COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO

SINGLE AUDIT REPORT
Fiscal Year Ended
June 30, 2008

BASIC FINANCIAL STATEMENTS AND SUPPLEMENTAL SCHEDULE

With Independent Auditors' Report Thereon
June 30, 2008

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
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Fiscal Year Ended June 30, 2008

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BENITEZ-JAIME, CPA-PSC
Certified Public Accountants and Business Consultants

Independent Auditors' Report on Basic Financial Statements and Supplementary Schedule of Expenditures of Federal Awards

The Honorable Mayor, Members of the
Municipal Legislature and People of
the Municipality of Cataño
Cataño, 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 Cataño of the Commonwealth of Puerto Rico (the "Municipality"), as of and for the year ended June 30, 2008, which collectively comprise the Municipality's basic financial statements as listed in the accompanying table of contents. These financial statements are the responsibility of the Municipality's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Cataño of the Commonwealth of Puerto Rico, as of June 30, 2008, 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 accompanying financial statements have been prepared assuming that the Municipality of Cataño will continue as a going concern. As discussed In Note 14 to the financial statements, the Municipality's general fund has reported recurring excesses of expenditures and other financing uses over revenues and other financing sources, which have lead to significant liquidity and cash flows shortfalls. These conditions raise 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.

In accordance with Government Auditing Standards we have also issued our report dated November 14, 2008, on our consideration of the Municipality of Cataño of the Commonwealth of Puerto Rico internal control over financial reporting and on our test of its compliance with certain provisions of laws, regulations, contracts and grants. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the result of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and importance for assessing the results of our audit.

P.O. Box 191503, San Juan, Puerto Rico 00919-1503 TEL. 787-603-1600

The accompanying Management's Discussion and Analysis and the Budgetary Comparison Schedule are not required parts of the basic financial statements referred to above, 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 required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Municipality's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States and Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements of the Municipality. The schedule of expenditures and federal awards have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

November 14, 2008
Toa Alta, Puerto Rico

Stamp No. 2313623 was affixed to the original report.

CPA - PSC

As management of the Municipality of Cataño (the Municipality), we offer readers the following discussion and analysis of the Municipality's financial activities reported in the accompanying basic financial statements for the fiscal year ended June 30, 2008. We encourage readers to consider the information presented here in conjunction with additional information that is furnished in the Municipality's financial statements, which follow this narrative.

FINANCIAL HIGHLIGHTS

Government-Wide Highlights:

- The Municipality's assets exceeded its liabilities (net assets) by $69,376,382 at June 30, 2008. The Municipality's net assets decreased by $9,293,809 (excess of expenses over revenues) during the fiscal year ended June 30, 2008.

- At June 30, 2008, the Municipality's assets decreased $10,525,520 in comparison with the prior fiscal year.

- At June 30, 2008, the Municipality's liabilities decreased $1,231,711 in comparison with the prior fiscal year.

- The revenues of the Municipality for the fiscal year ended June 30, 2008 decreased $1,712,818 in comparison with the prior fiscal year.

- The Municipality's expenses for the fiscal year ended June 30, 2008 increased $3,052,234 in comparison with the prior fiscal year.

Governmental Funds' Highlights:

- The total fund balances of governmental funds amounted to $9,380,022 at June 30, 2008, which decreased by $22,260,011 (excess of expenditures and other financing uses over revenues and other financing sources) during fiscal year ended June 30, 2008.

- At June 30, 2008, the total assets of governmental funds decreased $21,699,264 in comparison with the prior fiscal year.

- At June 30, 2007, the total liabilities of governmental funds increased $560,747 in comparison with the prior fiscal year.

- The total revenues of governmental funds for the fiscal year ended June 30, 2008 decreased $948,907 in comparison with the prior fiscal year.

- The total expenditures of governmental funds for the fiscal year ended June 30, 2008 increased $9,582,152 in comparison with the prior fiscal year.

OVERVIEW OF THE BASIC FINANCIAL STATEMENTS

The purpose of financial reporting is to provide external users of basic financial statements with information that will help them to make decisions or draw conclusions about the Municipality. There are many external parties that use the basic financial statements of the Municipality; however, these parties do not always have the same specific objectives. In order to address the needs of as many parties as reasonably possible, the Municipality, in accordance with required financial reporting standards, presents this Management's Discussion and Analysis (MD&A) as an introduction to the accompanying basic financial statements. This narrative represents an overview and analysis of the financial activities of the Municipality for the fiscal year ended June 30, 2008. 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.

The Municipality's basic financial statements include three components: (1) government-wide financial statements (GWFS), (2) governmental fund financial statements (GFFS), and (3) notes to the basic financial statements (NBFS). This report also contains additional required and other supplementary information in addition to the basic financial statements themselves. These components are described below.

The basic financial statements focus on: (1) the Municipality as a whole (government-wide financial reporting) and, (2) the Municipality's major individual governmental funds. Both perspectives allow the users to address relevant questions, broaden a basis for comparison (year to year or government to government) and enhance the Municipality's accountability. The components of the basic financial statements are described below.

a) Government-wide Financial Statements

The GWFS are composed of: (1) the statements of net assets (SNA) and (2) the statement of activities (SA). These financial statements can be found immediately following this MD&A. GWFS are designed to provide readers with a broad overview of the Municipality's operations 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 June 30, 2008. The GWFS are prepared using methods that are similar to those used by most private businesses.

1. Statement of Net Assets

The purpose of SNA is to attempt to report all assets owned and all liabilities owed by the Municipality. The Municipality reports of all of its assets when it acquires ownership over the assets and reports all of its liabilities when they are incurred. For example, the Municipality reports buildings and infrastructure as assets, even though they are not available to pay the obligations incurred by the Municipality. On the other hand, the Municipality reports liabilities, such as claims and judgments, even though these liabilities might not be paid until several fiscal years into the future.

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

2. Statement of Activities

The SA presents information showing how the Municipality's net assets changed during the fiscal year ended June 30, 2008, by presenting all of the Municipality's revenues and expenses. As previously discussed, the items reported in SA are measured in a manner similar to the approach used by a commercial enterprise in that revenues are recognized when earned or established criteria are satisfied, and expenses are recorded when incurred by the Municipality. Consequently, revenues are reported even when they may not be collected for several months after the end of the fiscal year and expenses are recorded even though they may not have used cash during the current year.

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

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

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

GWFS and GFFS present all of the Municipality's governmental activities, which are supported mostly by taxes and intergovernmental revenues (such as federal and state grants and contributions). All services normally associated with the Municipality fall into this category, including culture, recreation and education; general government; health and sanitation; public safety; public housing and welfare; and economic and urban development.

b) Governmental Fund Financial Statements

The Municipality's GFFS 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, with an emphasis on the Municipality's major 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.

Governmental funds are used to account for all of the services provided by the Municipality. These funds are used to account for essentially the same functions reported as governmental activities in the GWFS. Unlike GWFS, the focus of GFFS is directed to specific activities of the Municipality rather than the Municipality as a whole; therefore, GFFS report the Municipality's operations in more detail than the GWFS.

GFFS provide a detailed short-term view of the Municipality's finances that assist in determining whether there will be adequate financial resources available to meet the current needs of the Municipality, which is, evaluating the Municipality's near-term financing requirements. For financial reporting purposes, the Municipality classifies its governmental funds within the following types: (1) general fund, (2) debt service fund, (3) special revenue funds, and (4) capital projects funds.

GFFS are prepared on an accounting basis that is significantly different from that used to prepare GWFS. In general, GFFS focus on near-term inflows and outflows of expendable financial resources, consequently, generally measure and account for cash and other assets that can easily be converted to cash. For example, amounts reported on the balance sheet include capital assets within a very short period of time, but do not include capital assets such as land and buildings. Governmental fund liabilities generally include amounts that normally are going to be paid within a very short period after the end of the fiscal year. The difference between a fund's total assets and total liabilities is reported as the fund balance, and generally indicates the amount that can be used to finance the next fiscal year's activities. Likewise, the operating statement for governmental funds reports only those revenues and expenditures that were collected in cash or paid with cash, respectively, during the current fiscal year or very shortly after the end of the fiscal year.

Because the focus of GFFS is narrower than that of the GWFS, it is useful to compare the fund information presented for governmental funds with similar information presented for governmental activities in the GWFS. By doing so, readers may better understand the long-term impact of the Municipality's near-term financial decisions. Both the governmental funds' balance sheet and the governmental funds' statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate the comparison between governmental funds and the governmental activities reported in the government-wide financial statements.

The Municipality has three major governmental funds. Each major fund is presented in a separate column in the governmental funds' balance sheet and the governmental funds' statement of revenues, expenditures and changes in fund balances. The three major governmental funds are: (1) general fund, (2) debt service fund and (3) capital improvements bond fund (a capital projects fund).

c) Notes to Basic Financial Statements

The NBFS provide additional information that is essential for a full understanding of the data provided in the GWFS and GFFS. The NBFS can be found immediately following the basic financial statements.

d) *Other Supplementary Information*

The basic financial statements are followed by a section of required supplementary information consisting of: (1) Budgetary Comparison Schedule – General Fund, (2) Schedule of Expenditures of Federal Awards, as detailed in the accompanying table of contents.

FINANCIAL ANALYSIS OF GOVERNMENT-WIDE FINANCIAL STATEMENTS

The Municipality's overall condensed financial position for the last two fiscal years are summarized as follows, based on the information included in the accompanying GWFS:

	2008	2007
Assets:		
Current assets	$ 31,502,809	$ 53,216,962
Noncurrent assets:		
Capital assets, net	118,878,409	107,665,453
Other noncurrent assets	207,828	232,151
Total assets	$ 150,589,046	$ 161,114,566
Liabilities:		
Current liabilities, excluding long-term obligations	20,188,573	18,894,438
Long-term obligations due within one year	5,905,656	5,740,000
Long-term obligations due after one year	55,118,435	57,809,937
Total liabilities	81,212,664	82,444,375
Net assets (liabilities):		
Invested in capital assets, net of related debt	$ 78,126,012	$ 75,298,253
Restricted	5,026,737	8,048,331
Unrestricted	(13,776,367)	(4,676,393)
Total net assets	$ 69,376,382	$ 78,670,191

At June 30, 2008, the Municipality's current assets, amounting to $31,502,809, are mainly composed of cash and cash equivalents ($25,943,138), property taxes receivable ($3,853,901), municipal license taxes receivable ($80,651) and intergovernmental receivables ($1,144,209).

The restricted cash of $17.951,194 represents resources legally designated for: (1) the payment of debt service, (2) the acquisition, construction and improvement of major capital assets, and (3) the operations of federally and state funded programs. Restricted cash also consists of unspent proceeds of bonds of $7,303,346. Restricted property taxes receivable of $906,767 represent resources set aside to redeem the bonds of the Municipality in minimum annual or biannual principal and interest payments.

During the current fiscal year, total assets decreased $10,525,520 principally because cash and cash equivalents decreased $20,437,202 (44% decrease) in comparison with the prior fiscal year. The decrease in cash and cash equivalents is mainly due to the excess of expenses over revenues of

During the current fiscal year, total assets decreased $10,525,520 principally because cash and cash equivalents decreased $20,437,202 (44% decrease) in comparison with the prior fiscal year. The decrease in cash and cash equivalents is mainly due to the excess of expenses over revenues of $9,293,809 and the additions to capital assets of $16,653,590 for the fiscal year ended June 30, 2008. Due to this situation during the current fiscal year the Municipality faced significant liquidity and working capital deficiencies that have worsened after the current fiscal year-end. At June 30, 2008, the Municipality's unrestricted deposits amounted to $7,991,944, which is significantly below the normal levels needed to operate safely and is the lowest unrestricted cash level of the Municipality in several years. The amount of unrestricted cash in commercial banks available at June 30, 2008 represent approximately 1.9 months of operating expenses of the general fund. The remaining cash balances amounting to $17,951,194 at June 30, 2008 are restricted and are not available to pay ordinary operating expenses of the general fund since are restricted for specific purposes stated in various grant agreements and bond indentures.

The Municipality's noncurrent assets, amounting to $119,086,237 at June 30, 2008, are substantially composed of capital assets, with a cost basis of $159,208,278, which are reported net of accumulated depreciation and amortization of $40,329,869. Those capital assets increased $11,212,956 in comparison with the prior fiscal year due to the net effect of the current year additions of $16,653,590 over depreciation expense of $5,440,634.

At June 30, 2008, the Municipality's current liabilities amounting to $26,094,229 are mainly composed of unearned municipal license taxes ($10,722,225), accounts payable and accrued liabilities ($9,466,348), and the portions due within one year of compensated absences ($2,505,708), bonds payable ($2,920,000) and legal claims and judgments ($198,000).

Deferred revenues principally consist of unearned revenues associated with municipal license taxes of $10,387,264. This amount represents the municipal license taxes corresponding to fiscal year ending June 30, 2009 that were collected in advance during the last quarter of the current fiscal year, as required by law. However, also during the last quarter of the current fiscal year, the Municipality used approximately $2.4 million of these unearned municipal license taxes to pay operating expenses and obligations of the current fiscal year, which will reduce the financial resources available to finance the next fiscal year's operations of the general fund.

As noted in the condensed statement of net assets, the Municipality's current assets exceeded current liabilities by $5,408,580 for a current ratio (current assets to current liabilities) of 1.21 to 1.00. Accordingly, the working capital (current assets minus current liabilities) of the Municipality decreased $23,173,944 (81% decrease) during the current fiscal year. Consequently, the current ratio decreased from 2.16 at June 30, 2007 to 1.21 at June 30, 2008. These conditions may result in significant difficulties for the Municipality to pay its obligations when due during the second half of fiscal year 2008-2009 and the possible accumulation of unpaid billings from suppliers of goods and services.

Management of the Municipality is currently evaluating different alternatives for the permanent financing of the Municipality's operations, principally to increase its revenue sources and implementing continuous cost reductions policies. As an initial step, during the last quarter of the current fiscal year, the Municipality commenced a project designed to maximize its property tax revenues by reviewing the assessed values and tax exemptions of taxable properties. This project has been carried over under a cooperative agreement with the Municipal Revenue Collection Center.

The success of management's plans and strategies to improve the Municipality's cash flow and liquidity and to achieve positive net changes in unrestricted net assets cannot be assured, as it is significantly dependent upon events and circumstances which outcome cannot presently be determined. However, management is committed to undertake whatever actions may be necessary to try to prevent operating and working capital deficiencies in the future.

The Municipality's noncurrent liabilities, amounting to $55,118,435 at June 30, 2008, are mainly composed of portions due after one year of bonds payable ($45,080,000), notes payable ($6,881,456), and compensated absences ($3,030,624).

At June 30, 2008, the liabilities of the Municipality decreased by $1,231,711 in comparison with the prior fiscal year, principally for the following facts:

- Bonds payable decreased by $2,920,000 due to the related debt service principal payments made during the current fiscal year.

- Notes payable decreased by $135,540 due to the related debt service principal payments made during the current fiscal year.

- Accrued compensated absences increased by $679,322 since the current year payments to employees ($2,336,832) were below the current year accumulation of vacations and sick leave days ($3,016,154).

- Accounts payable and accrued liabilities increased by $1,686,162 mainly due to the increase of $3,052,234 in expenses in comparison with the prior fiscal year and the decrease in cash balances referred to above which caused the Municipality to extend the average days in accounts payable in order manage cash balances more adequately.

As noted earlier, net assets may serve over time as a useful indicator of the Municipality's financial statement position. The assets of the Municipality exceeded liabilities by $69,376,382 at June 30, 2008.

The most significant portion of net assets ($78,126,012) reflects the Municipality's investment in capital assets (e.g. land, buildings, machinery, equipment, infrastructure, etc.), net of all related debt still outstanding that was issued to acquire, construct or improve those assets. The Municipality uses the capital assets to provide services to its citizens; consequently, these assets are not available for future spending. Although the Municipality's investment in capital assets is reported net of the outstanding related debt, the resources needed to repay that debt must be provided by other sources, as capital assets cannot be used to liquidate these liabilities.

Another significant portion of net assets ($4,981,770) at June 30, 2008, represents resources that are restricted for debt service payments and to finance the operations of federal and state funded programs. This portion of restricted net assets decreased $2,884,642 in comparison with the prior fiscal year because during the current fiscal year the Municipality made a non-routinary transfer of $3,434,000 from the debt service fund to the general fund, as permitted by law, to provide additional working capital and additional financial resources to mitigate the general fund's excess of expenditures over revenues of $11,423,085 for the fiscal year ended June 30, 2008. Accordingly, the legal margin of the Municipality has decreased consistently during the last three fiscal years to $672,840 at June 30, 2008, which has significantly reduced the Municipality's borrowing capability.

The remaining component of total net assets consists of unrestricted negative net assets amounting to ($13,776,367) at June 30, 2008. These unrestricted negative net assets are the consequence of the excess of expenses over revenues that consistently occurred during the last four fiscal years and the previous budgets that did not provide sufficient funding for incurred long-term obligations, such as bonds payable, notes payable compensated absences, claims and judgments, obligations under capital leases, etc. Historically, a significant portion of such obligations has been budgeted on a pay-as-you-go basis.

The total net assets of the Municipality decreased $9,293,809 for the fiscal year ended June 30, 2008. Such decrease is due to the deficiency of total revenues ($49,153,994) under expenses ($58,447,803) for the fiscal year ended June 30, 2008. The following is a comparative condensed presentation of the Municipality's results of operations as reported in the GWFS for the fiscal years ended June 30, 2008 and 2007:

	2008	2007
Program revenues:		
Program-specific operating grants and contributions	$ 2,518,699	$ 2,350,261
Program-specific capital grants and contributions	2,280,133	939,438
Charges for services	498,798	578,687
Total program revenues	5,297,630	3,868,386
General revenues:		
Property taxes	23,350,091	27,168,378
Municipal license taxes	12,742,763	10,989,572
Construction excise taxes	880,773	1,390,177
Sales and use taxes	3,802,068	1,777,973
Unrestricted grants and contributions	1,313,052	2,568,514
Interests and miscellaneous revenues	1,767,617	3,103,812
Total general revenues	43,856,364	46,998,426
Total revenues	49,153,994	50,866,812
Program expenses:		
General government	19,603,565	21,860,973
Urban and economic development	11,193,533	9,712,389
Health and sanitation	6,957,172	6,718,195
Public safety	6,217,369	5,191,969
Public housing and welfare	7,442,553	5,537,342
Culture, recreation and education	4,209,960	2,953,719
Interest on long-term obligations	2,823,651	3,420,982
Total expenses	58,447,803	55,395,569
Net decrease in net assets	(9,293,809)	(4,528,757)
Net assets, at beginning of fiscal year	78,670,191	83,228,628
Prior-period adjustments	-	(29,680)
Net assets, at end of fiscal year	$ 69,376,382	$ 78,670,191

As previously mentioned, the Municipality's net assets decreased by $9,293,809 during current fiscal year. Approximately 83% ($40,775,695) of the Municipality's total revenues for the current fiscal year came from property taxes, municipal license taxes, construction excise taxes and sales and use taxes, while 12% ($6,111,884) resulted from restricted and unrestricted capital and operating grants and contributions from other governments.

There was an increase of $4,765,052 in the excess of expenses over revenues of the Municipality as a whole, when the operating results for the fiscal current year are compared to those of the prior fiscal year. This occurred mainly due to the increase of $3,052,234 in total expenses while total revenues decreased $1,712,818. The most significant fluctuations among the current fiscal year revenues and those of the prior fiscal year were as follows:

- During the current fiscal year, the Municipality established a sales and use tax system that resulted in new tax revenues of $1,777,973.

- Property taxes revenues decreased by $3,818,287 because the current year property assessments and collections were lower that in the prior year. During the last four fiscal years, the property tax collections have decreased consistently from year to year due to a significant amount of residential and commercial properties within the territory of Cataño for which the assessed value for tax purposes has not been reviewed in decades. Also there is a significant amount of properties erroneously enjoying tax exemptions when in fact should be fully taxable for property tax purposes. Furthermore, the decrease in property tax revenues is mainly due to the decreased collection efforts made by the Municipal Revenue Collection Center during the last four fiscal years and the lack of effectiveness of the municipal property tax office, for which the Office of the Comptroller of Puerto Rico reported various administrative audit findings in the most recent audit reports.

  In order to mitigate the reduction in property tax revenues, as an initial step, during the last quarter of the current fiscal year, the Municipality commenced a project designed to maximize its property tax revenues by reviewing the assessed values and tax exemptions of taxable properties. This project has been carried over under a cooperative agreement with the Municipal Revenue Collection Center and has been carried out by a consulting firm on behalf of the Municipality.

- Municipal license tax revenues increased $1,753,191 during the current fiscal year because the current year collections were higher that in the prior year mainly to various settlements made with certain taxpayers during the current fiscal year. Although this increase is related to non-recurrent revenue streams, the Municipality consistently has implemented effective audit procedures to identify taxpayers with significant underpayments of municipal license taxes during the last four years.

- Sales and use taxes increased $2,024,094 during the current fiscal year because the sales tax revenue was generated for only seven months of the prior fiscal year since the sales tax system was implemented on November 15, 2006.

- Interest income decreased $1,147,458 in comparison with the prior fiscal year principally to the decrease of $20,437,202 (44 % decrease) in cash and cash equivalents, and the overall decrease in interest rates in the financial markets.

