Management's Discussion and Analysis

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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, 2005. 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.

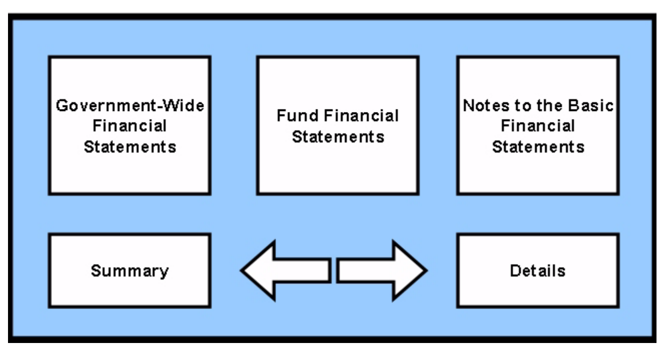
Financial Highlights

- The assets of the County exceeded liabilities at the close of the fiscal year 2004-2005 by $2.18 billion (net assets). Of this amount, $224 million is restricted for specific purposes (restricted net assets), and $2.43 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 $465 million.
- Total net assets increased by $201 million. For governmental activities, revenues exceeded expenses by $198 million. For business type activities, revenues exceeded expenses by $3 million.
- General revenues for governmental activities were $970 million. Of this amount, property taxes and property taxes in lieu of vehicle license fees accounted for $646 million or 67 percent; other taxes, interest and other general revenues accounted for $324 million or 33 percent.
- Program revenues for governmental activities were $2.2 billion. Of this amount, $1.8 billion or 81 percent was attributable to operating grants and contributions while charges for services accounted for $414 million or 19 percent.
- The total expenses for governmental activities were $2.99 billion. Public assistance accounted for $973 million or 33 percent of this amount, while public protection accounted for $960 million or 32 percent. Additionally, health and sanitation accounted for $546 million or 18 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.



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 the aforementioned 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 and the Tobacco Securitization Special Revenue Fund, both of which are considered to be major funds. Data from the other twenty-six 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:

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 services, wastewater management and airport operations. These 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.

Government-wide Financial Analysis

Net Assets
June 30, 2005 (In Thousands)

	Primary Government					
	Governmental Activities		Business-Type Activities		Total	
	2005	2004	2005	2004	2005	2004
ASSETS						
Current and other assets	$ 2,456,419	1,678,164	79,091	81,031	2,535,510	1,759,195
Capital assets	2,674,393	2,680,570	87,581	81,938	2,761,974	2,762,508
Total assets	5,130,812	4,358,734	166,672	162,969	5,297,484	4,521,703
LIABILITIES						
Long-term liabilities	2,335,192	2,301,177	3,250	3,538	2,338,442	2,304,715
Other liabilities	771,977	231,636	2,696	1,588	774,673	233,224
Total liabilities	3,107,169	2,532,813	5,946	5,126	3,113,115	2,537,939
NET ASSETS						
Invested in capital assets, net of related debt	2,341,126	2,324,806	84,416	78,485	2,425,542	2,403,291
Restricted	223,565	169,983			223,565	169,983
Unrestricted	(541,048)	(668,868)	76,310	79,358	(464,738)	(589,510)
Total net assets	$ 2,023,643	1,825,921	160,726	157,843	2,184,369	1,983,764

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 $2.18 billion at the close of fiscal year 2004-2005. 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 net assets had a deficit balance of $465 million.

The largest portion of the County's net assets (111 percent) reflects its investment of $2.43 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, $224 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 $465 million (an increase of $125 million). This increase was in large part due to increased Property taxes collected in lieu of vehicle license fee(VLF) revenue ($204 million), decrease in the State allocation of sales tax and VLF ($121 million) and an increase in other taxes ($44 million). A more detailed discussion of these revenue sources can be found below in the Analysis of Changes in Net Assets Revenues section.

