

Financial Oversight and Management Board  
for Puerto Rico

Financial Bridge Analysis

March 7, 2017



## Disclaimer

This report (the "Report") has been prepared by Ernst & Young Puerto Rico LLC ("EY"), from information and material supplied by the Oversight Board (or the "Board") and the Government of Puerto Rico and its advisors (collectively, the "Government") for the sole purpose of assisting the Board in analyzing the Fiscal Plan Comparison to Historical Results (the "Bridge") prepared by the Government.

The nature and scope of our services was determined solely by the Agreement between EY and the Board dated 15 February 2017 (the "Agreement"). Our procedures were limited to those described in that Agreement. Our work was performed only for the use and benefit of the Board and should not be used or relied on by anyone else. Other persons who read this Report who are not a party to the Agreement do so at their own risk and are not entitled to rely on it for any purpose. We assume no duty, obligation or responsibility whatsoever to any other parties that may obtain access to the Report.

The services we performed were advisory in nature. While EY's work in connection with this Report was performed under the standards of the American Institute of Certified Public Accountants (the "AICPA"), EY did not render an assurance report or opinion under the Agreement, nor did our services constitute an audit, review, examination, forecast, projection or any other form of attestation as those terms are defined by the AICPA. None of the services we provided constituted any legal opinion or advice. This Report is not being issued in connection with any issuance of debt or other financing transaction.

In the preparation of this Report, EY relied on information provided by the Board, the Government or publicly available resources, and such information was presumed to be current, accurate and complete. EY has not conducted an independent assessment or verification of the completeness, accuracy or validity of the information obtained. Any assumptions, forecasts or projections contained in this Report are solely those of the Government and any underlying data were produced solely by the Government.

The Board has the knowledge, experience and ability to form its own conclusions. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected and those differences may be material. EY takes no responsibility for the achievement of projected results.

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

## EY worked closely with the Government team to analyze the detailed information supporting the Bridge

### On-Site Work

- EY's restructuring team commenced work in San Juan on February 15 and has worked full-time at the Hacienda offices
- EY submitted a detailed data/document request to the Government, and, as discussed on the prior pages, these parties were generally timely and diligent in fulfilling this request to the extent the information was readily available

### Analyzed public, private, and system-generated data to provide observations on methodology and trends

- EY analyzed several publicly available documents as well as financial models/forecasts and various reports generated through the Government's systems
- EY evaluated the consistency of information presented for the Governmental Funds and Component Funds

### FY14 – FY17 Bridge

- Encouraged enhanced mapping of actual results to Fiscal Plan and documentation of adjustments made to historical results sourced from the Government system
- Improved Bridge format to present revenues and expenditures by category, allowing for better visibility into trends
- Majority of the effort was expended on the analysis of normalized Governmental Funds revenues and expenditures, as defined in the Bridge

# Executive Summary





## 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

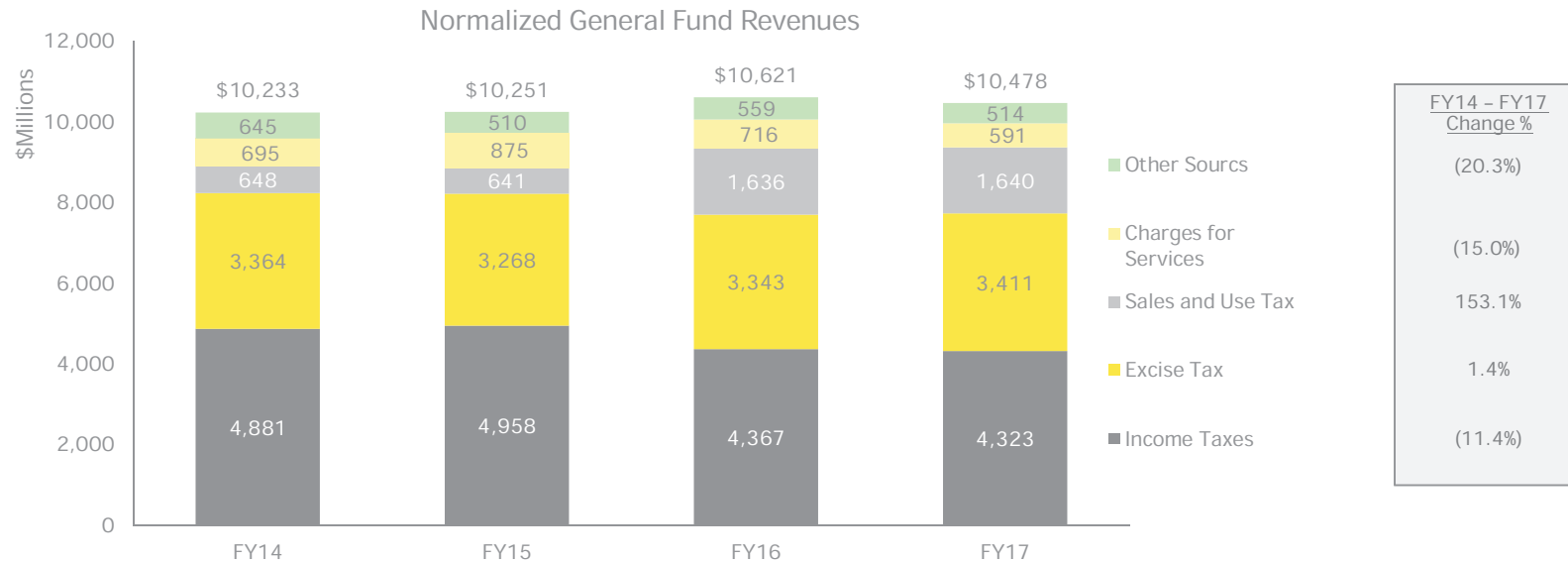
The absolute value of manual adjustments to system-generated data were as follows:

- \$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

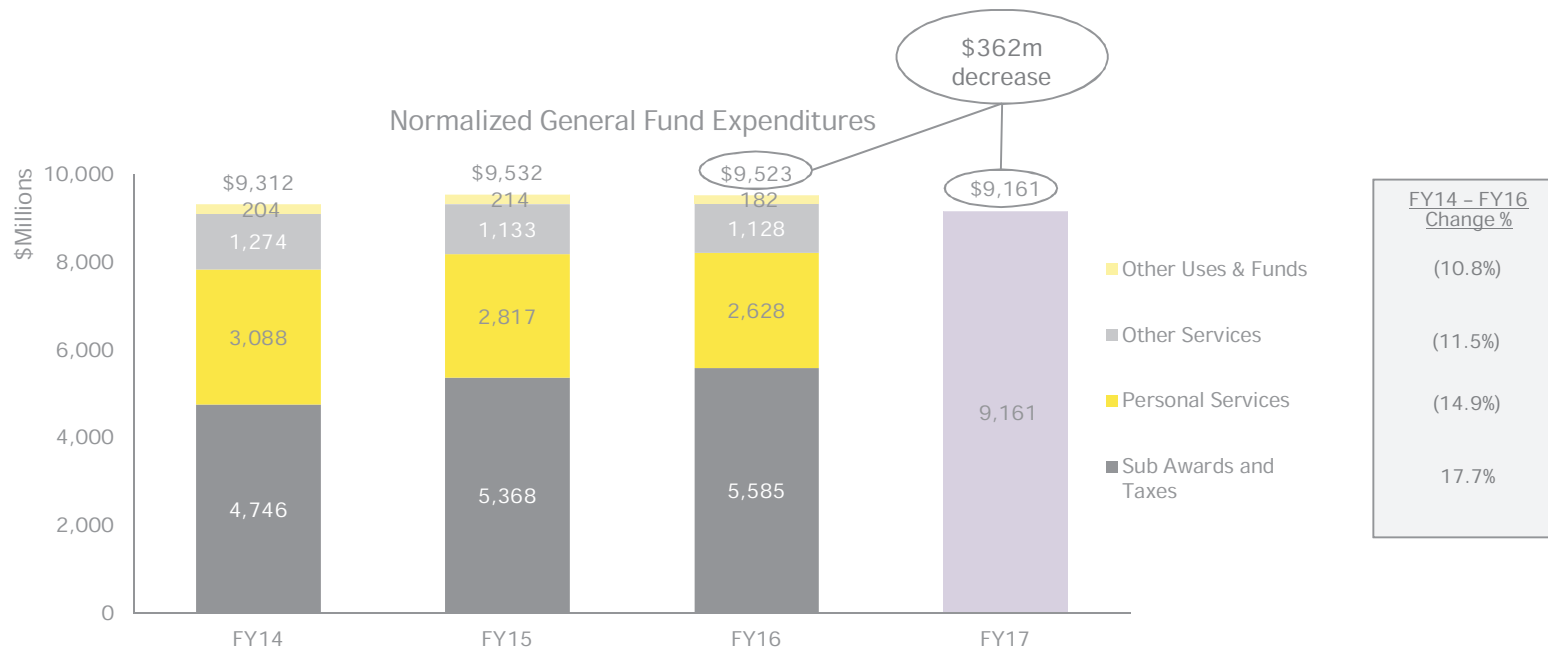


Source: PRIFAS, Fiscal Plan

## 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.

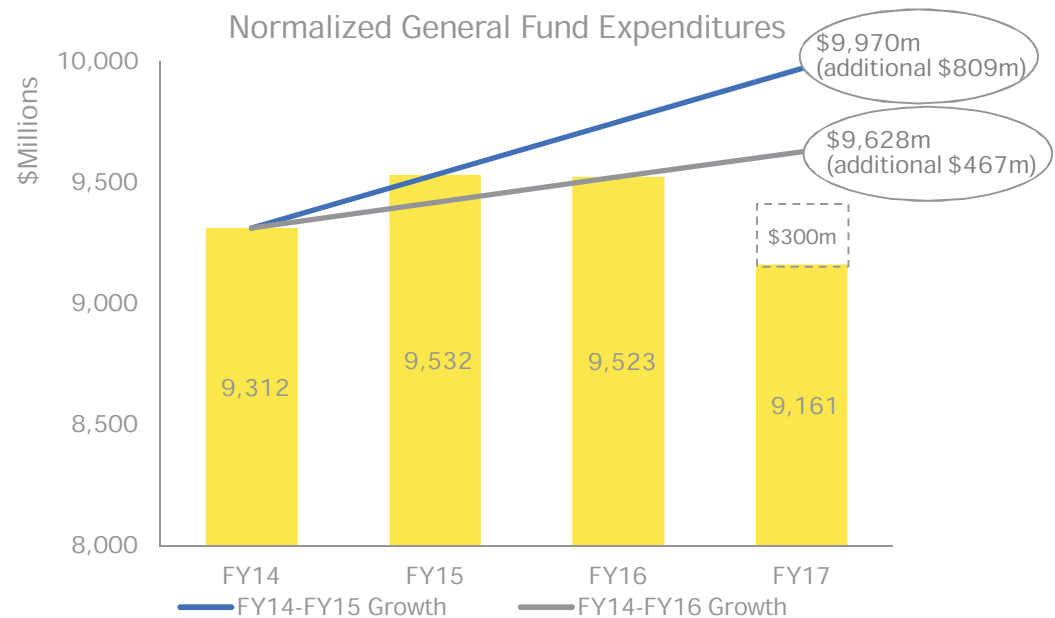
Total operating expenditures have increased from FY14 to FY16 despite reductions in payroll and other services



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)

# Bridge Analysis



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# Summary version of the Bridge as provided on February 28<sup>th</sup>

Fiscal Plan Governmental Funds Projections - Modified Accrual (\$ millions)					
		Historical			Fiscal Plan
		2014A	2015A	2016A	2017P
<u>Governmental Funds Revenues</u>					
1	General Fund Revenue	\$10,644	\$10,511	\$10,792	\$10,496
2	Federal Funds Revenue	6,093	6,216	5,986	6,020
3	Adjustments	(411)	(260)	(171)	(18)
4	Subtotal General Fund	16,326	16,466	16,607	16,498
5	Other Governmental Funds Revenue	\$826	\$883	\$954	\$942
6	Adjustments	(53)	(55)	(57)	(117)
7	Subtotal Other Governmental Funds Revenue	773	828	896	825
8	Adjusted Governmental Funds Revenues (Lines 4 + 7)	\$17,099	\$17,295	\$17,503	\$17,323
<u>Governmental Funds Expenditures</u>					
9	General Fund (ex. Debt Service, Capital, Pensions and SUT (FAM portion)	\$10,182	\$10,139	\$9,974	\$9,698
10	Federal Funds Expenditures	5,766	5,930	5,954	6,000
11	Adjustments	(870)	(607)	(451)	(537)
12	Subtotal General Fund (ex. Debt Service, Capital, Pensions and SUT (FAM portion)	15,079	15,462	15,477	15,161
13	General Fund (Debt Service, Capital, Pensions and SUT (FAM portion)	2,324	351	105	2,695
14	Adjustments	(2,296)	(331)	(77)	(2,695)
15	Subtotal General Fund (Debt Service, Capital, Pensions and SUT (FAM portion)	28	21	28	-
16	Subtotal General Fund	15,106	15,482	15,505	15,161
17	Non-major Governmental Funds	\$3,096	\$2,942	\$2,341	\$159
18	Adjustments	(2,932)	(2,817)	(2,203)	-
19	Subtotal Non-major Governmental Funds	164	125	138	159
20	Adjusted Governmental Funds Expenditures (Lines 16 + 19)	\$15,270	\$15,607	\$15,643	\$15,320
21	Normalized Governmental Funds, Net (Lines 8 - 20)	\$1,829	\$1,687	\$1,860	\$2,003

Memo: For purposes of illustrative analysis, Federal Funds Revenue and Expenditures were excluded to normalize revenues and expenditures.

