

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, 2006.

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 2006 by \$2.57 billion (net assets). Of this amount, \$2.46 billion is invested in capital assets, net of related debt; \$225 million is restricted for specific purposes (restricted net assets); and the remaining portion represents a deficit balance in unrestricted net assets of (\$117) million.
- Total net assets increased by \$388 million. For governmental activities, revenues exceeded expenses by \$369 million. For business type activities, revenues exceeded expenses by \$18.7 million.
- General revenues for governmental activities were \$1.25 billion. Of this amount, property taxes and property taxes in lieu of vehicle license fees accounted for \$778 million or 62 percent; other taxes, sales and use taxes for roads, sales and use taxes for public protection, sales and uses taxes, interest and other general revenues accounted for \$475 million or 38 percent.

- Program revenues for governmental activities were \$2.3 billion. Of this amount, \$1.8 billion or 80 percent was attributable to operating grants and contributions while charges for services accounted for \$456 million or 20 percent.
- The total expenses for governmental activities were \$3.14 billion. Public Protection accounted for \$1.02 billion or 32.5 percent of this amount, while Public Assistance accounted for \$1.01 billion or 32.4 percent. Additionally, health and sanitation accounted for \$560 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.

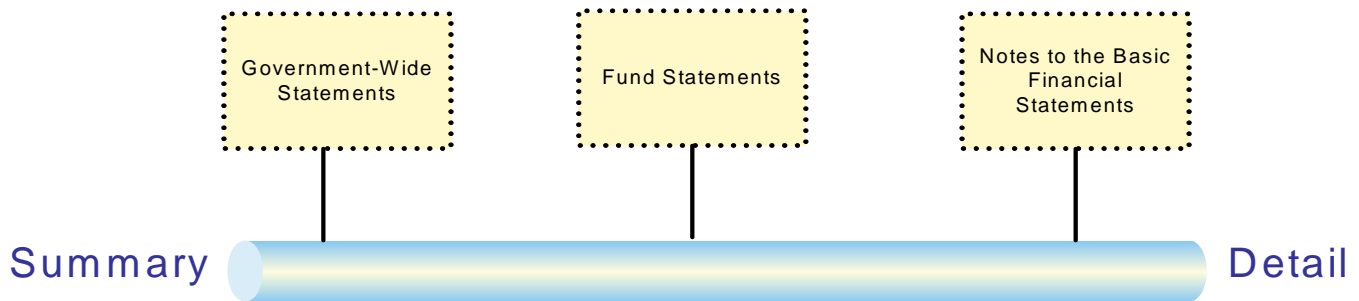
The Government-wide financial statements are designed to provide readers with a broad overview of County finances, in a manner similar to a private-sector business.

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



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



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, health and sanitation, public assistance, education and recreation and cultural. The business-type activities of the County include airport operations, wastewater management and sanitation districts.

Fund financial statements are groupings of related accounts that are used to maintain control over resources that have been segregated for specific activities or objectives. The County, like other state and local governments, uses fund accounting to ensure and demonstrate 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 supplemental 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 supplemental 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. 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 supplemental 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 supplemental 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, internal service funds and fiduciary funds and are presented immediately following the required supplementary information section of this report.

Government-wide Financial Analysis

Table 1

	Net Assets June 30, 2006 (In Thousands)					
	Governmental Activities		Primary Government Business Type Activities		Total	
	2006	2005	2006	2005	2006	2005
ASSETS						
Current and other assets	\$ 2,610,156	2,456,419	84,646	79,091	2,694,802	2,535,510
Capital assets	2,710,793	2,674,393	100,174	87,581	2,810,967	2,761,974
Total assets	5,320,949	5,130,812	184,820	166,672	5,505,769	5,297,484
LIABILITIES						
Long-term liabilities	2,396,272	2,335,192	3,134	3,250	2,399,406	2,338,442
Other liabilities	530,516	771,977	3,349	2,696	533,865	774,673
Total liabilities	2,926,788	3,107,169	6,483	5,946	2,933,271	3,113,115
NET ASSETS						
Invested in capital assets, net of related debt	2,367,442	2,341,126	97,212	84,416	2,464,654	2,425,542
Restricted	224,635	223,565			224,635	223,565
Unrestricted	(197,916)	(541,048)	81,125	76,310	(116,791)	(464,738)
Total net assets	\$ 2,394,161	2,023,643	178,337	160,726	2,572,498	2,184,369

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 \$2.57 billion at the close of fiscal year 2006.

