MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

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, 2004. The intent of the information presented here, in conjunction with the Letter of Transmittal is to provide the reader 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.

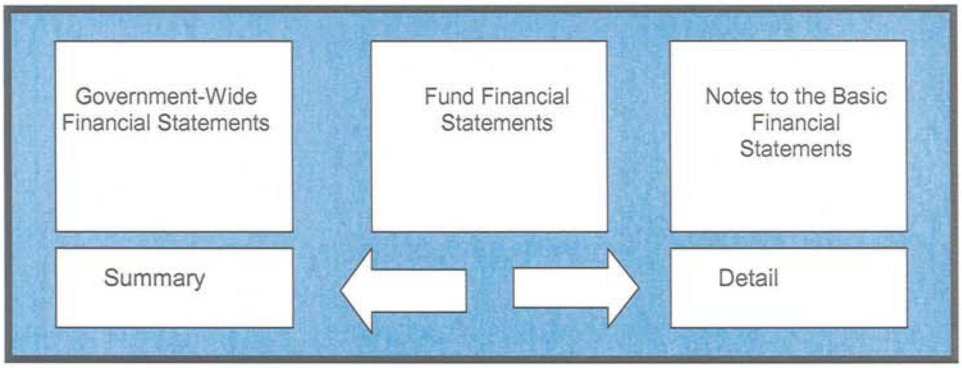
FINANCIAL HIGHLIGHTS

- The assets of the County exceeded liabilities at the close of the fiscal year 2003-2004 by $1.98 billion (*net assets*). Of this amount, $170 million is restricted for specific purposes (*restricted net assets*), and $2.4 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 $590 million.
- Total net assets decreased by $356 million. For governmental activities, expenses exceeded revenues by $363 million. For business type activities, revenues exceeded expenses by $7 million.
- General revenues for governmental activities were $1.1 billion. Of this amount, $626 million or 55 percent was attributable to sales tax and vehicle license fees while property taxes accounted for $497 million or 43 percent.
- Program revenues for governmental activities were $1.8 billion. Of this amount, $1.3 billion or 73 percent was attributable to operating grants and contributions while charges for services accounted for $422 million or 23 percent.
- The total expenses for governmental activities were $3.3 billion. Public protection accounted for $1.2 billion or 35 percent of this amount while public assistance accounted for $1.1 billion or 32 percent. Additionally, health and sanitation accounted for $565 million or 17 percent.

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.



MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

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.

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, public assistance, health and sanitation, recreational and cultural, and education. 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 compliance with finance-related legal requirements. 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 Statements 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:

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

- **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 Sanitation Districts and Other (nonmajor) enterprise funds. Nonmajor enterprise funds are combined and aggregated. Individual fund data for each nonmajor enterprise fund is provided in the Combining Financial Statements and Supplementary Information section in this report.

- **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 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. Additionally, mail services are included within the facilities function, and printing and record storage services are included in the purchasing function. Because all of 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 eight 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 Statements/Schedules 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 San Diego County Employees Retirement Association (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 Statements/Schedules 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 funds and internal service funds and are presented immediately following the Required Supplementary Information section of this report.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

GOVERNMENT-WIDE FINANCIAL ANALYSIS

Net Assets
June 30, 2004
(In Thousands)

		Governmental Activities		Business-type Activities		Total	
		2004	**2003**	**2004**	**2003**	**2004**	**2003**
Assets:							
Current and other assets	$	1,678,164	1,834,009	81,031	82,211	1,759,195	1,916,220
Capital assets		2,680,570	2,665,784	81,938	71,756	2,762,508	2,737,540
Total assets		4,358,734	4,499,793	162,969	153,967	4,521,703	4,653,760
Liabilities:							
Long-term liabilities		2,301,177	1,972,099	3,538	494	2,304,715	1,972,593
Other liabilities		231,636	339,539	1,588	1,806	233,224	341,345
Total liabilities		2,532,813	2,311,638	5,126	2,300	2,537,939	2,313,938
Net Assets:							
Invested in capital assets, net of related debt		2,324,806	2,261,697	78,485	71,293	2,403,291	2,332,990
Restricted		169,983	243,815		15	169,983	243,830
Unrestricted		(668,868)	(317,357)	79,358	80,359	(589,510)	(236,998)
Total net assets	$	1,825,921	2,188,155	157,843	151,667	1,983,764	2,339,822

Analysis of Net Assets

Net assets may serve over time as a use indicator of a government's financial position. In the case of the County, assets exceeded liabilities by $1.98 billion at the close of fiscal year 2003-2004. The County also had positive balances in two of its categories of net assets, (Invested in capital assets net of related debt and Restricted net assets). Unrestricted assets had a deficit balance of $590 million.

