Translation of financial statements originally issued in Spanish

# Panama Canal Authority

## Report and Financial Statements
## September 30, 2006

**(Translation of financial statements originally issued in Spanish)**
# Panama Canal Authority

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## September 30, 2006


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**Report of Independent Auditors**

Translation of a report originally issued in Spanish
(See explanation in the notes to the financial statements)

To the Board of Directors of the
Panama Canal Authority

We have audited the accompanying balance sheet of the Panama Canal Authority as of September 30, 2006, and the related statements of income, changes in equity, and cash flows for the year then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Panama Canal Authority as of September 30, 2006, the result of its operations, and its cash flows for the year then ended, in conformity with International Financial Reporting Standards.

PricewaterhouseCoopers (signed)

December 6, 2006
Panama, Republic of Panama

**(Translation of financial statements originally issued in Spanish)**

## Panama Canal Authority

# Balance Sheet
## September 30, 2006
**(In thousands of balboas)**

| | 2006 | 2005 |
|---|---|---|
| **Assets** | | |
| Properties, plant, and equipment, net of accumulated depreciation (Notes 2 and 14) | B/. 2,181,293 | B/. 2,095,404 |
| Account receivable (Note 3) | 20,140 | 20,140 |
| Current assets | | |
| Cash and cash equivalents (Note 4) | 821,170 | 664,428 |
| Investments (Note 5) | 490,399 | 305,654 |
| Accounts receivable (Note 6) | 31,946 | 26,030 |
| Inventories: | | |
| Materials and supplies, net of allowance for obsolescence and slow turnover of B/.6,510 (2005 - B/.5,236) | 25,678 | 26,534 |
| Fuel | 3,437 | 4,538 |
| Other current assets | 25,135 | 12,397 |
| Total current assets | 1,397,765 | 1,039,581 |
| Total assets | B/. 3,599,198 | B/. 3,155,125 |
| **Equity and Liabilities** | | |
| Equity | | |
| Equity (Note 14) | B/. 1,904,540 | B/. 1,904,547 |
| Retained earnings: | | |
| Appropriated retained earnings (Note 7) | 1,154,918 | 794,325 |
| Unappropriated retained earnings (Note 8) | 315,332 | 268,850 |
| Total equity | 3,374,790 | 2,967,722 |
| Severance pay (Note 9) | 10,000 | 10,000 |
| Current liabilities | | |
| Accounts payable (Note 10) | 98,943 | 62,464 |
| Provision for marine accident claims (Note 11) | 27,715 | 27,524 |
| Accrued salaries and leave | 83,540 | 84,495 |
| Other liabilities | 4,210 | 2,920 |
| Total current liabilities | 214,408 | 177,403 |
| Total equity and liabilities | B/. 3,599,198 | B/. 3,155,125 |

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

**(Translation of financial statements originally issued in Spanish)**

## Panama Canal Authority

## Statement of Income
## For the Year Ended September 30, 2006
**(In thousands of balboas)**

| | 2006 | 2005 |
|---|---|---|
| **Revenues** | | |
| Toll revenues | B/. 1,026,427 | B/. 847,539 |
| Vessel-transit-related services | 318,476 | 269,235 |
| | 1,344,903 | 1,116,774 |
| Other revenues: | | |
| Electric power sales | 74,008 | 45,430 |
| Potable water sales | 19,018 | 17,499 |
| Interest income | 50,085 | 23,243 |
| Miscellaneous | 6,811 | 6,169 |
| Total other revenues | 149,922 | 92,341 |
| Total revenues | 1,494,825 | 1,209,115 |
| **Expenses** | | |
| Fee per net ton (Note 10) | 252,796 | 190,960 |
| Salaries and wages | 332,190 | 317,221 |
| Employee benefits | 41,795 | 40,362 |
| Materials and supplies | 36,124 | 33,610 |
| Fuel | 63,175 | 39,467 |
| Transportation, meals, and lodging abroad | 711 | 750 |
| Allowances and local transportation | 769 | 624 |
| Services rendered by third parties | 37,049 | 33,620 |
| Panamanian Treasury (Tesoro Nacional) – public service fees | 1,577 | 29,000 |
| Insurance | 9,892 | 13,700 |
| Marine accidents, net (Note 11) | 3,004 | 4,123 |
| Obsolete and slow turnover inventory | 2,958 | 899 |
| Other expenses | 8,608 | 8,206 |
| | 790,648 | 712,542 |
| Less capitalized labor and materials (Note 12) | 47,835 | 48,806 |
| | 742,813 | 663,736 |
| Income before depreciation | 752,012 | 545,379 |
| Depreciation (Note 2) | 76,087 | 61,445 |
| Net income (Note 13) | B/. 675,925 | B/. 483,934 |