22	Normalized Revenues (Lines 4 - 2)	\$10,233	\$10,251	\$10,621	\$10,478
23	Normalized Expenditures (Lines 12 - 10)	\$9,312	\$9,532	\$9,523	\$9,161

Source: Fiscal Plan Comparison to Historical Results

FY14 is based on audited financials. Material assumptions and adjustments impact the reliability of the FY15 and FY16 results

	FY14	FY15	FY16	FY17
Source of Data	<ul style="list-style-type: none"> <li>Revenue: 2014 Audited Financial Statements, Commonwealth report</li> <li>Expenditures for General Fund: Based on the 2014 Audited Financial Statements and the Commonwealth report. Itemization was prepared by Government.</li> <li>Expenditures for Blended Component Units: 2014 Audited Financial Statements</li> </ul>	<ul style="list-style-type: none"> <li>Revenues and Expenditures where system-generated</li> <li>System data contains most adjustments but is lacking audit adjustments</li> </ul>	<ul style="list-style-type: none"> <li>Both Revenues and Expenditures where system-generated</li> <li>FY16 data is very preliminary and required significant adjustments</li> </ul>	<ul style="list-style-type: none"> <li>Fiscal Plan</li> </ul>
Quality of data	<ul style="list-style-type: none"> <li>High for Revenue and blended component units</li> <li>Medium for Expenditures. Itemization prepared by Government and cannot be verified via the 2014 Audited Financial Statements</li> </ul>	<ul style="list-style-type: none"> <li>Low - Audit adjustments have not been yet developed and recorded</li> </ul>	<ul style="list-style-type: none"> <li>Low - Government needs to reconcile accounts and record adjustments to get the data to be audit-ready</li> </ul>	<ul style="list-style-type: none"> <li>Based on FY17 Budget</li> <li>Expenditures could be understated</li> </ul>
Discrete Component Units ("CU") source of Data	<ul style="list-style-type: none"> <li>FY14 data based on the 2014 Audited Financial Statements and the financial statements of the individual CUs</li> </ul>	<ul style="list-style-type: none"> <li>Certain CUs have audited financials and others have draft audits</li> </ul>	<ul style="list-style-type: none"> <li>Data for some is unavailable, for others it is either system-generated or draft audit</li> </ul>	<ul style="list-style-type: none"> <li>Some CUs are independently forecasted and others are averages of prior years</li> </ul>

Source: 2014 Audited Financial Statements, Commonwealth Report, discussions with Government, Component Unit financial statements, Fiscal Plan



Methodology: The Bridge includes normalizing adjustments with the objective of (a) reflecting operating run rates and (b) allowing for comparability to FY17 projections

Begin: Total Governmental Activities

- Less: Capital Outlays

- Less: Debt Service

- Less: Retirement Contributions

- Less: Working Capital Changes

- Less: Non-reoccurring items, excluded entities, and other financing sources / (uses)

End: Normalized Governmental Activities

Risks:

- The Government's FY15 and FY16 data is preliminary and is subject to material change
- While it is possible to assess the Government's financial adjustments, it is more difficult to confirm that all the necessary adjustments are being made

Analyses Undertaken Included:

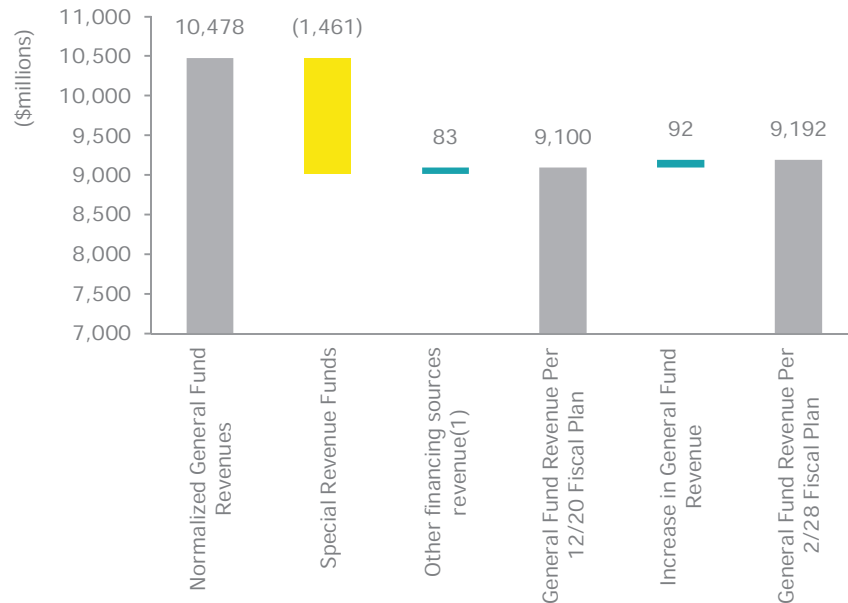
- Revision of the Bridge presentation to more closely align with the Fiscal Plan
- Analysis of key trends and adjustments to financials
- Identified items for further consideration
  - Resulted in Government making additional adjustments

Source: Fiscal Plan Comparison to Historical Results

# 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

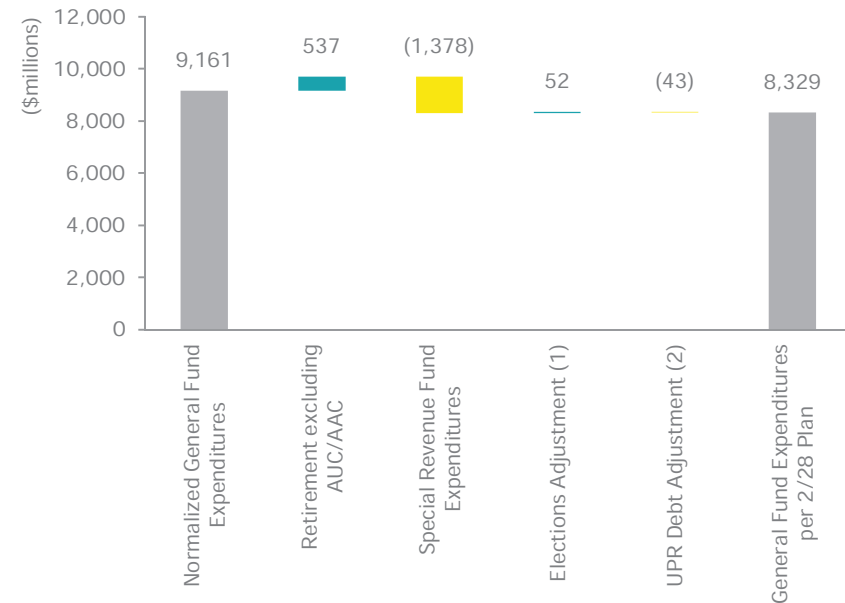
- The chart below details the walk from normalized general fund revenues to general fund revenues in the 2/28 Fiscal Plan
- Revenue in the 2/28 Fiscal Plan increased by \$92m when compared to the December Fiscal Plan reflecting an update based on year-to-date activity



(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

## Various measures and formal legislative changes have impacted historical results that directly impact the FY17 projection

### Act No. 66-2014

- Enacted in June 2014 to freeze new hires, salaries, utility rates paid to PRASA, and formula-based appropriations (due to expire in June 2017)
- The Fiscal Plan extends most of Act 66's fiscal control measures and proposes to permanently repeal formula appropriations and convert them to fixed amounts adjusted annually by inflation