The largest portion of the County's net assets (96 percent) reflects its investment of \$2.46 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, \$225 million, represents resources that are subject to external restrictions on how they may be used. External restrictions include those imposed by grantors, contributors, laws and/or regulations of other governments.

The remaining portion of the County's net assets represents a deficit of (\$117 million). This deficit was \$348 million less than the prior year's deficit of (\$465 million) and was due in large part to the overall increase in net assets of \$388 million, principally due to a \$203 million increase in operating grants and contributions; \$73 million in property taxes; and \$58 million in property taxes in lieu of vehicle license fees.



Table 2

**Changes in Net Assets
June 30, 2006 (In Thousands)**

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Revenues:						
Program revenues:						
Charges for services	\$ 455,559	414,384	29,006	30,651	484,565	445,035
Operating grants and contributions	1,792,663	1,589,378	9,994	3,700	1,802,657	1,593,078
Capital grants and contributions	5,283	32,303	58	1,036	5,341	33,339
General revenues:						
Property taxes	516,569	443,525			516,569	443,525
Other taxes	34,219	34,812			34,219	34,812
Sales and use taxes for roads	38,702	35,961			38,702	35,961
Sales and use taxes for public protection	236,438	222,218			236,438	222,218
Property taxes in lieu of vehicle license fees	261,695	203,788			261,695	203,788
Sales and use taxes	23,475	89,102			23,475	89,102
Interest	63,810	38,066	7,048	1,730	70,858	39,796
Other	78,651	83,079	160	287	78,811	83,366
Total revenues	3,507,064	3,186,616	46,266	37,404	3,553,330	3,224,020
Expenses:						
Governmental Activities:						
General government	240,158	232,826			240,158	232,826
Public protection	1,021,464	960,227			1,021,464	960,227
Public ways and facilities	128,268	122,797			128,268	122,797
Health and sanitation	559,709	545,805			559,709	545,805
Public assistance	1,015,481	972,592			1,015,481	972,592
Education	32,488	27,394			32,488	27,394
Recreation and cultural	23,376	21,405			23,376	21,405
Interest expense	116,692	106,612			116,692	106,612
Business-type Activities:						
Airport			7,699	8,117	7,699	8,117
Wastewater Management			4,733	5,076	4,733	5,076
Sanitation Districts			15,133	20,564	15,133	20,564
Total expenses	3,137,636	2,989,658	27,565	33,757	3,165,201	3,023,415
Change in net assets before transfers	369,428	196,958	18,701	3,647	388,129	200,605
Transfers	1,090	764	(1,090)	(764)		
Change in net assets	370,518	197,722	17,611	2,883	388,129	200,605
Net assets at beginning of year	2,023,643	1,825,921	160,726	157,843	2,184,369	1,983,764
Net assets at end of year	\$ 2,394,161	2,023,643	178,337	160,726	2,572,498	2,184,369