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

**(Translation of financial statements originally issued in Spanish)**

# Panama Canal Authority

## Statement of Changes in Equity
## For the Year Ended September 30, 2006
**(In thousands of balboas)**

| | Equity | Retained Earnings Appropriated | Retained Earnings Unappropriated | Total Equity |
|---|---|---|---|---|
| **Balance as of September 30, 2004** | B/. 1,904,568 | B/. 579,241 | B/. 183,708 | B/. 2,667,517 |
| Transfer to Panamanian Treasury (Note 8) | - | - | (183,708) | (183,708) |
| Net income | - | - | 483,934 | 483,934 |
| Contributions to the investment program (Note 7) | - | 147,784 | (147,784) | - |
| Corporate reserve for contingencies and working capital (Note 7) | - | 37,700 | (37,700) | - |
| Other equity reserves (Note 7) | - | 29,600 | (29,600) | - |
| Properties transferred to the Government of Panama (Notes 2 and 14) | (21) | - | - | (21) |
| **Balance as of September 30, 2005** | 1,904,547 | 794,325 | 268,850 | 2,967,722 |
| Transfer to Panamanian Treasury (Note 8) | - | - | (268,850) | (268,850) |
| Net income | - | - | 675,925 | 675,925 |
| Contributions to the investment program (Note 7) | - | 76,974 | (76,974) | - |
| Corporate reserve for contingencies and working capital (Note 7) | - | 23,466 | (23,466) | - |
| Reserve for Enterprise capitalization | | 182,003 | (182,003) | - |
| Reserve for Canal expansion (Note 7) | - | 120,000 | (120,000) | - |
| Other equity reserves (Note 7) | - | (41,850) | 41,850 | - |
| Properties transferred to the Government of Panama (Notes 2 and 14) | (7) | - | - | (7) |
| **Balance as of September 30, 2006** | B/. 1,904,540 | B/. 1,154,918 | B/. 315,332 | B/. 3,374,790 |

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

**(Translation of financial statements originally issued in Spanish)**

## Panama Canal Authority

## Statement of Cash Flows
## For the Year Ended September 30, 2006
**(In thousands of balboas)**

| | 2006 | 2005 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | B/. 675,925 | B/. 483,934 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 76,087 | 61,445 |
| Loss on retirement or disposal of properties, plant, and equipment | 316 | 478 |
| Obsolete and slow turnover inventory | 2,958 | 899 |
| Provision for marine accident claims | 3,004 | 4,123 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (5,916) | (8,841) |
| Inventories | (1,001) | (5,700) |
| Other current assets | (12,738) | (6,962) |
| Current liabilities | 34,001 | 2,776 |
| Net cash provided by operating activities | 772,636 | 532,152 |
| **Cash flows from investing activities** | | |
| Acquisition and installation of properties, plant, and equipment, net | (162,299) | (149,797) |
| Net increase in investments | (184,745) | (166,394) |
| Net increase in time deposits with original maturities over 90 days | (282,196) | (172,629) |
| Net cash used in investing activities | (629,240) | (488,820) |
| **Cash flows from financing activities** | | |
| Transfer to Panamanian Treasury | (268,850) | (183,708) |
| Net decrease in cash and cash equivalents | (125,454) | (140,376) |
| Cash and cash equivalents at beginning of the year | 229,193 | 369,569 |
| Cash and cash equivalents at end of the year (Note 4) | B/. 103,739 | B/. 229,193 |
| **Investing activity that did not represent cash outlay** | | |
| Properties transferred to the Government of Panama (Notes 2 and 14) | B/. (7) | B/. (21) |

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

**Explanation Added for Translation into English**

The accompanying financial statements have been translated from Spanish into English for international use. These financial statements are presented in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board. Certain accounting practices applied by the Panama Canal Authority that conform with International Financial Reporting Standards may not conform with accounting principles generally accepted in the country of use.

## 1. General Information

The Panama Canal Authority (PCA) is an autonomous agency of the Government of Panama, established in conformity with Article 310 of the Political Constitution of the Republic of Panama. The PCA is responsible for the administration, operation, conservation, maintenance, modernization, and other related activities of the Panama Canal (the Canal), that are necessary to ensure the safe, uninterrupted, efficient and profitable operation of the Canal in accordance with the constitutional and legal regulations in effect. The PCA has its own patrimony and the right to manage it. The PCA was organized on June 11, 1997 under Law No.19 (Organic Law).