The largest portion of the County's net assets (121 percent) reflects its investment of $2.4 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 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, $170 million (9 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 $590 million (an increase of $353 million). This deficit was due in large part to the issuance of $454 million in taxable pension obligation bonds.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

Changes in Net Assets
For the Year Ended June 30, 2004
(In Thousands)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Revenues						
Program revenues:						
Charges for services	$ 421,961	408,860	27,946	27,336	449,907	436,196
Operating grants and contributions	1,339,083	1,288,166	4,153	3,769	1,343,236	1,291,935
Capital grants and contributions	67,357	40,587	1,539	839	68,896	41,426
General revenues:						
Property taxes	496,917	459,340			496,917	459,340
Interest	18,452	30,213	417	1,437	18,869	31,650
State allocation of sales tax and vehicle license fees	625,577	636,225			625,577	636,225
Other	4,200	3,964			4,200	3,964
Total revenues	2,973,547	2,867,355	34,055	33,381	3,007,602	2,900,736
Expenses:						
General government	234,759	234,062			234,759	234,062
Public protection	1,173,532	1,140,484			1,173,532	1,140,484
Public ways and facilities	160,344	142,356			160,344	142,356
Public assistance	1,052,911	1,035,065			1,052,911	1,035,065
Health and sanitation	564,796	598,189			564,796	598,189
Recreational and cultural	26,493	23,520			26,493	23,520
Education	31,722	30,850			31,722	30,850
Interest expense	91,897	87,627			91,897	87,627
Sanitation Districts			15,828	15,216	15,828	15,216
Other Enterprise Funds			11,378	11,482	11,378	11,482
Total expenses	3,336,454	3,292,153	27,206	26,698	3,363,660	3,318,851
Excess(deficiency) before special item and transfers	(362,907)	(424,798)	6,849	6,683	(356,058)	(418,115)
Special Item: gain on sale of properties		474		27		501
Transfers	673	(160)	(673)	160		
Increase(decrease) in net assets	(362,234)	(424,484)	6,176	6,870	(356,058)	(417,614)
Net assets at beginning of year	2,188,155	2,612,639	151,667	144,797	2,339,822	2,757,436
Net assets at end of year	$ 1,825,921	2,188,155	157,843	151,667	1,983,764	2,339,822

Analysis of Changes in Net Assets

The County's net assets decreased by $356 million during the fiscal year 2003-2004.

Governmental activities

Governmental activities decreased the County's net assets by $362 million. This decrease was largely due to the $450 million of contributions paid to SDCERA during fiscal year 2003-2004 to reduce the County's unfunded accrued actuarial liability. This was offset in part by a change in accounting estimate reflected as a reduction of $54 million to the public protection function expense on the Government-wide statement of activities that resulted from the reduction of the County's projected liability of landfill closure and postclosure costs from $101 million at June 30, 2003. For further information, please see the Notes to the basic financial statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

Revenue

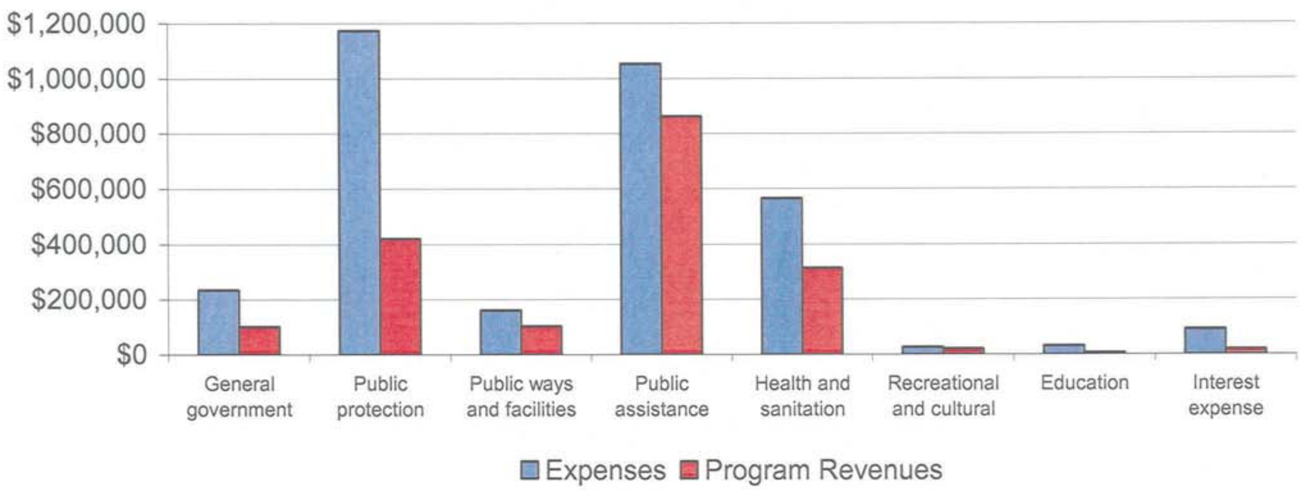
Total revenues for governmental activities were $2.97 billion, an increase of 4 percent or $106 million over the previous year.