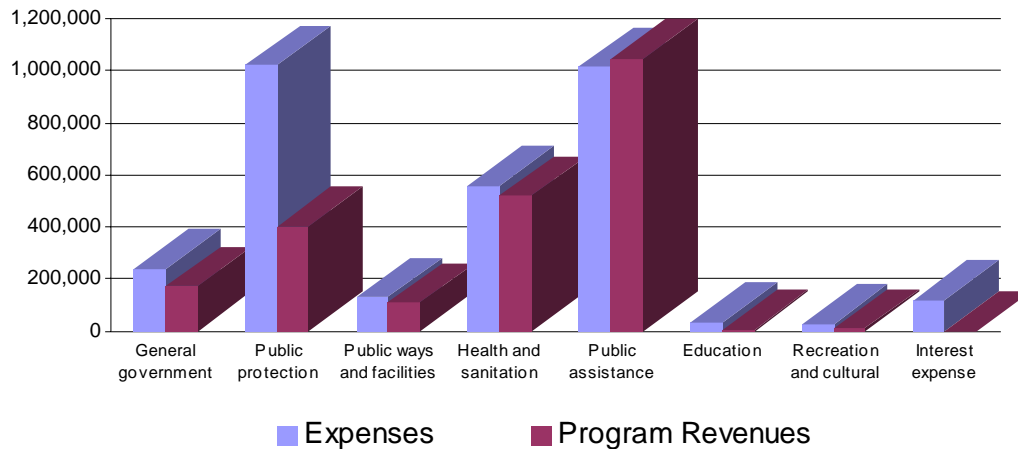
Analysis of Changes in Net Assets

The County's total net assets increased by \$388 million during fiscal year 2006. (Certain fiscal year 2005 balances were reclassified to conform with the current year presentation.) The increase of \$388 million was attributed to: increases of \$208 million in total assets (includes

an increase of \$159 in current and other assets and a \$49 million increase in capital assets); and a decrease in total liabilities of \$180 million (includes a decrease of \$241 million of other liabilities offset by an increase in long-term liabilities of \$61million).



**Chart 1
Expenses and Program Revenues - Governmental
Activities (In Thousands)**



Governmental activities:

Governmental activities increased the County's net assets by \$371 million, accounting for 96% of the total increase in net assets (Business-type activities accounted for the remaining 4%, \$17.6 million).

Expenses:

- Total expenses for governmental activities were \$3.14 billion, an increase of \$148 million or 5% (\$138 million in functional expenses and \$10 million in interest expense) over the prior year. Public protection was the largest functional expense (32.5 percent), followed by public assistance (32.4 percent) and health and sanitation (18 percent).

Increases in program expenses were attributed to the following:

- \$77 million was due to an increase in contracted services including: \$22 million in public works roads related projects; \$7 million in other public works projects; an \$18 million increase in public assistance related

contracted services including aid and other public assistance programs; \$13 million in social administration services and programs; \$11 million in mental health related services; and \$6 million in other general contracted services.

- \$44 million was attributable to an increase in salaries and benefit costs of approximately 3% over the previous year. As a service delivery entity, the County's major cost component is salaries and benefits, which accounts for approximately 45% of the total expenses. The County's overall strategy of deleting, freezing and temporarily funding positions has minimized the impact of negotiated salary increases and increased benefit costs.
- \$17 million was due to increases of \$5 million in contributions to other agencies; \$5 million for various sheriff adult detention costs; \$2 million for homeland security grant related expenses; \$2 million for library books/publications; and \$3 million for various sundry



charges.

- A \$10 million increase in interest expenses occurred as a result of higher rates on both existing variable rate debt and new debt issued during the current fiscal year.

Revenues:

Total revenues for governmental activities were \$3.51 billion, an increase of 10 percent or \$320 million from the previous year.

Program revenues increased by \$217 million. This increase was due primarily to a combined net increase of \$176 million in operating grants and contributions and capital grants and contributions coupled with a \$41 million increase in charges for services.