Changes in Net Assets
For the Year Ended June 30, 2005 (In Thousands)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
Revenues:						
Program revenues						
Charges for services	$ 414,384	351,928	30,651	27,404	445,035	379,332
Operating grants and contributions	1,769,805	1,747,368	3,700	4,671	1,773,505	1,752,039
Capital grants and contributions	32,303	67,357	1,036	1,539	33,339	68,896
General revenues						
Property taxes	441,716	412,587			441,716	412,587
Property taxes in lieu of vehicle license fees	203,788				203,788	
Other taxes	96,927	52,489			96,927	52,489
State allocation of sales tax and vehicle license fees	106,548	227,688			106,548	227,688
Interest	38,066	21,992	1,730	417	39,796	22,409
Other	83,079	92,138	287	24	83,366	92,162
Total revenues	3,186,616	2,973,547	37,404	34,055	3,224,020	3,007,602
Expenses:						
Governmental Activities						
General government	232,826	286,997			232,826	286,997
Public protection	960,227	1,124,382			960,227	1,124,382
Public ways and facilities	122,797	164,551			122,797	164,551
Health and sanitation	545,805	592,426			545,805	592,426
Public assistance	972,592	1,017,705			972,592	1,017,705
Education	27,394	31,722			27,394	31,722
Recreation and cultural	21,405	26,774			21,405	26,774
Interest expense	106,612	91,897			106,612	91,897
Business-type Activities						
Airport			8,117	7,373	8,117	7,373
Wastewater Management			5,076	4,005	5,076	4,005
Sanitation Districts			20,564	15,828	20,564	15,828
Total expenses	2,989,658	3,336,454	33,757	27,206	3,023,415	3,363,660
Excess (deficiency) before transfers	196,958	(362,907)	3,647	6,849	200,605	(356,058)
Transfers	764	673	(764)	(673)		
Increase (decrease) in net assets	197,722	(362,234)	2,883	6,176	200,605	(356,058)
Net assets at beginning of year	1,825,921	2,188,155	157,843	151,667	1,983,764	2,339,822
Net assets at end of year	$ 2,023,643	1,825,921	160,726	157,843	2,184,369	1,983,764

Analysis of Changes in Net Assets

The County's net assets increased by $201 million during the fiscal year 2004-2005. (Certain fiscal year 2003 - 2004 balances were reclassified to conform with the current year presentation.)

Governmental activities:

Governmental activities increased the County's net assets by $197.7 million for the year ended June 30, 2005, accounting for 99% of the total increase in net assets. Governmental activities operating revenues exceeded operating expenses by $196.9 million. Transfers provided a total increase in net assets of $.8 million.

Revenues:

Total revenues for governmental activities were $3.19 billion, an increase of 7 percent or $213 million from the previous year. Total program revenues increased $50 million, due in part to increases in realignment revenues which fund health, mental health and social services programs.

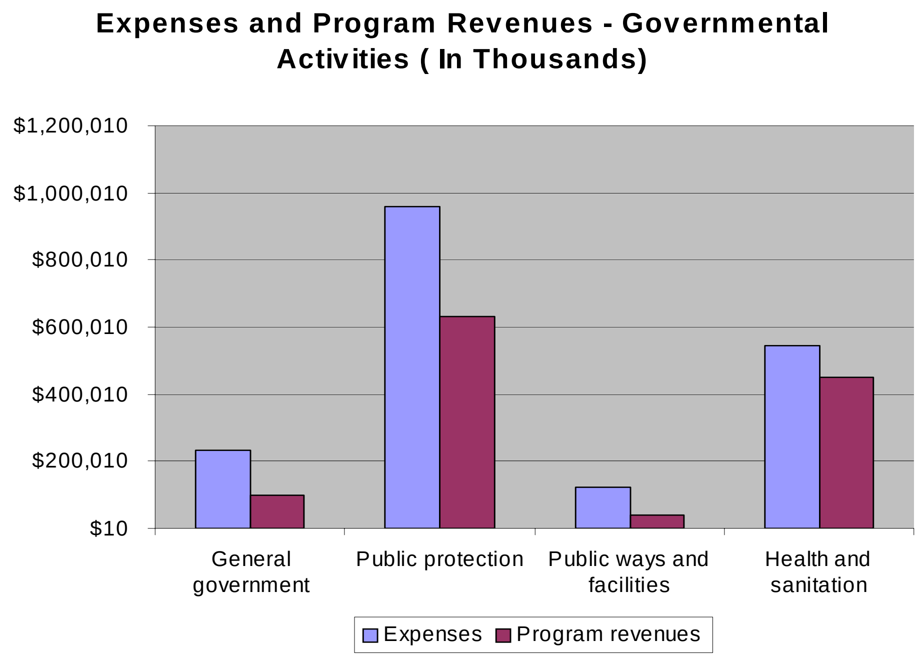
The $163 million increase in general revenues is primarily due to the following:

$29 million of the increase was due to property taxes, which increased 7% over the previous year. The increase was due to significant growth in assessed property values as real estate activity remained strong.

