ROMAN TORO & CO., PSC
Certified Public Accountants
Honesty - Integrity - Experience

Members of:
American Institute of Certified Public Accountants
and PR Society of Certified Public Accountants
José D. Román Toro, CPA, President
Website: www.cparomantoropr.com

PO Box 3043
Yauco PR 00698-3043
Tel. (787) 856-6220
Fax (787) 856-6233

May 22, 2017

Honorable Mayor and Members of
The Municipal Assembly
Municipality of Humacao

We have audited the financial statements of Municipality of Humacao (the Municipality) for the fiscal year ended June 30, 2016, and have issued our report thereon dated March 27, 2017. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our letter to you dated February 19, 2016. As per you request, we are also communicating to you the following information related to our audit.

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the Municipality are described in Note 2 to the financial statements. New accounting policies were adopted and the application of existing policies was not changed during year, as further discussed in the notes. We noted no transactions entered into by the Municipality during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were management's estimate of its pension obligation, contingencies and accumulated vacations. We evaluated the key factors and assumptions used to develop the accounting estimate in determining that it is reasonable in relation to the financial statements taken as a whole.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosure affecting the financial statements was the disclosure of pension obligations and the going concern of the Commonwealth of Puerto Rico in separate notes to the financial statements because certain judgment was required to determine the significance of these matters and the impact to the financial statements.

In all, the financial statement disclosures are neutral, consistent, and clear.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit; however, pension information could not be audited because the audited information was not provided by the PR Employee Retirement System.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the financial statements taken as a whole.

Disagreements with Management

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated March 29, 2017.

Required Supplementary Information

We applied certain limited procedures to the management discussion and analysis, the budgetary comparison information, and the employee retirement system information, and the financial data schedule, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

Other Matters

During the course of our audit, we discussed with management certain issues which could impact future operations of the Municipality and should be aware, in order to develop adequate responses if deemed necessary. We are summarizing these issues in the following paragraphs.

Federal Compliance Framework and Single Audit Guidance

In 2014, the U.S. Office of Management and Budget (OMB) issued the consolidated guidance on federal assistance administration and audit. This consolidated guidance supersedes requirements from eight (8) OMB Circulars: A-21, A-87, A-110, A-122; A-89, A-102 Common Rule, A-133, and A-50. The new guidance is divided into three main categories: (1) Administrative Requirements; (2) Cost Principles; and (3) Audit Requirements. The guidance is located in the Code of Federal Regulations under title 2, Subtitle A, Parts 200 through 299 (2 C.F.R. 200).

Federal Compliance Framework and Single Audit Guidance, continued

Our previous communications included a brief summary of the changes proposed; however, due to the extent of the guidance we cannot discuss all changes in this communication. For this year's Single Audit, the requirement threshold was raised from the previous $500,000 of annual federal expenditures to $750,000. Additionally, the Type A program determination increased from $300,000 or 3% of $10 million or more, to $750,000 or 3% of $25 million or more. The minimum amount of an entity's annual federal expenditures that the auditor must audit previously set at 25%/50% was lowered to 20%/40%. The effect of this new rule on this year's Single Audit for the Municipality was that less programs would be automatically considered for audit (as Type As), although all would still be subject to selection based on risk assessment. The coverage of federal programs audited; however, was not significantly impacted since this year's audit covered was 89% versus 96% last year. This new rule is not expected to significantly reduce the coverage amount in future years if current grant funding levels continue.

Increase Obligations to Employee Retirement System

Since 2011, additional payroll costs to Municipalities were imposed in order to alleviate the financial crisis that the PR Employee Retirement System (ERS) encountered by its own faults. Previously, the Municipality contributed 9.275% of each eligible employee's salary for their pension. The new impositions required that the Municipality pay an additional incremental of 1% contribution on eligible employees' earnings for their pension benefits for the next 5 years, which will then be increased to a 1.25% incremental contribution for another 5 years until 2021. The Municipality will have to carefully consider this additional cost when hiring new employees participating in the ERS because, at the final implementation year and future years, this pension contribution will be the most significant payroll benefit awarded to its employees, surpassing all other payroll taxes and benefits combined for each employee.

