

MOSS ADAMS LLP
Certified Public Accountants | Business Consultants

COMMUNICATIONS WITH THOSE CHARGED WITH GOVERNANCE UNDER SAS NO. 114

To the City Council Members, and
LaVonne Griffin-Valade, City Auditor
City of Portland, Oregon

We have audited the financial statements of the governmental activities, the business-type activities, each major fund and the aggregate remaining fund information of the City of Portland, Oregon (the City) as of and for the year ended June 30, 2013, and have issued our report thereon dated December 20, 2013. Professional standards require that we provide you with the following information related to our audit.

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA, GOVERNMENT AUDIT STANDARDS, THE SINGLE AUDIT ACT, AND THE OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-133

As stated in audit contract that became effective on May 18, 2012, our responsibility, as described by professional standards, is to form and express an opinion about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of your responsibilities.

Our responsibility is to plan and perform the audit in accordance with generally accepted auditing standards and to design the audit to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes consideration of the City's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the City's compliance with the types of compliance requirements described in the "U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement" applicable to each of its major federal programs for the purpose of expressing an opinion on the City's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the City's compliance with those requirements.

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We are also responsible for communicating significant matters related to the financial statement audit that, in our professional judgment, are relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures for the purpose of identifying other matters to communicate to you.

OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

Our responsibility for other information in the financial statements does not extend beyond the financial information identified in our report. We do not have an obligation to perform any procedures to corroborate other information contained in these documents. However, we have read the information and nothing came to our attention that caused us to believe that such information or its manner of presentation is materially inconsistent with the information or manner of its presentation appearing in the financial statements.

PLANNED SCOPE AND TIMING OF THE AUDIT

We performed the audit according to the planned scope previously communicated to you in the contract dated May 18, 2012.

SIGNIFICANT AUDIT FINDINGS**Qualitative Aspects of Accounting Practices**

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note I to the financial statements. Throughout the course of an audit, we review changes, if any, to significant accounting policies or their application, and the initial selection and implementation of new policies. These policies have been consistently followed during the year. New standards adopted by the City during the year are also disclosed in Note I, and other than the time and effort to implement them, did not require significant changes to the financial statements.

Significant Accounting Estimates

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 are:

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- The depreciable lives and the net book value of the City's capital assets.
- The provision for discounts and allowances on the City's accounts and loans receivables.
- The accrued liabilities for the City's claims and judgments and risk financing activities.
- The accruals for City employee post-employment healthcare and retirement benefits.

Financial Statement Disclosures

The disclosures in the financial statements are consistent, clear and understandable. Certain financial statement disclosures are especially sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were:

- Note I addressing the reporting entity and component units included in the City's financial statements, along with the other significant accounting policies of the City.
- Note III.A disclosing the City's cash and investments including interest rate, credit, and custodial credit risks inherent in the City's investment portfolio.
- Note III.B disclosing the amount of discounts, allowances, and provision for uncollectible accounts including the various loan receivable programs of the City at June 30, 2013.
- Note III.I disclosing changes to the City's long-term debt balances along with details of each debt outstanding and future repayment terms.
- Note IV. A through C disclosing details and accruals for the City's risk financing activities, claims, judgments, commitments, and contingent liabilities.
- Note IV. D and E disclosing on the details of employee post-employment health and retirement benefit programs. As of June 30, 2013, the actuarially determined unfunded liabilities for benefits earned totaled \$3 billion, not including the City's portion of the funded status of its involvement in the cost-sharing portion of Oregon PERS. This compares to the recorded liability of only \$1.3 billion.

Significant Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all factual and judgmental misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. None of the misstatements detected as a result of audit procedures were material, either individually or in the aggregate, to the financial statements as a whole.

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The following summarizes the impact of uncorrected misstatements in the fiscal year 2013 financial statements that were identified during the current year audit. Management has determined that the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

- Capital Asset Additions - Certain Parks properties acquired in prior years totaling approximately \$9.5 million were not capitalized. An entry was made in the current year to record the acquisition of these properties.
- Portland Development Commission – There was an overstatement of expenses and accrued liabilities in the amount of \$0.2 million in the Portland Development Commission, a discretely presented component unit of the City.

The uncorrected errors noted above were determined by management to be immaterial to the financial statements taken as a whole.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as 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 requested and received certain representations from management that are included in the management representation letter dated December 20, 2013.

