

Financial Oversight and Management Board
for Puerto Rico

Financial Bridge Analysis

March 7, 2017



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Introduction



Overall support and acknowledgement

As a part of this mandate, the EY team was provided open access to the majority of the relevant parties as well as the data available for FY14 - FY17. We want to acknowledge the assistance provided by the Government team in the preparation of our Report.

It is important to emphasize that the comments in the Report about the lack of adequate supporting information are not meant to be critical of the Government team or any of the advisors, but to underscore the point that the quality of information especially for FY15 and FY16 is still subject to significant changes which makes a meaningful comparison to FY17 very challenging.

We thank the following teams that we met with while preparing this Report:

- Hacienda - (Raul Maldonado Gautier, Roxana Cruz, Omar Rodriguez, Reylam Guerra Goderich)
- AAFAF - (Gerardo Portela, Mohammad Yassin Mahmud)
- Office of Management and Budget ("OMB") - (Jose Marrero, Jose Rodriguez, Rebeca Maldonado Morales)
- Conway Mackenzie
- KPMG

EY's scope included an analysis of the Bridge methodology, documentation, and historical trends to comment on FY17 projections

EY Scope	Approach
<p>Methodology and adjustments</p>	<ul style="list-style-type: none"> Analyzed Bridge methodology to ensure consistency of entities included and comparability of actual financial results to projections Analyzed adjustments made to normalize historical financial information: <ul style="list-style-type: none"> Exclusion of debt service, capital expenditures and retirement contributions One-time items and excluded entities Working capital adjustments Analyzed Governmental Funds and Component Units separately
<p>Substance of Bridge documentation</p>	<ul style="list-style-type: none"> Comparison of FY14 Audited Financial Statements (or "Audited Financial Statements") to Bridge amounts Comparison of FY17 Budget prepared by the Government to FY17 Fiscal Plan projections prepared by the Government and dated December 20, 2016 (the "Fiscal Plan," "Plan," or "FY17 Plan") and to Bridge amounts Analyzed source information used to present FY15 and FY16 financial results, including system-generated data, system adjustments and manual adjustments
<p>Historical revenue and expenditure trends</p>	<ul style="list-style-type: none"> Analyzed historical revenues by source Analyzed historical expenditures by agency and by expense type Compared historical trends (FY14 - FY16) to FY17 projections Majority of the effort was expended on the analysis of normalized Governmental Funds revenues and expenditures, as defined in the Bridge

Bridge Analysis



Key Takeaways

1

The Bridge was prepared by the Government at the request of the Board to confirm the Government's baseline projections for FY17. While the FY14 financial results are audited, the FY15 and FY16 information in the Bridge relies on material adjustments and estimates made by the Government that are still preliminary

2

FY17 general fund revenues are in line with historical and year-to-date trends:

- The increase in Sales and Use Tax as a result of the increase in rates in FY16 has been mostly offset by a constant decline in Income Taxes from FY14 to FY17

3

FY17 general fund expenditures could be understated by a range of \$360m to \$810m, based on:

- Government's Fiscal Plan observations that cost of Government has not decreased
- Analysis of historical trends of normalized general fund expenditures
 - A hypothetical extrapolation of historical general fund expenditures suggests a potential understatement of FY17 general fund expenditures in the range of \$467m to \$809m
- Discussions with the Government

Key Takeaway 1: FY15 and FY16 information relies on material adjustments and estimates made by the Government that are still preliminary

Source of FY15 and FY16 information

- The FY15 and FY16 data was initially sourced from the Commonwealth Financial Information and Operating Data Report dated December 2016
- The Government determined that this source had significant estimates and adjustments, making it unreliable, and decided to source it instead from system-generated data

