

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

**MUNICIPIO DE SANTA ISABEL**  
**AUDITORIA 2005-2006**  
**30 DE JUNIO DE 2006**

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DE ASUNTOS MUNICIPALES  
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**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL**

**BASIC FINANCIAL STATEMENTS AND  
SUPPLEMENTAL SCHEDULE**

**SINGLE AUDIT REPORT**

**With Independent Auditors' Report Thereon  
JUNE 30, 2006**

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Basic Financial Statements and  
Supplemental Schedule  
Single Audit Report  
June 30, 2006**

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**MENDOZA & RAMOS**  
Contadores Públicos Autorizados, C.S.P.

P.O. Box 35 • Guayama, Puerto Rico 00785

**INDEPENDENT AUDITORS REPORT**

HONORABLE MAYOR AND MUNICIPAL COUNCIL  
MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

We have audited the accompanying financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Santa Isabel, Puerto Rico, as of and for the year ended June 30, 2006, which collectively comprise the Municipality's financial statements as listed in the table of contents. Our responsibility is to express an opinion of 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the respective financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality's of Santa Isabel as of June 30, 2006, and the respective changes in financial position, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and budgetary comparison information on pages 4 through 12 and page 60, are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated January 31, 2007, on our consideration of the Municipality's internal control structure over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

## INDEPENDENT AUDITORS REPORT

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The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

The accompanying financial statements have been prepared assuming that the Municipality of Santa Isabel will continue as a going concern. During several years, the Municipality of Santa Isabel has increased its deficit by exceeding its expenditures over its revenues. As of June 30, 2006, the unreserved accumulated deficit for its general fund (for governmental funds) amounted to \$6,062,699, with total liabilities in the amount of \$10,222,784 and total assets amounting to \$4,160,085, including available cash of \$899,981 to pay mature liabilities within the current year. These conditions raised substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

*Mendoza & Ramos*  
MENDOZA & RAMOS

CONTADORES PUBLICOS AUTORIZADOS, C.S.P.

December 8, 2006  
Guayama, Puerto Rico

The stamp number 2134174  
was affixed to the original of this report.



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

Management of the Municipality of Santa Isabel of the Commonwealth of Puerto Rico (the Municipality) provides this *Management's Discussion and Analysis* (MD&A) for the readers of the Municipality's basic financial statements. This narrative represents an overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2006. Because this MD&A is designed to focus on the current year activities, resulting changes and currently known facts, we encourage readers to consider the information presented in this MD&A in conjunction with the additional information furnished in the accompanying basic financial statements.

**FINANCIAL HIGHLIGHTS**

**a) Government-Wide Highlights**

- **Assets** – The Municipality has reported assets amounting to \$26.2 millions in the accompanying statement of net assets, of which the most significant are capital assets, investments, cash and tax receivables amounting to \$17.6 millions, \$1.5 millions, \$3.9 millions and \$3.1 millions, respectively.
- **Liabilities** – The Municipality has reported liabilities amounting to \$22.1 millions in the accompanying statement of net assets, of which the most significant are deferred revenues, bonds payable, intergovernmental payable and notes payable, amounting to \$0.8 millions, \$7.2 millions, \$4.6 millions and \$7 millions respectively.
- **Net assets** – The assets of the Municipality exceeded its liabilities by \$4.1 millions at June 30, 2006, which is presented as “net assets” in the accompanying statement of net assets. Restricted net assets and unrestricted deficit amounted to \$4.6 millions and (\$15.7) millions, respectively. Net assets invested in capital assets amounted to \$14.9 millions.
- **Net change in net assets** – The Municipality's net assets increased by \$0.7 millions during fiscal year ended June 30, 2006. Net assets at June 30, 2005 (as restated) amounted to \$3.4 millions. The increased in net assets was principally for positive result of operations and increase in the Municipality's overall financial position in comparison with the prior fiscal year.
- **Revenues** – The Municipality has reported total revenues amounting to \$12.0 millions in the accompanying statement of activities, of which the most significant are tax revenues, operating grants and capital grants and contributions amounting to \$4.1 millions, \$3.2 millions, and \$0.4 million, respectively.
- **Expenses** – The Municipality has reported total expenses amounting to \$11.4 millions in the accompanying statement of activities.

**b) Governmental Funds Highlights**

- **Assets** – The Municipality's governmental funds have reported combined assets amounting to \$11.5 millions in the accompanying balance sheet – governmental funds, of which the most significant are investments, cash and due from other funds, amounting to \$1.5 millions, \$3.9 millions, and \$2.9 millions respectively.

- **Liabilities** – The Municipality’s governmental funds have reported combined liabilities amounting to \$13.2 millions in the accompanying balance sheet – governmental funds, of which the most significant are deferred revenues, accounts payable, due to other funds and intergovernmental payable amounting to \$3.0 millions, \$2.1 millions, \$2.9 millions, and \$4.6 millions respectively.
- **Governmental fund balances** – The Municipality’s governmental funds reported combined fund deficit amounting to (\$1.6) million, of which \$7.9 millions and (\$6.3) millions represents reserved and unreserved fund balances (deficit), respectively.
- **Net change in governmental fund balances** – The Municipality’s governmental fund balances decreased by (\$0.3) millions during fiscal year ended June 30, 2006. Governmental fund balances (deficit) at June 30, 2005, as restated, amounted to (\$1.3) millions. The increase in fund balances (deficit) represents the excess of expenditures and other financing uses over revenues and other financing sources.
- **Revenues** – The Municipality’s governmental funds have reported combined revenues amounting to \$12.1 millions in the accompanying statement of revenues, expenditures and changes in fund balances – governmental funds, of which the most significant are property taxes, intergovernmental grants and contributions, municipal license and construction excise taxes amounting to \$2.4 millions, \$7.6 millions, \$1.0 millions and \$0.8 million, respectively.
- **Expenditures** – The Municipality’s governmental funds have reported combined expenditures amounting to \$13.9 millions in the accompanying statement of revenues, expenditures and changes in fund balances – governmental funds, of which the most significant are categorized as general government; culture recreation and education and urban and economic development amounting to \$3.5 millions, \$4.4 millions, and \$3.1 millions respectively.

## USING THIS ANNUAL REPORT

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

## OVERVIEW OF THE BASIC FINANCIAL STATEMENTS

The Municipality’s financial statements include three components: (1) the government-wide financial statements, (2) the fund financial statements, and (3) the notes to the financial statements (collectively known as the basic financial statements). This report also contains additional required supplementary information (budgetary schedules) and other supplementary information (combining financial statements) in addition to the basic financial statements themselves. These components are described below:

### Government-Wide Financial Statements

The *government-wide financial statements* are designed to provide readers with a broad overview of the Municipality’s operations and finance as a whole in a manner similar to private-sector business. These statements provide short-term and long-term information about the Municipality’s financial position, which assist the Municipality’s management to determine the economic condition at the end of the fiscal year. These financial statements are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This basically means that these financial statements follow methods that are similar to those used by most businesses. They take into account all revenues and expenses connected with the fiscal year ended June 30, 2006 even if cash involved have not been received or paid. The government-wide financial statements include: (1) the statements of net assets and (2) the statement of activities.

### **Statement of Net Assets**

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

### **Statement of Activities**

The statement of activities presents information showing how the Municipality's net assets changed during the fiscal year ended June 30, 2006. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods (such as uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenues for each function of the Municipality.

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

### **Fund Financial Statements**

The Municipality's fund financial statements, which consist of: (1) the balance sheet – governmental funds and (2) the statement of revenues, expenditures and changes in fund balances – governmental funds. These financial statements report the financial position and results of operations of the Municipality's governmental funds.

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

The fund financial statements focus on: (1) individual parts of the Municipality's government and (2) reporting the Municipality's operations in more detail than the government-wide financial statements. For financial reporting purposes, the Municipality classifies its funds within the following fund categories: (1) general fund, (2) debt service fund, (3) special revenue funds and (4) capital projects funds (collectively known as the "governmental funds").

Governmental funds are used to account for all of the services provided by the Municipality. 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. They also focus on the balances of spendable resources available at the end of the fiscal year (June 30, 2006). This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These statements provide a detailed short-term view of the Municipality's finances that assists in determining whether there will be adequate financial resources available to meet the current needs of the Municipality, that is, evaluating the Municipality'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 fund 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 Municipality's near-term financial decisions.

For financial reporting purposes the Municipality has three major funds: (1) the general fund, (2) state legislature joint resolutions, (3) the head start and (4) the debt service.

### **Notes to the Basic Financial Statements**

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

### **Required Supplementary Information**

The basic financial statements are followed by a section of required supplementary information consisting of a budgetary comparison between actual operating results with the original budget and the final amended budget for the general fund.

### **INFRASTRUCTURE ASSETS**

Historically, a government's largest group of assets (infrastructure – roads, bridges, traffic signals, underground pipes [unless associated with a utility], etc.) have not been reported nor depreciated in governmental financial statements. GASB 34 requires that these assets be valued and reported within the governmental column of the Government-Wide Financial Statements. Additionally, the government must elect to either (a) depreciate these assets over their estimated useful life or (b) develop a system of asset management designed to maintain the service delivery potential to near perpetuity. If the government develops the asset management system (modified approach) which periodically (at least every third year), by category, measures and demonstrates its maintenance of locally established levels of service standards, the government may record its cost of maintenance in lieu of depreciation. The information about the condition and maintenance of condition of the government infrastructure assets should assist financial statement users in evaluating a local government and its performance over time.

As of July 1, 2003, the Municipality retroactively recorded the historical costs of infrastructure assets. Also the Municipality elected to depreciate infrastructure assets instead of using the modified approach.

### **FINANCIAL ANALYSIS OF THE MUNICIPALITY AS A WHOLE**

#### **Net Assets**

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial position. In the case of the Municipality, net assets (excess of assets over liabilities) amounted to (\$4.1) millions at June 30, 2006, compared to (\$3.4) millions at the end of the previous year, as restated.

The largest portion of the Municipality's net assets are invested in capital assets net of their related debt (\$14.9 millions). The Municipality's net assets is also composed of net assets amounting to \$4.8 millions that are restricted for (1) future debt service payments, (2) the future acquisition or construction of capital assets and (3) other purposes, mainly the financing of federal and state assisted programs. In addition, the Municipality's net asset are reported net of an unrestricted deficit of \$15.7 millions.

The unrestricted deficit is the consequence of previous budgets which did not provide funding for incurred long-term obligations such as compensated absences and others. Historically, such obligations have been budgeted on a pay as you

go basis without providing funding for their future liquidation. Consequently, the Municipality cannot draw from its existing assets to provide services to its citizens and depends on its taxing ability to continue its operations.

The portion of the Municipality's net assets invested in capital assets such as land, buildings, equipment, etc., less any outstanding related debt used to acquire those assets, are used by the Municipality to provide services to its citizens; consequently these assets are not available for future spending. Although the Municipality's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from the debt service fund, since the capital assets themselves cannot be used to liquidate these liabilities.

The following is a condensed presentation of the Municipality's financial position, as reported in the government-wide financial statements:

**Condensed Statement of Net Assets:**

	2006	2005	Change	%
Current assets	\$ 8,628,173	8,139,031	\$ 489,142	6%
Noncurrent assets	17,647,561	15,974,627	1,672,934	10%
Total assets	<u>26,275,734</u>	<u>24,113,658</u>	<u>2,162,076</u>	9%
Current liabilities outstanding	9,837,926	9,047,157	790,769	9%
Noncurrent liabilities outstanding	12,320,718	11,633,058	687,660	6%
Total liabilities	<u>22,158,644</u>	<u>20,680,215</u>	<u>1,478,429</u>	7%
Net assets/(liabilities):				
Invested in capital assets, net of related debt	14,963,561	13,128,627	1,834,934	14%
Restricted	4,814,558	5,962,758	(1,148,200)	(19%)
Unrestricted	<u>(15,661,029)</u>	<u>(15,657,942)</u>	<u>(3,087)</u>	-
Total net assets	<u>\$ 4,117,090</u>	<u>3,433,443</u>	<u>\$ 683,647</u>	20%

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## Changes in Net Assets

The Municipality's net assets increased by \$0.7 millions. Approximately 34 percent of the Municipality's total revenues came from taxes, while 63 percent resulted from restricted and unrestricted capital and operating grants, contributions and reimbursements, including federal financial assistance. The Municipality's expenses cover a range of services. The largest expenses were for general government (25 percent), culture, recreation and education (22 percent) and urban and economic development (25 percent).

The following is a condensed presentation of the Municipality's results of operations, as reported in the government-wide financial statements:

<u>Condensed Statement of Activities:</u>	<u>2006</u>	<u>2005</u>	<u>Change</u>	<u>%</u>
<b>Revenues:</b>				
<b>Program revenues:</b>				
Operating grants and contributions	\$ 3,233,263	4,506,913	\$ (1,273,650)	(28%)
Capital grants and contributions	444,907	1,231,615	(786,708)	(64%)
Charges for services	53,795	406,733	(352,938)	(87%)
<b>General revenues:</b>				
Property taxes	2,377,635	2,466,230	(88,595)	(4%)
Municipal license taxes	957,973	1,045,501	(87,528)	(8%)
Construction excise taxes	785,940	616,635	169,305	27%
Unrestricted intergovernmental contributions	3,953,425	2,657,062	1,296,363	49%
Unrestricted interest on deposits	205,174	85,410	119,764	140%
Miscellaneous	71,586	17,554	54,032	308%
<b>Total revenues</b>	<b>12,083,698</b>	<b>13,033,653</b>	<b>(949,955)</b>	<b>(7%)</b>
<b>Expenses:</b>				
General government	2,946,761	3,840,872	(894,111)	(23%)
Urban and economic development	2,953,397	4,939,379	(1,985,982)	(40%)
Public safety	743,450	848,829	(105,379)	(12%)
Health and sanitation	909,038	253,906	655,132	258%
Culture, recreation and education	2,611,049	3,399,408	(788,359)	(23%)
Public housing and welfare	930,772	1,256,879	(326,107)	(26%)
Interest on bonds, notes and capital lease obligati	305,584	363,094	(57,510)	(16%)
<b>Total expenses</b>	<b>11,400,051</b>	<b>14,902,367</b>	<b>(3,502,316)</b>	<b>(24%)</b>
<b>Net increase in net assets</b>	<b>683,647</b>	<b>(1,868,714)</b>	<b>2,552,361</b>	<b>(137%)</b>
<b>Net assets - at beginning of year, as restated</b>	<b>3,433,443</b>	<b>5,302,157</b>	<b>(1,868,714)</b>	<b>(35%)</b>
<b>Net assets - at end of year</b>	<b>\$ 4,117,090</b>	<b>3,433,443</b>	<b>\$ 683,647</b>	<b>20%</b>

## FINANCIAL ANALYSIS OF THE MUNICIPALITY'S GOVERNMENTAL FUNDS

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

**Governmental Funds** - The focus of the Municipality's *governmental funds* is to provide information on near-term inflows, outflows, and balance 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 fiscal year. The following is a condensed presentation of the Municipality's balance sheet and results of operations of governmental funds:

<u>Condensed Balance Sheet - Governmental funds:</u>	2006	2005	Change	%
Total assets - major funds	\$ 9,581,850	7,785,758	\$ 1,796,092	23%
Total assets - nonmajor funds	1,976,049	2,599,897	(623,848)	(24%)
Total assets	<u>11,557,899</u>	<u>10,385,655</u>	<u>1,172,244</u>	11%
Total liabilities - major funds	12,310,184	10,796,700	1,513,484	14%
Total liabilities - nonmajor funds	902,492	1,036,252	(133,760)	(13%)
Total liabilities	<u>13,212,676</u>	<u>11,832,952</u>	<u>1,379,724</u>	12%
Fund Balances:				
Reserved - major funds	3,583,242	1,563,645	2,019,597	129%
Reserved - nonmajor funds	1,073,557	4,520,274	(3,446,717)	(76%)
Unreserved - nonmajor funds	-	-	-	
Unreserved - major funds	(6,311,576)	(7,531,216)	1,219,640	(16%)
Total net assets	<u>\$ (1,654,777)</u>	<u>(1,447,297)</u>	<u>\$ (207,480)</u>	14%

Condensed Statement of Operations - Governmental funds:

Total revenues - major funds	\$ 10,127,967	9,769,599	\$ 358,368	4%
Total revenues - nonmajor funds	2,031,570	3,133,665	(1,102,095)	(35%)
Total revenues	<u>12,159,537</u>	<u>12,903,264</u>	<u>(743,727)</u>	(6%)
Total expenditures - major funds	11,736,347	14,423,883	(2,687,536)	(19%)
Total expenditures - nonmajor	2,180,966	3,763,415	(1,582,449)	(42%)
Total expenditures	<u>13,917,313</u>	<u>18,187,298</u>	<u>(4,269,985)</u>	(23%)
Other financing sources - major funds (excluding operating transfers among funds)	1,410,000	264,486	1,145,514	433%
Net change in fund balances	<u>\$ (347,776)</u>	<u>(5,019,548)</u>	<u>\$ 4,671,772</u>	(93%)

## **CAPITAL ASSETS AND DEBT ADMINISTRATION**

### **Capital Assets**

The accompanying statement of net assets reported total gross capital assets, at cost, amounting to \$22,033,970 of which \$12,195,303 represents buildings, structures and buildings improvements assets at June 30, 2006. The related accumulated depreciation and amortization of capital assets amounted to \$4,386,409, of which \$1,875,743 is related to buildings, structures and buildings improvements assets at June 30, 2006. This investment in capital assets includes land, buildings, improvements, equipment, infrastructure and construction in progress. Infrastructure assets are items that are normally immovable and of value only to the municipal government, such as roads, bridges, streets and sidewalks, drainage systems. Lighting systems, and similar items.

Actual costs incurred to purchase or construct capital assets were \$2,145,276 for the year ended June 30, 2006. Depreciation charges for the year totaled \$472,342.

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

### **Debt Administration**

The laws and regulations of the Commonwealth of Puerto Rico have established a limitation for the issuance of general obligation municipal bonds and notes for the payment of which the good faith, credit and taxing power of each municipality may be pledged.

The applicable laws and regulations also require that in order for a municipality to be able to issue additional general obligation bonds and notes, such municipality must have sufficient "payment capacity". Act No. 64 provides that a municipality has sufficient "payment capacity" to incur additional general obligation debt if the deposits in such municipality's Redemption fund and the annual amounts collected with respect to such municipality's Special Additional Tax (as defined below), as projected by the Government Development Bank for Puerto Rico, will be sufficient to service to maturity the Municipality's outstanding general obligation debt and the additional proposed general obligation debt ("Payment Capacity").

The Municipality is required under applicable laws and regulations to levy the Special Additional Tax in such amounts as shall be required for the payment of its general obligation municipal bonds and notes. In addition, principal of and interest on all general obligation municipal bonds and notes and on all municipal notes issued in anticipation of the issuance of general obligation bonds issued by the Municipality constitute a first lien on the Municipality's Basic Tax revenues. Accordingly, the Municipality's Basic Tax revenues would be available to make debt service payments on general obligation municipal bonds and notes to the extent that the Special Additional Tax Levied by the Municipality, together with moneys on deposit in the Municipality's Redemption Fund, are not sufficient to cover such debt service. It has never been necessary to apply Basic Taxes to pay debt service on general obligation debt of the Municipality.

### **ECONOMIC FACTORS AND NEXT BUDGETS AND RATES**

The Municipality relies primarily on property and municipal license taxes, as well as, federal and state grants to carry out the governmental activities. Historically, property and municipal license taxes have been very predictable with increases not generally exceeding ten percent. Federal grant revenues may vary if new grants are available but the revenue is also very predictable.

Those factors were considered when preparing the Municipality's budget for the 2006-2007 fiscal year. There were no significant changes between the budget for fiscal year 2005-2006 and the one for fiscal year 2006-2007.

#### **FINAL COMMENTS**

The Municipality of Santa Isabel is a governmental entity whose powers and authority vested on its executive and legislative branches are specifically established in the Municipal Autonomous Act approved in August 1991. By virtue of such powers, it provides a wide range of services to its constituents which includes, among others, public works, education, public safety, public housing, health, community development, recreation, waste disposal, welfare and others. The Municipality's principal sources of revenues are derived from property taxes, municipal license taxes, subsidies from the Commonwealth of Puerto Rico's General Fund and contributions from the Traditional and Electronic Lottery sponsored by said Government.

#### **FINANCIAL CONTACT**

The Municipality's financial statements are designed to present users (citizens, taxpayers, customers, investors and creditors) with a general overview of the Municipality's finances and demonstrate the Municipality's accountability. If you have any questions about the report or need additional financial information, contact the Municipality's Director of Finance, Mr. Irma M. Vargas Aguirre, at PO Box 725, Santa Isabel, Puerto Rico, 00757.

**Commonwealth of Puerto Rico**  
**Municipality of Santa Isabel**  
**Statement of Net Assets**  
**June 30, 2006**

**Assets**

**Current assets:**

Cash in commercial banks	\$	947,959
Accounts receivable, net of allowance for doubtful accounts:		
Property taxes		1,705,348
Intergovernmental		1,445,071
Municipal license		5,467
Construction excise taxes		48,865
Interest		15,818
Restricted assets :		
Cash with commercial banks		708,480
Cash with fiscal agent		2,252,293
Investments		1,498,872
Total current assets		8,628,173

**Noncurrent assets:**

Capital assets, net of accumulated depreciation and amortization of \$4,386,409		17,647,561
Total noncurrent assets		17,647,561
Total assets	\$	26,275,734

**Current Liabilities (due within one year):**

Accounts payable	\$	2,124,301
Intergovernmental payables		4,621,702
Accrued interest payable on long-term debt		246,731
Deferred revenues		884,946
Current portion of long-term obligations:		
Bonds payable		286,000
Other debts		1,674,246
Total current liabilities		9,837,926

**Noncurrent liabilities (due in more than one year):**

Total liabilities		12,320,718
	\$	22,158,644

**Net assets (liabilities):**

Invested in capital assets, net of related debt	\$	14,963,561
Restricted for:		
Capital projects		2,554,275
Debt service		1,376,667
Other specified purposes		883,616
Unrestricted net assets		(15,661,029)
Total net assets	\$	4,117,090

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

**Commonwealth of Puerto Rico**  
**Municipality of Santa Isabel**  
**Statement of Activities**  
**June 30, 2006**

Functions/programs	Expenses	Charges for services	Program Revenues		Net Expenses and Charges in Net Assets
			Operating grants and contributions	Capital grants and contributions	
Governmental activities :					
General government	\$ 2,946,761	\$ -	\$ -	\$ -	\$ (2,946,761)
Urban and economic development	2,953,397	750	768,331	404,907	(1,779,409)
Public safety	743,450	17,089	71,188	40,000	(615,173)
Health and sanitation	909,038	20,549	-	-	(888,489)
Culture, recreation and education	2,611,049	15,407	2,057,669	-	(537,973)
Welfare and housing assistance	930,772	-	336,075	-	(594,697)
Interest on long-term obligation	305,584	-	-	-	(305,584)
<b>Total governmental activities</b>	<b>\$ 11,400,051</b>	<b>\$ 53,795</b>	<b>\$ 3,233,263</b>	<b>\$ 444,907</b>	<b>\$ (7,668,086)</b>
<b>General Revenues:</b>					
<b>Taxes:</b>					
Property taxes					2,377,635
Municipal license taxes					957,973
Construction excise taxes					785,940
<b>Total taxes</b>					<b>4,121,548</b>
Grants and contributions, not restricted to specific programs					3,953,425
Interests on deposits					205,174
Miscellaneous					71,586
<b>Total general revenues</b>					<b>8,351,733</b>
					683,647
					3,433,443
					<b>\$ 4,117,090</b>

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

**COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL**

Balance Sheet  
Governmental Funds  
June 30, 2006

**MAJOR FUNDS**

	MAJOR FUNDS					Total Governmental Funds
	General Fund	State Legislative Joint Resolutions	Head Start	Debt Service	Other Nonmajor Fund	
<b>ASSETS</b>						
Cash in commercial banks	\$ 899,981	\$ -	\$ -	\$ -	\$ 47,978	\$ 947,959
Account receivable, net of doubtful accounts:						
Property taxes	1,396,163	-	-	309,185	-	1,705,348
Municipal license	5,467	-	-	-	-	5,467
Construction excise taxes	48,865	-	-	-	-	48,865
Interest	10,313	-	-	5,505	-	15,818
Due from other funds	893,553	2,034,609	-	-	1,564	2,929,726
Due from governmental entities	754,107	-	39,680	-	651,284	1,445,071
Other	-	-	-	-	-	-
Restricted assets:						
Cash in commerical bank	-	141,453	73,233	-	493,794	708,480
Cash in fiscal agent	151,636	-	-	1,319,228	781,429	2,252,293
Investments	-	1,498,872	-	-	-	1,498,872
<b>Total assets</b>	<b>\$ 4,160,085</b>	<b>\$ 3,674,934</b>	<b>\$ 112,913</b>	<b>\$ 1,633,918</b>	<b>\$ 1,976,049</b>	<b>\$ 11,557,899</b>
<b>LIABILITIES</b>						
Accounts payable	\$ 594,191	\$ 1,462,236	\$ 8,638	\$ -	\$ 59,236	\$ 2,124,301
Intergovernmental	4,621,702	-	-	-	-	4,621,702
Due to other funds	2,033,073	-	77,450	10,520	808,683	2,929,726
Deferred revenue	2,973,818	-	26,825	-	34,573	3,035,216
Matured bonds due and payable	-	-	-	255,000	-	255,000
Matured interests due and payable	-	-	-	246,731	-	246,731
<b>Total liabilities</b>	<b>10,222,784</b>	<b>1,462,236</b>	<b>112,913</b>	<b>512,251</b>	<b>902,492</b>	<b>13,212,676</b>
<b>FUND BALANCE</b>						
Reserved for:						
Encumbrances	97,241	-	-	-	-	97,241
Debt service	-	-	-	1,121,667	-	1,121,667
Capital projects	-	2,212,698	-	-	341,577	2,554,275
Other specified purposes	151,636	-	-	-	731,980	883,616
Unreserved, reported in:						
General fund	(6,311,576)	-	-	-	-	(6,311,576)
<b>Total fund balances (deficit)</b>	<b>(6,062,699)</b>	<b>2,212,698</b>	<b>-</b>	<b>1,121,667</b>	<b>1,073,557</b>	<b>(1,654,777)</b>
<b>TOTAL LIABILITIES AND FUND BALANCE</b>	<b>\$ 4,160,085</b>	<b>\$ 3,674,934</b>	<b>\$ 112,913</b>	<b>\$ 1,633,918</b>	<b>\$ 1,976,049</b>	<b>\$ 11,557,899</b>

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

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF SANTA ISABEL**  
 Reconciliation of the Balance Sheet - Governmental Funds  
 to the Statement of Net Assets  
 June 30, 2006

Aggregate fund balance (deficit) reported in the balance sheet - governmental funds	\$ (1,654,777)
Governmental activities' amounts reported in the statement of net assets and the balance sheet - governmental funds are different because:	
Capital assets used in governmental activities are not financial resources, therefore, are not reported in the governmental funds	17,647,561
Deferred (unavailable) revenues in the governmental funds that are recorded as revenues in the statement of activities	2,150,270
The following liabilities are not due (mature) in the current period, therefore, are not reported in the governmental funds:	
Accrued employees' christmas bonus	(150,860)
Compensated absences	(1,572,128)
Bonds and notes payable	(6,984,000)
Debt to intergovernmental agencies	(4,418,286)
Landfill closure and postclosure care costs	<u>(900,690)</u>
Net assets as reported in the accompanying statement of net assets	<u>\$ 4,117,090</u>

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

**COMMONWEALTH OF PUERTO RICO**  
**MUNICIPALITY OF SANTA ISABEL**  
**Statement of Revenues, Expenditures and**  
**Changes in Fund Balance - Governmental Funds**  
**Year Ended June 30, 2006**

	MAJOR FUNDS					Total Governmental Funds
	General Fund	State Legislative Joint	Head Start	Debt Service	Other Nonmajor Funds	
		Resolutions				
<b>REVENUES</b>						
<b>Taxes:</b>						
Property taxes	\$ 1,601,292	\$ -	\$ -	\$ 864,097	\$ -	\$ 2,465,389
Municipal license	957,973	-	-	-	-	957,973
Construction excise taxes	785,940	-	-	-	-	785,940
Charges of service	19,552	-	-	-	34,242	53,794
<b>Intergovernmental grants and contributions:</b>						
Federal government	-	-	1,672,549	-	1,079,002	2,751,551
State government	3,940,804	9,000	-	-	917,620	4,867,424
Investment earnings	132,159	73,015	-	-	706	205,880
Miscellaneous	71,586	-	-	-	-	71,586
<b>Total Revenues</b>	<b>\$ 7,509,306</b>	<b>82,015</b>	<b>1,672,549</b>	<b>864,097</b>	<b>2,031,570</b>	<b>\$ 12,159,537</b>
<b>EXPENDITURES</b>						
<b>Current:</b>						
General government	3,557,370	-	-	-	221	3,557,591
Urban and economic development	1,860,105	-	-	-	1,323,507	3,183,612
Public safety	651,533	-	-	-	83,412	734,945
Health and Sanitation	691,214	-	-	-	8,851	700,065
Culture, recreation and education	560,305	1,814,015	1,672,549	-	368,787	4,415,656
Welfare and housing assistance	348,671	6,000	-	-	396,188	750,859
<b>Debt service:</b>						
Principal	-	-	-	269,000	-	269,000
Interest	-	-	-	305,585	-	305,585
<b>Total Expenditures</b>	<b>7,669,198</b>	<b>1,820,015</b>	<b>1,672,549</b>	<b>574,585</b>	<b>2,180,966</b>	<b>13,917,313</b>
<b>Excess (Deficiency) of Revenues over expenditures</b>	<b>(159,892)</b>	<b>(1,738,000)</b>	<b>-</b>	<b>289,512</b>	<b>(149,396)</b>	<b>(1,757,776)</b>
<b>OTHER FINANCING SOURCES (USES)</b>						
Transfer in from other funds	-	-	-	491,463	-	491,463
Transfer out to other funds	(191,463)	(300,000)	-	-	-	(491,463)
Special Items	-	-	-	-	-	-
Proceeds from bond issuance	1,410,000	-	-	-	-	1,410,000
<b>Total Other Financing Sources (uses)</b>	<b>1,218,537</b>	<b>(300,000)</b>	<b>-</b>	<b>491,463</b>	<b>-</b>	<b>1,410,000</b>
<b>NET CHANGE IN FUND BALANCES (DEFICITS)</b>	<b>1,058,645</b>	<b>(2,038,000)</b>	<b>-</b>	<b>780,975</b>	<b>(149,396)</b>	<b>(347,776)</b>
<b>FUND BALANCE (DEFICIT) AT BEGINNING OF YEAR, AS RESTATED</b>	<b>(7,121,344)</b>	<b>4,250,698</b>	<b>-</b>	<b>340,692</b>	<b>1,222,953</b>	<b>(1,307,001)</b>
<b>FUND BALANCE (DEFICIT) AT END OF YEAR</b>	<b>\$ (6,062,699)</b>	<b>\$ 2,212,698</b>	<b>\$ -</b>	<b>\$ 1,121,667</b>	<b>\$ 1,073,557</b>	<b>\$ (1,654,777)</b>

