MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

This section of the County of San Diego's (County) Comprehensive Annual Financial Report provides a narrative overview and analysis of the basic financial activities of the County as of and for the year ended June 30, 2003. We hope that the information presented here, in conjunction with the Letter of Transmittal, provides you with a clearer picture of the County's overall financial status. Unless otherwise indicated, all amounts in this section are expressed in thousands of dollars.

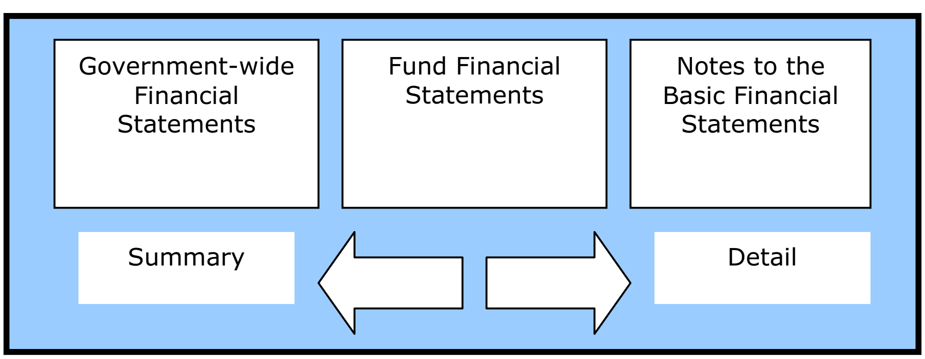
FINANCIAL HIGHLIGHTS

- The assets of the County exceeded liabilities at the close of the fiscal year 2002-2003 by $2.3 billion (*net assets)*. Of this amount, approximately $244 million is restricted for specific purpose (*restricted net assets*), and $2.3 billion is invested in capital assets, net of related debt. The remaining portion of the net assets represents a deficit balance in unrestricted net assets of approximately $237 million.
- The County's total net assets decreased by approximately $418 million due in large part to the deficit. The deficit was due to increased contributions attributed to the increased unfunded accrued actuarial liability owed to the San Diego County Employees Retirement Association (SDCERA) as a result of the approved enhanced retirement benefits for members of SDCERA.
- In October 2002, the County issued approximately $737 million of Taxable Pension Obligation Bonds. A portion of the proceeds were used to escrow a principal amount of $156 million of the County's outstanding 1994 Taxable Pension Obligation Bonds.
- General revenues were $1.1 billion. Of this amount, approximately $636 million or 56 percent was attributable to state sales tax and motor vehicle fees while property taxes accounted for approximately $459 million or 41 percent.
- The net expense for governmental activities was $1.5 billion. Public protection accounted for approximately $782 million or 50 percent of this amount while health and sanitation accounted for $265 million or 17 percent.
- At June 30, 2003, the General Fund's total fund balance was approximately $599 million. Of this amount, the unreserved-undesignated fund balance was $269 million or 9 percent of the total fiscal year 2002-2003 expenditures of $2.9 billion.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the County's basic financial statements. The County's basic financial statements comprise three components: 1) **Government-wide** financial statements 2) **Fund** financial statements, and 3) **Notes** to the basic financial statements. Required Supplementary Information is included in addition to the basic financial statements.

The illustration below depicts the required components of the basic financial statements.



Government-wide Financial Statements are designed to provide readers with a broad overview of County finances, in a manner similar to a private-sector business.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

The _statement of net assets_ presents information on all County assets and liabilities, with the difference between the two reported as *net assets.* Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the County is improving or deteriorating.

The _statement of activities_ presents information showing how the County's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, *regardless of the timing of related cash flows.* Thus, revenue and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both of these government-wide financial statements distinguish functions of the County that are principally supported by taxes and intergovernmental revenues (*governmental activities)* from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities).* The governmental activities of the County include general government, public protection, public ways and facilities, health and sanitation, public assistance, education, and recreational and cultural. The business-type activities of the County include airport operations, wastewater management and sanitation districts.

Fund Financial Statements are groupings of related accounts that are used to maintain control over resources that have been segregated for specific activities or objectives. The County, like other state and local governments, uses fund accounting to ensure and demonstrate finance-related legal compliance. All of the funds of the County can be divided into three categories: *governmental funds, proprietary funds* and *fiduciary funds*.

Governmental funds are used to account for essentially the same functions reported as *governmental activities* in the government-wide financial statements. However, unlike the government-wide financial statements, governmental funds financial statements focus on *near-term inflows* and *outflows of spendable resources,* as well as on *balances of spendable resources* available at the end of the fiscal year. Such information may be useful in evaluating a county's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for *governmental activities* in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental funds balance sheet and the governmental funds statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities.*

The County maintains twenty-eight individual governmental funds. Information is presented separately in the governmental funds balance sheet and in the governmental funds statement of revenues, expenditures and changes in fund balances for the General Fund, the Tobacco Securitization Special Revenue Fund, and the Tobacco Securitization Joint Special Revenue Fund, all of which are considered to be major funds. Data from the other governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the Combining Financial Statement and Supplementary Information section in this report.

