

COMMUNICATIONS WITH THOSE CHARGED WITH GOVERNANCE UNDER SAS NO. 114

To the City Council Members, and
Mary Hull Caballero, 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, 2014, and have issued our report thereon dated December 19, 2014. 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 the 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.

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.E, 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, 2014.
- 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, 2014, the actuarially determined unfunded liabilities for benefits earned totaled \$2.8 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 \$1.4 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 2014 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. We agree with this assessment.

- **Capital Asset Additions** - Certain Parks properties acquired in prior years totaling approximately \$21.4 million had not been capitalized when originally acquired by the City. An entry was made in the fiscal year 2014 financial statements to record the acquisition of \$6.1 million of these properties. The remaining properties, estimated at an additional \$15.3 million, will be recorded as additions for the year ending June 30, 2015.
- **Land Improvements Depreciation** - During the year, the Water Bureau identified certain assets capitalized between 1992 and 2006 that were originally classified as land, but should have been classified as land improvements and depreciated over their useful lives. The Water Bureau made a correcting adjustment of approximately \$2 million, charging depreciation expense for depreciation for the year ending June 30, 2014 rather than restating beginning net position.
- **Evaluation of Project Status** - Certain Portland Bureau of Transportation construction planning projects totaling \$3.4 million should have been expensed as of June 30, 2014 representing projects that were terminated and will not be completed.
- **Portland Development Commission** - There was an overstatement of revenues and understatement of beginning net position in the amount of \$1.2 million in the Portland Development Commission (PDC), a discretely presented component unit of the City. Prior period revenue associated with amounts owed to PDC by the City under an Intergovernmental Agreement for property management of the Union Station was recorded in the fiscal year 2014 financial statements.

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 letters dated December 19, 2014.

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

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facts. To our knowledge, there were no such consultations with other accountants.

OTHER MATTERS

Progress Made in Addressing the Declining Financial Position of the City's Governmental Activities - In the previous two years, we have reported to you our concerns about the City's costs of providing its general governmental services exceeding the revenues used to finance them. The cost of providing the City's governmental services has exceeded governmental revenues by over \$1.5 billion over the past twelve years as evidenced by a decline in net position from \$1.788 billion at the end of 2002, to \$0.212 billion at 2014 fiscal year end. 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 costs of providing services are covered by current revenues.

We reported to you previously that the two most significant drivers of the excess costs 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 cost of annual benefits actually earned, the majority of which is associated with the City's police and firefighter retirement plan. The City's retirement plan for police and firefighters hired before 2007, 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 annual benefit payments for the City's retirement plan for police and firefighters are funded with a dedicated property tax.

In prior years, we recommended that management develop financial policies and metrics based on the full accrual basis of accounting for its general government activities to supplement the policies and metrics previously applied based on the budgetary basis of accounting. In addition, we recommended that management review its current capital replacement policies and evaluate if revisions to the policies and metrics would be prudent to address the deferred maintenance inherent in the trend of significant decline in the net book value of the capital assets.

Status and Recommendations: We understand that steps have been taken to partially address the City's capital asset maintenance and replacement needs including a recent resolution passed by Council to implement a policy of dedicating a portion of year-end fund balances for replacement of capital assets. In addition, we understand that the City has been evaluating new revenue sources that would be dedicated to investments in infrastructure. We have learned that you are considering new capital asset replacement policies that will accelerate maintenance and replacement projects. Finally, we note that the City's investment in capital assets will improve by virtue of adjusting for properties acquired in prior years that were not properly capitalized as noted in our Schedule of Findings and Questioned Costs included in the separately bound Single Audit report.

The City has also taken steps to address the declining net position caused by the police and firefighters disability and retirement fund by placing all new police and firefighters hired after 2006 in Oregon PERS and funding their benefits currently on an actuarial basis. The remaining risk to the City is the limitation on the property tax millage rate restricted to

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funding the benefit payments for those hired before 2007. We are aware that management periodically reviews the risks associated with the dedicated property tax revenue stream, and the latest review revealed a very small probability, and a reduced risk to the City compared to previous such reviews, that dedicated property tax revenues would be insufficient to fund retiree benefit payments when due in certain future years.

Further, we note that the City decided to reinstate the Chief Financial Officer (CFO) position within the Office of Management and Finance, with a directive for the CFO to report directly to the City Council on long-term sustainability metrics. Our understanding is that one of the purposes of the periodic reporting of these metrics, is to assist the Council in the establishment of financial policies designed to assist in making decisions that will enhance the City's ability in ensuring its long-term financial health.

We commend the City for taking these steps, and recommend that you continue to work with management on additional steps that will be necessary to successfully address these issues. One such additional step we recommend to management is to consider the broader use of capital asset reserve funds where either existing revenues would be set aside, or broader based use charges would be assessed departments that use capital assets to assist in the financing of future maintenance and replacement projects.

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, 2014, 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, 2014, 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
February 25, 2015