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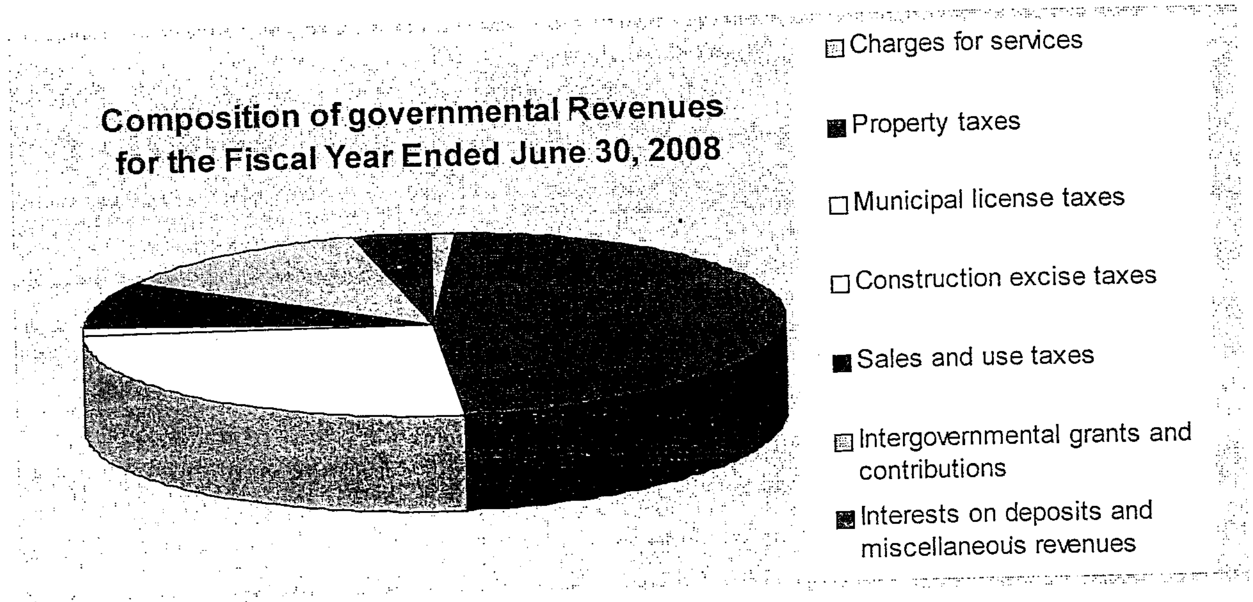
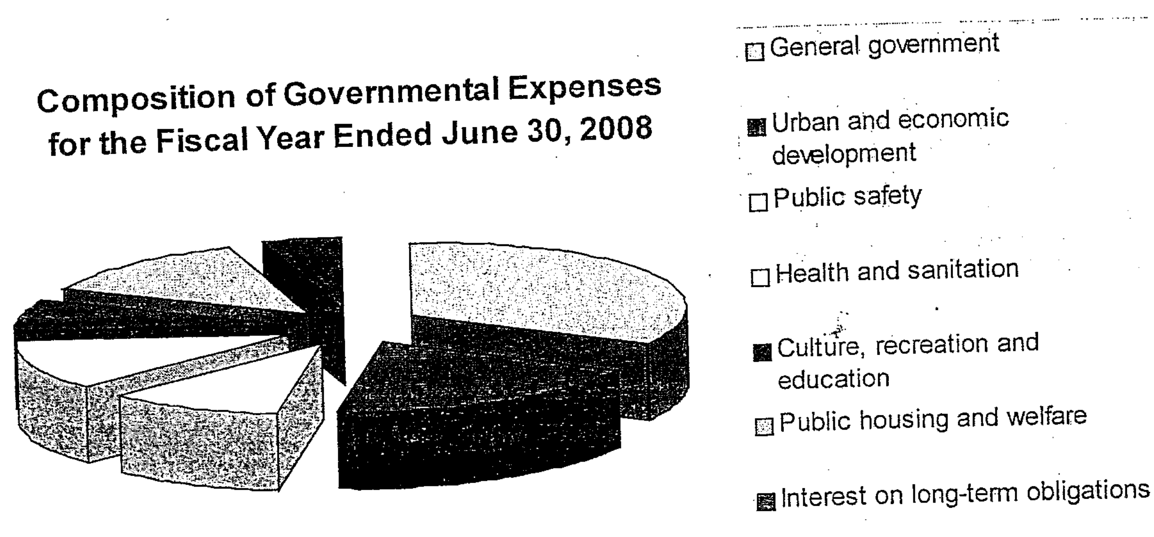
The following chart presents the composition of revenues for the fiscal year ended June 30, 2008:



The Municipality's expenses cover a wide range of services. The largest expenses of the Municipality for the fiscal year ended June 30, 2008 were related to: (1) general administrating and operating costs ($19,603,565), which were classified as "general government", (2) urban ad economic development ($11,193,533), (3) health and sanitation ($6,957,172), (4) public housing and welfare ($7,442,553), and (5) public safety ($6,217,369). The most significant fluctuations between the current fiscal year's expenses and those of the prior fiscal year occurred in the general government expenses, which decreased by $2,257,408. The following chart presents the composition of expenses for the fiscal year ended June 30, 2008:



FINANCIAL ANALYSIS OF GOVERNMENTAL FUNDS

Condensed Balance Sheet - Governmental Funds
June 30, 2008 and 2007

	2008	2007
Assets:		
Total assets - major governmental funds	$ 29,641,757	$ 51,744,962
Total assets - other governmental funds	2,947,286	2,543,345
Combined total assets	32,589,043	54,288,307
Liabilities:		
Total liabilities - major governmental funds	21,306,481	20,983,278
Total liabilities - other governmental funds	1,902,540	1,664,996
Combined total liabilities	23,209,021	22,648,274
Fund balances:		
Reserved - major governmental funds	10,816,664	27,872,676
Reserved - other governmental funds	1,044,746	878,349
Unreserved - major governmental funds	(2,481,388)	2,889,008
Combined total fund balances	9,380,022	31,640,033
Total liabilities and fund balances	$ 32,589,043	$ 54,288,307

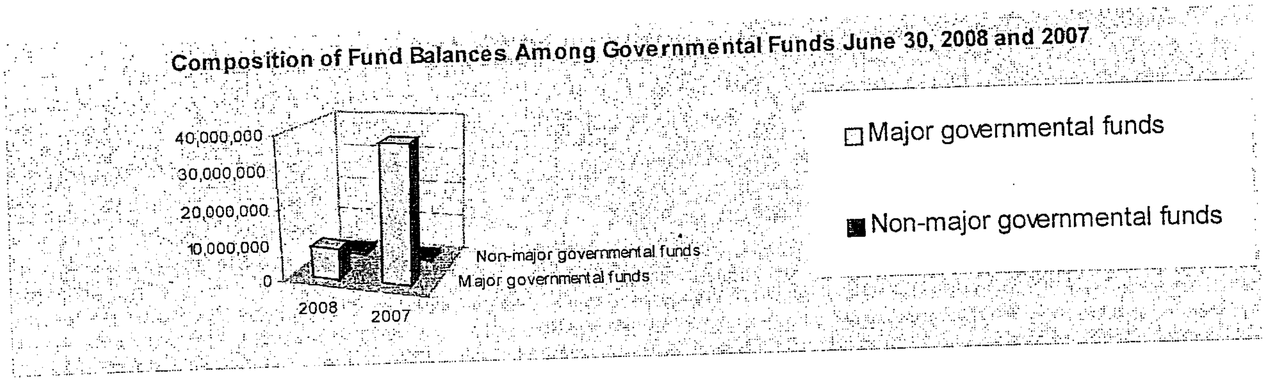
Analysis of Financial Position of Governmental Funds

As discussed earlier, the Municipality uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The focus of the Municipality's governmental funds is to provide information on near-term inflows, outflows, and balances of expendable resources. Such information is useful in assessing the Municipality's compliance with finance-related legal requirements. Specifically, unreserved fund balance may serve as a useful measure of the Municipality's net resources available for spending at the end of the fiscal year.

For a detailed explanation of the individual fluctuations of total assets and total liabilities of governmental funds, please refer to the previous financial analysis of the government-wide financial statements included in this management's discussion and analysis, where a detailed discussion of most of these fluctuations has been made.

At June 30, 2008, the total assets of governmental funds decreased by $21,699,264 in comparison with the prior fiscal year principally for the decrease of $20,437,202 (44% decrease) in cash and cash equivalents. In the other hand, at June 30, 2008, the total liabilities of governmental funds increased $560,747 in comparison with the prior fiscal year.

At the end of the current fiscal year, total unreserved fund deficit of the governmental funds amounted to $2,481,388 (general fund), while total fund balance reached $9,380,022. The total fund balances decreased by $22,260,011 during the current fiscal year. The following table presents a comparison of fund balances for the last two fiscal years:



The following is a detailed financial analysis of the Municipality's governmental funds:

Major Governmental Funds

General fund (GF) - The GF is the principal operating fund of the Municipality.. The GF's total assets amounted to $13,036,771 at June 30, 2008. Such assets consist principally of: (1) cash and cash equivalents ($8,231,090), and (2) tax receivables ($3,298,677).

The GF's total liabilities amounted to $14,743,882 at June 30, 2008. Such liabilities are composed mainly of: (1) deferred revenues ($10,644,950), and (2) accounts payable and accrued liabilities, including amounts due to other governments ($4,098,932).

At the end of the current fiscal year, unreserved fund deficit of the GF amounted to $2,481,388, while total fund deficit reached $1,707,111.

Total assets decreased $7,581,553 and total liabilities decreased $885,809 in comparison with the prior fiscal year. The most significant fluctuations in the assets and liabilities of the general fund are the following:

- Cash and cash equivalents decreased $5,325,643 (40% decrease) in comparison with the prior fiscal year. The decrease in cash and cash equivalents is mainly due to the excess of expenses and other financing uses over revenues and other financing sources of $6,695,744. Due to this situation during the current fiscal year the general fund faced significant liquidity and working capital deficiencies that have worsened after the current fiscal year-end. At June 30, 2008, the GF's unrestricted deposits amounted to $7,991,944, which is significantly below the normal levels needed to operate safely and is the lowest unrestricted cash level of the GF in several years. The amount of unrestricted cash in commercial banks available at June 30, 2008 represent approximately 1.9 months of operating expenses of the GF. The remaining cash balances amounting to $239,146 at June 30, 2008 are restricted and are not available to pay ordinary operating expenses of the general fund since are restricted for specific purposes.

- Accounts payable and accrued liabilities increased $545,395 due to the overall increase of $3,536,627 in total expenditures of the GF for the fiscal year ended June 30, 2008.

- Deferred revenues decreased $1,431,204 principally due to the decrease of $350,750 in unearned municipal license taxes and the decrease of unavailable municipal license taxes and intergovernmental grants and contributions of $1,080,454. During the last quarter of the current fiscal year, the Municipality used approximately $2.4 million of the next fiscal year's municipal license taxes (Deferred municipal licenses) that were collected in advance through June 30, 2008. These financial resources were used by the Municipality to pay operating expenses and obligations of the current fiscal year, which will reduce the financial resources available to finance the operations of the general fund for the fiscal year 2008-2009.

Debt service fund (DSF)- The DSF's total assets amounted to $9,270,962 at June 30, 2008, which consists mainly of restricted cash in fiscal agent ($8,298,168) and restricted property taxes receivable ($906,767). The DSF's total liabilities amounted to $4,289,192 at June 30, 2008, which are composed of: (1) matured bonds due and payable ($2,920,000), (2) matured interest due and payable ($1,364,094) and (3) due to general fund ($5,098). At the end of the current fiscal year, DSF's total and reserved fund balance reached $4,981,770.

Total assets of the DSF decreased $3,068,485 and total liabilities decreased $183,843 in comparison with the prior fiscal year. The most significant fluctuations in the balance sheet of the DSF is related to the cash in fiscal agent which decreased $3,065,192 due to a transfer of $3,434,000 to the general fund made during the current fiscal year, as permitted by law, to provide additional working capital and additional financial resources to mitigate the general fund's excess of expenditures over revenues of $11,423,085 for the fiscal year ended June 30, 2008.

The consistent reduction in cash in fiscal agent during the last four fiscal years has reduced the Municipality's borrowing capability because the legal margin of the Municipality has continued decreasing from year to year down to $672,840 at June 30, 2008.

Capital improvements bond fund (CIBF)- The CIBF's total assets amounted to $7,334,024 at June 30, 2008, which consist mainly of restricted cash in fiscal agent ($7,303,346) to be used in the acquisition, construction or improvement of major capital assets. The CIBF's total liabilities amounted to $2,273,407 at June 30, 2008, which are mainly composed of accounts payable to suppliers ($2,100,247). At the end of the current fiscal year, CIBF's total and reserved fund balance reached $5,060,617.

Total assets of the CIBF decreased $11,453,167 and total liabilities increased $1,392,855 in comparison with the prior fiscal year. The most significant fluctuations in the balance sheet of the DSF is related to the cash in fiscal agent which decreased $11,431,057 due the current year capital outlays of $12,845,335 for various major capital projects. Accounts payable increased $1,405,965 principally due to the overall increase of $6,461,328 in capital outlays in comparison with the prior year fiscal year.

Other governmental funds (OGF)- The OGF's total assets amounted to $2,947,286 at June 30, 2008, which consist mainly of restricted cash ($2,110,534) and receivables from intergovernmental grants and contributions ($825,999). The OGF's total liabilities amounted to $1,902,540 at June 30, 2008, which are composed of deferred revenues ($334,961), accounts payable and accrued liabilities ($659,603) and amounts due to other funds ($907,976). At the end of the current fiscal year, OGF's total and reserved fund balance reached $1,044,746.

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Condensed Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds
Fiscal Years Ended June 30, 2008 and 2007

	2008	2007
Revenues:		
Total revenues - major governmental funds	$ 46,004,455	$ 47,879,145
Total revenues - other governmental funds	4,229,993	3,304,210
Combined total revenues	50,234,448	51,183,355
Expenditures:		
Total expenditures - major governmental funds	68,884,909	59,037,239
Total expenditures - other governmental funds	3,609,550	3,875,068
Combined total expenditures	72,494,459	62,912,307
Excess of expenditures over revenues	(22,260,011)	(11,728,952)
Other financing sources, net:		
Other financing sources, net - major governmental funds	454,046	262,655
Other financing uses, net - other governmental funds	(454,046)	(262,655)
Combined other financing sources (uses), net	-	-
Deficiency of revenues and other financing sources under expenditures and other financing uses	$ (22,260,011)	$ (11,728,952)
Fund balance, at beginning of fiscal year	31,640,033	43,398,665
Prior-period adjustments	-	(29,680)
Fund balance, at end of fiscal year	$ 9,380,022	$ 31,640,033

Analysis of Operating Results of Governmental Funds

Major Governmental Funds

General fund (GF) – The total fund balance of the GF decreased $6,695,744 (excess of expenditures and other financing uses over revenues and other financing sources) during current fiscal year. Total revenues, expenditures and other financing sources (net) amounted to $38,967,614, $50,390,699 and $4,727,341, respectively, for the fiscal year ended June 30, 2008.

Approximately 91% ($35,643,308) of the GF's total revenues for the current fiscal year came from property taxes, municipal license taxes, construction excise taxes and sales and use taxes, while 5% ($1,762,891) resulted from intergovernmental grants and contributions. Total revenues increased $812,381 (2% increase) in comparison with prior fiscal year.

The GF's most significant fluctuations among the current fiscal year revenues and those of the prior fiscal year were as follows:

- Property taxes revenues decreased by $1,065,134 (6% decrease) because the current year property assessments and collections were lower that in the prior year. During the last four fiscal years, the property tax collections have decreased consistently from year to year due to a significant amount of residential and commercial properties within the territory of Cataño for which the assessed value for tax purposes has not been reviewed in decades. Also there is a significant amount of properties erroneously enjoying tax exemptions when in fact should be fully taxable for property tax purposes. Furthermore, the decrease in property tax revenues is mainly due to the decreased collection efforts made by the Municipal Revenue Collection Center during the last four fiscal years and the lack of effectiveness of the municipal property tax office, for which the Office of the Comptroller of Puerto Rico reported various administrative audit findings in the most recent audit reports.

  In order to mitigate the reduction in property tax revenues, as an initial step, during the last quarter of the current fiscal year, the Municipality commenced a project designed to maximize its property tax revenues by reviewing the assessed values and tax exemptions of taxable properties. This project has been carried over under a cooperative agreement with the Municipal Revenue Collection Center and has been carried out by a consulting firm on behalf of the Municipality.

- Municipal license tax revenues increased $2,052,217 during the current fiscal year because the current year collections were higher that in the prior year mainly to various settlements made with certain taxpayers during the current fiscal year. Although this increase is related to non-recurrent revenue streams, the Municipality consistently has implemented effective audit procedures to identify taxpayers with significant underpayments of municipal license taxes during the last four years.

- Sales and use taxes increased $2,024,094 during the current fiscal year because the sales tax revenue was generated for only seven months of the prior fiscal year since the sales tax system was implemented on November 15, 2006.

- Interest income decreased $626,127 in comparison with the prior fiscal year principally to the decrease of $5,325,643 (40% decrease) in cash and cash equivalents, and the overall decrease in interest rates in the financial markets.

- Intergovernmental grants and contributions decreased by $822,834 mainly due to the aggregate decrease in: (1) the contributions in lieu of taxes from the Puerto Rico Electric Power Authority, (2) the contributions received from the Puerto Rico Department of Treasury as a partial reimbursement of the Christmas bonuses paid by the Municipality to its employees, and (3) other intergovernmental grants and contributions.

Total expenditures increased $3,536,327 (8% increase) in comparison with prior fiscal year. The most significant fluctuation between the current fiscal year expenditures and those of the prior fiscal year occurred in the public housing and welfare, which increased by $1,636,078, urban and economic development, which increased $797,214, and pt blic safety expenditures, which increased $706,698.

During the last four fiscal years, the Municipality's general fund has reported recurring excesses of expenditures over revenues, which have lead to consistent significant reductions in unrestricted cash and cash equivalents that were partially mitigated with annual transfers of financial resources from the debt service fund to the general fund to mitigate budgetary and cash flows shortfalls. Accordingly, during the current fiscal year the Municipality transferred excess cash amounting to $3,434,000 from the debt service fund to the general fund, as permitted by law, to provide additional working capital and additional financial resources to mitigate the general fund's excess of expenditures over revenues of $11,423,085 for the fiscal year ended June 30, 2008.

These conditions have resulted in subsequent significant cash shortfalls and liquidity problems for the general fund during the first half of the fiscal year 2008-2009, which may result in significant difficulties to pay its obligations when due during the second half of fiscal year 2008-2009 and the possible accumulation of unpaid billings from suppliers of goods and services.

Management of the Municipality is currently evaluating different alternatives for the permanent financing of the GF's operations, principally to increase its revenue sources and implementing continuous cost reductions policies. As an initial step, during the last quarter of the current fiscal year, the Municipality commenced a project designed to maximize its property tax revenues by reviewing the assessed values and tax exemptions of taxable properties. This project has been carried over under a cooperative agreement with the Municipal Revenue Collection Center.

The success of management's plans and strategies to improve the GF's cash flow and liquidity and to achieve positive net changes in unrestricted net assets cannot be assured, as it is significantly dependent upon events and circumstances which outcome cannot presently be determined. However, management is committed to undertake whatever actions may be necessary to try to prevent operating and working capital deficiencies in the future.

Debt service fund (DSF) – The total fund balance of the DSF decreased by $2,884,642 during current fiscal year. Total revenues, expenditures and other financing uses (net) amounted to $6,436,740, $5,648,188 and $3,673,194, respectively, for the fiscal year ended June 30, 2008.

Approximately 89% ($5,740,439) of DSF's total revenues for the current fiscal year came from restricted property taxes, which decreased $2,500,834 in comparison with the prior fiscal year because the current year property assessments and collections were lower that in the prior year for the same reasons explained previously. The decrease in property tax revenues in the DSF is 29% in comparison with the prior fiscal year, which is significantly higher than the 6% decrease in property taxes of the general fund. Management understands that the Municipal Revenue Collection Center (CRIM, by its Spanish acronyms) has not credited all property tax collections to the Municipality's debt service fund due to the currently unfinished implementation of the new information system of CRIM, which have delayed the accounting of property tax collections of the Municipality for over three quarters. Management is currently evaluating different alternatives, including the possibility of a lawsuit against CRIM, to resolve this controversy that is affecting the Municipality's borrowing capability significantly.

As discussed above, during the current fiscal year the Municipality transferred excess cash amounting to $3,434,000 from the debt service fund to the general fund, as permitted by law, to provide additional working capital and additional financial resources to mitigate the general fund's excess of expenditures over revenues of $11,423,085 for the fiscal year ended June 30, 2008.

Capital improvements bond fund (CIBF) – The total fund balance of the CIBF decreased by $12,846,022 during current fiscal year specifically due to the investment of $12,845,335 (capital outlays) in works and permanent improvement projects as well as the acquisition of other capital assets during the current fiscal year. The investment in works and permanent improvements projects is mainly composed of capital outlays related to the construction in progress of a new diagnostic and health treatment center, the construction of a stadium and other permanent improvement projects developed. Total revenues, expenditures and other financing uses (net) amounted to $600,101, $12,846,022 and $600,101, respectively, for the fiscal year ended June 30, 2008.

All revenues of the CIBF came from interests on cash balances deposited in fiscal agent for future use in permanent improvement projects. Substantially all expenditures were capital outlays ($12,845,335) for the fiscal year ended June 30, 2008 which were paid from accumulated unspent proceeds of bonds.

Other governmental funds (OGF) – The total fund balance of the OGF increased $166,397 during current fiscal year. Total revenues, expenditures and other financing uses (net) amounted to $4,229,993, $3,609,550 and $454,046, respectively, for the fiscal year ended June 30, 2008. Substantially all revenues of OGF came from intergovernmental grants and contributions ($4,210,994) from the governments of the Commonwealth of Puerto Rico and the United States of America, while the most significant expenditures were related to capital outlays ($2,622,118).

BUDGETARY HIGHLIGHTS OF GENERAL FUND

The original budget of the general fund for the fiscal year ended June 30, 2008 amounted to $43,578,360, which remained unchanged after the budget line reclassifications were approved during the current fiscal year.

The total actual revenues (budgetary basis) of the general fund for the fiscal year ended June 30, 2008 exceeded the total actual expenditures (budgetary basis) by $10,277,814. This excess was partially mitigated by transfers of cash from other governmental funds of $4,712,452, which represent additional budgetary resources. Accordingly, the net budgetary result of the general fund was an excess of expenditures and other financing uses over revenues and other financing sources of $5,565,362 (budgetary basis) for the fiscal year ended June 30, 2008, which is a violation of the Act No. 81, known as the *Autonomous Municipalities Act of the Commonwealth of Puerto Rico*. Accordingly, the Municipality shall amortize such budgetary deficiency during the next fiscal year through a budgetary reserve within the next fiscal year's budget of the general fund, as required by law.

The total actual revenues (budgetary basis) of the general fund for the fiscal year ended June 30, 2008 were $38,891,625, which is ($116,034) less than the budgeted revenues. The most significant fluctuations in actual revenues (budgetary basis) occurred with: (1) sales and use taxes revenues which were $1,151,723 more than their respective budgeted amounts, and (2) intergovernmental grants and contributions, which were $1,110,308 less than the budgeted expenditures.