Operating and capital grants and contributions increased by $78 million or 6 percent, due in part to donated infrastructure (roads), and monies received from governmental agencies related to Firestorm 2003.

Property tax revenues increased by $38 million or 8 percent during the year. Most of this increase was attributable to the strong real estate market and continued growth in the assessed value of property.

State allocation of sales tax and vehicle license fees decreased by $11 million or 2 percent. Most of this decrease was attributable to a decrease in motor vehicle license fee revenue received from the State.

Expenses and Program Revenues - Governmental Activities (In Thousands)



Expenses

Total expenses for governmental activities were $3.34 billion. Public protection is the largest function in expense (35 percent), followed by public assistance (32 percent) and health and sanitation (17 percent). These ratios for revenues and expenses are substantially similar to 2003. Of the total expenses, $1.1 billion, or 34 percent, were financed by taxes. Expenses increased by $44 million or 1 percent, as further explained below.

Public protection expenses increased by $33 million, or 3 percent. This amount includes a reduction of $54 million in expenses associated with a change in accounting estimate that resulted from the reduction of the County's projected liability of landfill closure and postclosure costs at June 30, 2003. Without this adjustment, the increase in public protection would have been $87 million or 8 percent due in part to costs incurred related to the October 2003 firestorm by the Office of Emergency Services and other departments within the Public Safety and Land Use and Environment Groups.

Public assistance expenses increased by $18 million or 2 percent. This was to an increase in salaries and benefits of $40 million, offset by pension costs of approximately $22 million.

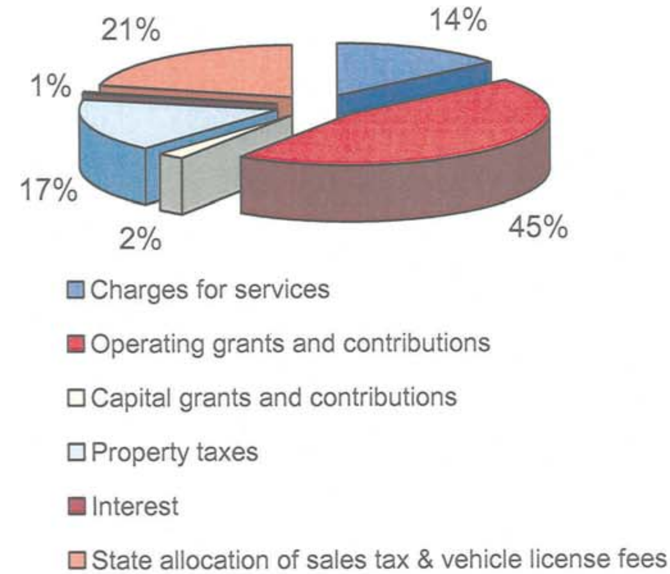
MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

Revenues By Sources

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 allocation of sales tax and vehicle license fees are not shown by program, but are effectively used to support program activities Countywide. State allocation of sales tax and vehicle license fees (21 percent) and property taxes (17 percent) are the second and third largest sources of funds for the County.

At the end of fiscal year 2003-2004, total revenues for the governmental activities were $2.97 billion, while total expenses for governmental activities were $3.34 billion.

Revenues by Source - Governmental Activities (In Thousands)



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."