Material weaknesses in FY15 and FY16 data

- The FY15 system-generated data is preliminary and subject to audit and other adjustments
- The FY16 system-generated data requires account reconciliations and adjustments to become a more reliable source
- The information presented in the Bridge includes the Government's significant adjustments to the system-generated data, and includes material estimates without adequate supporting documentation
 - Accrual and other adjustments have not been completed for FY16. The Government's assumption in the Bridge is that FY16 accrual adjustments will be the same as FY15 adjustments
 - Certain FY16 accounts were adjusted to reflect a consistent trend as compared to FY15, without further documentation
 - Certain FY15 entries were reclassified to FY16 as a result of an incorrect bank reconciliation adjustment

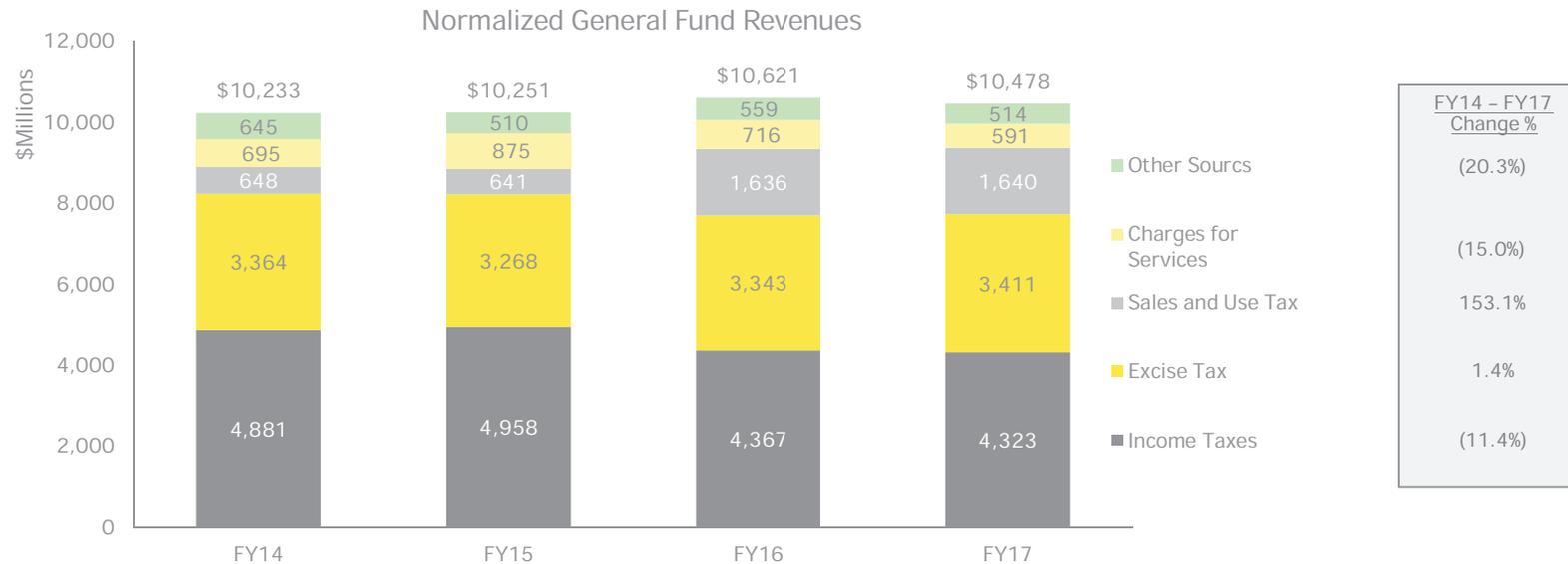
The absolute value of manual adjustments to system-generated data were as follows:

- \$663m in FY15
- \$1,668m in FY16

Key Takeaway 2: FY17 general fund revenues are in line with historical and year-to-date trends

The following chart represents the "Normalized General Fund Revenue" (includes Special Revenue Fund Revenues), broken out by major revenue sources (inclusive of applicable adjustments).