Management Consultation with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

OTHER MATTERS

Addressing the Declining Financial Position of the City's Governmental Activities – The City has a solid track record of managing its governmental funds on a budgetary basis to meet its current service needs and allow for the maintenance of resources at year-end sufficient to meet City policies and municipal government recommended best practices. As a result, the City has maintained an excellent credit rating from the various credit rating agencies that evaluate the City's debt outstanding. However, the expenses of the City's governmental activities on a full accrual basis of accounting have exceeded its revenue by over \$1.4 billion over the last eleven years including an excess expense of \$183 million in the fiscal year ending June 30, 2013. As a result, governmental net position has decreased from a balance in excess of \$1.788 billion to \$.355 billion over that time

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frame. The net position trend is a measure commonly used to determine whether a government's financial condition is improving or declining. It also is a measure of how well the City's financial policies are addressing intergenerational equity, or in other words, how well the current actual expenses of providing services are covered by current revenues.

The two most significant drivers of the excess cost over revenues is the use of capital assets in excess of investing in replacements or retaining revenues and placing them in reserve funds for the purpose of funding future replacements, and the annual funding of employee post-employment benefit programs at amounts less than the annual benefits actually earned. The City's retirement plan for police and firefighters, and the City's other post-employment benefit programs, are not pre-funded on an actuarial basis, but rather, funded as benefit payments are made to retirees. The benefit payments for the City's retirement plan for police and firefighters hired before 2008 is funded with a dedicated property tax. An additional factor impacting the declining net position is the use of financial metrics based on the budgetary basis of accounting and related financial policies that were not developed with a goal of requiring the true expense of providing current services to be financed with current revenue streams.

The City has addressed one of the significant contributors with a relatively recent change to the Fire and Police Disability and Retirement Fund by requiring all police and firefighters hired after 2007 to enter Oregon PERS retirement plan which is funded on an actuarial basis. Those hired prior to 2008 are still in the FPD&R plan.

There are at least a couple significant consequences or risks of the City's current declining net position trend. One often overlooked consequence, is the inherent unfairness that results when future generations end up paying a significant portion of the costs incurred by past users or beneficiaries of City services. In addition, there is an increased risk that the portion of current revenues that are required to make the payments against prior obligations will not allow sufficient resources left over to maintain current service levels.

Recommendations: We recommended to management in a separate letter that OMF develop financial policies and metrics based on the full accrual basis of accounting for its governmental activities, to supplement the policies and metrics applied to the budgetary basis financial statements. In addition, we recommended to management that before the budget is officially adopted, that the Budget Office and OMF work together to project what the government wide financial statement ending balances would be based on the activities and projects included in the budget, along with estimates of what the full accrual year-end entries would be. The policies and metrics could address desired levels of cash, working capital, debt and other long-term obligations, and ending net position levels that the City deems appropriate, healthy and sustainable. They should also address which costs of providing services should be funded with current revenues, and plans on how significant costs to be covered in the future will be funded. The later would require an analysis of all the significant causes for the decline in net position, which causes have already been addressed, and which causes have yet to be addressed.

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In addition, we recommended that management review its current capital replacement policies and evaluate if revisions to the policies and metrics are prudent to address the deferred maintenance inherent in the trend of significant decline in the net book value of the capital assets. One element that could be evaluated is whether it would be prudent to expand the current capital asset reserve program used for certain computer equipment to other types of City capital assets. Another might be establishing metrics on what percentage of the annual budget could be available for capital and debt service expenditures that allows the City to still meet desired current service levels.

We encourage the City Commissioners to continue to reach out to management to understand the drivers to the declining net position trends, the revision of financial policies and metrics that may come from their analysis, and to adopt any changes that are found to be prudent so the City continues to have sufficient resources as necessary to meet desired service levels on a sustainable basis.

AUDITOR INDEPENDENCE

Auditor independence, in fact and appearance, is essential so that the public may justifiably perceive the audit process as an unbiased review of management's presentation of financial information.

At least annually, we will disclose to the City Council the nature of all relationships between Moss Adams and the City of Portland, Oregon, that, in our professional judgment, may reasonably be thought to bear on our independence.

We are not aware of any relationships between our Firm and the City of Portland, Oregon, for the year ended June 30, 2013, and through the date of this letter, that may reasonably be thought to impact our independence. Accordingly, relating to our audit of the financial statements of the City of Portland, Oregon, as of and for the year ended June 30, 2013, we confirm we are independent with respect to the City within the meaning of Rule 101 of the American Institute of Certified Public Accountants' Code of Professional Conduct, its interpretations and rulings.

This information is intended solely for the information and use of the City Council, City Auditor, management, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Moss Adams, LLP

Eugene, Oregon
December 20, 2013