The PCA, in coordination with government entities designated by law, is also responsible for the management, maintenance, use and conservation of the water resources of the Canal watershed, including lakes and their tributary streams.

With the expiration of the 1977 Torrijos-Carter Treaty at noon on December 31, 1999, the Panama Canal reverted to the Republic of Panama free of debts and liens, becoming an inalienable patrimony of the Republic of Panama, open to the peaceful and uninterrupted passage of vessels of all nations and whose use will be subject to the requirements and conditions established by the Political Constitution of Panama, the Organic Law of PCA, and its management.

As of September 30, 2006, the PCA had a total of 9,210 employees, of which 7,875 were permanent and 1,335 were temporary. As of September 30, 2005, the total was 9,223 employees, of which 7,974 were permanent and 1,249 were temporary.

**Summary of Significant Accounting Policies**

A summary of the principal accounting policies adopted in preparing the financial statements of PCA are as follows:

**Basis of Preparation**
The accompanying financial statements have been prepared under the historical cost convention, in conformity with International Financial Reporting Standards issued by the International Accounting Standards Board that were in effect at the date of the financial statements. PCA's management authorized and approved the issuance of these financial statements on December 6, 2006.

Preparing the financial statements, in conformity with the International Reporting Standards, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Future actual results could differ from those estimates. The most significant estimates for these financial statements are the provisions for marine accident claims and for inventory of supplies and materials, and the depreciation of properties, plant, and equipment.

***Interpretations and amendments to the published Standards effective in 2005***
The following amendment and interpretation to the Standards are mandatory for PCA's accounting periods beginning on or after January 1, 2005:

- IAS 39 (Modified), Transition and initial recognition of financial assets and liabilities (effective since January 1, 2005).

PCA's management evaluated the relevance of these amendments and interpretations in relation with PCA operations and concluded their compliance.

***Standards, interpretations and amendments to the published Standards not yet in effect***
Certain new Standards, amendments and interpretations to the existing Standards which have been published and which are mandatory for PCA accounting periods beginning on or after January 1, 2007, or subsequent periods, but that PCA has not adopted in advance, are the following:

- IFRS 7, Financial Instruments: Disclosures and complementary amendment to IAS 1, Presentation of Financial Statements – Capital disclosures (effective for periods beginning on or after January 1, 2007). IFRS 7 introduces new disclosures to improve the qualitative and quantitative information about the exposure to risks derived from financial instruments. It replaces IAS 30 and the disclosure requirements of IAS 32, Financial Instruments: Disclosures and Presentation.

PCA will start applying these Standards, interpretations and amendments on fiscal year 2007 and does not expect that they will have any impact on PCA's financial statements.

**Monetary Unit**
The PCA maintains its accounting records in balboas (B/.), the monetary unit of the Republic of Panama, which is at par with the US dollar.

**Properties, Plant, and Equipment**
Items of properties, plant, and equipment with a value of five thousand balboas or more are recorded at cost. The cost of items that are not capitalized or under five thousand balboas is expensed as incurred.

Depreciation is calculated using the straight-line method over the following estimated useful lives of the depreciable assets:

| | |
|---|---|
| Buildings | 25 - 75 years |
| Structures | 5 - 100 years |
| Equipment | 3 - 75 years |

The useful life of assets is reviewed periodically to ensure that the depreciation period is consistent with the economic benefit expectations of the components of properties, plant, and equipment.

The gain or loss resulting from the retirement or disposal of an asset is the difference between the net proceeds and the net book value of the asset. The gain or loss is reflected in the statement of income when incurred, except for buildings and properties that were received from the Government of Panama, which are charged against equity when they are demolished or returned back to the Government of Panama.

Maintenance and repairs are expensed as incurred, while major improvements are capitalized. Dredging costs incurred for recurrent maintenance of the waterway, as a result of landslides and erosion, are expensed. Dredging costs for substantial improvements to the waterway are capitalized and depreciated over their estimated useful lives.

Construction in progress represents plant and properties under construction and includes construction and other direct costs. Such items are not subject to depreciation until the assets are completed and placed in operation.

**Impairment of Assets**
Assets that are subject to amortization are reviewed annually to identify any impairment losses, whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. An impairment loss is recognized when the asset's carrying amount exceeds its recoverable amount, which is the higher of an asset's net selling price and its value in use.

**Cash and Cash Equivalents**
For purposes of the statement of cash flows, PCA's cash and cash equivalents consist of cash on hand, deposits in current and saving accounts, and time deposits with original maturity dates of less than 90 days.