### Sales and Use Tax

- In 2016, Sales and Use Tax increased from 7.0% to 11.5%, resulting in a substantial increase in related revenues (approximately \$641m in 2015 to approximately \$1.6b in 2016 (per the Bridge))
- The Fiscal Plan assumes approximately \$1.6b in FY17

### Petroleum Tax

- Petroleum products tax increased from \$9.25 to \$15.50 per barrel in 2015, increasing revenues to be used for debt service on debt raised by HTA and PRIFA
- The Fiscal Plan assumes this tax increase in FY17

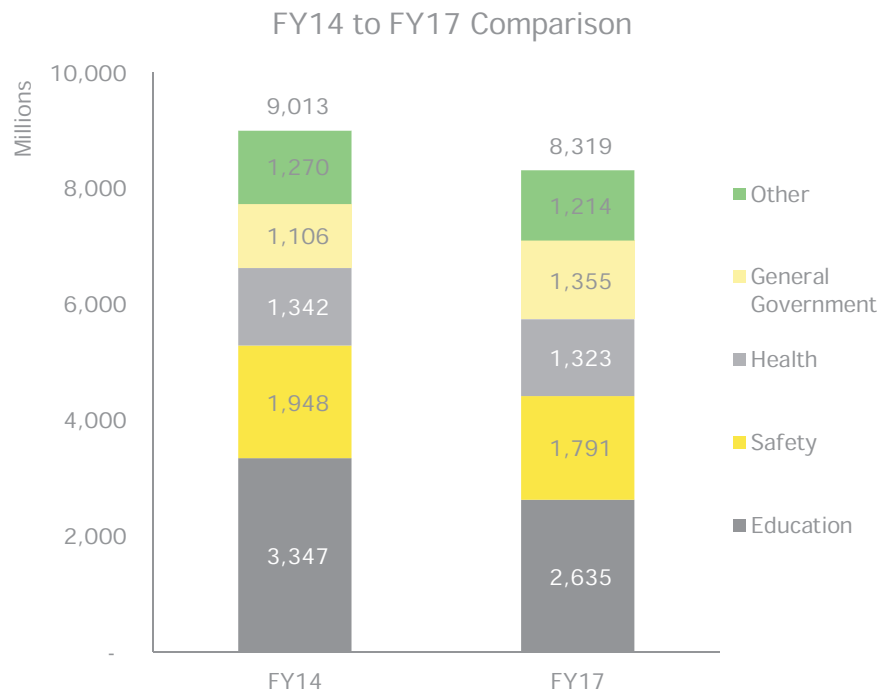
### General revenue and expenditure measures

- Various revenue enhancement and cost control measures undertaken from FY14 through FY16 that impact FY17
- The Fiscal Plan assumes the continuation of the elimination of earned income tax credit, reduction in senior citizen bonus, reduction in school transportation costs and school consolidations, judicial and legislative budget reductions, freezing of utility payments, incremental payroll expense reductions, etc.

Source: Commonwealth of Puerto Rico Fiscal Plan (October 14, 2016), No. 66-2014 (Approved June 17, 2014), Bloomberg.com, discussions with Government

# A comparison of FY14 and FY17 expenditures by agency shows a significant decline in Department of Education expenditures

- ▶ The reduction in Department of Education expenditure is partly driven by reductions in salary, transportation-related expenditures, and teaching materials costs



## FY 14

- ▶ Based on General Fund (Operating Fund) per Audited Financial Statements
- ▶ Excludes:
  - ▶ Transfer Outs for Debt Service (per Audited Financial Statements)
  - ▶ AUC / AAC (per Bridge)
  - ▶ GDB appropriated debt (per Bridge)

## FY 17

- ▶ Based on "Subtotal General Fund (ex. Debt Service, Capital, Pensions and SUT (FAM portion))" (per Bridge)
- ▶ Excludes:
  - ▶ Special Revenue Fund (per Fiscal Plan)

Source: 2017 Adopted Budget, Fiscal Plan Comparison to Historical Results

# Appendix



# (A) Analysis of Governmental Funds

There have been five versions of the Bridge submitted in the last four weeks, with adjustments amounting to hundreds of millions of dollars

	Date	Gov. Funds – Change in Net Position (\$ in millions)				Comments
		FY14	FY15	FY16	FY17	
v1	Jan 28 <sup>th</sup>	\$963	\$1,030	\$1,419	\$1,318	<ul style="list-style-type: none"> <li>• FY14 data sourced from the Audited Financial Statements</li> <li>• FY17 sourced from Fiscal Plan</li> <li>• FY15 and FY16 data sourced mostly from Commonwealth Financial Information and Operating Data Report from December 2016</li> <li>• Commonwealth report included significant estimates for FY15 and FY16</li> </ul>
v2	Feb 15 <sup>th</sup>	\$1,600	\$1,221	\$3,117	\$2,022	<ul style="list-style-type: none"> <li>• Pension contributions were subtracted from Change in Net Position.</li> <li>• \$167m of debt service in FY17 was corrected</li> <li>• FY15 and FY16 data sourced from system-generated information</li> <li>• FY15 data is almost ready to be audited and therefore appears to be more reliable than the FY16 data</li> <li>• FY16 data requires additional work to be a more reliable source of information</li> </ul>
v3	Feb 22 <sup>nd</sup>	\$1,248	\$880	\$1,089	\$1,468	<ul style="list-style-type: none"> <li>• Pension contributions were added to expenditures due to lack of clarity around historical contributions</li> <li>• FY14 accruals timing difference removed</li> <li>• FY15 and FY16 include material adjustments to system-generated data</li> </ul>
v4	Feb 27 <sup>th</sup>	\$1,829	\$1,754	\$1,971	\$2,003	<ul style="list-style-type: none"> <li>• Material manual adjustments were made to FY15 and FY16 data to soften revenue and expenditure trends</li> </ul>
v5	Feb 28 <sup>th</sup>	\$1,829	\$1,687	\$1,860	\$2,003	<ul style="list-style-type: none"> <li>• Refinement of manual adjustments to FY15 and FY16 data to soften revenue and expenditure trends</li> </ul>

# Certain entities were excluded from the Bridge analysis to make it consistent with the Fiscal Plan projections

See below for the entities that were included and excluded from the analyses:

	Governmental Activities	Component Units
Included	<ul style="list-style-type: none"> <li>• General Fund :               <ul style="list-style-type: none"> <li>• General Operating Fund</li> <li>• Entities with Independent Treasuries</li> <li>• Non Budgetary Funds (Special Revenue Funds, Internal Revenue Funds and Other General-Type Funds)</li> </ul> </li> <li>• Blended Component Units</li> <li>• Other Governmental Funds: Debt Service and Capital Projects</li> </ul>	<ul style="list-style-type: none"> <li>• Business-Type Activities</li> <li>• Discretely Presented Component Units</li> <li>• Fiduciary Funds (retirement system fiduciary funds)</li> <li>• (See Appendix B for complete list of included component units)</li> </ul>
Excluded	<ul style="list-style-type: none"> <li>• The Children’s Trust Fund (Blended Component Unit)</li> </ul>	<ul style="list-style-type: none"> <li>• Business-Type Activities Excluded:               <ul style="list-style-type: none"> <li>• Water Pollution Control Revolving Fund</li> <li>• Safe Drinking Water Treatment Revolving Loan Fund</li> </ul> </li> <li>• Discretely Presented Component Units Excluded:               <ul style="list-style-type: none"> <li>• Aqueduct and Sewer Authority (PRASA)</li> <li>• Electric Power Authority (PREPA)</li> <li>• Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives (COSSEC)</li> <li>• Municipal Finance Agency (MFA)</li> </ul> </li> <li>• Fiduciary Funds Excluded:               <ul style="list-style-type: none"> <li>• Agency Fund (Special Deposit Fund)</li> </ul> </li> </ul>

Source: Fiscal Plan Comparison to Historical Results



## EY analyzed the Bridge revenue methodology and specific adjustments to determine if the normalization is inclusive of all the correct items

EY compared revenue details to source documents and analyzed the normalizing adjustments for consistency in presentation.