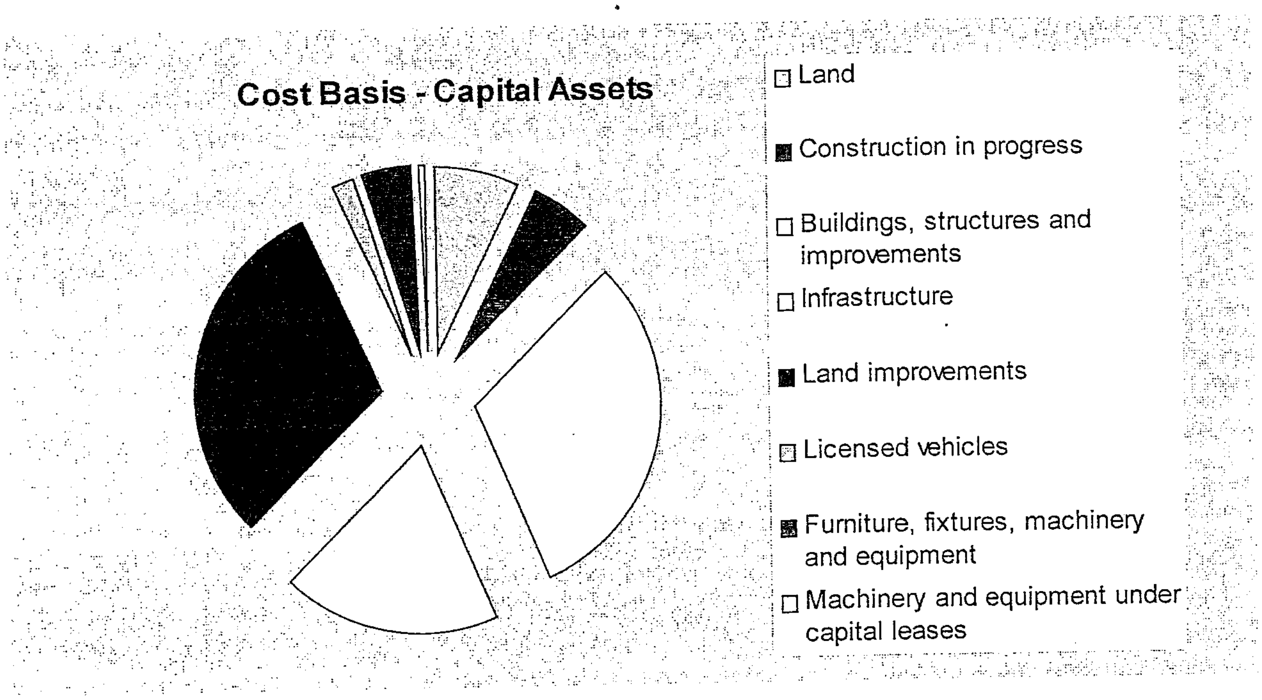
The total actual expenditures (budgetary basis) of the general fund for the fiscal year ended June 30, 2008 were $49,169,439, which is ($5,591,079) more than the budgeted expenditures. The most significant fluctuations in actual disbursements (budgetary basis) occurred with general government expenditures, which were $2,830,881 more than their respective budgeted amounts. Also the health and sanitation expenditures, and the urban and economic development expenditures reported excesses of actual expenditures over their respective budgeted amounts of $2,177,913 and $1,127,219, respectively. Such fluctuations are mainly due to the lack of adequate controls and procedures in place over the preparation and monitoring of the annual budget of the general fund. Also, the fluctuations are related to non-budgetary funds classified as part of the general fund for financial reporting purposes. Such funds were not considered as part of the budgeted expenditures of the Municipality's general fund for the fiscal year ended June 30, 2008.

We encourage readers to consider the budgetary information presented here in conjunction with additional information that is furnished in Note 1 of the Municipality's basic financial statements and the accompanying supplementary information, which follow this narrative.

CAPITAL ASSETS AND DEBT ADMINISTRATION

a) Capital Assets

The Municipality has invested $159,208,278 in capital assets used in governmental activities, which have an accumulated depreciation and amortization of $40,329,869 at June 30, 2008. During the current fiscal year, the Municipality made capital additions ($16,653,590), which were partially offset by the depreciation expense ($5,440,634) for the same period. The following chart presents the composition of capital assets at June 30, 2008:



Approximately 98% percent of the total capital additions made to capital assets during the fiscal year ended June 30, 2008 were related to construction in progress ($16,250,980) related to the new medical diagnostic and treatment center and other important projects. Other capital additions for the fiscal year ended June 30, 2008 were the following:

Machinery, equipment, furniture and fixtures	$ 158,028
Licensed vehicles	173,509
Licensed software	71,073
Other capital additions for the fiscal year ended June 30, 2008	$ 402,610

We encourage readers to consider the capital assets information presented here in conjunction with more detailed capital assets information furnished in the notes to the accompanying financial statements.

b) Debt Administration

The Municipality finances a significant portion of its construction activities through bond and note issuances, and through 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.

At June 30, 2008, the Municipality's total bonded debt amounted to $48,000,000, consisting of bonds payable. Such debt is backed by the full faith and credit of the Municipality. The following is a summary of the most significant transactions of the debt activity for the fiscal year ended June 30, 2008:

- Bonds payable decreased by $2,920,000 due to the related debt service principal payments made during the current fiscal year.
- Notes payable decreased by $135,540 due to the related debt service principal payments made during the current fiscal year.
- Accrued compensated absences increased by $679,322 since the current year payments to employees ($2,336,832) were below the current year accumulation of vacations and sick leave days ($3,016,154).

We encourage readers to consider the information presented here in conjunction with more detailed long-term debt information furnished in the notes to the accompanying financial statements.

ECONOMIC FACTORS

The territory of Cataño covers an area of approximately 4.8 square miles. Cataño is a municipality with a population 32,859 persons, with average ages of approximately 31 years. Cataño is characterized by being one of the economic integration centers of the north metropolitan area of Puerto Rico since it is considered one of the principal source of jobs and services of warehousing and distribution of Puerto Rico.

The people of Cataño have an average family income of $16,968 per year while the per capita income is approximately $8,400 per year. Accordingly, 46.7% of the residents of Cataño live under the poverty limits. The unemployment rate in Cataño is approximately 10.3%.

According to the Puerto Rico Department of Labor and Human Resources, the labor force decreased from 1.42 million in 2007 to 1.41 million in 2008 for Puerto Rico as a whole. In addition, the average unemployment rate increased from 18.7% in 2007 to 21.4% in 2008.

The principal commercial industry in Cataño was the warehousing and distribution industry. However, the public sector provided the majority of jobs during the current fiscal year. Other commercial industries that provided significant amounts of jobs in Cataño were the retailing industries.

Of the total population of the Municipality, 54 percent are considered to live under the poverty level. This rate is higher than the overall rate for Puerto Rico (48 percent). Approximately 40 percent of the population of the Municipality receives public financial assistance as their principal source of income.

The economy of the Municipality is closely linked to the economy of the Commonwealth of Puerto Rico, which ultimately is greatly affected by the condition of the United States of America. Direct investment, exports, transfer payments, interest rates, inflation, and tourist expenditures are exogenous variables that are affected by the economy of the United States of America.

The preliminary reports issued by the Puerto Rico Planning Board (a governmental agency of the Commonwealth of Puerto Rico) about the performance of the economy of the Municipality indicate that the economy decreased 1.8% in terms of total real gross product during the fiscal year ended June 30, 2008.

The Municipality has established policies and programs directed at developing the warehousing, distribution and services industries. Selective tax exemptions and other incentives have stimulated domestic and foreign investment. Infrastructure expansion and modernization have been, to a large extent, financed by bonds issued by the Municipality and certain grants from the U.S. Department of Housing and Urban Development and the Federal Emergency Management Agency. Economic progress has been aided by significant increases in the levels of education and occupational skills of the population of the Municipality.

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

REQUEST FOR INFORMATION

This financial report is designed to provide a general overview of the Municipality's finances for all of the Municipality's citizens, taxpayers, customers, investors and creditors. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Municipality of Cataño, Department of Finance, P.O. Box 428, Cataño, Puerto Rico, 00963.

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COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Statement of Net Assets
June 30, 2008

Assets		Governmental activities
Current assets:		
Cash in commercial banks, including cash equivalents of $7,700,000		$ 7,991,944
Accounts receivable, net of allowance for doubtful accounts of $12,935,115:		
Taxes:		
Property taxes	$ 2,947,134	
Municipal license taxes	80,651	
Construction excise taxes	9,676	
Sales and use taxes	261,216	
Accrued interests on deposits	55,955	
Intergovernmental grants and contributions	318,210	
Other	7,700	
Total accounts receivable		3,680,542
Inventories and other current assets		146,363
Restricted assets:		
Cash and cash equivalents:		
Cash in commercial banks, including cash equivalents of $400,000	$ 2,055,376	
Cash in fiscal agent	15,895,818	
Accounts receivable:		
Intergovernmental grants and contributions	825,999	
Property taxes, net of reserve for doubtful accounts of $3,972,902	906,767	
Total restricted assets		19,683,960
Total current assets		31,502,809
Noncurrent assets:		
Capital assets, at cost:		
Depreciable capital assets	$ 135,028,569	
Nondepreciable capital assets	24,179,709	
Total capital assets, at cost	159,208,278	
Less: accumulated depreciation and amortization	(40,329,869)	
Total capital assets, net of accumulated depreciation and amortization		118,878,409
Deferred charges, net of accumulated amortization of $240,169		207,828
Total noncurrent assets		119,086,237
Total assets		$ 150,589,046

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Statement of Net Assets (concluded)
June 30, 2008

Liabilities and net assets		Governmental activities
Current liabilities (due within one year):		
Accounts payable:		
Excess of checks drawn over bank balance	$ 44,639	
Accounts payable to suppliers	3,538,958	
Intergovernmental payables	515,335	
Accrued liabilities:		
Accrued employees' bonuses	1,210,000	
Accrued interests on notes and obligations under leases	33,472	
Total accounts payable and accrued liabilities		$ 5,342,404
Unearned municipal license tax revenues		10,387,264
Liabilities related to restricted assets:		
Accounts payable to suppliers	2,759,850	
Unearned intergovernmental grants revenue	334,961	
Accrued interests on bonds	1,364,094	
Current portion of bonds payable	2,920,000	
Total current liabilities related to restricted assets:		7,378,905
Current portion of other long-term obligations:		
Notes payable	144,732	
Obligations under capital leases	137,216	
Compensated absences	2,505,708	
Claims and judgments	198,000	
Total current portion of long-term obligations		2,985,656
Total current liabilities		26,094,229
Noncurrent liabilities, excluding current portion (due in more than one year) :		
Noncurrent portion of liabilities related to restricted assets - bonds payable		45,080,000
Notes payable		6,881,456
Obligations under capital leases		126,355
Compensated absences		3,030,624
Total noncurrent liabilities		55,118,435
Total liabilities		81,212,664
Net assets (deficits):		
Invested in capital assets, net of related debt		78,126,012
Restricted for:		
Debt service	$ 4,981,770	
Federal and state funded programs	44,967	
Total restricted net assets		5,026,737
Unrestricted deficit		(13,776,367)
Total net assets		$ 69,376,382

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Statement of Activities
Fiscal Year Ended June 30, 2008

Functions/programs	Expenses, including depreciation expense of $5,440,634	Program revenues: Charges for services	Program revenues: Program – specific operating grants and contributions	Program revenues: Program – specific capital grants and contributions	Net (expenses) and changes in net assets
Governmental activities:					
General government	$19,603,565	494,294	-	-	$ (19,109,271)
Urban and economic development	11,193,533	-	151,841	-	(11,041,692)
Health and sanitation	6,957,172	4,504	-	-	(6,952,668)
Public safety	6,217,369	-	5,987	87,836	(6,123,546)
Public housing and welfare	7,442,553	-	1,770,033	2,192,297	(3,480,223)
Culture, recreation and education	4,209,960	-	3,000	-	(4,206,960)
Interest on long-term obligations	2,823,651	-	587,838	-	(2,235,813)
Total governmental activities	$58,447,803	498,798	2,518,699	2,280,133	(53,150,173)

General revenues:	
Taxes:	
Property taxes	$ 23,350,091
Municipal license taxes	12,742,763
Construction excise taxes	880,773
Sales and use taxes	3,802,068
Total tax revenues	40,775,695
Intergovernmental grants and contributions, not restricted to specific programs	1,313,052
Interest on deposits	1,227,302
Miscellaneous	540,315
Total general revenues	43,856,364
Net decrease in net assets	(9,293,809)
Net assets at the beginning of fiscal year	78,670,191
Net assets at end of fiscal year	$ 69,376,382

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Balance Sheet – Governmental Funds
June 30, 2008

	Major governmental funds				
Assets	**General Fund**	**Debt service fund**	**Capital improvements bond fund**	**Other governmental funds**	**Total governmental Funds**
Cash and cash equivalents in commercial banks	$ 7,991,944	-	-	-	$ 7,991,944
Accounts receivable, net of reserve for doubtful accounts of $12,935,115:					
Taxes:					
Property taxes	2,947,134	-	-	-	2,947,134
Municipal license taxes	80,651	-	-	-	80,651
Construction excise taxes	9,676	-	-	-	9,676
Sales and use taxes	261,216				261,216
Accrued interests on deposits	19,161	5,503	30,678	613	55,955
Intergovernmental grants and contributions	257,686	60,524	-	-	318,210
Due and advances from other funds	1,076,094	-	-	-	1,076,094
Other	7,700	-	-	-	7,700
Inventories and other assets	146,363	-	-	-	146,363
Restricted assets:					
Cash and cash equivalents:					
Cash and cash equivalents in commercial banks	-	-	-	2,055,376	2,055,376
Cash in fiscal agent	239,146	8,298,168	7,303,346	55,158	15,895,818
Accounts receivable:					
Intergovernmental grants and contributions	-	-	-	825,999	825,999
Due from other funds	-	-	-	10,140	10,140
Property taxes, net of allowance for doubtful accounts of $3,972,902	-	906,767	-	-	906,767
Total assets	$ 13,036,771	9,270,962	7,334,024	2,947,286	$ 32,589,043
Liabilities					
Accounts payable and accrued liabilities:					
Excess of checks drawn over bank balance	44,639	-	-	-	44,639
Accounts payable to suppliers	3,538,958	-	-	-	3,538,958
Intergovernmental payables	515,335	-	-	-	515,335
Deferred revenues:					
Unearned municipal license taxes	10,387,264	-	-	-	10,387,264
Unavailable intergovernmental grants	257,686	-	-	-	257,686
Liabilities related to restricted assets:					
Accounts payable to suppliers	-	-	2,100,247	659,603	2,759,850
Due and advances to other funds	-	5,098	173,160	907,976	1,086,234
Unearned intergovernmental grants	-	-	-	334,961	334,961
Matured bonds due and payable	-	2,920,000	-	-	2,920,000
Matured interest due and payable	-	1,364,094	-	-	1,364,094
Total liabilities	14,743,882	4,289,192	2,273,407	1,902,540	23,209,021
Fund balances (deficits)					
Reserved for:					
Encumbrances	292,604	-	-	-	292,604
Debt service	-	4,981,770	-	-	4,981,770
Capital assets and projects	-	-	5,060,617	999,779	6,060,396
Advances from other funds	335,310			-	335,310
Inventories and other assets	146,363	-	-	-	146,363
Federal and state funded programs	-	-	-	44,967	44,967
Unreserved	(2,481,388)	-	-	-	(2,481,388)
Total fund balances (deficits)	(1,707,111)	4,981,770	5,060,617	1,044,746	9,380,022
Total liabilities and fund balances	$ 13,036,771	9,270,962	7,334,024	2,947,286	$ 32,589,043

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Reconciliation of the Balance Sheet – Governmental Funds
to the Statement of Net Assets
June 30, 2008

The amounts of governmental activities reported in the statement of net assets and the balance sheet – governmental funds, are different for the following reasons:

Total fund balances reported in the balance sheet – governmental funds	$ 9,380,022
Add (Deduct):	
Capital assets used in governmental activities are not considered available financial resources at fiscal year-end, therefore, are not reported in the governmental funds. This is the carrying amount of capital assets, net of accumulated depreciation and amortization of $40,329,869 at June 30, 2008.	118,878,409
Certain deferred revenues for unavailable intergovernmental grants in the governmental funds are recognized as revenues in the statement of activities. This is the amount of intergovernmental grant revenues that are measurable but not available at June 30, 2008.	257,686
Debt issued by the Municipality has associated costs (debt issuance costs) that are paid from current available financial resources in the governmental funds. However, these costs are deferred in the statement of net assets and reported net of accumulated amortization of $240,169.	207,828
The following liabilities are not due (mature) in the current fiscal year, therefore, are not reported in the governmental funds at June 30, 2008 pursuant to GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Funds Financial Statements*:	
Bonds payable	(45,080,000)
Notes payable	(7,026,188)
Obligations under capital leases	(263,571)
Compensated absences	(5,536,332)
Claims and judgments	(198,000)
Accrued interests on notes payable	(33,472)
Accrued employees' bonuses	(1,210,000)
Net assets – governmental activities, as reported in the statement of net assets	$ 69,376,382

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Statement of Revenues, Expenditures and
Changes in Fund Balances (Deficits) – Governmental Funds
Fiscal Year Ended June 30, 2008

	Major governmental funds				
	General fund	Debt service fund	Capital improvements bond fund	Other governmental funds	Total governmental funds
Revenues:					
Taxes:					
Property taxes	$ 17,609,652	5,740,439	-	-	$ 23,350,091
Municipal license taxes	13,350,815	-	-	-	13,350,815
Construction excise taxes	880,773	-	-	-	880,773
Sales and use taxes	3,802,068	-	-	-	3,802,068
Total tax revenues	35,643,308	5,740,439	-	-	41,383,747
Intergovernmental grants and contributions	1,762,891	587,838	-	4,210,994	6,561,723
Interests on deposits	504,276	108,463	600,101	14,462	1,227,302
Charges for services	516,857	-	-	4,504	521,361
Miscellaneous	540,282	-	-	33	540,315
Total revenues	38,967,614	6,436,740	600,101	4,229,993	50,234,448
Expenditures:					
Current:					
General government	17,267,809	-	-	-	17,267,809
Urban and economic development	9,500,719	-	687	-	9,501,406
Health and sanitation	6,852,253	-	-	-	6,852,253
Public safety	5,917,935	-	-	5,987	5,923,922
Public housing and welfare	6,297,654	-	-	981,445	7,279,099
Culture, recreation and education	2,985,367	-	-	-	2,985,367
Debt service:					
Principal	285,723	2,920,000	-	-	3,205,723
Interest	97,102	2,728,188	-	-	2,825,290
Capital outlays	1,186,137	-	12,845,335	2,622,118	16,653,590
Total expenditures	50,390,699	5,648,188	12,846,022	3,609,550	72,494,459
Revenues over (under) expenditures	(11,423,085)	788,552	(12,245,921)	620,443	(22,260,011)
Other financing sources (uses):					
Transfers from other governmental funds	4,817,591	-	-	100,061	4,917,652
Transfers to other governmental funds	(90,250)	(3,673,194)	(600,101)	(554,107)	(4,917,652)
Total other financing sources (uses), net	4,727,341	(3,673,194)	(600,101)	(454,046)	-
Net increase (decrease) in fund balances	(6,695,744)	(2,884,642)	(12,846,022)	166,397	(22,260,011)
Fund balances at beginning of fiscal year	4,988,633	7,866,412	17,906,639	878,349	31,640,033
Fund balances (deficits) at end of fiscal year	$ (1,707,111)	4,981,770	5,060,617	1,044,746	$ 9,380,022

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Reconciliation of Statement of Revenues, Expenditures and Changes in Fund Balances (Deficits) - Governmental Funds to the Statement of Activities
Fiscal Year Ended June 30, 2008

The amounts of governmental activities reported in the statement of activities and the statement of revenues, expenditures and changes in fund balances - governmental funds, are different for the following reasons:

Total net decrease in fund balances reported in the statement of revenues, expenditures and changes in fund balances – governmental funds	$ (22,260,011)
Add (Deduct):	
The following revenues recorded in the statement of activities do not necessarily provide current financial resources, therefore, sometimes are deferred in the governmental funds. This is the net change in deferred revenues of the following revenue items, which are measurable but not available at fiscal year end:	
Municipal license taxes	(608,052)
Intergovernmental grants and contributions	(449,839)
Governmental funds report capital outlays as expenditures. However in the statement of activities the cost of those assets is allocated over their estimated useful lives as depreciation and amortization expense. This is the amount by which capital outlay expenditures ($16,653,590) exceeded depreciation expense ($5,440,634) for the fiscal year ended June 30, 2008.	11,212,956
Repayment of principal of long-term obligations is reported as an expenditure in the governmental funds, however, the repayment reduces long-term liabilities in the statement of net assets.	3,205,723
Amortization of deferred charges reported in the statement of activities does not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds.	(24,323)
Some expenses, net, reported in the statement of activities do not require the use of current financial resources, therefore, are not reported as expenditures in the governmental funds, including the net change in accrued compensated absences of $679,322 for the fiscal year ended June 30, 2008.	(370,263)
Net decrease in net assets, as reported in statement of activities	$ (9,293,809)

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

1. Background Information and Summary of Significant Accounting Policies

The Municipality of Cataño (the Municipality) is a local municipal government constituted in 1927 in the Commonwealth of Puerto Rico (the Commonwealth). The Municipality has full legislative, fiscal and all other governmental powers and responsibilities expressly assigned by Public Act No. 81 of August 30, 1991, as amended, known as *Autonomous Municipalities Act of the Commonwealth of Puerto Rico* (Act No. 81). The Municipality is one of seventy-eight municipalities legally separated from the Commonwealth's government.

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

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

a) 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 fiscal year ended June 30, 2008, in conformity with accounting principles generally accepted in the United States of America (GAAP), as prescribed by the Governmental Accounting Standards Board (GASB).

According to the financial reporting model established by GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* (GASB No. 34), the required basic 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).

RSI, consisting of a Management's Discussion and Analysis (MD&A), is information presented along with, but separate from, Municipality's basic financial statements.

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 fiscal year ended June 30, 2008, based on the Municipality's knowledge of the transactions, events and conditions reflected in the basic financial statements. The MD&A also highlights certain key fiscal policies that control the Municipality's operations.

Other supplementary information presented in this report for purposes of additional analysis consist of: (1) combining and individual non-major governmental fund financial statements, (2) budgetary comparison schedule – debt service fund, and (3) schedules of capital assets used in the operations of governmental funds, as listed in the accompanying table of contents.

On July 1, 2005, the Municipality adopted the provisions of Statement No. 44, *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1* (GASB No. 44). This statement amended the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles,* which provides guidance for the preparation of the statistical section of the Municipality's Comprehensive Annual Financial Report (CAFR). Accordingly, the statistical section of this Comprehensive Annual Financial Report has been modified to present more detailed information, typically in ten-year trends, that assists users in utilizing: (1) the basic financial statements, (2) the notes to basic financial statements, and (3) the required supplementary information, to assess the economic condition of a government.

b) *Financial Reporting Entity*

The Municipality follows the provisions of GASB Statement No. 14, *The Financial Reporting Entity* (GASB No. 14) and GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units – an Amendment of GASB Statement No. 14* (GASB No. 39) to determine its financial reporting entity.

The accompanying basic financial statements include all departments, agencies and municipal operational units that are under the legal and administrative control of the Mayor, and whose financial resources are under the legal custody and control of the Municipality's Director of Finance and Budget, as prescribed by Act No. 81.