**Investments**
Purchases of investments are recognized on the settlement date, the date on which PCA pays and receives the asset.

Investments are acquired with the intention to be held to maturity and are recorded at amortized cost. Amortized cost is the initial cost of the investment, adjusted by the cumulative amortization of any discount or premium on acquisition. The amortization of the discount or premium is recorded as an increase or decrease of interest income in the statement of income.

**Inventories**
The inventories of materials, operating supplies, and fuel are valued at average cost, which does not exceed net realizable value, after the allowance for supplies and materials inventory.

**Allowance for Supplies and Materials**
The supplies and materials inventory is annually evaluated to determine if stock levels are adequate or are in excess and should be reduced due to obsolescence, impairment, diminishment of quality, slow turnover or are not useful for the operation and functioning of the Canal.

If any inventory item of supplies and materials complies with the previously mentioned characteristics, the allowance is adjusted to its reasonable value to recognize the probable loss.

**Accounts Payable**
The accounts payable are recognized at their cost, being all goods or services rendered at their reasonable value to be paid in the future.

**Revenue Recognition**
Revenues are recognized as a result of the economic benefits which flow to the PCA and those revenues could be easily measured. The following specific criteria have to be complied before revenues are recognized:

*Toll Revenue*
The toll revenue is recognized once vessels complete their transits through the Canal.

*Services Rendered*
Revenues from other services are recognized when services are rendered.

*Interest*
Interest income on bank deposits and investments are recognized as accrued.

(In thousands of balboas)

### Severance Pay

Severance labor payments are charged to expense as incurred, except for the portion corresponding to the years of employment with the Panama Canal Commission, as explained in Note 9.

### Retirement Benefits

Retirement benefits for PCA employees are provided for through a statutory contribution plan with the Panamanian Social Security (Caja de Seguro Social), which assumes responsibility for the retirement benefits. Contributions are made in accordance with parameters established by the Social Security organic law.

### Financial Instruments

Financial assets and liabilities presented on the balance sheet correspond to cash, accounts receivable, investments, and accounts payable. Financial instruments are classified as assets and liabilities according to the substance of the contractual agreement from which they originated. The interests, gains or losses generated by a financial instrument, classified as asset or liability are recorded as expenses or revenues or against the respective provision, if applicable.

## 2. Properties, Plant, and Equipment

Properties, plant, and equipment are as follows:

| | September 30, 2005 Beginning Balance | Additions | Retirements | Transfers and Reclassifications | September 30, 2006 Ending Balance |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Land | B/. 1,022,222 | B/. - | B/. - | B/. - | B/. 1,022,222 |
| Buildings | 82,924 | 3,340 | - | 66 | 86,330 |
| Structures | 496,767 | 32,326 | (8) | 17,694 | 546,779 |
| Equipment | 663,350 | 103,764 | (2,403) | (16,661) | 748,050 |
| Constructions in progress | 146,707 | 162,299 | - | (139,430) | 169,576 |
| | 2,411,970 | 301,729 | (2,411) | (138,331) | 2,572,957 |
| **Accumulated Depreciation** | | | | | |
| Buildings | 20,129 | 3,180 | - | 67 | 23,376 |
| Structures | 86,933 | 19,305 | - | 3,986 | 110,224 |
| Equipment | 209,504 | 53,602 | (2,088) | (2,954) | 258,064 |
| | 316,566 | 76,087 | (2,088) | 1,099 | 391,664 |
| **Net value** | B/. 2,095,404 | B/. 225,642 | B/. (323) | B/. (139,430) | B/. 2,181,293 |

**(In thousands of balboas)**

| | September 30, 2004 Beginning Balance | Additions | Retirements | Transfers and Reclassifications | September 30, 2005 Ending Balance |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Land | B/. 1,022,222 | B/. - | B/. - | B/. - | B/. 1,022,222 |
| Buildings | 80,175 | 2,941 | (192) | - | 82,924 |
| Structures | 445,703 | 51,055 | - | 9 | 496,767 |
| Equipment | 588,819 | 77,986 | (3,446) | (9) | 663,350 |
| Constructions in progress | 128,892 | 149,797 | - | (131,982) | 146,707 |
| | 2,265,811 | 281,779 | (3,638) | (131,982) | 2,411,970 |
| **Accumulated Depreciation** | | | | | |
| Buildings | 16,871 | 3,407 | (149) | - | 20,129 |
| Structures | 68,755 | 18,177 | - | 1 | 86,933 |
| Equipment | 172,634 | 39,861 | (2,990) | (1) | 209,504 |
| | 258,260 | 61,445 | (3,139) | - | 316,566 |
| **Net value** | B/. 2,007,551 | B/. 220,334 | B/. (499) | B/. (131,982) | B/. 2,095,404 |

PCA recorded losses in retirement or disposal of fixed assets for B/.316 (2005 - B/.478). During 2006, the main assets retired included lighting system, winch, computer system, various projectors, forklift trucks, uninterruptible power system, and gasoline tank. During 2005, the main assets retired included a mobile crane, portable transformers, a satellite communication system, vehicles, a portable air compressor, and forklift trucks.