In addition, see Appendix C for a detailed explanation of the line items in the Bridge.

	FY14	FY15 & FY16	FY17
Governmental Fund Revenue	<ul style="list-style-type: none"> <li>EY confirmed each line item to the 2014 Audited Financial Statements and to the Commonwealth Report</li> <li>EY analyzed system-generated detail by source</li> </ul>	<ul style="list-style-type: none"> <li>EY analyzed the system-generated revenue by source to:                             <ul style="list-style-type: none"> <li>Understand historical revenue trends</li> <li>Understand adjustments made to system-generated revenue</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>EY confirmed each Bridge line item to the Fiscal Plan source</li> </ul>
Normalization Adjustments	<ul style="list-style-type: none"> <li>EY analyzed each adjustment to:                             <ul style="list-style-type: none"> <li>Confirm the adjustment was consistent across each period</li> <li>Confirm the adjustment was consistent with the methodology used to develop the Fiscal Plan</li> </ul> </li> </ul>		

## EY analyzed the Bridge expenditure methodology and specific adjustments to determine if the normalization is inclusive of all the correct items

EY analyzed the expenditures in each period included in the Bridge.

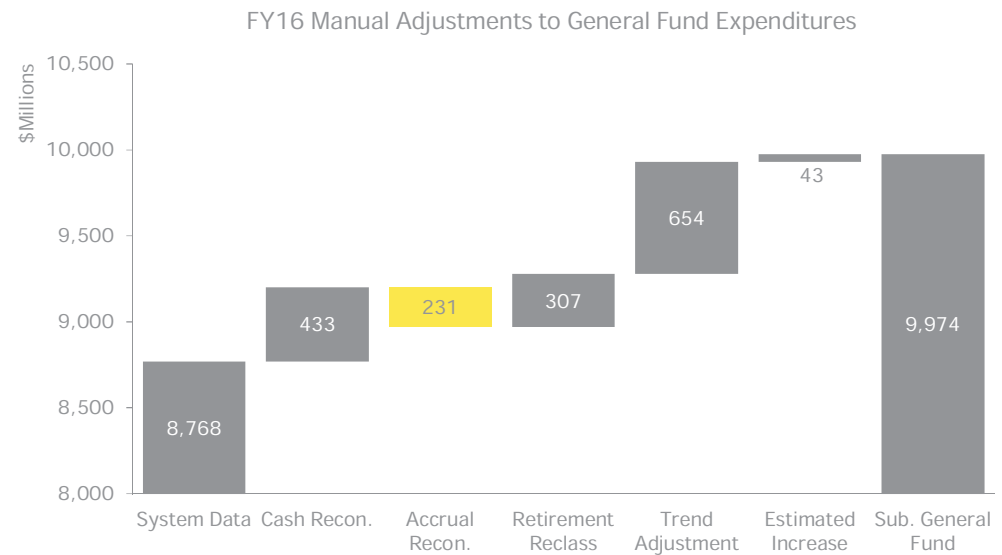
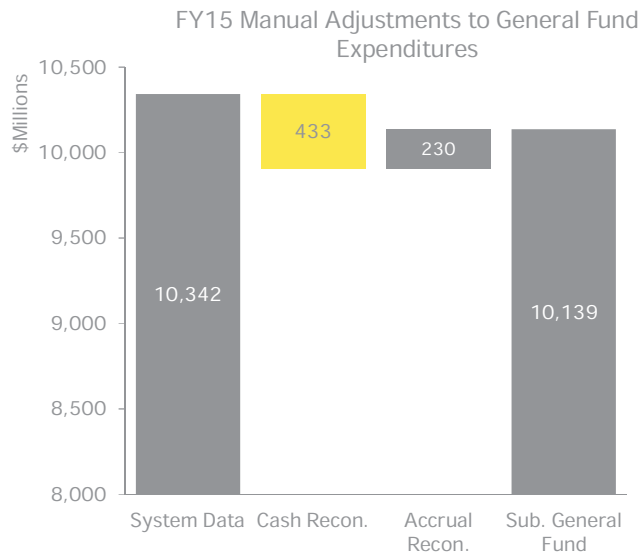
In addition, see Appendix C for a detailed explanation of the line items in the Bridge.

	FY14	FY15 & FY16	FY17
Governmental Fund Expenditures	<ul style="list-style-type: none"> <li>EY analyzed the system-generated expenditures by agency and expense type</li> </ul>	<ul style="list-style-type: none"> <li>EY analyzed the system-generated expenditures by agency and concept of spend to:                             <ul style="list-style-type: none"> <li>Understand historical expenditure trends</li> <li>Understand adjustments made to system-generated expenditures</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>EY analyzed the FY17 Adopted Budget and the General Fund expenditures in the Fiscal Plan</li> </ul>
Normalization Adjustments	<ul style="list-style-type: none"> <li>EY analyzed each adjustment to:                             <ul style="list-style-type: none"> <li>Confirm the adjustment was consistent across each period</li> <li>Confirm the adjustment was consistent with the methodology used to develop the Fiscal Plan</li> </ul> </li> </ul>		

FY15 and FY16 information was sourced from the Government's accounting system. Material adjustments were made to system data to arrive at the expenditures in the Bridge