General revenues increased by \$103 million. This increase was primarily due to the following:

- \$73 million of the increase was due to increases in current and delinquent property taxes chiefly because of significant growth in assessed property values.
- \$58 million of the increase was due to property taxes in lieu of vehicle license fees. This revenue source replaced the previous distribution of vehicle license fees to local governments. In fiscal year 2005, the State established initial allocations from the Vehicle License Fee Property Tax Compensation Fund to cities and counties. Allocations of \$244 million for fiscal year 2005-2006 were calculated based on a formula that took into account adjusted actual allocations for fiscal year 2005 and the growth in taxable assessed value. Additionally, the County received a \$17.7 million positive true-up adjustment from the previous fiscal year.
- \$26 million or 67% of the increase was attributable to an increase in interest earnings as the annual pool investment earnings rate increased to 3.47% from the prior year of 2.24%.
- \$14 million of the increase was attributable to an increase in the Proposition 172 one half

cent sales and uses tax which is used exclusively for public protection related activities. This increase occurred as a result of growth in the California economy.

- \$66 million represents a decrease in sales and use taxes principally due to the receipt of \$62 million in fiscal year 2005 one-time monies received for the securitization of swapped Vehicle License Fee (VLF)/Educational Revenue from the State of California.

The County's governmental activities rely on several sources of revenue to finance ongoing operations. As shown in **Chart 2** on the following page, operating grants and contributions of \$1.8 billion accounted for 51%, the largest share of this revenue. These monies are 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 health and sanitation programs. 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 general revenues of \$778 million account for 22% of governmental activities. Additionally, \$456 million applicable to charges for services accounted for 13%, while sales and use taxes of \$299 million accounted for 9% of these revenues.

At the end of fiscal year 2006, total revenues for the governmental activities were \$3.51 billion, while total expenses for governmental activities were \$3.14 billion.

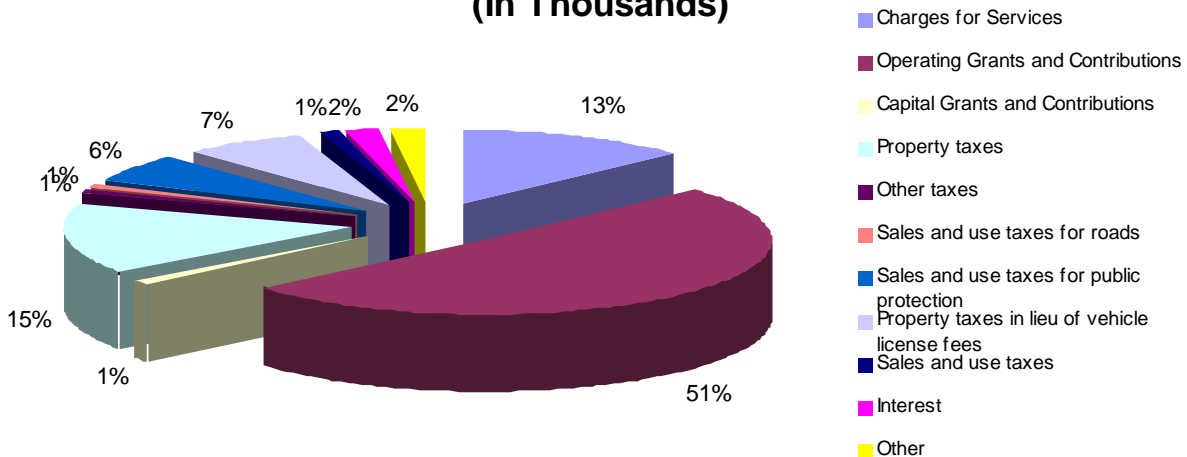
Other factors concerning the finances of the County's major governmental funds are discussed in the governmental funds section of the "Financial Analysis of the County's Funds."

Business-type Activities:

Business-type activities are intended to recover all or a significant portion of their costs through user fees and charges. As shown in **Chart 3**, charges for services represent \$29 million or 62%



Chart 2
Revenues By Source - Governmental Activities
(In Thousands)



while grants (\$10 million) and interest earnings (\$7 million) represent 21% and 15% of total revenues respectively.

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 2006, the County's governmental funds reported combined

ending fund balances of \$1.88 billion, an increase of \$359 million in comparison with the prior year fund balance. Of the total June 30, 2006 amount, \$1.33 billion constitutes unreserved fund balance, which is available for spending at the County's discretion. The remaining \$552 million 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 (\$2 million), (3) to pay debt service (\$128 million), and (4) for a variety of other purposes (\$245 million).

