January 12, 2004

Honorable Members of the Board of Supervisors
County of San Diego
San Diego County Administration Center
San Diego, California, 92101

Ladies and Gentlemen:

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the County of San Diego, California (the County) for the fiscal year ended June 30, 2003 with the Independent Auditors’ Report, submitted in compliance with California Government Code Section 25253. The Auditor and Controller’s department has prepared the CAFR in conformance with the principles and standards for financial reporting set forth by the Governmental Accounting Standards Board (GASB). Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the County. We believe that the data, as presented, is accurate in all material respects; that its presentation fairly shows the financial position and the results of the County’s operations as measured by the financial activity of its various funds; and that the included disclosures will provide the reader with an understanding of the County’s financial affairs.

This is the second year the County prepared the CAFR using the new financial reporting requirements as prescribed by the GASB Statement No. 34, Basic Financial Statements - and Management’s Discussion and Analysis - for State and Local Governments (GASB 34). This GASB Statement requires that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of a Management’s Discussion & Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the report of the independent auditors.

Our CAFR is divided into the following sections:

The Introductory Section includes information about County government, the County’s economy, general management system, strategic initiatives, selected other financial information, and acknowledgements.

The Financial Section is prepared in accordance with the GASB 34 requirements by including the MD&A, the Basic Financial Statements including notes, and the Required Supplementary Information. The Basic Financial Statements include the government-wide financial statements that present an overview of the County’s entire financial operations and the fund financial statements that present the financial information of each of the County’s major funds, as well as non-major governmental, fiduciary, and other funds. Also included in this section is the Independent Auditors’ Report on the financial statements and schedules.

The Statistical Section provides trend data and non-financial information useful in assessing the County’s financial condition. In this regard, it contains various tables, which present ten years of historical information concerning financial data, debt statistics, and miscellaneous social and economic data. This information is often of special interest to potential investors, creditors and other interested readers.
SAN DIEGO COUNTY PROFILE
The San Diego County is the southernmost major metropolitan area in the State of California and covers 4,255 square miles, extending 70 miles along the Pacific Coast from Mexico to Orange County, and inland 75 miles to Imperial County along the international border shared with Mexico. Riverside and Orange counties form the northern boundary. The County enjoys a wide variety of climate and terrain, from coastal plains and fertile inland valleys to mountain ranges and the Anza-Borrego Desert in the east. The Cleveland National Forest occupies much of the interior portion of the County. The climate is equitable in the coastal and valley regions where most resources and population are located. The average annual rainfall in the coastal areas is 10 inches, so that the County is highly dependent on imported water.

The County population in January 2003 was estimated to be 2,961,600, an increase of 1.8% over January 2002, making it the third largest county by population in California and the fifteenth largest Metropolitan Statistical Area in the United States. Between 1970 and 1995, the San Diego region’s population growth outpaced both the state and the nation, according to the San Diego Association of Governments (SANDAG), who projects that trend to continue through 2020. There are 18 incorporated cities in the County; of them, the City of San Diego is the largest, with population of approximately 1.275 million. In addition, Tijuana, Mexico, with an estimated population of 1.2 million, is a substantial urban neighbor with a shared border, workforce, and economy.

The racial and ethnic composition of the County is as diverse as its geography. According to SANDAG’s analysis of the 2000 Census, 55% of the population is White; 27%, Hispanic; 9%, Asian; 5%, Black; and 4%, all other groups. The growth in the Hispanic population over the last 10 years, 47%, has significantly exceeded total County population growth of 13%. SANDAG projects that both the Hispanic and Asian population shares will continue to increase through 2020. SANDAG also projects an older San Diego County by 2020, based on statistics such as median age and rate of increase of populations over 65.

COUNTY GOVERNMENT, ECONOMY AND OUTLOOK

San Diego County Government
The County was incorporated on February 18, 1850, and functions under a charter adopted in 1933, as subsequently amended from time to time. A five-member Board of Supervisors elected to four-year terms in district nonpartisan elections governs the County. The Board of Supervisors appoints the Chief Administrative Officer and the County Counsel. The Chief Administrative Officer appoints the Chief Financial Officer and the Auditor and Controller. Elected officials include the Assessor/Recorder/County Clerk, District Attorney, Sheriff and Treasurer-Tax Collector.