During fiscal years ended September 30, 2006, and 2005, there were no retirements due to demolished buildings.

PCA transferred equipment to the Government of Panama for a net value of B/.7 (2005 - B/.21). These assets were transferred to the Government of Panama as they were not useful for the operation of the Canal. (See Note 14)

(In thousands of balboas)

## 3. Account Receivable

The account receivable from the Office of Transition Administration (OTA) represents the portion of the Canal's investment program that was not transferred by the Panama Canal Commission (the Commission) to PCA on December 31, 1999. Since May 2004, these funds, which have no due date, were transferred to the Treasury of the United States of America and do not generate interest. The OTA was terminated on October 1, 2004, and its responsibility to pay these funds to the PCA was transferred to the General Services Administration (GSA), a U.S. government agency.

## 4. Cash and Cash Equivalents

Cash and cash equivalents are composed as follows:

| | 2006 | 2005 |
|---|---|---|
| Cash on hand | B/. 34 | B/. 25 |
| Deposits in current accounts | 7,957 | 8,832 |
| Deposits in saving accounts | 59,842 | 59,895 |
| Time deposits with original maturities under 90 days | 35,906 | 160,441 |
| Total cash and cash equivalents | 103,739 | 229,193 |
| Time deposits with original maturities over 90 days not exceeding 360 days | 717,431 | 435,235 |
| | B/. 821,170 | B/. 664,428 |

Article 44 of the Organic Law states that PCA's funds may be placed in short-term investment grade instruments and may not be used to buy other types of financial investment instruments issued by Panamanian or foreign public or private entities, or to grant loans to such entities or to the Panamanian Government. All investments in time deposits are placed in investment grade banks.

(In thousands of balboas)

## 5. Investments

Investments were acquired with the intention to be held to maturity, and are mainly composed of bonds. All the investments are short-term and have been placed in investment grade instruments.

Changes in investments held to maturity are stated as follows:

| | 2006 | 2005 |
|---|---|---|
| Balance at beginning of the year | B/. 305,654 | B/. 139,260 |
| Additions | 638,506 | 553,292 |
| Redemptions | (453,761) | (386,898) |
| Balance at the end of the year | B/. 490,399 | B/. 305,654 |

| | 2006 | 2005 |
|---|---|---|
| Fair value | B/. 490,295 | B/. 305,060 |
| Unrealized loss | 104 | 594 |
| Amortized cost | B/. 490,399 | B/. 305,654 |

## 6. Accounts Receivable

The accounts receivable are detailed as follows:

| | 2006 | 2005 |
|---|---|---|
| Transit-related services | B/. 8,229 | B/. 4,043 |
| Electric power sales | 15,985 | 14,706 |
| Other services | 1,730 | 764 |
| Government entities | 6,002 | 6,517 |
| | B/. 31,946 | B/. 26,030 |

Accounts receivable from government entities include B/.4,781 (2005 - B/.4,499) due from the National Institute of Pipelines and Sewerage (Instituto de Acueductos y Alcantarillados Nacionales [IDAAN]) for water treatment services provided.

(In thousands of balboas)

## 7. Appropriated Retained Earnings

Changes in appropriated retained earnings are detailed as follows:

| | Beginning Balance | Net Appropriations | Ending Balance |
|---|---|---|---|
| **2006** | | | |
| Investment program | B/. 591,325 | B/. 76,974 | B/. 668,299 |
| Reserve for catastrophic risks | 36,000 | - | 36,000 |
| Reserve for the social and environmental program of the Canal watershed | 10,000 | - | 10,000 |
| Corporate reserve for contingencies and working capital | 99,400 | 23,466 | 122,866 |
| Reserve for Enterprise capitalization | - | 182,003 | 182,003 |
| Reserve for Canal expansion | - | 120,000 | 120,000 |
| Other equity reserves | 57,600 | (41,850) | 15,750 |
| | B/. 794,325 | B/. 360,593 | B/. 1,154,918 |
| **2005** | | | |
| Investment program | B/. 443,541 | B/. 147,784 | B/. 591,325 |
| Reserve for catastrophic risks | 36,000 | - | 36,000 |
| Reserve for the social and environmental program of the Canal watershed | 10,000 | - | 10,000 |
| Corporate reserve for contingencies and working capital | 61,700 | 37,700 | 99,400 |
| Other equity reserves | 28,000 | 29,600 | 57,600 |
| | B/. 579,241 | B/. 215,084 | B/. 794,325 |

Article 41 of the Organic Law allows PCA to set aside funds from net income of the year to cover the costs of the investment program and the modernization and expansion of the Canal, as well as for other equity reserves that may be needed.