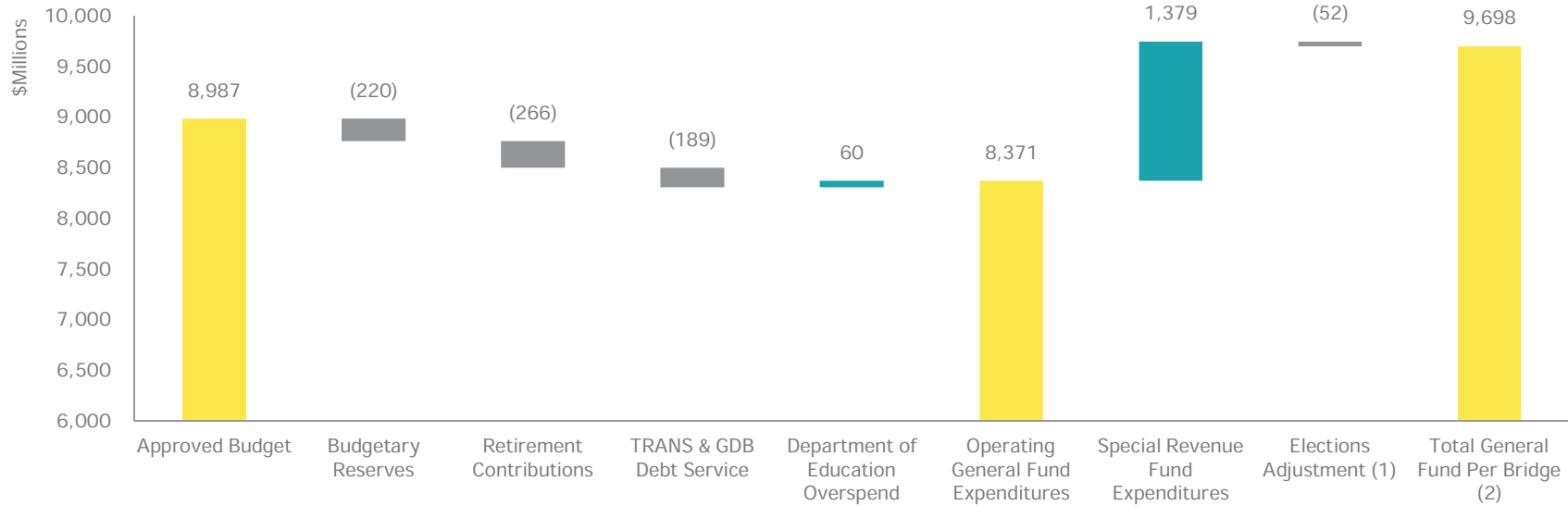
Material manual adjustments were made to FY15 and FY16 to account for account reconciliations, accruals and reclassifications.

- FY15 data is in the process of being analyzed in order to have it ready to be audited
- FY16 data is very raw and required more than \$1 billion in adjustments to arrive at normalized results



Source: Fiscal Plan Comparison to Historical Results, discussions with Government, PRIFAS

# The FY17 Fiscal Plan is based on the FY17 Approved Budget with the addition of certain adjustments



(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: 2017 Adopted Budget, Fiscal Plan Comparison to Historical Results

# Historical Federal Funds revenue trends are consistent with historical Federal Funds expenditure trends

EY analyzed the revenue and expenditure line items for Federal Funds to compare if the historical trends for FY14 – FY16 were consistent.

- ▶ Health-related expenditures increased by approximately \$700M, driven almost entirely by an increase in payments for ASES health premiums
- ▶ Education-related expenditures decreased by approximately \$322M, driven by a reduction in salaries, professional services, and food



Source: PRIFAS and Fiscal Plan

# (B) Analysis of Component Units



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## EY analyzed methodology used to present the Component Units in the Bridge

- EY analyzed all material normalization adjustments to historical financials and Fiscal Plan Projections for Component Units
- EY analyzed the financial models used for independently forecasted component units
  - FY15 and FY16 financial information is preliminary or unavailable making it challenging to validate the FY17 trends
  - Supporting information required to explain the trends for the Highway Transportation Authority and the Puerto Rico Industrial Company was not provided
  - Expenditure trends for several Component Units included increased pension costs and reduced utility expenses partially due to decreasing rates

Historical Trend of Change in Net Position - Component Unit / Enterprise Funds (\$ Millions)					
		Historical			Fiscal Plan
		2014A	2015A	2016A	2017P
<u>Change in Net Position</u>					
1	Component Units	(\$3,471)	(\$458)	(\$618)	\$647
2	Enterprise Funds	(6)	118	108	(17)
3	Total Change in Net Position	(\$3,477)	(\$340)	(\$511)	\$630
4	( - ) Entities Excluded from Fiscal Plan	315	316	455	(62)
5	Total for Entities Incl. in Fiscal Plan	(\$3,162)	(\$24)	(\$56)	\$569
6	( + ) Depreciation, Amortization & Interest Expense	1,444	1,467	1,349	0
7	( + ) Normalization Adjustments	2,551	(363)	(256)	143
8	Normalized Change in Net Position	\$832	\$1,080	\$1,037	\$712
9	Less: GDB (Normalized Change in Net Position)	(\$252)	(\$286)	(\$243)	\$98
10	Normalized Change in Net Position Ex. GDB	\$580	\$794	\$794	\$810

Source: Fiscal Plan Comparison to Historical Results

## Component units included in the plan

### Major Component Units Included in the Fiscal Plan

- ▶ Government Development Bank
- ▶ Highway Transportation Authority
- ▶ University of Puerto Rico
- ▶ Puerto Rico Health Insurance Administration

### Enterprise Funds (Business-Type Activities)

- ▶ Lotteries
- ▶ Puerto Rico Medical Service Administration
- ▶ 9-1-1 Fund

### Non-Major Component Units Included in the Fiscal Plan

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>▶ Puerto Rico Ports Authority</li> <li>▶ Puerto Rico Industrial Development Company</li> <li>▶ Company for the Integral Development of the "Península de Cantera"</li> <li>▶ Integrated Transit Authority</li> <li>▶ Port of the Americas Authority</li> <li>▶ Puerto Rico Tourism Company</li> <li>▶ Agricultural Enterprises Development Administration</li> <li>▶ Puerto Rico Public Private Partnerships Authority</li> <li>▶ Puerto Rico Council on Education</li> <li>▶ Puerto Rico Convention Center District Authority</li> <li>▶ Puerto Rico Conservatory of Music Corporation</li> <li>▶ Puerto Rico Public Broadcasting Corporation</li> <li>▶ Farm Insurance Corporation of Puerto Rico</li> <li>▶ Corporation for the "Caño Martín Peña" Enlace Project</li> <li>▶ Corporation for the Development of the Arts, Science and Film Industry</li> <li>▶ Puerto Rico Trade and Export Company</li> <li>▶ Land Authority of Puerto Rico</li> </ul> | <ul style="list-style-type: none"> <li>▶ Local Redevelopment Authority of the Lands and Facilities of Naval Station</li> <li>▶ Fine Arts Center Corporation</li> <li>▶ Puerto Rico School of Plastic Arts</li> <li>▶ National Parks Company of Puerto Rico</li> <li>▶ Cardiovascular Center Corporation of Puerto Rico and the Caribbean</li> <li>▶ University of Puerto Rico Comprehensive Cancer Center</li> <li>▶ Puerto Rico Land Administration</li> <li>▶ Puerto Rico Telephone Authority</li> <li>▶ Musical Arts Corporation</li> <li>▶ AFICA</li> <li>▶ Employment and Training Enterprises Corporation</li> <li>▶ Corporation of Industries for the Blind and Mentally Retarded and Incapacitated Persons of Puerto Rico</li> <li>▶ Institute of Puerto Rican Culture</li> <li>▶ Culebra Conservation and Development Authority</li> <li>▶ Solid Waste Authority</li> <li>▶ Automobile Accidents Compensation Administration</li> <li>▶ Institutional Trust of the National Guard of Puerto Rico</li> </ul> |
|---|--|