Many of the County’s functions are required under County ordinances or by state or federal mandate, as County government is the delivery system for federal, state and local programs. The County supports a wide range of services to its residents including regional services such as courts and elections, public health and welfare, and environmental services. The County also provides the unincorporated areas public safety, basic community services such as planning and parks, and infrastructure such as roads and waste disposal. State and federally mandated programs, primarily in the social and health services areas, are directed to be maintained at certain minimum levels, with eligible costs subject to reimbursement according to specific guidelines; however, not all mandated costs are reimbursed.

San Diego Economy and Outlook
In 2002, Forbes Magazine recognized San Diego as the “Best Place” for business and careers, citing a diversified economy and skilled labor force. In recent years the County has enjoyed economic stability, outpacing the state economy despite a general downturn in California. For example, the unemployment rate for the County has been lower than that of the State for the last 5 years, and at July 2003 was 4.7% as compared to 6.7% for the State. Much of this economic strength was characterized by employment gains, personal income increases, rising levels of commercial and industrial development and steady population growth. Looking forward, the state and federal economies are expected to grow slowly, with increases in business investment and slow growth in consumer spending. The San Diego economy is expected to perform in line with the slow expansion of the state and federal economies and to maintain its favorable position in relation to such comparative statistics as unemployment and job growth.

The County’s economic base consists of a significant manufacturing presence in the fields of electronics and shipbuilding, a large tourist industry attracted by the favorable climate of the region, and a considerable defense-related presence. Highlights of County employment as of July 2003 are listed below.
• Non-agricultural employment totaled 1,220,300 jobs.
• The services industry constitutes the largest employment sector and accounted for approximately 44.1% of nonagricultural employment as of July 2003, with a total of 538,500 employed.
• The wholesale and retail trade industries were the second largest, non-government sector, comprising approximately 14.8% of non-agricultural employment with a total of 180,000 jobs.
• Government accounted for approximately 17.1% of total employment and manufacturing accounted for an additional 8.9%. The U.S. Department of Defense contributed about $13.6 billion to the local economy in fiscal year 2002-2003, through wages paid to the uniformed military and civilian personnel, and for equipment and services purchased from local businesses, and continued to rise during fiscal year 2002-2003. San Diego's military presence is anticipated to remain relatively stable and may even increase due to the consolidation of military operations and facilities. Agriculture accounted for approximately .88% of total employment.
• The construction and transportation sectors of employment are greatly influenced by the general health of the economy due to the fact that they serve the local market exclusively. The construction industry in particular has a significant multiplier effect on the economy as a whole. These two sectors are therefore directly influenced by the growth of population and housing. Construction also benefited in fiscal year 2002-2003 from the historically low interest rates.
• Employment growth over the next year is expected to come from the software and computer services and business services industries. Overall, the San Diego economy in fiscal year 2003-2004 is expected to add approximately 22,000 jobs, down slightly from 2002.

County revenues based on the local economy such as property taxes, sales taxes, and charges for services have benefited from the region's strength. For example, new real estate construction plus active resale markets over the last 5 years have resulted in an increase of 42% in the assessed value of property subject to property taxes (net of exemptions). Going forward, real estate markets are expected to remain strong but not spectacular. In addition to conditions of demand and supply, real estate market activity is also affected by interest rates. Mortgage rates increased during the summer of 2003, but are expected to remain low by historical standards over the near term.

The difficult side of accelerating property values is that housing has become less affordable for San Diegans; the update of the County General Plan 2020 is in the process of providing land use and zoning regulations to accommodate expected population growth. Transportation demands and traffic congestion will affect the current and future quality of life, given suburban residential growth and business expansion, such as the gaming industry, outside city centers on formerly rural and agricultural land.

GENERAL MANAGEMENT SYSTEM
The General Management System (GMS) is the formal comprehensive guide for planning, implementing, monitoring and rewarding all functions and processes of County Government. The GMS establishes good business practices and fiscal discipline, both of which are essential to achieve the County of San Diego's vision, "A County Government that has earned the respect and support of its residents." In 2003 the County received two major awards for use of the GMS:

• Grand Golden Watchdog Award from the San Diego County Taxpayers' Association
• Challenge Award from the California State Association of Counties

The purpose of the GMS is to optimize the efficient application of resources in the delivery of services to our residents. These resources include not just taxpayer dollars, but all San Diego County assets, including our unique natural and cultural resources, the expertise and creativity of County employees, and the informed interest of County residents. The idea behind the GMS is straightforward: the County will be able to provide superior services if we set sound goals and apply strong management principles to achieve those goals.

