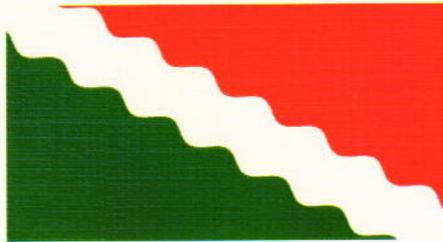


**OFICINA DEL COMISIONADO DE ASUNTOS MUNICIPALES  
ÁREA DE ASESORAMIENTO, REGLAMENTACIÓN E INTERVENCIÓN FISCAL  
ÁREA DE ARCHIVO DIGITAL**

**MUNICIPIO DE SAN SEBASTIAN  
AUDITORÍA 2010-2011  
30 DE JUNIO DE 2011**

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

*FISCAL YEAR ENDED JUNE 30, 2011*



**BASIC FINANCIAL STATEMENTS ACCOMPANIED BY  
REQUIRED SUPPLEMENTARY INFORMATION**

**HON. JAVIER JIMENEZ PEREZ  
MAYOR**

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

67 *Wc*

**BASIC FINANCIAL STATEMENTS ACCOMPANIED BY  
REQUIRED SUPPLEMENTARY INFORMATION**

**FISCAL YEAR ENDED JUNE 30, 2011**

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**TABLE OF CONTENTS**

	<b>Pages</b>
<b><u>PART I – FINANCIAL:</u></b>	
Independent Auditors' Report .....	1-2
Required Supplementary Information (Part I): Management's Discussion and Analysis .....	3-13
<b><u>BASIC FINANCIAL STATEMENTS:</u></b>	
<b>Governmental Wide Financial Statements:</b>	
Statement of Net Assets .....	14
Statement of Activities .....	15
<b>Governmental Funds Financial Statements:</b>	
Balance Sheet .....	16
Statement of Revenues, Expenditures and Changes in Fund Balances .....	17
Reconciliation of the Balance Sheet- Governmental Funds to Statement of Net Assets .....	18
Reconciliation of Statement of Revenues, Expenditures and Changes in Fund Balances to the Statement of Activities .....	19
<b><u>PROPRIETARY FUND FINANCIAL STATEMENTS:</u></b>	
Statement of Net Assets .....	20
Statement of Activities .....	21
Statement of Cash Flows .....	22-23
Notes to the Basic Financial Statements .....	24-54
Required Supplementary Information:	
Required Supplementary Information (Part II):	
Budgetary Comparison Schedule – General Fund .....	55
Note to Budgetary Comparison Schedule – General Fund .....	56

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

BASIC FINANCIAL STATEMENTS ACCOMPANIED BY  
REQUIRED SUPPLEMENTARY INFORMATION

FISCAL YEAR ENDED JUNE 30, 2011

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TABLE OF CONTENTS (Continued)

**Federal Awards and Single Audit Section**

Supplementary Information	
Schedule of Expenditures of Federal Awards.....	57
Notes to Schedule of Expenditures of Federal Awards .....	58
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.....	59-60
Independent Auditor's Report on compliance with Requirements that could have a Direct and Material Effect on Each Major Program and on Internal Control over Compliance in Accordance with OMB Circular A-133 .....	61-62
Schedule of Findings and Questioned Costs.....	63-64
Summary Schedule of Prior Audit Findings .....	65

## INDEPENDENT AUDITOR'S REPORT

Honorable Mayor and Members of the  
Municipal Assembly  
Municipality of San Sebastián, Puerto Rico

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of **Municipality of San Sebastián, Puerto Rico**, as of and for the year ended June 30, 2011, which collectively comprise the Municipality of San Sebastián, Puerto Rico's basic financial statements as listed in the table of contents. These financial statements are the responsibility of Municipality of San Sebastián, Puerto Rico's management. Our responsibility is to express opinions on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Municipality of San Sebastián, Puerto Rico, as of June 30, 2011, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

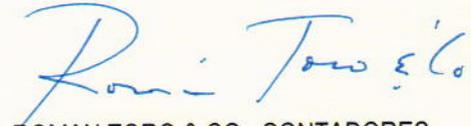
In accordance with *Government Auditing Standards*, we have also issued our report dated January 20, 2012, on our consideration of the Municipality of San Sebastián, Puerto Rico's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant 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 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and budgetary comparison information on pages 3 through 13 and 55 through 56 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

## INDEPENDENT AUDITOR'S REPORT

(CONTINUED)

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Municipality of San Sebastián, Puerto Rico's financial statements as a whole. The accompanying schedule of expenditures of federal awards on page 57 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget *Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the financial statements as a whole.

  
ROMAN TORO & CO., CONTADORES  
PUBLICOS AUTORIZADOS, CSP  
LICENSE #35 - IN FORCE

Yauco, Puerto Rico  
January 20, 2012

Stamp #E9974 was affixed to  
the original of this report

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

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The management of **Municipality of San Sebastián**, Puerto Rico (**Municipality**) offers this narrative overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2011. The Management's Discussion and Analysis (MD&A) is designed to focus on the current year activities, resulting changes and currently known facts, and much of the information is comparable to prior year. This MD&A should be read in conjunction with the accompanying basic financial statements and the accompanying notes to those financial statements.

The new reporting model, required by Governmental Accounting Standards Board Statement No. 34, was implemented during the fiscal year 2003-2004. This MD&A is prepared in order to comply with such pronouncement and, among other purposes, to provide the financial statements users with the following major information:

- a broader basis in focusing important issues;
- acknowledgement of an overview of the Municipality's financial activities;
- provide for an evaluation of its financial condition as of the end of the indicated fiscal year, compared with prior year results;
- identification of uses of funds in the financing of the Municipality's variety of activities and;
- assess management's ability to handle budgetary functions.

**GOVERNMENTAL ACTIVITIES – FINANCIAL HIGHLIGHTS**

The following are key financial highlights for the fiscal year:

- The Municipality's assets exceeded its liabilities at June 30, 2011 by \$38,115,535, and at June 30, 2010 by \$35,172,236, as restated;
- The Municipality's total net assets increase by \$2,943,299 during fiscal year 2010-2011;
- As of June 30, 2011, the Municipality's governmental funds reported combined ending fund balance of \$14,440,484, an increase of \$5,240,247 from the prior year;
- At June 30, 2011, the Statement of Net Asset presented an unrestricted deficit of \$(6,465,804);
- During fiscal year 2010-2011, the Municipality issue \$3,045,000 in bonds and notes debts;
- The Municipality's capital assets inventory increase as a result of this year's operations. Capital assets as of June 30, 2011 were \$50,830,850 (net of accumulated depreciation);
- The investment in capital assets for this year was \$37,146,163 (net of related debt);
- Loans principal payments were \$1,330,000 and \$1,325,000 in 2011 and 2010, respectively.

**BUSINESS-TYPE ACTIVITIES – FINANCIAL HIGHLIGHTS**

- The total net assets of the proprietary fund amounted to \$1,011,770, of which \$431,680 are invested in capital assets, net of related debt, while \$491,290 are restricted for the operations of federally funded programs.
- The total net assets of the proprietary fund increased by \$38,244 during the fiscal year ended on June 30, 2011.

**OVERVIEW OF THE BASIC FINANCIAL STATEMENTS**

This discussion and analysis are intended to serve as an introduction to the Municipality's financial statements. The Municipality's basic financial statements comprise three components: government-wide financial statements; fund financial statements; and notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

FOR THE FISCAL YEAR ENDED JUNE 30, 2011

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**GOVERNMENT-WIDE FINANCIAL STATEMENTS**

The government-wide financial statements are composed of: (1) the statement of net assets and (2) the statement of activities. These financial statements can be found immediately following this MD&A. These financial statements are designed to provide readers with a broad overview of the Municipality's finances, in a manner similar to a private-sector business.

**STATEMENT OF NET ASSETS**

The purpose of the statement of net assets is to attempt to report all assets owned and all liabilities owed by the Municipality. The Municipality reports of all of its assets when it acquires ownership over the assets and reports all of its liabilities when they are incurred. For example, the Municipality reports buildings and infrastructure as assets, even though they are not available to pay the obligations incurred by the Municipality. On the other hand, the Municipality reports liabilities, such as claims and judgments, bonds and notes payable, obligations under capital leases, compensated absences and certain accounts payable and accrued liabilities, even though these liabilities might not be paid until several fiscal years into the future.

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

**STATEMENT OF ACTIVITIES**

The statement of activities presents information showing how the Municipality's net assets changed during the fiscal year ended June 30, 2011, by presenting all of the Municipality's revenues and expenses. As previously discussed, the items reported in the statement of activities are measured in a manner similar to the approach used by a commercial enterprise in that revenues are recognized when earned or established criteria are satisfied, and expenses are recorded when incurred by the Municipality. Consequently, revenues are reported even when they may not be collected for several months after the end of the fiscal year and expenses are recorded even though they may not have used cash during the current year.

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

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

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

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**GOVERNMENT-WIDE FINANCIAL STATEMENTS (CONTINUED)**

Both of the government-wide financial statements of the Municipality are principally supported by taxes and intergovernmental revenues. The Municipality's activities include; general government, public safety, public works, culture, recreation, health and welfare, and interests. Property taxes, volume of business taxes, sales taxes, and state and federal grants finance most of these activities.

**FUND FINANCIAL STATEMENTS**

The Municipality's fund financial statements consist of: (1) the balance sheet – governmental funds, (2) the statement of revenues, expenditures and changes in fund balances – governmental funds, (3) the statement of net assets – proprietary fund, (4) the statement of revenues, expenses and changes in fund net assets – proprietary fund, and (5) the statement of cash flows – proprietary fund. These financial statements report the financial position, the results of operations and cash flows of the Municipality's governmental and proprietary funds, with an emphasis on the Municipality's major governmental and proprietary funds.

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

**GOVERNMENTAL FUNDS**

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

The Municipality adopts an annual appropriated budget for its general fund. A budgetary comparison statement has been provided for the general fund to demonstrate compliance with this budget.

**PROPRIETARY FUND**

The proprietary fund is a fund used to report the financial position, results of operation and cash flows of Villa Soigal (Project No. 63-29-665705492,01-3), is a housing development consisting of 120 dwelling units located in San Sebastián.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

FOR THE FISCAL YEAR ENDED JUNE 30, 2011

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**FUND FINANCIAL STATEMENTS (CONTINUED)**

**PROPRIETARY FUND (CONTINUED)**

The project is owned by the Municipality, but its operations are carried out by a private management agent unrelated to the Municipality. The housing development project of Villas Soigal has been designed to assist various segments of the general public in obtaining adequate and reasonable priced rental housing. The project operates under financing through the Section 8 New Construction and Substantial Rehabilitation Program of the U.S. Department of Housing and Urban Development and the Section 515 Rural Rental Housing Loans Program of the U.S. Department of Agriculture. The purpose of Villas Soigal is to provide adequate housing to low-income residents of the Municipality.

The activities of Villas Soigal have been reported as a proprietary fund in the accompanying basic financial statements since GAAP permits the use of enterprise funds to report any activity for which a fee is charged to external users of goods or services, regardless of whether the government intends to fully recover the cost of the goods or services provided. Thus, it is common to use proprietary fund reporting to account for services where the government intends to recover only a portion of its costs through fees or user charges.

Proprietary funds provide the same type of information as the GWFS, but in more detail.

**NOTES TO THE BASIC FINANCIAL STATEMENTS**

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

**OTHER INFORMATION**

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

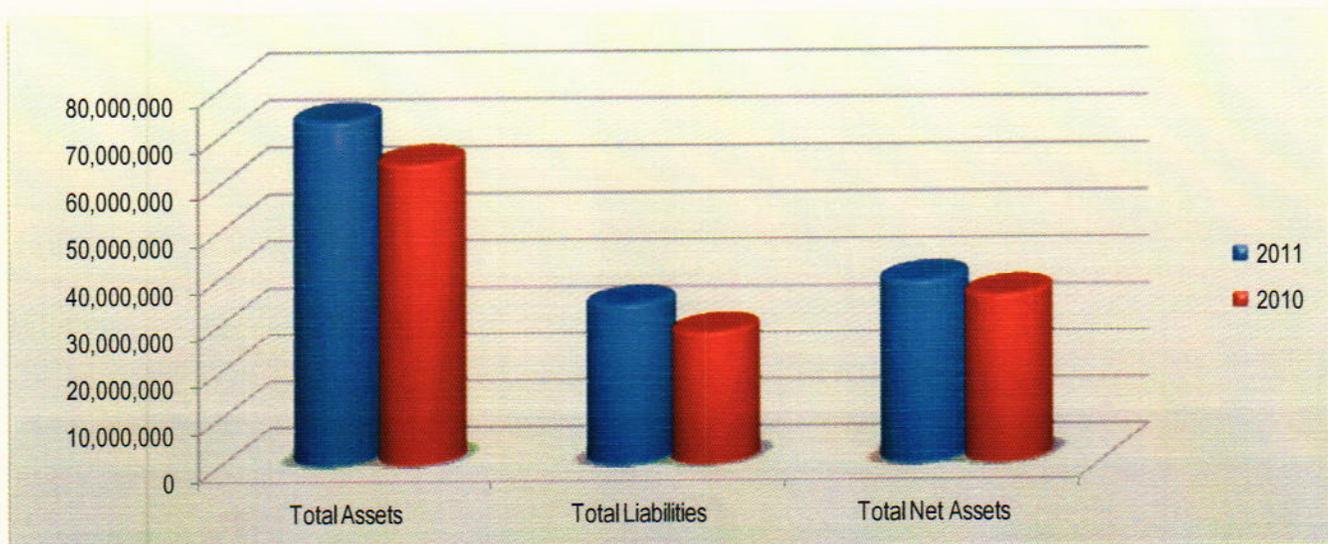
**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**GOVERNMENT-WIDE FINANCIAL ANALYSIS**

**GOVERNMENTAL NET ASSETS**

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the Municipality, governmental activities assets exceeded liabilities by \$38,115,535 as of June 30, 2011, versus \$35,172,236 as of June 30, 2010, as restated, and business-type activities assets exceeded liabilities by \$1,011,770 as of June 30, 2011, versus \$973,526 as of June 30, 2010. Our analysis below focuses on the net assets (**Table 1**) and changes in net assets of the Municipality's governmental activities and business-type activities.

