

November 12, 2004

The Honorable Mayor and
Members of City Council
City of Portsmouth
Portsmouth, Virginia 23704

Dear Council Members:

We are pleased to present the Comprehensive Annual Financial Report of the City of Portsmouth, Virginia (the City) for the fiscal year ended June 30, 2004, in accordance with State statutes and City Code. This report was prepared by the City's Department of Finance in accordance with generally accepted accounting principles as set forth in the pronouncements of the Governmental Accounting Standards Board. In accordance with these guidelines, this report is presented in four sections, as follows:

- (1) Introductory Section - which contains the City's organizational structure, this Letter of Transmittal and the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting;
- (2) Financial Section - which consists of the independent auditors' report, management's discussion and analysis, the basic financial statements, including the notes to the basic financial statements, required supplementary information and supplementary information;
- (3) Statistical Section - which is unaudited and includes selected financial and general information presented on a multi-year comparative basis; and,
- (4) Compliance Section - which is comprised of the independent auditors' reports on internal control and compliance with applicable laws and regulations as required by the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the Schedule of Expenditures of Federal Awards with related notes and the Schedule of Findings and Questioned Costs.

Responsibility for both the accuracy of the presented data and the completeness and fairness of the presentation, including all disclosures, rests with City management. We believe the data as presented is accurate in all material respects; that it is presented in a manner designed to fairly set forth the financial position and results of operations of the City as measured by the financial activity of its various funds; and, that all disclosures necessary to enable the reader to gain the maximum understanding of the City's financial affairs have been included.

The City of Portsmouth, Virginia was established by act of the Virginia General Assembly in 1858. It is a political subdivision of the Commonwealth of Virginia operating under the council-manager form of government. City Council consists of a mayor and six other council members.

The City is not part of a county and has taxing powers subject to statewide restrictions and tax limits.

The City provides a full range of municipal services, including police and fire, sanitation, recreation and cultural activities, economic development, health and social services, street and highway maintenance, public improvements, planning and zoning, building inspections and environmental code compliance, general administrative services, education and water and sewer services.

The financial reporting entity includes all funds of the primary government (the City), as well as the component units for which the City is financially accountable. The Portsmouth School Board (School Board), the Portsmouth Parking Authority (Parking Authority), the Industrial Development Authority of the City of Portsmouth (Industrial Development Authority) (IDA) and the Portsmouth Port and Industrial Commission (PPIC) are included in the report as discretely presented component units in a separate column in the government-wide financial statements to emphasize that they are legally separate from the City and to differentiate their financial position and results of operations from that of the City. Each of these component units are administered by separate boards which are appointed by City Council or are elected by the general public in the case of the School Board. Excluded are the financial statements of the Portsmouth Redevelopment and Housing Authority. This organization is associated with the City, but is a legally separate entity which operates with considerable autonomy outside of the direct control of the Portsmouth City Council and for which the City is not financially accountable.

ECONOMIC CONDITION AND OUTLOOK

The City Council's focus continued during 2004 in their three major priority areas for the City: Economic Development, Neighborhood Quality and Fiscal Strength. Over the past six years, the City has made major investments in the area of economic development. These investments are beginning to yield the dividends of increasing revenues and a positive image for this 250-year old city. The positive impacts from these focused initiatives will favorably impact the City's fiscal strength thereby enhancing the City's ability to channel resources into improving the quality of life of our citizens and by creating an environment conducive for business and tourism.

As we work to achieve balance in the many and often competing needs within the City's available resources, the City must have a vision and objectives to guide the decision-making and budget development processes. In order to maintain current bond ratings, the City Council initiated a fiscal strength philosophy with the following targets:

- Develop a plan for eliminating reliance on Revenue Anticipation Notes (RAN's) used as short-term borrowing to meet current operating cash requirements;
- Increase annual funding from the General Fund to eliminate cash flow deficits in the Internal Service funds in each of the next three budget years;
- Achieve an undesignated fund balance target of 12.5% of General Fund revenues, with a target of 15% after the cash flow deficits in the Internal Service funds are eliminated;
- Decrease reliance on General Fund contributions to the Golf Fund and Waste Management Fund;

- Maintain debt affordability by issuing debt with a debt outstanding to assessed value ratio cap of 5%, and general fund supported debt service to General Fund ratio cap of 12%;
- Increase General Fund contributions to the pension trust funds to reduce the unfunded pension liability; and
- Analyze the requirements and develop a plan for converting the Public Utility General Obligation Bonds to Public Utility Revenue Bonds.

The growth in our tax base is a significant factor to the City's economic and fiscal health. More than 66% of General Fund revenues are provided by general property and other local taxes. The assessed value of real property rose by \$148.7 million, or 4.6% during 2004. New construction added an additional \$50 million, bringing the total increase in assessments to 6.2 %. These increases reflect the current national and regional trends of increasing real estate values. This increase in assessment values is an extremely positive indicator in evaluating Portsmouth's local economy.