Business-type Activities

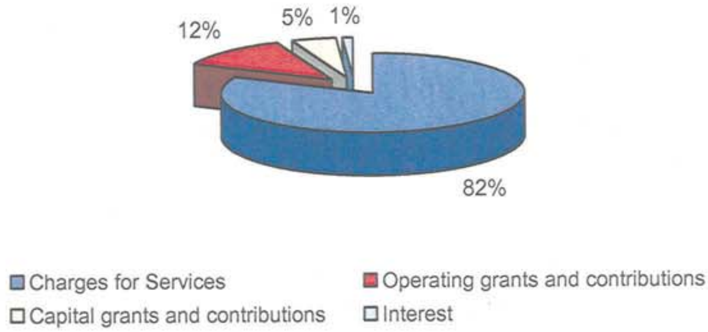
The County has two business-type activities: Sanitation Districts and Other. Business-type activities increased the County's net assets by $6 million.

Revenues

At June 30, 2004, total revenues for the business-type activities were $34 million. 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 percent). Operating grants and contributions as well as capital grants and contributions accounted for 17 percent of business-type activities.

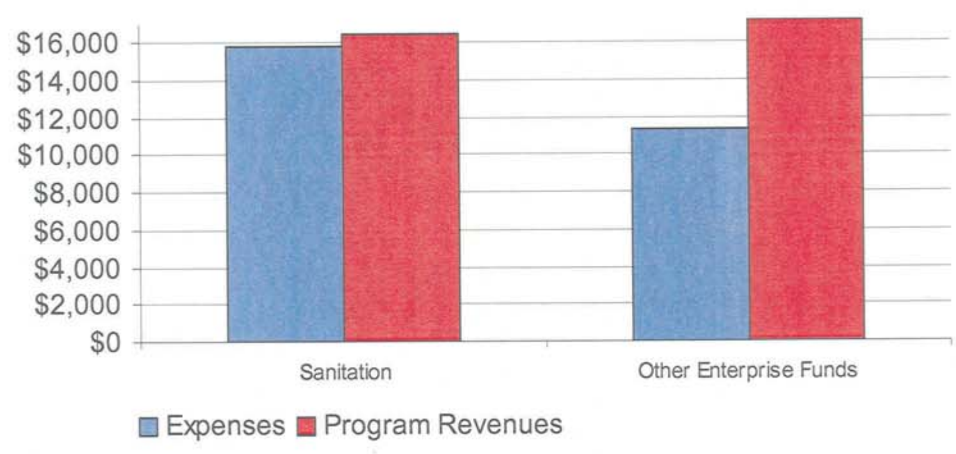
MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

Revenues By Source - Business-Type Activities (In Thousands)



Expenses
At the end of fiscal year 2003-2004, the business-type activities reported total expenses of $27 million. The largest expense category was Sanitation Districts, which had expenses of $16 million or 58 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."

Expenses and Program Revenues - Business-Type Activities (In Thousands)



FINANCIAL ANALYSIS OF THE COUNTY'S FUNDS

The County uses fund accounting to demonstrate and ensure compliance with finance-related legal requirements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

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 2003-2004, the County's governmental funds reported combined ending fund balances of $1.29 billion, a decrease of $57 million in comparison with the prior year fund balance. $872 million of the total June 30, 2004 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 ($114 million), (2) for landfill closure costs ($23 million), (3) to pay debt service ($78 million), and (4) for a variety of other purposes ($207 million).

Revenues for governmental functions overall totaled $2.9 billion representing a 3 percent increase. Expenditures for governmental functions, totaled $3.4 billion, a 1 percent increase from the fiscal year ended June 30, 2003.

GENERAL FUND

The General Fund is the chief operating fund of the County. At the end of fiscal year 2003-2004, the unreserved fund balance of the General Fund was $338 million, while total fund balance was $551 million, a decrease of $48 million from fiscal year 2002-2003. 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 11 percent of total General Fund expenditures of $2.9 billion, while total fund balance represents 19 percent of that same amount.

TOBACCO SECURITIZATION SPECIAL REVENUE FUND

This Special Revenue Fund is used 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 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.