Fiscal Year ending	Average Contribution Percentage
2011	10.275%
2012	11.275%
2013	12.275%
2014	13.275%
2015	14.275%
2016	15.525%
2017	**16.775%**
2018	18.025%
2019	19.275%
2020	20.525%
2021	20.775%

Since 2013, the system can charge the Municipality for a proportional part of any annual deficiency calculated by the plan's actuary so that the plan's net position does not decrease below $1 billion, called the Uniform Additional Contribution (UAC; Law 447 of 1951, as amended, Article 1-104(42)). Given the dire situation of the ERS, it is more than likely that an UAC will be required to maintain the plan's net position above $1 billion, and, as the plan's annual pension cost increases and the annual contributions remain insufficient, the UAC will in turn also increase annually.

For FY2015 and FY2016, the UAC was set at ~$350 million and was divided by the participating employers in the ERS; however, some employers did not contribute their respective portion of the UAC in timely fashion,[1] which worsens the plan's net position and increase future UACs for all employers. As it stands, this additional pension contribution may become a significant burden on future budgets and must be closely monitored by the Municipality's management.

[1] *Gobierno atrás y no avanza con aportaciones a Retiro Central*, Ely Acevedo Denis, Noticel.com, Abril 23, 2015.

Increase Obligations to Employee Retirement System, Continued

GASB 68: Accounting and Financial Reporting for Pensions requires all employers participating in the ERS to record in their accounting their proportional share of the ERS's net position asset or liability and annual net pension cost. This translates to reporting the proportionate share of the ERS's pension deficit in the Municipality's audited financial statements as an employer participating in the plan. Since the plan's deficit is significant, the proportionate share required to be reported by the Municipality was unaudited and subject to change, which is why our opinion on the government-wide financial statements was qualified for limited scope.

The combination of these situations creates a significant financial burden on the Municipality in future years which will require serious concessions when developing the annual budget. This is complicated with the fact that the ERS system has a $30 billion net pension liability for which its principal contributors, the Central Government (59% of annual contributions)[2] and its agencies and corporations, are facing liquidity and budget shortfalls to the extent that their contributions are not consistent nor at any level near enough to alleviate the ERS's negative net position.

Electric Utility Costs and Subsidy

In recent years there has been significant discussions and attempts by the Puerto Rico Government to require Municipal facilities, structures, buildings, and properties to pay electric utility costs. The Puerto Rico Electric Power Authority is facing liquidity and solvency problems, and is trying to find new sources of income and reduce operating costs (including concessions and donations of free electricity service to various entities). Municipalities have been exempted from paying electric utilities in exchange for the PR Electric Power Authority, but if changed, it would present a significant new cost to the Municipality's finances.

AEE Utility Costs for FY 2015 (Un-audited and last available)	
Public lighting	$1,628,327
Municipal dependencies	$2,888,788

As part of our audit procedures for the 2015-2016 fiscal year, we obtained a confirmation from the Puerto Rico Electric Power Authority (PREPA) for the electricity consumption costs, which in turn represents the contribution in lieu of taxes (CELI). The confirmation from PREPA representative did not include information on CELI because the corporation was not confirming this information. The Municipality should monitor the continuing developments in energy policy by the state, since any changes are expected to significantly impact the Municipality's operations.

Law 154 of 2013: Limits on Municipal Budgeting and Accumulated Surpluses

Effective July 1, 2014, Municipalities are restricted by law to prepare their annual budgets using their audited annual financial statements ("single audits") in order to determine the budgeted annual revenues of volume of business tax, sales and use tax, and licenses and permits taxes. Additionally, the law restricts the use of accumulated surpluses for the amortization of municipal debt. While the law allows for a reserve of 30% of accumulated and annual fund surpluses, the rest is restricted by the law for service of the municipality's debt, stating that in cases where the Municipality reflects a surplus in the current budget, the surplus should be used to pay off the accumulated debt, with certain exceptions.