The Municipality's management has considered all potential component units (whether governmental, not-for-profit, or profit-oriented) for which it may be financially accountable, and other legally separate organizations for which the Municipality is not financially accountable but the nature and significance of their relationship with the Municipality may be such that exclusion of their basic financial statements from those of the Municipality would cause the accompanying basic financial statements to be misleading or incomplete. Accordingly, a legally separate organization would be reported as a component unit of the Municipality if all of the following criteria are met:

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

The Municipality's management has concluded that, based on the aforementioned criteria, there are no legally separate entities or organizations that should be reported as component units of the Municipality for the fiscal year ended June 30, 2008.

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 report information of all governmental activities of the Municipality as a whole. These statements are aimed at presenting a broad overview of the Municipality's finances by reporting its financial position and results of operations using methods that are similar to those used by most private businesses.

The focus of GWFS is on the operational accountability of the Municipality as a single economic unit and not on compliance with budgets, regulatory requirements or on the use of available or currently expendable financial resources (referred to as fiscal accountability). 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 by presenting all of the Municipality's assets and liabilities, with the difference between these two items reported as "net assets" (equity) and or net liabilities. 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 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** – This net asset category consists of capital assets, net of accumulated depreciation and amortization, reduced by the outstanding balances of bonds payable, notes payable and other debts that are attributed to the acquisition, construction or improvement of those assets (capital-related debt). 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 assets has been reduced by any related unspent debt proceeds and any related unamortized debt issuance costs.

  In addition, for the purposes of determining the outstanding debt attributed to capital assets, the following items are excluded from the calculation: (1) interest payable, (2) accrued interest on deep discount debt and non-capital accrued liabilities (e.g. compensated absences, claims and judgments, etc.), and (3) debt used to finance capital acquisitions by parties outside the Municipality. Furthermore, the computation of net assets invested in capital assets, net of related debt, excludes inter-fund loans and other financial assets.

- **Restricted net assets** – This net asset category consists of net resources restricted by external parties (such as debt covenants, 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 consists of 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.

On July 1, 2005, the Municipality adopted the provisions of Statement No. 46, *Net Assets Restricted by Enabling Legislation* (GASB No. 46). This Statement requires that limitations on the use of net assets imposed by enabling legislation be reported as restricted net assets. This Statement clarified that a legally enforceable enabling legislation restriction is one that a party external to the Municipality (such as citizens, public interest groups, or the judiciary) can compel the Municipality to honor. This Statement states that the legal enforceability of an enabling legislation should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if the Municipality has other cause for consideration. Although the determination that a particular restriction is not legally enforceable may cause the Municipality to review the enforceability of other restrictions, it should not necessarily lead the Municipality to the same conclusion for all enabling legislation restrictions.

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.

The Municipality has reported the following types of restricted net assets in the accompanying statement of net assets as of June 30, 2008:

(1) **Debt service** – Represent net resources available to cover future debt service payments of bonds payable.

(2) **Federal and state funded programs** – Represent net resources available from certain federal and state grants, which have been set aside to carry out several programs.

- **Unrestricted net assets** – Generally, this category consists of the excess of assets over related liabilities that are neither externally nor legally restricted, neither invested in capital assets. However, at June 30, 2008, this category has a negative balance of $13,776,367 because liabilities exceeded the related assets. Generally, the assets recorded within this category are designated to indicate that management does not consider them to be available for general operations. Assets reported within this category 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 Municipality's results of operations by showing, how the Municipality's net assets changed during the fiscal year ended June 30, 2008, 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) public housing and welfare. The governmental operations of the Municipality's departments and 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
- Department of planning and budget
- Department of human resources
- Department of legal services
- Department of municipal secretary
- Department of internal audit
- Department of public relations
- Center for governmental operations

Urban and economic development:
- Department of public works
- Department of public terminals and convention center
- Market Square

Public safety:
- Department of emergency management – civil defense
- Department of municipal police
- Department of private police

Health and sanitation:
- Department of recycling services
- Eulalia Kuilan diagnostic and treatment center

Culture, recreation and education:
- Department of sports and recreation
- Juana Matos multi-service center
- Cultural center
- La Esperanza recreational facilities
- Schooling director
- Alberto Dávila library

Public housing and welfare:

Department of public housing
Department of federal programs
Wilson Ramos elderly center
Department of citizen affairs

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: (1) the net cost of the function/program that must be financed from the Municipality's general revenues or (2) the net program revenue that contributes to the Municipality's general revenues. The accompanying statement of activities reports the following categories of program revenues for the fiscal year ended June 30, 2008:

- **Charges for services** – These revenues 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 revenues include fees charged for specific services, charges for licenses and permits, and fines and forfeitures, among others.

- **Program-specific operating and capital grants and contributions** – These revenues consist of transactions that are either mandatory or voluntary non-exchange transactions with other governments, organizations, or individuals that restrict the resources for use in a particular 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. Capital grants and contributions consist of revenues or resources that are restricted for capital purposes – to purchase, construct or renovate capital assets associated with a specific program. Restricted operating and capital 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, sales and use taxes and construction excise taxes are reported as general revenues. All other non-tax revenues (including unrestricted interest on deposits, 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 costs of other functions/programs of the

Municipality. Even though some of these costs have been charged to certain funds in the GFFS as indirect cost allocations permitted under some federal programs, the Municipality has reported these indirect costs as direct expenses of the general government function. Accordingly, the Municipality generally does not allocate general government (indirect) costs to other functions.

The effects of all inter-fund 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 non-exchange revenues that can be used to support the Municipality's programs or services. These governmental activities are also generally reported in the GFFS.

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 financed and operated in a manner similar to private business enterprises, where the costs of providing goods or services to the general public (expenses, including depreciation) is financed primarily through user charges; or where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

d) Governmental Fund Financial Statements

A fund is a fiscal and accounting entity consisting of a self-balancing set of accounts used to record assets, liabilities and residual equities, deficits or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with GAAP and/or special regulations, restrictions or limitations.

The accompanying GFFS are composed of: (1) the balance sheet – governmental funds, (2) the statement of revenues, expenditures and changes in fund balances (deficits) – governmental funds and (3) the statement of revenues and expenditures – budget and actual – budgetary basis – general fund.

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 governmental 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 fiscal year have complied with public decisions concerning the raising and spending of public moneys in the short term (generally one fiscal year).

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 fund and a major governmental 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.

- *Debt service fund* – The debt service fund is a major governmental 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 payable for which debt service payments are legally mandated to be accounted for in a debt service fund and/or (2) bonds payable or any 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. Consistently with the prior fiscal years' financial statement presentation, during the fiscal year ended June 30, 2008, the financial activity accounted for in the debt service fund was specifically related to bonds payable.

  The outstanding balance of general long-term debts for which debt service payments do not involve the advance accumulation of resources (such as obligations under capital leases) are only accounted for in the accompanying statement of net assets. The debt service payments of such debts are generally accounted for as debt service – principal and debt service – interest expenditures in the general fund.

  Special revenue funds - The special revenue funds are non-major governmental funds, as defined below, used by the Municipality to account for revenues derived from grants, contributions or other revenue sources that are either self-restricted by the Municipality or legally restricted by outside parties for use in specific purposes (except for revenues that are earmarked for expenditures in major capital projects which are accounted for in the capital projects fund). The uses and limitations of each special revenue fund are specified by municipal ordinances or federal and state statutes. However, resources restricted to expenditures 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.

- *Capital projects funds* – Capital projects funds are non-major governmental funds, as defined below, used to account for the financial resources used for the acquisition, construction or improvement of major capital facilities and other assets. Significant capital outlays financed from proceeds of general obligation, public improvement or special obligation bonds accounted for also in the capital projects funds.

  The use of the capital projects funds has been reserved only for major capital acquisitions, construction or improvement 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 furniture, office equipment, vehicles and other minor capital assets or improvements) have been reported in the governmental fund from which financial resources were used for the payment.

The focus of the GFFS is on major governmental funds, which generally represent the Municipality's most important funds. Accordingly, the Municipality is required to segregate governmental funds between major and non-major categories within the GFFS. Major individual governmental funds are reported individually as separate columns in the GFFS, while data from all non-major governmental funds are aggregated into a single column, regardless of fund type.

By definition, the Municipality's general fund is considered a major governmental fund for financial reporting purposes. In addition, any other governmental fund would be classified as a major governmental fund in the GFFS 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 non-operating revenues (net of allowances for uncollectible accounts), except for other financing sources. Total expenditures for these purposes mean all expenditures, including operating and non-operating expenditures, except for other financing uses.

Based on the aforementioned criteria, the Municipality's major governmental funds reported in the accompanying GFFS are: (1) the general fund, (2) the debt service fund, and (3) the capital improvements bond fund.

The capital improvements bond fund is a major capital projects fund used to account for the financial resources arising from bond issuance proceeds used in the acquisition or construction of major capital facilities, other assets and permanent improvements. The most significant transactions of this fund are related to capital outlays and proceeds from issuance of bonds.

The Municipality periodically undertakes a comprehensive evaluation of its fund structure to ensure that complies with all aspects that are of importance to users of general purpose external financial reports. Consequently, all superfluous funds and some internal funds currently used by Municipality in the day-to-day accounting procedures have not been reported as individual governmental funds in the accompanying fund financial statements. Accordingly, the accompanying fund financial statements include only the minimum number of funds consistent with legal and operating requirements and, consequently, the following types of similar internal funds have been combined into single funds in the accompanying fund financial statements:

- The various capital improvement bond issues outstanding have been reported as a single major capital projects fund, the capital improvements bond fund.

- Numerous less significant capital project and special revenue funds have been combined into single nonmajor capital project and special revenue funds, respectively. These funds are reported as supplementary information in the accompanying combining and individual non-major governmental fund financial statements.

- Program-specific capital grants awarded by the Legislature of the Commonwealth of Puerto Rico have been combined into a single nonmajor capital projects fund, the legislative joint resolutions fund.

The accompanying GFFS are accompanied by the following schedules required by GAAP: (1) the reconciliation of the balance sheet – governmental funds to the statement of net assets, and (2) the reconciliation of the statement of revenues, expenditures and changes in fund balances (deficits) – governmental funds to the statement of activities.

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 on deposits and investments) 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 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 non-exchange transactions are recorded using the criteria set forth by GASB Statement No. 33, *Accounting and Financial Reporting for Non-exchange Transactions* (GASB No. 33). GASB No. 33 established accounting and reporting standards for non-exchange transactions involving cash and financial or capital resources (for example, most taxes, grants and private donations). In a non-exchange 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 non-exchange transactions into the following four classes in the accompanying basic financial statements: (a) derived tax revenues, (b) imposed non-exchange revenues, (c) government mandated non-exchange transactions, and (d) voluntary non-exchange transactions.

In the case of derived tax revenue transactions, which result from assessments the Municipality places on exchange transactions, receivables and revenues are recorded when the underlying exchange has occurred.

In the case of imposed non-exchange revenue transactions (such as property taxes and municipal license taxes), which result from assessments made by the Municipality on non-governmental 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 and municipal license are generally recorded as revenues (net of amounts considered not collectible) in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted.

Government-mandated non-exchange transactions (such as grants and contributions) result when a government at one level (such as the federal or state government) provides resources to the Municipality and the provider government requires the Municipality to use those resources for a specific purpose or purposes established in the provider's enabling legislation. In these type of transactions, receivables and revenues are generally recorded when all eligibility requirements imposed by the provider have been met. For the majority of grants, 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.

Voluntary non-exchange transactions (such as donations and certain grants and entitlements) result from legislative or contractual agreements, other than exchanges, willingly entered into by two or more parties. In these types of transactions, receivables and revenues are generally accounted for in the same manner as government-mandated non-exchange transactions discussed above. Events that are neither exchange nor non-exchange transactions are recorded when it is probable that a loss has been incurred and the amount of loss is reasonably estimable.

Receipts of any type of revenue sources collected in advance for use in the following fiscal year are recorded as unearned (deferred) revenues.

According to GASB No. 34, all general capital assets and the unmatured long-term liabilities are recorded only in the accompanying statement of net assets. 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, as detailed in the accompanying table of contents, 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 (flow of current financial resources) and the modified accrual basis of accounting. Accordingly, the accompanying statement of revenues, expenditures and changes in fund balances – governmental funds, reports changes in the amount of financial resources available in the near future as a result of transactions and events of the fiscal year reported. Therefore, revenues are generally recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current fiscal year or soon enough thereafter to pay liabilities of the current fiscal year. For this purpose, the Municipality generally considers most revenues (municipal licenses taxes, construction excise taxes, sales and use taxes, interests on deposit, intergovernmental grants and contributions and certain charges for services) to be available if collected within 90 days after June 30, 2008, 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, 2008.

The principal revenue sources considered susceptible to accrual include property taxes, municipal license taxes, intergovernmental grants and contributions, interest on deposits, and certain charges for services. 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 non-exchange transactions are recorded in a similar manner to the GWFS, using the previously discussed criteria set forth by GASB No. 33 for non-exchange transactions, but subject to and limited by the availability criteria discussed above. Accordingly, property tax and municipal license tax receivables are also generally recorded in the fiscal year when an enforceable legal claim has arisen while property tax and municipal license tax revenues (net of amounts considered not collectible) are also generally recorded in the fiscal year when resources are required to be used or the first fiscal year that the use of the resources is permitted. Receivables and revenues from federal and state grants and contributions, donations and entitlements are also generally recorded when all eligibility requirements imposed by the provider have been met (generally, as qualifying reimbursable expenditures are incurred for expenditure-driven grants).

Interests on deposits are recorded when earned since these revenues are considered both measurable and available at June 30, 2008.

Pursuant to the provisions of GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements* (GASBI No. 6), in the absence of an explicit requirement (i.e., the absence of an applicable modification, discussed below) the Municipality generally accrues a governmental fund liability and expenditure (including salaries, professional services, supplies, utilities, etc.) in the period in which the government incurs the liability, to the extent that these liabilities are normally expected to be liquidated in a timely manner and in full with current available financial resources. GASBI No. 6 modified the recognition criteria for certain expenditures and liabilities reported under the modified accrual basis of accounting prior to GASB No. 34, and clarified a number of situations in which the Municipality should distinguish between governmental fund liabilities and general long-term liabilities. Therefore, the accompanying balance sheet – governmental funds generally reflects only assets that will be converted into cash to satisfy current liabilities. Long-term assets and those assets that will not be converted into cash to satisfy current liabilities are generally not accounted for in the accompanying balance sheet – governmental funds. At the same time, long-term liabilities (generally, those unmatured that will not require the use of current financial resources to pay them) are not accounted for in the accompanying balance sheet – governmental funds.

Modifications to the accrual basis of accounting in accordance with GASBI No. 6 include:

- Principal and interest on bonds payable are recorded when they mature (when payment is due), except for principal and interest of bonds due on July 1, 2008, which are recorded as governmental fund liabilities at June 30, 2008 which is the date when resources were available in the debt service fund.

- Notes payable, obligations under capital leases, compensated absences, and legal claims and judgments are recorded only when they mature (when payment is due).

- Certain accounts payable, intergovernmental payables and other accrued liabilities not due and payable (unmatured) or not normally expected to be liquidated in full and in a timely manner with available and expendable financial resources, are recorded in the accompanying statement of net assets. Such liabilities are recorded in the governmental funds when they mature.

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

The measurement focus of the GFFS is on decreases of 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.

f) Stewardship, Compliance and Accountability

Budgetary Control

According to Act No. 81, 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. 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 budgets are prepared.

The Mayor must submit, for the fiscal year commencing on the next July 1, an annual budgetary resolution project (the Project) to the Commissioner of Municipal Affairs of the Commonwealth (the Commissioner) and the Municipal Legislature no later than May 10 and May 15, respectively. The Commissioner preliminary verifies that the Project complies with all the applicable laws and regulations and may provide comments and suggestions to the Mayor on or before June 13.

The Municipal Legislature has 10 business days, up to the immediately preceding 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 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 doing 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 fiscal 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 purposes, 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, capital outlays, principal expenditures, interest expenditures, etc.) within the general and debt service funds, respectively.

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 using the budgetary (statutory) basis of accounting, which is not in accordance with GAAP.

According to the budgetary basis of accounting, revenue is generally recorded 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 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 fiscal 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 fiscal year-end. Other appropriations, mainly capital projects appropriations, are continuing accounts for which the Municipal Legislature has authorized that n unspent balance from the prior year be carried forward and made available for current spending.

The accompanying statement of revenues and expenditures – budget and actual – budgetary basis – general fund, provides information about the general fund's original budget, its amendments, and the actual results of operations of such governmental fund under the budgetary basis of accounting for the fiscal year ended June 30, 2008. 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, 2008, which is prepared by the Municipality's Department of Finance. Copies of that report may be obtained by writing to the Municipality's Director of Finance at P.O. Box 428, Cataño, Puerto Rico 00963.

Because accounting principles applied for the purposes of the developing data on a budgetary basis differ significantly from those used to present the governmental fund financial statements in conformity with GAAP, a reconciliation of the differences between the general fund's budgetary basis and GAAP actual amounts is presented as follows:

Excess of expenditures and other financing uses over revenues and other financing sources – budgetary basis – general fund	$ (5,565,362)
Timing differences:	
Net effect of current year encumbrances recorded as expenditures for budgetary purposes versus prior year encumbrances recorded as current year expenditures for GAAP purposes	(318,323)
Non-budget expenditures	(330,189)
Basis of accounting differences:	
Net decrease in property taxes receivable, net of allowance for doubtful accounts	(117,258)
Net decrease in municipal license taxes receivable	(549,692)
Net decrease in construction excise taxes receivable	(203,876)
Net increase in sales and use taxes receivable	345
Net decrease in intergovernmental receivables	(449,839)
Net decrease in other receivables, net of allowance for doubtful accounts	(14,863)
Net decrease in inventories and other current assets	(47,385)
Net increase in due and advances from other funds	14,889
Net decrease in excess of checks drawn over bank balance	946,802
Net decrease in deferred revenues	1,431,204
Net increase in accounts payable to suppliers	(1,472,069)
Net increase in intergovernmental payables and accrued liabilities	(20,128)
Excess of expenditures and other financing uses over revenues and other financing sources –general fund– GAAP basis	$ (6,695,744)

During the fiscal year ended June 30, 2008, the general fund's actual expenditures and other financing uses exceeded the respective actual revenues and other financing uses (budgetary basis) by $6,695,744 in violation of the Act No. 81. Accordingly, the Municipality shall amortize such budgetary deficiency during the next fiscal year through a budgetary reserve within the next fiscal year's budget of the general fund, as required by law.

g) *Unrestricted and Restricted Deposits*

The Municipality's deposits at June 30, 2008 are composed of: (1) demand deposits in commercial banks and (2) demand deposits in the Government Development Bank for Puerto Rico (GDB, fiscal agent. Proceeds from all bonds and the funds related to certain federal grant awards are required by law to be held with GDB.

The Municipality follows the practice of pooling cash. At June 30, 2008, the pool cash account in commercial banks had a balance of $322,363 of which $288,398 and $78,604 have been recorded in the non-major capital project funds and the non-major special revenue funds, respectively. In addition, the general fund reported an excess of checks over bank balance of $44,639, which represents the portion of the pool cash balance allocated to the general fund at June 30, 2008. Any deficiency in the pooled cash account is assumed by the general fund and covered through future budgetary appropriations.

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 Commonwealth's Secretary of the Treasury, but not in the Municipality's name.

Cash in fiscal agent in the debt service fund consists principally of property tax collections amounting to $8,298,168 that are restricted for the payment of the Municipality's debt service of bonds, as required by law. Cash in fiscal agent of $239,146 in the general fund consists of program-specific contributions awarded by the Puerto Rico Electric Power Authority that are restricted for the acquisition, construction and improvement of certain minor infrastructure assets. Cash with fiscal agent recorded in the capital improvements bond fund consists of unspent proceeds of bonds amounting to $7,303,346 that are restricted for the acquisition, construction or improvements of major capital assets. Cash in fiscal agent of $55,158 in the non-major capital project funds consists of unspent resources restricted for the acquisition, construction or improvements of major capital assets.

Restricted cash in commercial banks for other governmental funds, amounting to $2,055,376, represents the balance of interest and non-interest bearing accounts restricted for the operations of various federal and state funded programs.

Cash equivalents consist of certificates of deposits held in commercial banks with original maturities of three months or less. The certificates of deposit recorded in the general fund amounting to $7,700,000 are unrestricted while the certificates of deposit of $400,000 recorded in the legislative joint resolutions fund (nonmajor capital projects fund) are restricted for specific purposes approved by the Legislature of the Commonwealth. Certificates of deposits are recorded at cost, which approximate fair value.

h) *Unrestricted and Restricted Accounts Receivable*

Receivables consist of all revenues earned but not collected at June 30, 2008. 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 governmental 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 inter-fund loans) or "advances to/from other funds" (i.e. the non-current portion of inter-fund loans), as applicable. All other outstanding balances between funds are reported as "due to/from other funds".

On July 1, 2007, the Municipality adopted the provisions of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* (GASB No. 48). Accordingly, transactions in which the Municipality is willing to exchange an interest in its expected future cash flows from collecting specific receivables or specific future revenues for immediate cash payments, generally, a single lump sum are either regarded as a sale or as a collateralized borrowing resulting in a liability depending on its continuing involvement with those receivables or future revenues. Accordingly, a transaction will be reported as a collateralized borrowing unless the criteria indicating that a sale has taken place are met. If it is determined that a transaction involving receivables should be reported as a sale, the difference between the carrying value of the receivables and the proceeds should is recognized in the period of the sale in the accompanying statement of activities and statement of revenues, expenditures and changes in fund balances – governmental funds.. If it is determined that a transaction involving future revenues should be reported as a sale, the revenue is deferred and amortized, except when specific criteria are met.

GASB No. 48 also provides guidance to be used for recognizing other assets and liabilities arising from a sale of specific receivables or future revenues, including residual interests and recourse provisions. According to the criteria set forth by GASB. No. 48, there were no transactions involving receivables that should be reported as a sale as of and for the fiscal year ended June 30, 2008, therefore, the adoption of GASB No. 48 had no effect in the accompanying basic financial statements.

i) Inventories and Other Current Assets

Inventories consist of construction materials and inventories of office supplies, food and medicines, which are held for consumption. Other current assets consist of prepaid costs. Generally, inventories are capitalized and stated at amortized cost using the first-in, first-out method (FIFO). Inventories and prepaid expenses in the GWFS and GFFS are generally recorded as assets (consumption method) when purchased (paid) rather than charged to expenditure.

j) Deferred Charges

Deferred charges in the accompanying statement of net assets consist of bond issuance costs, net of accumulated amortization. Deferred charges are amortized over the term of the related debt using the straight-line method. In the GFFS, bond issuance costs are recorded in the current period as expenditures, whether or not withheld from the actual debt proceeds received. Amortization expense of deferred charges allocated among all functions/activities in the statement of activities amounted to $24,323 for the fiscal year ended June 30, 2008.

k) *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.