The funds for the investment program are determined based on investments expected to be realized during the year.

The equity reserves established up to date are as follows:

**Reserve for Catastrophic Risks**
The Board of Directors approved a reserve for catastrophic risks to cover the deductibles on the catastrophic insurance policy for a maximum total of B/.36,000. In fiscal years 2006 and 2005, PCA did not make appropriations to this reserve.

**Reserve for the Social and Environmental Program of the Canal Watershed**
The Board of Directors approved the establishment of a reserve to finance the social and environmental program of the Canal watershed. The purpose of this program is to preserve the natural resources and to promote the development and integral management of the watershed. In fiscal years 2006 and 2005, PCA did not make appropriations to this reserve.

**Corporate Reserve for Contingencies and Working Capital**
The Board of Directors approved a reserve for contingencies and working capital. The amount of this reserve will be defined based on the average of 30 days of Canal revenues or billing, and will be funded in stages, periodically, as agreed by the Board of Directors. In fiscal year 2006, the Board of Directors approved the increase of this reserve by B/.23,466 (2005 – B/.37,700) for a total of B/.122,866 (2005 – B/.99,400).

**Reserve for Enterprise Capitalization**
The Board of Directors approved a reserve for the Enterprise capitalization. The purpose of this reserve is to ensure and facilitate the long term financial projection of the Enterprise. This reserve will be funded in stages, according to the periodicity agreed by the Board of Directors. During fiscal year 2006, the Board of Directors approved to reserve B/.182,003.

**Reserve for Canal Expansion**
The Board of Directors approved an equity reserve for the construction program of the third set of locks in the Panama Canal. These funds will be segregated based on expected outlays during the program execution. In fiscal year 2006, the Board of Directors approved to reserve B/.120,000. (See Note 17b)

**Other Equity Reserves**
In addition, the Board of Directors approved the establishment of other equity reserves to contemplate programs to support the operation and administration of the Canal. During fiscal year 2005, the Board of Directors approved the increase of these reserves by B/.29,600 for a total of B/.57,600. During fiscal year 2006, the Board of Directors approved the use and partial reversal of these reserves by B/.41,850, for a total of B/.15,750, at the end of period.

## 8. Unappropriated Retained Earnings

Article 41 of the Organic Law also establishes that after covering the costs for the investment program and the reserves detailed in Note 7, any surplus shall be remitted to the Panamanian Treasury in the following fiscal period.

## 9. Severance Pay

In May 1999, the Panama Canal Commission's Board of Directors approved the transfer of B/.10,000 to PCA for severance payments to involuntarily terminated employees. This amount takes into account the employees' years of service with the Commission.

PCA's Personnel Administration Regulation establishes that severance will be paid only to employees who are terminated due to a reduction in force according to the dispositions described in section two of this regulation. All employees with at least 12 continuous months of permanent services will be entitled to severance pay. For severance payment purposes, the years of service that shall be credited are as follows:

1. For employees hired as permanent by the Commission prior to December 18, 1997, the years of service with both, PCA and the Commission, even though the severance pay will be calculated separately.

2. For permanent employees hired after December 18, 1997, only the years of service with PCA starting on December 31, 1999.

Employees that are receiving a retirement pension from the United States of America Federal Government or from the Panamanian Social Security or, according to a resolution by the Panamanian Social Security, any person who will receive a pension within thirty days following severance, are not entitled to severance pay.

All severance payments for the time worked in PCA will be recorded in the statement of income as they are incurred.

(In thousands of balboas)

## 10. Accounts Payable

The accounts payable are as follows:

| | 2006 | | 2005 | |
|---|---|---|---|---|
| Panamanian Treasury | B/. | 20,713 | B/. | 17,546 |
| Suppliers and others | | 78,230 | | 44,918 |
| | B/. | 98,943 | B/. | 62,464 |

Article 39 of the Organic Law establishes that PCA shall pay annually to the Panamanian Treasury a fee per net ton, or its equivalent, collected from vessels paying tolls for the use of the Canal. This fee shall be set by PCA. The total of such fees amounted to B/.252,796 (2005 - B/.190,960).