Our County has an annual budget of more than $4 billion and approximately nineteen thousand employees who serve nearly three million residents spread over more than 4,000 square miles. Coordination, fiscal and operational discipline, and shared commitment are vital. The GMS facilitates and organizes the goal setting process. The GMS then links goal setting and long-range planning and resource allocation to goal attainment, which includes monitoring, evaluation, cooperation, motivation, and recognition. The GMS helps ensure that County employees adhere to core principles, promoting a culture that values our employees, partners, and customers and institutionalizes continuous improvement and innovation.
The GMS process begins with long-range, five-year strategic planning process. This is followed by short-term, two-year operational planning process, which encompasses the budget process and wherein each department’s strategic objectives and resources allocated to achieving them are detailed. Monitoring and control take place throughout the year. Evaluation mechanisms are used to ensure that goals are tracked, plans followed, and risks identified. Functional threading maximizes efficient use of personnel and material resources by coordinating staff and linking the functions they perform. Motivation, rewards, and recognition encourage continuing progress by rewarding those who meet and exceed goals. The system completes a full circle in a fiscal year and begins again with a review of the Strategic Plan and development of a new Operational Plan.

County management defines and communicates GMS objectives. Lines of authority flow from the Board of Supervisors to the Chief Administrative Officer (CAO), Assistant CAO (ACA0), and the five Group General Managers/Deputy CAOs. These senior managers supervise appointed department heads, from whom authority flows down to line staff. Despite the crucial role of management, successful GMS application depends on strong and effective leadership at all levels of County service. Every County employee is expected to help set goals, strive to achieve them, and be rewarded for achievement.

The GMS helps ensure that sound planning, preparedness, and improvement become permanent organizational ethics. With the GMS as a guide, the County continues to use strong fiscal management practices, while remaining focused on providing superior services to County residents. The principles and procedures outlined by the GMS are meant to apply to every County function on an ongoing basis.

**STRATEGIC INITIATIVES AND ACHIEVEMENTS**

San Diego County continues to adjust to the two significant external events of the last few years. First, the terrorist attacks and ensuing domestic and international Wars on Terrorism have colored forever the criticality of core government functions such as preparedness and safety. As one of the top geographical areas for Federal defense spending and related activity, San Diego County has experienced direct effects from the military buildup. Second, the first steps towards resolution of the substantial structural State budget shortfall have exacerbated the uncertainty surrounding State support to local governments for discretionary as well as mandated programs. With resources re-allocated in response to those two events, the County has taken early action to plan for and transition program reductions, and these efforts are expected to continue into fiscal year 2003-2004.

As the starting point of the GMS, the County’s Strategic Plan defines broad organization-wide goals as Strategic Initiatives, which help prioritize specific ‘front-line’ County efforts and programs. Initiatives and Required Disciplines were:

- **KIDS**
  Improve opportunities for children

- **THE ENVIRONMENT**
  Promote natural resource management strategies that ensure environmental preservation, quality of life, and economic development.

- **SAFE AND LIVABLE COMMUNITIES**
  Promote safe and livable communities

The Strategic Plan also recognizes that maintaining operational excellence is what enables us to accomplish our Strategic Initiative goals. Key Required Disciplines of operations include:

- Fiscal Stability
- Customer Satisfaction
- Regional Leadership
- Skilled, Competent Workforce
- Essential Infrastructure
- Information Management
- Accountability/Transparency
- Continuous Improvement

Some of the significant achievements of the last year in the Initiatives and Required Disciplines are:
KIDS
- Linked eligible needy children to no-cost and low-cost healthcare coverage with improved application processes for Medi-Cal and Healthy Families and other enrollment efforts.
- Conducted programs to encourage healthy behaviors in children, such as immunizations, weight management, and asthma best practices campaign.
- Provided care and services for at-risk youth and children, including San Pasqual Academy, a residential education facility, juvenile diversion programs that link Corrections, Parks, and Farm & Home Advisor staff, and linking Children’s Mental Health Services to a number of other related programs.