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

**Commonwealth of Puerto Rico**  
**Municipality of Santa Isabel**  
**Reconciliation of Statement of Revenues, Expenditures and Changes**  
**in Fund Balance - Governmental Funds to the Statements of Activities**  
**For the Year Ended June 30,2006**

Net change in fund balances- total governmental funds \$ (347,776)

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

Revenues in the statement of activities that not provide current financial resources, therefore are not reported as revenues in the funds:

Net Change in Property Tax Revenue Deferred in GFFS	(87,754)
Net Change in PREPA Contribution in Liue of Taxes Revenue Deferred in GFFS	36,053
Net Change in State Treasury Department Christmas Bonus Reimbursement Deferred in GFFS	(24,138)

Under the modified accrual basis of accounting used in the governmental funds, expenditures are not recognize for transactions that are not normally paid with expendable financial resources. In the Statements of Activities , however, wich is presented in the accrual basis, expenses and liabilities are presented regardless of when financial resources are available:

Net Change in Compensated Absences Liability	269,243
Net Change in Christmas Bonus	51,971
Landfill Closure and Post closure care costs	30,483
Net Change in Unemployment Debt	(3,159)
Net Change in PREPA Contribution in Liue of Taxes Liability	(36,053)

Govnermental funds report capital outlays as expenditures. However in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation and amortization expenses. This the amount by which capital outlays exceed depreciation expenses. 1,672,934

Repayment of principal of long-term obligation is an expenditures in the governmental funds, but the repayment reduces long-term liabilities in the statement of net assets 531,843

Financing agreements are not recognized in the governmental funds, but such financing agreements increase long-term liabilities in the statement of net assets

Proceeds on issuance of long- term debt (bonds) are recorded as other financing sources in the fund financial statements, but the issuances increase long-term liabilities in the statement of net assets (1,410,000)

Net changes in net assets reported in the accompanying statements of activities \$ 683,647

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Basic Financial Statements  
June 30, 2006

**1. Summary of Significant Accounting Policies**

The Municipality of Santa Isabel of the Commonwealth of Puerto Rico (the "Municipality") is a local government with full legislative, fiscal and administrative powers to operate as a government under Law No. 81 of August 30, 1991, as amended, known as the *Autonomous Municipalities 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 and economic development, and many other general and administrative duties.

**a) *New Financial Reporting Model***

The accompanying basic financial statements present the financial position and the results of operations of the Municipality as a whole, and its various governmental funds as of and for the year ended June 30, 2006, in conformity with accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board (GASB).

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.

According to the new 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 RSI, 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, 2006, based on the Municipality's knowledge of the transactions, events and conditions

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Notes to Basic Financial Statements  
June 30, 2006

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

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.

**b) Financial Reporting Entity**

The accompanying basic financial statements include all departments, agencies and municipal entities that: (1) are under the legal and administrative control of the Mayor and (2) whose funds are under the legal custody and control of the Municipality's Director of Finance and Budget, as prescribed by Law No. 81.

The Municipality's management has considered all potential component units for which it may be financially accountable and other legally separate organizations for which the nature and significance of their relationship with the Municipality may be such that exclusion of their basic financial statements from those of the Municipality would cause the Municipality's basic financial statements to be misleading or incomplete.

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

On July 1, 2003, the Municipality adopted the provisions of GASB Statement No. 39 – *Determining Whether Certain Organizations are Component Units* (GASB No. 39). This

COMMONWEALTH OF PUERTO RICO  
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Notes to Basic Financial Statements  
June 30, 2006

statement provides additional guidance in determining whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Generally, GASB No. 39 requires reporting a component unit if an organization rises and holds economic resources for the direct benefit of a governmental unit.

The Municipality's management has concluded that, based on the aforementioned criteria, there are no legally separate entities or organizations that should be reported as component units of the Municipality as of June 30, 2006 nor for the year then ended.

*c) Government-wide Financial Statements*

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

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

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

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

- **Invested in capital assets, net of related debt** – These consist of capital assets, net of accumulated depreciation and amortization, reduced by the outstanding balances of bonds, notes and other debt that are attributed to the acquisition, construction or improvement of those assets. For the purposes of determining the outstanding debt attributed to capital assets, the total long-term debt related to the acquisition, construction or improvement of capital

COMMONWEALTH OF PUERTO RICO  
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Notes to Basic Financial Statements  
June 30, 2006

assets have been reduced by any related unspent debt proceeds and any related unamortized debt issuance costs.

- **Restricted net assets** – These consist of net assets restricted by external parties (such as creditors, grantors, contributors, laws or regulations of other governments, etc.), or net assets for which constraints are imposed by constitutional provisions or enabling legislation. Enabling legislation is defined as legislation that authorizes the Municipality to assess, levy, charge or otherwise mandate payment of resources (from external resource providers). Enabling legislation establishes restrictions if it includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation.

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

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

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

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

The accompanying statement of activities presents the results of the Municipality's operations by showing how the Municipality's net assets changed during the year ended June 30, 2006, using a net (expense) revenue format. This statement presents the cost of each function/program as well as the extent to which each of the Municipality's functions, programs or other services either contributes to or draws from the Municipality's general revenues (such as property taxes, municipal license taxes, construction excise taxes, etc.).

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Basic Financial Statements  
June 30, 2006

operational units are classified within the following functions/programs in the accompanying basic financial statements:

**General Government:**

- Municipal Legislature
- Mayor's Office
- Department of Finance and Budget
- Department of Human Resources
- Department of Municipal Secretary
- Department of Internal Audit
- Department of Public Relations

**Urban and Economic Development:**

- Department of Public Works

**Public Safety:**

- Department of Municipal Police
- Office of Emergency Management

**Health and Sanitation:**

- Department of Health
- Department of Sanitation

**Culture, Recreation and Education:**

- Department of Recreation and Sports

**Welfare and Housing Assistance:**

- Department of Elderly Affairs
- Department of Service to Citizen

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

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Basic Financial Statements  
June 30, 2006

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

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

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

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

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

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Basic Financial Statements  
June 30, 2006

These governmental activities are also generally reported in the governmental fund financial statements.

The Municipality has no fiduciary activities, which are those in which the Municipality would be holding or managing net assets for specific individuals or other external parties in accordance with trust agreements or other custodial arrangements. In addition, the Municipality has no operations or activities that are primarily financed and operated in a manner similar to private business enterprises, where the costs of providing goods or services to the general public is financed primarily through user charges.

**d) *Governmental Fund Financial Statements***

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

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

- ***General fund*** – The general fund is the Municipality's main operating and major fund, as defined below, used to account for all financial resources and governmental activities, except for financial resources required to be accounted for in another fund. It is presumed that the Municipality's governmental activities have been reported in the general fund except for transactions for which one of the following compelling reasons has required the use of another fund: (1) legal requirements, (2) GAAP requirements or (3) the demands of sound financial administration requiring the use of a governmental fund other than the general fund.
- ***Special revenue funds*** – The special revenue funds are and nonmajor funds, as defined below, used by the Municipality to account for revenues derived from grants or other revenue sources (other than major capital projects) that are either self-restricted by the Municipality or legally restricted by outside parties for use in specific purposes. The uses and limitations of each special revenue fund are specified by municipal ordinances or federal and

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state statutes. However, resources restricted to expenditure for purposes normally financed from the general fund are reported in the Municipality's general fund provided that all applicable legal requirements are appropriately satisfied. In this case, a special revenue fund to account for such kind of transactions will be used only if legally mandated.

- **Debt service fund** – The debt service fund is a major fund, as defined below, used by the Municipality to account for the accumulation of resources for, and the payment of, principal and interest for: (1) bonds and notes for which debt service payments are legally mandated to be accounted for in a debt service fund and/or (2) general long-term debt for which the Municipality is being accumulating financial resources in advance, to pay principal and interest payments maturing in future years. Principal and accrued interest due on July 1 of the following fiscal year related to long-term debt for which debt service payments are accounted for in the debt service fund, are recorded as debt service fund's liabilities at June 30, if resources are available at June 30 for its payment.

General long-term debts for which debt service payments do not involve the advance accumulation of resources (such as obligations under capital leases, compensated absences, claims and judgments, and notes payable, among others) are accounted for in the accompanying statement of net assets. The debt service payments of such debts are generally accounted for in the general fund.

- **Capital projects funds** – Capital projects funds are major and nonmajor funds, as defined below, used to account for the financial resources used in the acquisition or construction of major capital facilities, other assets and permanent improvements. Significant capital outlays financed from general obligation bond proceeds are accounted for also in the capital projects funds.

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

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

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

Based on the aforementioned criteria, the Municipality's major governmental funds reported in the accompanying governmental fund financial statements are: (1) the general fund, (2) the state legislative joint resolutions fund, (3) head start fund, and (4) debt service fund.

The state legislative joint resolutions fund is a major fund used to account for financial resources derived from capital and operating grants awarded each year by the Commonwealth's Senate and House of Representatives (the Commonwealth's Legislature). The purpose of the amounts awarded by the Commonwealth's Legislature vary from year to year, but are generally restricted to (1) partially subsidy certain qualifying administrative and operational activities of the Municipality, (2) provide specific multipurpose services to citizens and (3) finance the acquisition or construction of capital assets approved by the Commonwealth's Legislature.

The head start fund is a major fund used to account for financial resources derived from Federal grants from the Administration for Children and Families of the United States Department of Health and Human Services related to Head Start and Early Head Start Programs. The purpose of the amounts awarded by the Grantor is restricted to (1) provide specific services to eligible participants.

e) *Measurement Focus and Basis of Accounting*

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

All revenues, expenses, gains, losses, assets and liabilities resulting from exchange and exchange-like transactions are generally recorded when the exchange takes place. In exchange transactions, each party to the transaction receives and gives up essentially equal values.

An exchange-like transaction is one in which there is an identifiable exchange and the values exchanged, though related, may not be quite equal. Nevertheless, the exchange characteristics of the exchange-like transaction are strong enough to justify treating it as an exchange for

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accounting purposes (examples include fees for licenses and permits, charges for services, and miscellaneous revenues, which are recorded as revenues when collected because they are generally not measurable until actually received).

All revenues, expenses, gains, losses and assets resulting from nonexchange transactions are recorded using the criteria set forth by GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* (GASB No. 33), which the Municipality adopted on July 1, 2003. GASB No. 33 established accounting and reporting standards for nonexchange transactions involving cash and financial or capital resources (for example, most taxes, grants and private donations). In a nonexchange transaction, the Municipality gives (or receives) value without directly receiving (or giving) equal value in return. This is different from an exchange transaction, in which each party receives and gives up essentially equal values. According to GASB No. 33, the Municipality groups its nonexchange transactions into the following four classes in the accompanying basic financial statements: (a) derived tax revenues, (b) imposed nonexchange revenues, (c) government mandated nonexchange transactions, and (d) voluntary nonexchange transactions.

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

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

Government-mandated nonexchange transactions (such as grants and contributions) result when a government at one level (such as the federal or state government) provides resources to another government (such as the Municipality), and the provider government requires the recipient government to use those resources for a specific purpose or purposes established in the provider's enabling legislation. In these types of transactions, receivables and revenues are generally recorded as follows:

- For reimbursement-type (commonly known as "expenditure-driven awards"), receivables and revenues are recorded when all eligibility requirements imposed by the provider have been met. The Municipality must expend resources on the specific purpose or project before the provider reimburses any amounts. Revenue is, therefore, generally recognized as qualifying reimbursable expenditures are incurred.
- For other types of grants (mainly grants and contributions with purpose restrictions but with no time requirements), receivables and revenues are recorded when all applicable

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eligibility requirements are met. When the provider is a government (including the government of the United States of America) the applicable recognition period for both, the provider and the recipient, is the provider's fiscal year and begins on the first day of that year.

Voluntary nonexchange transactions (such as donations and certain grants and entitlements) result from legislative or contractual agreements, other than exchanges, entered into willingly by two or more parties. In these types of transactions, receivables and revenues are generally accounted for in the same manner as government-mandated nonexchange transactions discussed above.

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

Events that are neither exchange nor nonexchange transactions are recorded when it is probable that a loss has been incurred and the amount of loss is reasonably estimable.

The measurement focus and the basis of accounting used in the accompanying GWFS differ significantly from the measurement focus and basis of accounting used in the preparation of the accompanying GFFS. Therefore, the accompanying GFFS include reconciliations to better identify the relationship between the GWFS and the GFFS.

**Governmental fund financial statements** – The accompanying GFFS are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are generally recognized as soon as they are both measurable and available. Revenues are generally considered to be available when they are collectible within the current year or soon enough thereafter to pay liabilities of the current year. For this purpose, the Municipality considers most revenues to be available if collected within 90 days after June 30, 2006, except for property taxes for which the availability period is 60 days. Revenue sources not meeting this availability criterion or collected in advance are recorded as deferred revenues at June 30, 2006. The principal revenue sources considered susceptible to accrual include property taxes, municipal license taxes, intergovernmental grants and contributions and interest income. These principal revenue sources meet both measurability and availability criteria in the accompanying GFFS, except for amounts recorded as deferred revenues.

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

All revenues, expenses, gains, losses and assets resulting from nonexchange transactions are recorded in a similar manner to the GWFS, using the previously discussed criteria set forth by

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GASB No. 33 for nonexchange transactions, but subject to and limited by the availability criteria discussed above. Accordingly, municipal license tax receivables and revenues are generally recorded when the underlying exchange has occurred. Property tax receivables are also generally recorded in the period when an enforceable legal claim has arisen while property tax revenues (net of amounts considered not collectible) are also generally recorded in the period when resources are required to be used or the first period that the use of the resources is permitted. Receivables and revenues from reimbursement-type grants, contributions, donations and entitlements are also generally recorded as qualifying reimbursable expenditures are incurred, while receivables and revenues from other types of grants are recorded when all eligibility requirements imposed by the provider have been met.

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

As previously discussed, on July 1, 2003, the Municipality adopted the provisions of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements* (GASBI No. 6), which modifies the recognition criteria for certain expenditures and liabilities reported under the modified accrual basis of accounting and clarifies a number of situations in which the Municipality should distinguish between governmental fund liabilities and general long-term liabilities.