Major Initiatives

As an older core city, Portsmouth has expended considerable efforts and resources to continue its renaissance. Since Portsmouth is surrounded by other independent cities, annexation is not possible with development and redevelopment focused inside City limits. Consequently, the City has undertaken an asset management strategy to inventory and analyze the best and highest uses for the properties located within the City for potential development activity. The major development and redevelopment areas within the City are described below.

Victory Crossing Business Park

The former Fairwood property consists of over 500 acres. It formerly supported temporary housing that was constructed during the World War II era. The IDA acquired 135 acres of this site in April 1988 and identified it as a site for redevelopment.

Now known as Victory Crossing Business Park, this site is immediately adjacent to the Victory Crossing Shopping Center. It is located in the center of Hampton Roads, thus, providing an avenue for future employment and economic growth. As previously stated, the land designated for the park had originally supported residential use. The residential units on the 135 acre site have been razed and site preparations have been initiated to support new development. Improvements to the site and the surrounding street corridors include a 5-acre regional retention basin and the restoration of Greenwood Drive, a major thoroughfare at the park's southern boundary. The Virginia Department of Transportation (VDOT) has approved and budgeted for road improvements for Victory Boulevard extending from Cavalier Boulevard to Greenwood Drive. This is the primary access road on the western boundary of the property.

In 2004, a Master Development Agreement between the IDA and a master developer was executed. Work continues on the development of a "class A" business office park and the proposed development of a 40-acre community college campus for Tidewater Community College.

PortCentre Commerce Park

PortCentre Commerce Park is a 60-acre commerce park located south of the downtown business district with immediate interstate access via Interstate 264. An additional 12 acres is being cleared for future expansion. The park offers incentives to qualifying companies through the Empowerment Zone, Enterprise Zone, HUB Zone and Foreign Trade Zone.

In 1998, the IDA completed construction on a 100,000 square foot speculative office/warehouse building located in the park. The building, known as PortCentre I, was an initiative by the IDA to spur additional development in PortCentre Commerce Park. The building is now privately owned with seven tenants.

In 2003, seven businesses (Wright's Engineering, Woolpert, LLP, CDI Marine, Dow Construction, Chesapeake Drywall and Electric Boat) announced plans to locate in the park representing a capital investment of over \$10.6 million and the creation of 240 new jobs.

In 2004 Woolpert, LLP, Electric Boat, and Premier Copper and Brass all completed construction on their new buildings. Ocean Marine Yacht Center completed a \$1.2 million expansion project of their repair facility. Currently, there are 21 businesses within the park, and three additional projects pending which will bring over 100 new employees. When all three deals are finalized it will leave only one parcel remaining for sale.

Westbury (formerly Ida Barbour)

In October 1997, Portsmouth was one of 27 cities awarded a \$24.8 million Federal Hope VI grant to revitalize the Ida Barbour housing community (now known as Westbury) located on 41 acres in the downtown area of the City. The application was submitted by the Portsmouth Redevelopment and Housing Authority. A total of 663 low-income housing units constructed in 1955 will be redeveloped into a new mixed income community of 278 units for rental and home ownership. To date, 663 low-income housing units have been replaced with 62 units of single-family homes and 58 rental units. A third phase, consisting of 99 homeownership units began construction in June 2004. Construction of an additional 59 rental units will begin early next year. This development, to be completed by 2006, will convert the property to a taxable status and is expected to yield annual tax revenue of \$325,000 upon full buildout.

Cox Property

The Cox property is a 640-acre tract of industrial property with deep-water access, one of the only such tracts available on the East Coast. This property is serviced by the Western Freeway, which provides direct highway access to the region's major interstate thoroughfares.

In 2004 the announcement was made that Maersk/APM Terminals Virginia, after purchasing this tract privately, would develop a \$450 million shipping terminal, bringing 210 new jobs to Portsmouth. This announcement was the largest investment announcement made in Virginia during 2004, and the 8th largest investment announcement in Virginia's history.

New Port Community

In 2004, L.M. Sandler & Sons, Inc. completed its plans for the development of a new residential neighborhood on the 200-acre parcel adjacent to Victory Crossing Business Park. The urban-inspired residential community will total 1,600 units, complete with a lifestyle center.

Scotts Creek Property

Earl Industries purchased the Scotts Creek property from the PPIC. This 21.2-acre site is being developed as their administrative headquarters, and will include an office building and warehouse space. They will invest \$11 million in this project, thereby creating 50 new jobs. Earl Industries also purchased Moon Engineering, which will be the future site of the ship repair business.