$204 million of the increase is due to property taxes in lieu of vehicle license fee(VLF) revenue. Beginning in Fiscal Year 2004-2005, the County's share of general purpose VLF was eliminated and replaced with property tax revenue previously distributed in the County for education funding via the 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. The swap of property tax for VLF general purpose revenues resulted from the State's Fiscal Year 2004-05 budget actions and the signing of SB1099. The mechanism used to shift property tax revenues from ERAF to cities and counties was the establishment of a new VLF Property Tax Compensation Fund which holds initial allocations of property tax before distributions to cities and counties in January and May of the fiscal year. The County's share of this "swapped" revenue was $204 million.

$121 million represents a decrease in the State allocation of sales tax and VLF. Decreases in VLF are a result of the "swap" explained above while decreased sales taxes were caused by the State's exchange of sales tax revenue for property tax revenue. Effective July 1, 2004, provisions of AB7X1, one of the 2003-04 State budget bills referred to as the "triple flip" took effect. It redirected one-quarter cent of sales tax to the State to repay up to $15 billion in bonds authorized by Proposition 57 (March 2004) to help the State finance its past debt. In turn, the State replaced the County's loss of sales tax revenue with a like amount of property tax revenue.

Interest earnings increased $16 million or 73%, as the annual pool investment earnings rate increased to 2.24% from the prior year of 1.59%.



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Expenses:

Total expenses for governmental activities were $2.99 billion, a decrease of 10% or $347 million from the prior year. Public assistance is the largest function in expense (33 percent), followed by public protection (32 percent) and health and sanitation (18 percent).

The total decrease in program expenses is attributed generally to the following:

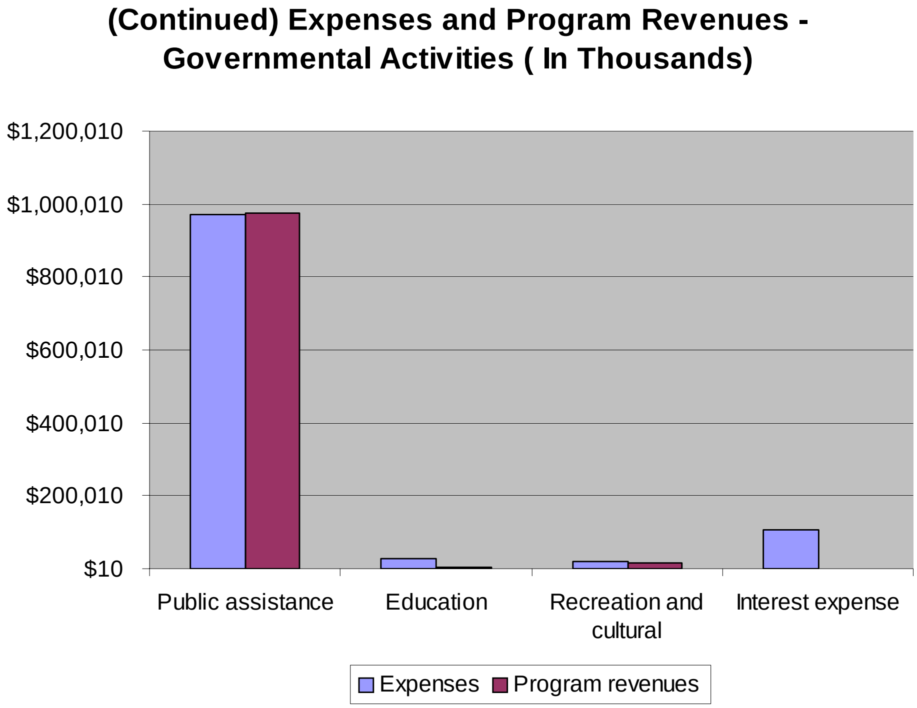
$450 million represented savings as a result of the prior year's contributions paid to SDCERA to reduce the County's unfunded accrued actuarial liability (UAAL). This was offset by Board action to pay down $25 million of the UAAL in the current fiscal year, for a net overall decrease in this category of expense of $425 million. The reduced expense was applicable across all functions.

