145,446	\$ 1,812,163	151,416
CRIM Debt Repayment Plan	353,991		46,078	307,913	48,860
Total long-term debt	<u>12,356,600</u>	<u>-</u>	<u>731,524</u>	<u>11,625,076</u>	<u>775,276</u>
Other long-term liabilities:					
Landfill obligation	5,833,123		225,737	5,607,386	237,024
Puerto Rico Treasury Department	-			-	
Puerto Rico Health Insurance Administration	770,024			770,024	
Compensated absences	1,872,518		641,905	1,230,613	135,777
Claims and judgments	265,000			265,000	
Total other long-term liabilities	<u>8,740,665</u>	<u>-</u>	<u>867,642</u>	<u>7,873,023</u>	<u>372,801</u>
Total noncurrent liabilities, governmental activities	<u>\$ 21,097,265</u>	<u>\$ -</u>	<u>\$ 1,599,166</u>	<u>\$ 19,498,099</u>	<u>\$ 1,148,077</u>
Component Unit:					
Villa Sojal Project mortgage payable	<u>\$ 1,407,604</u>	<u>\$ -</u>	<u>\$ 61,687</u>	<u>\$ 1,345,917</u>	<u>\$ 65,986</u>

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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.

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

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(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, 2006 was approximately \$406,000. 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, 2006, 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, 2006 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 \$5.6 million as of June 30, 2006. (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 it 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, 2006**

20. COMMITMENTS

The Municipality of San Sebastián has a contract for deposit of solid waste with the Municipality of Moca landfill for \$29,167 monthly renewable each six months.

21. RESTATEMENT

a. Fund Balance

The beginning fund balance of the general fund, the capital project fund and other governmental funds has been restated to recognize corrections of accounting errors. The following schedule reconciles the fund balance at July 1, 2005 as previously reported to the beginning fund balance, as restated:

<u>Fund</u>	<u>Balance at beginning of year, as previously reported</u>	<u>Correction of errors</u>	<u>Balance at beginning of year, as restated</u>
General Fund	\$ (859,966)	\$ (131,753)	\$ (991,719)
Other Governmental Funds	267,851	(8,478)	259,373
Capital Project	(841,827)	692,983	(148,844)
 Total	 <u>\$ (1,433,942)</u>	 <u>\$ 552,752</u>	 <u>\$ (881,190)</u>

b. Net Assets

Net assets at beginning of year have been adjusted to reflect the following restatements:

Net assets at beginning of year as previously reported	\$ 9,759,804
Debt not recognized on prior year	(353,991)
Payments of long-term debt not recognized	225,000
Correction of errors	<u>600,404</u>
 Net assets at beginning of year as restated	 <u>\$10,231,217</u>

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

22. SUBSEQUENT EVENTS

a. Sales Taxes Implementation

Effective on October 1, 2006, the Municipality imposed a sales tax of 1.50% to be applicable over all direct sales to consumers, including certain services as approved by the Municipal Legislature.

Section 6189 of the Puerto Rico Internal Revenue Code of 1994, as amended, authorizes the Municipalities in Puerto Rico to impose a sales and use tax to consumers. This tax must be imposed in conformity with the base, exemptions and limitations contained in Subtitle BB of the Code. The Municipal Sales Tax is specifically imposed over all sales transactions of taxable items and combined transactions (as defined by the municipal internal regulation) taken place within municipal limits. The Municipal Sales Tax is also specifically imposed over the purchase price for the use, storage or consumption of taxable transactions (as defined by the municipal internal regulation) taken place within Municipal limits.

b. Issuance of General Obligation Bonds

On July 13, 2006, the Governmental Development Bank of Puerto Rico (GDB) approved the issuance of \$1,150,000 general obligation bonds to the Municipality. Bonds are due in annual installments ranging from \$25,000 to \$95,000 through July 1, 2031. Also, on August 4, 2006, the Governmental Development Bank of Puerto Rico (GDB) approved the issuance of \$485,000 general obligation bonds to the Municipality. Bonds are due in annual installments, through August 6, 2016.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

<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)		
Community Development Block Grant Program, Entitlement Grants Pass through Administration of Families and Children:	14.218	\$ 1,245,013
Emergency Shelter Grant Program	14.231	1,281
Section 8 - Rental Housing Choice Voucher Program	14.871	544,627
Pass through Commissioner Office of Municipal Affairs - Community Development Block Grants/State Program - SBGP	14.228	147,481
Subtotal U.S. Department of HUD		<u>1,938,402</u>
U.S. Department of Health and Human Services (HHS)		
Pass through Governor's Office of Child Services and Community Development:		
Head Start Program	93.600	3,275,893
Pass through Administration of Families and Children:		
Child Care and Development Block Grant	93.575	202,198
Pass through the Puerto Rico Elderly Commission		
Special Programs for the Aging Title III, Part D, Disease Prevention and Health Promotion Services	93.043	13,544
Subtotal U.S. Department of HHS		<u>3,491,635</u>
U.S. Department of Agriculture		
Pass-through Education Department:		
Child and Adult Care Food Program	10.558	269,693
Subtotal U.S. Department of Agriculture		<u>269,693</u>
U.S. Department of Justice		
Pass-through Department of Justice		
Local Law Enforcement Block Grant	16.592	44,218
Subtotal U.S. Department of Justice		<u>44,218</u>
U.S. Department of Commerce		
Grant for Public Works and Economic Development Facilities	11.300	102,124
Subtotal U.S. Department of Commerce		<u>102,124</u>
U.S. Department of Transportation - National Highway Traffic Safety Administration		
Pass-through Department of Transportation (Traffic Safety Commission)		
State and Community Highway Safety	20.600	52,756
Subtotal U.S. Department of Transportation		<u>52,756</u>