Table 1 Statement of Net Assets	Governmental Activities		Business-type Activities		Total	
	2011	2010 (as restated)	2011	2010	2011	2010 (as restated)
Current and non-current assets	\$ 20,549,144	\$ 14,135,167	\$ 623,448	\$ 557,146	\$ 21,172,592	\$14,692,313
Capital assets	50,830,850	48,173,719	1,387,792	1,503,201	52,218,642	49,676,920
<b>Total Assets</b>	<b>71,379,994</b>	<b>62,308,886</b>	<b>2,011,240</b>	<b>2,060,347</b>	<b>73,391,234</b>	<b>64,369,233</b>
Current liabilities	6,108,660	4,059,930	137,345	127,499	6,246,005	4,187,429
Long-term liabilities	27,155,799	23,076,720	862,125	959,322	28,017,924	24,036,042
<b>Total Liabilities</b>	<b>33,264,459</b>	<b>27,136,650</b>	<b>999,470</b>	<b>1,086,821</b>	<b>34,263,929</b>	<b>28,223,471</b>
Net assets:						
Investment in capital assets, net of related debt	37,146,163	39,118,777	431,680	456,228	37,577,843	39,575,005
Restricted	7,435,176	504,362	491,290	452,660	7,926,466	957,022
Unrestricted (Deficit)	(6,465,804)	(4,450,903)	88,800	64,638	(6,377,004)	(4,386,265)
<b>Total Net Assets</b>	<b>\$ 38,115,535</b>	<b>\$ 35,172,236</b>	<b>\$ 1,011,770</b>	<b>\$ 973,526</b>	<b>\$ 39,127,305</b>	<b>\$36,145,762</b>



**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**GOVERNMENT-WIDE FINANCIAL ANALYSIS (CONTINUED)**

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

**GOVERNMENTAL ACTIVITIES**

Governmental activities increased the Municipality's net assets. Key elements of this increase are as follows: the Municipality's governmental activities had net expenses of \$14,674,085. However, these services are intended to be primarily funded by taxes, as opposed to charges for services and grants, and those taxes and other general revenues exceed net expenses by \$2,943,299. In addition, business-type activities increased the Municipality's net assets by \$38,244.

The cost of all governmental activities and business-type activities this year was \$26,866,137 and 589,592, respectively. **Table 2** presents the cost of each of the Municipality's largest programs.

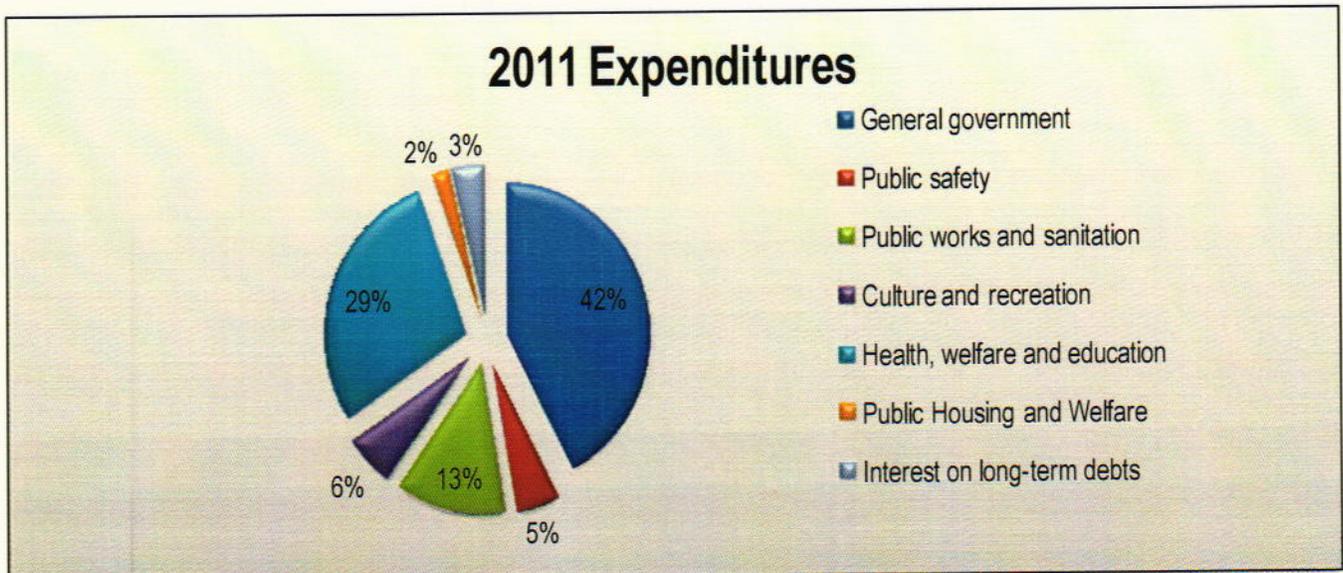
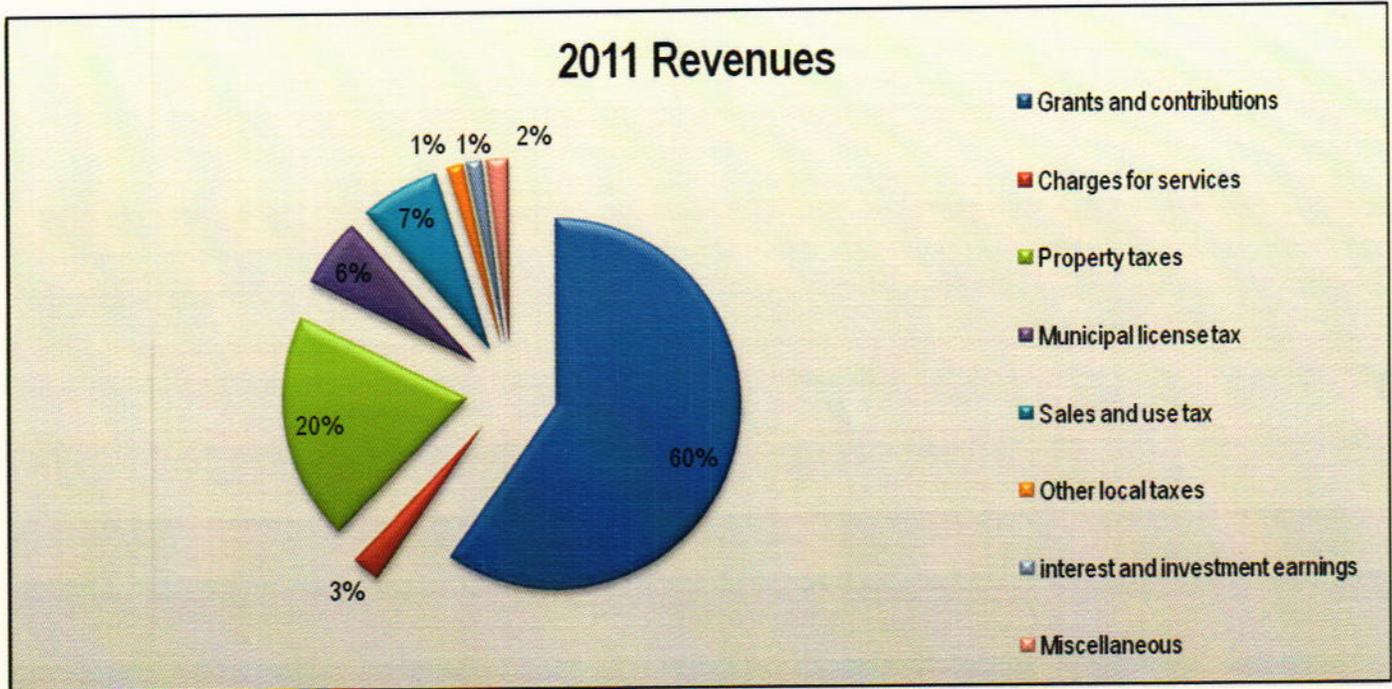
Table 2 Statement of Activities	Governmental Activities		Business-type Activities		Total	
	2011	2010	2011	2010	2011	2010
<b>Revenues</b>						
Program revenues:						
Grants and contributions	\$ 17,594,992	\$ 13,867,086	616,893	597,668	\$ 18,211,885	\$ 14,464,754
Charge for services	765,782	809,985			765,782	809,985
General revenues:						
Property taxes	6,070,049	5,183,643			6,070,049	5,183,643
Municipal license tax	1,850,609	1,762,048			1,850,609	1,762,048
Sales and use tax	2,118,170	2,191,842			2,118,170	2,191,842
Other local taxes	437,089	430,309			437,089	430,309
Interest and investment earnings	400,931	230,257	8,878		409,809	230,257
Miscellaneous	571,814	589,377	2,065	10,326	573,879	599,703
<b>Total revenues</b>	<b>29,809,436</b>	<b>25,064,547</b>	<b>627,836</b>	<b>607,994</b>	<b>30,437,272</b>	<b>25,672,541</b>
<b>Expenses</b>						
General government	11,656,413	6,473,865			11,656,413	6,473,865
Public safety	1,343,478	1,325,547			1,343,478	1,325,547
Public works and sanitation	3,480,357	5,753,879			3,480,357	5,753,879
Culture and recreation	1,560,460	2,366,385			1,560,460	2,366,385
Health, welfare and education	7,942,272	6,390,909			7,942,272	6,390,909
Public Housing and Welfare			520,336	546,676	520,336	546,676
Interest on long-term debts	883,157	674,993	69,256	75,482	952,413	750,475
<b>Total expenses</b>	<b>26,866,137</b>	<b>22,985,578</b>	<b>589,592</b>	<b>622,158</b>	<b>27,455,729</b>	<b>23,607,736</b>
Changes in net assets	2,943,299	2,078,969	38,244	(14,164)	2,981,543	2,064,805
Net assets – beginning, as restated	35,172,236	33,093,267	973,526	987,690	36,145,762	34,080,957
<b>Net assets – ending</b>	<b>\$ 38,115,535</b>	<b>\$ 35,172,236</b>	<b>1,011,770</b>	<b>973,526</b>	<b>\$ 39,127,305</b>	<b>\$ 36,145,762</b>

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

FOR THE FISCAL YEAR ENDED JUNE 30, 2011

GOVERNMENT-WIDE FINANCIAL ANALYSIS (CONTINUED)



**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**GOVERNMENT-WIDE FINANCIAL ANALYSIS (CONTINUED)**

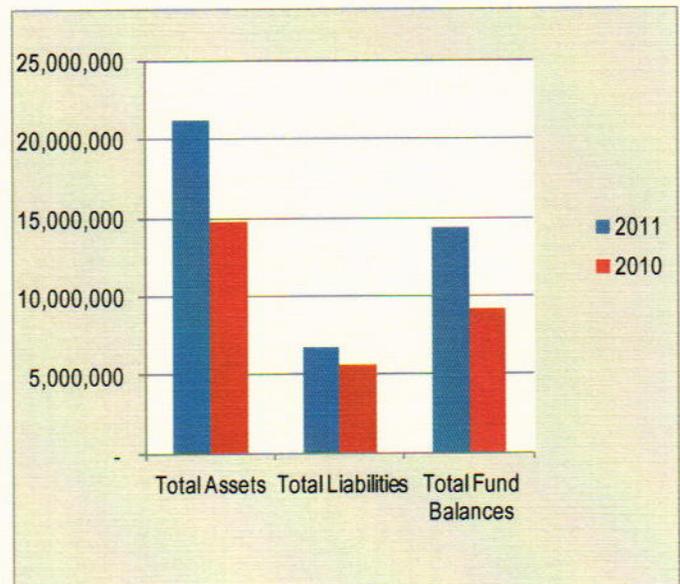
Approximately thirty-four percent (34%) of the Municipality's governmental activities and business-type activities total revenue came from taxes, while sixty percent (60%) resulted from grants and contributions. Federal grants represent thirty-eight percent (38%) of the Municipality grants revenues. The Municipality's governmental activities and business-type activities expenses included items such as general government, public safety, public works, culture and recreation, health and welfare, public housing and welfare, and interest on long term debts.

Approximately forty-two percent (42%) of total expenses resulted from general government, thirteen percent (13%) from public works, six percent (6%) from culture and recreation and twenty-nine percent (29%) from health and welfare.

**GOVERNMENT FUND FINANCIAL ANALYSIS**

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

<b>Table 3 Balance Sheet</b>	<b>2011</b>	<b>2010 (as restated)</b>
<b>Assets:</b>		
Total assets – Major Funds	\$ 17,197,409	\$ 12,096,433
Total assets – Other Funds	4,000,073	2,659,871
<b>Total assets</b>	<b>\$ 21,197,482</b>	<b>\$ 14,756,304</b>
<b>Liabilities:</b>		
Total liabilities – Major Funds	\$ 5,498,632	\$ 4,943,952
Total liabilities – Other Funds	1,258,366	612,115
<b>Combined total liabilities</b>	<b>6,756,998</b>	<b>5,556,067</b>
<b>Fund Balances:</b>		
Restricted	12,536,206	8,203,520
Assigned	584,956	243,285
Unassigned	1,319,322	753,432
<b>Combined total fund balances</b>	<b>14,440,484</b>	<b>9,200,237</b>
<b>Total liabilities and fund balances</b>	<b>\$ 21,197,482</b>	<b>\$ 14,756,304</b>



The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the Municipality's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of its fiscal year. At June 30, 2011, the Municipality's governmental funds reported combined ending fund balances of \$14,440,484, an increase of \$5,240,247 from the prior year.

The Municipality has an unassigned fund balance of \$1,319,322 in its General Fund. The remainder of the balance is assigned and restricted to indicate that it is not available for new spending because it has already been committed; (a) to liquidate prior year obligations (\$343,673), (b) to pay debt service (\$2,193,469) and (c) for other restricted purposes (\$10,584,020).

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

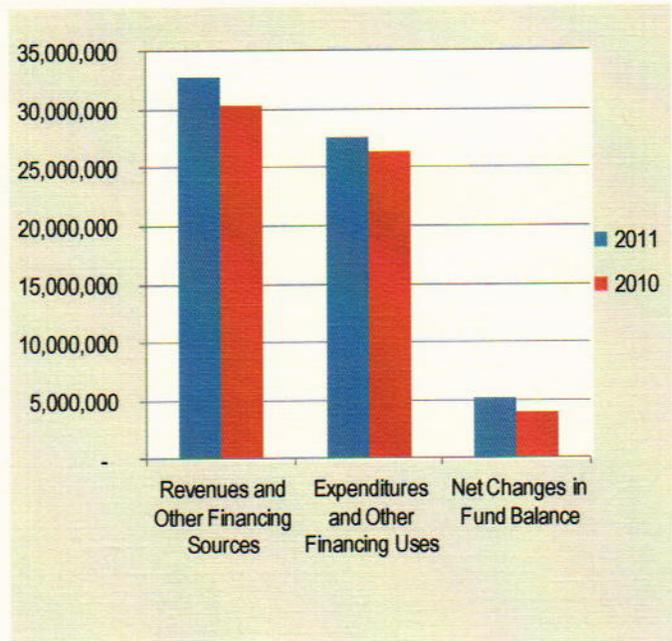
**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**GOVERNMENT FUND FINANCIAL ANALYSIS (CONTINUED)**

**Table 4**

**Changes in Fund Balances**

	<u>2011</u>	<u>2010</u>
Revenues:		
Total revenues – Major Funds	\$ 22,328,926	\$ 17,793,226
Total revenues – Other Funds	7,480,510	7,271,321
Combined total revenues	<u>29,809,436</u>	<u>25,064,547</u>
Expenditures:		
Total expenditures – Major Funds	20,836,120	19,547,230
Total expenditures – Other Funds	6,778,069	6,842,442
Combined total expenditures	<u>27,614,189</u>	<u>26,389,672</u>
Other financing sources (uses):		
Other financing sources – Major Funds	3,045,000	5,275,000
Net changes in fund balance	5,240,247	3,949,875
Fund Balance – beginning, as restated	9,200,237	5,250,362
Fund Balance – ending	<u>\$ 14,440,484</u>	<u>\$ 9,200,237</u>



**PROPRIETARY FUND FINANCIAL ANALYSIS**

At June 30, 2011, the total assets of proprietary fund amounted to \$2,011,240, which consisted principally of: (1) restricted cash in commercial banks of \$602,425, and (2) capital assets of \$1,387,792, net of accumulated depreciation.