Proprietary funds are generally used to account for services for which the County charges customers – either outside customers, or internal departments of the County. Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The County maintains the following types of proprietary funds:

- **Enterprise funds** are used to report the same functions presented as *business-type activities* in the government-wide financial statements. The County uses enterprise funds to account for the Airport, Wastewater Management and Sanitation Districts. Each is considered to be a major fund of the County.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

- **Internal service funds** are an accounting device used to accumulate and allocate costs internally among the County's various functions. Internal service funds are used to account for the financing of public works and communications equipment; the financing of materials and supplies (purchasing); for start up services for new and existing county service districts; for the County's uninsured risk management activities; the financing of fleet services; for mail, printing and record storage services; for facilities management activities; for the financing of information technology services; and for the financing of clothing and personal sundry items for persons institutionalized at various county facilities. Because these services predominantly benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

  The County's nine internal service funds are combined into a single, aggregated presentation in the proprietary funds financial statements. Individual fund data for the internal service funds is provided in the form of combining statements in the Combining Financial Statement and Supplementary Information section in this report.

Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of these funds are not available to support the County's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds.

Notes to the Basic Financial Statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Required Supplementary Information is presented concerning the County's General Fund budgetary schedule, and SDCERA pension schedules. The County adopts an annual appropriated budget for its General Fund. A budgetary comparison schedule has been provided for the General Fund to demonstrate compliance with this budget. In addition, a budgetary comparison schedule has been provided for the Tobacco Securitization Special Revenue Fund for it was determined to be a major governmental fund. The SDCERA pension schedules have been provided to present SDCERA's progress in funding its obligation to provide pension benefits to County employees.

Combining Financial Statement and Supplementary Information section of this report presents combining and individual fund statements and schedules referred to earlier that provide information for nonmajor governmental funds, enterprise and internal service funds and are presented immediately following the Required Supplementary Information section of this report.

GOVERNMENT-WIDE FINANCIAL ANALYSIS

This is the second year that the County has presented its financial statements under the new reporting model required by the Governmental Accounting Standards Board Statement No. 34 (GASB 34), *Basic Financial Statements – and Management's Discussion and Analysis (MD&A) – for State and Local Governments.* Because this reporting model changed significantly both the recording and presentation of financial data, the County's CAFR for fiscal year ending June 30, 2003 did not provide comparative information other than in its MD&A. This year marks the first time that two years of financial information in the GASB 34 format are available.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

Net Assets
June 30, 2003

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Assets:						
Current and other assets	$ 1,861,646	1,724,081	82,211	84,625	1,943,857	1,808,706
Capital assets	2,665,784	2,618,279	71,756	66,371	2,737,540	2,684,650
Total assets	4,527,430	4,342,360	153,967	150,996	4,681,397	4,493,356
Liabilities:						
Long-term liabilities	1,999,103	1,502,993	464	477	1,999,567	1,503,470
Other liabilities	340,172	226,728	1,836	5,847	342,008	232,575
Total liabilities	2,339,275	1,729,721	2,300	6,324	2,341,575	1,736,045
Net assets:						
Invested in capital assets, Net of related debt	2,261,697	2,178,892	71,293	66,026	2,332,990	2,244,918
Restricted	243,815	161,838	15	34,151	243,830	195,989
Unrestricted	(317,357)	271,909	80,359	44,495	(236,998)	316,404
Total net assets (restated)	$ 2,188,155	2,612,639	151,667	144,672	2,339,822	2,757,311

Analysis of Net Assets

Net assets may serve over time as a useful indicator of a government's financial position. In the case of the County, assets exceeded liabilities by $2.3 billion at the close of fiscal year 2002-2003. At the end of fiscal year 2002-2003, the County had positive balances in two of its categories of net assets, (Invested in capital assets net of related debt and Restricted net assets), however, its unrestricted assets had a deficit balance of $237 million.

The largest portion of the County's net assets (99 percent) reflects its investment of $2.3 billion in capital assets (e.g. land, infrastructure, buildings, and equipment); less any related outstanding debt used to acquire those assets. The County uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending.

Although the County's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be liquidated for these liabilities.

An additional portion of the County's net assets, $244 million (10 percent), represents resources that are subject to external restrictions on how they may be used. External restrictions include those imposed by grantors, contributors, laws/regulations of other governments, or restrictions imposed by law through constitutional provisions or legislation.

The remaining portion of the County's net assets represents a deficit unrestricted net assets balance of $237 million (deficit of 10 percent). This deficit is due in large part to the increased unfunded accrued actuarial liability owed to the SDCERA as the result of approved enhanced retirement benefits for members of SDCERA.