General Fund revenues show a modest increase from FY14 to FY17, driven by the increase in SUT rate, which was mostly offset by decreases in income taxes and other revenues

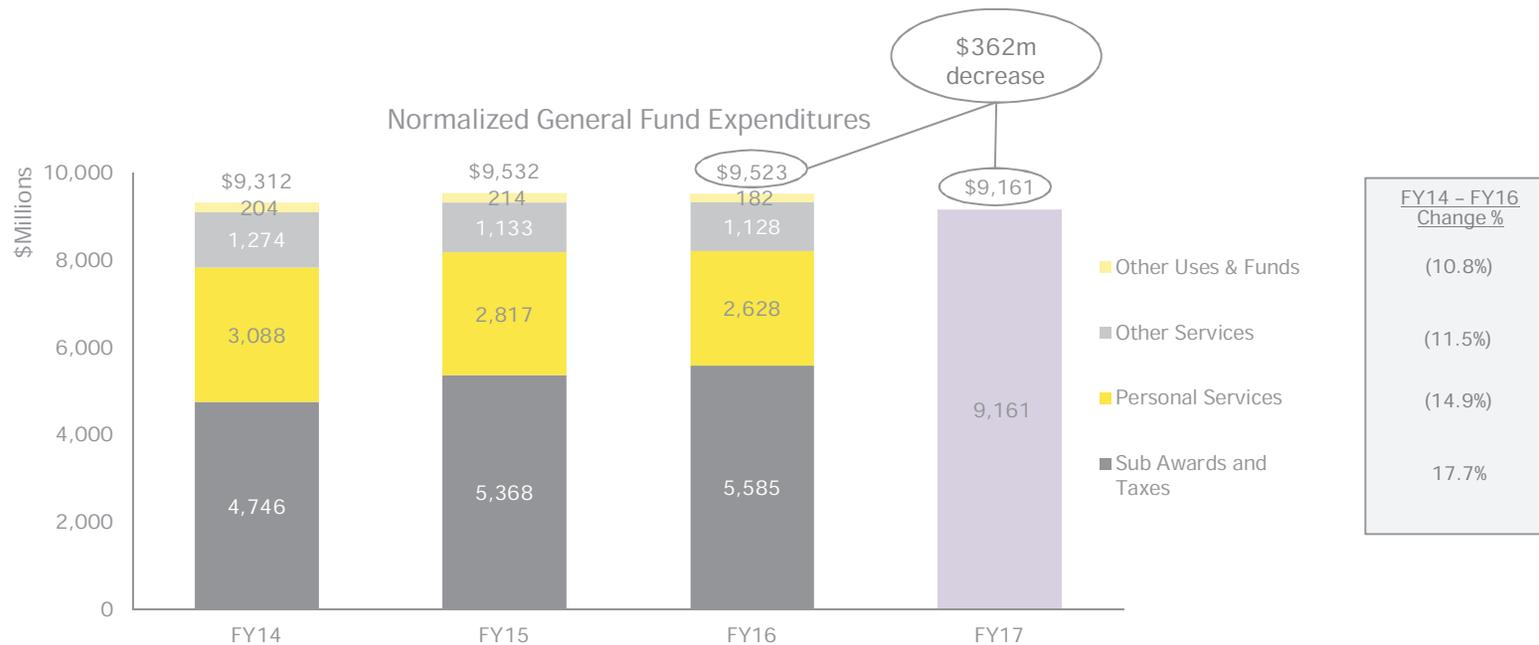


Source: PRIFAS, Fiscal Plan

Key Takeaway 3: FY17 expenditures could be understated by a range of \$360m to \$810m FY17 general fund expenditures show a \$362m reduction as compared to FY16

The following chart represents the "Normalized General Fund Expenditures" (includes Special Revenue Fund Expenditures) broken out by major expenditure categories (inclusive of applicable adjustments). Note that data for FY17 is not available in comparable detail.