## Evaluation of independently forecasted Major Component units

Component Unit	Normalized EBITDA			Fiscal Plan FY17	Comments
	FY14	FY15	FY16		
Puerto Rico Health Insurance Administration ("ASES")	(\$82)	\$16	\$87	\$134	<ul style="list-style-type: none"> <li>In FY15, ASES changed from a "third-party administrator" model in which the Government is responsible for the cost of health services provided, to a "managed care organization" in which ASES pays the insurers a fixed premium for each insured beneficiary and the insurers are responsible for the cost of such services</li> <li>This change resulted in higher Federal Funds reimbursements</li> <li>In February 2017, ASES reaffirmed the FY17 financial projections</li> </ul>
University of Puerto Rico ("UPR")	\$106	\$139	\$159	\$109	<ul style="list-style-type: none"> <li>FY14 - FY16 revenue has remained fairly steady while expenditures have decreased primarily due to salaries and utilities</li> <li>The FY17 Fiscal Plan includes increased payroll costs and higher utilities expenditure levels compared to FY16</li> </ul>
Government Development Bank for Puerto Rico ("GDB")	\$252	\$286	\$243	(\$98)	<ul style="list-style-type: none"> <li>GDB previously served as interim lender to Government entities but no longer performs this role</li> <li>As a result, in FY17, GDB is no longer projected to receive revenue from most of its previous sources of income including its loans to select public corporations and its investment income</li> <li>However, the GDB continues to project income from government municipalities and a small portfolio of private entities and certain loans guaranteed by the Tourism Development Fund. This income is projected to fall by 24% from the FY16 level. Total revenue has fallen by 57%</li> <li>Although the GDB is no longer underwriting new loans, it but will still honor limited deposit withdrawal requests from municipalities and entities outside the FEGP</li> <li>GDB's operating expenses have fallen by 40%</li> </ul>
Highway Transportation Authority ("HTA")	\$501	\$566	\$482	\$540	<ul style="list-style-type: none"> <li>Supporting information required to explain the projected \$58m increase from FY16 to FY17 has not been provided</li> </ul>

Source: Fiscal Plan Comparison to Historical Results

Note: Yellow highlighted cells indicated financial data is unavailable and green highlighted cells indicate data is preliminary

## Evaluation of independently forecasted Non- Major Component units

Component Unit	Normalized EBITDA			Fiscal Plan FY17	Comments
	FY14	FY15	FY16		
Autoridad de los Puertos ("Port Authority")	(\$2)	(\$1)	\$9	\$9	<ul style="list-style-type: none"> <li>FY17 projections are in line with FY16</li> <li>The improvement in FY16 EBITDA is primarily due to a decrease in general and administrative expenses due in part to lower rates for light and power</li> </ul>
Compañía de Turismo ("Tourism")	\$12	\$7	\$15	\$3	<ul style="list-style-type: none"> <li>FY17 Fiscal Plan EBITDA decreases due to slightly lower total revenue and higher expenditures related to pension contribution</li> </ul>
Agricultural Enterprises Development Administration ("AEDA")	\$20	\$3	\$3	\$1	<ul style="list-style-type: none"> <li>FY13 - FY16 Revenue and expenditures have remained fairly steady except for the increase in pension expense (~\$9.6 million/year) beginning in 2015</li> </ul>
Corporacion del Centro Cardiovascular de Puerto Rico y del Caribe ("Cardio")	(\$2)	(\$1)	(\$6)	(\$5)	<ul style="list-style-type: none"> <li>Net patient revenue has fallen from FY14 - FY16 due to insurance carriers purchasing devices directly. Government expects to slowly begin reversing this trend in FY17 and beyond with nuclear medicine, ER redesign, and medical tourism growth.</li> <li>Otherwise, the historical financials have been rather consistent</li> </ul>
Integrated Transit Authority ("PRITA")	(\$18)	(\$9)	(\$9)	(\$31)	<ul style="list-style-type: none"> <li>PRITA was created to integrate the Puerto Rico and Municipal Island Maritime Transport Authority and the Metropolitan Bus Authority. These entities were reported separately in FY14 and FY15</li> <li>PRITA commenced operations in FY16 and resulted in additional management overhead expenses which impacted FY17</li> </ul>
Puerto Rico Industrial Development Company ("PRIDCO")	\$20	\$16	\$23	\$22	<ul style="list-style-type: none"> <li>Supporting information required to explain the increase from FY15 to FY16 was not provided</li> </ul>

Source: Fiscal Plan Comparison to Historical Results

Note: Yellow highlighted cells indicated financial data is unavailable and green highlighted cells indicate data is preliminary

## Evaluation of independently forecasted Enterprise Funds units

Entity	Normalized EBITDA			Fiscal Plan FY17	Comments
	FY14	FY15	FY16		
Lotteries	\$4	\$17	\$17	\$0	<ul style="list-style-type: none"> <li>FY17 Normalized EBITDA decreases compared to historical as the Plan includes lower revenues</li> <li>Actual Electronic Lottery revenue through January 2017 is also lower compared to FY16, reaffirming the lower revenue estimate in the Plan</li> </ul>
Puerto Rico Medical Services Administration	(\$28)	(\$8)	(\$17)	(\$25)	<ul style="list-style-type: none"> <li>FY17 revenue is fairly consistent with FY16 however, expenditures have increased due to pension costs</li> </ul>
9-1-1 Fund	(\$4)	(\$4)	(\$5)	(\$6)	<ul style="list-style-type: none"> <li>FY17 revenues and expenditures are in line with normalized historical financials.</li> </ul>

Source: Fiscal Plan Comparison to Historical Results

Note: Yellow highlighted cells indicated financial data is unavailable and green highlighted cells indicate data is preliminary