The balance payable to the Panamanian Treasury represents the fee per net ton payment that is outstanding at September 30, 2006.

## 11. Provision for Marine Accident Claims

The provision for marine accident claims for B/.27,715 (2005 - B/.27,524), represents the estimated value of filed or anticipated claims for accidents occurred in Canal waters for which PCA expects to be liable.

PCA carries out investigations to determine the cause of each marine accident. When the cause of the accident is determined, PCA records, if applicable, a provision based on an estimate of the vessel's permanent and temporary repair costs. The amount of the provision is reviewed at the date of the balance sheet, and if necessary, it is adjusted to reflect the best estimate at that moment.

(In thousands of balboas)

Changes in the provision for marine accident claims are detailed, as follows:

| | | 2006 | | 2005 |
|---|---|---|---|---|
| Balance at the beginning of the year | B/. | 27,524 | B/. | 24,887 |
| Plus: Current year adjustments and new claims | | 3,389 | | 4,809 |
| Minus: Prescribed claims | | 385 | | 686 |
| | | 3,004 | | 4,123 |
| | | 30,528 | | 29,010 |
| Minus: Payments | | 2,813 | | 1,486 |
| Balance at the end of the year | B/. | 27,715 | B/. | 27,524 |

Provisions are included in the marine accident claims expense in the statement of income.

## 12. Capitalized Labor and Materials

To execute its investment program, PCA contracts the services of suppliers and also utilizes its own resources and equipment.

The direct costs such as labor, supplies and materials, equipment (fuel, maintenance and depreciation), and other expenses related to these investments are originally recorded as operating expenses when incurred. These costs are credited in the statement of income under the specific line item and charged to the investment program.

Among the most significant investment projects carried out during the year ended September 30, 2006 are the following: deepening of Gatun Lake and Culebra (Gaillard) Cut, rehabilitation of the tow tracks, deepening of the entrances of the Canal, acquisition and installation of hydraulic operators, straightening of the Culebra (Gaillard) Cut, improvements to all locks' lighting system, acquisition of towing locomotives, and new ships' landing station in the Culebra (Gaillard) Cut. During the year ended September 30, 2005, the following projects were accomplished: deepening of Gatun Lake and Culebra (Gaillard) Cut, rehabilitation of the tow tracks, straightening of the Culebra (Gaillard) Cut, acquisition and assembly of drilling and blasting barge, deepening of the entrances of the Canal, acquisition and installation of hydraulic operators, improvements to all locks' lighting system, replacement of the locks' approach wall fenders from wood to rubber.

## 13. Income Taxes

The PCA is not subject to income taxes, as states in Article 43 of the Organic Law which exempts it from the payment of all national or municipal taxes, except for the employer's contribution of social security, educational insurance, workmen's compensation, fees for public services, and the fees per net ton.

## 14. Equity

Article 310 of the Political Constitution of the Republic of Panama states that PCA has its own patrimony and the right to manage it.

Upon the transfer of the Canal to the Republic of Panama at noon on December 31, 1999, PCA became the administrator of all personal and real estate property identified in the Organic Law of PCA as the patrimony necessary to operate and maintain the Canal.

This patrimony is divided into two groups: the inalienable patrimony, comprised of land, lakes, rivers, dams, locks and anchorages, as established in Article 2 of the Organic Law, and the economic patrimony, comprised of installations, buildings, structures and equipment that support the operation of the Canal, as established in Article 33 of the same Law.

In compliance with these requirements, the Government of Panama transferred the related land and buildings to PCA. In order to record the assets transferred by the Government of Panama as part of PCA's patrimony, a conservative method was used to reflect an estimated market value for each asset subsequently registered in the Public Registry.

Preliminary appraisal reports of land and buildings were provided by the Department of Patrimonial Goods of the Office of the Comptroller General of the Republic of Panama and the Department of Public Registry of the Ministry of Economy and Finance in January and August 2002, respectively. In the opinion of PCA's Administration, the adjustments to determine those values will not have an adverse effect on the financial position.

PCA transferred to the Government of Panama equipment with a value of B/.7 (2005 - B/.21) because they were not useful for the operation of the Canal.

## 15. Remunerations and Benefits to Key Managers

PCA paid remunerations and benefits to key managers for a total of B/.1,748 (2005 – B/.1,782).