At June 30, 2011, the total liabilities of the proprietary fund amounted to \$999,470, which consisted principally of: (1) mortgage notes payable of \$956,112, and (2) accounts payable and accrued liabilities of \$38,059.

The total net assets of proprietary fund amounted to \$1,011,770 at June 30, 2011, of which \$431,680 are invested in capital assets, and \$491,290 are reserved for program activities.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**BUDGETARY HIGHLIGHTS**

Budget and actual comparison schedules are provided in the Basic Financial Statements for the General Fund. The Budgetary Comparison Schedule of the General Fund shows the original adopted budgets, the final revised budget, actual results, and variance between the final budget and actual results for the general and major special revenue funds. **Table 5** summarizes the results of the General Fund's Budgetary Comparison Schedule:

<b>Table 5</b>	<b>Final Budget</b>	<b>Actual Amounts</b>	<b>Variance</b>
Total revenues	\$ 14,064,670	\$ 14,260,443	\$ 195,773
Total expenditures, encumbrances and other financing uses	<u>14,064,670</u>	<u>13,380,689</u>	<u>683,981</u>
<b>Excess or deficiency</b>	<b>\$ -</b>	<b>\$ 879,754</b>	<b>\$ 879,754</b>

The original and the final budget of the General Fund for the fiscal year ended June 30, 2011 amounted to \$ 13,914,670 and \$14,064,670, respectively. Over the course of the fiscal year, the Municipality revised the General Fund's budget in order to include increases and decreases in revenues that were identified during the course of the fiscal year based on current developments that positively affected the Municipality's finances. The laws and regulations of the Commonwealth mandate a balanced budget.

The total actual revenues (budgetary basis) of the general fund for the fiscal year ended June 30, 2011 were \$14,260,443, which is one percent (1%), or \$195,773 more than the budgeted revenues. In addition, the total actual expenditures and other financing sources (budgetary basis) of the general fund for the fiscal year ended June 30, 2011 were \$13,380,689, which is five percent (5%), or \$683,981 less than the budgeted expenditures.

**CAPITAL ASSETS AND DEBT ADMINISTRATION**

The Municipality's investment in capital assets for its governmental type activities as of June 30, 2011 amounted to \$50,830,850 (net of accumulated depreciation). This investment in capital assets includes land, buildings, improvements, furniture and fixtures, vehicles and equipment, and infrastructure. The total increase in the Municipality's investment in capital assets for the current fiscal year was \$2,657,131. **Table 6** present the major classes of capital assets.

<b>Table 6 Capital Assets</b>	<b>Amount</b>
Construction in progress	\$ 3,700,666
Land	5,737,776
Buildings and building improvements	27,924,613
Furniture and fixtures	586,912
Vehicles and equipment	1,151,016
Infrastructure	<u>11,729,867</u>
<b>Total Assets</b>	<b>\$ 50,830,850</b>

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED)

FOR THE FISCAL YEAR ENDED JUNE 30, 2011

**LONG-TERM DEBT**

At June 30, 2011, the Municipality had total of \$27,155,799 in general obligations and others outstanding debts, as shown in Table 7. Of this amount, \$19,272,000 comprises debt backed by the full faith and credit of the government and \$7,883,799 is other obligations.

<b>Table 7</b>	
<b>Long Term Debts</b>	<b>Amount</b>
General obligations bonds and notes	\$ 19,272,000
Others	<u>7,883,799</u>
<b>Total Long Term Debts</b>	<b><u>\$ 27,155,799</u></b>

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

**ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS AND RATES**

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

All of these factors were considered in preparing the Municipality's budget for the 2011 fiscal year. Some cost reductions helped fund improvements of existing facilities, public safety and works, economic development initiatives and human service improvements.

**REQUESTS FOR INFORMATION**

This financial report is designed to provide a general overview of the Municipality's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional information contact the Municipality's Finance Department at (787) 896-1550.

**Commonwealth of Puerto Rico  
Municipality of San Sebastián  
Statement of Net Assets  
June 30, 2011**

	<u>Governmental Activities</u>	<u>Business-type Activities</u>	<u>Total</u>
<b>ASSETS:</b>			
Cash and investments	\$ 10,454,139	\$ 602,425	\$ 11,056,564
Cash with fiscal agent	9,097,167	-	9,097,167
Receivables:			
Municipal license taxes	299,670	-	299,670
Sales and use taxes	173,720	-	173,720
Property taxes	20,972	-	20,972
Rent, licenses and permits	78,426	-	78,426
Intergovernmental	28,053	-	28,053
Federal grants	384,270	-	384,270
Others	12,727	-	12,727
Other assets	-	21,023	21,023
	<u>20,549,144</u>	<u>623,448</u>	<u>21,172,592</u>
Capital assets:			
Land, improvements, and construction in progress	9,438,442	58,350	9,496,792
Other capital assets, net of depreciation	41,392,408	1,329,442	42,721,850
Total capital assets	<u>50,830,850</u>	<u>1,387,792</u>	<u>52,218,642</u>
<b>TOTAL ASSETS</b>	<b><u>71,379,994</u></b>	<b><u>2,011,240</u></b>	<b><u>73,391,234</u></b>
<b>LIABILITIES:</b>			
Accounts payable and accrued liabilities	1,141,283	38,059	1,179,342
Bonds and notes payable	940,000	-	940,000
Accrued interests	425,729	5,299	431,028
Due to governmental units	1,733,825	-	1,733,825
Deferred revenues:			
Municipal license taxes	1,371,655	-	1,371,655
Federal grants	185,818	-	185,818
Others	310,350	-	310,350
Long-term liabilities:			
Due within one year	1,877,763	93,987	1,971,750
Due in more than one year	25,278,036	862,125	26,140,161
<b>TOTAL LIABILITIES</b>	<b><u>33,264,459</u></b>	<b><u>999,470</u></b>	<b><u>34,263,929</u></b>
<b>NET ASSETS</b>			
Invested in capital assets, net of related debt	37,146,163	431,680	37,577,843
Restricted for:			
Debt service	2,193,469	-	2,193,469
Other purposes	5,241,707	491,290	5,732,997
Unrestricted (deficit)	<u>(6,465,804)</u>	<u>88,800</u>	<u>(6,377,004)</u>
<b>TOTAL NET ASSETS</b>	<b><u>\$ 38,115,535</u></b>	<b><u>\$ 1,011,770</u></b>	<b><u>\$ 39,127,305</u></b>

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

Commonwealth of Puerto Rico  
Municipality of San Sebastian  
Statement of Activities  
For the Year Ended June 30, 2011

Functions/Programs	Program Revenues			Net (Expense) Revenue and Changes in Net Assets			
	Expenses	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-type Activities	Total
<b>Governmental Activities:</b>							
General government	\$ 11,656,413	\$ 60,055	\$ 69,833	\$ -	\$ (11,526,525)	\$ -	\$ (11,526,525)
Public safety	1,343,478	-	-	-	(1,343,478)	-	(1,343,478)
Public works and sanitation	3,480,357	-	157,329	4,062,789	739,761	-	739,761
Culture and recreation	1,560,460	-	190,000	250,000	(1,120,460)	-	(1,120,460)
Health, welfare and education	7,942,272	705,727	5,569,397	1,126,922	(540,226)	-	(540,226)
Interest on long-term debt	883,157	-	-	-	(883,157)	-	(883,157)
<b>Total governmental activities</b>	<b>\$ 26,866,137</b>	<b>\$ 765,782</b>	<b>\$ 5,986,559</b>	<b>\$ 5,439,711</b>	<b>(14,674,085)</b>	<b>-</b>	<b>(14,674,085)</b>
<b>Governmental Activities:</b>							
Public Housing and welfare	\$ 520,336	\$ -	\$ 616,893	\$ -	-	96,557	96,557
Interest on long-term debt	69,256	-	-	-	-	(69,256)	(69,256)
<b>Total business-type activities</b>	<b>\$ 589,592</b>	<b>\$ -</b>	<b>\$ 616,893</b>	<b>\$ -</b>	<b>-</b>	<b>27,301</b>	<b>27,301</b>
<b>General revenues:</b>							
Property taxes					6,070,049	-	6,070,049
Municipal license tax					1,850,609	-	1,850,609
Sales and use tax					2,118,170	-	2,118,170
Other local taxes					437,089	-	437,089
Grant and contributions not restricted to specific programs					6,168,722	-	6,168,722
Interest and investment earnings					400,931	8,878	409,809
Miscellaneous					571,814	2,065	573,879
Total general revenues					17,617,384	10,943	17,628,327
<b>Change in net assets</b>					<b>2,943,299</b>	<b>38,244</b>	<b>2,981,543</b>
Net assets - beginning-as restated					35,172,236	973,526	36,145,762
<b>Net assets - ending</b>					<b>\$ 38,115,535</b>	<b>\$ 1,011,770</b>	<b>\$ 39,127,305</b>

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

**Commonwealth of Puerto Rico  
Municipality of San Sebastián  
Balance Sheet  
Governmental Funds  
June 30, 2011**

	General Fund	Head Start	Debt Service	State Assignment	Loans Fund	Other Governmental Funds	Total Governmental Funds
<b>Assets</b>							
Cash and investments	\$ 4,890,948	\$ 13,500	\$ -	\$ 2,500,000	\$ -	\$ 3,049,691	\$ 10,454,139
Cash with fiscal agent			3,491,679		5,405,523	199,965	9,097,167
Receivables:							
Municipal license taxes	299,670					-	299,670
Sales and use taxes			46,547			127,173	173,720
Property taxes			20,972			-	20,972
Rent, licenses and permits	78,426					-	78,426
Intergovernmental						28,053	28,053
Federal grants		37,676				346,594	384,270
Others	9,714	808				2,205	12,727
Due from other funds	401,946					246,392	648,338
<b>Total assets</b>	<b>\$ 5,680,704</b>	<b>\$ 51,984</b>	<b>\$ 3,559,198</b>	<b>\$ 2,500,000</b>	<b>\$ 5,405,523</b>	<b>4,000,073</b>	<b>\$ 21,197,482</b>
<b>Liabilities and Fund Balances</b>							
<b>Liabilities :</b>							
Accounts payable and accrued liabilities	\$ 355,487	\$ 47,753			\$ 62,460	675,583	\$ 1,141,283
Bonds and notes payable			940,000			-	940,000
Accrued interests			425,729			-	425,729
Due to governmental units	1,733,825					-	1,733,825
Due to other funds	246,392	4,231			750	396,965	648,338
Deferred revenues:							
Municipal license taxes	1,371,655					-	1,371,655
Federal grants						185,818	185,818
Others	310,350					-	310,350
<b>Total liabilities</b>	<b>4,017,709</b>	<b>51,984</b>	<b>1,365,729</b>	<b>-</b>	<b>63,210</b>	<b>1,258,366</b>	<b>6,756,998</b>
<b>Fund balances:</b>							
Nonspendable							
Restricted		-	2,193,469	2,500,000	5,342,313	2,500,424	12,536,206
Committed						241,283	584,956
Assigned	343,673					-	343,673
Unassigned	1,319,322					-	1,319,322
<b>Total fund balances</b>	<b>1,662,995</b>	<b>-</b>	<b>2,193,469</b>	<b>2,500,000</b>	<b>5,342,313</b>	<b>2,741,707</b>	<b>14,440,484</b>
<b>Total liabilities and fund balances</b>	<b>\$ 5,680,704</b>	<b>\$ 51,984</b>	<b>\$ 3,559,198</b>	<b>\$ 2,500,000</b>	<b>\$ 5,405,523</b>	<b>\$ 4,000,073</b>	<b>\$ 21,197,482</b>

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

**Commonwealth of Puerto Rico**  
**Municipality of San Sebastian**  
**Statement of Revenues, Expenditures and Changes in Fund Balances**  
**Governmental Funds**  
**For the Year Ended June 30, 2011**

	General Fund	Head Start	Debt Service	State Assignment	Loans Fund	Other Governmental Funds	Total Governmental Funds
<b>Revenues</b>							
Property taxes	\$ 4,313,130	\$ -	\$ 1,756,919	\$ -	\$ -	\$ -	\$ 6,070,049
Municipal license taxes	1,850,609					-	1,850,609
Sales and use taxes	14,852		606,506			1,496,812	2,118,170
Charges for services	758,412					-	758,412
Federal grants and contributions		3,141,911				3,789,933	6,931,844
State contributions	6,168,722			2,500,000		1,994,426	10,663,148
Licenses and permits	444,459					-	444,459
Interest, fines and penalties	380,693		2,459		10,614	7,165	400,931
Other revenues	379,640					192,174	571,814
<b>Total revenues</b>	<b>14,310,517</b>	<b>3,141,911</b>	<b>2,365,884</b>	<b>2,500,000</b>	<b>10,614</b>	<b>7,480,510</b>	<b>29,809,436</b>
<b>Expenditures</b>							
<b>Current</b>							
General government	8,143,347				19,116	43,205	8,205,668
Public safety	1,140,113					57,899	1,198,012
Public works and sanitation	2,677,707					1,622,126	4,299,833
Culture	289,325					-	289,325
Recreation	338,834					202,554	541,388
Education		3,122,569					3,122,569
Health and welfare	827,707					3,794,263	4,621,970
Capital outlay					2,064,245	1,058,022	3,122,267
Debt service:						-	
Principal			1,330,000			-	1,330,000
Interest and other charges			883,157			-	883,157
<b>Total expenditures</b>	<b>13,417,033</b>	<b>3,122,569</b>	<b>2,213,157</b>	<b>-</b>	<b>2,083,361</b>	<b>6,778,069</b>	<b>27,614,189</b>
Excess (deficiency) of revenues over (under) expenditures	893,484	19,342	152,727	2,500,000	(2,072,747)	702,441	2,195,247
<b>Other financing sources (uses)</b>							
Bonds and notes					3,045,000	-	3,045,000
Transfers in	270,484		497,690			257,608	1,025,782
Transfers out	(497,690)	(19,342)	(1,400)		(241,252)	(266,098)	(1,025,782)
<b>Total other financing sources (uses)</b>	<b>(227,206)</b>	<b>(19,342)</b>	<b>496,290</b>	<b>-</b>	<b>2,803,748</b>	<b>(8,490)</b>	<b>3,045,000</b>
Net change in fund balances	666,278	-	649,017	2,500,000	731,001	693,951	5,240,247
Fund balance (deficit), beginning-as restated	996,717	-	1,544,452	-	4,611,312	2,047,756	9,200,237
Fund balance (deficit), ending	1,662,995	\$ -	\$ 2,193,469	\$ 2,500,000	\$ 5,342,313	\$ 2,741,707	\$ 14,440,484