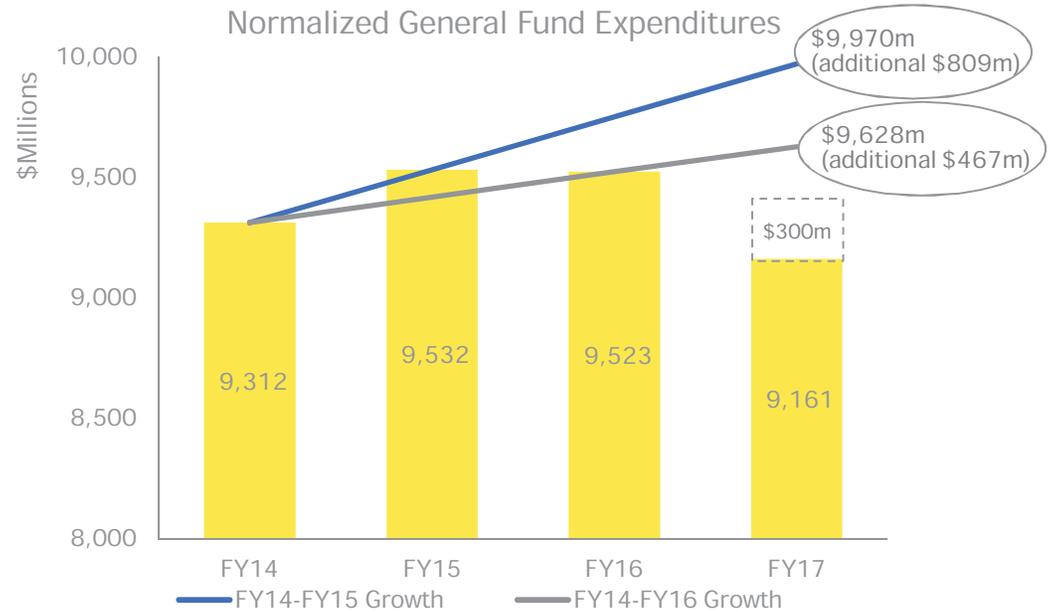
Total operating expenditures have increased from FY14 to FY16 despite reductions in payroll and other services



Source: PRIFAS, Fiscal Plan Comparison to Historical Results

Key Takeaway 3: A hypothetical extrapolation of historical expenditures suggests a potential understatement in the range of \$467m to \$809m

- A hypothetical extrapolation of historical general fund expenditures suggests a potential understatement of general fund expenditures in the FY17 projections
 - A two year trend (FY14-FY16) results in FY17 expenditures of \$9,628m, a potential understatement of \$467m
 - A two year trend (FY14-FY15) results in FY17 expenditures of \$9,970m, a potential understatement of \$809m
- It is important to note that the FY17 expenditures of \$9,161 exclude a "Reconciliation Adjustment" of \$300m, that would partially offset the potential understatement



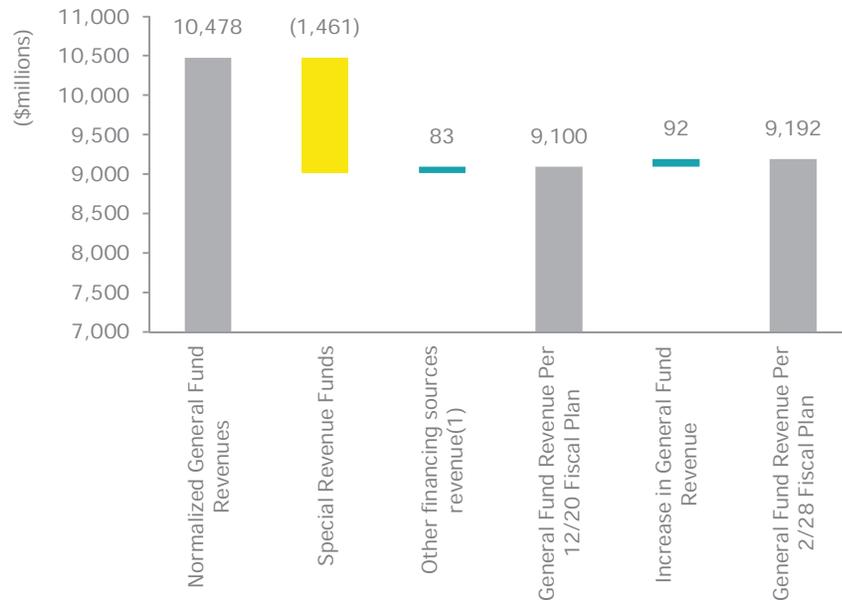
Source: Fiscal Plan Comparison to Historical Results