Offsetting the above decrease are the following increases in expenses:

$30 million is attributable to increases in salaries and benefit costs, an increase of 2.4% over the previous year. As a service delivery entity, the County's major cost component is salaries and benefits, amounting to approximately 43% of the total County expenditures. The County's overall strategy whereby some positions are deleted, some are frozen and others are temporarily funded has minimized the impact of negotiated salary increases and increased benefit costs.

$15 million is attributable to increased interest expense on borrowings to meet cash flow needs of operations.

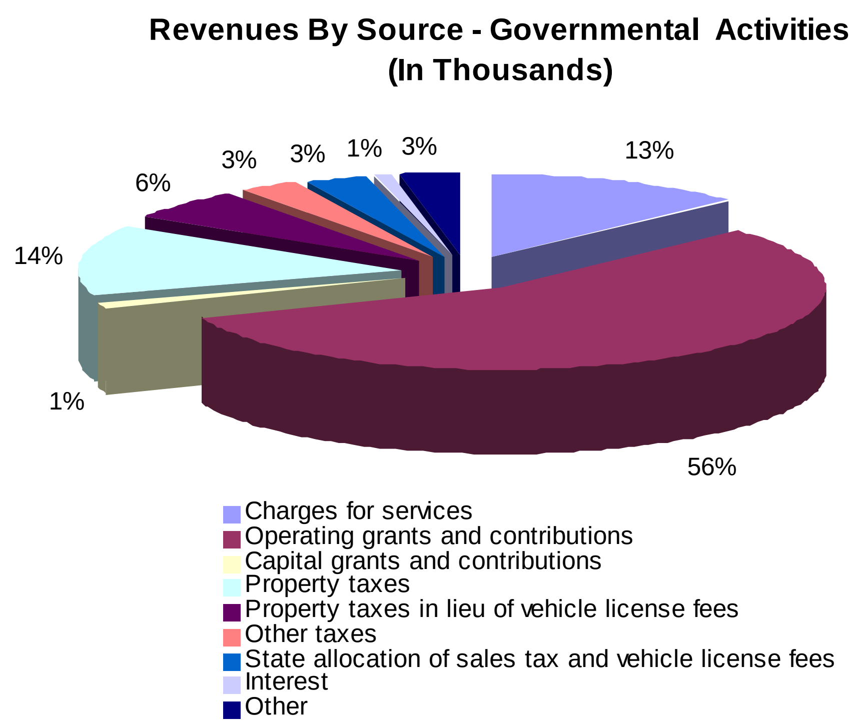
$3 million represents basic increases in the costs of services and supplies across all functions.



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 (56 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 property taxes in lieu of vehicle license fees are not shown by program, but are effectively used to support program activities County-wide. Combined, these revenues account for 20% of governmental activities.

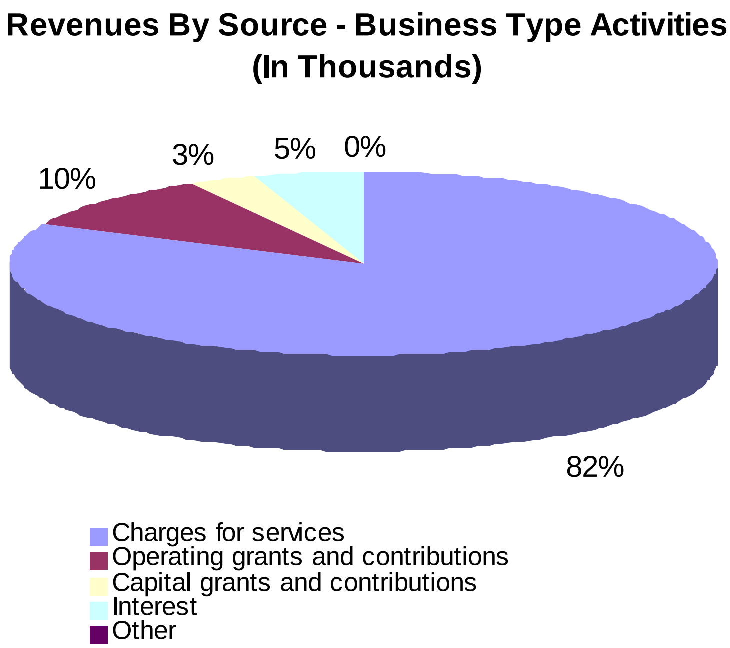
At the end of fiscal year 2004-2005, total revenues for the governmental activities were $3.19 billion, while total expenses for governmental activities were $2.99 billion.