TOBACCO SECURITIZATION JOINT SPECIAL REVENUE FUND

This Special Revenue Fund accounts 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 Sanitation Districts Funds, which are considered to be major funds of the County. Conversely, the nonmajor Enterprise Funds and the Internal Service Funds are combined into single, aggregated presentations in the proprietary fund financial statements with the individual fund data provided in combining statements, which can be found in the Combining Financial Statements/Schedules and Supplemental Information section of this report. Due to the quantitative nature of the Airport and the Wastewater Management Enterprise Funds, the county has elected to not report them as major funds beginning fiscal year 2003-04. Therefore, these funds have been included in the Other Enterprise Funds column in the basic financial statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

Sanitation Districts
The change in net assets for the Sanitation Districts decreased from $2.4 million in fiscal year 2002-2003 to $977 thousand in fiscal year 2003-2004. This change was largely due to a 47 percent increase in expenses for repairs and maintenance (from $2.4 million to $3.5 million) and a 72 percent decrease in revenue from interest and dividends ($1 million). While the charges for services increased by 2 percent and the sewage processing costs decreased by 5 percent, the increased revenue and the savings amounted to $781 thousand.

Fiduciary Funds

The County maintains fiduciary funds for the assets of the Pension Trust Fund, the Investment Trust Fund, and the Agency Funds.

Pension Trust Fund
This fund is under the control of the Board of Retirement. The fund accumulates employer and employee contributions and earnings from the fund's investments. Disbursements are made from the fund for retirement, disability and death benefits and refunds. This fund includes all assets of the retirement system. As of the end of fiscal year 2003-2004, the net assets of the Pension Trust Fund totaled $5.5 billion, an increase of $1.4 billion over the prior year. The change is primarily due to the following: (a) County and member contributions of $734 million, including $450 million in pension obligation bond proceeds; (b) appreciation in the fair value of pension trust investments and investment income of $936 million; less (c) member benefits paid and pension costs of $265 million.

Investment Trust Fund
This fund was established to account for the external portion of the County Treasurer's investment pool. This fund consists of school districts, special districts, and funds held for other governments. The Investment Trust Fund's net assets totaled $2.4 billion, a decrease in net assets of $81 million, primarily resulting from distributions of teeter and school bond proceeds.

Agency Funds
The Agency Funds maintain assets held in an agent capacity for other governments, organizations and individuals. These assets do not support the County's programs or services. Any portion of the Agency Funds' assets held at fiscal year end for other County funds, are reported in those funds rather than in the Agency Funds.

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 transfers of appropriations, budget corrections, re-budgets, and account reclassifications. At June 30, 2004, the variances between the original and final budgets for the deficiency of revenues under expenditures ($527.6 million) and for other financing sources, $450.1 million, resulted in a total change of ($77.5 million) in budgeted fund balance between the original and final budgets.

Increased appropriations caused significant variances between the original and the final budgets as follows:

- $29.2 million related to Firestorm 2003 activities in public protection, health and sanitation, and recreation and culture. The source of funding was $19.6 million in fund balance, $3.0 million in transfer of appropriations from contingency reserves, and $6.6 million in State and Federal grants and other revenue. The appropriations related to immediate responses to emergency situations as well as to longer-term efforts of repairs and prevention and affect both private and public real and personal property. Specific programs included burned automobile and other debris removal, counseling and other assistance for fire victims, repair of guardrails on County-owned roads, and repairs to County parks.
- $454.1 million in long-term debt proceeds from the issuance of Taxable Pension Obligation Bonds. Bond proceeds were expended across all functions for the purpose of reducing the unfunded actuarial accrued liability to SDCERA.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

- $30.8 million for a new electronic voting system in the General function, funded by Federal and State grants, and management reserves.
- $17.7 million for salaries and benefits across all functions for incentives earned in Fiscal Year 2002-2003 through the County's Quality First program, funded by fund balance.
- $14.7 million for services by the Health & Human Services Agency for health and sanitation and public assistance, funded by increased intergovernmental revenue.
- $8.1 million net change in appropriated management reserves for future one-time projects, across all functions, including new reserves of $17.0 million appropriated from prior year's fund balance.
- In public protection, $3.5 million for a new fire and safety helicopter funded by fund balance and $4.7 million for appropriations related to homeland security, funded by a combination of State funds and fund balance
- $13.3 million for costs in health and sanitation associated with closing a former County-owned landfill, based on funds set aside for that purpose.

In addition, the installation of a new accounting system added $19.4 million in budgeted revenue associated with prior year encumbrances.

