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May 20, 2016

Honorable Mayor and Members of
The Municipal Assembly
Municipality of Humacao

In planning and performing our audit of the financial statements of Municipality of Humacao as of and for the year ended June 30, 2015, in accordance with auditing standards generally accepted in the United States of America, we considered Municipality of Humacaoôs internal control over financial reporting (internal control) 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 Municipalityôs internal control. Accordingly, we do not express an opinion on the effectiveness of the Municipalityôs internal control.

However, during our audit we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions regarding those matters. We previously reported on the Municipalityôs internal control in our report dated March 30, 2016. This letter does not affect our report dated March 30, 2016, on the financial statements of Municipality of Humacao.

We will review the status of these comments during our next audit engagement. We have already discussed many of these comments and suggestions with various Municipalityôs personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Sincerely,

Román Toro & Co.

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Municipality of Humacao
Memorandum on Management Letter Points
Year Ended June 30, 2015

New Federal Compliance Framework and Single Audit Guidance

As of December 19, 2014, the Municipality is required to comply with the U.S. Office of Management and Budget (OMB) consolidated guidance on federal assistance administration and audit contained in Code of Federal Regulations under title 2, Subtitle A, Parts 200 through 299 (2 C.F.R. 200). 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 (Subparts A through D, covering Circulars A-102, A-110 and A-89); (2) Cost Principles (Subpart E, covering Circulars A-21, A-87, A-122 and 45 C.F.R. Part 75); and (3) Audit Requirements (Subpart F, covering Circulars A-133 and A-50).

The changes implemented into each area will have a significant impact on the Municipalityôs operations and compliance in the future. Management must assure that its policies and procedures are reviewed and amended, wherever necessary, to comply with the new requirements, guidance and terminology on both compliance and internal control. We strongly recommend that the Municipality prepare for the implementation of these changes by reviewing its current policies and procedures that impact its current federal programs and instruct both management personnel and employees regarding the impact this new guidance may have on each other responsibilities.

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 employeeôs salary for their pension. The new impositions required that the Municipality pay an additional incremental of 1% contribution on eligible employeesô 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%

Additionally, since 2013, the system can annually charge the Municipality for a proportional part of any annual deficiency calculated by the planôs actuary so that the planôs 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 planôs net position above $1 billion, and, as the planôs annual pension cost increases and the annual contributions remain insufficient, the UAC will in turn also increase annually.

Increase Obligations to Employee Retirement System (continued)

For FY2014, the UAC was set at $120 million and for FY2015 was more than $350 million, and was divided by the participating employers in the ERS; however, some employers are not contributing their respective portion of the UAC in timely fashion.[1] Late or missing contributions worsens the planôs net position and will increase future UACs for all employers, including those that are faithfully complying with their legally required contributions. As it stands, this additional pension contribution may become a significant burden on future budgets and must be closely monitored by the Municipalityôs management.

For the 2015 fiscal year, a new accounting standard entered into effect titled GASB 68: *Accounting and Financial Reporting for Pensions*, which required the Municipality and all employers participating in the ERS to record in their accounting their proportional share of the ERSôs net position asset or liability and annual net pension cost. This translates to reporting the annual proportionate share of the ERSôs pension deficit in the Municipalityôs audited financial statements as an employer participating in the plan. Since the planôs deficit is significant (~$30 billion as of June 30, 2014, unaudited), the proportionate share required to be reported by the Municipality ascended to a $88 million net pension liability and a $5 million annual net pension cost for the year ended June 30, 2015.[2] As of the date of our audit report, this information provided by the ERS 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; however, the underlying problem is not necessarily in the control of the Municipality: the ERS system has a $30 billion net pension liability for which its principal contributors, the Central Government (59% of annual contributions) 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 ERSôs negative net position.

Electric Utility Costs and Subsidy

AEE Utility Costs for FY 2015 (Un-audited and Estimated)	
Public lighting	$1,628,327
Municipal dependencies	$2,888,786

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 being exempt from paying municipal taxes. If such treatment is discontinued or changed, it would present a significant new cost to the Municipalityôs finances.

[1] *Gobierno atrás y no avanza con aportaciones a Retiro Central*, Ely Acevedo Denis, Noticel.com, Abril 23, 2015.
[2] Carta Circular 1300-23-16 del 24 de febrero del 2016, Departamento de Hacienda de Puerto Rico

Electric Utility Costs and Subsidy (continued)

As part of our audit procedures for the 2014-2015 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 was not provided to us until March 8, 2016, and the PREPA representative informed us that the confirmation 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 Municipalityôs 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 (ñsingle auditsò) 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 municipalityôs 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.

The Municipality should consider these factors when preparing its next yearôs budget and future plans, and consider amending its current plans respectively. Much uncertainty exists in Puerto Ricoôs current economy, making it harder to design annual budgets to provide services with fewer resources. The Puerto Rico Planning Board reported in its ñ2015 Report to the Governor of Puerto Ricoò 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.

Limits to GDB financing and cash with fiscal agent

In 2016, the Puerto Rico Government Development Bank has reported that it is facing serious liquidity and solvency difficulties, and is limited in providing resources to other government entities. Currently, the GDB is the principal means of debt financing for all Municipalities, and the current situation may limit access to capital for future projects or access to emergency financing to cover budget shortfalls or accumulated deficits. The Municipality should 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.

[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

Lateness of financial statement preparation

The Municipality did not produce its financial statements and accompanying notes and required supplemental information in a timely manner. The financial statements and accompanying documentation were submitted to us on various occasions because of late preparation of accounting information due to various reasons, but mainly due to the lateness of pension information produced by the ERS required to be included to comply with generally accepted accounting principles. After the pension information was released to the Municipality and the public on March 8, 2016, the first draft of the Municipalityôs financial statements were provided to us on March 14, 2016 and the final draft was provided to us on March 29, 2016.

Currently, the main submission deadline for the Municipalityôs audited financial statements is 9 months after the closing fiscal year (9 months after June 30, meaning March 31st of the next calendar year), as required by the Single Audit Act, since the Municipality receives, administers, and expends federal funds. However, other federal and state fiscal and regulatory agencies, as well as private entities and the general public, might request and require the audited financial statements in a timelier manner. In a 2011 study, the Governmental Accounting Standards Board found that financial report information retains at least some of its usefulness to readers, including municipal bond analysts, legislative fiscal staff, and researchers at taxpayer associations and citizen groups, for up to 6 months after fiscal year-end.[4] The same study found that local governments like Municipalities issue their financial statements on average of 6 months after fiscal year end, while state governments issue their reports in about 7 months. Compare this information with the Municipalityôs 9 months timeframe, and the Puerto Rico state government and Employee Retirement System 22 months and ongoing timeframe.

The late preparation of the financial statements and its accompanying documentation causes delays in the performance of the annual audit and emission of the audit report. These delays significantly increase the risk that the Municipality will not submit the reports to the required fiscal federal and local agencies in compliance with applicable laws and regulations as well as individual grant agreements. The Municipality should consider communicating and coordinating with the Employee Retirement System before or at the next fiscal yearôs closing date in order to obtain the information in a reasonable timeframe to allow its accountants to prepare the financial statements in a timely manner for the auditor to complete their procedures and issue their report.

[4] Research Brief: The Timeliness of Financial Reporting By State And Local Governments Compared With The Needs of Users, Governmental Accounting Standards Board, March 2011.