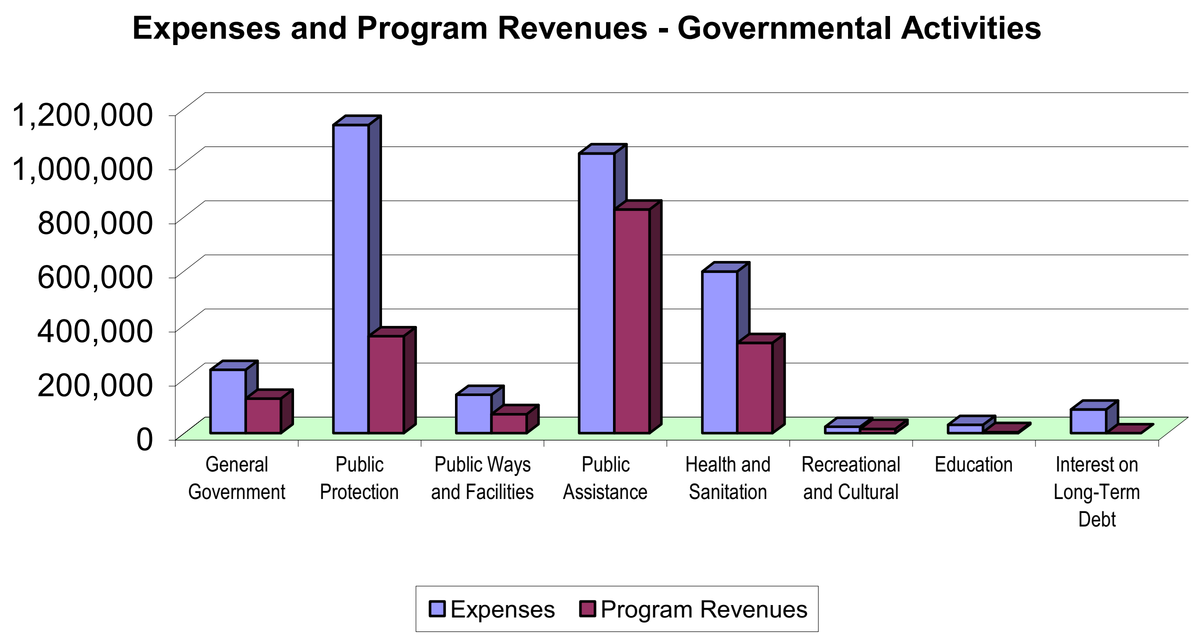
MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

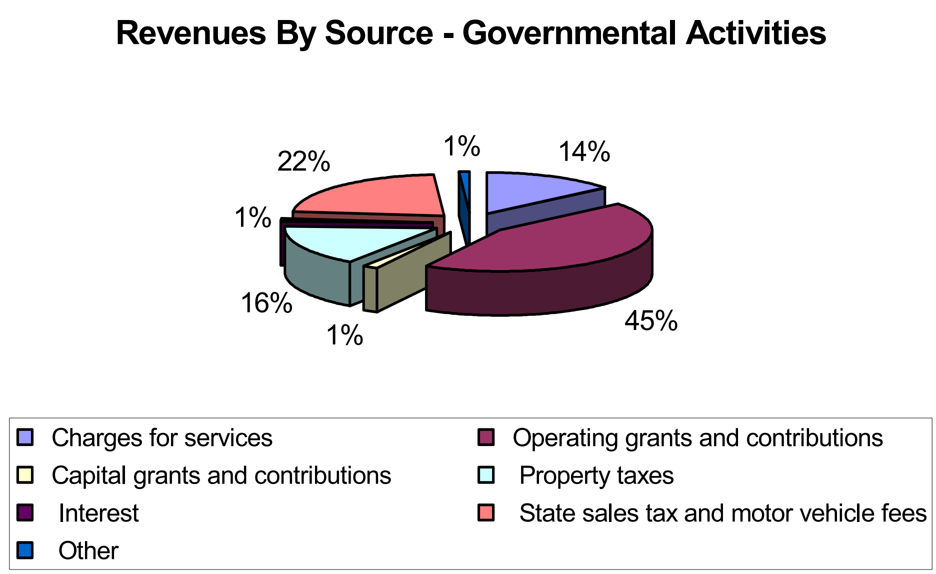
Changes in Net Assets
June 30, 2003

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Revenues						
Program revenues:						
Charges for services	$ 408,860	380,996	27,336	42,345	436,196	423,341
Operating grants and contributions	1,288,166	1,173,494	3,769	5,763	1,291,935	1,179,257
Capital grants and contributions	40,587	30,128	839	501	41,426	30,629
General revenues:						
Property taxes	459,340	412,400			459,340	412,400
Interest	30,213	39,041	1,437	2,694	31,650	41,735
State sales tax and motor vehicle fees	636,225	605,175			636,225	605,175
Other	3,964	5,011			3,964	5,011
Total revenues	2,867,355	2,646,245	33,381	51,303	2,900,736	2,697,548
Expenses:						
General government	234,062	171,273			234,062	171,273
Public protection	1,140,484	823,520			1,140,484	823,520
Public ways and facilities	142,356	168,202			142,356	168,202
Public assistance	1,035,065	825,028			1,035,065	825,028
Health and sanitation	598,189	547,200			598,189	547,200
Recreational and cultural	23,520	18,021			23,520	18,021
Education	30,850	24,119			30,850	24,119
Interest on long-term debt	87,627	61,340			87,627	61,340
Airport			7,125	7,973	7,125	7,973
Wastewater Management			4,357	3,808	4,357	3,808
Transit				17,085		17,085
Sanitation Districts			15,216	15,306	15,216	15,306
Total expenses	3,292,153	2,638,703	26,698	44,172	3,318,851	2,682,875
Excess (deficiency) before special item and transfers	(424,798)	7,542	6,683	7,131	(418,115)	14,673
Special item: gain (loss) on sale of properties	474	1,054	27	(5,145)	501	(4,091)
Transfers	(160)	359	160	(359)		
Increase (decrease) in net assets	(424,484)	8,955	6,870	1,627	(417,614)	10,582
Net assets at beginning of year (restated)	2,612,639	2,603,684	144,797	143,045	2,757,436	2,746,729
Net assets at end of year	$ 2,188,155	2,612,639	151,667	144,672	2,339,822	2,757,311

Analysis of Changes in Net Assets
The County's net assets decreased by $417,614 during the current fiscal year.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)





Governmental activities
Governmental activities decreased the County's net assets by approximately $424 million. This decrease was largely due to the increase in expenses of approximately $653 million or 25 percent while the increase in revenues was approximately $221 million or eight percent. These activities are further discussed below.