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."

Business-type Activities:

The net assets of business-type activities increased by $2.9 million or 1.8%, indicating that these activities generated revenues sufficient to cover the costs of operations. Revenues increased 9% to $37.4 million due to an increase in charges for services and expenses of 20% to $33.7 million, primarily due to increased costs of sewage processing and costs of repairs and maintenance.



Financial Analysis of the County Funds

The County uses fund accounting to demonstrate and ensure 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 and the Tobacco Securitization Special Revenue Fund. Nonmajor Governmental Funds include Special Revenue Funds, Debt Service Funds, and Capital Project Funds.

As of the end of fiscal year 2004-2005, the County's governmental funds reported combined ending fund balances of $1.52 billion, an increase of $224 million in comparison with the prior year fund balance. Of the total June 30, 2005 amount, $942 million 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 ($177 million), (2) for landfill closure costs ($26 million), (3) to pay debt service ($148 million), and (4) for a variety of other purposes ($225 million).

Revenues for governmental functions overall totaled $3.12 billion representing a 6 percent increase. Expenditures for governmental functions, totaled $3.0 billion, a 13 percent decrease from the fiscal year ended June 30, 2004.

General Fund:

The General Fund is the chief operating fund of the County. At the end of fiscal year 2004-2005, the unreserved fund balance of the General Fund was $376 million, while total fund balance was $667 million, an increase of $116 million from fiscal year 2003-2004. This was primarily attributed to increases in property tax revenues of $215 million, federal aid of $31 million and charges for current services of $8 million offset by a decrease in State aid of $138 million. 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 15 percent of total General Fund expenditures of $2.5 billion, while total fund balance represents 26 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. At the end of fiscal year 2004-2005, fund balance was $332 million, a decrease of $14 million from fiscal year 2003-2004. This represents the net of transfers out of the fund of $23 million to support health related program expenditures and interest earnings of $9 million.

Other Governmental Funds:

Other Governmental funds consist of twenty-six nonmajor funds, which include Special Revenue Funds, Debt Service Funds, and Capital Project Funds. Individual fund data for each of these nonmajor governmental funds is provided in the Combining Financial Statements and Supplementary Information Section of this report. As of the end of fiscal year 2004-2005, the Fund Balance of the Other Governmental Funds totaled $518 million, an increase of $122 million over the prior year. The change is primarily due to the following: an increase in the fund balance of the SANCAL Capital Projects Fund of $63 million due to proceeds from a bond issuance; an increase of $52 million in the fund balance of the Pension Obligation Bonds Fund due to transfers in of $106 million and principal and interest payments of $16 million and $41 million, respectively; an increase of $16 million in the fund balance of the Edgemoor Development Fund due to proceeds from the sale of capital assets.

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 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 Sanitation Districts, the County has elected not to report them as a major fund beginning fiscal year 2004-05.

As of the end of fiscal year 2004-2005, the Net Assets of the Enterprise Funds totaled $160 million, an increase of $3 million over the prior year, primarily due to an increase in the net assets of the Airport Fund as a result of an increase in charges for services of $2 million and a decrease in non-operating expenses of $1.7 million.

Net Assets of the Internal Service Funds totaled $103 million, a decrease of $10 million from the prior year. The net change in the Internal Service Funds is primarily due to a decrease of $6 million in the Risk Financing Fund due to an excess of claims ($43 million) over revenue ($37 million); a decrease in the Facilities Management Fund of $3 million due to increase utilities ($2 million) and repairs and maintenance costs ($1 million); and a decrease of $1 million in the Fleet Services Fund due to increased fuel expense.