# (C) Bridge Line Item Explanations

# Revenue methodology summary by line item

Governmental Funds Revenues	Comment
1 Income Taxes	Major items include: Individuals, Corporations, Withholdings from non-residents
2 Sales and Use Tax	General Fund Only
3 Excise Taxes	Major items include: Alcoholic Beverages, Act 154, Tobacco and Motor Vehicles
4 Property Taxes	Includes only an additional real property tax on residential and commercial real properties with appraised values in excess of approximately \$210,000
5 Other Taxes	Major items include: Motor vehicle licenses, slot machines, alcoholic beverage license
6 Charges for Services	Fees for Trademarks, Permits, Documents Rights
7 Revenue from Global Tobacco Settlement	Related to the Children's Trust
8 Revenue from Component Units	Primarily includes transfers from the State Insurance Fund, the Tourism Company and the Puerto Rico Automobile Accidents Compensation Administration
9 Intergovernmental Revenue	Primarily includes Federal Grants and Subsidies
10 Offshore Rum Excise Tax	Includes customs duties collected in Puerto Rico and excise taxes on shipments of rum from Puerto Rico to the United States mainland
11 Interest and Investment Earnings	Consists primarily of interest, dividends and other distributions on investments held by the Commonwealth and its Blended Component Units
12 Other	Includes some general fund and special revenue fund items
13 Subtotal General Fund	Sum of lines 1-12
14 Sales and Use Tax (Debt Related)	COFINA SUT
15 Sales and Use Tax (FAM portion)	Portion of SUT tax for municipalities. This is not included in the governmental funds
16 Revenue from Component Units	Revenue related to the Puerto Rico Infrastructure Financing Authority Debt Service Fund
17 Municipal Property Tax	Property taxes are assessed, determined and collected for the benefit of the municipalities by the Municipal Revenues Collection Center ("CRIM")
18 Other Intergovernmental Revenue	Public Buildings Authority debt service revenues
19 Interest and Investment Earnings	Interest and Investment from Blended Component Units
20 Other	Other Blended Component Unit Revenue
21 Subtotal Other Governmental Funds	Sum of lines 14-20
22 Governmental Funds Revenues	Lines 13+21
<u>Adjustments to Governmental Funds Revenues</u>	
23 Revenue from Global Tobacco Settlement	Removed - related to Children's Trust which is not part of the plan
24 Revenue from Component Units	Primarily transfers from the State Insurance Fund and the plan does not forecast more transfers
25 Interest and Investment Earnings	Excluded - Interest income is not considered in the fiscal plan.
26 SRF gross-up adjustment	Government adjustment to remove special revenue transferred to Component units
27 Reclassification of unemployment related transfers to "transfers in"	Removed - unemployment related transfers should be charged to "Other financing sources (uses)"
28 HTA related increase in petroleum taxes	Clawed back petroleum taxes added back to normalize historical trends
29 2014 Special Dividend	Special dividend declared by the Compulsory Insurance Joint Association
30 Sales and Use Tax (FAM)	Portion of SUT tax for municipalities. Removed - not included in the governmental funds
31 Revenue from Component Units	Removed - related to Puerto Rico Infrastructure Financing Authority debt service
32 Other Intergovernmental Revenue	Removed - related to Public Buildings Authority debt service
33 Interest and Investment Earnings	Related to Interest which is not included in the plan
34 Adjustments to Governmental Funds Revenues	Sum of lines 23-33
35 Adjusted Governmental Funds Revenues	Lines 22 + 34

Source: Commonwealth Report, Audited Financial Statements, and conversations with Management

## Expenditure methodology summary by line item

Governmental Funds Expenditures	Comment
1 Sub Awards and Taxes	Primarily related to subsidies to the University of Puerto Rico, Road Authority and the Health Administration,
2 Personal Services	Primarily related to salaries, payments to professionals and consultants, and temporary wages
3 Other Services	Primarily related to employee medical insurance, workers compensation and other benefits
4 Materials and Supplies	Primarily related to drugs and medicine, food, and office materials
5 Other Uses	Primarily related to computer equipment
6 Other Funds (Operating expenses ex CapEx and Debt for OMEP, CRUV, LDA, CIRIO, and PHA)	Operating expenses for entities with separate treasuries
7 Subtotal General Fund (ex. Debt Service, Capital, Pensions and SUT (FAM portion))	Sum of lines 1-6
8 Capital Outlay	Expenditures for capital outlays, including the acquisition or construction of capital facilities and other capital assets
9 Equipment Purchases	Primarily related to expenditures for computer equipment and software. However, not all expenditures meet the capitalization threshold
10 Principal	Principal payments related to long term debt, lines of credit with GDB, appropriation bonds, G.O. bonds and revenue bonds
11 Interest and Other	Interest payments on debt issued
12 Other Funds (CapEx for OMEP, CRUV, LDA, CIRIO, and PHA)	Capital expenditures for entities with separate treasuries
13 Other Funds (Debt Service for OMEP, CRUV, LDA, CIRIO, and PHA)	Debt service for entities with separate treasuries
14 Sales and Use Tax (FAM portion)	Portion of SUT tax for municipalities. This is not included in the governmental funds
15 Subtotal General Fund (Debt Service, Capital, Pensions and SUT (FAM portion))	Sum of lines 8-14
16 Federal Funds	Expenditures related to federal grants and subsidies
17 Subtotal General Fund	Lines 7+15+16
18 Public Buildings Authority (ex. Capital Expenditures and Debt)	General expenditures for the Public Buildings Authority (a blended component unit)
19 Infrastructure Financing Authority	General and capital expenditures for the Puerto Rico Infrastructure Financing Authority. FY15 & FY16 include the issuance of Bond Anticipation Notes. (a blended component unit)
20 Special Communities Perpetual Trust	General expenditures for the Special Communities Perpetual Trust (a blended component unit)
21 The Children's Trust	General expenditures for the Children's Trust (a blended component unit)
22 Maritime Shipping Authority	General expenditures for the Maritime Shipping Authority (a blended component unit)
23 Commonwealth of Puerto Rico	Capital projects fund for the Commonwealth of Puerto Rico
24 Capital Outlays	Capital projects for the blended component units
25 Intergovernmental	Intergovernmental expenditures for the blended component units
26 Debt Service	Principal and Interest payments for COFINA, debt service fund and blended component units
27 Subtotal Non-major Governmental Funds	Sum of lines 18-26
28 Governmental Funds Expenditures	Lines 17+27

Source: Commonwealth Report, Audited Financial Statements, and conversations with Management

# Expenditure methodology summary by line item

Governmental Funds Expenditures	Comment
<u>Adjustments to Governmental Funds Expenditures</u>	
29 Retirement excluding AUC/AAC	Excluded - focus of the bridge was on the operational expenditures
30 AUC/AAC	Excluded - Fiscal Plan assumes that the Commonwealth no longer makes AUC/AAC payments
31 GDB appropriated debt	Represents appropriation for GDB related debt
32 SRF gross-up adjustment	Government adjustment to remove special revenue transferred to Component units
33 HTA related increase in petroleum taxes	Clawed back petroleum taxes added back to normalize historical trends
34 Audit adjustments (unrecorded liabilities)	Government adjustment for unrecorded liabilities
35 Equipment Purchases	Excludes only the capitalized equipment expenditures that meet the capitalization threshold
36 Capital Outlay	Excluded - focus of the bridge was on operational expenditures
37 Principal	Excluded - focus of the bridge was on operational expenditures
38 Interest and Other	Excluded - focus of the bridge was on operational expenditures
39 Other Funds (CapEx)	Excluded - focus of the bridge was on operational expenditures
40 Other Funds (Debt Service)	Excluded - focus of the bridge was on operational expenditures
41 Sales and Use Tax (FAM portion)	Excluded - not part of governmental funds.
42 The Children's Trust	Excluded - Children's Trust is not part of the fiscal plan
43 Intergovernmental	Excluded - relates to capital projects for blended component units and the Children's Trust
44 Commonwealth of Puerto Rico	Excluded - relates to capital projects fund
45 Non-major Governmental Funds Capital Outlays	Excluded - relates to capital projects for blended component units
46 Infrastructure Financing Authority (HTA Transfer)	Excluded - relates to the Bond Anticipation Notes in FY15 and FY16
47 Non-major Governmental Funds Debt Service	Excluded - relates to the blended funds principal and interest payments
48 Adjustments to Governmental Funds Expenditures	Sum of lines 29-47
49 Adjusted Governmental Funds Expenditures	Lines 28 + 48
50 Normalized Governmental Funds, Net	Line 35 of Revenues - Line 49 of Expenditures

Source: Commonwealth Report, Audited Financial Statements, and conversations with Management

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