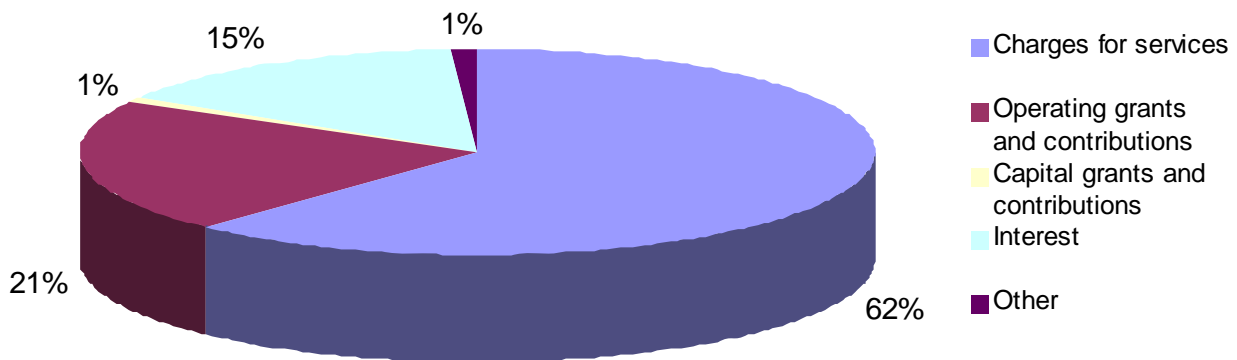
Revenues for governmental functions overall totaled \$3.42 billion representing a 9% increase. Expenditures for governmental functions, totaled \$3.2 billion, a 6% increase from the fiscal year ended June 30, 2005.

- *General Fund:*

The General Fund is the chief operating fund of the County. At the end of fiscal year 2006, the unreserved fund balance of the General Fund was \$626 million, while total fund balance was \$899 million, an increase of \$231 million from fiscal year 2005.



Chart 3
Revenues By Source - Business Type Activities
(In Thousands)



This was primarily attributed to increases in property tax revenues of \$65 million, property tax in lieu of vehicle license fees of \$58 million, state aid of \$67 million and federal aid of \$41 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 24 percent of total General Fund expenditures of \$2.66 billion, while total fund balance represents 34 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 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 2006, fund balance was \$440 million, an increase of \$108 million from fiscal year 2005. This increase was attributable to: \$123 million

transfers in of bond proceeds from the Tobacco Securitization Joint Special Revenue Fund resulting from the issuance of the San Diego County Tobacco Asset Securitization Corporation refunding bonds; interest earnings of \$9 million; and transfers out of \$25 million to support health related program expenditures.

• *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 supplemental information section of this report. As of the end of fiscal year 2006, the fund balance of the other governmental funds totaled \$538 million, an increase of \$20 million over the prior year. This change was primarily due to the following: a \$41 million increase in the fund balance of the Road Fund, due mostly to a \$25 million increase in sales and use tax revenue; a \$9 million increase in gas tax revenue; an increase of \$9 million in charges for services; and a decrease in the fund balance of



the SANCAL Capital Projects Fund of \$22 million due principally to transfers out of \$19 million to the Capital Outlay Fund to pay for capital related expenditures and \$5 million to the Information Technology Internal Service Fund to fund the payment of information technology software costs, offset by interest earnings of \$2 million.

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. Individual proprietary fund data is presented in the combining financial statements/schedules and supplemental information section of this report.

The net assets of business-type activities Enterprise Funds increased by \$18 million or 11%, indicating that these activities generated revenues sufficient to cover the costs of operations. Although operating revenues decreased by \$2 million, non-operating revenues increased \$11 million. This was primarily due to a \$6 million increase in grant revenues and a \$5 million increase in interest income received by the Airport Enterprise Fund.