For financial reporting purposes, the Municipality defines capital assets as assets with an individual cost of $500 or more at the date of acquisition, construction or improvement, 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 government-wide statement of activities. In the governmental funds, all capital assets are recorded as capital outlays (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 constructed or acquired prior to June 30, 2002 and certain lands, buildings, structures and building improvements. The method used to deflate the current costs with an approximate price index was used only in the case of certain items for which the historical cost documentation was not available. Actual historical costs were used to value the infrastructure acquired or constructed after June 30, 2002 as well as, construction in progress, machinery and equipment and licensed vehicles acquired prior or after such date.

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.

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:

	Years
Land improvements	20
Buildings, structures and building improvements	30 to 50
Infrastructure	20 to 50
Motor vehicles	8
Furniture and fixtures	5 to 20
Machinery and equipment, excluding those held under capital leases	5 to 20
Machinery and equipment under capital leases	3 to 5

Depreciation and amortization expense of capital assets is recorded as a direct expense 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.

Impaired capital assets that will no longer be used by the Municipality, if any, are reported at the lower of carrying value or fair value. Impairment losses on capital assets with physical damages that will continue to be used by the Municipality are measured using the restoration cost approach. Impairments of capital assets that are subject to a change in the manner or duration of use, or assets affected by enactment or approval of laws or regulations or other changes in environmental factors or assets that are subject to technological changes or obsolescence, if any, are measured using the service units approach.

l) Deferred Revenues

In the GFFS, deferred revenue arises when one of the following situations occur:

- Potential revenue does not meet both the "measurable" and "available" criteria for revenue recognition in the current period (unavailable revenue). As previously discussed, available is defined as due (or past due) at June 30, 2008 and collected within 90 days (60 days for property taxes) thereafter to pay obligations due at June 30. In subsequent periods, when both criteria are met, the liability for deferred revenue is removed and revenue is recognized.
- The Municipality receives resources before it has a legal claim to them (unearned revenue). 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.

m) 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, 2008 and (2) is not contingent on a specific event that is outside the control of the Municipality and the employee (such as illness). Compensated absences that relate to future services or are contingent on a specific event outside the control of the employer or the employee are accounted for in the period when those services are rendered or those events take place.

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 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 before reaching 10 years of services, such regular sick leave is not paid to the employee, if not consumed. In addition upon termination of employment, an employee does not receive compensation for compensatory time, if not consumed previously. 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 when matured (when payment is due), for example, as a result of employee resignations or retirements.

n) Long-term Debt

The long-term liabilities reported in the accompanying statements of net assets include the Municipality's bonds payable, notes payable, obligations under capital leases, accrued compensated absences, and accrued 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 on July 1, 2008 are recorded as governmental fund liabilities in the GFFS (debt service fund) when resources are available in the debt service fund (June 30, 2008). In the GFFS, the face amount of debt issued (gross debt reported) is reported as other financing sources when issued.

In the GWFS debt issuance costs are reported as deferred charges, which are amortized under the straight-line method over the life of the debt, while in the GFFS such costs are recognized as expenditures during the current period.

Non-interest bearing notes payable are accounted for under the provisions of Opinion No. 21, *Interest on Receivables and Payables*, issued by the Accounting Principles Board (APB No. 21). 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. The discount is amortized over the life of the notes using the effective interest method. Amortization of the notes discount is recorded as part of interest expense in the statement of activities. In the GFFS, notes discount is recognized as other financing uses during the current period.

o) Leases

The Municipality classifies its lease agreements either as operating or capital leases according to Statement No.13, *Accounting for Leases*, issued by FASB (FASB No. 13). Capital lease agreements are generally non-cancelable and involve, substance over form, the transfer of substantially all benefits and risks inherent in the ownership of the leased property, while operating leases do not involve such transfer. Accordingly, a capital lease involves the recording of an asset and a related lease obligation at the inception of the lease. According to FASB No. 13, the Municipality classifies a lease agreement as a capital lease if at its inception the lease meets one or more of the following four criteria:

- By the end of the lease term, ownership of the leased property is transferred to the Municipality.
- The lease agreement contains a bargain purchase option.
- The lease term is substantially equal (75 percent or more) to the estimated useful life of the leased property.
- At the inception of the lease, the present value of the minimum lease payments, with certain adjustments, is 90 percent or more of the estimated fair value of the leased property.

Although the Municipality is prevented legally from entering into obligations extending beyond one fiscal year, most capital lease agreements entered by the Municipality contain fiscal funding clauses or cancellation clauses that make the continuation of the agreements subject to future appropriations. Leases that meet at least one of the aforementioned four criteria and have a fiscal funding or a cancellation clause have been recorded as capital leases in the accompanying GWFS, since the likelihood of invoking the provision is considered remote. The Municipality's lease agreements do not include contingent rental payments nor escalation clauses.
In the GWFS, the obligation under capital leases is recorded at the lesser of the estimated fair value of the leased property or the present value of the minimum lease payments, excluding any portion representing executory costs and profit thereon to be paid by the lessor. A portion of each minimum lease payment is allocated to interest expense and the balance is applied to reduce the lease obligation using the effective interest method.

In the GFFS, the net present value of the minimum lease payments at the inception of the capital lease is recorded simultaneously as: (1) expenditures and (2) other financing sources. Minimum lease payments are recorded as expenditures in the GFFS.

p) *Accounting for Pension Costs and Post-Employment Benefits*

On July 1, 2007, the Municipality adopted the provisions of GASB Statement No. 50, *Pension Disclosures* (GASB No. 50), which amended GASB No. 27 by requiring disclosure of how the contractually required contribution rate is determined by governments participating in multi-employer cost-sharing pension plans.

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.

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 state government of the Commonwealth of Puerto Rico is considered to be the sponsor of the Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities (ERS) and System 2000, a multi-employer cost-sharing defined benefit pension plan and a hybrid defined contribution plan, respectively, in which the employees of the Municipality participate. The Municipality is considered a participant, and not a sponsor, of these retirement systems since the majority of the participants in the aforementioned pension trust funds are employees of the Commonwealth of Puerto Rico and the basic financial statements of such retirement systems are part of the financial reporting entity of the Commonwealth of Puerto Rico.

q) *Risk Management*

The Municipality carries commercial insurance covering casualty, theft, tort claims and other losses. Insurance policies are negotiated by the Commonwealth's Department of Treasury (the Department of Treasury) on behalf of all municipalities of Puerto Rico. The Department of Treasury 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 the Municipal Revenue Collection Center ("CRIM", by its Spanish acronyms), a governmental entity responsible for billing and collecting property taxes on behalf of all municipalities of Puerto Rico.

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), a component unit of the Commonwealth. This insurance is compulsory for all licensed vehicles used on public roads and 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 (SIFC), 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 cost reimbursement basis.

The Municipality also obtains medical insurance coverage from several health insurance companies for its employees. Different health insurance coverage and premium options are negotiated each year by the Department of Treasury on behalf of the Municipality. The current insurance policies have not been canceled or terminated at June 30, 2008. Premiums are paid on a monthly basis directly to the insurance company. In the past three years, the Municipality has not settled claims that exceeded insurance coverage.

r) *Reservations of Fund Balances*

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

- ***Encumbrances*** – Represent reservations of fund balances for commitments related to unperformed (executory) contracts for goods or services (future expenditures under purchase orders, contracts and other commitments). These committed amounts represent reservations of unexpired appropriations and generally will become liabilities in future fiscal years as the goods or services are received.

- ***Debt service*** – Represent fund balances available to cover future debt service payments (principal and interest) on bonds payable, which are accounted for in the debt service fund.

- ***Capital assets and projects*** – Represent the reservation of financial resources to be used for the acquisition, construction or improvement of capital assets under contracts and other commitments.

- ***Advances from other funds*** – Represent the reservation of financial resources set aside for long-term inter-fund receivables, which are not considered current available financial resources at June 30, 2008.

- ***Inventories and other assets*** – Represent the reservation of financial resources set aside for inventories and prepaid costs, which are not considered current available financial resources at June 30, 2007.

- ***Federal and state funded programs*** – Represent financial resources set aside for use in federal and state grant programs.

s) *Inter-fund Activities*

The Municipality has the following types of reciprocal and non-reciprocal inter-fund activities recorded among governmental funds in the accompanying GFFS:

- ***Inter-fund loans*** – Represent amounts provided with a requirement for repayment, which are recorded as "due from" in the lender governmental fund and "due to" in the borrower governmental fund. Inter-fund receivables, which are not considered to be currently available financial resources, are reported as advances. For amounts not expected to be collected within a reasonable period of time, inter-fund receivables/payables are reduced to the estimated realizable value and the amount that is not expected to be repaid is reported as an operating transfer from the governmental fund that made the loan.

- ***Inter-fund transfers*** – Represent flows of assets (permanent reallocation of financial resources among governmental funds) without equivalent flows of assets in return and without a requirement for repayment. Operating transfers are reported as other financing sources in the governmental fund making transfers and as other financing sources in the governmental fund receiving transfers.

- *Inter-fund reimbursements* – Represent repayments from the governmental fund responsible for particular expenditures or expenses to the governmental fund that initially paid for them.

In the GFFS, inter-fund activity has not been eliminated, as permitted by GAAP.

t) 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, 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.

u) Future Adoption of Accounting Pronouncements

In December 2006, GASB issued its Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* (GASB No. 49). This Statement identifies the circumstances under which a governmental entity would be required to report a liability related to pollution remediation. According to the standard, a government would have to estimate its expected outlays for pollution remediation if it knows a site is polluted and any of the following recognition triggers occur:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem.

- A government has violated a pollution prevention-related permit or license.

- A regulator has identified (or evidence indicates it will identify) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the clean up.

- A government is named (or evidence indicates that it will be named) in a lawsuit to compel it to address the pollution.

- A government begins or legally obligates itself to begin cleanup or post-cleanup activities (limited to amounts the government is legally required to complete).

Liabilities and expenses would be estimated using an "expected cash flows" measurement technique, which is used by environmental professionals but will be employed for the first time by governments. GASB No. 49 also will require governments to disclose information about their pollution obligations associated with clean up efforts in the notes to the financial statements.

The requirements of GASB No. 49 are effective for the Municipality's fiscal year commencing on July 1, 2008.

In June 2007, GASB issued its Statement No. 51, *Accounting and Financial Reporting for Intangible Assets* (GASB No. 51). This Statement requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. Accordingly, existing authoritative guidance related to the accounting and financial reporting for capital assets should be applied to these intangible assets, as applicable. This Statement also provides authoritative guidance that specifically addresses the nature of these intangible assets. Such guidance should be applied in addition to the existing authoritative guidance for capital assets. The guidance specific to intangible assets referred to above includes guidance on recognition. This Statement requires that an intangible asset be recognized in the statement of net assets only if it is considered identifiable. Additionally, this Statement establishes a specified-conditions approach to recognizing intangible assets that are internally generated. Effectively, outlays associated with the development of such assets should not begin to be capitalized until certain criteria are met. Outlays incurred prior to meeting these criteria should be expensed as incurred. This Statement also provides guidance on recognizing internally generated computer software as an intangible asset. This guidance serves as an application of the specified-conditions approach described above to the development cycle of computer software. This Statement also establishes guidance specific to intangible assets related to amortization. This Statement provides guidance on determining the useful life of intangible assets when the length of their life is limited by contractual or legal provisions. If there are no factors that limit the useful life of an intangible asset, the Statement provides that the intangible asset be considered to have an indefinite useful life. Intangible assets with indefinite useful lives should not be amortized unless their useful life is subsequently determined to no longer be indefinite due to a change in circumstances.

The requirements of GASB No. 51 are effective for the Municipality's fiscal year commencing on July 1, 2009.

In November 2007, GASB issued its Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments (GASB No. 52)*. This Statement establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value.

GASB No. 52 more appropriately reports the resources available in endowments and more closely aligns financial reporting with the objectives of endowments. It results in property held for similar purposes by comparable entities being reported in the same manner. Reporting land and other real estate held as investments at fair value enhances users' ability to meaningfully evaluate an entity's investment decisions and performance.

The requirements of GASB No. 52 are effective for the Municipality's fiscal year commencing on July 1, 2008.

In June 2008, GASB issued its Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. This Statement requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting. The guidance in this Statement also addresses hedge accounting requirements. GASB No. 53 provides specific criteria that governments will use to determine whether a derivative instrument results in an effective hedge. Changes in fair value for effective hedges that are achieved with derivative instruments will be recognized in the reporting period to which they relate.

The requirements of GASB No. 52 are effective for the Municipality's fiscal year commencing on July 1, 2008.

The Municipality's management has concluded that the future adoption of GASB Statements No. 49, 51, 52 and 53 will not have a significant impact on the Municipality's basic financial statements.

2. Deposits

The Municipality follows the provisions GASB Statement No. 40 (GASB No. 40), *Deposit and Investment Risk Disclosure, an Amendment to GASB Statement No. 3*. Accordingly, the following is essential information about credit risk, interest rate risk, custodial credit risk, and foreign exchange exposure of deposits and investments of the Municipality at June 30, 2008:

- **Credit risk** – This is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. In compliance with the laws and regulations of the Commonwealth of Puerto Rico, the Municipality has adopted, as its custodial credit risk policy, the *Statement of Uniform Investment Guidelines for the Municipalities of the Commonwealth of Puerto Rico, issued by the Government Development Bank for Puerto Rico* as promulgated by Law No. 113 of August 3, 1995. Accordingly, the Municipality is only allowed to invest in obligations of the Commonwealth of Puerto Rico, obligations of the United States of America, certificates of deposit, commercial paper, bankers' acceptances or in pools of obligations of the Municipalities of Puerto Rico, which are managed by GDB. According to the aforementioned investment guidelines, the Municipality is not allowed to invest in marketable securities or any other type of investments (debt securities) for which credit risk exposure may be significant. Consequently, at June 30, 2008 and for the fiscal year then ended, the Municipality invested only in certificates of deposit in commercial banks, which are insured by the Federal Deposit Insurance Corporation (FDIC), generally up to a maximum of $250,000 per depositor through 2009 ($100,000 thereafter). No investments in debt of equity securities were made during the fiscal year ended June 30, 2008. Therefore, the Municipality's management has concluded that the credit risk related to any possible loss related to defaults by commercial banks on the Municipality's deposits is considered low at June 30, 2008.

- **Interest rate risk** – This is the risk that changes in interest rates of debt investments will adversely affect the fair value of an investment. The Municipality manages its exposure to declines in fair values by: (1) not including debt or equity investments in its investments portfolio at June 30, 2008, (2) limiting the weighted average maturity of its investments in certificates of deposit to periods of three months or less and (3) keeping most of its banks deposits and certificates of deposit in interest bearing accounts generating interest at prevailing market rates as required by the *Statement of Uniform Investment Guidelines for the Municipalities of the Commonwealth of Puerto Rico, issued by the Government Development Bank for Puerto Rico* (the adopted policy of the Municipality). At June 30, 2008, the interest rate risk associated with the Municipality's cash and cash equivalent is considered low since the investment portfolio of the Municipality consists of certificates of deposit and do not include debt securities or any type of investments that could be affected by changes in interest rates.

- **Custodial credit risk** – In the case of deposits, this is the risk that in the event of a bank failure, the Municipality's deposits may not be recovered. Pursuant to the *Statement of Investment Guidelines for the Government of the Commonwealth of Puerto Rico,* the balances deposited in commercial banks by the Municipality are insured by the Federal Deposit Insurance Corporation (FDIC), generally up to a maximum of $250,000 per depositor through 2009 ($100,000 thereafter). In addition, public funds deposited in commercial banks by the Municipality are fully collateralized for the amounts deposited in excess of the federal depository insurance. All securities pledged as collateral are held in the Municipality's name by the agents of the Commonwealth's Secretary of Treasury. Deposits of GDB, amounting to $15,895,818 at June 30, 2008 ($15,916,327 bank balance), are uninsured and uncollateralized. However, no losses related to defaults by GDB on deposit transactions have been incurred by the Municipality through June 30, 2008. It is management's policy to only maintain deposits in banks affiliated to FDIC to minimize the custodial credit risk, except for GDB. Therefore, the Municipality's management has concluded that at June 30, 2008, the custodial credit risk associated with the Municipality's cash and cash equivalents is considered low.

- **Foreign exchange risk** – This is the risk that changes in exchange rates will adversely affect the value of an investment or a deposit. According to the aforementioned investment guidelines, adopted by the Municipality, the Municipality is prevented from investing in foreign securities or any other types of investments for which foreign exchange risk exposure may be significant. Accordingly, management has concluded that the foreign exchange risk related to the Municipality's deposits is considered low at June 30, 2008.

Cash and cash equivalents at June 30, 2008, are classified in the accompanying balance sheet – governmental funds a follows:

	Major governmental funds				
	General fund	Debt service fund	Capital improvements bond fund	Other governmental funds	Total
Unrestricted:					
Cash in commercial banks	$ 291,944	-	-	-	$ 291,944
Cash equivalents in commercial banks	7,700,000	-	-	-	7,700,000
Restricted:					
Cash in commercial banks	-	-	-	1,655,376	1,655,376
Cash equivalents in commercial banks	-	-	-	400,000	400,000
Cash in fiscal agent	239,146	8,298,168	7,303,346	55,158	15,895,818
Total carrying amount of deposits	$ 8,231,090	8,298,168	7,303,346	2,110,534	$25,943,138
Excess of checks drawn over bank balance in commercial banks	$ 44,639	-	-	-	$ 44,639

3. Property Taxes

The Municipality is authorized by Act No. 81 to impose and collect property taxes from any natural or legal person that, at January 1 of each calendar year: (1) is engaged in trade or business and is the owner of personal or real property used in trade or business or (2) owns residential real property with a value in excess of $15,000 (at 1957 market prices).

Personal property taxes are self-assessed by taxpayers every year using the book value of personal property assets owned by the taxpayer at January 1 (lien; levy date) and reporting such taxable value through a personal property tax return filed on May 15 (due date and collection date) subsequent to the assessment date. The total personal property tax rate in force at June 30, 2008 was 6.83 percent (of which taxpayers pay 6.63 percent and the remaining 0.20 percent is paid by the Department of Treasury, as a subsidy).

Real property taxes are assessed every January 1 (lien; levy date) and is based on estimated current values of the property, deflated to 1957 market prices. Real property taxes a due and collectible on January 1 and July of every fiscal year. The total real property tax rate in force at June 30, 2008 was 8.83 percent (of which 8.63 percent is paid by taxpayers and the remaining 0.20 percent is also paid by the Department of Treasury, as a subsidy).

Residential real property occupied by its owner (not engaged in trade or business) is exempt from property taxes only on the first $15,000 of the assessed value (at 1957 market prices). For exempt amounts, the Department of Treasury assumes the payment of the basic tax (4.00 percent and 6.00 percent for personal and real property, respectively), except for property assessed for less than $3,500 (at 1957 market prices), for which no payment is made by the Department of Treasury.

Included within the total personal and real property tax rates of 6.83 percent and 8.83 percent, respectively, there is a portion of the tax rate in the amount of 1.40 percent that is restricted for the Municipality's debt service requirements on bonds. Such amounts are recorded in the Municipality's debt service fund.

The composition of property taxes receivable and the related deferred revenue is as follows at June 30, 2008:

	Major governmental funds		
	General fund	Debt service fund	Total
Property taxes receivable	$ 15,859,689	4,879,669	$ 20,739,358
Less: allowance for doubtful accounts	(12,912,555)	(3,972,902)	(16,885,457)
Net property taxes receivable	$ 2,947,134	906,767	$ 3,853,901

Property tax revenues amounted to $23,350,091 for the fiscal year ended June 30, 2008.

4. Municipal License Taxes

The Municipality is authorized by Act No. 81 to impose and collect municipal license taxes to any natural or legal person having trade or business activities within the territory of Cataño. This is a self-assessed tax generally based on the business volume of taxpayers, measured by gross revenues. The Municipality establishes the applicable tax rates. At June 30, 2008, the municipal license tax rates imposed by the Municipality were 1.50 percent for financial institutions and 0.50 percent for other types of taxpayers. Any taxpayers that have been granted with a partial tax exemption under any of the tax incentive acts of the Commonwealth ultimately pay municipal license taxes at reduced tax rates, generally between 60 percent and 90 percent under standard rates.

Each taxpayer must asses the corresponding municipal license tax by declaring the volume of business through a tax return to be filed every April 15, based on the actual volume of business (revenues) generated in the preceding calendar year. Taxpayers with a sales volume of $1 million or more must include audited financial statements with their tax return filings. 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 on April 15. 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 date of the declaration (generally April 15), a 5 percent discount is granted automatically on the total tax amount due. Total municipal license tax receivable amounted to $80,651 at June 30, 2008. Municipal license tax revenues for the fiscal year ended June 30, 2008 amounted to $12,742,763 and $13 350,815 in the accompanying statement GWFS and GFFS, respectively .

Any municipal license taxes collected in advance (that is, pertaining to a future fiscal year) are recorded as deferred revenues in the GWFS and the GFFS. Unearned municipal license tax revenues recorded in the accompanying GWFS and GFFS amounted to $10,387,264 respectively at June 30, 2008. This amount represents the municipal license taxes corresponding to fiscal year ending June 30, 2009 that were collected in advance during the last quarter of the current fiscal year, as required by law. However, also during the last quarter of the current fiscal year, the Municipality used approximately $2.4 million of the aforementioned unearned municipal license taxes to pay operating expenses and obligations of the current fiscal year, which will reduce the financial resources available to finance the next fiscal year's operations of the general fund.

5. Sales and Use Taxes

The Municipality imposes a sales and use tax pursuant to the provisions of the Puerto Rico Internal Revenue Code, as amended. The tax consists of one percent (1.0%) on the sales price of taxable items or on the purchase prices of all usage, storage, or consumption of taxable items, excluding wholesales. The sales and use tax is a self-assessed tax collected by the Municipality through monthly tax returns due on the twentieth day of the immediate following month. The tax returns are filed by the respective businesses that are required by law to withhold the tax from consumers on each taxable product or service.

Sales and use tax revenues amounted to $3,802,068 for the fiscal year ended June 30, 2008. In addition, at June 30, 2008, the sales and use tax receivable in the general fund amounted to $261,216, which represents the tax reported on substantially all sales and use tax returns for the month of June 2008 which were filed by the respective withholders in July 2008.