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 2004-2005, the net assets of the Pension Trust Fund totaled $6.4 billion, an increase of $850 million over the prior year. The change is primarily due to the following: (a) County and member contributions of $356 million, (b) appreciation in the fair value of pension trust investments and investment income of $795 million; less (c) member benefits paid and pension costs of $302 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 $2.6 billion, an increase in net assets of $164 million, primarily resulting from undistributed school bond proceeds, undistributed property tax collections and prepaid unsecured taxes.

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, 2005, the variances between the original and final budgets for the excess of revenues over expenditures, $49.5 million, and for other financing sources, $35.5 million, resulted in a total change of $85 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:

- $33.2 million for the Integrated Property Tax System funded from securitizing the repayment of the Vehicle License Fee Gap loan.
- $25 million to reduce the unfunded actuarial accrued liability to SDCERA also funded from securitizing the repayment of the Vehicle License Fee Gap loan.
- $7.5 million increase based on increased State revenues. The Governor's Proposed Budget cut funding in the Probation Department Temporary Assistance for Needy Families (TANF). The shortfall would have resulted in the closure of a juvenile camp and ranch treatment beds and other reductions in juvenile and adult probation services, therefore, General Purpose Revenues replaced the TANF funding for these programs in the County's Adopted Operational Plan. In the final State budget, however, State General Revenues were allocated to continue State categorical funding for these programs. This allowed the County to reallocate the General Purpose

Revenues to fund a variety of one-time and on-going services including capital projects, major maintenance and increased costs in the Defense Attorney/Contract Administration department.

- $7.4 million for salaries and benefits for incentives earned through the County's Fiscal Year 2003-2004 Quality First program, funded by fund balance.
- $16.2 million net change in appropriated management reserves for future one-time projects.
- $8.4 million for costs associated with closing the San Marcos landfill, funded from the Environmental Trust Fund ($3 million), Land Acquisition-Divestiture Holding Fund ($4 million) and the Solid Waste Landfill Closure Reserve ($1.4 million), bringing the total project cost to $23.2 million.
- $7.7 million to fund unbudgeted expenditures related to revenue sharing requirements of the Memorandum of Understanding with the State Courts and for payments for undesignated fees pursuant to Assembly Bill 1759 based on traffic court fines, fees and forfeitures ($6.5 million) and fund balance ($1.2 million).
- $8.8 million to fund increased costs in the In-Home Supportive Services Program in Aging and Independence Services based on increased funding from the State Department of Social Services.
- $60.5 million reduction in appropriations for carryover adjustments for year-end encumbrances.

Actual revenues fell short of the final budgeted amounts by $80 million, while expenditures fell short of the budgeted amount by $275.7 million. The combination of revenue and expenditure shortfalls resulted in a net favorable operating variance of $195.7 million. Other financing sources and uses of funds resulted in a favorable variance from budget of $50.9 million and there was no variance in the increase to the reserve for inventories of materials and supplies. These combined variances result in a variance in the net change in fund balance of $246.6 million. Some highlights of the actual results compared to budgeted results are:

Property Tax in Lieu of Vehicle License Fee (VLF): In Fiscal Year 2004-05, the State established initial allocations from the VLF Property Tax Compensation Fund to cities and counties. This replaced the previous distribution of vehicle license fees to local governments. The County budgeted $196.9 million for this revenue source and received $204 million, resulting in a favorable variance of $7.1 million. In addition, during Fiscal Year 2005-06 the County will be receiving a $17.7 million positive true-up adjustment for Fiscal Year 2004-05. (For further VLF discussion see 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. The total favorable variance in this category is $36.3 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 $31.8 million and $75.9 million respectively. The expenditure variances result from demand for services being less than the budgeted level. 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 and commercial real estate. This segment of the economy contributed to a positive variance of $24.6 million in property taxes.