## 16. Contingent Liabilities, Commitments and Contract

*Contingent liabilities*
PCA has received claims and is a defendant in various legal proceedings mainly related to marine accidents. The PCA's contingent liabilities amounted approximately to B/.2,797 (2005 - B/.2,595) corresponding to marine accident claims. It is management's opinion that the outcome of these matters is not likely to have a material adverse effect on the PCA's financial position.

*Commitments*
Commitments under uncompleted construction contracts and undelivered purchase orders amounted approximately to B/.146,000 (2005 - B/.177,000).

*Contract*
On September 16, 2006, the PCA and the National Institute of Pipelines and Sewerage (Instituto de Acueductos y Alcantarillados Nacionales [IDAAN]) subscribed Contract No.139-2006 for the purchase and sale of blocks of potable water for the area of La Chorrera, for a 30-year period, renewable on mutual agreement. PCA agrees to build a water treatment plant, to be known as Mendoza, on the shores of Gatun Lake, District of La Chorrera, which shall include all works, machinery, accessories, and equipments necessary for the production and sale of blocks of potable water to IDAAN at an approximate cost of B/.26,150. IDAAN agrees to install potable water delivery pipelines and to build all necessary infrastructure to meet minimum water supply requirements.

## 17. Subsequent Events

### a. Referendum on the Proposal for the Expansion of the Panama Canal through the Construction of the Third Set of Locks

On April 24, 2006, PCA Board of Directors approved Agreement No. 112 by which the PCA submitted for consideration of the Executive Branch the proposal to expand the Canal's capacity, in the existing route, through the construction of the third set of locks. This proposal for the expansion of the Canal was formally presented to the President of the Republic of Panama, who in turn submitted it for debate to the Cabinet Council. On June 26, 2006, the Cabinet Council approved for consideration of the National Assembly, Bill No.224, the proposal for the construction of the third set of locks in the Panama Canal and other dispositions. Law No.28 created on July 17, 2006, and promulgated on July 18, 2006, approved the proposal and authorized the Electoral Tribunal to regulate and conduct a national referendum. As stated in Article No.325 of the Constitution of the Republic of Panama, the referendum shall not be held before three months following the approval of the Executive Branch; therefore, the date established for the referendum was October 22, 2006. According to Law No.28, this is the Sunday following expiration of the three-month period. The final result of the national referendum was the citizens' approval of the proposal of the Canal Expansion Program.

**b. Canal Expansion Program through the Construction of a Third Set of Locks**

On November 24, 2006, the Board of Directors approved an equity reserve for B/.120,000 for the construction program of the third set of locks in the Panama Canal.

The third set of locks program is a plan to expand the Canal's capacity composed of three integrated components: 1) the construction of two lock facilities – one on the Atlantic side and another on the Pacific side, each with water reutilization basins; 2) the excavation of new access channels to the new locks and the widening of existing navigational channels; and, 3) the deepening of existing navigation channels and the elevation of Gatun Lake's maximum operating level.

The objectives of the Canal expansion are to: 1) achieve long-term sustainability and growth through the payments it makes to the National Treasury; 2) maintain the Canal's competitiveness as well as the value added by Panama's maritime route to the national economy; 3) increase the Canal's capacity to capture the growing tonnage demand with the appropriate levels of services for each market segment; and, 4) make the Canal more productive, safe, and efficient.

The program will have an approximate estimated cost of B/.5,250 million, which includes provisions for contingencies and inflation during the construction period. This estimate assumes 2% average annual inflation.

The execution of the program of the third set of locks will begin in 2007 and will take up to 8 years, between 2007 and 2014. The third set of locks could begin operations in 2015. During the construction period, the Canal tonnage payments and contributions for operational surplus to the National Treasury will be maintained and increased. These payments will not be less than that paid in 2005 or than that made in 2006.

Program investments for the construction of the third set of locks will be recovered through tolls collected by the Canal.

The financing of the third set of locks will be the result of combining a reasonable tolls increase, implemented immediately after the expansion program is approved through referendum, with interim external financing sources in order to meet requirements during the peak period of the Canal expansion.

Therefore, the third set of locks program will be financed through a mix of PCA capital contributions and interim external financing. The amount to come from external financing will depend on (1) investment amounts required by the project; (2) the need to build as fast as it is technically and economically viable; (3) Canal revenues resulting from Canal traffic volumes and the price policy implemented by PCA.

The source for the repayment of this interim financing will be the Canal tolls and no State guarantees will be utilized to back up the third set of locks program. The external financing contracts undersigned by PCA will be solely guaranteed by the cash flows that the program will generate.