The Commonwealth of Puerto Rico imposes a separate state sales and use tax of 0.5%, which is imposed and collected by the Puerto Rico Treasury Department (PRTD) through monthly tax returns due on the twentieth day of the immediate following month. This 0.5% tax is administered by the Government Development Bank for Puerto Rico for the following purposes: (1) 0.2% is deposited in the new "Municipal Debt Service Fund", strictly for granting loans to the municipalities of Puerto Rico, (2) 0.2% for the creation of the "Municipal Development Fund" % which will be distributed among all municipalities pursuant to a statutory formula, and (3) 0.1% for the creation of the "Permanent Improvements Fund", to be distributed by the Legislature of the Commonwealth of Puerto Rico to carry out public works and permanent improvement projects in the municipalities of Puerto Rico. Accordingly, during the fiscal year ended June 30, 2008, the Municipality recorded intergovernmental grants and contributions revenues in the debt service fund amounting to $587,838, which represents the contributions collected from PRTD arising from the 0.2% portion of the state sales tax to be used to cover future debt service payments of the Municipality's bonds. In addition, at June 30, 2008, the debt service fund has an intergovernmental receivable of $60,524 related to the contributions from the PRTD for the month of June 2008, which were collected in July 2008.

6. Construction Excise Taxes

The Municipality imposes and collects municipal construction excise taxes to most natural and legal persons and any governmental instrumentality that carry out activities related to construction, expansion, major repairs, relocations, alterations and other types of permanent improvements to residential, commercial and industrial buildings and structures within the territorial area of the Municipality. The tax is also applicable to infrastructure projects, the installation of machinery, equipment and fixtures, and other types of construction-related activities.

The construction excise tax generally is a self-assed tax imposed at a 5 percent (5%) over the cost of the project, net of certain exemptions such as the costs associated with the acquisition of land, project design and other engineering fees, licenses and permits, legal and accounting fees, and most marketing and advertising costs. The tax is paid by the taxpayer prior to the commencement of the project.

All single-family residential construction projects not related to housing development projects, condominiums, or any similar projects, are exempt from construction excise taxes for the first $75,000 of project construction costs. In addition, all single-family residential improvement projects are exempt from construction excise taxes for the first $15,000 of the project improvement costs. All projects related to church-related religious organizations in good standing are exempt from construction excise taxes. Furthermore, all projects carried out on buildings and structures classified as historical treasures by the Puerto Rico Planning Board have an exemption of 3.25 percent (3.25%) in the tax rate applicable to construction excise taxes.

Total construction excise tax receivable amounted to $9,676 at June 30, 2008. Construction excise tax revenues amounted to $880,773 for the fiscal year ended June 30, 2008.

7. Intergovernmental Receivables and Payables

Intergovernmental receivables and payables recorded in the accompanying GWFS and GFFS are as follows:

	Major governmental funds	Other governmental funds	Total governmental funds	Statement of net assets
Intergovernmental receivables:				
Grants and contributions:				
Puerto Rico Treasury Department:				
State sales tax contributions – debt service fund	$ 60,524	-	60,524	$ 60,524
Christmas bonus reimbursement – general fund	257,686	-	257,686	257,686
U.S. Department of Homeland Security:				
Homeland Security Grant	-	4,200	4,200	4,200
FEMA – Public Assistance Grant	-	330,560	330,560	330,560
TANF Funds	-	85	85	85
Puerto Rico Department of Justice	-	34,376	34,376	34,376
U.S. Department of Health and Human Services:				
Child Care Sendec Program	-	1,179	1,179	1,179
Even Start Program	-	249,778	249,778	249,778
U.S. Department of Housing and Urban Development	-	205,821	205,821	205,821
Total intergovernmental receivables	$ 318,210	825,999	1,144,209	$ 1,144,209
Intergovernmental payables:				
Payroll withholdings (general fund):				
Association of Employees of Commonwealth of Puerto Rico	78,864	-	78,864	78,864
Puerto Rico Treasury Department	73,132	-	73,132	73,132
Employees Retirement System of the Government of the Commonwealth of Puerto Rico	300,336	-	300,336	300,336
Utilities (general fund):				
Puerto Rico Aqueduct and Sewer Authority	63,003	-	63,003	63,003
Total intergovernmental payables	$ 515,335	-	515,335	$ 515,335

8. Inter-fund Transactions

The composition of inter-fund balances and transactions at June 30, 2008 and for the fiscal year then ended is as follows:

	Due/advances from:		
Due/advances to:	**General fund**	**Other governmental funds**	**Total governmental funds**
Major governmental funds:			
Debt service fund	$ 5,098	-	$ 5,098
Capital improvements bond fund	173,160	-	173,160
Other governmental funds	897,836	10,140	907,976
Total	$ 1,076,094	10,140	$ 1,083,234

	Transfers in:		
Transfers out:	**General fund**	**Other governmental funds**	**Total governmental funds**
Major governmental funds:			
General fund	$ -	90,250	$ 90,250
Debt service fund	3,673,194	-	3,673,194
Capital improvements bond fund	600,101	-	600,101
Other governmental funds	544,296	9,811	554,107
Total	$ 4,817,591	100,061	$ 4,917,652

Inter-fund receivables and payables represent the pending settlements of the aforementioned transfers, which are considered by management to be fully realizable at June 30, 2008. The principal purposes of inter-fund receivables and payables are:

- Recognize in the general fund the routinary due from the debt service fund, amounting to $5,098, related to the accrued interests for June 30, 2008, which were subsequently transferred to the general fund on July 2008.

- Recognize in the general fund the routinary due from the capital improvements bond fund, amounting to $173,160, related to the accrued interests for June 2008, which were subsequently transferred to the general fund on July 2008.

- Recognize in the general fund the outstanding balance of the loans granted to nonmajor capital project and special revenue funds ($1,544,296) to temporarily cover the payroll and other operating costs of several federally and state funded programs.

The inter-fund receivables recorded in the general fund as of June 30, 2008 include advances (long-term inter-fund receivables) from non-major capital project funds and non-major special revenue funds of $330,560 and $4,750, respectively. Accordingly, the accompanying GFFS include reservations in fund balances in the aggregate amount of $335,310 for these long-term inter-fund receivables, which are not considered current available financial resources at June 30, 2008.

The principal purposes of inter-fund transfers are to:

- Make a routinary transfer of interest income, amounting to $239,194, from the debt service fund to the general fund, as permitted by law. This interest income is generated by the debt service fund's deposits and is transferred on a monthly basis to the general fund.

- Make a non-routinary transfer of $3,434,000 from the excess cash in fiscal agent of the debt service fund to the general fund to cover certain operating needs of the Municipality.

- Make a routinary transfer of interest income, amounting to $600,101, from the capital improvements bond fund to the general fund, as permitted by law. This amount represents interest income that is generated by the unspent proceeds of bond issuances that is transferred on a monthly basis to the general fund.

- Make non-routinary residual equity transfers from unrestricted non-major special revenue and capital project funds amounting to $536,185 to the general fund pursuant to a comprehensive evaluation made by management during the current fiscal year of the fund structure of the Municipality to eliminate all superfluous funds and to ensure it complies with all aspects that are of importance to users of general purpose external financial reports. Management understands that after making these residual equity transfers the Municipality has the minimum number of governmental funds needed to maintain legal and self-imposed managerial requirements established by the Municipality.

- Make routinary transfer from the general fund to non-major special revenue funds to finance certain capital outlays.

9. Capital Assets

Capital assets activity for the fiscal year ended June 30, 2008:

	Balance at beginning of fiscal year	Additions	Reclassification of completed works and permanent improvement projects	Balance at end of fiscal year
Governmental activities:				
Cost basis:				
Capital assets, not being depreciated/amortized:				
Land	$ 10,886,735	-	-	$ 10,886,735
Construction in progress	7,470,633	16,250,980	(10,428,639)	13,292,974
Total capital assets, not being depreciated/amortized	18,357,368	16,250,980	(10,428,639)	24,179,709
Capital assets, being depreciated/amortized:				
Land improvements	44,450,709	-	159,825	44,610,534
Buildings, structures, and improvements	43,689,209	-	9,477,318	53,166,527
Infrastructure	26,502,543	-	791,496	27,294,039
Machinery and equipment, and furniture and fixtures	5,608,838	158,028	-	5,766,866
Office and medical equipment under capital leases	798,925	-	-	798,925
Licensed vehicles	2,994,178	173,509	-	3,167,687
Licensed software	152,918	71,073	-	223,991
Total capital assets, being depreciated/amortized	124,197,320	402,610	3,186,148	135,028,569
Total cost basis of capital assets	142,554,688	16,653,590	10,428,639	159,208,278

	Balance at beginning of fiscal year	Depreciation and amortization expense	Reclassifications and adjustments	Balance at end of fiscal year
Governmental activities:				
Accumulated depreciation and amortization:				
Land improvements	9,534,820	1,760,243	-	11,295,063
Buildings, structures, and improvements	12,160,383	1,643,720	-	13,804,103
Infrastructure	5,884,395	854,949	-	6,739,344
Machinery and equipment, and furniture and fixtures	4,560,258	471,970	-	5,032,228
Office and medical equipment under capital leases	437,891	174,167	-	612,058
Licensed vehicles	2,158,570	528,536	-	2,687,106
Licensed software	152,918	7,049	-	159,967
Total accumulated depreciation and amortization	34,889,235	5,440,634	-	40,329,869
Net capital assets	$ 107,665,453	11,212,956	-	$ 118,878,409

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

Governmental activities:	
General government	$ 2,273,479
Public safety	231,170
Urban and economic development	1,629,850
Health and sanitation	42,642
Public housing and welfare	101,177
Culture, recreation, and education	1,162,316
Total depreciation and amortization expense	$ 5,440,634

10. Deferred Revenues

Deferred revenues recorded in the accompanying GWFS and the GFFS are as follows:

	General fund	Other governmental funds	Total governmental funds	Statement of net assets
Measurable but unavailable revenues:				
Intergovernmental grants and contributions	$ 257,686	-	257,686	$ -
Total measurable and unavailable revenues	257,686	-	257,686	-
Unearned revenues:				
Municipal license taxes	10,387,264	-	10,387,264	10,387,264
Intergovernmental grants and contributions	-	334,961	334,961	334,961
Total unearned revenues	10,387,264	334,961	10,722,225	10,722,225
Total deferred revenues	$ 10,644,950	334,961	10,979,911	$ 10,979,911

11. Long-Term Obligations

The general long-term debt activity for the fiscal year ended June 30, 2008 is as follows:

	Balance at beginning of fiscal year	Borrowings or additions	Payments or deductions	Balance at end of fiscal year	Balance due within one year
Bonds payable:					
General obligation serial bonds	$ 42,420,000	-	(2,120,000)	40,300,000	$ 2,055,000
Public improvement serial bonds	8,500,000	-	(800,000)	7,700,000	865,000
Notes payable:					
CRIM - Act No. 146 of October 11, 2001	544,357	-	(19,960)	524,397	21,774
CRIM - Act No. 42 of January 26, 2000	6,617,371	-	(115,580)	6,501,791	122,958
Obligations under capital leases	413,754	-	(150,183)	263,571	137,216
Compensated absences	4,857,010	3,016,154	(2,336,832)	5,536,332	2,505,708
Claims and judgments	198,000	-	-	198,000	198,000
Total	$ 63,550,492	3,016,154	(5,542,555)	61,024,091	$ 5,905,656

Historically, the general fund has been used to liquidate certain notes payable, compensated absences, obligations under capital leases , federal cost disallowances and any other long-term liabilities other than bonds.

a) *Debt Limitation*

The Municipal Legislature is legally authorized to approve the contracting of debts of the Municipality. Nevertheless, the laws and regulations of the Commonwealth of Puerto Rico also provide that:

- Direct obligations of the Municipality (evidenced principally by bonds and bond anticipation notes) are backed by the full faith, credit and taxing power of the Municipality; and

- Direct obligations are not to be issued by the Municipality if the amount of the principal of, and the interest on, such bonds and bond anticipation notes (and on all 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 bond anticipation 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 and bond anticipation notes to be repaid with the proceeds of property taxes restricted for debt service.

In addition, before any new bonds are issued, the revenues of the debt service fund should be sufficient to cover the projected debt service requirement. The Municipality's available legal debt margin amounted to $672,840 at June 30, 2008, as published by the Government Development Bank for Puerto Rico.

During the fiscal years ended June 30, 2008, 2007 and 2006, the Municipality made transfers of excess cash from the debt service fund to the general fund amounting to $3,434,000, $7,213,676 and $5,993,656, respectively, as permitted by law, to provide additional working capital and additional financial resources to mitigate the general fund's excess of expenditures over revenues. Accordingly, the legal margin of the Municipality has decreased from $2.9 million in 2006 to $672,840 at June 30, 2008.

*b). **Bonds Payable***

The Municipality issues general obligation, special obligation and public improvement bonds to finance the acquisition, construction and improvement of capital assets, as well as, to finance certain operating needs, including the payment to suppliers in certain circumstances.

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

The Municipality levies an annual additional special tax of 1.80 percent 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 are set aside to redeem the bonds payable of the Municipality in minimum annual or semiannual principal and interest payments. The collections of this special tax are recorded in the Municipality's debt service fund.

For financial reporting purposes, the outstanding balances of bonds represent the total principal to be repaid. Bonds payable is composed as follows at June 30, 2008:

	Outstanding amount
General Obligation Bonds:	
2004 serial bonds (face amount of $1,720,000) for the acquisition of major capital assets; due in annual principal installments ranging from $260,000 to $315,000; plus interests due in semiannually installments at variable rates (4.23% at June 30, 2008) through July, 1, 2010	$ 910,000
2001 serial bonds (face amount of $7,240,000) for the acquisition of major capital assets; due in annual principal installments ranging from $195,000 to $715,000; plus interests due in semiannually installments at variable rates (3.21% at June 30, 2008) through July, 1, 2019	5,815,000
2004 serial bonds (face amount $10,450,000) for the acquisition of major capital assets; due in annual principal installments ranging from $315,000 to $800,000; plus interests due in semiannually installments at variable rates (4.23% at June 30, 2008) through July, 1, 2024	9,455,000
2000 serial bonds (face amount $11,850,000) for the acquisition of major capital assets; due in annual principal installments ranging from $315,000 to $1,170,000; plus interests due in semiannually installments at variable rates (3.21% at June 30, 2008) through July 1, 2018	9,030,000

	Outstanding amount
1998 serial bonds (face amount of $18,825,000) for the acquisition of major capital assets; due in annual principal installments ranging from $260,000 to $1,635,000; plus interests due in semiannually installments at variable rates (5.52% at June 30, 2008) through July 1, 2022	15,090,000
Total general obligation bonds	$ 40,300,000

Public Improvement Bonds:

1998 serial bonds (face amount of $14,520,000) for the acquisition of major capital assets; due in annual principal installments ranging from $315,000 to $1,370,000; plus interests due in semiannually installments at variable rates (7.41% at June 30, 2008) through July 1, 2014	7,700,000
Total bonds payable	$ 48,000,000

Variable interest rates on serial bonds are reviewed periodically by GDB and are based on the fluctuation of GDB's weighted average rate for its commercial paper program. Under this program, GDB issues commercial paper: (1) in the taxable and tax-exempt markets of the United States of America, (2) in the Eurodollar market, and (3) to corporations having tax exemptions under the Commonwealth's Industrial Incentives Acts and, which qualify for benefits provided by the former Section 936 of the U.S. Internal Revenue Code.

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

Fiscal year ending June 30,	Principal	Interest	Total
2009	$ 2,920,000	2,669,697	$ 5,589,697
2010	3,135,000	2,502,037	5,637,037
2011	3,280,000	1,941,138	5,221,138
2012	3,370,000	2,318,796	5,688,796
2013	3,560,000	2,119,633	5,679,633
2014-2018	14,055,000	6,368,437	20,423,437
2019-2023	14,840,000	4,739,956	19,579,956
2024-2028	2,840,000	934,394	3,774,394
Totals	$ 48,000,000	23,594,088	$ 71,594,088

At June 30,2008, accrued interest payable on bonds amounted to $1,364,094, which are recorded in the debt service fund and the statement of net assets. Interest expense on bonds amounted to $2,728,189 for the fiscal year ended June 30, 2008.

According to sections 103 and 148 to 150 of the U.S. Internal Revenue Code and sections 1.148 to 1.150 of the U.S. Treasury Regulation, the Municipality's the tax-exempt bonds are subject to the arbitrage rebate requirements. At June 30, 2008, the Municipality had no federal arbitrage liability on bonds since interest income earned from the investment of unspent bond proceeds were made in bank deposits that generate yields lower than the rates applicable to the debt service payments.

c) ***Notes Payable to Municipal Revenue Collection Center (CRIM)***

The Municipality had the following notes payables to CRIM at June 30, 2008:

- **Public Act No. 146** – On September 24, 2002, CRIM, on behalf of the municipalities of Puerto Rico, entered into a financing agreement with GDB pursuant to the provisions of Public Act No. 146 of October 11, 2001, as amended (Act No. 146). The purpose of this financing agreement was to extinguish in advance certain bonds payable issued by Public Finance Corporation (PFC), a subsidiary of GDB, which were originally issued to pay certain property tax receivables owned by the municipalities of Puerto Rico through 1996, which were acquired by PFC with recourse.

  The original face amount of the note allocated by CRIM to the Municipality was $731,579, for a term not exceeding 30 years. The note bears interest at 6.50 percent during its first five years. Subsequently, from years 6 through 30, the loan shall bear variable interest at a rate of 125 points over the 5-year LIBOR rate, which will be adjusted every five years. During the first five years of the note, commenced on July 1, 2003, the Municipality paid only interests through the fiscal year ended June 30, 2008. Effective July 1, 2008, the repayment terms and conditions of the note shall be renegotiated to allow the Municipality to pay the outstanding balance of the note in equal installments of principal plus interest, through maturity. Interest payments on this financing agreement are accounted for in the general fund.

  At June 30, 2008, the outstanding principal of the note payable to CRIM amounted to $524,397. The principal and interest maturities are as follows:

Fiscal year Ending June 30,	Principal	Interest	Total
2009	$ 21,774	33,437	$ 55,211
2010	21,774	32,022	53,796
2011	21,774	27,776	49,550
2012	21,774	24,237	46,011
2013	21,774	21,611	43,385
2014-2018	108,870	81,886	190,756
2019-2023	108,870	68,113	176,983
2024-2028	108,870	32,730	141,600
2029-2033	88,917	3,185	92,102
Totals	$ 524,397	324,997	$ 849,394

- **Public Act No. 42** – The Commonwealth's Pubic Act No. 42 of January 26, 2000 (Act No. 42) 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 authorized CRIM to finance a debt that the municipalities of Puerto Rico had with such entity from year 2000. In addition, on December 16, 2002 the Municipality entered into a repayment agreement with GDB and CRIM to pay off debts of $7,092,328. The repayment agreement bears interest at variable rates determined by GDB (6.30 percent at June 30, 2005) but not exceeding 8.00 percent. Principal and interest payments on this financing agreement are accounted for in the general fund. The outstanding principal and accrued interest balances of this note amounted to $6,501,791 and $31,644, respectively, at June 30, 2008. The principal and interest maturities are as follows:

Fiscal year ending June 30,	Principal	Interest	Total
2009	$ 122,958	33,437	$ 156,395
2010	130,807	32,022	162,829
2011	139,157	30,607	169,764
2012	168,186	26,361	194,547
2013	176,774	29,991	206,765
2014-2018	840,930	131,803	972,733
2019-2023	1,145,857	96,420	1,242,277
2024-2028	1,384,579	31,046	1,415,625
2029-2033	2,127,515	25,653	2,153,168
2034-2037	265,028	885	265,913
Totals	$ 6,501,791	438,225	$ 6,940,016

d) Capital Lease Obligations

The Municipality is obligated under capital leases with third parties that expire through 2011 for the acquisition of machinery and equipment. At June 30, 2008, the capitalized costs and the related accumulated depreciation of the leased machinery and equipment amounted to $798,925 and $612,058, respectively, which are accounted for as capital assets in the accompanying statement of net assets. Amortization charges applicable to capital leases and included within depreciation expense amounted to $174,167 for the fiscal year ended June 30, 2008. The present value of the future minimum capital lease payments reported in the accompanying statement of net assets is as follows:

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	Fiscal year ending June 30,	Amount
	2009	$ 152,989
	2010	117,225
	2011	15,445
Total future minimum lease payments		285,659
Less: amounts representing future interests at a rate of 8.00%		(22,088)
Present value of minimum lease payments at June 30, 2008		263,571
Less: current portion of obligation under capital leases		(137,216)
Obligation under capital leases, excluding current portion		$ 126,355

e) Compensated Absences

At June 30, 2008, the liability for compensated absences is composed as follows:

Vacations	$ 2,490,089
Sick leave	2,902,470
Compensatory time	143,774
Total compensated absences	$ 5,536,332

12. Employees' Retirement Systems

a) Plan Description

The Municipality's employees participate in the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS), a cost-sharing multi-employer (as related to the Municipality's reporting entity) defined pension plan established by the Commonwealth. Substantially all full-time employees of the Commonwealth and substantially all municipalities are covered by ERS under the terms of Public Act No. 447 of May 15, 1951, as amended (Act No. 447). All regular and temporary employees of the Municipality become plan members of ERS at the date of employment, while it is optional for officers appointed.

ERS members, other than those joining it after March 31, 1990, are eligible for the benefits described below:

- ***Retirement Annuity***

ERS members are eligible for a retirement annuity upon reaching the following age:

Policemen and firemen:
50 with 25 years of credited service
58 with 10 years of credited service

Other employees:
55 with 25 years of credited service
58 with 10 years of credited service

ERS members are eligible for monthly benefit payments determined by the application of the 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 member is eligible, is limited to a minimum of $300 per month and a maximum of 75 percent of the average compensation.

- ***Merit Annuity***

  ERS members are eligible for merit annuity with a minimum of 30 years or more of credited service. The annuity for which the plan member is eligible is limited to a minimum of 65 percent and a maximum of 75 percent of the average compensation.

- ***Deferred Retirement Annuity***

  A participating employee who ceases to be an employee of the Municipality after having accumulated a minimum of ten years of credited service qualifies for retirement benefits provided his/her contributions are left in ERS until reaching 58 years of age.

- ***Coordinated Plan***

  On the coordinated plan, by the time the employee reaches 65 years old and begins to receive social security benefits, the pension benefits are reduced by the following:

  (a) $165 per month, if retired with 55 years of age and 30 years of credited service.

  (b) $110 per month, if retired with less than 55 years of age and 30 years of credited service.

  (c) All other between $82 and $100 per month.

  (d) Disability annuities under the coordinated plan are also adjusted at age 65 and in some cases can be reduced over $165 per month.

- ***Non-Coordinated Plan***

  On the non-coordinated plan the participating employee and does not have any change on the pension benefits upon receiving social security benefits.

- ***Reversionary Annuity***

  An ERS member, upon retirement, could elect to receive a reduced retirement annuity giving one or more benefit payments to his/her dependents. The life annuity payments would start after the death of the retiree for an amount not less than $240 per year or greater than the annuity payments being received by the retiree.

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- *Occupational Disability Annuity*

  A participating employee, who as a direct result of the performance of his/her occupation is totally and permanently disabled, is eligible for a disability annuity of 50 percent of the compensation received at the time of the disability.