*30/04/2012*

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

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

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**TOTAL FUND BALANCES – GOVERNMENTAL FUNDS..... \$ 14,440,484**

Amounts reported for Governmental Activities in the Statement of Net Assets are different because:

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

Non Depreciable Capital Assets .....	\$ 9,438,442	
Depreciable Capital Assets.....	58,721,488	
Accumulated Depreciation.....	<u>(17,329,080)</u>	
 Total Capital Assets.....		 50,830,850

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

General Bonds and Notes Payable .....	(19,272,000)	
Compensated Absences.....	(2,630,652)	
Property Tax Debt – Law 42.....	(959,098)	
Property Tax Debt – Law 146.....	(158,921)	
LIMS Repayment Plan.....	(32,272)	
Claims and Judgments .....	(3,600,000)	
State Health Insurance Administration .....	(256,266)	
Landfill Post-Closures Costs.....	<u>(246,590)</u>	
 Total Long-Term Liabilities .....		 <u>(27,155,799)</u>

**TOTAL NET ASSETS OF GOVERNMENTAL ACTIVITIES..... \$ 38,115,535**

See accompanying Notes to Basic Financial Statements.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

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

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

**NET CHANGE IN FUND BALANCES – TOTAL GOVERNMENTAL FUNDS ..... \$ 5,240,247**

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. In the current period, these amounts are:

Capital Assets Additions .....	4,557,664	
Depreciation Expense .....	<u>(1,893,193)</u>	
Excess of Capital Assets Additions over Depreciation Expense .....		2,664,471

Disposal of capital assets require removal of cost of the capital assets from the capital asset account on the Statement of Net Assets, resulting in a loss on disposal of capital assets on the Statement of Activities .....		(7,341)
--	--	---------

Debt proceeds provide current financial resources to governmental funds, but issuing debt increases long- term liabilities in the Statement of Net Assets. In the current period, these amounts are: Bonds and Notes Payable.....		(3,045,000)
--	--	-------------

Repayment of debt proceeds principal is expenditure in the governmental funds, but the repayment reduces Long-Term Liabilities in the Statement of Net Assets. In the current year the repayments were. ....		1,330,000
--	--	-----------

Repayment of long-term principal is expenditure in the governmental funds, but the repayment reduces Long-Term Liabilities in the Statement of Net Assets. In the current year, the repayments were:		
Property Tax Debt – Law 42.....	20,949	
Property Tax Debt – Law 146.....	7,568	
Estimated Landfill Post-closure Care Cost.....	14,754	
Compensated absences .....	(9,123)	
Claims and Judgments.....	(3,335,000)	
LIMS Repayment Plan .....	<u>61,774</u>	
Total Additional Expenditures .....		<u>(3,239,078)</u>

**CHANGE IN NET ASSETS OF GOVERNMENTAL ACTIVITIES ..... \$ 2,943,299**

See accompanying Notes to Basic Financial Statements.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
STATEMENT OF NET ASSETS- PROPRIETARY FUND  
June 30, 2011

	<b>Business-type Activities</b>
<b>ASSETS:</b>	
<b>Current Assets:</b>	
Cash	\$ 111,135
Miscellaneous prepaid expenses	3,469
Total current assets	114,604
Restricted Assets:	
Restricted cash	491,290
Capital Assets:	
Land	58,350
Building and other depreciable assets, net of accumulated depreciation	1,329,442
Total capital assets	1,387,792
Other assets	17,554
<b>Total Assets</b>	<b>\$ 2,011,240</b>
<b>LIABILITIES:</b>	
Current Liabilities:	
Mortgage payable	\$ 93,987
Accounts payable- 30 days	15,868
Accrued liabilities	14,266
Tenant security deposits	13,224
Total current liabilities	137,345
Non-current liabilities:	
Mortgage payable	862,125
Total liabilities	999,470
<b>NET ASSETS</b>	
Invested in Capital Assets, Net of Related Debt	431,680
Restricted deposits	491,290
Unrestricted	88,800
Total net assets	1,011,770
<b>Total Liabilities and Net Assets</b>	<b>\$ 2,011,240</b>

See accompanying notes to basic financial statements

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
STATEMENT OF ACTIVITIES- PROPRIETARY FUND  
FOR THE FISCAL YEAR ENDED JUNE 30, 2011

	<b>Business-type Activities</b>
<b>REVENUES</b>	
Rent	\$ 616,893
Other	2,065
Total revenues	618,958
<b>EXPENSES</b>	
Administrative	150,675
Utilities	18,904
Operating and maintenance	152,793
Taxes and insurance	47,297
Depreciation	150,667
Total expenses	520,336
Operating income	98,622
<b>NON OPERATING REVENUES (EXPENSES)</b>	
Interest received	8,878
Interest on mortgage	(69,256)
Total non operating revenues (expenses)	(60,378)
<b>Net Change in Net Assets</b>	38,244
Net Assets, Beginning of Year, as restated	973,526
<b>NET ASSETS, END OF YEAR</b>	\$ 1,011,770

See accompanying notes to basic financial statements

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
STATEMENT OF CASH FLOWS- PROPRIETARY FUND  
FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

	<b>Business-type Activities</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>	
Cash received from tenants and HUD	\$ 619,649
Other cash received	2,065
	621,714
Administrative	(36,282)
Management fees	(48,960)
Salaries and wages	(117,318)
Utilities	(18,904)
Operating and maintenance	(97,743)
Miscellaneous taxes and insurance	(47,661)
	(366,868)
Net cash provided by operating activities	254,846
<b>CASH FLOW FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>	
Interest paid in capital debt	(69,862)
Mortgage principal payment	(90,861)
Purchase of capital assets	(35,258)
Net cash used in capital and related financing activities	(195,981)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>	
Deposits to reserve for replacement and interest retained in account	(34,916)
Interest on investment	8,878
Deposits to and interest earned and retained for insurance escrow	(24,636)
Withdrawal from insurance account	21,052
Net cash used in investing activities	(29,622)
Net increase in cash	29,243
Cash at beginning of year	81,892
Cash at end of year	\$ 111,135

Continue

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
STATEMENT OF CASH FLOWS – PROPRIETARY FUND  
FOR THE FISCAL YEAR ENDED JUNE 30, 2011  
(CONTINUED)

**RECONCILIATION OF OPERATING INCOME TO  
CASH FLOWS FROM OPERATING ACTIVITIES**

Operating income	\$ 98,622
Adjustment to reconcile change in net assets to net cash provided by operating activities:	
Depreciation	150,667
(Increase) decrease in:	
Receivables	1,480
Miscellaneous prepaid expenses	93
Tenant security deposits	(132)
Increase (decrease) in:	
Accounts payable- 30 days	5,718
Payroll	(1,734)
Tenant security deposits	132
	156,224
Net cash provided by operating activities	\$ 254,846

See accompanying notes to basic financial statements

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS**

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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The Municipality of San Sebastián, Puerto Rico (Municipality) is a local governmental with full legislative, fiscal and administrative power to operate as a governmental under Law No. 81 of August 30, 1991, as amended, known as the *Autonomous Municipality Act of the Commonwealth of Puerto Rico (Law No. 81)*.

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

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

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

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

In June 1999, GASB issued Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB No. 34). This statement established new financial reporting requirements for state and local governments. On July 1, 2003, the Municipality adopted the provisions of GASB No. 34 as well as other statements referred to below.

The accompanying basic financial statements present the financial position and the results of operations of the Municipality and its various funds and fund types. The basic financial statements are presented as of June 30, 2011, and for the fiscal year then ended. The more significant of these accounting policies are described below and, where appropriate, subsequent pronouncements will be referenced.

According to the financial reporting model established by GASB No. 34, the minimum required financial statement presentation applicable to the Municipality is composed of the following elements: (1) government-wide financial statements (GWFS), (2) governmental fund financial statements (GFFS), (3) notes to basic financial statements, and (4) required supplementary information (RSI).

The required supplementary information, which consists of a management discussion and analysis (MD&A), is information presented along with, but separate from, the Municipality's basic financial statements. The MD&A is a narrative report that introduces the accompanying basic financial statements and provides an analytical overview of the Municipality's financial activities for the year ended June 30, 2011, based on the Municipality's knowledge of the transactions, events and conditions reflected in the basic financial statements. The MD&A also highlights certain key fiscal policies that control the Municipality's operations.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

As previously mentioned, on July 1, 2003, other statements and interpretations were also adopted in conjunction and simultaneously with GASB No. 34. Those statements and interpretations are: (1) GASB Statement No. 33 – *Accounting and Financial Reporting for Nonexchange Transactions*, (2) GASB Statement No. 37 – *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments: Omnibus*, (3) GASB Statement No. 38 – *Certain Financial Statement Note Disclosures* and (4) GASB Interpretation No. 6 – *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*.

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

**A. FINANCIAL REPORTING ENTITY**

The accompanying basic financial statements include all departments and organizations units whose funds are under the custody and control of the Municipality. In evaluating the Municipality as a reporting entity, management has addressed all the potential component units. The decision to include any potential component unit in the reporting entity was made by applying the provisions of GASBS No. 14, *The Financial Reporting Entity*, as amended by GASB 39, *Determining Whether Certain Organizations are Component Units – an Amendment of GASB 14*.

The basic criteria for including a potential component unit within the reporting entity is if potential component units are financially accountable and other legally separate organizations for which the Municipality is not financially accountable but the nature and significance of their relationship with the Municipality may be such that exclusion of the financial statements from those of the Municipality would cause the accompanying basic financial statements to be misleading or incomplete. Accordingly, a legally separate organization would be reported as a component unit of the Municipality if all of the following criteria are met:

- The Mayor appoints a voting majority of an organization's governing body and, either (1) the Municipality has the ability to impose its will on that organization or (2) the organization has the potential to provide specific financial benefits to, or impose specific financial burdens on the Municipality.
- The economics resources, for which the Municipality is entitled, either received or held by the separate organization, are entirely or almost entirely for the direct benefit of the Municipality or its constituents.

The Municipality's management has concluded that based on the aforementioned criteria, there are no legally separate entities or organizations that should be reported as component units of the Municipality for the fiscal year ended June 30, 2011. Accordingly, these basic financial statements present only the Municipality as the reporting entity.

These financial statements present the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality, as of June 30, 2011, and the respective changes in financial position, where applicable, thereof for the fiscal year then ended.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**B. MEASUREMENT FOCUS AND BASIS OF ACCOUNTING**

**GOVERNMENT-WIDE FINANCIAL STATEMENTS**

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

**GOVERNMENTAL FUND FINANCIAL STATEMENTS**

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

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

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

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

Expenditures are generally recorded when a liability is incurred, as under accrual accounting. Modifications to the accrual basis of accounting include the following:

- ❖ Employee's vested annual vacation and sick leave is recorded as expenditure when utilized. The amount of accumulated annual vacation and sick leave unpaid at June 30, 2011, has been reported only in the government-wide financial statements.

**C. FINANCIAL STATEMENT PRESENTATION**

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

C. FINANCIAL STATEMENT PRESENTATION (CONTINUED)

GOVERNMENT-WIDE FINANCIAL STATEMENTS

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

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

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

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

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

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

GOVERNMENTAL FUND FINANCIAL STATEMENTS

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

C. FINANCIAL STATEMENT PRESENTATION (CONTINUED)

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

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

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

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

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

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

**Head Start Fund** – This is the fund used to account for all transactions of the Head Start Program. The objectives of this program are to provide comprehensive health, educational, nutritional, social and other developmental services primarily to economically disadvantaged pre-school children and infants and toddlers so that the children will attain school readiness.

**Debt Service Fund** – This is the fund used to account for the accumulation of resources for and the payment of, general long-term debt principal, interest, and related costs.

**State Assignment Fund** – This is the fund used to account for all the transactions of the State Assignments by Legislature Resolutions. The primarily objectives of this assignment is the development of construction projects on communities.

**Loans Fund** – This is the fund used to account for all financial resources and transactions related to the loans for construction purposes and capital outlays of the Municipality, which is financed by loans from the Government Development Bank of Puerto Rico.

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

D. FINANCIAL REPORTING PRESENTATION

The accounts of the Municipality are organized on the basis of funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues, and expenditures. Fund types are as follows:

**General Fund** – Is the general operating fund of the Municipality. It is used to account for all governmental activity, except those required to be accounted for in another fund.

**Special Revenue Fund**– This is the fund used to account for revenues derived from local funds, state grants or other restricted revenue sources. The uses and limitations of each special revenue fund are specified by Municipality ordinances or state statutes.

**Debt Service Fund** – This is the fund used to account for the accumulation of resources for and the payment of, general long-term debt principal, interest, and related costs.

**Capital Projects Fund** – This is the fund used to account for financial resources used for the acquisition or construction of major capital facilities. The uses and limitations of each capital projects fund are specified by Municipality ordinances or state statutes.

E. FUND BALANCES

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

Pursuant to the provisions of GASB 54, the fund balances amounts are reported as non-spendable, restricted, committed, assigned and unassigned, based on the relative strength of the constraints that control how specific amounts can be spent, as described as follows:

- ❖ **Non-spendable** – Represent resources that cannot be spent readily with cash or are legally or contractually required not to be spent, including but not limited to inventories, prepaid items, long-term balances of loans and notes receivable.
- ❖ **Restricted** – Represent resources that can be spent only for the specific purposes stipulated by constitutional provisions, external resource providers (externally imposed by creditors or grantors), or through enabling legislation (that is, legislation that creates a new revenue source and restricts its use). Effectively, restrictions may be changed or lifted only with the consent of resource providers.
- ❖ **Committed** – Represent resources used for specific purposes, imposed by formal action of the entity's highest level of decision making authority (Municipal Legislature through resolutions and ordinances) and can only be changed by similar law, ordinance or resolution, no later than the end of the fiscal year.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

E. FUND BALANCES (CONTINUED)

- ❖ **Assigned** – Represent resources intended to be used by the Municipality for specific purposes but do not meet the criteria to be classified as restricted or committed (generally executive orders approved by the Mayor). Intent can be expressed by the Municipal Legislature, the Mayor or by an official or body to which the Municipal Legislature delegates authority in conformity with Autonomous Municipalities Act of Puerto Rico, as amended. In governmental funds other than the general fund, assigned fund balance represents the remaining amount that is not restricted or committed.
- ❖ **Unassigned** – Represent the residual classification for the Municipality's general fund and includes all spendable amounts not contained in the other classifications. In other funds, the unassigned classification is used only to report a deficit balance resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned.