Revenue
Operating and capital grants and contributions increased by approximately $125 million or ten percent, due in part to additional revenue realized for increased costs in various programs, including In Home Supportive Services costs, which were higher in fiscal year 2002-2003 due to caseload growth and higher individual

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

provider costs. Additionally, this increase may be attributable to reimbursement of increased expenditures incurred for the East Mesa Detention Facility project.

Property tax revenues increased by approximately $47 million or eleven percent during the year. Most of this increase is attributable to a continued strong real estate market and consequent growth in the assessed value of property.

State sales tax and motor vehicle fees increased by approximately $31 million or five percent. Most of this increase is attributable to an increase in motor vehicle license fee revenue. The growth in this revenue is due to an increase in the number and values of vehicles registered statewide, influenced by the number and cost of new car purchases. Additionally, in fiscal year 2002-2003, the County received one-time commercial vehicle revenues.

<u>Expenses</u>
Total expenses for governmental activities were $3.3 billion. The majority of these expenses were for public protection and public assistance. Of the total expenses, approximately $1 billion, or 33 percent, were ultimately financed by taxes.

Public protection expenses increased by approximately $317 or thirty-eight percent. Most of this increase is attributable to the public protection's share of the increased unfunded accrued actuarial liability owed to the SDCERA. In February 2002, the County Board of Supervisors adopted enhanced retirement benefits for members of SDCERA resulting in this increased obligation to SDCERA.

Public assistance expenses increased by approximately $210 million or twenty-five percent. This was due in part to the public assistance's share of the increased unfunded accrued actuarial liability owed to the SDCERA as referred to above. Additionally, services and supplies expenses increased due to an increase in the In Home Supportive Services' individual providers' costs attributable to an increase in hourly wages and health benefits, and an increase in demand for services.

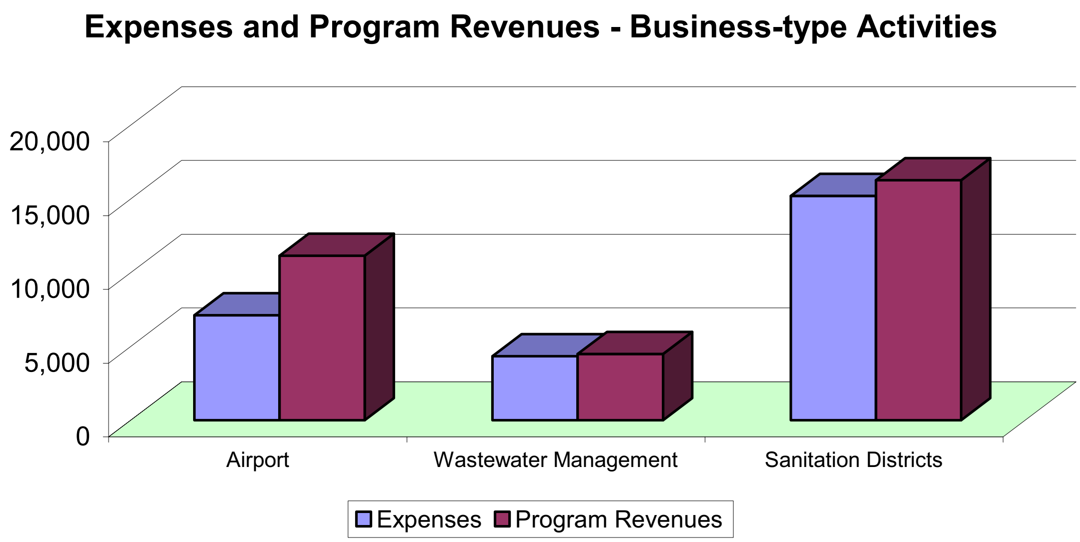
Recreational and cultural expenses increased by approximately $5 million or thirty-one percent. This increase is attributable to an increase in salaries and benefits and other charges consisting of payments to external entities for the purchase of land for open space preservation and habitat in the Department of Parks and Recreation.