- *Nonoccupational Disability Annuity*

  A participating employee, totally and permanently disabled for causes not related to his/her occupation and with no less than 10 years of credited service, is eligible for an annuity of 1.50 percent of the average compensation of the first 20 years of credited services, increased by 2 percent for every additional year of credited service in excess of 20 years.

- *Death Benefits*

  Occupational:

  (a) **Surviving spouse** – annuity equal to 50 percent of the participating employee's salary at the date of the death.

  (b) **Children** - $10 per month for each child, minor or student, up to a maximum benefit per family of $100.

  Nonoccupational:

  Beneficiary – the contributions and interest accumulated as of the date of the death plus an amount equal to the annual compensation at the time of the death.

  Post-retirement:

  Beneficiary with surviving spouse age 60 or over and a child, 18 or under, up to 30 percent (60 percent, if not covered under Title II of the Social Security Act) (increased to 50 percent effective January 1, 2005) of retiree's pension or otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of $750.

- *Refunds*

  A participating employee who ceases his/her employment with the Municipality without the right to a retirement annuity has the right to a refund of the contributions to ERS plus any interest earned thereon.

- *Cost of Living Adjustment for Pension Benefits*

  Public Act No. 10 of May 21, 1992 (Act No. 10) provided for increases of 3 percent every three or more years of retirement. Act No. 10 requires further legislation to grant this increase every three years subject to the presentation of actuarial studies regarding its costs and the source of financing. To protect the financial health of ERS, the increase granted during 2001 and the one granted on January 1, 2005 are being financed by the Municipality and the other participating employers.

To avoid any economic impact on ERS, the employers are responsible for contributing to ERS the amounts to cover the benefit payments and the employer and employee contributions with respect to the participants covered until the participants reach the normal retirement age.

- ***Amendment to Act No. 447 effective January 1, 2000 to create a Defined Contribution Plan***

On September 24, 1999, Public Act No. 305, an amendment to Act No. 447, was enacted to establish a defined contribution plan, known as System 2000, to cover employees joining ERS on or after January 1, 2000.

Employees that participated in the original plan as of December 31, 1999, had the opportunity to elect to either stay in the defined benefit plan or transfer to System 2000. Employees that joined the Municipality on or after January 1, 2000, were only allowed to become members of System 2000.

System 2000 is a hybrid defined contribution plan, also known as a cash balance plan. Under this new plan, there is a pool of plan assets, which is invested by the System, together with those of the cost-sharing multi-employer defined benefit plan. Neither the Commonwealth nor the Municipality guarantee benefits at retirement age. The annuity is based on a formula which assumes that each fiscal year the employee's contribution (with a minimum of 8.28 percent of the employee's salary up to a maximum of 10 percent) is invested as instructed by the employee in an account which either: (1) earns a fixed rate based on the two-year Constant Maturity Treasury Notes, (2) earns a rate equal to 75 percent of the return of the ERS' investment portfolio (net of management fees), or (3) earns a combination of both alternatives. Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. Disability benefits are not granted under System 2000, rather are provided to those participants that voluntarily elect to participate in a private insurance long-term disability program. The employers' contributions (9.28 percent of the employee's salary) with respect to employees under System 2000 will continue and will be used to fund the cost-sharing multi-employer defined benefit plan.

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

Historically, the state government of the Commonwealth has reported ERS and System 2000 in its basic financial statements as pension trust funds. Accordingly, the Commonwealth is currently assuming any actuarial deficiency that may exist or arise related to the Municipality's participating employees because ERS does not allocate to the Municipality any actuarial deficiencies pertaining to participating municipal employees. The Municipality is only required by law to make statutory contributions at the rates detailed below.

- ***Recent Amendments to Act No. 447***

The Senate and the House of Representatives of the Commonwealth of Puerto Rico have the authority for establishing or amending the contribution requirements of System 2000 by approving the necessary amendments or laws, subject to the final approval of the Governor of the Commonwealth of Puerto Rico.

In June and July 2003, the Governor of the Commonwealth signed three Public Acts that provided the following certain benefits to retirees:

(a) Increase in minimum monthly pension payments to $300, effective January 1, 2005.

(b) Triennial 3 percent increase in all pensions, effective January 1, 2005.

(c) Increase in widow and/or beneficiaries to 50 percent of the benefit received by the deceased pensioner, effective January 1, 2005.

All the benefits granted will be funded through budgetary assignments in the Municipality's general fund with respect to its retired employees.

The Board of Trustees of ERS approved, effective November 17, 2003, an increase in the amount granted on personal loans to participating employees from $3,000 to $5,000.

b) *Funding Policy*

The contribution requirements to ERS is established by law and is not actuarially determined. These contributions are as follows:

Municipality and other employers	9.28 percent of applicable payroll
Employees:	
Coordination plan:	5.78 percent of gross salary up to $6,600 per year, plus 8.28 percent gross salary in excess of $6,600.
Supplementation plan:	8.28 percent of gross salary. This is the only choice available to policemen, firemen and mayors

The contribution requirement to System 2000 is also established by law and is not actuarially determined. These contributions are as follows:

Municipality and other employers	9.28 percent of applicable payroll
Employees:	5.78 percent of gross salary up to $6,600 per year, plus 8.28 percent gross salary in excess of $6,600.

During the fiscal years ended June 30, 2006, 2007, and 2008, the Municipality and the participating employees contributed exactly 100 percent of the required contributions to ERS and System 2000. The combined actual contributions made by the Municipality and its participating employees to ERS and System 2000 (which are exactly 100% of the required amounts) were as follows during the last three fiscal years:

Fiscal year ended June 30,	Employer contributions	Employee contributions
2006	1,305,423	1,159,463
2007	1,378,392	1,224,562
2008	1,554,446	1,380,965

The above actual employer contributions for the fiscal years ended June 30, 2006, 2007, and 2008 include the employer contributions to System 2000 amounting to $543,572, $639,110 and $720,738, respectively. In addition, the above actual employee contributions for the fiscal years ended June 30, 2006, 2007, and 2008 include the employee contributions to System 2000 amounting to $488,227, $573,180 and $646,387, respectively.

The authority under which the funding policy and the obligations to contribute to ERS and System 2000 are established or amended, is held by the Board of Trustees of ERS, which upon their approval must obtain a final approval of the House of Representatives, the Senate and the Governor of the Commonwealth of Puerto Rico.

Readers can obtain copies of the audited basic financial statements (GAAP basis) of ERS and System 2000 by writing to Mr. Juan Cancel, Executive Director of the Retirement Systems Administration of the Commonwealth of Puerto Rico (the entity that administers ERS and System 2000) at PO Box 42003, Minillas Station, Santurce, Puerto Rico 00940.

13. Commitments and Contingencies

The Municipality is defendant in various legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Public Act No. 104 of June 25, 1955, as amended, persons are authorized to sue the Municipality only for causes of actions set forth in said Act to a maximum amount of $75,000 or $150,000 if it involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as provided in Public Act No. 9 of November 26, 1975, as amended, the Municipality may provide its officers and employees with legal representation as well as assume the payment of any judgment that may be entered against them. There is no limitation on the payment of such judgments.

With respect to pending and threatened litigation, the Municipality has reported liabilities of $198,000 for awarded or anticipated unfavorable judgments as of June 30, 2008. Management believes that any unfavorable outcome in relation to pending or threatened litigation would not be significant, if any.

The Municipality has reported, outstanding encumbrances amounting to $292,604 in the general fund at June 30, 2008. The Municipality intends to honor these encumbrances, which will continue to be liquidated under the current year's budget during a lapse period that extends into the subsequent fiscal year. The Municipality has outstanding construction project commitments amounting to approximately $2 million at June 30, 2008,.

The Municipality receives financial assistance from the federal Governments of the United States of America and the Commonwealth in the form of grants and entitlements. Receipt of grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal laws and regulations, including the expenditure of resources for eligible purposes.

Accordingly, expenditures financed by these programs are subject to financial and compliance audits by the appropriate grantor. Disallowance as a result of these audits may become liabilities of the Municipality.

The *"Reports on Compliance and Internal Control in Accordance with Government Auditing Standards and the Requirements of OMB Circular A-133"* for the fiscal year ended June 30, 2007, disclosed various instances of noncompliance with applicable laws and regulations and with internal accounting and administrative controls. If expenditures are disallowed due to noncompliance with grant programs regulations, the Municipality may be required to reimburse the grantor the disallowed amounts. Management believes that the Municipality will be able to comply with the terms of corrective action plans that may be requested by the federal grantors, if any. Consequently, the accompanying basic financial statements do not include any provision or reserve for possible disallowed costs arising from the federal funds disbursed during the fiscal year ended June 30, 2008.

14. Liquidity, Cash Flows and Subsequent Events

The accompanying statement of activities reported a net decrease in net assets of $9,293,809 for the fiscal year ended June 30, 2008. In addition, during the last four fiscal years, the Municipality's general fund has reported recurring excesses of expenditures over revenues, which have lead to consistent significant reductions in unrestricted cash and cash equivalents that were partially mitigated with annual transfers of financial resources from the debt service fund to the general fund to mitigate budgetary and cash flows shortfalls. Accordingly, during the current fiscal year the Municipality transferred excess cash amounting to $3,434,000 from the debt service fund to the general fund, as permitted by law, to provide additional working capital and additional financial resources to mitigate the general fund's excess of expenditures over revenues of $11,423,085 for the fiscal year ended June 30, 2008.

Due to the situations referred to above, during the current fiscal year the Municipality faced significant liquidity and working capital deficiencies that have worsened after the current fiscal year-end. At June 30, 2008, the Municipality's unrestricted deposits amounted to $7,991,944, which is significantly below the normal levels needed to operate safely and is the lowest unrestricted cash level of the Municipality in several years. The amount of unrestricted cash in commercial banks available at June 30, 2008 represent approximately 1.9 months of operating expenses of the general fund. The remaining cash balances amounting to $17,951,194 at June 30, 2008 are not available to pay ordinary operating expenses of the general fund since are restricted for specific purposes stated in various grant agreements and bond indentures.

During the last quarter of the current fiscal year, the Municipality used approximately $2.4 million of the next fiscal year's municipal license taxes that were collected in advance through June 30, 2008. These financial resources were used by the Municipality to pay operating expenses and obligations of the current fiscal year, which will reduce the financial resources available to finance the operations of the general fund for the fiscal year 2008-2009.

These conditions have resulted in significant cash shortfalls and liquidity problems for the Municipality during the first half of the fiscal year 2008-2009, which may result in significant difficulties to pay its obligations when due during the second half of fiscal year 2008-2009 and the possible accumulation of unpaid billings from suppliers of goods and services.

Management of the Municipality is currently evaluating different alternatives for the permanent financing of the Municipality's operations, principally to increase its revenue sources and implementing continuous cost reductions policies. As an initial step, during the last quarter of the current fiscal year, the Municipality commenced a project designed to maximize its property tax revenues by reviewing the assessed values and tax exemptions of taxable properties. This project has been carried over under a cooperative agreement with the Municipal Revenue Collection Center.

The success of management's plans and strategies to improve the Municipality's cash flow and liquidity and to achieve positive net changes in unrestricted net assets cannot be assured, as it is significantly dependent upon events and circumstances which outcome cannot presently be determined. However, management is committed to undertake whatever actions may be necessary to try to prevent operating and working capital deficiencies in the future.

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REQUIRED SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Budgetary Comparison Schedule – General Fund
Fiscal Year Ended June 30, 2008

	Budgeted amounts		Actual amounts - budgetary basis (Note 1)	Variance with final budget - over (under)
	Original	Final		
Revenues:				
Taxes:				
Property taxes	$ 18,386,341	18,386,341	17,726,910	$ (659,431)
Municipal license taxes	12,900,000	12,900,000	12,941,705	41,705
Construction excise taxes	800,000	800,000	1,084,649	284,649
Sales and use taxes	2,650,000	2,650,000	3,801,723	1,151,723
Charges for services	557,632	557,632	509,156	(48,476)
Intergovernmental grants and contributions	2,873,199	2,873,199	1,762,891	(1,110,308)
Interest on deposits and investments	388,738	388,738	524,309	135,571
Miscellaneous	451,749	451,749	540,282	88,533
Total revenues	39,007,659	39,007,659	38,891,625	(116,034)
Expenditures:				
Current:				
General government	5,774,359	14,135,384	16,966,265	2,830,881
Urban and economic development	8,874,522	8,452,755	9,579,974	1,127,219
Public safety	6,126,337	5,541,809	5,957,123	415,314
Health and sanitation	7,520,756	4,720,357	6,898,270	2,177,913
Culture, recreation and education	5,649,510	5,317,654	3,026,038	(2,291,616)
Public housing and welfare	5,376,429	5,013,393	6,344,761	1,331,368
Debt service:				
Principal	285,723	285,723	285,723	-
Interest	97,102	97,102	97,102	-
Capital outlays	14,183	14,183	14,183	-
Total expenditures	39,718,921	43,578,360	49,169,439	5,591,079
Expenditures over revenues	(711,262)	(4,570,701)	(10,277,814)	(5,707,113)
Other financing sources (uses):				
Prior year's budgetary cash surplus readjustment	-	3,859,439	-	(3,859,439)
Operating transfers-in from other funds	711,262	711,262	5,802,702	5,091,440
Operating transfers-out to other funds	-	-	(1,090,250)	(1,090,250)
Total other financing sources (uses), net	711,262	4,570,701	4,712,452	141,751
Expenditures and other financing uses over revenues and other financing sources	$ -	-	(5,565,362)	$ (5,565,362)

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

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Schedule of Expenditures of Federal Awards
June 30, 2008

Federal Grantor/Program Title	Federal CFDA Number	Pass-Through Grantor's Number	Expenditures
U.S. Department of Housing and Urban Development			
Pass-through State – Commissioner Office of Municipal Affairs			
Community Development Block Grant-Small Cities (SBGP)	14.219	N/A*	$1,542,547
Emergency Shelter Grants Program	14.231	S-05-DC-72-001	7,667
Total U.S. Department of Housing and Urban Development			1,550,214
U.S. Department of Health and Human Services			
Passed through the Office of Administration for Children and Families			
Child Care and Development Block Grant	93.575	241-2007-000118	92,344
Total U.S. Department of Health and Human Services			92,344
U.S. Department of Education			
Even Start – State Educational Agencies	84.213	N/A	192,850
Total U.S. Department of Education			192,850
U.S. Department of Agriculture			
Child and Adult Care Food Program	10.558	N/A	19,352
Total U.S. Department of Transportation			19,352
U.S. Department of Transportation			
Federal Transit – Formula Grant	20.513		46,518
Total U.S. Department of Transportation			46,518
Total Federal Financial Assistance			$ 1,901,278

*Major Programs

NOTE 1 - GENERAL

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Municipality of Cataño of the Commonwealth of Puerto Rico and is presented on the accrual basis of accounting. The Municipality of Cataño reporting entity is defined in Note 1 to the Municipality's basic financial statements. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Therefore, some amounts presented in this schedule may differ from amounts presented in our used in the preparation of the basic financial statements.

NOTE 2 - RELATIONSHIP TO THE BASIC FINANCIAL STATEMENTS

Revenues and expenditures of the federal awards are included in the Municipality's basic financial statements within the Major and Nonmajor Governmental Funds. The reconciliation between the expenditures in the basic financial statements and expenditures in the Schedule of Expenditures of Federal Awards is as follows:

Expenditures in the basic financial statements:

Nonmajor Governmental Funds	$ 3,609,550
Less non-federal expenditures	(1,708,272)
Expenditures in the Schedule of Expenditures of Federal Awards	$ 1,901,278

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Report on Compliance and on Internal Control over Financial Reporting Based on an audit of Financial Statements performed in accordance with Government Auditing Standards
June 30, 2008

To the Honorable Mayor
and the Municipality of Cataño
Cataño, Puerto Rico

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the Municipality of Cataño of the Commonwealth of Puerto Rico (the Municipality) as of and for the year ended June 30, 2008, which collectively comprise the Municipality's basic financial statements and have issued our report thereon dated November 14, 2008. 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 *Governmental Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Municipality's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Municipality's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Municipality's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Municipality's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles, such that there is more than a remote likelihood that a misstatement of the Municipality's financial statements that is more than inconsequential will not be prevented or detected by the Municipality's internal control. We consider the deficiencies described in the accompanying schedule of findings and questioned costs to be significant deficiencies in internal control over financial reporting as items 08-01 thru 08-06.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Municipality's internal control.

... Juan, Puerto Rico 00919-1503 TEL. 787-603-1600

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider items 08-01, 08-02, 08-03 and 08-06 to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Municipality of Cataño of the Commonwealth of Puerto Rico 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 items 08-07 thru 08-16.

We noted certain matters that we reported to management of the Municipality of Cataño, in a separate letter dated November 14, 2008.

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

This report is intended solely for the information and use of the Municipality's management, municipal legislature, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Toa Alta, Puerto Rico
November 14, 2008

Stamp No. 2313624 was affixed to the original report.

CPA - PSC

BENITEZ-JAIME, CPA-PSC
Certified Public Accountants and Business Consultants

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Report on compliance with requirements applicable to each major program and on Internal Control over compliance in accordance with OMB Circular A-133
June 30, 2008

To the Honorable Mayor
and the Municipality of Cataño
Cataño, Puerto Rico

Compliance

We have audited the compliance of the Municipality of Cataño of the Commonwealth of 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 year ended June 30, 2008 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 Municipality's management. Our responsibility is to express an opinion on 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 Municipality's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Municipality's compliance with those requirements.

As described in items 08-07, 08-08, 08-12, 08-13, 08-14 and 08-15 in the accompanying Schedule of Findings and Questioned Costs, the Municipality did not comply with the equipment and real property management, cash management, reporting requirements, special tests and provisions, and earmarking requirements that are applicable to its Community Development Block Grant – Small Cities. 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 noncompliance described in the preceding paragraph, the Municipality of Cataño, Commonwealth of Puerto Rico, complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2008.

The results of our auditing procedures also disclosed other instance of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as items 08-09, 08-10, 08-11 and 08-16.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Report on compliance with requirements applicable to each major program and on Internal Control over compliance in accordance with OMB Circular A-133
June 30, 2008

Internal Control Over Compliance

The management of Municipality of Cataño, Commonwealth of Puerto Rico is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered 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, but not for the purpose of expressing an opinion on the effectiveness of the Municipality's internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Municipality of Cataño internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as items 08-01thru 08-06 significant deficiencies.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs, we consider items 08-01, 08-02, 08-03 and 08-06 to be material weaknesses.

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

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

Toa Alta, Puerto Rico
November 14, 2008

CPA - PSC

Stamp No. 2313625 was affixed to the original report.

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Schedule of Finding and Questioned Costs
June 30, 2008

Section I - Summary of Auditors' Results

Financial Statements

Type of auditors' report issued: Unqualified

Internal control over financial reporting:

Material weakness (es) identified? __X__ yes _____ no

Control deficiencies identified not considered to be material weakness? __X__ yes _____ none reported

Noncompliance material to financial statements noted? __X__ yes _____ no

Federal Awards

Internal Control over major programs:

Material weakness (es) identified? __X__ yes _____ no

Control deficiencies not considered to be material weaknesses? __X__ yes _____ none reported

Type of auditor's report issued on compliance

For major programs: Qualified

Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section .510(a)? __X__ yes _____ no

Identification of major programs:

CFDA Numbers	Name of Federal Program or Cluster
14.219	Community Development Block Grant – Small cities Program

Dollar threshold used to distinguish Between Type A and Type B programs: $300,000

Auditee qualified as low-risk auditee? _____ yes __X__ no

Section II - Financial Statement Findings

The current year findings and questioned costs were discussed with the Municipality's management which generally concurred with our comments and recommendations. The Municipality of Cataño will respond to the following findings through the issuance of a separate letter addressed to the Cognizant Agency.

08-01 DEFICIENCIES IN THE UNIFORM ACCOUNTING SYSTEM AND OTHER ACCOUNTING RECORDS

The Uniform Accounting System (UAS) and the accounting records currently used by the Municipality 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). The UAS is a system promulgated by the Office of the Commissioner of Municipal Affairs of Puerto Rico (OCAM, by its Spanish acronyms), a governmental entity created by law to provide technical assistance to the municipalities of Puerto Rico in several administrative and fiscal matters.

The Municipality's UAS mostly provides for the recording of revenue collections, disbursements and other limited transactions. In addition, the accounting records are not fully integrated, and a double entry system is not generally followed. Accounting records are maintained on the cash basis and budgetary accounting bases (two accounting bases that differ significantly from GAAP) and do not comply with Statement No. 34 of the Governmental Accounting Standards Board (GASB 34), as amended.

The following specific additional conditions were noted in relation to the UAS of the Municipality:

- Accounting transactions are currently accounted for simultaneously through manual and computerized accounting systems for which no reconciliation procedures are made among them, including the accounting records currently used by federal programs which are not reconciled with the UAS. The balance sheet accounts in the UAS are not reconciled and adjusted to conform them to the Municipality's audited basic financial statements.

- The UAS does not have the capabilities of: (1) distinguish between expenditures (expenses) incurred and encumbered, (2) recording and processing all types of capital asset transactions, principally the accounting of depreciation and amortization expense, (3) recording and processing all transactions related to revenues susceptible to accrual (accounts receivable) and, (4) recording and processing transactions related to long-term debt, including bonds and notes payable, obligations under capital leases, reserves for federal cost disallowances, legal claims and judgments, compensated absences, estimated liability for municipal solid waste landfill closure and post-closure maintenance costs, etc.

- No adequate year-end closing procedures are made to account for all transactions affecting all funds.

- No adequate segregation is made between items representing actual accounts payable and those representing outstanding encumbrances. Accordingly, material amounts of unrecorded liabilities are generally recorded at fiscal year-end.

- The management of the federal programs administered by the Municipality maintains separate accounting records for each federal program, which are not reconciled with the UAS (the official accounting system of the Municipality).

- No adequate and complete accounting records are kept for inter-fund balances and transactions.

- The audit adjustments resulting from Single Audits are not completely posted in the UAS.

The basic financial statements of the Municipality must be prepared using the financial information obtained from various municipal departments and accounting records outside of the official UAS, and from information obtained from regulators and independent third parties. In addition, the Department of Finance does not maintain accounting records and working papers supporting the balances and disclosures reported in the basic financial statements, principally those related to government-wide financial reporting.

The Department of Finance does not maintain accounting records supporting the following procedures performed as part of the preparation of the basic financial statements of the Municipality:

- The conversion of accounting records from the cash basis of accounting to the modified accrual basis of accounting used by governmental funds;

- The conversion of governmental funds from the modified accrual basis to the accrual basis of accounting used by government-wide financial statements; and

- Working papers and analyses of significant balances reported in the basic financial statements, such as capital assets, accounts receivable (municipal licenses, grants and contributions, etc.), deferred revenues, accounts payable, and long-term obligations (for which the general practice is to rely upon the notifications received from the Government Development Bank for Puerto Rico, the Puerto Rico Treasury Department, the Federal Government and the Municipal Revenue Collection Center for the balance of its outstanding debt and the withholding for its debt service).