At June 30, 2011, the accompanying fund financial statements reported fund balances as restricted, assigned and unassigned.

F. BUDGETARY DATA

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

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

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

1. Prior of May 31 of each fiscal year, the Mayor submits to the Municipal Legislature a proposed budget for the fiscal year commencing the following July 1 in addition of a budget message;

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

F. BUDGETARY DATA (CONTINUED)

2. The budget document is available for public inspection prior to its approval by the Municipal Legislature;
3. The Commissioner of Municipal Affairs examines the budget to verify if it complied with the law's standards and sends it to the Mayor for any comments or recommendation before the limited date establishes by the Law;
4. Prior to June 13, the annual budget is legally enacted through passage of the annual appropriation ordinance;
5. If a budget is not adopted prior to the end of the end of the fiscal year, the annual budget for the preceding fiscal year, as approved by the Municipal Legislature and the Mayor, is automatically renewed for the ensuing fiscal year until a new budget is approved. This permits the Municipality to continue making payments for its operating and other expenses until the new budget is approved;
6. Subsequent to the enactment of the annual appropriation ordinance, the Municipal Legislature has the authority to make necessary amendments made during the fiscal year and are reflected in the budget information included in the Budgetary Comparison Schedule – General Fund;
7. Budgetary data for the Special Revenue Fund has not been presented in the accompanying basic financial statements as such funds are budgeted over the life of the respective grant or project and not on an annual basis.

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

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

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

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

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**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**F. BUDGETARY DATA (CONTINUED)**

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

**G. CASH, CASH EQUIVALENT AND INVESTMENT**

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

Under the laws and regulations of the Commonwealth, public funds deposited by the Municipality in commercial banks must be fully collateralized for the amounts deposited in excess of the federal depository insurance generally provided by the Federal Deposit Insurance Corporation (FDIC). All securities pledged as collateral are held by agents designated by the Commonwealth's Secretary of the Treasury, but not in the Municipality's name.

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

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

**H. RECEIVABLES**

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

**I. INVENTORIES**

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

J. CAPITAL ASSETS

Property, plant and equipment purchased or acquired is carried at historical cost or estimated historical cost. Contributed assets are recorded at fair market value as of the date received. Other costs incurred for repairs and maintenance is expensed as incurred.

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

Capital Assets	Years
Buildings and building improvements	20-50
Infrastructure	25-50
Vehicles and equipment	5-20
Furniture and fixtures	5-10

K. LONG-TERM OBLIGATIONS

The liabilities reported in the government-wide financial statements included general and special obligation bonds and notes, and other long-term liabilities, such as vacation, sick leave, litigation, long-term liabilities to other governmental entities.

In the fund financial statements, governmental fund types recognize bond issuances cost, during the current period. The face amount of debt issued is reported as other financing sources, while bond issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures.

L. COMPENSATED ABSENCES

The Municipality accrues accumulated unpaid vacation and sick leave and associated employee-related costs when earned (or estimated to be earned) by the employee. The Municipality's employees are granted 30 days of vacations and 18 days of sick leave annually. Vacations may be accumulated up to a maximum of sixty (60) days and sick leave up to a maximum of ninety (90) days. In the event of employee resignation, the employee is paid for accumulated vacation days up to the maximum allowed. Separation from employment prior to use of all or part of the sick leave terminates all rights for compensation, except for employees with ten years of service who are entitled to sick leave pay up to the maximum allowed. The Municipality accrued a liability for compensated absences, which meet the following criteria:

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**L. COMPENSATED ABSENCES (CONTINUED)**

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

The following is a summary of changes in the balance of Compensated Absences for the fiscal year ended June 30, 2011.

<u>BALANCE</u> <u>JULY 1, 2010</u>	<u>NEW ISSUES</u>	<u>RETIREMENTS</u> <u>AND CURRENT</u> <u>MATURATES</u>	<u>BALANCE</u> <u>JUNE 30, 2011</u>	<u>CURRENT</u> <u>PORTION</u>	<u>LONG-TERM</u> <u>PORTION</u>
\$ 2,621,529	\$ 186,146	\$ 177,023	\$ 2,630,652	\$ 360,167	\$ 2,270,485

**M. INSURANCE**

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

**N. INTERFUND TRANSACTIONS**

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

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**O. CLAIMS AND JUDGMENTS**

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

**P. USE OF ESTIMATES**

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

**Q. ACCOUNTING FOR PENSION COSTS**

For the purpose of applying the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers* (GASB No. 27), amended by GASB Statement No. 50, *Pension Disclosures*. The Municipality accounts for pension costs from the standpoint of a participant in a multiple-employer cost-sharing plan. Accordingly pension costs recognized in the accompanying basic financial statements are equal to the statutorily required contributions, with a liability recorded for any unpaid required contributions. The state government of the Commonwealth of Puerto Rico is considered to be the sponsor of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS) and System 2000, a multi-employer cost-sharing defined benefit pension plan and a hybrid defined contribution plan, respectively, in which the employees of the Municipality participate. The Municipality is considered a participant and not a sponsor, of these retirement systems since the majority of the participants in the aforementioned pension trust funds are employees of the Commonwealth of Puerto Rico and the basic financial statements of such retirement systems are part of the financial reporting entity of the Commonwealth of Puerto Rico. Accordingly, no portion of the net pension obligation (NPO) related to ERS has been allocated to the Municipality in the accompanying basic financial statements. The basic financial statements of the Commonwealth of Puerto Rico report the total amount of the net pension obligation of ERS, including any amount that may correspond to the Municipality.

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

**R. RISK FINANCING**

The Municipality carries commercial 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 ("CRIM") for the year ended June 30, 2011 amounted to \$375,706. The current insurance policies have not been cancelled or terminated. The CRIM also deducted \$307,183 for workers compensation insurance covering all municipal employees.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

S. FUTURE ADOPTION OF ACCOUNTING PRONOUNCEMENTS

The GASB has issued the following accounting standards that have effective dates after June 30, 2011:

- ❖ GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. This Statement is effective for periods beginning after June 30, 2012;
- ❖ GASB Statement No. 59, *Financial Instruments Omnibus*. This statement is effective for periods beginning after June 30, 2011;
- ❖ GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. This statement is effective for periods beginning after December 31, 2012;
- ❖ GASB Statement No. 61, *The Financial Reporting Entity: Omnibus- an amendment of GASB Statements No. 14 and No. 34*. This statement is effective for periods beginning after June 30, 2013;
- ❖ GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre- November 30, 1989 FASB and AICPA Pronouncements*. This statement is effective for periods beginning after December 31, 2012;
- ❖ GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*. This statement is effective for periods beginning after December 31, 2012;
- ❖ GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions (an amendment of GASB Statement No. 53)*. This statement is effective for periods beginning after June 30, 2013;

The Authority's management has concluded that the future adoption of these GASB Statements will not have a significant impact on the Authority's basic financial statements.

NOTE 2 – CASH AND CASH EQUIVALENTS

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

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 2 – CASH AND CASH EQUIVALENTS (CONTINUED)

**Credit risk** – This is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. In compliance with the laws and regulations of the Commonwealth, the Municipality has adopted, as its custodial and credit risk policy, the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico*. Accordingly the Municipality invests only in obligations of the Commonwealth, obligations of the United States of America, certificates of deposits, commercial paper, bankers' acceptances, or in pools of obligations of the municipalities of Puerto Rico, which are managed by GDB. According to the aforementioned investment guidelines, the Municipality does not invest in marketable securities or any types of investments for which credit risk exposure may be significant. Therefore, the Municipality's management has concluded that the risk related to any possible loss related to defaults by commercial banks on the Municipality's deposits is considered low at June 30, 2011.

**Interest rate risk** – This is the risk that changes in interest rates of debt investments will adversely affect the fair value of an investment. The Municipality manages its exposure to declines in fair values by: (1) not including debt investments in its investment portfolio at June 30, 2011, (2) limiting the weighted average maturity of its investments to three months or less, and (3) keeping most of its bank deposits in interests bearing accounts generating interests at prevailing market rates. At June 30, 2011, the Municipality's investments in certificates of deposits are recorded at cost, which approximates their fair value. Therefore, the Municipality's management has concluded that at June 30, 2011, the interest rate risk associated with the Municipality's cash and cash equivalents is considered low.

**Custodial credit risk** – In the case of deposits, this is the risk that in the event of a bank failure, the Municipality's deposits may not be recovered. Pursuant to the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico* the balances deposited in commercial banks by the Municipality are insured by the Federal Deposit Insurance Corporation (FDIC) generally up to a maximum of \$250,000 per depositor. In addition, public funds deposited in commercial banks by the Municipality are fully securities pledged as collateral are held, in the Municipality's name, by the agents of the Commonwealth's Secretary of Treasury. Deposits with GDB are uninsured and uncollateralized. However, no losses related to defaults by GDB on deposit transactions have been incurred by the Municipality through June 30, 2011. Therefore, the Municipality's management has concluded that at June 30, 2011 the custodial credit risk associated with the Municipality's cash and cash equivalents is considered low.

**Foreign exchange risk** – The risk that changes in exchange rates will adversely affect the value of an investment or a deposit. According to the aforementioned investment guidelines, the Municipality is prevented from investing in foreign securities or any other types of investments in which foreign exchange risk exposure may be significant. Accordingly, management has concluded that the foreign exchange risk related to the Municipality's deposits is considered low at June 30, 2011.

The Municipality's bank balances in commercial banks of \$4,890,948 in the General Fund, \$13,500 in the Head Start Fund, \$2,500,000 in the State Assignment Fund and \$3,049,691 in other governmental funds, were fully collateralized at June 30, 2011. The deposits at GDB of \$3,491,679 in the Debt Service Fund, \$5,405,523 in Loans Fund and \$199,965 in other governmental funds are unsecured and uncollateralized, as no collateral is required to be carried by governmental banks.

NOTE 3 – RECEIVABLES

A. SALES AND USE TAXES RECEIVABLES

As described below in Note 15, the Municipal Legislature approved the imposition of the municipal sales and use tax during fiscal year 2006-2007. Individuals, organizations and entities subject to collect the municipal sales and use tax must file a tax return to the Municipality. Tax is due each 20<sup>th</sup> day of each month based on tax collected in the preceding month. Therefore, sales tax receivable of \$173,720 in the governmental funds represents the amount due by the taxpayers at June 30, 2011.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

NOTE 3 – RECEIVABLES

B. PROPERTY TAXES RECEIVABLES

Property taxes receivable in the other governmental funds represents debt service fund's advances from fiscal year 2010-2011, not collected by the Municipality at June 30, 2011. Following is a detail of the property taxes receivable:

<u>Governmental Entity</u>	<u>Amount</u>
Municipal Revenue Collection Center (CRIM)	\$ 20,972
<b>Total</b>	<b>\$ 20,972</b>

C. INTERGOVERNMENTAL RECEIVABLES

State government receivable in the other governmental funds represents expenditures incurred, not yet reimbursed by the state agencies. Following is a detail of the state government receivable:

<u>Description</u>	<u>Amount</u>
State Department of Labor- Law 52	\$ 28,053
<b>Total</b>	<b>\$ 28,053</b>

D. FEDERAL GRANTS RECEIVABLE

Federal grants receivable in the governmental funds represent expenditures incurred, not yet reimbursed by the federal agencies or the pass-through grantors. Following is a detail of the federal grants receivable:

<u>Description</u>	<u>Amount</u>
Head Start	\$ 37,676
Public & Indian Housing	17,665
Community Development Block Grant	248,461
Homeland Security	55,235
Child Care Food Program	8,773
Homelessness Prevention and Rapid Re-housing Program	5,032
Others	11,428
<b>Total</b>	<b>\$ 384,270</b>

E. OTHERS ACCOUNTS RECEIVABLE

At June 30, 2011, the Municipality maintained an account receivable in the General Fund from the Puerto Rico Electric Power Authority of \$7,082 and other miscellaneous receivables amounting to \$2,632. In addition, the Head Start Fund and the other governmental funds maintained miscellaneous receivables amounting to \$808 and \$2,205, respectively.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 4 – DUE FROM / TO OTHER FUNDS**

Interfund receivables and payables at June 30, 2011 are summarized as follows:

Receivable Fund	Payable Fund	Purpose	Amount
General Fund	Head Start Fund	Payroll and related accruals paid and not reimbursed	\$ 4,231
General Fund	Loans Fund	Payroll and related accruals paid and not reimbursed	750
General Fund	Other Governmental Funds	Payroll and related accruals paid and not reimbursed	396,965
Other Governmental Funds	General Fund	Cash pool in the same bank account	<u>246,392</u>
<b>Total</b>			<b><u>\$ 648,338</u></b>

**NOTE 5 – CAPITAL ASSETS**

A summary of capital assets and changes occurring in 2011 for the Municipality was as follows:

Governmental Activities	Balance July 1, 2010 (as restated)	Additions	Retirements / Reclassifications	Balance June 30, 2011
Capital asset, not being depreciated:				
Land	\$ 5,737,776	\$ -	\$ -	\$ 5,737,776
Construction in progress	<u>2,030,906</u>	<u>2,286,600</u>	<u>(616,840)</u>	<u>3,700,666</u>
<b>Total capital assets not being depreciated</b>	<u>7,768,682</u>	<u>2,286,600</u>	<u>(616,840)</u>	<u>9,438,442</u>
Capital assets, being depreciated:				
Buildings and building improvements	35,678,823	752,460	-	36,431,283
Furniture and fixtures	2,624,592	230,906	(94,550)	2,760,948
Vehicles and equipment	5,458,664	1,011,005	-	6,469,669
Infrastructure	<u>12,166,055</u>	<u>893,533</u>	-	<u>13,059,588</u>
<b>Total capital assets being depreciated</b>	<u>55,928,134</u>	<u>2,887,904</u>	<u>(94,550)</u>	<u>58,721,488</u>
Less accumulated depreciation for:				
Buildings and building improvements	(7,595,904)	(910,766)	-	(8,506,670)
Furniture and fixtures	(1,938,897)	(322,349)	87,210	(2,174,036)
Vehicles and equipment	(4,919,767)	(398,886)	-	(5,318,653)
Infrastructure	<u>(1,068,529)</u>	<u>(261,192)</u>	-	<u>(1,329,721)</u>
<b>Total accumulated depreciation</b>	<u>(15,523,097)</u>	<u>(1,893,193)</u>	<u>87,210</u>	<u>(17,329,080)</u>
<b>Total capital assets being depreciated, net</b>	<u>40,405,037</u>	<u>994,711</u>	<u>(7,340)</u>	<u>41,392,408</u>
<b>Governmental activities capital assets, net</b>	<b><u>\$ 48,173,719</u></b>	<b><u>\$ 3,281,311</u></b>	<b><u>\$ (624,180)</u></b>	<b><u>\$ 50,830,850</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 5 – CAPITAL ASSETS (CONTINUED)**