Pursuant to the provisions of GASBI No. 6, in the absence of an applicable accrual modification, governmental fund liabilities and expenditures should be accrued. Liabilities that governments normally pay in a timely manner and in full from expendable available financial resources (for example, salaries and utilities) should be recognized when incurred, without regard to the extent to which resources are currently available to liquidate the liability.

Modifications to the accrual basis of accounting include:

- Employees' accumulated vacation, sick leave and compensatory time (compensated absences) is recorded as expenditure when consumed. The amount of the unpaid compensated absences has been reported only in the accompanying statements of net assets.
- Principal and interest on bonds and notes payable are recorded when they mature (when payment is due), except for principal and interest due in July 1 of the following fiscal year, which are recorded when resources are available in the debt service fund (generally June 30).
- Obligations under capital leases, amounts subject to claims and judgments under litigation and other long-term obligations are recorded only when they mature (when payment is due).
- Accounts payable and accrued liabilities not expected to be liquidated with available and expendable financial resources are recorded in the accompanying statement of net assets but not in the governmental funds.

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- Executory purchase orders and contracts are recorded as a reservation of fund balance in the GFFS.

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

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

Under the new financial reporting model established by GASB No. 34, all general capital assets and the unmatured long-term liabilities (determined using the modified accrual basis of accounting) are no longer reported in account groups within the governmental fund balance sheet but are incorporated into the accompanying statement of net assets since July 1, 2003.

*f) Stewardship, Compliance and Accountability*

**Budgetary Control**

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

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

The Municipal Legislature has 10 business days, up to June 13, to discuss and approve the Project with modifications. The Municipal Legislature may amend the budgets submitted by the Mayor but may not increase any items so far to cause a deficit without imposing taxes or identifying other sources of revenue to cover such deficit. After the Municipal Legislature modifies and preliminarily approves the Project, the modified Project is sent back to the Mayor for his approval or rejection within 6 days. The Mayor may decrease or eliminate any line item but may not increase or insert any new line item in the budgets. The Mayor may also veto the

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budgets in their entirety and return it to the Municipal Legislature with his objections. If the Mayor rejects the Project, the Municipal Legislature will have up to 8 days to adopt or reject the recommendations or objections of the Mayor. The approved Project is sent again to the Mayor, which then would have 3 days to sign and approve it.

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

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

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

The legal level of budgetary control (i.e., the level at which expenditures may not legally exceed appropriation) is at the functions/program level (general government, urban and economic development, public safety, health and sanitation, culture, recreation and education, and public housing and welfare) within a fund.

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

**Budgetary Accounting**

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

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

The Municipality uses encumbrance accounting to record the full amount of purchase orders, contracts and other commitments of appropriated resources as deductions from the appropriation prior to actual expenditure. In the governmental funds, encumbrance accounting is a significant

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aspect of budgetary control. Accordingly, expenditures are generally recorded when the related expenditure is incurred or encumbered. Available appropriations and encumbrances are established to lapse one year after the end of the fiscal year. Amounts required to settle claims and judgments against the Municipality, and certain other liabilities, are not recognized until they are encumbered or otherwise processed for payment. Unencumbered appropriations and encumbrances lapse at year-end. Other appropriations, mainly capital projects appropriations, are continuing accounts for which the Municipal Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending.

The accompanying budgetary comparison schedule provides information about the general fund's original budget, the amendments made to such budget, and the actual general fund's results of operations under the budgetary basis of accounting for the fiscal year ended June 30, 2006. Further details of the Municipality's budgetary control at the legal level may be obtained from the Budgetary Liquidation Report for the fiscal year ended June 30, 2006. Copies of that report may be obtained by writing to the Municipality's Director of Finance and Budget.

Accounting principles applied for purposes of developing data on a budgetary basis differ significantly from those used to present the governmental fund financial statements in conformity with GAAP. Accordingly, the accompanying budgetary comparison schedule is accompanied by a reconciliation of the differences between the budgetary basis and GAAP actual amounts.

The Municipality does not legally adopt budgets for the state legislative joint resolutions capital fund. The financial resources received by these funds are not subject to budgeting by the Municipality since the resources received each year from the respective grantors varies from year to year, and the respective amounts are granted at their discretion.

**g) *Unrestricted and Restricted Deposits***

The Municipality's deposits are composed of cash on hand, demand deposits and cash equivalents in: (1) commercial banks, (2) the Government Development Bank for Puerto Rico (GDB), a governmental bank and a major component unit of the Commonwealth, who is statutorily designated as fiscal agent of the Municipality, and (3) the Municipal Revenue Collection Center (CRIM, by its Spanish acronyms), a governmental entity responsible for the imposition and collection of property taxes on behalf of all municipalities of Puerto Rico.

The Municipality follows the practice of pooling cash. The balance in the pooled cash account is available to meet current operating requirements. Under the laws and regulations of the Commonwealth, public funds deposited by the Municipality in commercial banks must be fully collateralized for the amounts deposited in excess of the federal depository insurance generally provided by the Federal Deposits Insurance Corporation (FDIC). All securities pledged as collateral are held by agents designated by the Secretary of the Treasury of the Commonwealth, but not in the Municipality's name.

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Restricted assets include cash and cash equivalents in commercial banks, GDB and CRIM. These cash balances are classified as restricted assets since its use is limited for the specified purposes discussed below, which are established by applicable agreements or required by law.

Restricted cash with fiscal agent in the general and debt service funds represent property tax collections which are retained and restricted for the payment of the Municipality's debt service, as established by law. Restricted cash in fiscal agent in other governmental funds consists of unspent proceeds of bonds and notes, and the balance of interest and noninterest bearing accounts which are restricted for: (1) the acquisition, construction or improvement of major capital assets and the operations of federal and state funded programs.

Restricted cash includes cash equivalents amounting to \$1,498,472 at June 30, 2006, consisting of certificates of deposit with original maturities of three months or less. These cash equivalents are recorded in the state legislative joint resolutions fund, consequently, are restricted for use in specific activities accounted for in such fund.

***h) Unrestricted and Restricted Accounts and Notes Receivable***

In the accompanying GWFS, receivables consist of all revenues earned but not collected at June 30, 2006. Major receivable balances for the governmental activities include property taxes and intergovernmental receivables.

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

Intergovernmental receivables are composed of: (1) amounts owed to the Municipality for reimbursement of expenditures incurred pursuant to federal and state funded programs (recorded in the general fund, special revenue funds and capital project funds), and (2) contributions in lieu of taxes from the Puerto Rico Electric Power Authority, recorded in the general fund.

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

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

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*i) Inventories*

Inventories consist of materials, supplies, food and medicine inventories held for consumption. Generally, inventories are recorded as expenditures when purchased (purchase method).

*j) Capital Assets*

Capital assets used in governmental activities include land and land improvements, buildings, structures and building improvements, machinery and equipment, furniture and fixtures, licensed vehicles, construction in progress, and infrastructure. These assets are capitalized and reported in the accompanying statement of net assets. Infrastructure assets are generally stationary in nature and include roads, bridges, streets and sidewalks, drainage systems and other similar assets.

The Municipality defines capital assets as assets with an individual cost of \$500 or more at the date of acquisition or construction, and with useful lives extending beyond one year. All assets with individual costs under \$500 or with useful lives not exceeding one year, are charged directly to expense in the accompanying statement of activities. In the governmental funds, all capital assets are recorded as expenditures.

In the statement of net assets, all capital assets are recorded at cost or estimated historical cost if actual cost was unavailable, except for donated capital assets, which are recorded at their estimated fair value at the date of donation. Estimated historical costs based on deflated current costs were used to value a significant portion of the infrastructure and certain land, buildings, structures and building improvements constructed or acquired prior to June 30, 2003. The method to deflate the current costs using an approximate price index was used only in the case of certain items for which their historical cost documentation was not available. Actual historical costs were used to value the infrastructure, land, building, structures, building improvements, construction in progress, machinery and equipment and licensed vehicles constructed or acquired during or after the year ended June 30, 2004.

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

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

	<u>Years</u>
Land improvements	20
Buildings, structures and building improvements	30 to 50
Infrastructure	20 to 50
Licensed vehicles	8
Furniture and fixtures	5 to 20
Machinery and equipment, excluding those held under capital leases	5 to 20

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

***k) Deferred Revenues***

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

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

Deferred revenues at the government-wide level arise only when the Municipality receives resources before it has a legal claim to them.

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**l) *Compensated Absences***

Compensated absences are accounted for under the provisions of Statement No. 16, *Accounting for Compensated Absences*, issued by GASB (GASB No. 16). Compensated absences include paid time off made available to employees in connection with vacation, sick leave and compensatory time. The liability for compensated absences recorded in the accompanying statement of net assets is limited to leave that: (1) is attributable to services already rendered on or before June 30, 2006 and (2) is not contingent on a specific event (such as illness) that is outside the control of the Municipality and the employee. The liability for compensated absences includes salary-related costs, which are directly and incrementally related to the amount of salary paid to the employee (such as employer's share of social security taxes and medicare taxes).

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

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

The liability for compensated absences is reported in the statement of net assets. A liability for compensated absences is reported in the GFFS only if they have matured, for example, as a result of employee resignations and retirements.

**m) *Long-term Debt***

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

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

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On July 1, 2003, the Municipality adopted the provisions of APB Opinion No. 21, *Interest on Receivables and Payables* (APB No. 21), to account for certain non-interest bearing notes payable to: (1) CRIM, , a discretely presented component unit of the Commonwealth, and (2) Puerto Rico Treasury Department, an agency (governmental unit) of the primary government of the Commonwealth.

According to APB No. 21, the Municipality has recorded such notes at present value with an imputed interest rate that approximates the rate that would have been used, using the same terms and conditions, if it had been negotiated by an independent lender. In the accompanying statement of net assets, such notes payable are reported net of the applicable unamortized discount, which is the difference between the present value and the face amount of the notes.

**n) Accounting for Pension Costs**

For the purpose of applying the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers* (GASB No. 27), the Commonwealth of Puerto Rico is considered to be the sponsor of the Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities (ERS) and System 2000, the two retirement systems in which the employees of the Municipality participate. Accordingly, the Municipality is considered a participant and not a sponsor of these retirement systems since the majority of the participants in the aforementioned pension trust funds are part of the financial reporting entity of the Commonwealth. Accordingly, no portion of the net pension obligation (NPO) related to ERS has been allocated to the Municipality in the accompanying basic financial statements. The basic financial statements of the Commonwealth account for the total amount of the net pension obligation of ERS, including any amount that may be allocated to the Municipality.

According to GASB No. 27, 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.

**o) Risk Management**

The Municipality carries commercial insurance covering casualty, theft, tort claims and other losses. Insurance policies are negotiated by the Puerto Rico Treasury Department (the Treasury Department) on behalf of all municipalities of Puerto Rico. The Treasury Department pays the insurance premiums on behalf of the Municipality and then is reimbursed each year through monthly equal payments deducted from the Municipality's gross property tax collections made by CRIM.

The Municipality carries insurance coverage for death and bodily injuries caused by automobile accidents. This insurance is obtained through the Automobile Accidents Compensation Administration ("ACAA", by its Spanish acronym), a discretely component unit of the Commonwealth. This insurance is compulsory for all licensed vehicles used on public roads and

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

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

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

The Municipality also obtains medical insurance coverage for its employees. The current insurance policies have not been cancelled or terminated at June 30, 2006. In the past three years, the Municipality has not settled claims that exceeded insurance coverage.

**p) Reservations of Fund Balances**

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

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

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q) *Interfund Activities*

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

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

In the GFFS, interfund activity has not been eliminated, as permitted by GAAP.

r) *Use of Estimates*

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

s) *Future Adoption of Accounting Pronouncements*

In June 2005, GASB issued its Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB No. 45). This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities/assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local government employers. The requirements of this statement are effective for the Municipality's fiscal year commencing on July 1, 2008.

In September 2006, GASB issued its Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* (GASB No. 48). This Statement established standards for the measurement, recognition, and display of transactions where governments sometimes exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments, generally, a single lump sum. This Statement establishes criteria that the Municipality will use to ascertain whether

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the proceeds received should be reported as revenue or as a liability. The requirements of this statement are effective for the Municipality's fiscal year commencing on July 1, 2007.

The Municipality's management has concluded that the future adoption of GASB Statements No. 45 and 48 will not have a significant impact on the Municipality's basic financial statements.

## 2. DEPOSITS

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

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

The Municipality's bank balance of deposits with financial institutions is categorized to provide an indication of the level of collateral risk assumed by the Municipality at June 30, 2006. Risk categories are described as follows:

- Category 1:** Deposit is insured or collateralized with securities held by the Secretary of the Treasury' agents in the Municipality's name.
- Category 2:** Deposit is collateralized with securities held by pledging financial institution's trust department or agent in the Municipality's name.
- Category 3:** Deposit is uncollateralized; including any bank balance that is collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the Municipality's name.

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The carrying amount (book balance) of cash at June 30, 2006 consists of the following:

	General fund	State legislative joint resolution funds	Head start	Debt service	Nonmajor funds	Totals
Unrestricted (category 1):						
Cash in commercial banks	\$ 899,981	-	-	-	47,978	\$ 947,959
Restricted (category 1):						
Cash in commercial banks	-	141,453	73,233	-	493,794	708,480
Restricted (category 3):						
Cash in GDB or CRIM, as fiscal agents	151,636	-	-	1,319,228	781,429	2,252,293
<b>Total deposits</b>	<b>\$ 1,051,617</b>	<b>141,453</b>	<b>73,233</b>	<b>1,319,228</b>	<b>1,323,201</b>	<b>\$ 3,908,732</b>

The Municipality's bank balances in commercial banks amounting to \$947,959 at June 30, 2006 were fully collateralized (Category 1). The bank balance of deposits in GDB and CRIM, which is uninsured and uncollateralized (Category 3), amounted to \$2,252,293 at June 30, 2006.

### 3. MUNICIPAL LICENSE TAXES

The Municipality is authorized by Law No. 81 to impose and collect municipal license taxes on all trade or business activities operated by any natural or legal person within the territorial area of Santa Isabel. This is a self-assessed tax generally based on the business volume measured by gross sales. The Municipality establishes the applicable tax rates. At June 30, 2006, the municipal tax rates imposed by the Municipality were 1.50% for financing institutions and 0.30% for other types of taxpayers. Any taxpayers that have been granted with partial tax exemptions under any of the incentive tax laws of the Commonwealth ultimately pay municipal license taxes at reduced tax rates, generally between 60% and 90% under standard rates.

Each taxpayer must assess his/her corresponding municipal license tax by declaring his/her volume of business through a tax return to be filed every April 15 based on the actual volume of business generated in the preceding calendar year.

Taxpayers with a sales volume of \$1 million or more must include audited financial statements with their tax returns. The tax can be paid by the taxpayer in two equal installments due on July 15 and January 15, subsequent to the filing of the declaration.

The first installment of the tax covers the six-month period ended December 31, subsequent to the filing date of the declaration, while the second installment of the tax covers the six-month period ended June 30 of the subsequent calendar year. If a taxpayer elects to pay the tax in full on the filing

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date of the declaration (generally April 15), a 5% discount is granted automatically on the total tax amount due.

Any municipal license taxes collected in advance (that is, pertaining to a future period) are recorded as deferred revenues. Deferred municipal license tax revenues recorded in the accompanying GWFS and GFFS amounted to \$823,548 at June 30, 2006, which represents municipal licenses collected in advance for the taxable year 2006-2007.