In addition to increased revenues, operating expenses decreased by \$6 million. This decrease was mainly due to a reduction in the cost of sewage processing for the Sanitation Districts.

Net Assets of the internal service funds totaled \$83 million, a decrease of \$20 million from the prior year. This net change in the internal service funds was primarily due to a decrease of \$16 million in the Risk Financing Fund resulting from an excess of claims (\$53 million) over revenue (\$37 million); and a decrease in the net assets of the Road and Communication Equipment Fund of approximately \$4 million which was chiefly due to an operating transfer of \$5 million to the Road Special Revenue Fund.

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 2006, the net assets of the Pension Trust Fund totaled \$7.3 billion, an increase of \$972 million over the prior year. This change was primarily due to the following: County and member contributions of \$344 million; an appreciation in the fair value of pension trust investments of \$829 million; net investment earnings of \$133 million; less member benefits paid and pension costs of \$334 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 \$130 million, primarily resulting from a distribution from pooled investments of \$16.62 billion, offset by contributions on pooled investments of \$16.43 billion and investment earnings of \$67 million.

- *Agency Funds:*

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 (see Notes to required supplementary information) 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 offset by the amount of budget carried forward to the subsequent fiscal year. At June 30, 2006 net expenditure appropriations increased by \$34 million offset by a decrease in appropriations for transfers-out of \$26 million for a net increase of \$8 million. (The net appropriation increase included \$194 million in net budget amendments offset by \$186 million for the amount of budget carried forward to the subsequent fiscal year.)

Appropriation increases of note to the original adopted budget were the following:

- \$19.1 million for the expansion of mental health services pursuant to the Mental Health Services Act, Proposition 63, that was approved by California voters in November, 2004 and became effective January 1, 2005.
- \$15.0 million in additional funding for the Edgemoor Skilled Nursing Facility construction project based on fund balance. Design issues with steel fireproofing and fabrication and San Diego's heavy rains caused delays resulting in the need for additional funding.
- \$13.9 million for salaries and benefits for a six day catch up in the general ledger for split payroll needs, funded by fund balance.
- \$10.9 million in Proposition 172 funding for various projects within the Public Safety Group. This includes \$4.0 million for maintenance projects within the Sheriff, \$1.0 million in funding for ASTREA, \$0.8 million for Tasers for the Sheriff, \$0.5 million for enhancements to the Automated Field Reporting/Records Management System within the Sheriff, \$0.6 million for improved security at the District Attorneys regional court facilities, \$0.8 million for upgrades and

enhancements for information technology within the District Attorney, \$0.8 million to open a dorm at the Camp Barrett juvenile facility, \$0.5 million for the creation of the East County Gang Task Force and \$1.9 million for various other projects in the Public Safety Group.

- \$10.4 million for the payment of costs related to the transition of information technology from Computer Sciences Corporation to Northrup Grumman Information Technology, Inc., funded by fund balance.
- \$17.0 million for salaries and benefits for incentives earned through the County's Fiscal Year 2005 Quality First program, funded by fund balance.
- \$6.6 million for the Central Ave Flood Control Improvement Project to upgrade drainage facilities to alleviate flooding in the vicinity of Central Ave in Bonita, funded through fund balance. With additional funding from FEMA, the estimated total project cost is \$10.0 million.
- \$5.0 million in the Department of Planning and Land Use for contracts with existing fire service entities in order to establish year - round fire protection and emergency response services in areas where these services are not provided, funded by fund balance.
- \$5.0 million for land acquisition for the San Luis Rey River Park project, funded by fund balance.
- \$4.7 million net change in appropriated management reserves for future one - time projects based on fund balance.

Actual revenues exceeded the final budgeted amounts by \$104.1 million, while expenditures fell short of the budgeted amount by \$328.6 million. The combination of excess revenue and expenditure shortfall resulted in a net favorable operating variance of \$432.7 million. Other financing sources and uses of funds resulted in a unfavorable variance from budget of \$55.5



million and there was no variance in the increase to the reserve for inventories of materials and supplies. These combined amounts resulted in a variance in the net change in fund balance of \$377.2 million.