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

<u>Governmental activities</u>	<u>Amount</u>
General government	\$ 204,326
Public Safety	145,466
Public Works	615,921
Culture	211,456
Recreation	518,291
Health and Welfare	<u>197,733</u>
<b>Total depreciation expenses</b>	<b><u>\$ 1,893,193</u></b>

A summary of capital assets and changes occurring in 2011 for Villa Soigal Project was as follows:

<u>Business-type Activities</u>	<u>Balance July 1, 2010</u>	<u>Additions</u>	<u>Retirements / Reclassifications</u>	<u>Balance June 30, 2011</u>
Capital asset, not being depreciated:				
Land	\$ 58,350	\$ -	\$ -	\$ 58,350
<b>Total capital assets not being depreciated</b>	<u>58,350</u>	<u>-</u>	<u>-</u>	<u>58,350</u>
Capital assets, being depreciated:				
Land improvements	739,624	-	-	739,624
Building and building improvements	3,655,372	-	-	3,655,372
Building equipment	461,980	34,891	-	496,871
Furniture and fixtures	33,584	-	-	33,584
Equipment	<u>12,333</u>	<u>370</u>	<u>-</u>	<u>12,703</u>
<b>Total capital assets being depreciated</b>	<u>4,902,893</u>	<u>35,261</u>	<u>-</u>	<u>4,938,154</u>
Less accumulated depreciation for:				
Land improvements	(523,901)	(18,490)	-	(542,391)
Building and building improvements	(2,682,722)	(141,747)	-	(2,824,469)
Building equipment	(208,152)	-	10,404	(197,748)
Furniture and fixtures	(32,395)	(295)	-	(32,690)
Equipment	<u>(10,872)</u>	<u>(542)</u>	<u>-</u>	<u>(11,414)</u>
<b>Total accumulated depreciation</b>	<u>(3,458,042)</u>	<u>(161,074)</u>	<u>10,404</u>	<u>(3,608,712)</u>
<b>Total capital assets being depreciated, net</b>	<u>1,444,851</u>	<u>(125,813)</u>	<u>10,404</u>	<u>1,329,442</u>
<b>Governmental activities capital assets, net</b>	<b><u>\$ 1,503,201</u></b>	<b><u>\$ (125,813)</u></b>	<b><u>\$ 10,404</u></b>	<b><u>\$ 1,387,792</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 6 – ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

Accounts payable and accrued liabilities in governmental fund financial statements represent expenditures incurred during fiscal year 2010-2011, and not paid by the Municipality at June 30, 2011. Following is a detail of these accounts payable and accrued liabilities by major fund:

<b>Major Governmental Funds</b>	<b>Accounts Payable</b>	<b>Accrued Liabilities</b>	<b>Total</b>
General Fund	\$ 242,172	\$ 113,315	\$ 355,487
Head Start Fund	47,753	-	47,753
Loans Fund	62,460	-	62,460
Other Governmental Funds	<u>675,583</u>	-	<u>675,583</u>
<b>Total</b>	<b><u>\$ 1,027,968</u></b>	<b><u>\$ 113,315</u></b>	<b><u>\$ 1,141,283</u></b>

**NOTE 7 – BONDS AND NOTES PAYABLE**

As described below in Note 10, the Municipality issues general and special obligation bonds and notes, principally, to provide funds for the acquisition and construction of major capital facilities, to pay debt incurred in prior years, and to cover the expenditures of a special event. At June 30, 2011, the government-wide and fund financial statements presented the following accounts payable, regarding to the outstanding balance of these bonds and notes:

<b>Description</b>	<b>Amount</b>
Principal	\$ 940,000
Accrued interests	<u>425,729</u>
<b>Total</b>	<b><u>\$ 1,365,729</u></b>

**NOTE 8 – DUE TO OTHER GOVERNMENTAL UNITS**

As of June 30, 2011, balance due to other governmental units consists of the following:

<b>Governmental Agency</b>	<b>Amount</b>
Puerto Rico Electric Power Authority	\$ 7,081
General Service Administration	2,514
Puerto Rico Water and Sewer Authority	79,668
Municipal Revenue Collection Center	53,255
Retirement System Administration	74,199
Retirement System Administration- Special Laws	1,463,746
Puerto Rico Department of Treasury	3,614
Puerto Rico Department of Labor	4,694
Internal Revenue Service	<u>45,054</u>
<b>Total</b>	<b><u>\$ 1,733,825</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 9 – DEFERRED REVENUES**

- A. Municipal license taxes** – The deferred revenues of \$1,371,655 in the General Fund relates to volume of business tax collected in fiscal year 2010-2011 that will be earned in fiscal year 2011-2012.
- B. Federal Grants** – The deferred revenues presented in the other governmental funds represents the portion of federal grants received for which qualifying expenditures have not been incurred. Deferred revenues from the federal government are as follows:

Program Description	Amount
Child & Adult Care Food Program	\$ 73,086
Child Care Development Block Grant	89,551
Child Care (CRREET)	23,055
Others	<u>126</u>
<b>Total</b>	<b><u>\$ 185,818</u></b>

- C. Others** – The deferred revenues of \$310,350 in the General Fund is composed of \$295,924 and \$14,426 from the municipal license taxes and rent, respectively.

**NOTE 10 – GENERAL LONG-TERM DEBTS**

Long-term liability activity for the year ended on June 30, 2011, was as follows:

**Governmental Activities**

Description	Beginning Balance (as restated)	Borrowings or Additions	Payments or Deductions	Ending Balance	Due Within One Year
Bonds and Notes Payable	\$ 17,557,000	\$ 3,045,000	\$ (1,330,000)	\$ 19,272,000	\$ 1,440,000
Property Tax Debt – Law 42	980,046	-	(20,948)	959,098	22,264
Property Tax Debt – Law 146	166,489	-	(7,568)	158,921	7,568
LIMS Repayment Plan	94,046	-	(61,774)	32,272	32,272
Estimated landfill post-closure care cost	261,344	-	(14,754)	246,590	15,492
Compensated absences	2,621,529	186,146	(177,023)	2,630,652	360,167
Claims and Judgments	265,000	3,600,000	(265,000)	3,600,000	-
Health Insurance Administration	<u>256,266</u>	-	-	<u>256,266</u>	-
<b>Total</b>	<b><u>\$ 22,201,720</u></b>	<b><u>\$ 6,831,146</u></b>	<b><u>\$ (1,877,067)</u></b>	<b><u>\$ 27,155,799</u></b>	<b><u>\$ 1,877,763</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 10 – GENERAL LONG-TERM DEBTS (CONTINUED)**

**Business-type Activities**

Description	Beginning Balance	Borrowings or Additions	Payments or Deductions	Ending Balance	Due Within One Year
<b><u>Business-type Activities</u></b>					
Villa Soigal Project Mortgage	\$ 1,046,973	\$ -	\$ (90,861)	\$ 956,112	\$ 93,987
<b>Total</b>	<b>\$ 1,046,973</b>	<b>\$ -</b>	<b>\$ (90,861)</b>	<b>\$ 956,112</b>	<b>\$ 93,987</b>

**A. GENERAL OBLIGATIONS BONDS AND NOTES PAYABLE**

The Municipality issues general and special obligation bonds and notes, principally, to provide funds for the acquisition and construction of major capital facilities, to pay debt incurred in prior years, and to cover the expenditures of a special event. Bonds and notes payables as of June 30, 2011, are comprised of the following individual issues:

DESCRIPTION	AMOUNT
\$3,420,000, Series 1996, for construction purposes, payable in annual installments ranging from \$70,000 to \$315,000, excluding variable interest from 4.70% to 6.58%, through January 1, 2016	\$ 1,360,000
\$1,010,000, Series 1996, for construction purposes, payable in annual installments ranging from \$20,000 to \$95,000, excluding variable interest from 4.70 to 6.58%, through January 1, 2015	340,000
\$1,800,000, Series 1997, for construction purposes, payable in installments ranging from \$20,000 to \$165,000, excluding variable interest from 4.87% to 6.56%, through July 1, 2021	1,190,000
\$1,510,000, Series 2001, for construction purposes, payable in annual installments ranging from \$20,000 to \$135,000, excluding variable interest from 2.70% to 5.60%, through July 1, 2026	1,210,000
\$1,110,000, Series 2005, for construction purposes, payable in annual installments ranging from \$50,000 to \$105,000, excluding variable interest from 3.28% to 4.80%, through January 1, 2019	690,000
\$1,150,000, Series 2007, for construction purposes, payable in annual installments ranging from \$20,000 to \$95,000, excluding variable interest from 1.53% to 7.00%, through July 1, 2031	1,045,000
\$485,000, Series 2007, for construction purposes, payable in annual installments ranging from \$30,000 to \$65,000, excluding variable interest from 1.53% to 7.00%, through July 1, 2016	285,000
\$670,000, Series 2007, for construction purposes, payable in annual installments ranging from \$75,000 to \$120,000, excluding variable interest from 1.53% to 6.00%, through July 1, 2013	230,000
\$2,810,000, Series 2005, for operational purposes, payable in annual installments ranging from \$225,000 to \$345,000, excluding variable interest from 4.50% to 5.00%, through July 1, 2014	990,000

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**A. GENERAL OBLIGATIONS BONDS AND NOTES PAYABLE (CONTINUED)**

DESCRIPTION	AMOUNT
\$967,000, Series 2008, for operational purposes, payable in annual installments ranging from \$80,000 to \$ 142,000, excluding variable interest from 1.43% to 6.00%, through July 1, 2017	712,000
\$3,445,000, Series 2008, for construction purposes, payable in annual installments ranging from \$50,000 to \$295,000, excluding variable interest from 1.53% to 7.50%, through July 1, 2032	3,280,000
\$660,000, Series 2010, for construction purposes, payable in annual installments ranging from \$75,000 to \$120,000, excluding variable interest from 6.00% to 7.00%, through July 1, 2016	505,000
\$990,000, Series 2010, for construction purposes, payable in annual installments ranging from \$10,000 to \$80,000, excluding variable interest from 6.00 to 7.00%, through July 1, 2034	965,000
\$1,510,000, Series 2010, for construction purposes, payable in annual installments ranging from \$20,000 to \$130,000, excluding variable interest from 6.00% to 7.50%, through July 1, 2034	1,465,000
\$605,000, Series 2010, for construction purposes, payable in annual installments ranging from \$5,000 to \$50,000, excluding variable interest from 6.00% to 7.50%, through July 1, 2034	590,000
\$1,510,000, Series 2010, for construction purposes, payable in annual installments ranging from \$25,000 to \$120,000, excluding variable interest from 4.75% to 6.75%, through July 1, 2034	1,460,000
\$2,770,000, Series 2011, for construction purposes, payable in annual installments ranging from \$60,000 to \$255,000, excluding variable interest from 6.00% to 7.50%, through July 1, 2030	2,710,000
\$275,000, Series 2011, for operational purposes, payable in annual installments ranging from \$30,000 to \$50,000, excluding variable interest from 6.00 to 7.50%, through July 1, 2017	<u>245,000</u>
<b>Total General Obligations</b>	<b><u>\$ 19,272,000</u></b>

These bonds and notes are payable with the following Municipality's resources:

- ❖ Special ad valorem property tax, which is restricted for debt service and retained by the Government Development Bank for Puerto Rico for such purposes;
- ❖ Municipal sales taxes resources restricted for debt service, and;
- ❖ Operational resources.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 10 – GENERAL LONG-TERM DEBTS (CONTINUED)**

**A. GENERAL OBLIGATIONS BONDS AND NOTES PAYABLE (CONTINUED)**

The annual requirements to amortize the general obligations bonds outstanding as of June 30, 2011 are as follows:

Year Ending June 30,	Principal payment	Interest payment	Total
2012	\$ 1,440,000	\$ 1,096,695	\$ 2,536,695
2013	1,540,000	1,131,672	2,671,672
2014	1,510,000	1,044,814	2,554,814
2015	1,260,000	980,205	2,240,205
2016	1,270,000	899,523	2,169,523
2017-2021	3,602,000	3,675,297	7,277,297
2022-2026	3,435,000	2,614,982	6,049,982
2027-2031	3,865,000	1,293,064	5,158,064
2032-2036	1,350,000	180,813	1,530,813
<b>Total</b>	<b><u>\$ 19,272,000</u></b>	<b><u>\$ 12,917,065</u></b>	<b><u>\$ 32,189,065</u></b>

The mortgage payable by the Business-type Activities 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.

Annual requirements to maturity of the mortgage are as follows:

Year Ending June 30,	Principal payment	Interest payment	Total
2012	\$ 93,987	\$ 64,443	\$ 158,430
2013	100,781	57,649	158,430
2014	108,067	50,364	158,431
2015	115,878	42,551	158,429
2016	124,256	34,174	158,430
2017-2019	413,143	45,984	459,127
<b>Total</b>	<b><u>\$ 956,112</u></b>	<b><u>\$ 295,165</u></b>	<b><u>\$ 1,251,277</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 10 – GENERAL LONG-TERM DEBTS (CONTINUED)**

**B. PROPERTY TAX DEBTS – LAW 42**

On January 26, 2000, Act No. 42 was enacted to authorize the CRIM to enter into a financing agreement of up to \$200 million, for a term not exceeding 30 years. The financing agreement allows for the financing of a debt that the municipalities of Puerto Rico have with the CRIM, arising from the final settlements of property tax advances versus actual collections through fiscal year 2000. The amounts that the municipalities will collect from the additional property taxes resulting from the increases in the subsidy from the Commonwealth to the municipalities are assigned through this law to repay such loan. The increase in this subsidy was the result of the Public Law No. 238 of August 15, 1999.

In addition, on February 12, 2003, the Municipality entered into a repayment agreement with the Government Development Bank for Puerto Rico (GDB) and the CRIM, to pay off the excess of property tax advances through fiscal year 2000 and 2001. The CRIM retains the payment from the property tax advances of the Municipality. The amounts retained by the CRIM are remitted to GDB on July 1 of each year through July 1, 2032. The outstanding balance of the note payable to the CRIM at June 30, 2011 amounted to \$959,098.

**C. PROPERTY TAX DEBT – LAW 146**

On September 24, 2002, the CRIM, on behalf of the municipalities of Puerto Rico, entered into a financing agreement with GDB pursuant to the provisions of Law No. 146 of October 11, 2001. The purpose of this financing agreement was to extinguish in advance certain bonds payable issued by the Public Finance Corporation, a subsidiary of the GDB, which were originally issued to pay certain property tax receivables owned by the municipalities of Puerto Rico through 1996. The outstanding balance of the note payable to the CRIM at June 30, 2011 amounted to \$158,921.

**D. PROPERTY TAX DEBTS – LIMS REPAYMENT PLAN**

The Municipality entered into a financing agreement with the CRIM for the payment of the Municipality's share of the cost of an information management system, acquired by the CRIM on behalf of all municipalities, for the management of a digital database of taxpayer's properties located in Puerto Rico. The outstanding balance of the note payable to the CRIM at June 30, 2011 amounted to \$32,272.