Actual revenues fell short of the final budgeted amounts by $123 million, while expenditures fell short of the budget by $268.8 million. The combination of revenue and expenditure shortfalls resulted in a net favorable operating variance of $145.8 million. Other financing sources and uses of funds resulted in a favorable variance from budget of $39.7 million; an increase to the reserve for inventories of materials and supplies, a favorable variance of $.2 million. These combined variances result in a net variance in fund balance of $185.8 million. Some highlights of the actual results compared to budgeted results are:

Vehicle License Fee (VLF) Reduction. Collected by the State and distributed to cities and counties as general purpose revenues, the VLF is an annual fee on the ownership of registered vehicles. Since 1999, California drivers had paid a lower VLF rate than the legislated amount, with the shortfall backfilled by State revenues. The acceleration of the State budget crisis in June 2003 resulted in a series of events that first suspended the backfill and subsequently eliminated VLF general purpose revenues for the County altogether. (The County continues to receive VLF under realignment health, mental health, and social services programs.) With a budget of $195.0 million and revenues of $150.8 million budget, the unfavorable variance due to the backfill loss was $44.2 million. (See also the VLF discussion in the section below entitled "Economic Factors and Next Year's Budget and Rates.)

Salaries and Benefits. In the continuing environment of uncertainty over State and Federal funding, many County functions have deferred hiring staff for ongoing programs in anticipation of future budget constraints that began in fiscal year 2003-2004. The total favorable variance in this category was $43.0 million across all functions.

Health and Human Services Agency. Funded by a combination of State, Federal, and County revenues, most Agency programs are carried out in the functional areas of health and sanitation and public assistance, with favorable expenditure variances of $35.2 million and $71.7 million, respectively. The expenditure variances resulted from changes in demand for services in various programs, reductions in service level requirements, decreased need for contracted services, and reduced aid payments. These lowered expenditures were offset by corresponding reductions in Federal and State revenue.

Debt management. The County planned to pay down an additional $53.2 million of the principal debt of the 2002 Pension Obligation Bonds (POBs). Due to market conditions this did not occur. Instead, appropriations of $12.1 million were used to prepay SANCAL debt, resulting in a positive variance of $41.5 million in transfers out. The savings were re-budgeted for fiscal year 2004-2005 to defease the remaining 1994 POBs.

Strong real estate markets. The real estate market in San Diego County has been robust for several years due to low interest rates and high demand for residential and commercial real estate. This segment of the economy contributed to positive variances in several revenue categories, including $38.4 million in property and other taxes and $9.1 million in charges for document and recording services.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
Required Supplementary Information

Delayed expenditures. Various County projects such as maintenance and information technology take place over more than one fiscal year; however, at inception they are budgeted at full expected cost, resulting in favorable expenditure variances that are re-budgeted in the new fiscal year. For example, in public protection, $8.2 million in unexpended appropriations for information technology projects, regional communications system expansion, and the East Mesa Juvenile Detention Facility were re-budgeted in fiscal year 2004-05. Also, $3.5 million appropriated during the year for a fire and safety helicopter as noted above was not expended and was re-budgeted in fiscal year 2004-05.

Firestorm 2003. Not all of the funds that were appropriated to cover estimated costs of Firestorm 2003 recovery programs were expended. In most cases, the remaining funds have been re-budgeted and will be spent in subsequent years. In recreation and culture, for example, $4.3 million appropriated for parks repair and other fire-related projects were unspent. Lesser unspent amounts for other Firestorm-impacted programs included abandoned vehicle abatement ($.1 million) and consultant costs for plan checks ($.2 million).

Funding for public protection. The County received several grants that had not been budgeted, including $10.9 million for reimbursement of prior years' costs under the Federal Southwest Border Grant program. In another revenue category, however, Charges for Services, revenue from the cities that contract with the Sheriff is $5.5 million below budget, due to reduced demand and adjustments.

Reserves. The County appropriates annually management and contingency reserves based on both ongoing general purpose revenues and prior years' fund balance for a variety of one-time capital and operating expenditures as well as potential emergencies, such as Firestorm 2003. Unexpended reserves resulted in a positive variance of $27.1 million. In addition, in fiscal year 2003-04, the County set aside $23.0 million for economic uncertainty with the intent that it not be spent unless unusual needs arose; of that amount, $22.1 million was unexpended at year-end.