Highlights of actuals compared to budgeted amounts are discussed below:

- *Property Tax in Lieu of Vehicle License Fee (VLF):*

In fiscal year 2005, 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. For fiscal year 2006, VLF revenues were budgeted conservatively at \$200.5 million due to lack of information from the State at the time to support a higher estimate. Subsequent to budget adoption, the State calculated allocations for fiscal year 2006 based on a formula that took into account adjusted actual allocations for fiscal year 2005 and growth in the County's gross taxable assessed value. Information on the adjusted actuals was released in October, 2005 and the County received a \$17.7 million positive true-up adjustment for fiscal year 2005. The published assessed value growth factor for 2006 was 13.3%, which established the County's 2006 property tax in lieu of vehicle license fees base at \$247.3 million. The true-up adjustment combined with the increase in the base amount resulted in a positive variance of \$60.2 million for the fiscal year.

- *Supplemental Property Taxes:*

Supplemental property taxes are derived from additions to the tax roll during the year. The actual amount of these revenues in fiscal year 2006 was over twice the amount budgeted, a positive variance of \$26.8 million. This is the result of a change in the distribution formula combined with a sustained strong growth in assessed values from an active real estate market. The change in the distribution formula shifted more supplemental taxes to the County as a result of the recent property tax in lieu of

VLF legislation.

- *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. In addition, the Sheriff's department is having recruiting difficulties due to a nationwide shortage of peace officers. The total favorable variance across all functions in this category is \$49.2 million of which \$7.0 million is attributable to the Sheriff's department.

- *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 \$58.1 million and \$59.8 million respectively. The expenditure variances result from demand for services being less than the budgeted level. These lowered expenditures were offset by corresponding reductions in Federal and State revenue.

- *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 in the new fiscal year. For example, in the Department of Planning and Land Use, re-budgets include: \$16.9 million for the removal of dead, dying and diseased trees; \$2.5 million for the Fire Safety and Fuels Reduction Program; and \$0.8 million in funding from the Indian Gaming Local Community Benefit Committee to acquire fire equipment for fire agencies in the unincorporated area. The Department of Parks and Recreation has re-budgeted \$1.5 million for various projects in local parks and community centers. In the Sheriff's Department, re-budgeted amounts included: \$1.5 million for the Cal-ID mugshot replacement system, \$1.0 million for Regional Paging System enhancements and maintenance; \$0.5 million



for enhancements to the Automated Field Reporting/Records Management System; and \$0.5 million for the Jail Information Management System retrofit; and \$1.0 million for equipment and administrative costs related to the Buffer Zone Protection Program grant.

• *Appropriated Management 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 \$37.6 million. In addition, in fiscal year 2006, the County set aside \$34.8 million for economic uncertainty with the intent that it not be spent unless unusual needs arose; of that amount, \$34.2 million was unexpended at year end.

Capital Assets and Commitments

Capital Assets

At June 30, 2006, the County's capital assets for both governmental and business-type activities was \$2.81 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 2006 was as follows:

Governmental Activities:

- \$34.9 million towards the construction and improvement of County maintained roads, bridges, and other road related infrastructure. An additional \$14.2 million in infrastructure was donated by developers.
- \$18.6 million towards the construction of the Edgemoor Skilled Nursing Facility in Santee. Total project costs are estimated at \$98.8 million.
- \$8.5 million towards the construction of the Assessor/Recorder/County Clerk and Land Use and Environment Group building in San

Marcos. Total project costs are estimated at \$9.2 million.