THE ENVIRONMENT
- Advanced the Multiple Species Conservation Program through land acquisition and grants.
- Implemented water quality improvement programs for stormwater management, including inter-agency efforts, best management practices for County facilities, and working with trade and industry groups.
- Led regional responses to a variety of public, environmental, and agricultural health threats such as West Nile Virus and Newcastle Disease.
- Balanced competing land use needs by work with community and industry groups on General Plan 2020.
- Strengthened working relationships with the 17 Tribal Governments.

SAFE AND LIVABLE COMMUNITIES
- Improved emergency preparedness and response through Federal and State funding.
- Addressed primary contributors to crime by implementing Proposition 36 treatment opportunities, improved behavioral health services for dually-diagnosed, and screenings for substance abuse problems.
- Enhanced programs to counter domestic violence with the Domestic Violence Response Team and continued funding for the Domestic Violence Hotline.
- Increased community residents’ accountability for public safety through neighborhood revitalization, housing fraud investigations, and programs designed to monitor registered sex offenders.
- Expanded County Medical Services to increase access to health care and developed a variety of services related to seniors, such as timely response to elder abuse victims.
- Maintained and expanded parks through the renovation or construction of playgrounds and sports fields.
- Expanded information resources with the construction of new branch libraries in Valley Center and Cardiff and obtained Proposition 14 Bond funding for Julian and Lemon Grove libraries.

OTHER FINANCIAL INFORMATION

Internal Controls
In developing and evaluating the County’s accounting system, consideration is given to the adequacy of internal accounting controls. Internal accounting controls are designed to provide reasonable, but not absolute, assurance regarding: (1) the safeguarding of assets against loss from unauthorized use or disposition; and (2) the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived; and (2) the evaluation of costs and benefits requires estimates and judgments by management. All internal control evaluations occur within the above framework. We believe that the County’s internal accounting controls adequately safeguard assets and provide reasonable assurance of proper recording of financial transactions.

Strategic and Operational Planning (Budgetary) Process
A five-year Strategic Plan is updated annually to provide long-term direction to County managers and staff. It embodies the tenets of County’s General Management System (GMS) and is built on mutually held expectations for the future. Each fiscal year a two-year Operational Plan is prepared and details each department’s strategic objectives and the resources required to achieve them. The Operational Plan is monitored regularly and is linked to the GMS system of rewards and recognition. The annual Line-Item Budget incorporates the first year of the Operational Plan and is formally adopted by the Board of Supervisors pursuant to Government Code 29000.
Pension Trust Fund
The San Diego Employees’ Retirement Association (SDCERA) is a contributory defined benefit plan established July 1, 1939, under provisions of the County Employees Retirement Law of 1937. The plan is integrated with the Social Security System and substantially all employees participate. As a result of last year's adoption of enhanced retirement benefits, the County incurred an increased obligation pursuant to the Retirement Law as an unfunded accrued actuarial liability (UAAL) to the Association. In October 2002 the County issued $737.3 million in Pension Obligation Bonds (POBs). The proceeds were used to escrow a portion of outstanding prior POBs and to fund a portion of the aforementioned UAAL. As of June 30, 2002, the total estimated UAAL was $1,246.7 million. For further details concerning this transaction please refer to the Management Discussion and Analysis (MD&A) and Note 4F to the Financial Statements.

Cash Management
The Treasurer, at the delegation of the Board of Supervisors, directs the investment of available County cash, along with cash from other local agencies such as school districts. All deposits are commingled in a pooled investment fund (Pool) and are invested according to an investment policy whose objectives are safety of principal, liquidity, and a rate of return consistent with prudent management. At June 30, 2003, the average yield on investments was 1.74%.

Risk Management
The County purchases insurance for property damage (including earthquake), certain casualty claims, public-officials bond, employee dishonesty, faithful performance, and other risks, and pays deductible amounts that vary with each type of insurance.