The annual requirements to amortize the property tax debts outstanding as of June 30, 2011 are as follows:

Year Ending June 30,	Principal payment	Interest payment	Total
2012	\$ 62,104	\$ 69,850	\$ 131,954
2013	31,230	67,020	98,250
2014	32,717	65,063	97,780
2015	34,297	63,012	97,309
2016	35,977	60,862	96,839
2017-2021	209,011	267,886	476,897
2022-2026	269,983	195,147	465,130
2027-2031	352,672	100,690	453,362
2032-2035	<u>122,300</u>	<u>7,407</u>	<u>129,707</u>
<b>Total</b>	<b><u>\$ 1,150,291</u></b>	<b><u>\$ 896,937</u></b>	<b><u>\$ 2,047,228</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

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**NOTE 10 – GENERAL LONG-TERM DEBTS (CONTINUED)**

**E. COMPENSATED ABSENCES**

The government-wide statement of net assets includes \$2,630,652 of accrued sick leave benefits, and accrued vacation benefits, representing the Municipality's commitment to fund such costs from future operations.

**F. CLAIMS AND JUDGMENTS**

Liabilities of \$3,600,000 reported in the statement of net assets represent the balance owed for claims and judgments at June 30, 2011, as described in Note 19.

**G. STATE INSURANCE HEALTH ADMINISTRATION**

Liabilities of \$256,266 reported in the statement of net assets represent the balance owed for services provided by the State Insurance Health Administration to the Municipality and not paid at June 30, 2011.

**NOTE 11 – LANDFILL POST-CLOSURE CARE COST OBLIGATION**

The Municipality owns a municipal solid waste landfill and adopted the required provisions of Statement No. 18, "Accounting for Municipal Solid Waste Landfill Post-Closure Care Costs", issued by the Governmental Accounting Standards Board (GASB No. 18) and the regulations set forth by the U.S. Environmental Protection Agency (EPA) in its "Solid Waste Disposal Facility Criteria", issued on October 9, 1991. State and federal laws and regulations require the Municipality to place a final cover on its landfill site when closed and perform certain maintenance and monitoring functions at the landfill site for 30 years after closure. Although post-closure care costs are paid only near or after the date that the landfill stops accepting waste, the Municipality reports a portion of these post-closure care costs as an operating expense in each period based on landfill capacity used as of each statement of net assets date. The Municipality discontinued its landfill operations and ceased to accept solid waste in January 1993. Post-closure care procedures were assumed by the Municipality and the closure process was completed in January 17, 1997.

The total estimated liability for post-closure care costs has been determined in \$246,590 as of June 30, 2011.

**NOTE 12 – DEBT RETIREMENT**

Revenues of the Debt Service Fund consist of the ad-valorem property taxes which are recognized as revenue when collected from taxpayers and reported by the Municipal Revenue Collection Center of the Commonwealth of Puerto Rico to the Municipality.

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

**NOTE 13 – PROPERTY TAXES**

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

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**NOTE 13 – PROPERTY TAXES (CONTINUED)**

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

The tax rate per annum is 9.08% for real property and 5.83% for personal property of which 1.03% of both belong to the Commonwealth of Puerto Rico and 8.05% and 4.80%, respectively, belongs to the Municipality. From the portion belonging to the Municipality, 6.00% and 3.00%, respectively, represents the Municipality's basic tax rate that is appropriated for general purposes and therefore accounted for through the General Fund.

The remaining portions 2.25% for real property and 2.00% for personal property represents the ad-valorem property taxes withheld by the Municipal Revenue Collection Center of the Commonwealth of Puerto Rico and restricted for debt service, which is accounted for through the Debt Service Fund (See Note 8). The Municipality has not reached the maximum statutory tax rate limit for the basic tax while there is no limitation for the ad-valorem tax rate.

The Commonwealth of Puerto Rico grants complete real property tax exoneration on the first \$15,000 assessed valuation on residential units occupied by their owners. However, the Municipality receives the full amount levied, except for residential units assessed at less than \$3,500 on which a complete exemption is granted. The Municipal Revenue Collection Center, instead of the property taxpayer, becomes the source of payment in these cases.

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

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

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

**NOTE 14 – MUNICIPAL LICENSE TAXES**

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

- ❖ 1.50% for financial institutions.
- ❖ 1.00% for savings and loan associations.
- ❖ 0.50% for other organizations over \$500,000.
- ❖ 0.40% for other organizations up to \$500,000.

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

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**NOTE 15 – SALES AND USE TAXES**

On July 4, 2006, the Legislature of the Commonwealth of Puerto Rico approved Act No. 117 ("Act 117") which amends the Puerto Rico Internal Revenue Code of 1994 to provide for a sales and use tax of 5.5% to be imposed by the Commonwealth Government. Act 117 also authorizes each municipality government to impose a municipal sales and use tax of 1.5%. This municipal sales and use tax has in general the same tax base and limitations (except for unprocessed foods) as those provided by the Commonwealth's sales and use tax.

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 Subtitle BB of the Code. The Municipal Sales Tax is specifically imposed overall sales transactions of taxable items and combined transactions (as defined by the municipal internal regulation) taken place within municipal limits. The Municipal 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.

The Municipal Legislature approved the imposition of the municipal sales and use tax during fiscal year 2006-2007. Individuals, organizations and entities subject to collect the municipal sales and use tax must file a tax return to the Municipality. Tax is due each 20<sup>th</sup> day of each month based on tax collected in the preceding month. Resources are recorded in the General Fund.

Also, on July 29, 2007, the Governor of Puerto Rico signed into Law an amendment of Act No. 117, H.B. 2193 known as Act No. 80. The most significant amendments were: first, to uniform the tax rate at 7% of which the municipalities will collect 1% and the Puerto Rico Treasury Department the other 6%, 05% of the 6% belongs to the municipality and it is distributed through three separate funds: Municipal Development Fund, Municipal Redemption Fund and Municipal Improvements Fund; secondly the establishment of a Local Commercial Rule and the elimination of source and nexus rules to impose the sale and use tax. These funds are administered by the Government Development Bank for Puerto Rico. Finally, the Law restricts the use of the funds by the municipalities to certain specific activities.

**NOTE 16 – INTERGOVERNMENTAL REVENUES**

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

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 17 – INTERFUND TRANSFERS**

Interfund transfers during the fiscal year ended at June 30, 2011, are summarized as follows:

<b>Transfer Out</b>	<b>Transfer In</b>	<b>Purpose</b>	<b>Amount</b>
General Fund	Debt Service Fund	Debt retirement	\$ 497,690
Head Start	General Fund	To cover prior year operational loans	19,342
Debt Service Fund	General Fund	To cover operating expenditures	1,400
Loans Fund	General Fund	To cover operating expenditures	241,252
Other Governmental Funds	General Fund	To cover operating expenditures	8,490
Other Governmental Funds	Other Governmental Funds	To cover operating expenditures	<u>257,608</u>
<b>Total</b>			<b><u>\$ 1,025,782</u></b>

**NOTE 18 – EMPLOYEE'S RETIREMENT PLAN**

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

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

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

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 18 – EMPLOYEE'S RETIREMENT PLAN (CONTINUED)**

Law Number 305 of September 24, 1999, amends the Act Number 447 that establish a savings program. All employees active in the system as of December 31, 1999 may elect to transfer from defined contribution programs to the new savings program (a defined contribution plan). Employees in the savings program may now contribute from a minimum of 8.275% up to a maximum of 10% of their monthly salary, and will be invested in an account which will either: (a) earn a fixed rate based on the two-year Constant Maturity Treasury Note or, (b) earn a rate equal to 75% of the return of the System's investment portfolio (net of management fees), or (c) earn a combination of both alternatives. If at time of retirement accumulated benefits amount to \$10,000 or less may elect to receive a lump sum distribution up to the accumulated benefits. Under the new program the retirement age is reduced from 65 to 60 for those employees who joined the current plan on or after April 1, 1990.

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

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

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

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

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

The amount of the total pension benefit obligation is based on a standardized measurement established by GASBS No. 27, *Financial Reporting for Defined Benefit Pension Plans and Notes Disclosure for Defined Contributions Plans*. The standardized measurement is the actuarial present value of estimated defined pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee services performed to date.

The measure is intended to help users assess the System's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among other public retirement systems. The measure is independent of the actuarial funding method used to determine contributions to the plan.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

**NOTE 18 – EMPLOYEE'S RETIREMENT PLAN (CONTINUED)**

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

Contributions in 2006 and prior years were made based on percentages established by the law. Such percentage has not been based on actuarial studies, as required by accounting principles generally accepted in the United States of America. An actuarial compilation of the annual contribution applicable to the Municipality has not been prepared. Accordingly, the accounts by which the actual contributions differ from the required actuarial contributions are not known.

The total pension expenditures recorded in the category of administration for the Fiscal Year Ended June 30, 2011 was approximately \$386,186. All employees who at the time of employment are 55 years old or less are eligible to participate in the System. No benefit is payable if the participant receives a refund of his accumulated contributions.

The historical trend information regarding the accumulation of assets and pension benefit obligation in the ERS is not available. For the ten-year trend information, refer to the separately issued financial statements of the ERS as of and for the fiscal year ended June 30, 2011. The P.R. Retirement Plan Administration provides additional information of the ERS. They issue a public available financial report that includes financial statements and required supplementary information for ERS, as a component unit of the Commonwealth of Puerto Rico. That report may be obtained by writing to the Administration at PO Box 42003, Minillas Station, San Juan, P.R. 00940.

**NOTE 19 – CONTINGENCIES**

**A. CLAIMS AND JUDGMENTS**

The Municipality is, at present, a defendant in a number of legal matters that arise from alleged improper application of policies and negligence in the ordinary course of the Municipality's activities. With respect to pending litigation, the Municipality has reported liabilities of \$3,600,000 in the government wide statement of net assets.

It is management's opinion, based on the advice of the legal counsel, that the potential claims against the Municipality not covered by insurance will materially affect the financial resources for its payment.

In addition, the Municipality is a defendant or co-defendant in several legal proceedings, which are in discovery stage. Certain of these claims are covered by insurance. Legal counsels with the information currently available cannot determine the final outcome of these proceeding. However, it has been the Municipality's experience that such actions are settled for amounts substantially less than the claim amounts.

**B. FEDERAL GRANTS**

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)**

**NOTE 20 – FUND BALANCE**

As of June 30, 2011, the fund balance is comprised of the following:

Fund Balance	General Fund	Head Start	Debt Service Fund	State Assignment Fund	Loans Fund	Other Governmental Fund	Total
<b>Restricted for:</b>							
General Government	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 246,391	\$ 246,391
Public Works and Sanitation	-	-	-	2,500,000	-	284,353	2,784,353
Recreation	-	-	-	-	-	286,857	286,857
Health and Welfare	-	-	-	-	-	159,119	159,119
Capital Outlays	-	-	-	-	5,342,313	1,523,704	6,866,017
Debt Service	-	-	2,193,469	-	-	-	2,193,469
<b>Assigned for:</b>							
General Government	235,285	-	-	-	-	-	235,285
Public Safety	6,872	-	-	-	-	-	6,872
Public Works and Sanitation	94,780	-	-	-	-	61,020	155,800
Culture	4,876	-	-	-	-	-	4,876
Recreation	1,860	-	-	-	-	-	1,860
Health and Welfare	-	-	-	-	-	180,263	180,263
<b>Unassigned</b>	<u>1,319,322</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,319,322</u>
<b>Total Fund Balance</b>	<b><u>\$ 1,662,995</u></b>	<b><u>\$ -</u></b>	<b><u>\$ 2,193,469</u></b>	<b><u>\$ 2,500,000</u></b>	<b><u>\$ 5,342,313</u></b>	<b><u>\$ 2,741,707</u></b>	<b><u>\$ 14,440,484</u></b>

**NOTE 21 – ACCOUNTING CHANGES AND RESTATEMENTS**

**A. GOVERNMENTAL FUND FINANCIAL STATEMENTS**

The following restatements have been made in the governmental fund financial statements, which are reported as an adjustment to the beginning fund balances:

Description	General Fund	Debt Service	Loans Fund	Other Governmental Fund	Total
Fund balance, beginning	\$ 1,965,602	\$ 1,544,452	\$ 4,611,312	\$ 1,975,656	\$ 10,097,022
To record the Retirement System Administration - Special Laws debt	(968,885)	-	-	-	(968,885)
To adjust prior year accounts payable	-	-	-	72,100	72,100
<b>Fund balance, beginning as restated</b>	<b><u>\$ 996,717</u></b>	<b><u>\$ 1,544,452</u></b>	<b><u>\$ 4,611,312</u></b>	<b><u>\$ 2,047,756</u></b>	<b><u>\$ 9,200,237</u></b>

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTES TO THE BASIC FINANCIAL STATEMENTS (CONTINUED)

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NOTE 21 – ACCOUNTING CHANGES AND RESTATEMENTS (CONTINUED)

B. GOVERNMENTAL WIDE FINANCIAL STATEMENTS

The following restatements have been made in the governmental wide financial statements, which are reported as an adjustment to the beginning net assets:

<u>Governmental Activities</u>	
<u>Description</u>	<u>Total</u>
Net assets, beginning	\$ 36,725,292
To record the Retirement System Administration - Special Laws debt	(968,885)
To adjust prior year accounts payable	72,100
To record the State Insurance Health Administration debt	(256,266)
To adjust prior year bonds payable	(875,000)
Adjustment to capital assets	<u>474,995</u>
<b>Net assets, beginning as restated</b>	<b><u>\$ 35,172,236</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**BUDGETARY COMPARISON SCHEDULE- GENERAL FUND**

**FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

	<u>Budgeted Amounts</u>		<u>Actual Amounts</u>	<u>Variance with</u>
	<u>Original</u>	<u>Final</u>	<u>(Budgetary Basis)</u> <u>(See Note A)</u>	<u>Final Budget</u> <u>Positive</u> <u>(Negative)</u>
<b>REVENUES:</b>				
Property taxes	\$ 3,936,400	\$ 3,936,400	\$ 4,263,056	\$ 326,656
Municipal license taxes	1,800,000	1,800,000	1,850,609	50,609
Sales taxes	-	-	14,852	14,852
Charges for services	702,500	702,500	758,412	55,912
State contributions	6,163,770	6,163,770	6,168,722	4,952
Licenses and permits	792,000	792,000	444,459	(347,541)
Interest, fines and penalties	126,000	126,000	380,693	254,693
Other revenues	394,000	394,000	379,640	(14,360)
Prior year allocation	-	150,000	-	(150,000)
<b>Total revenues</b>	<u>13,914,670</u>	<u>14,064,670</u>	<u>14,260,443</u>	<u>195,773</u>
<b>EXPENDITURES, ENCUMBRANCES AND OTHER FINANCING USES:</b>				
Current:				
General government	8,496,523	8,528,790	7,862,091	666,699
Public safety	1,116,762	1,184,126	1,140,113	44,013
Public works and sanitation	2,695,359	2,792,413	2,922,619	(130,206)
Culture	311,475	323,293	289,325	33,968
Recreation	345,410	353,271	338,834	14,437
Health, welfare and education	949,141	882,777	827,707	55,070
<b>Total expenditures, encumbrances and other financing uses</b>	<u>13,914,670</u>	<u>14,064,670</u>	<u>13,380,689</u>	<u>683,981</u>
<b>EXCESS (DEFICIENCY) OF REVENUES OVER (UNDER) EXPENDITURES, ENCUMBRANCES AND OTHER FINANCING SOURCES (USES)</b>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 879,754</u>	<u>\$ 879,754</u>