#### 4. PROPERTY TAXES

The Municipality is authorized by Law No. 81 to impose and collect personal and real property taxes. Under the laws and regulations of the Commonwealth, personal property taxes can be imposed to any natural or legal person that at January 1 of each year is engaged in trade or business and is the owner of personal property used in trade or business.

Personal property taxes are self-assessed by taxpayers every year generally using the book value of personal property assets owned by the taxpayer at January 1 (assessment date) and reporting such taxable value through a personal property tax return filed on May 15 subsequent to the assessment date. The total personal property tax rate in force at June 30, 2006 was 6.53% (of which taxpayers pay 6.33% and 0.20% is reimbursed by the Department of Treasury). Real property taxes are assessed by CRIM. The assessment on real property is made every January 1 and is based on estimated current values of the property deflated to 1957 market prices. The total real property tax rate in force at June 30, 2006 was 8.53% (of which 8.33% is paid by taxpayers and 0.20% is also reimbursed by the Department of Treasury).

Residential real property occupied by its owner is exempt by law from property taxes on the first \$15,000 of the assessed value (at 1957 market prices). For such exempt amounts, the Department of Treasury assumes payment of the basic tax (4% and 6% for personal and real property, respectively) to the Municipality, except for property assessed of less than \$3,500 (at 1957 market prices), for which no payment is made.

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

Law No. 81 provides for the levy of an annual special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation. Such special tax is levied and collected by

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CRIM. Collections of this special tax are remitted to the Commonwealth's debt service fund for payment of debt service on general obligations of the Commonwealth.

In addition, 1.50% of the total personal and real property taxes collected by CRIM is restricted for the Municipality's debt service requirements and is retained by GDB for such purposes.

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

- i. Thirty five percent (35%) of its net earnings (defined as the excess of revenues over expenses less an amount earmarked for the Fund for Rent and Home Improvement Subsidy Program for the Low-Income Qualifying Elderly) is earmarked to the municipalities of the Commonwealth, of which a maximum of \$26 million, on an annual basis, is distributed to the Municipal Equalization Fund held by CRIM to cover operating expenses and permanent improvements of the municipalities.
- ii. An additional amount not exceeding \$16 million, on an annual basis, is distributed to the Municipal Equalization Fund, provided it is within the 35% corresponding to the municipalities of the Commonwealth. When the accumulated municipal appropriations from the municipalities' Puerto Rico Health Reform are covered up to June 30, 1997, these resources will be assigned to the Health Insurance Administration, a component unit of the Commonwealth.

The general fund property tax receivable, net of an allowance for uncollectible accounts of \$5,669,650 amounted to \$1,396,163 at June 30, 2006. The composition of the property tax receivable and the related allowance for doubtful accounts is as follows:

	<u>General fund</u>
Property tax receivable	\$ 7,065,813
Allowance for doubtful accounts	5,669,650
Net property tax receivable	<u>\$ 1,396,163</u>
Deferred (unavailable) property tax revenues in GFFS	<u>\$ 1,396,163</u>

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**5. DUE FROM (TO) GOVERNMENTAL ENTITIES**

1. Amounts due from governmental entities as of June 30, 2006 follows:

	Commonwealth entities	Federal government
Puerto Rico Power Authority (PREPA) 2005-2006 contribution in lieu of taxes	\$ 684,037	\$ -
US Department of Health and Human Services – Head Start		39,680
State Administration for Child Care and Development (ACUDEN) – Child Care and Development Block Grant		126,514
State Administration for Child Care and Development (ACUDEN) – Community Services Block Grant		25
State Department of Labor- Law 52	481,529	
State Department of Education – Child and Adult Food Program		10,806
Puerto Rico Department of Treasury – Christmas bonus reimbursement	70,070	
State Police Department	32,410	
<b>Total</b>	<b>\$ 1,268,046</b>	<b>\$ 177,025</b>

The amount due from Puerto Rico Department of Treasury – Christmas bonus (\$70,070) and (\$684,037) from PREPA are recorded as deferred revenues in the governmental funds statements (general fund) since is not available as required by modified accrual basis of accounting.

2. Amounts due to governmental entities as of June 30, 2006 follows:

	Governmental entities
State Treasury Department	\$ 1,634,681
State Retirement System Administration	2,053,041
Internal Revenue Services	31,211
Puerto Rico Water and Sewer Authority	623,731
State Department of Labor	225,295
Commonwealth Employees Association	15,561
State Public Service Commission	22,532
State Solid Waste Administration	14,610
Puerto Rico General Services Administration	1,040
<b>Total</b>	<b>\$ 4,621,702</b>

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**6. INTERFUND BALANCES**

On July 1, 2003 the Municipality adopted the provisions of Statement No. 38, *Certain Financial Statement Note Disclosures*, issued by the Governmental Accounting Standards Board. This statement requires the disclosure of the flow of resources between funds and to assess the collectibility of interfund balances. Interfund balances at June 30, 2006 consisted of the following:

<b>Operating transfers-in:</b>				
<b>Operating transfers-out:</b>	<b>Debt service fund</b>	<b>Total</b>		
<b>Major funds:</b>				
General fund	\$ 191,463	\$ 191,463		
State legislative joint resolution funds	300,000	300,000		
<b>Total</b>	<b>\$ 491,463</b>	<b>\$ 491,463</b>		

<b>Due/advances to:</b>	<b>General fund</b>	<b>State legislative joint resolutions fund</b>	<b>Nonmajor governmental funds</b>	<b>Total</b>
<b>Major funds:</b>				
General fund	\$ -	2,033,009	64	\$ 2,033,073
State legislative joint resolution funds	-	-	-	-
Head start fund	77,450	-	-	77,450
Debt service fund	10,520	-	-	10,520
Nonmajor governmental funds	805,583	1,600	1,500	808,683
<b>Total</b>	<b>\$ 893,553</b>	<b>2,034,609</b>	<b>1,564</b>	<b>\$ 2,929,726</b>

At June 30, 2006 all amounts due to among funds are considered collectible by the Municipality's management.

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**7. CAPITAL ASSETS**

Capital asset activity for the year ended June 30, 2006, was as follows:

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

	Balance at June 30, 2005, as restated	Additions/ increases	Disposals/ decreases	Balance at June 30, 2006
<b><u>COST BASIS:</u></b>				
Cost basis of capital assets, not subject to depreciation and amortization:				
Land	\$ 1,165,285			\$ 1,165,285
Construction in progress	1,827,561	1,813,757	-	3,641,318
Total cost basis of capital assets, not subject to depreciation and amortization	<u>2,992,846</u>	<u>1,813,757</u>	<u>-</u>	<u>4,806,603</u>
Cost basis of capital assets, subject to depreciation and amortization:				
Buildings, structures and building improvements	12,195,303			12,195,303
Infrastructure	2,400,646			2,400,646
Land improvements	62,800			62,800
Licensed vehicles	1,559,149	109,439		1,668,588
Machinery and equipment	677,950	222,080	-	900,030
to depreciation and amortization	<u>16,895,848</u>	<u>331,519</u>	<u>-</u>	<u>17,227,367</u>
Total cost basis of capital assets	<u>\$ 19,888,694</u>	<u>2,145,276</u>	<u>-</u>	<u>\$ 22,033,970</u>
	Balance at June 30, 2005	Depreciation and Amortization Expense	Reclassifications	Balance at June 30, 2006
<b><u>ACCUMULATED DEPRECIATION AND AMORTIZATION:</u></b>				
Buildings, structures and building improvements	\$ 1,653,410	222,333		\$ 1,875,743
Infrastructure	1,050,255	64,434		1,114,689
Land improvements	1,320	1,130		2,450
Licensed vehicles	910,896	132,389		1,043,285
Machinery and equipment	298,186	52,056	-	350,242
Total accumulated depreciation and amortization	<u>3,914,067</u>	<u>472,342</u>	<u>-</u>	<u>4,386,409</u>
<b>CAPITAL ASSETS, NET</b>	<u>\$ 15,974,627</u>			<u>\$ 17,647,561</u>
The depreciation expense is detailed as follow:				
General government				14,228
Public safety				50,274
Welfare and housing assistance				8,505
Culture recreation and education				210,273
Health and sanitation				9,150
Urban and economic development				179,912
Total depreciation and amortization expense				<u>\$ 472,342</u>

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**8. EMPLOYEES RETIREMENT SYSTEM**

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

The System is independent, thus assets may not be transferred to another system or used for any purpose other than to benefit each system's participants. The System issues publicly available financial reports that include its basic financial statements and required supplementary information for each of them, including required six-year trend information. Those reports may be obtained by writing to the administrator of the System.

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

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

On September 24, 1999, an amendment to Act No. 447 of May 15, 1951, which created the System, was enacted with the purpose of establishing a new pension system ("System 2000"). System 2000 became effective on January 1, 2000. Employees participating in the current system as of December 31, 1999, had the option to either stay in the defined benefit plan or transfer to the new program. Persons joining the government on or after January 1, 2000, are the only required to become members of System 2000.

System 2000 is a hybrid defined contribution plan, also known as cash balance plan. Under this new plan, there is a pool of pension assets, which will be invested by the System, together with those of the current defined benefit plan. The Commonwealth nor the Municipality will not guarantee benefits at retirement age. The annuity will be based on a formula which assumes that each year the employees' contribution (with a minimum of 8.275 percent of the employees' salary up to a maximum of 10.00 percent) will be invested in an account which will either: (1) earn a fixed rate based on the two-year Constant Maturity U.S. Treasury Note; (2) earn a rate equal to 75 percent of the return of the System 2000's investment portfolio (net of management fees); or (3) earn a combination of both alternatives. Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances.

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Disability pensions are not being granted under System 2000. The employer's contributions (9.275 percent of the employees' salary which is applicable to the Municipality) will be used to fund the current plan.

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

**Funding Policy:**

Contribution requirements are established by law and are as follows:

Municipality	9.275% of gross salary
Employees:	
Hired on or before March 31, 1990	5.775% of gross salary up to \$6,600 8.275 of gross salary over \$6,600
Hired on or after April 1, 1990	8.275% of gross salary

On August 12, 2000, Act No. 174 was approved to allow certain participants of the ERS to be eligible for early retirement upon attaining at least age 55 with 25 years of service, provided they made their election on or before April 1, 2001. Those who elected early retirement under this law will receive monthly benefits of 75 percent (if 25 or more year of service and 55, or 30 or more years or services and age 50) or benefits of 65 percent (if 25 years of service by less than age 55) of their average compensation which is computed based on the highest 36 months of compensation recognized by the System. In these cases, the employer (including the Municipality) is responsible for contributing to the System the amount needed to cover the benefit payments and employer contribution with respect to the participants covered until the participants reaches the normal retirement age.

Historically, the Commonwealth has reported the System as a single-employer plan (as relates only to the financial reporting entity of the Commonwealth) in its comprehensive annual financial report. Accordingly, any actuarial deficiency that may exist or arise related to the Municipality's participating employees will be assumed by the Commonwealth since the System does not allocate any actuarial deficiencies pertaining to municipal employees participating in the System. The Municipality is only required by law to make statutory contributions in the rates mentioned above. As a result, no net pension obligation nor net pension asset that may be allocable to the

Municipality's participating employees, if any, has been recorded in the accompanying basic financial statements.

**9. LONG-TERM DEBT**

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

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

In addition, before any new bonds or notes are issued, the revenues of the debt service fund should be sufficient to cover the projected debt service requirement. At June 30, 2006, the Municipality is in compliance with the debt limitation requirements. The general long-term debt activity for the year ended June 30, 2006 was as follows:

	Balance at June 30, 2005, as restated	Borrowings or Additions	Payments or Deductions	Balance at June 30, 2006	Due Within One Year
Bonds and bond anticipation note payables	\$ 6,106,000	\$ 1,410,000	\$ (277,000)	\$ 7,239,000	\$ 286,000
Notes payable to:					
Puerto Rico Treasury Department:					
Financing agreement for the excess of property tax advances over collections	157,923	-	(37,902)	120,021	37,902
Financing agreement to settle two legal demands	1,633,314		(192,155)	1,441,159	192,155
CRIM:					
Act No. 42 - Financing agreement for the excess of property tax advances over collections through fiscal year 2000	541,513	-	(7,834)	533,679	8,327
Act No. 146 - Financing of delinquent property tax accounts sold	688,000	-		688,000	-
LIMS Reimbursement	129,374	-	(16,840)	112,534	17,857
Fiscal Year 2004-2005 Final Settlement	47,896	-	-	47,896	47,896
State Department of Labor - Financing Agreement	140,296	134,506	(131,347)	143,455	33,108
Health Insurance Administration	646,617	-		646,617	-
Compensated absences	1,618,322	897,053	(943,247)	1,572,128	550,000
Estimated landfill closure and postclosure care costs	931,173	-	(30,483)	900,690	-
Puerto Rico Power Authority - fiscal year power utility expense	647,984	684,037	(647,984)	684,037	684,037
Christmas bonus	202,831	150,860	(202,831)	150,860	150,860
<b>Total</b>	<b>\$ 13,491,243</b>	<b>\$ 3,276,456</b>	<b>\$ (2,487,623)</b>	<b>\$ 14,280,076</b>	<b>\$ 2,008,142</b>

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**a) Bonds Payable**

The Municipality issues general and special (public improvements) obligations bonds and notes to provide for the acquisition and construction of major capital facilities and equipment, as well as, to cover certain operating needs. Bonds and notes payable at June 30, 2006 is composed of the following debts:

<u>General and Special Obligations:</u>	<u>Outstanding Amount</u>
\$1,850,000 special obligation bonds series of 2003 payable in semi annual installments ranging from \$30,000 to \$140,000 through July 2027, interest from 5% to 6.50%	\$ 1,750,000
\$730,00 special obligation bonds series of 2003 payable in semi annual installment ranging from \$10,000 to \$55,000 through July 2027, interest from 5% at 6.50%	690,000
\$155,000 notes payable series of 2002 in semi annual installments ranging from \$20,000 to \$25,000 through July, 2008, interest ranging from 2.70% to 5.00%	75,000
\$33,000 public improvement bonds series of 1994 payable in annual installments ranging from \$1,000 to \$2,000 through January 2018, interest at 4.50%	21,000
\$205,000 general obligation bonds series of 1997 payable in semi annual installments ranging from \$5,000 to \$20,000 through July 2022, interest from 4.86% to 6.71%	165,000
\$215,000 public improvement bonds series of 1994 payable in annual installments ranging from \$5,000 to \$15,000 through January 2018, interest at 4.5%	139,000
\$235,000 general obligation bonds series of 2000 payable in semi annual installments ranging of \$10,000 to \$30,000 through July 2011, interest from 2.70% to 7.81%	145,000
\$324,000 public improvement bonds series of 1987 payable in annual installments ranging from \$7,000 to \$23,000 through January 2011, interest at 5.00%	102,000
\$361,000 public improvement bonds series of 1992 payable in annual installments ranging from \$9,000 to \$25,000 through January 2016, interest at 5.00%	205,000

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<u>General and Special Obligations:</u>	<u>Outstanding Amount</u>
\$230,000 rent bond series of 2003 payable in annual installments ranging from \$9,000 to \$22,500 through July 2019, interest ranging 4.50% to 6.00%	221,000
\$390,000 public improvement bonds series of 1984 payable in annual installments ranging from \$15,000 to \$26,000 through January 2009, interest at 5.00%	75,000
\$580,000 general obligations bonds series of 2001 payable in semi annual installments ranging of \$35,000 to \$80,000 through July 2010, interest ranging from 5% to 8.0%	350,000
\$630,000 general obligations bonds series of 1997 payable in semi annual installments ranging of \$10,000 to \$60,000 through July 2020, interest from 4.7% to 6.63%	515,000
\$755,000 general obligation bonds series of 2001 payable in semi annual installments ranging of \$5,000 to \$65,000 through July 2025, interest ranging from 5% to 7.5%	695,000
\$185,000 general obligation bonds series 2004 payable in semi annual installments ranging from \$5,000 to \$ 15,000 through July 2028, interest ranging 5.0% to 6.5%	175,000
\$185,000 general obligation bonds series 2004 payable in semi annual installments ranging from \$5,000 to \$ 15,000 through July 2028, interest ranging 5.0% to 6.0%	175,000
\$55,000 general obligation note series of 2003 payable in semi annual installments ranging of \$5,000 to \$10,000 through July 2010, interest ranging from 5% to 6%	45,000
\$300,000 general obligation bond series of 2001 payable in annual installments ranging of \$7,000 to \$21,000 through July 2029, interest at 4.75%	286,000
\$1,410,000 general obligation bond series of 2006 payable in annual installments ranging of \$40,000 to \$115,000 through July 2025, interest ranging 5.32 to 5.5%	1,410,000
<b>Total bonds:</b>	<u>\$ 7,239,000</u>

These bonds are payable from the ad valorem property tax of 1.5% which is restricted for debt service and retained by the Government Development Bank for Puerto Rico for such purposes.