Capital Assets and Debt Administration

Capital Assets

At June 30, 2004, the County's capital assets for both the governmental and business-type activities was $2.8 billion net of accumulated depreciation. 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 capital asset activity in fiscal year 2003-2004 was as follows:

<u>Governmental Activities</u>

- $31.25 million towards the construction and improvement of County maintained roads, bridges, and other road related infrastructure. An additional $31 million was donated by developers.
- $10.45 million towards the construction of the East Mesa Juvenile Detention Facility. Total project costs are estimated at $52.95 million.
- $4.41 million for the acquisition of Boulder Oaks Ranch real property (Ramona) for wildlife habitat preservation and restoration.
- $3.29 million for the acquisition of real property in the Otay River Valley area for open space habitat restoration and passive recreation.
- $2.63 million for acquisition of real property in the Ramona area for an intergenerational community campus.
- $2.33 million for Multiple Species Conservation Program acquisitions.
- $2.32 million for the Kearny Mesa Assessor Recorder County Clerk building. Total project costs are estimated at $6.87 million.
- $2.30 million towards the construction of the Julian Shared Use Library. Total project costs are estimated at $3.09 million.
- $2.2 million for the acquisition of real property in North County for the future site of offices for Assessor/Recorder/County Clerk, the Department of Planning and Land Use, and the Department of Environmental Health.
- $2.04 million for a remodel of the Sheriff's Crime Lab. Total project costs are estimated at $2.6 million.

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- $1.65 million towards the construction of the Tijuana River Valley Sports Park. Total project costs are estimated at $2.77 million.
- $23.9 million towards the construction of numerous other capital outlay projects.
- During fiscal year 2003-2004, capital assets valued at $21.2 million, representing the four transit centers, was removed from inventory as a result of the divestiture of the County Transit System to the Metropolitan Transit Development Board.

Business-Type Activities
- $3.19 million for the acquisition of land for Palomar Airport.
- $2.19 million towards improvements in the Spring Valley Sanitation district including Outfall Sewer Rehabilitation, improvements to Central Avenue Sewer, Jamacha pump station modifications, and La Presa Trunk upgrade.
- $533 thousand towards the replacement of the Galloway Pump Station Force Main in Alpine Sanitation District. Total project costs are estimated at $2.1 million.
- $232 thousand towards the replacement of the Julian Sanitation District septic tank and aerobic digester. Total project costs are estimated at $629 thousand.

For government-wide financial statement presentation, governmental fund depreciable capital assets were depreciated from the 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.

Capital Commitments

As of June 30, 2004, capital commitments included the following:

- $32.7 million for the Registrar of Voters Integrated Voting System and the Medics Health Information System
- $35.7 million for the Valley Center Road, Riverside Drive, Camino Canada North County Animal Shelter, Otay Valley Regional Park, Spring Valley Gym/Teen Center, Polinsky Nursery, Vista Detention and the Information Technology Enterprise Resource Planning System financing
- $3.9 million for the Galloway Wastewater Pump Station and the Jamacha Blvd Sewer

Long-Term Obligations

At June 30, 2004, the County had outstanding governmental activity long-term obligations of $2.3 billion. Of this amount, $344 million pertains to outstanding certificates of participation, $37 million pertains to capital leases, and $1.9 billion pertains to other long-term obligations that include $1.27 billion of taxable pension obligation bonds, $440 million of San Diego County Tobacco Asset Securitization Corporation Bonds, $98 million for claims and judgments, $47 million for landfill closure and postclosure costs, $78 million for compensated absences, $6 million for other loans, $4 million for Redevelopment Agency revenue bonds, and $1 million for arbitrage rebate.

Long-term obligations for business-type activities totaled $3.5 million and consisted of $3 million for capital loans, $345 thousand for compensated absences and $195 thousand for a long-term contract payable in the Spring Valley Sanitation District.

During fiscal year 2003-2004, the County's total principal amount of bonds and notes payable for governmental activities increased by $386 million, before giving affect to the unamortized issuance premiums, discounts and unamortized deferred amount on refunding. The increase is due primarily to the County of San Diego's issuance of $454 million in taxable pension obligation bonds, offset by $70 million in principal debt service payments. The general long-term obligations for the business-type activities increased by $46 thousand due to an increase in compensated absences liabilities.

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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-
2004 Series A, B & C	Aa3	AA-	AA-

In addition, the County has an Issuer Credit Rating of Aa2 from Moody's and 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. On 2004, Moody's revised the County's negative outlook to stable and Standard & Poor's revised their outlook from positive to stable.

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

	Fiscal Year 2004	Fiscal Year 2003
Net Bonded Debt	$ 1,576,479	$ 1,191,754
Net Bonded Debt per Capita	523	402
Ratio of Net Bonded Debt to Assessed Value	.62 percent	.51 percent

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 2004-2005 General Fund budget used $129.2 million out of $215.4 million in unreserved fund balance and $4.0 million of reserved fund balance. Fund balance is used as a source of funds for one-time items.