The following section of this letter summarizes selected financial data that directly relates to fiscal strength targets initiated by the City Council and the progress currently being made toward their achievement.

FINANCIAL INFORMATION

School Board Funding

The following represents the City’s history of funding provided to the School Board over the last five fiscal years. It should be noted that beginning in fiscal year 2002 several changes were made to the financial management arrangement between the City and the Schools. The Sales and Use taxes previously received by the City and transferred to the Schools is now received directly by the Schools from the state. In addition, certain debt previously carried by the Schools is now recorded on the City’s books with the annual debt service paid directly by the City rather than transferring these funds to the Schools for payment.

Fiscal Year	Operating Payments to Schools	School Debt Service Payments	Total School Funding	Increase
2004	\$ 28,390,142	\$ 2,492,952	\$ 30,883,094	\$ 981,143
2003	27,379,813	2,522,138	29,901,951	1,405,726
2002	26,591,550	1,904,675	28,496,225	811,203
2001	27,685,022	-	27,685,022	1,169,369
2000	26,515,653	-	26,515,653	1,978,445

Note: Payments to schools have been adjusted to exclude sales and use taxes transferred to the Schools for 2000 and 2001 for comparative purposes. School debt service represents debt service on literary loans, 1997 taxable bonds for VRS liability refunding, VPSA bonds and qualified zone academy bonds. Payments to schools for 2001 excludes a one-time transfer of \$1.3 million for comparative purposes.

General Fund Balance

The General Fund accounts for all revenues and expenditures that are not accounted for in specific purpose funds. It finances the regular day-to-day operations of the City. A strong undesignated fund balance is an indication of financial flexibility and fiscal strength. The City's undesignated fund balance rose to 11% of general fund revenues in fiscal year 2004. The following table presents the City's ratio of undesignated fund balance to general fund revenue for the last five fiscal years:

Fiscal Year	Undesignated	Total	Ratio
	General Fund Fund Balance	General Fund Revenues	
2004	\$ 18,730,024	160,100,573	11.70%
2003	14,924,689	151,501,703	9.85%
2002	13,319,176	151,811,908	8.77%
2001	10,321,232	155,286,152	6.65%
2000	12,800,008	150,649,908	8.50%

Cash Management

The City uses a pooled cash concept to allow greater investment flexibility, and consequently, a better investment return. Cash from all funds, except those restricted for specific purposes or managed by fiscal agents, is pooled for investment purposes. Cash temporarily idle during the year was invested in overnight repurchase agreements and other investments ranging from one to thirty days to maturity. The City issued RAN's in August 2003 in anticipation of the collection of taxes and revenues. The RAN's were paid off prior to June 30, 2004.

Additional information on the City's financial status can be found in the Management's Discussion and Analysis section of this report.

INDEPENDENT AUDIT

State law requires that the financial statements of the City be audited by a certified public accountant selected by the City Council. An annual audit of the books of account, financial records, and transactions of all funds, component units and departments of the City has been performed by Cherry, Bekaert, and Holland, L.L.P., Certified Public Accountants for the fiscal year ended June 30, 2004.

The auditors' report, which includes their opinion on the basic financial statements of the City, is contained in this report on page 1.

CERTIFICATE OF ACHIEVEMENT

The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Portsmouth for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2003. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of a state and local government financial report. To be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

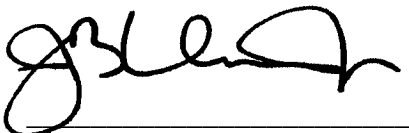
A Certificate of Achievement is valid for a period of one year only. The City of Portsmouth has received a Certificate of Achievement for the last twenty-four consecutive years (fiscal years 1980 through 2003). We believe our current report continues to conform to the Certificate of Achievement program requirements, therefore, we are submitting it to the GFOA.

ACKNOWLEDGMENTS

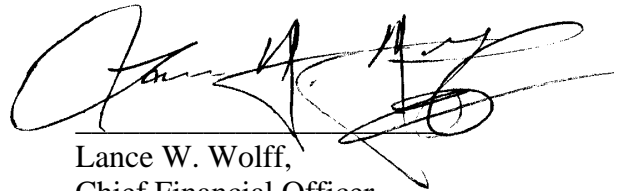
The Council's support and cooperation in planning and conducting the financial operations of the City is acknowledged and appreciated.

We also acknowledge and extend special recognition to the City's Controller and the staff of the Department of Finance for their efficient and dedicated service to the City. Their efforts to maintain the accounting and financial reporting system of the City of Portsmouth have led to the high quality of information being reported to the City Council and citizens of the City, as well as present and potential investors.

Respectfully submitted,



James B. Oliver, Jr.,
City Manager



Lance W. Wolff,
Chief Financial Officer