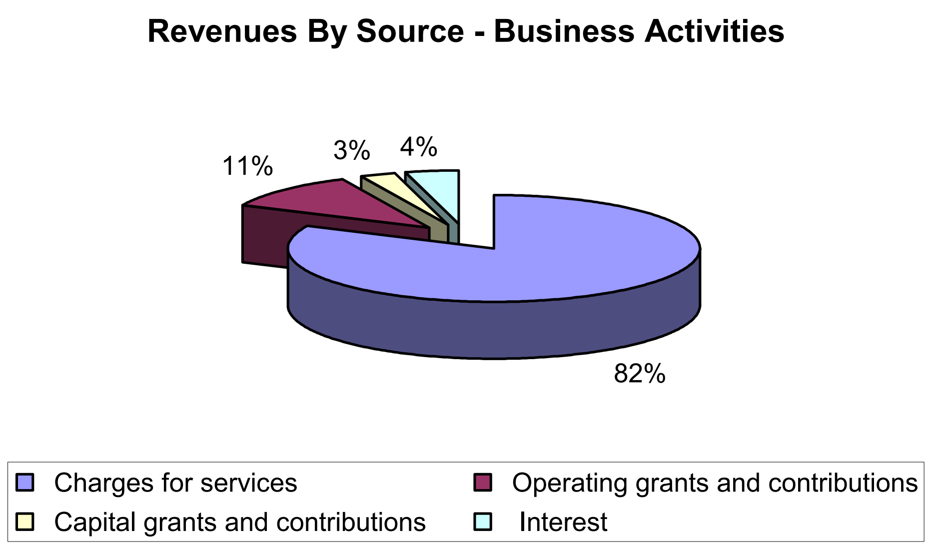
The charts on the previous page illustrate the County's governmental expenses and revenues by function and revenues by source. The County's governmental activities rely on several sources of revenue to finance ongoing operations. As shown, for governmental activities overall, without regard to program, operating grants and contributions are the largest single source of funds (45 percent). Operating grants and contributions are monies received from parties outside the County and are generally restricted to one or more specific programs. Examples of operating grants and contributions include State and Federal revenue for public assistance programs and for health and sanitation programs. General revenues such as property taxes and state sales tax and motor vehicle fees are not shown by program, but are effectively used to support program activities Countywide. State sales tax and motor vehicle fees (22 percent) and property taxes (16 percent) are the second and third largest sources of funds for the County. Public protection is the largest function in expense (35 percent), followed by public assistance (31 percent) and health and sanitation (18 percent). These ratios for revenues and expenses are substantially similar to 2002.

At the end of fiscal year 2002-2003, total revenue for the governmental activities was approximately $2.9 billion, while total expenses for governmental activities were approximately $3.3 billion.

Other factors concerning the finances of the County's major governmental funds are discussed in the Governmental Funds section of the "Financial Analysis of the County's Funds."

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)





Business-type Activities
The County has three business-type activities: Airport, Wastewater Management, and Sanitation. Business-type activities increased the County's net assets by $6,870. The total revenues and expenses were significantly less than reported in the previous fiscal year due to the divestiture of the Transit Enterprise Fund, which was effective June 28, 2002.

Revenue
At June 30, 2003, the total revenues including capital contributions and transfers for the business-type activities were $33,381. In keeping with the intent of recovering all or a significant portion of their costs through user fees and charges, business-type activities reported charges for services as their largest source of revenue (82%). Operating grants and contributions as well as capital grants and contributions were the other program revenue sources for the business-type activities.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

Expenses
At the end of fiscal year 2002-2003, the business-type activities reported total expenses of $26,698. The program revenues (charges for services, operating grants and contributions, and capital grants and contributions) financed all expenses recorded for the business-type activities.

As shown in the charts above, for all of the business-type activities, charges for services provide the largest share of revenues (82 percent) followed by operating grants and contributions (11 percent). For fiscal year 2002-2003, the largest of the County's business-type activities was the Sanitation Districts with total expenses over $15 million, comprising over fifty percent of the total business activities.

Other factors concerning the finances of the County's enterprise funds are discussed in the Proprietary Funds section of the "Financial Analysis of the County's Funds."

FINANCIAL ANALYSIS OF THE COUNTY'S FUNDS

As noted above, the County uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the County's governmental funds is to provide information on near-term inflows, outflows, and balances of resources that are available for spending. Such information is useful in assessing the County's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year. Types of Major Governmental Funds reported by the County include the General Fund, Tobacco Securitization Special Revenue Fund and the Tobacco Securitization Joint Special Revenue Fund. Nonmajor Governmental Funds include Special Revenue Funds, Debt Service Funds, and Capital Project Funds.

As of the end of fiscal year 2002-2003, the County's governmental funds reported combined ending fund balances of $1.35 billion, a decrease of $23 million in comparison with the prior year restated fund balance. Approximately $846 million of the total June 30, 2003 amount constitutes unreserved fund balance, which is available for spending at the County's discretion. The remainder of fund balance is reserved to indicate that it is not available for new spending because it has already been committed, (1) to liquidate existing contracts and purchase orders ($140 million), (2) for inactive landfill maintenance ($92 million), (3) to pay debt service ($72 million), and (4) for a variety of other purposes ($201 million).

Revenues for governmental functions overall totaled approximately $2.8 billion in the year ended June 30, 2003, which represents an 8% increase from the fiscal year ended June 30, 2002. Expenditures for governmental functions, totaling $3.4 billion, a twenty-five percent increase from the fiscal year ended June 30, 2002, attributed in large part to additional costs associated with the increased unfunded accrued actuarial liability in fiscal year ended June 30, 2003 due to the Board of Supervisors' adoption of enhanced retirement benefits for members of the SDCERA.

GENERAL FUND
The General Fund is the chief operating fund of the County. At the end of fiscal year 2002-2003, the unreserved fund balance of the General Fund was approximately $388 million, while total fund balance was approximately $599 million, an increase of $28 million from fiscal year 2001-2002. As a measure of the General Fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balance represents thirteen percent of total General Fund expenditures of $2.9 billion, while total fund balance represents twenty-one percent of that same amount.