The County is self-insured for all other risks. The self-insurance activities and resources are accounted for in two Internal Service Funds (ISFs), with the exception noted below of excess workers compensation. Risk liability levels for both ISFs are determined by actuarial studies, and reserves are being funded over a multi-year period from the rate structures charged to the operating funds. The risk management ISFs are also discussed in Note 58 to the Financial Statements. The ISFs are:

- The Employee Benefits ISF, for all uninsured employee risk management activities. The County purchases insurance for workers’ compensation in excess of $1 million.
- The Public Liability ISF, for all uninsured public risk management activities, such as premises liability, medical malpractice, false arrest, and general liability.

INDEPENDENT AUDIT
County Charter Section 802 requires an annual audit of the County’s accounts and financial transactions. The certified public accounting firm, KPMG LLP, has audited the accompanying basic financial statements compiled from these records. Their Independent Auditors’ Report on the financial statements is presented in the Financial Section.

CERTIFICATE OF ACHIEVEMENT
The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the County for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2002. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. The CAFR must satisfy both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to meet the Certificate of Achievement Program’s requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

OTHER AWARDS AND RECOGNITIONS
In addition to its awards for the GMS, the County has received recognitions for its activities that highlight progress in the Strategic Plan Initiatives as well as those that affirm operational excellence in its Required Disciplines. Some are listed below.

KIDS
San Pasqual Academy, a state-of-the-art residential education campus for foster care youth.
- National Association of Counties (NACo)-2003 Achievement Award
- CSAC-2003 California Community Partnership Award
California Chapter of the American Planning Association—2003 State Planning Award
EmpowerSD, an interactive website using Geographic Information System technology to facilitate self-sufficiency for families with children.
- NACo—2003 Achievement Award
- Environmental Systems Research Institute 2003 Health & Human Services International Users Conference—CEO’s Vision Award
- California Geographic Information Association—2002 Internet Award
- Center for Digital Government—2002 “Best of Web” Honorable Mention

THE ENVIRONMENT
Project Clean Water—a stakeholder-driven approach to developing and implementing consensus strategies for protecting the environment and economy.
- CSAC—2003 Merit Award
- NACo—2003 Achievement Award
- California Conference of Directors of Environmental Health—Excellence in Environmental Health Award

Pollution Prevention, County agencies’ work and efforts in pollution prevention.
- California Environmental Protection Agency—Certificate of Recognition for posting beach water quality status data on a single web page.

SAFE AND LIVABLE COMMUNITIES
Proposition 36, Substance Abuse and Crime Prevention Act Program, operated using only State revenues.
- San Diego County Taxpayer’s Association-2003 Golden Watchdog Finalist.

Job Placement for CalWORKS population, a joint effort with local businesses and business organizations.
- California Technology Trade and Commerce—Investment Fund Certificate of Recognition

Mental Health, a recovery-based disease management project for the treatment of schizophrenia.
- President’s New Freedom Commission on Mental Health-Citation

Books-by-Mail, a County library service for homebound residents.
- NACo - 2003 Achievement Award - Best-in-Class - County Libraries
- American Library Association - 2003 Bessie Boehm Moore-Thorndike Press Award

OPERATIONAL EXCELLENCE IN REQUIRED DISCIPLINES
Internet as delivery channel for information and services
- 2003 Digital Counties Survey—San Diego County tied for fourth best in the country

Purchasing and Contracting business processes and technology enhancements
- NACo—2003 Achievement Award Best in Class for Reverse Auction
- American Purchasing Institute—Achievement in Excellence in Procurement Award
- California Association of Public Purchasing Officials—Achievement in Excellence Procurement Award

Case Management System of the Public Defender
- California Public Defenders Association—2003 Program of the Year Award

ACKNOWLEDGMENTS
We would like to express our appreciation to the accounting staffs of County departments and the staff of the Auditor and Controller’s department whose coordination, dedication and professionalism are responsible for the preparation of this report. We would also like to thank KPMG LLP for their professional support in the preparation of the CAFR. Additionally, we would like to express our gratitude to William J. Kelly, retired Chief Financial Officer/Auditor and Controller, who after 33 years of dedicated County service, retired on December 11, 2003. Lastly, we thank the members of the Board of Supervisors, the Chief Administrative Officer, Group/Agency General Managers and their staffs for using sound business practices while conducting the financial operations of the County.

Respectfully,

DONALD F. STEUER
Chief Financial Officer

TRACY M. SANDOVAL
Assistant Chief Financial Officer/Auditor and Controller