- The potential expenditure understatement could be mitigated by expenditure reduction initiatives undertaken by the Government since FY15, including but not limited to:
 - School consolidations and reduction in school transportation costs
 - Payroll expense reductions (attrition, Christmas bonus, elimination of excess sick leave payment)
 - Freeze of automatic increases on budget formulas and CBA wage increases
- The financial impact of these initiatives remains uncertain. However, the Fiscal Plan indicates that:
 - The cost of government has increased (page 5 of Fiscal Plan)
 - The reduction in public sector workforce has not translated to payroll-related expenditure reductions given the employment of temporary hires and compensation raises (page 39 of Fiscal Plan)

Various adjustments were made to walk from the normalized General Fund revenues and expenditures in this report to the 2/28 Fiscal Plan projections

Normalized revenues to 2/28 Fiscal Plan

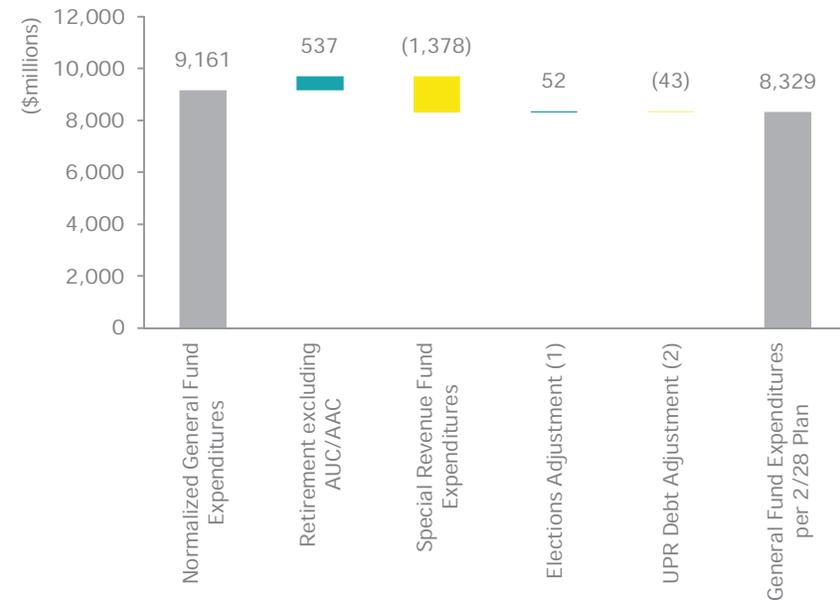
- The chart below details the walk from normalized general fund revenues to general fund revenues in the 2/28 Fiscal Plan
- Revenue in the 2/28 Fiscal Plan increased by \$92m when compared to the December Fiscal Plan reflecting an update based on year-to-date activity



(1) Other Financing Sources revenue was excluded from the bridge

Normalized expenditures to 2/28 Fiscal Plan

- The chart below details the walk from normalized general fund expenditures to general fund expenditures in the 2/28 Fiscal Plan
- General Fund Expenditures remain at the same level in the two Fiscal Plans



(1) "Elections" expenses were excluded from the Bridge as they only occur every fourth year

(2) Given that the University of Puerto Rico ("UPR") cannot make debt payments without the appropriated funds from the Government, the Fiscal Plan treats \$43m of the UPR appropriation as debt. For purposes of the Bridge, the \$43m was included to be more comparable to historical years

Source: Fiscal Plan Comparison to Historical Results, 2/28 Fiscal Plan

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