TOBACCO SECURITIZATION SPECIAL REVENUE FUND
This is a Special Revenue Fund established in fiscal year 2001-2002 to account for the $411 million (net of closing costs and reserve requirements) the County received from the Tobacco Asset Securitization Corporation related to the sale of approximately 25 years of tobacco settlement revenue in fiscal year 2001-2002. The County will continue to invest these funds in investment products to maximize the sustained long-term use of these dollars. Revenue from use of money and property increased by approximately $5 million, or

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

187 percent in fiscal year 2002-2003, and is attributable in part to the investment of these monies for an entire fiscal year in fiscal year 2002-2003, as opposed to a partial year in fiscal year 2001-2002.

TOBACCO SECURITIZATION JOINT SPECIAL REVENUE FUND
This is a Special Revenue Fund established in fiscal year 2001-2002 to account for the transactions of the San Diego County Tobacco Asset Securitization Corporation and Tobacco Securitization Joint Powers Authority, two component units, that are blended into the County's financial statements.

Proprietary Funds

The County's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail. The proprietary funds financial statements provide separate information for the Airport, Wastewater Management, and Sanitation Districts Funds, all of which are considered to be major funds of the County. Conversely, the Internal Service Funds are combined into a single, aggregated presentation in the proprietary fund financial statements with the individual fund data provided in combining statements, which can be found in the Combining Financial Statements and Supplemental Information section of this report.

Airport
There was a slight change in the revenues and expenses of the Airport Enterprise Fund from the previous year.

- Grant revenue decreased by $1,994 while charges for services increased by $1,917.
- Operating expenses decreased in fiscal year 2002-2003 due to a reduction in depreciation expense.

Wastewater Management
There was a slight change in the revenue and expenses of the Wastewater Management Enterprise Fund from the previous year.

- Total revenue decreased by $159. Charges for services increased by $390 while interest revenue and capital contributions decreased by $544.
- Operating expenses increased by $334 while operating transfers out increased by $140.

Sanitation Districts
There was very little change in the revenues and expenses of the Sanitation Districts from the previous fiscal year.

- Charges for services remained fairly constant, however interest revenue decreased from $2,286 reported in fiscal year 2001-2002 to $1,294 as reported in fiscal year 2002-2003.
- Operating expenses for fiscal year 2002-2003 was reported at $15,200, down from the $15,288 as reported in fiscal year 2001-2002.

Fiduciary Funds

The County maintains fiduciary funds for the assets of the Pension Trust Fund, an Investment Trust, and various Agency Funds. As of the end of fiscal year 2002-2003, the net assets of the Pension Trust Fund totaled $4.1 billion, representing an increase of $569,768 in total net assets since June 30, 2002. The change is primarily related to contributions by the County from the proceeds of pension obligation bonds. The Investment Trust Fund's net assets totaled $2.5 billion, with an increase in net assets of $554,244, primarily resulting from an increase in contributions into the pooled investments relating to the proceeds from new school bond issues, offset by an increase in distributions from pooled investments relating to the use of school bond proceeds.

General Fund budgetary highlights

The County's final budget differs from the original budget in that it contains supplemental appropriations approved during the fiscal year for various programs and projects, as well as budget corrections and account reclassifications. At June 30, 2003, the variances between the original and final budgets for net current revenues over (under) expenditures and for other financing sources were ($603,619) and $513,150, respectively, for a total variance of ($90,469) in budgeted fund balance. Significant variances were caused by:

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

- $737.3 million from the issuance of Taxable Pension Obligation Bonds. Bond proceeds were expended to reduce the County's unfunded actuarial accrued liability to SDCERA.
- $36.1 million in capital projects, including $12.2 million in parks projects and land acquisition, $8.2 million in projects related to public safety, $5.3 million in library projects, $4 million in projects for San Pasqual Academy and the Polinsky Children's Center, and $2.9 million to plan for the Waterfront Park. These projects were funded substantially by prior year's fund balance, management reserves, transfers of appropriations, grants, and donations from private parties.
- $11.2 million in increased payments for salaries and benefits. Significant changes include an increase of $14 million in incentives earned through the County's Quality First program. The Department of Child Support Services had a decrease of $2.5 million due to reduced State and Federal revenues.
- $22.9 million in payments for services and supplies. The County appropriated an additional $10.1 million for information technology and telecommunications, funded substantially by prior year's fund balance and management reserves. In addition the Health and Human Services Agency had net supplemental appropriations of $11.7 million across a number of programs, due to increased fees and State and Federal revenues. The Department of Child Support Services had a net decrease of $6 million due to reduced State and Federal revenues.
- $30.9 million in net budget reclassifications between Federal revenues and State revenues for the Health and Human Services Agency resulted from increased budgeted Federal revenues and decreased budgeted State revenues.

Actual revenues fell short of the final budgeted amounts by $64 million, while expenditures fell short of the budget by $281.1 million. The combination of revenue and expenditure shortfalls resulted in a net positive operating variance of $217.1 million. Other financing sources and uses of funds resulted in a negative variance from budget of $11.3 million. The variance of net change in fund balance from the final budget was a positive variance of $205.8 million. Some highlights of the actual results compared to budgeted results are:

Salaries and Benefits. In the current environment of uncertainty over State and Federal funding, many County functions deferred hiring staff for ongoing programs in anticipation of future budget constraints and planned increased retirement costs beginning in fiscal year 2003-2004. The total positive variance in this category is $44.9 million Countywide.