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

The Municipality levies an annual additional special tax of 1.50% of the assessed value of personal and real property. The proceeds of this additional special tax are deposited in a sinking fund established at GDB whereby sufficient funds must be set aside to redeem the bonds in minimum annual or biannual principal and interest payments. The proceeds of this special tax are recorded in the debt service fund.

Interest rates on serial bonds subject to variable rates are reviewed periodically by GDB and are based on the fluctuation of GDB's weighted average rate for its commercial paper program, not to exceed 8%. Under this program, GDB issues commercial paper in the U.S. taxable and tax-exempt markets, in the Eurodollar market and to corporations that have tax exemption under the Commonwealth's Industrial Incentives Act and qualify for benefits provided by the U.S. Internal Revenue Code Section 936.

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

<u>Year ended June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 340,000	447,777	\$ 787,777
2008	359,000	423,222	782,222
2009	385,000	402,514	787,514
2010	353,500	371,810	725,310
2011	373,000	348,971	721,971
2012-2016	1,440,000	1,713,878	3,153,878
2017-2021	1,692,500	995,159	2,687,659
2022-2026	1,773,000	447,057	2,220,057
2027-2031	523,000	38,640	561,640
Totals	<u>\$ 7,239,000</u>	<u>5,189,028</u>	<u>\$ 12,428,028</u>

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**b) Notes Payable to Puerto Rico Treasury Department**

**Financing of the excess of property tax advances over collections** - On November 1999 the Municipality entered into a financing agreement with the Puerto Rico Treasury Department to pay a debt related to the excess of property tax advances over collections made by the Puerto Rico Treasury Department prior to the creation of CRIM in 1993. The outstanding principal balances of the note payable to CRIM amounted to \$120,021 at June 30, 2006. The principal and implicit interest maturities are as follows:

<u>Year ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 33,563	4,338	\$ 37,901
2008	35,105	2,797	37,902
2009	36,718	1,184	37,902
2010	6,281	35	6,316
Total	<u>\$ 111,667</u>	<u>8,354</u>	<u>\$ 120,021</u>

**Loan for payment of legal settlement** - On December 1, 2003 the Municipality obtained a loan from the Puerto Rico Treasury Department to pay a legal settlement. The face amount of the loan was \$1,921,548 at no interest. This note has an imputed interest rate of 5.00% and was originally recorded at its present value of \$1,509,718, net of an unamortized discount of \$411,830, at inception. At June 30, 2006, the balance of this note amounted to \$1,441,149. The principal and discount amortization maturities are as follows:

<u>Year ending June 30,</u>	<u>Principal amortization</u>	<u>Discount amortization</u>	<u>Total</u>
2007	\$ 135,240	56,915	\$ 192,155
2008	142,159	49,995	192,154
2009	149,432	42,722	192,154
2010	157,078	35,077	192,155
2011	164,328	27,827	192,155
2012-2014	446,472	33,904	480,376
Total	<u>\$ 1,194,709</u>	<u>246,440</u>	<u>\$ 1,441,149</u>

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**c) Notes Payable to CRIM**

**Act No. 42** – Act No. 42 of January 26, 2000 was enacted to authorize CRIM to enter into a financing agreement of up to \$200 million, for a term not exceeding 30 years. The financing agreement allows for the financing of a debt that the municipalities of Puerto Rico have with 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 GDB and CRIM to pay off the remaining \$559,133 of excess of property tax advances through fiscal year 2000 and 2001. CRIM retains the principal and interest from the property tax advances of the Municipality. The amounts retained by CRIM are remitted to GDB on July 1 of each year through July 1, 2032. The repayment agreement bears interest at variable rates determined by GDB. The outstanding principal balances of the note payable to CRIM amounted \$533,679, at June 30, 2006. The principal and interest maturities are as follows:

<u>Year ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 8,327	32,895	\$ 41,222
2008	8,850	32,371	41,221
2009	9,406	31,815	41,221
2010	9,997	31,224	41,221
2011	10,625	30,596	41,221
2012-2016	64,019	142,088	206,107
2017-2021	86,821	119,284	206,105
2022-2026	117,748	88,359	206,107
2027-2031	159,691	46,415	206,106
2032-2033	58,195	3,638	61,833
Total	<u>\$ 533,679</u>	<u>558,685</u>	<u>\$ 1,092,364</u>

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COMMONWEALTH OF PUERTO RICO  
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**Financing of delinquent property tax accounts sold** – On April 22, 2002, the Municipality entered into a financing agreement with CRIM in the amount of \$688,000 for the payment of delinquent property tax account sold to private investors. The financing agreement in the form of a line of credit bearing interests at 6.50% during the first 5 years, and variable interests 125 points over LIBOR rate during the next 25 years. At June 30, 2006, the outstanding principal balances amounted to \$688,000. The principal and interest maturities are as follows:

<u>Year ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ -	44,720	\$ 44,720
2008	-	44,720	44,720
2009	11,360	44,385	55,745
2010	12,120	43,625	55,745
2011	12,932	42,813	55,745
2012-2016	78,871	199,854	278,725
2017-2021	109,065	169,661	278,726
2022-2026	150,818	127,907	278,725
2027-2031	208,554	70,173	278,727
2032-2033	104,280	7,210	111,490
Total	<u>\$ 688,000</u>	<u>795,068</u>	<u>\$ 1,483,068</u>

**LIMS** – On June 28, 2001, the Municipality entered into a financing agreement with CRIM for the payment of the Municipality's share of the cost of an information management system, acquired by CRIM on behalf of all municipalities, for the management of a digital database of taxpayers properties located in Puerto Rico. The face amount of the loan was \$181,113 and bears no interest. The note is payable in monthly installments of \$2,024 through December 1, 2011. This note has an imputed interest rate of 5.95%. At June 30, 2006, the balance of this note amounted to \$112,534. The principal and interest maturities are as follows.

<u>Year ending June 30,</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 17,857	6,434	\$ 24,291
2008	18,935	5,356	24,291
2009	20,079	4,212	24,291
2010	21,292	3,000	24,292
2011	22,577	1,715	24,292
2012	11,794	351	12,145
Total	<u>\$ 112,534</u>	<u>21,068</u>	<u>\$ 133,602</u>

COMMONWEALTH OF PUERTO RICO  
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June 30, 2006

**d) Health Insurance Administration (ASES)**

The Municipality entered into a financing agreement with ASES for the payment of the Municipality's indebtedness on the payment of the government's health insurance for fiscal years 1994-1995 thru 1996-1997. The face amount of the loan was \$927,516 and bears no interest. The note is payable with the municipality's share on the state's electronic lottery as per Act 29 of the 1<sup>st</sup> of July 1997. During fiscal year the municipality received no deduction of its balance. The balance at June 30, 2006 is \$646,617.

**e) Puerto Rico Power Authority (PREPA)**

The Municipality indebtedness to PREPA on the payment of the power utility for current fiscal year that amount to \$684,037. The outstanding balance will be paid from the PREPA annual contribution in lieu of taxes during next fiscal year. Therefore, an account receivable of \$684,037 to PREPA was accrued in the GWFS and general fund at June 30, 2006. The receivable in the general fund was charged against deferred revenue because it was not a current available financial resource at June 30, 2006.

**f) Compensated Absences**

At June 30, 2006, the liability for compensated absences is composed as follows:

	<u>Due within One year</u>	<u>Due after one year</u>	<u>Total</u>
Vacations and sick leave	\$ 550,000	\$ 1,022,128	\$1,552,128
Total	<u>\$550,000</u>	<u>\$ 1,022,128</u>	<u>\$1,552,128</u>

**10. LANDFILL CLOSURE AND POSTCLOSURE CARE COSTS OBLIGATIONS**

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 closure and postclosure care costs will be paid only near or after the date that the landfill stops accepting waste, the Municipality reports a portion of these closure and postclosure care costs as an operating expense in each period based on landfill capacity used as of each statement of net assets date. The \$900,690 reported as landfill closure and postclosure care liability at June 30, 2006, represents the cumulative amount reported to date based on the percentage used of the estimated capacity of the landfill. The Municipality will recognize the remaining estimated cost of closure and postclosure care \$90,069 as the remaining estimated capacity is filled. These amounts are based on what it would cost to perform all closure and postclosure care in 2004. The estimated closing date of the landfill is the year 2009, but the Municipality expects to expand the boundaries of the existing landfill to extend the useful life of the landfill. Actual cost may be higher due to inflation, changes in technology, or changes in regulations.

COMMONWEALTH OF PUERTO RICO  
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Notes to Basic Financial Statements  
June 30, 2006

**11. COMMITMENTS AND CONTINGENCIES**

**Litigations**

The Municipality is a defendant in a number of lawsuits arising principally from claims against the Municipality for alleged improper actions, and other legal matters that arise in the ordinary course of the Municipality's activities.

With respect to pending and threatened litigation, the Municipality has reported liabilities of approximately \$200,000 in the general fund for awarded unfavorable judgment. This amount was included in the financial statements and represents a liability with a fixed or expected due date, which will require future available financial resources for its payment.

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 not materially affect the financial resources for its payment.

**Federal Programs**

The municipality participates in a number of federal financial assistance programs. These programs are subject to audit on behalf the grantors to assure compliance with grant provisions. If expenditures are disallowed due to noncompliance with grant programs requirements, the Municipality may be required to reimburse, these costs, to the grantor agency. It is the Municipality's Management opinion, that any amount disallowed by federal agencies, will be immaterial to the financial statements.

**Commitments**

The Municipality has reported, outstanding encumbrances amounting to \$97,241 in the general fund at June 30, 2006. The municipality intends to honor these encumbrances, which will continue to be liquidated under the current year's budget during a lapse of period that extends into the subsequent fiscal year.

**12. CHRISTMAS BONUS**

The \$ 150,860 balance represents the accrued portion corresponding to fiscal year 2005-2006 of the Christmas bonus to be paid in December 2006.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Basic Financial Statements  
June 30, 2006

**13. RESTATEMENTS**

The following schedule reconciles the June 30, 2005 fund balances as previously reported by the Municipality to the beginning fund balances, as restated:

	June 30, 2005, fund balance, as previously Reported	Reclassifications and adjustments	June 30, 2005 fund balance, as restated
Major Funds:			
General Fund	(\$ 7,261,640)	\$ 140,296	(\$ 7,121,344)
Totals	(\$ 7,261,640)	\$ 140,296	(\$ 7,121,344)

The changes resulted principally from the effect of a debt reclassification to long term basis.

**14. SUBSEQUENT EVENTS**

On April 3, 2006 the Municipality legislative branch approved the municipal ordinance 30, 2005-2006 Series, to impose a Sales and Uses Tax of 1 percent within the territorial limits of the Municipality since July 1, 2006. This municipal ordinance was subsequently amended on June 27, 2006, by the municipal ordinance 39, 2005-2006 Series, in order to correct some errors and omissions on it.

But, on July 4, 2006 was enacted the Act 117, known as the Tax Fairness Act of 2006, which impose a Sales and Use Tax in Puerto Rico (applicable to most consumer goods sold, used, stored or used), know in Spanish as the "Impuesto sobre Ventas y Uso" (IVU). The new Sales and Use Tax, which became effective November 15, 2006 (July 1, 2006 for local governments with municipal ordinance approved at June 30, 2006), includes a Sales and Use Tax of 5.5 percent for the central government and 1.5 percent for local governments, which can impose their own sales tax through approval of a municipal ordinance.

After approval of the Act 117 on July 4, 2006, the Municipality executive branch, with the approval of the legislative branch, amends the municipal ordinance 30, 2005-2006 Series on July 16, 2006, as amended, in order to harmonize the sales and use tax imposed by the Municipality to the sales and use tax imposed by the central government on July 4, 2006 through enacted Act 117, as required by this Act.