**NOTE A – EXPLANATION OF DIFFERENCE BETWEEN BUDGETARY INFLOWS AND OUTFLOWS AND GAAP REVENUES AND EXPENSES**

**Explanation of Differences:**

**Sources/inflows of resources:**

Actual amounts (budgetary basis) "available for appropriation" from the budgetary comparison schedule	\$ 14,260,443
Differences-budget to GAAP	50,074
<b>Total revenues and other financing sources as reported on the statement of revenues, expenditures, and changes in fund balances</b>	<b><u>\$ 14,310,517</u></b>

**Uses/outflows of resources:**

Actual amounts (budgetary basis) "total charges to appropriations" from the budgetary comparison schedule	\$ 13,380,689
Differences-budget to GAAP:	
Accrual adjustments to expenditures	778,946
Prior year expenditure are not outflows of budgetary resources, but are expenditure for financial purposes	17,654
Encumbrances for supplies and equipment ordered, but not received, are reported in the year the order is placed for budgetary reporting purposes	(262,566)
Transfer to other funds are outflows of budgetary resources but are not expenditure for financial reporting purposes	(497,690)
<b>Total expenditures and other financing uses as reported on the statement of revenues, expenditures, and changes in fund balances</b>	<b><u>\$ 13,417,033</u></b>

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN

NOTE TO BUDGETARY COMPARISON SCHEDULE- GENERAL FUND

FOR THE FISCAL YEAR ENDED JUNE 30, 2011

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**NOTE B – STEWARDSHIP, COMPLIANCE AND ACCOUNTABILITY**

**A. BUDGETARY CONTROL**

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

The Municipality prepares its annual budget including the operations of the general fund.

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 as presented in the Budgetary Comparison Schedule-General Fund is the budget ordinance at June 30, 2011 representing the original budget. There were no supplemental appropriations for the year ended June 30, 2011.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

<u>FEDERAL GRANTOR/PASS-THROUGH OR CLUSTER TITLE</u>	<u>FEDERAL CFDA NUMBER</u>	<u>PASS-THROUGH IDENTIFICATION NUMBER</u>	<u>FEDERAL EXPENDITURES</u>
<b><u>U.S. Department of Agriculture</u></b>			
Direct Program:			
Rural Rental Housing Loan (Section 515 Direct Loan)	10.415		\$ 956,112
Pass-through Puerto Rico Education Department			
Child and Adult Care Food Program	10.558	CCC-013	346,259
Subtotal Department of Agriculture			<u>1,302,371</u>
<b><u>U.S. Department of Housing and Urban Development</u></b>			
Direct Programs:			
Community Development Block Grant Program, Entitlement Grants	14.218		<u>1,589,711</u>
Section 8 Housing Assistance Payments	14.195		563,229
ARRA-Homelessness Prevention and Rapid Re-Housing Program	14.257		172,835
Public and Indian Housing	14.850		50,336
Section 8 Housing Choice Voucher Program	14.871		<u>700,409</u>
Subtotal U.S. Dept. of Housing and Urban Development			<u>1,486,809</u>
<b><u>U.S. Department of Transportation</u></b>			
Pass-through Puerto Rico Department of Transportation (Traffic Safety Commission):			
State and Community Highway Safety (ARRA)	20.600	N/AV	<u>140,000</u>
<b><u>U.S. Department of Energy</u></b>			
Energy Efficiency and Conservation Block Grant (ARRA)	81.128		<u>161,415</u>
<b><u>U.S. Department of Health and Human Services</u></b>			
Pass-through Puerto Rico Governor's Office of Child Services and Community Development:			
Head Start Program	93.600	02CH994-06	3,122,568
ARRA- Head Start	93.708	02SE9944	116,610
Subtotal Head Start Cluster			<u>3,239,178</u>
Pass-through Puerto Rico Governor's Office of Child Services and Community:			
Child Care and Development Block Grant Cluster	93.575	241-2010-46	450,717
ARRA-Child Care and Development Block Grant	93.713		60,152
Subtotal Child Care Cluster			<u>510,869</u>
Subtotal Dept. of Health and Human Services			<u>3,750,047</u>
<b>TOTAL EXPENDITURES OF FEDERAL AWARDS</b>			<b><u>\$ 8,430,353</u></b>

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN**

**NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

**JUNE 30, 2011**

**NOTE A - BASIS OF PRESENTATION**

The accompanying schedule of expenditures of federal awards includes the federal grant activity of the Municipality and is presented on the modified accrual basis of accounting. Expenditures are recognized when the related liability is incurred. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, "Audits of States, Local Governments and Nonprofit Organizations". Therefore, some amounts presented in this schedule may differ from the amounts presented in, or used in the preparation of, the basic financial statements.

**NOTE B - FEDERAL CFDA NUMBER**

The Catalog of Federal Domestic Assistance (CFDA) Number is a program identification number determined by the OMB Catalog of Federal Domestic Assistance. The first two digits identify the federal department or agency that administers the program and the last three numbers are assigned by numerical sequence.

**NOTE C - PASS-THROUGH ENTITY IDENTIFYING NUMBER**

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

**NOTE D - RECONCILIATION OF EXPENDITURES PRESENTED IN THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS TO THE EXPENDITURES PRESENTED IN THE BASIC FINANCIAL STATEMENTS**

Description	Head Start Fund	Other Governmental Funds	Business-Type Activities
14.195	\$ -	\$ -	\$563,229
14.218	-	1,589,711	-
14.871	-	700,409	-
14.257	-	172,835	-
14.850	-	50,336	-
93.600	3,122,568	-	-
93.708	-	116,610	-
93.575	-	450,717	-
10.558	-	346,259	-
20.600	-	140,000	-
81.128	-	161,415	-
93.713	-	60,152	-
Total federal awards expenditures	3,122,568	3,788,444	563,229
Total nonfederal awards expenditures and changes in basis of accounting	-	2,989,625	26,364
Total expenditures, fund statements	<u>\$3,122,568</u>	<u>\$6,778,069</u>	<u>\$589,593</u>

The federal expenditure of Rural Rental Housing Loan (Section 515 Direct Loan, CFDA 10.415) is a loan guarantee and do not represent a cash award or expenditure for the fiscal year.

**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**

Honorable Mayor and Member of the  
Municipal Assembly  
Municipality of San Sebastián, Puerto Rico

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of Municipality of San Sebastián, Puerto Rico as of and for the year ended June 30, 2011, which collectively comprise Municipality of San Sebastián, Puerto Rico's basic financial statements and have issued our report thereon dated January 20, 2012. 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, Puerto Rico's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Municipality of San Sebastián, Puerto Rico's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Municipality of San Sebastián, Puerto Rico's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

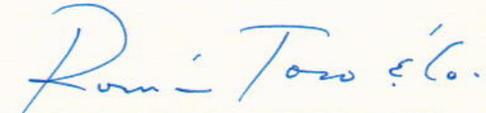
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether Municipality of San Sebastián, Puerto Rico'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 tests disclosed certain instances of noncompliance or other matters that are required to be reported under *Governmental Auditing Standards* and which are described in the accompanying schedule of findings and questioned costs as item 2011-III-I.

Municipality of San Sebastián, Puerto Rico's response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit Municipality of San Sebastián, Puerto Rico's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, others within the entity, Municipal Assembly, and 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.

  
ROMAN TORO & CO., CONTADORES  
PUBLICOS AUTORIZADOS, CSP  
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Yauco, Puerto Rico  
January 20, 2012

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**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH REQUIREMENTS THAT  
COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON  
INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

Honorable Mayor and Member of the  
Municipal Assembly  
Municipality of San Sebastián, Puerto Rico

**Compliance**

We have audited Municipality of San Sebastián, Puerto Rico's compliance, with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of Municipality of San Sebastián, Puerto Rico's major federal programs for the year ended June 30, 2011. Municipality of San Sebastián, Puerto Rico'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 an 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, Puerto Rico'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 of Municipality of San Sebastián, Puerto Rico's compliance with those requirements.

As described in item 2011-III-1 in the accompanying schedule of findings and questioned costs, the Municipality of San Sebastián, Puerto Rico did not comply with requirements regarding period of availability that are applicable to its Homelessness Prevention and Rapid Re-Housing Program (ARRA funded, CFDA 14.257). Compliance with such requirements is necessary, in our opinion, for the Municipality of San Sebastián, Puerto Rico to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Municipality of San Sebastián, Puerto Rico, complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2011.

## Internal Control Over Compliance

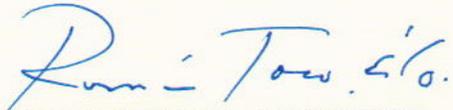
Management of Municipality of San Sebastián, Puerto Rico, is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Municipality of San Sebastián, Puerto Rico's internal control over compliance with the requirements that could have a direct and material effect on a major federal program to determine the auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Municipality of San Sebastián, Puerto Rico's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over compliance that might be *significant deficiencies* or *material weaknesses* and therefore, there can be no assurance that all deficiencies, *significant deficiencies*, or *material weaknesses* have been identified. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be a *material weakness*.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness* in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as item 2011-III-1 to be a *material weakness*.

Municipality of San Sebastián, Puerto Rico's response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit Municipality of San Sebastián, Puerto Rico's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, Municipal Assembly, others within the entity, 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.

  
ROMAN TORO & CO., CONTADORES  
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Yauco, Puerto Rico  
January 20, 2012

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**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE YEAR ENDED JUNE 30, 2011**

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**SECTION I – SUMMARY OF AUDITORS' RESULTS**

**Financial Statements**

Type of auditor's report issued:  Unqualified Opinion  Qualified Opinion  
 Adverse Opinion  Disclaimer Opinion

Internal control over financial reporting:

- Significant control deficiency identified?  Yes  None reported
  - Material weakness (es) identified?  Yes  No
- Noncompliance material to financial statements noted?  Yes  No

**Federal Awards**

Internal control over major programs:

- Significant control deficiency identified?  Yes  None reported
- Material weakness (es) identified?  Yes  No

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

Any audit finding disclosed that are required to be reported in accordance with Section 510(a) of Circular A-133?  Yes  No

Identification of Major Programs:

CFDA Number	Name of Federal Program or Cluster
10.415	Rural Rental Housing Loan
10.558	Child and Adult Care Food Program
14.195	Section 8 Housing Assistance Payments
14.218	Community Development Block Grant – Entitlement Grants
14.257	ARRA – Homelessness Prevention and Rapid Re-Housing Program
14.871	Section 8 Housing Choice Vouchers Program
20.600	State and Community Highway Safety (ARRA)
81.128	Energy Efficiency and Conservation Block Grant (ARRA)
93.575; 93.713	Child Care and Development Block Grant Cluster
93.600; 93.708	Head Start Programs Cluster

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

Auditee qualified as low-risk auditee?  Yes  No

**SECTION II – FINANCIAL STATEMENTS FINDINGS**

No findings are reported.

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (Continued)  
FOR THE YEAR ENDED JUNE 30, 2011**

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**SECTION III – FEDERAL AWARD FINDINGS**

**2011-III-1**

Type of finding: Federal Award.

Situation: Material weakness; compliance with federal regulations.

Federal Programs: ARRA – Homelessness Prevention and Rapid Re-Housing Program (14.257)

Compliance Requirements: Period of Availability requirements.

Prior-Year(s) Audit Finding(s): None.

Questioned Costs: None.

**Condition:**

The Municipality did not comply with expending the required sixty percent (60%) of the programs assigned funds within the first two years since its funds were available for obligation.

**Context:**

The program was awarded to the Municipality by HUD on July 24, 2009 for a total of \$568,040. The program's requirements in the American Recovery and Re-investment Act dictate that 60% of such funds must be expended within the first two years. In order to comply with such requirement, the program had to expend \$340,824 on or before July 24, 2011. As of June 30, 2011, the program had expended \$187,673, or 33% of the program's funds. As of July 24, 2011, the program had expended just over \$200,000 representing approximately 35% of the program's funds.

Questioned costs have not been determined because HPRP's requirements assign HUD the responsibility to determine proper action regarding this noncompliance situation.

**Criteria:**

Recipients of HPRP grants must expend at least sixty percent (60%) of such funds within two (2) years of the date on which funds became available for obligation; and expend one-hundred percent (100%) of such funds within three (3) years of such date as per the American Recovery and Re-investment Act's requirements (Page 123 Stat. 221).

**Cause:**

The department in charge of the program did not manage and supervise its performance with respect to timeliness of use of funds, and did not communicate with higher management when the risk of noncompliance became significant.

**Effect:**

The Program did not comply with federal law requirements on timely usage, and could be subject to funding decreases or early closure.

**Auditor's recommendation:**

The department in charge of the program should continue consulting with HUD over the use of the program, and try to meet the 3 year limit rule. The Municipality should also monitor its programs more closely to assure that objectives are being met on a timely manner in order to comply with deadline requirements.

**Views of responsible officials and corrective actions:**

Because it was a new program, the Municipality maintained constant communication with the federal agency to provide us information to comply with the eligibility requirement for the program participants. In November 2010, a new regulation was approved to establish the eligibility requirements and we then began to use the funds.

Up to the date of this report, \$363,508.48 has been disbursed which amounts to 65% expended of the total award. On average, the program is expending around \$30,000 per month, thus we expect the total funds of the program will be used in their entirety at the end of the program's award term limit.

**Audit finding status:**

Unresolved.

**End of Section**

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SAN SEBASTIAN  
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS  
FOR THE YEAR ENDED JUNE 30, 2011

Year	Finding Number	Finding	CFDA Number	Questioned Cost(s)	Comments
<b>(1) Prior Audit Findings, fully corrected or not noted during our audit:</b>					
2010	2010-III-1	Equipment and Real Property The municipality could not provide evidence of federal award agency instructions and authorization for the final disposition of the municipality's Early Head Start Program's equipment and property during the programs 2009 fiscal year.	93.600	Undetermined	The program's closure occurred in FY2010, and did not provide services during the fiscal year ended on June 30, 2011. No federal programs were closed during the year ended June 30, 2011.

**(2) Prior Audit Findings, not corrected or partially corrected:**

None.

**(3) Corrective action taken is significantly different from corrective action previously reported:**

None.

**(4) Prior Audit Findings, are no longer valid:**

None.

END OF SCHEDULE