[2] Carta Circular 1300-23-16 del 24 de febrero del 2016, Departamento de Hacienda de Puerto Rico

Law 154 of 2013: Limits on Municipal Budgeting and Accumulated Surpluses, Continued

The Municipality should consider these factors when preparing its next year's budget and future plans, and consider amending its current plans respectively. Much uncertainty exists in Puerto Rico's current economy, making it harder to design annual budgets to provide services with fewer resources. The Puerto Rico Planning Board reported in its "2015 Report to the Governor of Puerto Rico" reported a -0.6% decrease in the local economy in 2015, while it projects further decreases of -1.2% in 2016, and -2.0% in 2017,[3] while the central government considers imposing new costs to Municipalities. We encourage the Municipality to continue searching for new revenue sources and to continually monitor both its current budget and changes in laws and regulations which could or will impact it.

Doubts as to Government of Puerto Rico's Going Concern

The Commonwealth and most of its public corporations are in the midst of a profound fiscal crisis. Despite various measures undertaken in recent years to stimulate economic growth, reduce government expenses and increase revenues, the Commonwealth has been unable to spur economic growth and eliminate the recurrent excess of expenditures over revenues. The Commonwealth's financial position deterioration, in conjunction with continued structural imbalances between revenues and expenditures and the Commonwealth's recent inability to access the capital markets, have resulted in the Commonwealth becoming unable to pay scheduled debt payments while continuing to provide government services.

The Puerto Rico Government Development Bank (GDB), in particular, has reported that it is facing serious liquidity and solvency difficulties, and is limited in providing resources to other government entities. Under the current law, the GDB is the principal means of debt financing for all Municipalities; however, with the approval of Law 7 of 2017, the GDB cannot provide financing for capital projects or for emergency financing to cover budget shortfalls or accumulated deficits. It will also not be able to disburse any loan or credit facility without authorization of the Governor during the emergency period described by the law. While Law 7 states that the Bank shall honor the requests for withdrawal or transfer of any deposit by agencies, public corporations or instrumentality according to authorized by the Governor, this is limited to subject to availability of funds and aggregate disbursements established by the Governor, and shall honor any request for withdraw or transfer any deposit by a municipality when they certify, together with supporting documentation, that funds will be used for the payment of essential services, a term that has yet to be defined. As of the date of this letter, the term essential services under Law 7 has not yet been made public by the state government.

Going concern of an entity is an assumption that should be reviewed regularly by each entity. Given the current fiscal and economic situations affecting all Municipalities, this assumption is not longer assured without preparing for, or implementing, changes to its costs, revenue generation, and services. The Municipality should consult with its advisors and develop a fiscal plan to address the situations affecting the Municipality, including PROMESA, GDB, and any

[3] *Informe Económico al Gobernador y a la Asamblea Legislativa, AF 2015*, Junta de Planificación, p. 48: Perspectivas Económicas Para Los Años Fiscales 2016 y 2017 En El Contexto De Su Tendencia Histórica

Doubts as to Government of Puerto Rico's Going Concern, Continued

other identifiable threats. The Municipality should closely monitor its cash budgeting procedures (as opposed to its revenues and expenditures budget) to assure it maintains or has access to adequate levels of cash resources for its operations, otherwise its operations may be affected due to the extraordinary circumstances of the central government and the GDB. As of this communication, the current situation is unsustainable for all Municipalities in the long term, and perhaps in the short-term for cash strapped, deficit spending governments. Therefore, the Municipality can consider options jointly with its industry peers in order to identify and promote common interests, and better prepare to meet the impending changes.

Restriction on Use

This information is intended solely for the information and use of the Mayor, Municipal Assembly, and management of the Municipality of Humacao and is not intended to be, and should not be, used by anyone other than these specified parties.

Very truly yours,

ROMAN TORO & CO., CSP CPA's