COMMONWEALTH OF PUERTO RICO  
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Budgetary Comparison Schedule- General Fund  
(See Notes to Budgetary Comparison Schedule)  
June 30, 2006

	<u>Budgeted amounts</u>		<u>Actual amounts</u>	<u>Variance with</u>
	<u>Original</u>	<u>Final</u>	<u>(budgetary</u>	<u>final budget –</u>
<b>Revenues:</b>			<u>basis)</u>	<u>over (under)</u>
Property taxes	\$ 1,580,946	\$ 1,580,946	\$ 1,601,292	\$ 20,346
Municipal license taxes	861,073	861,073	952,507	91,434
Construction excise taxes	1,014,674	1,014,674	737,075	(277,599)
Intergovernmental grants and contributions	4,047,410	4,047,410	3,940,804	(106,606)
Interest on deposits	35,000	35,000	111,325	76,325
Charges for services	406,000	406,000	3,232	(402,768)
Miscellaneous	155,730	155,730	87,906	(67,824)
Total revenues	<u>\$ 8,100,833</u>	<u>\$ 8,100,833</u>	<u>\$ 7,434,141</u>	<u>\$ (666,692)</u>
<b>Expenditures:</b>				
General government	\$ 3,037,368	\$ 2,880,128	\$ 2,413,999	\$ (466,129)
Urban and economic development	2,720,628	2,788,491	2,806,099	17,608
Health and sanitation	725,316	725,361	692,233	(33,128)
Public safety	773,582	763,828	663,888	(99,940)
Public housing and welfare	333,095	395,085	352,332	(42,753)
Culture, recreation and education	510,843	548,450	573,375	24,925
Total expenditures	<u>\$ 8,100,832</u>	<u>\$ 8,101,343</u>	<u>\$ 7,501,926</u>	<u>\$ (599,417)</u>

**Reconciliation of differences:**

Sources/inflows of financial resources:

Actual amounts (budgetary basis) "available for appropriations"

from the budgetary comparison schedule \$ 7,434,141

Entity differences - non-budgeted expenditures 86,360

Differences in bases of accounting:

Net decrease in tax receivables (33,422)

Net increase in intergovernmental receivables 11,914

Net increase in accrued interests on deposits 10,313

Total revenues and special item reported on the

statement of revenues, expenditures and changes in fund balances \$ 7,509,306

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Budgetary Comparison Schedule- General Fund  
(See Notes to Budgetary Comparison Schedule)  
June 30, 2006

**Reconciliation of differences (concluded):**

Uses/outflows of financial resources:

Actual amounts (budgetary basis) "total charges to appropriations"		
from the budgetary comparison schedule	\$	7,501,926
Timing differences:		
Current year encumbrances recorded as expenditures for budgetary purposes		(69,567)
Prior year encumbrances recorded as expenditures for GAAP purposes		121,161
Entity differences - non-budgeted expenditures		458,693
Differences - budgetary basis to GAAP:		
Transfers to other funds are outflows of budgetary resources but are not expenditures for financial reporting purposes		(191,463)
Differences in bases of accounting:		
Net decrease in accounts payable and accrued liabilities		<u>(151,552)</u>
Total expenditures reported on the statement of revenues, expenditures and changes in fund balances	\$	<u><u>7,669,198</u></u>

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Budgetary Comparison Schedule- General Fund  
June 30, 2006

**1. 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, 2006 representing the original budget. There were no supplemental appropriations for the year ended June 30, 2006.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Schedule of Expenditures of Federal Awards  
June 30, 2006

Federal Grantor/Pass-Through Grantor/Program Title	Federal CFDA Number (note B)	Pass-Through Grantor's Number (note C)	Expenditures (note A)
<b><u>U.S. Department of Agriculture</u></b>			
Program:			
Passed through the P.R. Department of Education:			
Child and Adult Care Food Program	10.558	N/AV	<u>93,810</u>
<b>Total U.S. Department of Agriculture</b>			<u><b>93,810</b></u>
<b><u>U.S. Department of Housing and Urban Development</u></b>			
Program:			
Direct Program:			
Section 8 Housing Choice Vouchers	14.871	N/A	274,539
Program:			
Passed through the Office of Commissioner of Municipal Affairs:			
Community Development Block Grant - Small Cities Program	14.219	N/AV	<u>337,300</u>
<b>Total U.S. Department of Housing and Urban Development</b>			<u><b>611,839</b></u>
<b><u>U.S. Department of Health and Human Services</u></b>			
Program:			
Direct Program:			
Head Start and Early Head Start	93.600	N/A	1,672,549
Program:			
Passed through the P.R. Department of Family - Families and Children Administration:			
Child Care and Development Block Grant	93.575	N/AV	271,737
Community Services Block Grant	93.569	N/AV	<u>85,000</u>
<b>Total U.S. Department of Health and Human Services</b>			<u><b>2,029,286</b></u>
<b><u>U.S. Department of Justice</u></b>			
Program:			
Passed through the P.R. Police Department:			
Local Law Enforcement Block Grant	16.592	N/AV	<u>2,889</u>
<b>Total U.S. Department of Justice</b>			<u><b>2,889</b></u>

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Schedule of Expenditures of Federal Awards  
June 30, 2006

Federal Grantor/Pass-Through Grantor/Program Title	CFDA Number (note B)	Grantor's Number (note C)	Expenditures (note A)
<b><u>U.S. Department of Homeland Security</u></b>			
Program:			
Passed through the P.R. Emergency Management Agency Emergency Management Performance Grant	83.552	N/AV	3,770
Program:			
Passed through the P.R. Governor Authorized Representative (GAR): Public Assistance Grant	83.544	N/AV	94,641
<b>Total U.S. Department of Homeland Security</b>			<b><u>98,411</u></b>
			<b><u>\$ 2,836,235</u></b>

The accompanying notes are an integral part of this schedule.

COMMONWEALTH OF PUERTO RICO  
MUNICIPALITY OF SANTA ISABEL  
Notes to Schedule of Expenditures of Federal Awards  
June 30, 2006

**NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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 Government and Nonprofit Organizations.

**NOTE B - FEDERAL CFDA NUMBER**

The Catalog of Federal Domestic Assistance (CFDA) Number is a program identification number. 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 GRANTOR'S 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 federal awards received as a subrecipient. 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	Other Nonmajor Funds
10.558	-	\$ 93,810
14.871	\$ -	274,539
14.219	-	337,300
93.600	1,672,549	-
93.575	-	271,737
93.569	-	85,000
16.592	-	2,889
83.552	-	3,770
83.544	-	94,641
Total federal awards expenditures	1,672,549	1,163,686
Total nonfederal awards expenditures	-	1,017,280
Total expenditures, fund statements	\$ 1,672,549	\$ 2,180,966

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

To the Honorable Mayor and  
Members of the Municipal Legislature  
MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

We have audited the financial statements of governmental activities, each major fund and aggregated fund information of Municipality of Santa Isabel, Puerto Rico (the "Municipality"), as of and for the fiscal year ended June 30, 2006, and have issued our report thereon dated December 8, 2006. The report on basic financial statements described above includes an explanatory paragraph to describe that financial statements have been prepared assuming that Municipality of Santa Isabel will continue as a going concern. During several years, the Municipality of Santa Isabel has increased its deficit by exceeding its expenditures over its revenues. As of June 30, 2006, the unreserved accumulated deficit for its general fund (for governmental funds) amounted to \$6,062,699, with total liabilities in the amount of \$10,222,784 and total assets amounting to \$4,160,085, including available cash of \$899,981 to pay mature liabilities within the current year. These conditions raised substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustment that might result from the outcome of this uncertainty. 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.

**Compliance**

As part of obtaining reasonable assurance about whether the Municipality'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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Schedule of Findings and Questioned Costs as item 06-01.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Municipality's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Municipality's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable condition is described in the accompanying Schedule of Findings and Questioned Costs as item 06-01.

## INDEPENDENT AUDITORS' REPORT

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A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 06-01 to be material weakness.

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

*Mendoza & Ramos*  
MENDOZA & RAMOS  
CERTIFIED PUBLIC ACCOUNTANTS, C.S.P.

Guayama, Puerto Rico  
January 31, 2007

Stamp number 2134175 was  
affixed to the original of this  
report.



**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

To the Honorable Mayor and  
Members of the Municipal Legislature  
MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

**Compliance**

We have audited the compliance of the Municipality of Santa Isabel, Puerto Rico (the "Municipality") with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the fiscal year ended June 30, 2006. The Municipality'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 the Municipality's management. Our responsibility is to express an opinion on the Municipality'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 the Municipality's compliance with those requirements and performing such others procedures, as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Municipality's compliance with those requirements.

As described in item 06-03 in the accompanying schedule of findings and questioned costs, the Municipality did not comply with the requirement regarding reporting requirement that is applicable to its Head Start Program. Compliance with such requirement is necessary, in our opinion, for the Municipality to comply with the requirements applicable to that program.

As described in items 06-04, 06-05, 06-06 and 06-07 in the accompanying schedule of findings and questioned costs, the Municipality did not comply with the requirements regarding allowable cost, cash management, equipment and real property management, and procurement, suspension and debarment requirements that are applicable to its Community Development Block Grants – State-Administered Small Cities Program. Compliance with such requirements is necessary, in our opinion, for the Municipality to comply with the requirements applicable to that program.

In our opinion, except for the instances of noncompliance described in the preceding paragraphs for the Head Start Program and the Community Development Block Grants – State-Administered Small Cities Program, the Municipality complied, in all material respects, with the requirements

## INDEPENDENT AUDITORS' REPORT

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referred to above that are applicable to each of its major federal programs for the Fiscal Year Ended June 30, 2006. However, the results of our auditing procedures disclosed other instances of noncompliance with those requirements that are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying Schedule of Findings and Questioned Costs as item 06-02.

### Internal Control Over Compliance

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

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Municipality's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts and grants. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as items 06-02 to 06-07.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable condition described above, we believe consider items 06-02 to 06-07 to be material weakness.

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

  
MENDOZA & RAMOS  
CERTIFIED PUBLIC ACCOUNTANTS, C.S.P.

Guayama, Puerto Rico  
January 31, 2007

Stamp number 2134176 was  
affixed to the original of this  
report.



**FINDINGS AND QUESTIONED COST:**

- **Schedule of Findings and Questioned Costs**
- **Summary Schedule of Prior Audit Findings**

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

SECTION I-FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Financial Statements

Type of auditors' report issued:

- Unqualified Opinion
- Qualified Opinion
- Adverse Opinion
- Disclaimer Opinion

Internal control over financial reporting:

- Reportable condition(s) 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:

- Reportable condition(s) identified?  Yes  None Reported
- Material weakness (es) identified?  Yes  No

Type of auditors' 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 OMB Circular A-133?

- Yes  No

The Municipality's major programs were:

CFDA Number	Name of Federal Program
14.219	Community Development Block Grant / Small Cities Head Start Program
93.600	

Dollar threshold used to distinguish between Type A and Type B Programs:

\$300,000

Auditee qualified as low-risk auditee?

- Yes  No

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION II – FINANCIAL STATEMENT FINDINGS

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FINDING	06-01
CATEGORY	INTERNAL CONTROL
NONCOMPLIANCE	ACCOUNTING RECORDS
CONDITION	The Municipality accounting records do not have the necessary capabilities, procedures, internal controls and records to ensure accurate financial reporting and to prepare the Municipality's basic financial statements and federal programs' reports in conformity with Accounting Principles Generally Accepted in the United States of America for State and Local Governments (GAAP). Accounting records are not fully integrated, and a double entry system is not generally followed.
CRITERIA	Article 8.010 of State Act Number 81 of August 30, 1991 states that the Municipality should maintain an effective and update accounting records.
CAUSE	The Municipality did not established effective internal control to assure accurate financial reports according to the transaction records.
EFFECT	This situation does not allow the Municipality to have timely and accurate financial information for its decision making process. In addition, financial reports prepared may have errors or omissions that will affect future financial decisions. Another effect is the use of inaccurate financial information as a base for the preparation of annual budgets, which, therefore, may result in budgetary compliance problems.
RECOMMENDATION	The Municipality must established procedures to adequately maintain financial records, in order to have current and accurate financial information for the decision making process.
QUESTIONED COSTS	None
MANAGEMENT RESPONSE	Pending the Corrective Action Plan.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III-FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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FINDING	06-02
FEDERAL PROGRAM	HEAD START (CFDA 93.600) U. S. DEPARTMENT OF HEALTH AND HUMAN SERVICES
CATEGORY	COMPLIANCE
NONCOMPLIANCE	ALLOWABLE COST
TOPIC SENTENCE	Unallowable bank charges
CONDITION	During the fiscal year 2005-06, Early Head Start program bank charges totaled \$545.18. We analyzed the bank charges for the fiscal year. As a result we found: that \$345.00 (63%) of total bank charges represent NSF transactions charges (non-sufficient funds checks); \$181.98 (33%) of total bank charges represents overdraft penalties; \$15.00 (3%) of total bank charges represents services charges fees; and \$3.20 (1%) of total bank charges represents checks in excess penalties.
CRITERIA	As stated in 45 CFR (a), C, Sec. 92.22 (a) grant funds may be used only for the allowable costs of the grantee or sub-grantee.  OMB Circular A-87, Attachment A, Part C. 1(a) and (b), states that to be allowable under Federal awards, costs must be necessary and reasonable for proper and efficient performance and administration of Federal awards and must be allocable to Federal awards under the provisions of Circular A-87.
CAUSE	Lack of adequate controls to minimize and monitor the monthly bank charges to avoid inadequate charges like NSF (non-sufficient funds checks), overdraft penalties, services bank charges and checks in excess issued penalties among others non-allowable costs. Based on a monthly reasonable estimations reviewed the proportional use of federal program funds against the monthly expenses that were going to be paid for the program.
EFFECT	The continuous occurrence of this situation affects the non-compliance procedure to maintain adequate cash balance in accordance with the timing required to request funds and the capacity to cover the estimated expenses that are going to be paid in a monthly basis. Also there was no satisfactory evaluation of the cash on hands vs. expenditures analysis. This condition could result in the reimbursement of Early Head Start and/or Head Start funds to the awarding agency for those disbursements that were not allowable. Thus, unallowable costs will be considered as questioned costs

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III-FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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RECOMMENDATION	The Program should perform, besides the monthly bank reconciliation, periodic cash reconciliation to avoid the overdraft situations. In addition, to obtain a reliability and reasonable relationship between cash in hand and expenditures for the program, they should establish a well structure monthly analysis to assure that estimated requested funds were in accordance with the expenditures. In the implementation of these procedures the Program will going to avoid the unnecessary bank charges in order to compliance with the non allowable costs.
QUESTIONED COST	None
MANAGEMENT RESPONSE	Pending the Corrective Action Plan

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III-FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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FINDING	06-03
FEDERAL PROGRAM	HEAD START (CFDA 93.600) U. S. DEPARTMENT OF HEALTH AND HUMAN SERVICES
CATEGORY	COMPLIANCE
NONCOMPLIANCE	REPORTING
TOPIC SENTENCE	Payroll costs obligations incorrectly reported
CONDITION	During the fiscal year 2005-06, Early Head Start and Head Start Programs incorrectly report the payroll costs obligations on the "269 Reports" because the funds were transferred to the Municipal general account through the grantee and they did not make the payments.
CRITERIA	OMB Common Rule, Subpart C, Sec. 20 (b) (1), states that the financial management systems of other grantee must be accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant.
CAUSE	The Municipality did not complied with procedures to assure that the payroll payments were paid to the Commonwealth agencies.
EFFECT	The continuous occurrence of this situation inhibits the federal awarding agency from monitoring the programs financial performance. In addition, the Program could be sanctioned by the federal awarding agency due to the inaccurate filing of financial reports.
RECOMMENDATION	The Program's Administration has to establish procedures to be assured that the payroll payment they make to the Municipality will be properly documented and be paid to the Commonwealth Agency in a timely basis.
QUESTIONED COST	None
MANAGEMENT RESPONSE	Pending the Corrective Action Plan.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III-FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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FINDING	06-04
FEDERAL PROGRAM	COMMUNITY DEVELOPMENT BLOCK GRANT/SMALL CITIES (CDBG) (CFDA NO. 14.219) DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT PASS THROUGH STATE-OFFICE OF COMMISSIONER OF MUNICIPAL AFFAIRS
CATEGORY	COMPLIANCE
NONCOMPLIANCE	ALLOWABLE COST
TOPIC SENTENCE	Unallowable payroll costs
CONDITION	<p>During the fiscal year 2005-06, CDBG program has the Lideres Recreativos (03-FC-004) year assignment program. In testing the allowability of payroll costs for that program, we selected five employee files to perform our test.</p> <p>The test revealed that three out of five (60%) employees selected for testing do not have payroll sheet to validated the total hours per month worked an neither identified the activities that they performed. The two (40%) employee files left were not available at the moment of our audit test. During the fiscal year, such employees were compensated by the Municipality with CDBG funds amounting \$5,489.04. Wages paid were not supported by a certification which states that the employee works solely on that Program nor by an activity report which detail salaries distribution costs.</p>
CRITERIA	<p>As stated in 24 CFR (a), grant funds may be used only for the allowable costs of the grantee or subgrantee.</p> <p>OMB Circular A-87, Attachment A, Part C. 1b, states that to be allowable under Federal awards, costs must be allocable to Federal awards under the provisions of Circular A-87. Circular A-87, Attachment B. 8.a. and h.(3) and (4), establishes that compensation for personal services are allowable to the extent that they satisfy the specific requirements of the Circular and that the total compensation for individual employees is supported as provided in subsection h. Salaries and wages will be allowable if they are supported by periodic certifications that the employees worked solely on that program for the period covered by the certification.</p>