Health and Sanitation and Public Assistance. A decrease in expenditures for these functions within the Health and Human Services Agency of $91.1 million is related to reductions in service level requirements, decreased need for contracted services, and reduced aid payments. These lowered expenditures are offset by corresponding reductions in Federal and State revenue.

Strong real estate markets. The real estate markets in San Diego County have been robust for several years due to low interest rates and high demand for residential real estate. Originally projected to begin to show weakness in fiscal year 2002-2003, this segment of the economy contributed to positive variances in several revenue categories, including $12.7 million in property and other taxes and $8 million in charges for document and recording services, as part of the overall positive variance in changes for current services of $11.8 million.

Delayed expenditures. The budget included $12 million in appropriations related to debt management, including $7 million to commence a program of long-term debt prepayment. With the uncertainty surrounding funding sources from the State and in order to maintain flexibility for one-time resources, no prepayment was made. In addition, Information Technology and other multi-year projects experienced delays, including $7.7 million in unspent appropriations for County-wide Enterprise Resource Planning projects and $5.9 million for the Sheriff's Department.

Reserves. The County reserves from prior years' fund balance decreased by $4.9 million. Primarily this was attributed to changes in reserve for encumbrances, which decreased from $98.7 million in fiscal year 2001-2002 to $94.6 million in fiscal year 2002-2003.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

Capital Assets and Debt Administration

Capital Assets

At June 30, 2003, the County's capital assets for both the governmental and business-type activities amounted to approximately $2.7 billion net of accumulated depreciation. The investment in capital assets includes land, construction in progress, structures and improvements, equipment, and infrastructure (including roads, bridges, flood channels, and traffic signals). The significant expenditures for capital assets in fiscal year 2002-2003 are as follows:

Governmental Activities

- $37,868 towards the construction of and improvements to County maintained roads. These expenditures are ongoing.
- $29,984 towards the construction of the East Mesa Juvenile Detention Facility. Total project costs are estimated at $52,952.
- $4,446 for the reconstruction of Edgemoor Hospital. Total project costs are estimated at $5,690.
- $3,460 for acquisition of Derbas real property (Escondido) for the purposes of wildlife habitat preservation and restoration.
- $2,666 for acquisition of real property for the replacement of the Downtown Courthouse.
- $2,605 for the North County Regional Center Courthouse Annex Remodel. Total project costs are estimated at $5,507.
- $2,589 towards acquisitions for the Multiple Species Conservation Program.
- $2,325 towards the Kearny Mesa Assessor Recorder County Clerk building. Total project costs are estimated at $6,868.
- $2,130 towards the construction of the Spring Valley Library. Total project costs are estimated at $3,459.
- $1,938 towards the construction of bridges.

Business-Type Activities

- $2,867 for the improvements at the Ramona Airport. The costs include $1,096 for the runway extension, $1,560 for the sewer construction which is estimated to cost a total of $2,437, and $214 towards the construction of the control tower which is estimated to cost a total of $2,242.
- $2,106 for the realignment of the taxiway at Palomar Airport. Total project costs are estimated at $4,728.
- $754 towards improvements in the Spring Valley Sanitation district including outfall manhole replacement, Jamacha Boulevard 8" Sewer construction, and the Whitestone Canyon sewer line upgrade. Total of all projects' costs are estimated at $6,600.
- $298 towards the replacement of the Galloway Pump Station Force Main in Alpine Sanitation District. Total project costs are estimated at $2,100.
- $260 towards the replacement of the Julian Sanitation District septic tank and aerobic digester. Total project costs are estimated at $629.

For government-wide financial statement presentation, governmental fund depreciable capital assets were depreciated from acquisition date to the end of the current fiscal year. Governmental fund financial statements record capital asset purchases as expenditures.

Additional information about the County's capital assets can be found in the notes to the basic financial statements.

Long-Term Obligations

At June 30, 2003, the County had outstanding governmental activity long-term obligations of $1.999 billion and no outstanding general obligation bonds. Of this amount, $395 million pertains to outstanding certificates of participation, $41 million pertains to capital leases, and $1.563 billion pertains to other long-term obligations that include $824 million of taxable pension obligation bonds, $449 million of San Diego County Tobacco Asset Securitization Corporation Bonds, $101 million for claims and judgments, $101 million for landfill closures, $75.4 million for compensated absences, $7.1 million for other loans, $4.5 million for Redevelopment Agency revenue bonds, and approximately $1 million for arbitrage rebate.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

Long-term obligations for business-type activities totaled $494 thousand and consisted of $299 thousand for compensated absences and $195 thousand for a long-term contract payable in the Spring Valley Sanitation District.

During fiscal year 2002-2003, the County's total principal amount of long-term obligations for governmental activities increased by approximately $496 million. The increase is due primarily to the County of San Diego's issuance of $737.3 million of Taxable Pension Obligation Bonds. The general long-term obligations for the business-type activities increased by approximately $17 thousand.