CRITERIA:

Article 8.010(b) of Law No. 81 of August 30, 1991, known as the *Autonomous Municipalities Act of Puerto Rico* (Law No. 81), states that the Municipality must maintain its fund accounting in accordance with Accounting Principles Generally Accepted in the United States of America (GAAP), as promulgated by the Governmental Accounting Standards Board (GASB), the National Committee on Governmental Accounting (NCGA) and the Governmental Accounting, Auditing and Financial Reporting book (commonly known as Blue Book).

In addition, Article 8.010(c) of Law No. 81 states that uniform accounting system used by the Municipality must: (1) produce reliable reports and financial statements, (2) provide complete information about the results of operations of the Municipality, and (3) include the necessary internal controls to account all funds, capital assets and other assets of the Municipality.

Furthermore, Section 5 of the *Revised Regulation on Basic Standards for the Municipalities of Puerto Rico*, which were created pursuant to Article 19.011 of Law No. 81 and approved by the Office of the Commissioner of Municipal Affairs, state that the accounting system of the Municipality should include:

- Final entry books that allow for the preparation of month-end summaries of transactions for posting in the original entry records and for the gathering of information needed for the preparation of basic financial statements and other reports;

- Fiscal procedures for the system's operations, establishing proper internal controls and the prevention of irregularities. These procedures should provide for the timely and accurate performance of operations. It should include the necessary records, files, reconciliations, adjustments, closing entries, reports, and all other necessary documentation to support the basic financial statements.

Due to the conditions referred to above, the preparation of the Municipality's basic financial statements as of and for the fiscal year ended June 30, 2008 was more difficult and less efficient than would have been in ordinary circumstances. A significant amount of adjusting entries had to be made to the financial data and reports processed through the UAS in order to properly account for unrecorded transactions and to correct transactions recorded in the wrong accounting period. Since the accounts and other accounting records of the UAS are not designed to provide all the information necessary to prepare the Municipality's basic financial statements, the Municipality had to obtain and process financial data from several sources outside the UAS. These conditions represent material weaknesses in the Municipality's internal controls over financial reporting.

The continued failure to have an adequate accounting system 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:

We recommend the Municipality to explore different alternatives for the implementation of a new accounting system in compliance with all applicable federal and local laws and regulations. This process should include only accounting systems that will enable the Municipality to prepare its basic financial statements in a timely manner and in conformity with GAAP. The systems to be evaluated must provide the necessary financial information that will serve as the basis for the effective control of revenues, disbursements, assets and liabilities, and the reporting of such items in the Municipality's financial statements, including:

- The implementation of a double entry accounting system, the integration of all subsidiary ledgers and the reconciliation with the records maintained for federal funds;

- The preparation of periodic financial reports to be submitted to the Director of finance, the Mayor, the Municipal Legislature and the federal grantors; and

- Adequate training to all accounting personnel to improve the understanding of the system and to promote operational efficiency

The Department of Finance must establish and document new accounting policies and procedures addressed to correct the non-compliance situations referred to above. Accounting policies and procedures shall be promulgated by an appropriate level of management to emphasize their importance and authority. The documentation of such accounting policies and procedures shall be updated periodically according to a predetermined schedule.

08-02 INACTIVE AND UNNECESSARY FUNDS

The Municipality is maintaining an excessive number of funds that have been inactive for a long period. The accounting records include over 96 different funds (25 pertaining to the Special Revenue and 71 pertaining to the Capital Projects Funds) which amounted to $2,286,482, many of which have been inactive or had insignificant movement or operations during the year under audit.

This situation results from the need to analyze and close inactive funds when the fund's objective has been achieved or are no longer of significance. The internal control structure should provide for the accurate maintenance of the books, records, funds and accounts necessary to carry out the Municipality's operations.

CRITERIA:

Article 8.007(b) of the Law No. 81 of August 30, 1991, known as the *Autonomous Municipalities Act of Puerto Rico* (Law No. 81), states that funds without specific fiscal years should be closed when the fund's objectives have been completed.

NCGA Statement No. 1, paragraph 4, states that "governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration".

In addition, the recommended practice on "*Improving the Effectiveness of Fund Accounting*" (2004), issued by the Government Finance Officers Association of the United States and Canada (GFOA), states that it is important in this regard to distinguish accounting from financial reporting. Whereas an accounting system must collect all of the data needed to ensure and demonstrate legal compliance, financial reporting is concerned with only those aspects of compliance that are of importance to users of general purpose external financial reports.

This situation occurred because the Municipality has not analyzed and closed inactive funds and bank accounts when the fund's objectives have been met or are no longer relevant. The continued maintenance of these funds and accounts exposes the Municipality to the unauthorized use of funds from inactive accounts for activities not intended to be financed with these funds. The aforementioned conditions represent material weaknesses in the Municipality's internal controls over financial reporting.

RECOMMENDATION:

The Municipality should close all unnecessary and inactive funds or accounts. Budgetary balances or deficits remaining in those funds should be investigated and properly closed or established by law. The Municipality should determine whether the intended objectives of these funds were met. For all funds that have complied with the requirements, the Municipality should close them. Remaining balances in those funds should be disposed of in accordance with local and federal laws and regulations.

08-03 LACK OF MONITORING AND FRAUD PREVENTION ACTIVITIES

As part of our evaluation of internal controls of the Municipality we noted that the Municipality have not designed, documented nor placed in operations specific internal controls and procedures designed to prevent fraud and certain types of misappropriation of assets, including certain situations that may lead to material inadequate financial reporting. In addition, does not keep verifiable records of the results of monitoring activities performed to avoid embezzlement and the identification and evaluation of the different types of fraud risk factors associated with the Municipality's core processes. The aforementioned conditions represent material weaknesses in the Municipality's internal controls over financial reporting.

CRITERIA:

Article 6.004 of Law No. 81 of August 30, 1991, known as the *Autonomous Municipalities Act of Puerto Rico* (Law No. 81), states the Municipality shall perform interventions, audits and monitoring activities over all municipal operations financed with public funds, including: (1) the acquisition, use and disposition of capital assets, (2) transactions and operations of all administrative units (municipal departments), and (3) all accounts, records, books, contracts, budgets and any other financial activities.

These conditions arose by the lack of effective controls and procedures for the evaluation of significant risk factors in all municipal areas, the lack of proper planning of continued monitoring activities, and the lack of proper allocation of human resources and time schedules to perform the activities required by law.

RECOMMENDATION:

We also recommend the Municipality to prepare a manual of policies and procedures specifically designed to prevent and detect fraud. The Municipality should also keep formal documentation of all fraud prevention and monitoring activities performed by management, including the identification and evaluation of all fraud risk factors. Fraud risk assessments should be reviewed periodically to consider changes in the operating policies of the Municipality and the control environment.

08-04 CASH AND BANK ACCOUNTS

The Municipality has not established sufficient controls in the handling of bank accounts to prevent errors and irregularities from being timely detected. The following control deficiencies were noted during our examination:

a) Reconciling items or differences have been outstanding for more than one year without adequate explanation. The bank reconciliations are the following:

BANK ACCOUNT NAME	RECONCILING ITEMS AMOUNT
• Cuenta corriente	$ 2,682
• Empréstito $10,450,000	123,687
	$ 126,369

RECOMMENDATION:

Monthly bank reconciliations are a strong internal control feature over cash and could indicate any potential misapplications of cash. We recommend the Municipality identify and resolve reconciling items each month in order to provide a more accurate accounting of cash accounts, enhance the internal controls over the cash function, and improve cash management.

b) Checks totaling $1,613, as of June 30, 2008, have been outstanding for more than one year. The bank reconciliations are the following:

Account Name	Amount
Payroll Account	$1,613

RECOMMENDATION:

The Municipality should improve its control procedures over bank reconciliations to record the necessary adjustments when there are outstanding checks for more than one year. Stop payments should be issued to cancel checks outstanding over twelve months. Such checks should be substituted with new checks and deposited in the appropriate accounts in order to make the funds available to the Municipality.

08-05 PERSONNEL FILES AND RELATED PAYROLL PROCEDURES

During our audit, we tested a sample of 40 employee files and noted that several files lacked documentation supporting the employee's salary, status or eligibility. The following exceptions were noted during our examination:

Health examinations	2 files	5%
Employee evaluations	33 files	83%
Job Description OCAP-16	11 files	28%
Good Behavior certificate	5 files	13%
Regular or sick leave records	4 files	10%
Drug detection tests	3 files	8%
Child Support Form ASM-5	4 files	10%
PR Retirement System Documents	13 files	33%
Birth Certificate	2 files	5%
Change Report GMB-OP-15	3 files	8%
Copy of Social Security	2 files	5%

RECOMMENDATION:

The Personnel Department should review each employee file and ascertain their completeness. Management could design a standard checklist where the file reviewer could determine if documents are missing from each file. Signed exemptions certificates and authorizations for non-statutory withholdings should always support the amounts withheld from employees.

08-06 UNAUTHORIZED USE OF NEXT FISCAL YEAR'S MUNICIPAL LICENSE REVENUE

Municipal license tax revenues of the fiscal year 2008-2009, which were collected in advance from taxpayers between January 1 and June 30, 2008 (known in Spanish as "Patente en Suspenso"), were used by the Municipality to cover certain operating costs and cash flows shortages of the general fund incurred during the fiscal year ended June 30, 2008. Such unearned municipal license tax revenues amounted to $10,644,950 and were related to the Volume of Business Declaration Return of the fiscal year 2008-2009 which were filed by taxpayers between January and June 2008.

Those unearned revenues collected in advance pertain to the general fund's operating budget of the fiscal year 2008-2009, could not be used to pay obligations of the fiscal year 2007-2008 and were not authorized by a municipal ordinance or resolution.

The foregoing condition is primarily due to the following reasons:

- During prior fiscal years, the general fund's expenditures have exceeded its revenues consistently, which have lead the Municipality to also consistently consume in each fiscal year, the unearned municipal license revenues collected in advance for the next fiscal year.

- The Uniform Accounting System (UAS) does not provide for the gathering and recording of accurate financial information and preparation of accurate financial reports on a timely basis. Therefore, since current financial information is not readily available, management is not able to make effective and efficient decisions concerning the use of resources.

- The Municipality does not prepare cash flows forecasts and projections to anticipate any cash flows shortage.

- Management does not have timely and accurate information regarding its operations and cannot monitor the adherence to the established budget appropriations and cash flows.

- The Municipality is appropriating expenditures assuming that budgeted revenues have been actually collected.

- The budgeting system does not reflect actual revenues, therefore cannot prevent the obligation of expenditures for which current resources will not be available.

The continued occurrence of this situation will result in possible significant general fund limitations and eventual reduction or elimination of municipal services since future revenues will need to be used to pay for accumulated liabilities. The aforementioned conditions represent a material weakness in the Municipality's internal controls over financial reporting.

CRITERIA:

Article 8.004(b) of Law No. 81 of August 30, 1991, known as the *Autonomous Municipalities Act of Puerto Rico* (Law No. 81) states that the Municipality cannot use or obligate any amount in a given fiscal year that exceeds the appropriations and the resources authorized by ordinance or resolution for such fiscal year. In addition, the Municipality cannot be committed, in any form, to any contract or negotiation for the future payment of amounts that exceed the current fiscal year's budgeted resources.

RECOMMENDATION:

We recommend the Municipality to prepare cash flows forecasts and projections to anticipate any cash flows shortages and to avoid using financial resources of future fiscal years to cover the operating needs of the current fiscal year.

We also recommend that annual budgets must be 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 budgets are prepared. This process must ensure that the operational budget of the general fund is adjusted for uncollected budgeted revenues.

Section III - Federal Award Findings and Questioned Costs

Program	Findings/Noncompliance Recommendations	Questioned Cost
	GENERAL MATTEES APPLICABLE TO MORE THAN ONE PROGRAM	
All Federal Programs	**08-07 FEDERAL FINANCIAL REPORTS**	
	The accounting records maintained by the Federal Programs Office are not reconciled with the accounting records maintained by the Municipality's central accounting department records. The Municipality has not established procedures for the reconciliation of the transactions recorded in the Program's accounting records with those recorded in the Municipality's central accounting department records. As a result, this condition may lead to inaccurate reporting of programs supported activities.	NONE
	Criteria:	
	OMB Circular A-102, 20 (b) (2) requires recipient of federal funds to have a financial management system that provides for the maintenance of accurate, current and complete records of the financial esults of federally assisted activities in accordance with the financial reporting requirements of the Federal Program. The Municipality should prepare federal financial reports based on the Programs underlying accounting records.	
All Federal Programs	**08-08 EQUIPMENT AND REAL PROPERTY MANAGEMENT**	
	Statement of Condition:	
	The Municipality has not complied with the property management requirements. There were no physical inventories performed during the fiscal year ended June 30, 2008.	
	The Federal Programs has subsidiary ledger of equipment acquired with federal funds, however, such subsidiary ledger does not comply with federal requirements because it does not: (1) have information needed to calculate the federal share of the cost of the equipment, (2) have information about the identification number of the asset, such as the manufacturer's serial numbers, (3) identify the grant under which the program acquired the equipment, (4) have information about the location, use and condition of the	

equipment and the date the information was obtained, and (5) have all pertinent information on the ultimate transfer,

Program	Findings/Noncompliance Recommendations	Questioned Cost

replacement, or disposal of the equipment (6) have information about acquisition date and unit acquisition cost.

Furthermore, there is no evidence that the total amount of capital expenditures and the composition of capital assets incurred by Federal Programs have been reconciled with the general ledger or other control account to enhance the controls to prevent unauthorized disposition of assets.

Criteria:

29 CFR 97.32 (d) (2) established that the Municipality should take the physical inventory and reconcile the results with the property records. In addition, section (d) (3) establishes that a control system must be developed to ensure adequate safeguards to prevent loss, damage, or theft of the property.

Federal regulations also require that, every two years, at a minimum, a physical inventory shall be conducted and the results shall be reconciled with property records to verify the existence, current utilization, and continued need for the equipment. Any discrepancies between quantities determined by the physical inspection with those shown in the accounting records shall be investigated to determine the causes of the differences. Property records shall be accurate. Property records shall include the following for each item:

- A description of the equipment including manufacturer's serial numbers.
- Identification number, as the manufacturer's serial numbers.
- Identification of the grant under which the recipient acquired the equipment.
- The information needed to calculate the federal share of the cost of the equipment.
- Acquisition date and unit acquisition cost.
- Location, use and condition of the equipment and the date the information was obtained.
- All pertinent information on the ultimate transfer, replacement or disposal of the equipment.

Program	Findings/Noncompliance Recommendations	Questioned Cost
	Recommendation: A physical inventory of the Federal Programs capital assets should be taken as soon as possible. Physical inventory amounts should be reconciled with the property recorded on the subsidiary ledgers. This information should be reconciled with the monthly disbursements made against the budgetary accounts used for property acquisitions. Dispositions must also be made only upon approval of the Municipal Property Administrator and the Finance.	
Child and Care Food Program CFDA No. 10.558	**08-09 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $112,199, during the fiscal year. There were months which reported balances as high as $131,929, at the end of the month. Criteria: Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs. Recommendation: In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.	NONE
Emergency Shelter CFDA No. 14.231	**08-10 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $12,162, during the fiscal year. There were months which reported balances as high as $67,257, at the end of the month.	NONE

Program	Findings/Noncompliance Recommendations	Questioned Cost
	Criteria: Federal Regulation required that grantees shall conform to the standards applicable to advances from Federal Agencies. Amounts requested should be limited to the Program's immediate cash needs. Recommendation: In accordance with Federal Regulations, the Municipality should estimate drawdown of Federal funds as closely as possible to the actual disbursements.	
Child Care CFDA No. 93.575	**08-11 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $8,252, during the fiscal year. There were months which reported balances as high as $44,385, at the end of the month. Criteria: Federal Regulation required that grantees shall conform to the standards applicable to advances from Federal Agencies. Amounts requested should be limited to the Program's immediate cash needs. Recommendation: In accordance with Federal Regulations, the Municipality should estimate drawdown of Federal funds as closely as possible to the actual disbursements.	NONE
SBGP Program CFDA NO. 14.219	**08-12 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. During our review of the request of funds performed during the year, we noted	

the following deficiencies: NONE

a. From 83 request of funds performed during the year 25 (30%) disbursements has a delay of 10 days or more between the funds receipt date and the disbursement date.

Criteria:

Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Programs immediate cash needs.

Recommendation:

In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.

SBGP
CFDA NO. 14.219

08-13 FEDERAL CASH MANAGEMENT SYSTEM

Statement of Condition:

The Municipality has not established effective cash management procedures. During our review of the Program's disbursements, the following exception was noted: NONE

a. The bank account maintained a book overdraft amounting to $510, since the Program issue checks in excess of bank balance for such amount during the month of September 2007.

Criteria:

Federal regulations require that Grantee shall conform to the standards applicable to advances from Federal agencies. Amounts requested should be limited to the Program's immediate cash needs.

Recommendation:

In accordance with Federal regulations, the Municipality should estimate drawdowns of Federal funds as closely as possible to the actual disbursements.

SBGP
CFDA No. 14.219

08-14 INADEQUATE DOCUMENTATION OF PARTICIPANT FILES

Statement of Condition:

As part of our test to determine whether the grantee assure that the rehabilitation work is properly completed; we selected a sample of 31 participants. The following documents were not available for examination:

NONE

1. Inspection of the rehabilitation work upon completion	21 Files	68%
2. Evidence of construction material return	1 File	3%

Criteria:

According to 24 CFR, 570.506 the grantee must assure that the work is properly completed. For each residential rehabilitation activity the following records are needed:

a) Re-habilitation contract describing the deficiencies in each structure to be corrected.

b) An inspection of the rehabilitation work upon completion to assure that it was carried out in accordance with contract specifications.

Recommendation:

The Municipality must inspect the rehabilitation work upon completion to assure that it is carried out in accordance with the contract specifications.

SBGP
Program year 2000
Program year 2002
CFDA No. 14.219

08-15 EARMARKING REQUIREMENT

Statement of Condition:

As of June 30, 2008, the Municipality expended less than 70 percent of the funds over a period of up to three years, for activities that benefit low-and moderate-income persons as required by the federal regulation.

NONE

Program	Findings/Noncompliance Recommendations	Questioned Cost
	Criteria: According to 24 CFR, 570.420(e) and 570.430 the grantee must assure hat not less than 70 percent of the funds must be used over a period of up to three years, as specified by the grantee in its certification, for activities that benefit low-and moderate-income persons. Recommendation: The Municipality should establish procedures to ascertain that comply with the earmarking requirement in accordance with 24 CFR sections 570.420 and 570.430.	
Even Start CFDA No. 84.213	**08-16 FEDERAL CASH MANAGEMENT SYSTEM** Statement of Condition: The Municipality has not established effective cash management procedures. The program has an average cash balance of $13,584, during the fiscal year. There were months which reported balances as high as $89,889, at the end of the month. Criteria: Federal Regulation required that grantees shall conform to the standards applicable to advances from Federal Agencies. Amounts requested should be limited to the Program's immediate cash needs. Recommendation: In accordance with Federal Regulations, the Municipality should estimate drawdown of Federal funds as closely as possible to the actual disbursements.	NONE
	Total Questioned Costs	NONE

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Summary schedule of prior years audit findings
Fiscal Year 2006-2007
June 30, 2008

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance and Internal Control Based on the Audit of the General Purpose Financial Statements for Performed in Accordance with Government Auditing Standards for the Fiscal Year ended June 30, 2007. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2007-2008).

NR - Not resolved yet. Finding repeated in fiscal year 2007-2008.

Finding Number	Title	Corrective Action Taken
07-01	Deficiencies in the Uniform Accounting System and other Accounting Records	NR
07-02	Inactive and Unnecessary Funds	NR
07-03	Lack of monitoring and fraud prevention activities	NR
07-04	Cash and bank accounts	FR
07-05	Municipal license tax	FR
07-06	Disbursement test	NR
07-07	Personnel files and related payroll procedures	FR
07-08	Cash receipt test	FR

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Summary schedule of prior years audit findings
Fiscal Year 2006-2007
June 30, 2008

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in accordance with OMB Circular A-133 for the Fiscal Year ended June 30, 2007. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2007-2008).

NR - Not resolved yet. Finding repeated in fiscal year 2007-2008.

Finding Number	Title	Corrective Action Taken
07-09	Federal financial reports	NR
07-10	Procurement, suspension and debarment	FR
07-11	Equipment and Real Property Management	NR
07-12	Federal cash management system	FR
07-13	Federal cash management system	NR
07-14	Federal cash management system	NR
07-15	Federal cash management system	PR
07-16	Financial reporting	FR
07-17	Inadequate documentation of participant files	NR
07-18	Earmarking Requirement	NR
07-19	Matching, level of effort and earmarking	FR

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Summary schedule of prior years audit findings
Fiscal Year 2005-2006
June 30, 2008

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance and Internal Control Based on the Audit of the General Purpose Financial Statements for Performed in Accordance with Government Auditing Standards for the Fiscal Year ended June 30, 2006. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2007-2008).

NR - Not resolved yet. Finding repeated in fiscal year 2007-2008.

Finding Number	Title	Corrective Action Taken
06-01	Deficiencies in the Uniform Accounting System and other Accounting Records	NR
06-02	Inactive and Unnecessary Funds	NR
06-03	Lack of monitoring and fraud prevention activities	NR
06-04	Municipal license tax	FR
06-05	Disbursement test	FR
06-06	Personnel files and related payroll procedures	NR
06-07	Cash receipts test	FR
06-08	Bidding procedures	FR

COMMONWEALTH OF PUERTO RICO
MUNICIPALITY OF CATAÑO
Summary schedule of prior years audit findings
Fiscal Year 2005-2006
June 30, 2008

The following schedule contains the finding number and title of each of the findings included in the Report on Compliance with Requirements Applicable to Each Major Program and Internal Control over Compliance in accordance with OMB Circular A-133 for the Fiscal Year ended June 30, 2006. Under the heading Corrective Action Taken there will be the following:

FR - Fully resolved (indicating the corrective action plan was fully implemented).

PR - Partially resolved (indicating the corrective action plan was partially implemented and the finding repeated in fiscal year 2007-2008).

NR - Not resolved yet. Finding repeated in fiscal year 2007-2008.

Finding Number	Title	Corrective Action Taken
06-09	Accounting system	NR
06-10	Federal cash management system	FR
06-11	Federal cash management system	FR
06-12	Federal cash management system	NR
06-13	Federal cash management system	NR
06-14	Federal cash management system	PR
06-15	Financial Reporting	FR
06-16	Inadequate documentation of participant files	NR
06-17	Davis-Bacon Act	FR
06-18	Earmarking Requirement	NR
06-19	Equipment and Real Property Management	NR