Delayed expenditures: Many 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 into the new fiscal year. For example, $17.0 million has been re-budgeted in the Department of Public Works for the Hazardous Fuels Reduction Program and $2.4 million has been re-budgeted in the Department of Parks and Recreation for parks repair and other fire-related projects. In public protection, $5.0 million in unexpended appropriations for the Regional Communications System, the Jail Information Management System, the North County Regional Gang Task Force, the Cal-ID mugshot replacement system and U.S. Department of Justice Grants involving DNA analysis were re-budgeted the next fiscal year. Additionally, $1.3 million was re-budgeted in the Multi-Species Conservation and Watershed programs and another $.5 million was re-budgeted for document management technology costs.

Reserves: The County annually appropriates 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. Unexpended reserves resulted in a positive variance of $43.5 million. In addition, in FY 2004-05, the County set aside $17.4 million for economic uncertainty with the intent that it not be spent unless unusual needs arose; of that amount, $14.8 million was unexpended at year end.

Capital Assets and Debt Administration

Capital Assets

At June 30, 2005, the County's capital assets for both the governmental and business-type activities was $2.76 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 2004-2005 was as follows:

Governmental Activities:

- $23 million towards the construction and improvement of County maintained roads, bridges, and other road related infrastructure. An additional $23 million was donated by developers.
- $8.21 million towards the construction of the Edgemoor Skilled Nursing Facility in Santee. Total project costs are estimated at $83.79 million.
- $4.37 million towards the construction of the North County Animal Shelter. Total project costs are estimated at $6.69 million.
- $3.09 million for the acquisition of real property in the Otay River Valley area for open space habitat restoration and passive recreation.
- $2.34 million towards the construction of the Bonita Library. Total project costs are estimated at $4.49 million.
- $1.53 million towards the construction of a control panel system at the Vista Detention Facility. Total project costs are estimated at $2.65 million. ·
- $1.34 million towards the construction of a nursery at Polinsky Children's Center. Total project costs are estimated at $2.42 million.
- $1.25 million towards the construction of the East Mesa Juvenile Detention Facility. Total project costs are estimated at $52.95 million.
- $12.96 million towards the construction of numerous other capital outlay projects.

During fiscal year 2004-2005, capital assets valued at $18.81 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:

- $2.21 million towards the replacement of the Galloway Pump Station Force Main in Alpine Sanitation District. Total project costs are estimated at $4.28 million.
- $1.88 million towards runway rehabilitation at Gillespie Field Airport in El Cajon. Total project costs are estimated at $4.97 million.
- $1.01 million was donated by developers for sewer lines in the East Otay Mesa area.

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.

More detailed capital assets information, including depreciation as of June 30, 2005, can be found in Note IV-D of the notes to the basic financial statements.

Capital Commitments

As of June 30, 2005, capital commitments included the following:

- $72 million for the Integrated Voting System, Integrated Property Tax System, RCS Equipment, SMART system, Revenue Plus Collection System, Medics Health Information System, and the Automated Records Management and Field Reporting Software Installation.
- $80 million for the construction of the Edgemoor Skilled Nursing Facility, the Air Pollution Control Facility in Scripps Ranch, Valley Center Road, Spring Valley Gym/Teen Center, Mission Road, and Forester Creek Drainage system.
- $4.4 million for the Jamacha Boulevard Sewer and the Gillespie Field Runway.

More detailed capital commitments information, including depreciation as of June 30, 2005, can be found in Note IV-D.2 of the notes to the basic financial statements.

Long-Term Obligations

At June 30, 2005, the County had outstanding governmental activity long-term obligations of $2.3 billion. Of this amount, $393 million pertains to outstanding certificates of participation, $35 million pertains to capital leases, and $1.9 billion pertains to other long-term obligations that include $1.25 billion of taxable pension obligation bonds, $430 million of San Diego County Tobacco Asset Securitization Corporation Bonds, $104 million for claims and judgments, $48 million for landfill closure and postclosure costs, $77 million for compensated absences, $7.3 million for other loans, $4 million for the 1995 Redevelopment Agency revenue bonds.

Long-term obligations for business-type activities totaled $3.2 million and consisted of $2.9 million for capital loans and $324 thousand for compensated absences.