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III-FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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CAUSE	Employee was recruited to assist the Lideres Recreativos Program to perform recreational and competitions sports activities with the participants. There were no tracking for payroll sheets records. Also, there is no assertion in the certification of those payrolls. In this situation we have employees contracted to bring recreational and educational services on the Lideres Recreativos Program without a documented certification to do so.
EFFECT	This condition could result in the reimbursement of CDBG funds to the awarding agency or pass-through entity for those disbursements that were not allowable. Thus, unallowable costs will be considered as questioned costs.
RECOMMENDATION	The Municipality should evaluate the functions that the employee makes including the related documentations that support his/her participations in the particular program. Also, confirm the hired process to filled-out all the concerning documentation to stated the relationship between the employee and the program. Periodic employee certifications that employees worked or were assigned to a particular federal program should be obtained, to reinforce the compliance on existence for employees that work for the specific program.
QUESTIONED COSTS	None
MANAGEMENT RESPONSE	Pending the Corrective Action Plan.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

FINDING	06-05
FEDERAL PROGRAM	COMMUNITY DEVELOPMENT BLOCK GRANT/SMALL CITIES (CDBG) (CFDA NO. 14.219) DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT PASS THROUGH STATE-OFFICE OF COMMISSIONER OF MUNICIPAL AFFAIRS
CATEGORY	COMPLIANCE
NONCOMPLIANCE	CASH MANAGEMENT
TOPIC SENTENCE	Non-compliance with the cash management requirement
CONDITION	<p>During the fiscal year 2005-2006, the Municipality received \$306,998.28 from the pass-through entity ("Municipality Affairs Commissioner Office - OCAM") regarding the State Community Development Block Grant Program ("CDBG").</p>
CRITERIA	<p>In order to determine compliance with the cash management requirement, we selected for testing three remittances of funds received from "OCAM" amounting \$174,494.83 (57%). In the three cases, the time elapsed between the receipt and the disbursement of such funds was for more than ten days up to seven months.</p> <p>As stated in 24 CFR 85.21 and 31 CFR 205.33, Subpart B, grantees must minimize the time elapsing between the drawdown of Federal funds from the Federal government, or pass-through entity, and their disbursements for Federal program purposes.</p>
CAUSE	Municipality's Finance Department and CDBG accounting department, divisions responsible for the disbursement of funds, do not count with the resources or a plan, to attain and process within a reasonable period of time, all monthly disbursements which are requested for the different Municipality's divisions or federal programs.
EFFECT	If the recipient fails to expend those Federal assistance funds within a reasonable period, or fails to establish procedures to minimize the time elapsing between cash advances and the disbursements, the Municipality could be adversely affected in the benefits they are entitled to receive in the future.
RECOMMENDATION	According to priorities and monthly responsibilities, the Municipality's Finance Department and CDBG accounting department should implement a plan or a schedule to process and comply with all monthly disbursements within a reasonable period of time.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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QUESTIONED COSTS           None

MANAGEMENT RESPONSE Pending the Corrective Action Plan.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

FINDING	06-06
FEDERAL PROGRAM	COMMUNITY DEVELOPMENT BLOCK GRANT/SMALL CITIES (CDBG) (CFDA NO. 14.219) DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT PASS THROUGH STATE-OFFICE OF COMMISSIONER OF MUNICIPAL AFFAIRS
CATEGORY	COMPLIANCE
NONCOMPLIANCE	EQUIPMENT AND REAL PROPERTY MANAGEMENT
TOPIC SENTENCE	Non-compliance with the equipment and real property management requirement.
CONDITION	Federal Program Department does not have a property register that includes all the required information for purpose of accounting record, description and evaluation.
CRITERIA	<p>As stated in 24 CFR 85.32(d)(1), Subpart C, property records must be maintained and it shall includes:</p> <ul style="list-style-type: none"><li>• a description of the property,</li><li>• serial number or other identification number,</li><li>• the source of property, percentage of Federal participation in the property,</li><li>• the location,</li><li>• use and condition of the property,</li><li>• any ultimate disposition data including the date of disposal,</li><li>• sale price of property,</li></ul> <p>Also, a physical inventory of the property must be taken and the result reconciled with the property records at least on every two years, respectively.</p>
CAUSE	The Municipality does not maintain the appropriate information on the real property records to assure that it is in accordance with the federal regulation.
EFFECT	Municipality is not in compliance with Subpart C, 24 CFR 85.32 (d)(1).

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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RECOMMENDATION            Municipality should revise and updated its property records according to the federal regulation.

QUESTIONED COSTS        None

MANAGEMENT RESPONSE   Pending the Corrective Action Plan.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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FINDING	06-07
FEDERAL PROGRAM	COMMUNITY DEVELOPMENT BLOCK GRANT/SMALL CITIES (CDBG) (CFDA NO. 14.219) DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT PASS THROUGH STATE-OFFICE OF COMMISSIONER OF MUNICIPAL AFFAIRS
CATEGORY	COMPLIANCE
NONCOMPLIANCE	SUSPENSION AND DEBARMENT
TOPIC SENTENCE	Lack of controls over suspension and debarments
CONDITION	<p>The Municipality does not have procedures in place to verify the status of an entity as to suspensions and debarments when contracting services or procuring goods with federal funds.</p> <p>In testing procurement, suspension and debarments, we were not able to find evidence indicating that the Municipality performs procedures to assure that the individuals and entities that receive contracts or sub awards are not suspended or debarred from participation in federal programs.</p>
CRITERIA	As stated in 24 CFR 85.35 grantee and sub grantee must not make any award or permit any award (sub grant or contract) at any tier to any party which is debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549, "Debarment and Suspension".
CAUSE	The Municipality has no policies and procedures for the use of the list of parties excluded from federal procurement or non-procurement programs to assure that they do not award assistance to listed parties.
EFFECT	As a result of this deficiency, the Municipality could have procured goods or services from organizations and individuals that are suspended or debarred which could result in cost disallowances by the federal awarding agency.
RECOMMENDATION	The Municipality should amend their procurement procedures and include a step to verify whether or not the individual or entity is on the list of parties excluded from federal participation in procurement and non-procurement programs. The Municipality should also require the entities or individuals to submit a certification stating that they are not suspended or debarred.

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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SECTION III – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

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QUESTIONED COSTS        None.

MANAGEMENT RESPONSE Pending the Corrective Action Plan.

END OF SCHEDULE

MUNICIPALITY OF SANTA ISABEL, PUERTO RICO

SCHEDULE OF PRIOR AUDIT'S FINDINGS AND QUESTIONED COSTS  
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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(1) Audit Findings that have been Fully Corrected:

NONE

(2) Audit Findings not corrected or Partially Corrected:

FISCAL YEAR 2005

<b>Finding Number</b>	<b>CFDA</b>	<b>Questioned Cost</b>	<b>Comments</b>
05-III-01 Financial Administration	14.219	None	Situation still prevails
05-III-02 Equipment & Property	14.219	None	Situation still prevails
05-III-03 Period of Availability	14.219	None	Situation still prevails
05-III-04 Cash Management	14.219	None	Situation still prevails
05-III-05 Reporting	93.600	None	Situation still prevails
05-III-06 Reporting	93.575	None	Situation still prevails
05-III-07 Cash Management	93.575	None	Situation still prevails
05-III-09 Reporting	93.575	None	Situation still prevails

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

NONE

(4) Audit findings is no longer valid:

NONE

END OF SCHEDULE

## Municipality of Santa Isabel

### Corrective Action Plan Single Audit 2005-2006

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P. 2  
 Nº 1629

Abr. 26. 2007 1:07PM PROGRAMAS FEDERALES

Finding Reference Number	Responsible Employee	Corrective Action Planned	Expected Implementation Date
06-01	Mrs. Irma M. Vargas Finance Department Director	<p>The Municipality maintains two set of accounting records; a manual system and a Uniform Accounting System (UAS) promulgated by the Office of the Commissioner of Municipal Affairs of Puerto Rico (OCAM, by its Spanish acronym), a state governmental entity created by law to provide technical assistance to the municipalities of Puerto Rico in several administrative and fiscal matters.</p> <p>The manual system was the accounting system implemented before the UAS, but the OCAM required our Municipality to maintain both systems since the UAS implementation between 1993 and 1995. Our manual accounting system is the primary financial records for financial statements preparation purposes at the end of each fiscal year due to the fact that the computerized system real accounts balances carried forward from prior years were affected by accounting errors in the first years of the system operation.</p> <p>Some of the manual accounting records maintained by the Municipality consist of the following records, that provide information based on cash and budgetary basis:</p> <ul style="list-style-type: none"> <li>a) Cash Receipt Books – To record all receipts issued by the Official and Auxiliary Cash Collectors; each receipt is posted under each account of fund column title, and at the end of the month each column total is posted to the General Ledger.</li> <li>b) Cash Disbursement Books – To record all cash disbursements made by the Official Payer; each cash disbursement is charged to and account or to a fund, and at the end of the month each account or fund total is posted to the General Ledger.</li> <li>c) General Ledgers – To summarize monthly cash receipt and cash disbursement transactions charged to each account or fund.</li> </ul>	July 1, 2007

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 UNIDAD DE CORREO  
 Calle 160

## Municipality of Santa Isabel

### Corrective Action Plan Single Audit 2005-2006

Finding Reference Number	Responsible Employee	Corrective Action Planned	Expected Implementation Date
		<p>d) Purchase Orders and Contracts Registers – To record purchase orders and contracts issued against the budgeted amounts for each account or fund.</p> <p>Our Municipality and the OCAM know that both the manual system and the UAS do not have the necessary capabilities, procedures, internal controls and records to ensure accurate financial reporting and to prepare the Municipality's basic financial statements and federal programs' reports in conformity with Accounting Principles Generally Accepted in the United States of America for State and Local Governments (GAAP).</p> <p>For this reason, the OCAM was considering alternatives to improve the municipalities of Puerto Rico accounting system through the acquisition of new accounting software, but the formal bids conducted by the OCAM in the past year was cancelled.</p> <p>At this time, due to the limited resources in our Municipality, we can not consider to purchase a sophisticated accounting software (with a cost of approximately \$800,000) as has been the reality of other Municipalities with available resources, but we are in the process to install a low cost accounting software such as Peachtree in order to maintain a double entry system. We hope that this accounting software, in combination with manual records and a spreadsheet will permit and provide us a timely and accurate financial information for our decision making process in a short term basis, while we can obtain the resources needed to purchase a sophisticated accounting software.</p>	
06-02	Mr. Carlos Meléndez HS\EHS Program Director	<p>The Municipality is in the process to reimburse bank penalties due to overdrafts reported in the finding to the Administration of Children and Families (ACF).</p> <p>In order to ensure bank charges again in any Federal program bank account, the</p>	April 30, 2007

Nº 1629 P. 3  
 PROGRAMAS FEDERALES  
 1:07PM  
 Abr. 26. 2007

## Municipality of Santa Isabel

### Corrective Action Plan Single Audit 2005-2006

Finding Reference Number	Responsible Employee	Corrective Action Planned	Expected Implementation Date
		<p>Finance Director will not authorize for payment any voucher payable if the Federal program bank account and the related accounting books did not reflect the necessary cash balances to satisfy the payment of checks to be issued.</p> <p>The Federal programs staffs were properly advised that in the future, disbursements could be issued only if the Program has the resources available in its bank accounts.</p>	
06-03	Mr. Carlos Meléndez HS\EHS Program Director	<p>The Municipality enter into a long term loan through the Commonwealth of Puerto Rico Government Development Bank (GDB) to pay Municipal debts, including \$2,224,645 to the Commonwealth of Puerto Rico Retirement System Administration (RSA). This debt balance represents the total amount pending with the RSA, including the debt corresponding to HS\EHS Program employees. The Municipality is planning to realize the full payment of this debt balance in the first week of April, 2007.</p> <p>Actually, the Municipality is processing payroll payment to the Commonwealth of Puerto Rico and Federal Agencies in a timely basis.</p>	April 15, 2007.
06-04	Mrs. Janice Brugman Federal Programs Department (CDBG, Section 8 and CC&DBG) Director	The Office accountant will verify files of every employee contracted by the Municipality to perform duties under the "Líderes Recreativos" project, are filled with needed supporting documentation to fulfill stated regulations.	April 30, 2007
06-05	Mrs. Janice Brugman Federal Programs Department (CDBG, Section 8 and CC&DBG) Director	Disbursement process will be revised and procedures to comply with stated regulations regarding expenditures of received funds from Grantee (OCMA) will be establishes. The procedure will be discuss with personnel in charge of the disbursement procedures in both departments, Federal programs and Finance.	April 30, 2007
06-06	Mrs. Janice Brugman Federal Programs Department (CDBG, Section 8 and	Property register of equipment acquired with federal funds has been developed as the external auditor discusses this finding.	Done

## Municipality of Santa Isabel

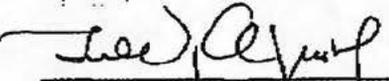
### Corrective Action Plan Single Audit 2005-2006

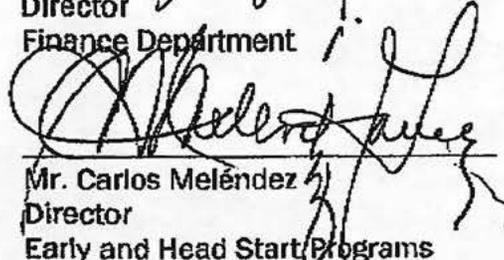
Nº 1629 P. 5

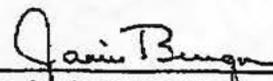
Finding Reference Number	Responsible Employee	Corrective Action Planned	Expected Implementation Date
	CC&DBG) Director		
06-07	Mrs. Janice Brugman Federal Programs Department (CDBG, Section 8 and CC&DBG) Director	Federal Programs Office Personnel will request the electronic page from the General Services Agency (GSA) were Excluded Parties List System (EPLS) is located and the resulted information will be use in the procurement process.	Done

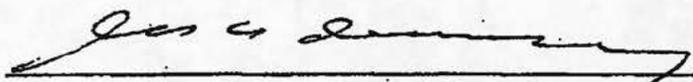
In compliance with the OMB Circular A-133, Subpart C—"Auditees", 300 "Auditee responsibilities", we prepared the corrective action plan described above on March 23, 2005 in accordance with 315(c).

Abr. 26. 2007 1:08PM PROGRAMAS FEDERALES

  
 \_\_\_\_\_  
 Mrs. Irma M. Vargas Aguirre  
 Director  
 Finance Department

  
 \_\_\_\_\_  
 Mr. Carlos Meléndez  
 Director  
 Early and Head Start Programs

  
 \_\_\_\_\_  
 Mrs. Janice Brugman  
 Director  
 Federal Programs Department

  
 \_\_\_\_\_  
 Hon. Enrique Questell Alvarado  
 Mayor