The County's credit ratings on its bonded program are as follows:

	Moody's	Standard & Poor's	Fitch Ratings
Certificates of Participation	A1	AA-	AA-
Pension Obligation Bonds			
1994 Series A	Aa3	AA-	Not rated
2002 Series A, B & C	Aa3	AA-	AA-

In addition, the County has an Underlying General Obligation rating of Aa2 from Moody's and an Issuer Creditor Rating of AA from Standard & Poor's. These ratings reflect the County's favorable general credit characteristics, which include a strong local economy, a sound financial position and a moderate debt profile. However, on October 2002, Moody's placed a negative outlook on all California county debt (except San Francisco). This is a result of the State of California's pending decision to divert revenue from local governments due to any budget shortfall.

Useful bond ratios to management, citizens, and investors are as follows:

	Fiscal Year 2003	Fiscal Year 2002
Net Bonded Debt	$1,191,754	$690,308
Net Bonded Debt per Capita	$402	$237
Ratio of Net Bonded Debt to Assessed Value	.51 percent	.32 percent

In March of 2002, the County implemented a new enhanced retirement package resulting in the increased unfunded accrued actuarial liability to the SDCERA. In October 2002, the County issued $737.3 million of taxable Pension Obligation Bonds to finance a portion of this liability.

Additional information about the County's long-term obligations can be found in the notes to the basic financial statements.

Economic factors and next year's budget and rates

- The fiscal year 2003-2004 General Fund budget utilized $149.2 million out of $388 million in unreserved fund balance. Fund balance is used as a source of funds for one-time items.

- The development of the fiscal year 2003-2004 budget was based on expectations for demand for services and availability of funding to support those services. Three related factors pose significant negative risks to our expectations: the State of California's budget crisis; the continuing weakness of the State's economy; and, the political and budgetary uncertainty brought on by the October 7, 2003 recall of Governor Davis.

    - The U.S. and California economies continue to give mixed signals regarding solid growth. The San Diego economy, however, continues to show positive but slow growth (i.e., gross regional product at 7.7% for 2000, at 2.6% for 2001, at 2.4% for 2002, and at 3.3% for 2003).

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
(Amounts Expressed in Thousands)

- The State of California's budget crisis, which began in fiscal year 2001-2002, is fueled largely by a decline in taxable income. The decline in taxable income is directly related to the weakened economy and the huge stock market declines that occurred beginning in March, 2000. The State also faces legal challenges to debt financing a portion of its revenue shortfall. Counties, as agents of the State, rely heavily on State revenues to fund locally provided programs. Further, the State has taken action in the past which has intertwined State revenues with local discretionary revenues. (See discussion on Vehicle License Fees below.) The State's budget crisis is not likely to be resolved soon. The Legislative Analyst's Office has estimated a budget shortfall of approximately $7.8 billion for fiscal year 2004-2005 assuming the deficit financing plan for fiscal year 2003-2004 succeeds.

- The Governor Elect took office in November 2003 and must balance campaign promises with the fiscal and legal realities facing State government.

- The County's general purpose revenues, with the exception of vehicle license fees (VLF), (i.e., property tax, sales tax, real property transfer tax, transient occupancy tax and other minor revenues) continue to perform well. Specifically:

  - The largest source of general purpose revenues is property taxes representing 55% of the total. Property taxes have not been directly impacted by weakness in the State economy. In contrast to the slowdown in the job market, demand for housing, boosted by low interest rates, has remained strong as attested to by significant increases in property values. Property taxes for fiscal year 2003-2004 are expected to exceed fiscal year 2002-2003 actuals by 7.8%.

  - VLF revenue is budgeted at a level 2.2% greater than the actual for fiscal year 2002-2003 and makes up 30% of general purpose revenues. However, the actual fiscal year 2003-2004 VLF revenues will be significantly below the fiscal year 2002-2003 level due to State policy actions. Specifically, in 1998, the State reduced the VLF paid by the vehicle owners and backfilled the revenue loss to counties and cities from State general funds. The fiscal year 2003-2004 State Budget eliminated the VLF backfill and reinstated the 2% license fee to vehicle owners. The VLF backfill was eliminated for the entire fiscal year, but the reinstatement of the 2% fee was made effective October 1, 2003, in order to give the Department of Motor Vehicles sufficient time to reprogram its computer system. The County anticipates a shortfall of approximately $31 million as a result of this three-month funding gap. In addition, the State has chosen to keep the Realignment Program whole with respect to the portion funded by VLF. That decision means the loss of an additional $7.5 million to the County's general purpose VLF revenue for a total of $38.5 million less than the $195 million budgeted in fiscal year 2003-2004. This revenue loss will be made up through a combination of over-realized revenues in other general purpose revenue categories (as available), savings in departmental operations and unappropriated fund balance from fiscal year 2002-2003.

  - Sales tax, approximately 3.1% of general purpose revenues, has been more sensitive to the slowdown. It was budgeted conservatively at 2% below fiscal year 2002-2003 actuals but 6.8% above the fiscal year 2002-2003 budgeted level.

  - The real property transfer tax makes up about 2.6% of the general purpose revenues. It is based on the dollar value of property sales and has been favorably impacted by the active real estate markets in the current environment of low interest rates. This revenue, too, was budgeted conservatively at 20% below fiscal year 2002-2003 actuals, but 6.5% above the fiscal year 2002-2003 budgeted level.

REQUESTS FOR INFORMATION

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors with a general overview of the County's finances and to demonstrate the County's accountability for the money it receives. If you have questions about this report or need additional financial information, please contact the Auditor and Controller's Office, County of San Diego, located at 1600 Pacific Highway, San Diego, California 92101.

Basic Financial Statements