During fiscal year 2004-2005, the County's total principal amount of bonds and notes payable for governmental activities increased by $24 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 $112 million in certificates of participation for the Edgemoor/Regional Communication System refunding. Offsets were $60 million in principal debt service payments and $30 million reduction of principal due to the refunding of the 1996 Regional Communication System. The long-term obligations for the business-type activities decreased by $93 thousand due to a debt service payments on capital loans.

More detailed long-term obligation activity, including interest rates and maturity dates, can be found in Note IV-I through IV-I-6 of the notes to the basic financial statements.

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

Credit Ratings	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. There were no changes in the credit ratings from the previous year.

Economic Factors and Next Year's Budget and Rates

The budget for FY 2005-06 resources to support County services contains an increase of $98.7 million, 2.4% over FY 2004-2005.

The San Diego economy continues to show positive growth (i.e., gross regional product at 4.9% for 2002, 4.5% for 2003, 4.4% for 2004, and forecasted at 4.5% for 2005).

The 2005-06 Budget Act is consistent with the two-year budget agreement reached between the State and local governments in July 2004 and the passage of Proposition 1A on the November 2004 ballot with respect to general purpose revenues. For the second year in a row the County will transfer $27.5 million of its property taxes to the Educational Revenue Augmentation Fund (ERAF) to assist the State to meet its funding obligations to local schools. This revenue loss was anticipated and factored into the County's 2005-06 Adopted Budget.

Since 1995-96 the State Property Tax Administration Grant program has assisted counties maintain timely property assessments. The 2005-06 Budget Act suspends for two years the entire $60 million that has historically been budgeted for the program. For the County, the revenue loss is $5.4 million and was not anticipated in the County's 2005-06 Adopted Budget. The County will be reviewing its options including identifying where costs can be reduced and whether any other funding source is available to cover all or a portion of this revenue loss.

Salaries and benefits are increasing by a net $63.8 million or 4.5%. This reflects negotiated increases in base pay and health insurance along with required payments to the retirement fund offset by the reduction of 65 staff years.

The County's *general purpose revenues* continue to perform well. Specifically:

- The largest source of general purpose revenues is property taxes ($400.5 million), representing 55% of the total. The demand for housing, boosted by low interest rates, has remained strong as attested to by significant increases in property values. For the last five years, local secured growth has been high (8.2% average annual growth excluding the State's 2004-05 property tax shift to schools) due to the County's strong overall economy and healthy real estate market. At present, real estate activity is still strong due to stable, historically low mortgage rates, the limited supply of housing for sale, and the area's population growth. As noted above, per the two-year agreement with the State, the County will relinquish $27.5 million in property tax revenues to ERAF. Current secured property tax revenues budgeted in the Fiscal Year 2005-06 Adopted Budget were based on the assumption that assessed value growth through June 30, 2005 would be 10%. Actual assessed value growth exceeded

13%, which is projected to raise current secured property tax revenue collections by $12.9 million.

- *Property Taxes in Lieu of Vehicle License Fees (VLF)* comprises 27.8% (an estimated $200.5 million) of General Purpose Revenues in Fiscal Year 2005-06. This revenue source replaces the previous distribution of vehicle license fees to local governments. In Fiscal Year 2004-05, the State established initial allocations from the VLF Property Tax Compensation Fund to cities and counties. The allocations for Fiscal Year 2005-06 are to be calculated based on a formula that takes into account adjusted actual allocations for Fiscal Year 2004-05 and growth in gross taxable assessed value in each county. Information on the adjusted actuals was released on October 14, 2005 and the County will be receiving a $17.7 million true-up adjustment for Fiscal Year 2004-05. In addition, the published assessed value growth factor for 2005-06 is 13.3% which establishes the County's 2005-06 property tax in lieu of vehicle license fee base at $247.3 million.

At June 30, 2005, *unreserved General Fund balance* was $376 million. Of this amount, the County appropriated to the General Fund $56.5 million of unreserved, undesignated fund balance and $3.7 million in reserved fund balance for Fiscal Year 2005-2006 expenditures of one-time items. The County's *Adopted Operational Plan* for Fiscal Years 2005-2006 (the Adopted Budget) and for Fiscal Year 2006-2007 (for planning purposes) and the County's *Capital Program* can be found on the internet at http://www.sdcounty.ca.gov/auditor/budinfo.html

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.