- The development of the fiscal year 2004-2005 budget was based on expectations for demand for services and availability of funding to support those services. Two related factors pose significant negative risks to the County's expectations: the State of California's forecasted budget imbalance for 2005-06 and beyond and the continuing sluggishness of the State's economy.

  - The U.S. and California economies continue to give mixed signals regarding solid growth. The San Diego economy, however, continues to show positive growth (i.e., gross regional product at 2.0% for 2001, at 2.7% for 2002, 3.5% for 2003, and at 4.2% for 2004).

  - The State of California's budget crisis, which began in fiscal year 2001-2002, was fueled by a decline in taxable income. The decline in taxable income was directly related to the weakened economy and the huge stock market declines that occurred beginning in March 2000. 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 VLF below.) The State's budget crisis is not likely to be resolved soon. The Legislative Analyst's Office has estimated the budget shortfall will exceed $6.0 billion for fiscal year 2005-2006.

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

  - The largest source of general purpose revenues is property taxes, representing 55% of the total. Property taxes were not directly impacted by weakness in the State economy. The demand for

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)
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housing, boosted by low interest rates, has remained strong as attested to by significant increases in property values. For the last four years, local secured growth has been high (8.1% average annual growth) due to the County's strong overall economy and healthy real estate market. This growth rate was expected to continue into Fiscal Years 2004-05 and 2005-06, however, the State of California's Fiscal Year 2004-05 Budget shifted $27.5 million of County property taxes to schools in each of these 2 years. Property taxes for fiscal year 2004-2005 are expected to fall $1.2 million or 0.3% below fiscal year 2003-2004 actuals.

- Vehicle License Fee (VLF) revenue. Beginning in Fiscal Year 2004-05, the County's share of VLF general purpose revenue was eliminated and replaced with money shifted from the County's Educational Revenue Augmentation Fund (ERAF). (The ERAF fund was established by state law in Fiscal Year 1992-93 to capture prescribed amounts of property tax to be shifted from local governmental agencies to local schools.) As noted above, this funding arrangement resulted from the State of California's FY 2004-05 budget actions and the signing of SB 1099. More specifically, the passage of SB 1099 made the following changes to the previous laws: eliminated the current VLF "offset" mechanism and permanently set the VLF rate at 0.65% as of January 1, 2005, eliminated VLF "backfill" payments along with the "trigger" provision in current law, replaced VLF backfill payments to cities and counties with property tax revenues shifted back from ERAF via a new VLF Property Tax Compensation Fund to be established by each county, established initial allocations for 2004-05 to each city and each county from the VLF Property Tax Compensation Fund, and provided for allocations in 2005-06 to be calculated based on a formula that takes into account adjusted actual allocations for Fiscal Year 2004-05 and the increase in gross taxable assessed value within each city or each county. This VLF/ERAF swap of funds follows State action during Fiscal Year 2003-04 to suspend VLF backfill payments during the first three months of that year. By August 2006 (Fiscal Year 2006-07), the State is required to make a one-time payment to counties and cities to make up for that suspension. The "loan" amount to be repaid to the County of San Diego is $60.0 million.

- Sales tax ($15.5 million and 2.4% of general purpose revenues) has been more sensitive to the slowdown. The Fiscal Year 2004-05 budgeted amount reflects a reduction from Fiscal Year 2003-04, but it is due to a reclassification of about one-fourth of the sales tax revenue ($5.15 million in FY 2004-05) to "property taxes in lieu of sales tax" to comply with the State's "triple flip" legislation approved in Fiscal Year 2003-04. More specifically, effective July 1, 2004, provisions of AB7 X1, one of the 2003-04 State budget bills referred to as the "triple flip", took effect. It enabled the State to redirect one-quarter cent of the local sales and use tax to the State to repay up to $15 billion in bonds authorized by Proposition 57 (March 2004) to help the State refinance its past debt. In turn, lost revenues are replaced on a dollar-for-dollar basis with countywide property tax revenues shifted back from the Educational Revenue Augmentation Fund (ERAF). Retail sales remain relatively strong in the unincorporated area with a before-triple-flip-adjustment sales tax growth of $0.6 million (3.0%) over the Fiscal Year 2003-04 Operational Plan in Fiscal Year 2004-05. Actual sales tax revenue for 2003-04 totaled $20.5 million.

- The real property transfer tax makes up about 2.7% of 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 38% below fiscal year 2003-2004 actuals, but 5.9% above the fiscal year 2003-2004 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.