See notes to Schedule of Expenditures of Federal Awards.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

<u>Federal Grantor/Program Title</u>	<u>Federal CFDA .Number</u>	<u>Federal Disbursements/ Expenditures</u>
U.S. Department of Homeland Security - Federal Emergency Management Agency (FEMA)		
Pass-through the Puerto Rico Governor's Office -(Governor's Authorized Representative-GAR)		
Public Assistance Grants	97.036	\$ 140,818
Hazard Mitigation Grant	97.039	368,628
Pass-through the Puerto Rico State Emergency Management Agency		
Pre-Disaster Mitigation	97.047	<u>50,025</u>
Subtotal U.S. Department of FEMA		<u>559,471</u>
TOTAL		<u>\$ 6,458,299</u>

See notes to Schedule of Expenditures of Federal Awards.

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**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

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	\$1,938,402
Health and Human Services Programs	3,478,091
Included within other governmental funds	<u>1,041,806</u>
	<u>\$6,458,299</u>
Total expenditures per schedule of expenditures of federal awards	<u>\$6,458,299</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, 2006, which collectively comprise the Municipality's basic financial statements and have issued our report thereon dated November 9, 2006. 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 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 assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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 on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our 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 the Municipality of San Sebastián in a separate letter dated November 9, 2006.

This report is intended solely for the information and use of the audit committee, Commissioner Office of Municipal Affairs, management 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 9, 2006

The stamp 2190965 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, 2006. Municipality of San Sebastián's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of 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's compliance with those requirements.

We noted certain matters involving in the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Municipality's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 06-1 06-3, 06-4, and 06-5.

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

In our opinion, except for the noncompliance described in the accompanying schedule of findings and questioned costs as item 06-1 to 06-5, the 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, 2006.

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 the 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 reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may

not be detected within a timely period by employees in the normal course of performing their assigned functions.

This report is intended solely for the information of the audit committee, Commissioner Office of Municipal Affairs, management 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 & C

San Juan, Puerto Rico
November 9, 2006

The stamp 2190966 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, 2006**

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 expressed a qualified opinion.
- f. Audit finding relative to the major program for Municipality of San Sebastián is reported in number 3 of this schedule.
- g. The programs tested as major programs included:
 - Section 8 - CFDA 14.871
 - CDBG - CFDA 14.218
 - Hazard Mitigation Plan - CFDA 97.039
- 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

None

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

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

a. Section 8 Voucher - CFDA 14.871

● **Condition 06-1**

During the audit, we reviewed 1 participant file. We observed that this file does not include evidence of corrections to be realized as result of unit inspection.

Criteria

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

Cause

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

Effect

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

Recommendation

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

Questioned Costs

-0-

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

● **Condition 06-2**

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

Criteria

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

Cause

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

Effect

The program does not comply with the cash management requirement.

Recommendation

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

Questioned Costs

-0-

● **Condition 06-3**

The program did not adjust the utility data schedule within the last twelve months.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

Criteria

The Municipality must maintain an up-to-date utility allowance schedule. Then, the Municipality must review utility rate data for each utility category each year and must adjust its utility allowance schedule if there has been a rate change of 10 percent or more for a utility category or fuel type since last time was revised (24 CFR Section 982.517).

Cause

The program realized the review but not adjusted the utility data schedule.

Effect

The program does not comply with federal regulation.

Recommendation

The program should update the utility review and should be adjusted as soon as possible.

Questioned Costs

-0-

● **Condition 06-4**

During the audit, we reviewed 15 participants' files. We observed that none of the files observed contains one or more release forms to allow the Municipality to obtain information from third parties, a federally prescribed general release for employment information and the Privacy Act Notice.

Criteria

The 24 CFR sections 5.212 and 5.230 established that the head of the household sign: (a) one or more release forms to allow the Municipality to obtain information from third parties; (b) a federally prescribed general release form for employments; and (c) privacy notice.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

Cause

The program does not request to the head of the household to sign the releases required.

Effect

The program is not in compliance with the federal regulations

Recommendation

The Municipality had to request the head of the household to sign the authorization for the release of information and the privacy act notice.

Questioned Costs

-0-

● **Condition 06-5**

During the audit, we reviewed 15 participants' files. We observed that none of the files observed contains evidence of the method used by the Program to determine that the rent to owner is reasonable in comparison to the rent for other comparable unassisted units

Criteria

The 24 CFR sections 982.4, 982.54(d)(15), 982.158(f)(7), and 982.507 establish the program must maintain records to document the basis for the determination that rent to owner is a reasonable rent (initially and during the term of the HAP contract). The program determinations must consider unit attributes such as location, quality, size, unit type and age of the unit, and any amenities hosing services, maintenance and utilities provided by the owner.

**COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF SAN SEBASTIÁN
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
FOR THE FISCAL YEAR ENDED JUNE 30, 2006**

Cause

The program does not made rent comparison with other unassisted units.

Effect

The program is not in compliance with the federal regulations

Recommendation

The Municipality had to maintain records to document the basis for the determination that rent to owner is a reasonable rent (initially and during the term of the HAP contract).

Questioned Cost

-0-

**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, 2006**

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.

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**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, 2006**

<u>Program</u>	<u>Finding/Noncompliance</u>	<u>Status</u>
<p>Head Start CFDA No. 93.600</p>	<p>Condition 05-1</p> <p>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.</p>	<p>Condition was corrected.</p>