- \$7.3 million towards the acquisition and improvement of an office building in Scripps Ranch for the Air Pollution Control District. Total project costs are estimated at \$7.6 million.
- \$3.5 million for the acquisition of real property located in downtown San Diego for future County space needs.
- \$3.2 million for the acquisition of real property in the San Luis Rey River corridor (Bonsall/Fallbrook) for future development of passive recreation improvements.
- \$2.3 million for acquisition of real property in the Otay River Valley area for open space habitat restoration and passive recreation.
- \$1.6 million towards the construction of the Bonita Library. Total projects costs are estimated at \$4.5 million.
- \$1.1 million towards passive recreation improvements for the Otay Valley Regional Park. Total projects costs are estimated at \$2 million.
- \$9.5 million towards the construction of numerous other capital outlay projects.

Business-Type Activities:

- \$6.8 million towards the construction of the Palomar Airport North Ramp. Total project costs are estimated at \$8.6 million.
- \$2.4 million towards runway rehabilitation at Gillespie Field Airport in El Cajon. Total project costs are estimated at \$5.4 million.
- \$1.3 million towards the Jamacha Boulevard sewer improvements in Spring Valley Sanitation District. Total project costs are estimated at \$2.2 million.

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, 2006, can be found in Note IV-D of the notes to the basic financial statements.

Capital Commitments

As of June 30, 2006, capital commitments included the following:

- \$57 million for the Integrated Voting System, Integrated Property Tax System, RCS Equipment, Medics Health Information System, and the Automated Records Management and Field Reporting Software Installation.
- \$103 million for the construction of the Edgemoor Skilled Nursing Facility, Valley Center Road, Wildcat Canyon Road, Route 54/94, Forester Creek Drainage System, Spring Valley Gymnasium, and the Medical Examiner and Veterinarian Building.
- \$3 million for the Spring Valley Sewer Improvements and the Spring Valley Sewer replacement.

More detailed capital commitments information, including depreciation as of June 30, 2006, can be found in Note IV-D.2 of the notes to the basic financial statements.

Long-Term Obligations

At June 30, 2006, for governmental activities, the County had outstanding long-term obligations of \$2.396 billion. Of this amount, \$357 million pertained to outstanding certificates of participation, and the remaining \$2.039 billion pertained to the following obligations: \$1.238 billion of taxable pension obligation bonds; \$584 million of San Diego County Tobacco Asset Securitization Corporation Bonds; \$16 million of Redevelopment Agency bonds; \$8 million for capital loans; \$7 million of unamortized issuance premiums; \$(22) million of unamortized issuance discounts; \$(48) million of unamortized deferred amounts on refundings; \$32 million for capital leases; \$122 million for claims and judgments; \$78 million for compensated absences; and,

\$24 million for landfill closure and postclosure costs.

Long-term obligations for business-type activities totaled \$3.1 million and consisted of \$2.7 million for capital loans and \$389 thousand for compensated absences.

During fiscal year 2006, the County's total principal amount of bonds and notes payable for governmental activities increased by \$115 million, before giving affect to the unamortized issuance, issuance premiums, unamortized issuance discounts and unamortized deferred amounts on refundings. The \$115 million increase was due to the following debt issuances offset by debt service payments and refundings discussed below:

- Increases - \$636 million

The County's issued \$28 million in certificates of participation for the 2005 North and East County Justice Facilities refunding; \$584 million of San Diego County Tobacco Securitization Corporation refunding (including the \$273 Capital Appreciation Bonds (CABs) recorded at their maturity value); a \$16 million Redevelopment Agency refunding; and a \$1 million Internal Service Fund loan.

Additionally \$7 million of principal was accreted (added) to the outstanding CAB principal balances outstanding. These issuances and the accreted amount totaled \$636 million.

- Decreases - \$521 million

Decreases to debt included: \$57 million in principal debt service payments and a \$464 million reduction of outstanding principal. This reduction included: a \$30 million refunding of the 2005 North and East County Justice Facilities debt; a \$430 million refunding of the San Diego County Tobacco Securitization Corporation debt; and a \$4 million refunding of the Redevelopment Agency debt.

The long-term obligations for business-type activities decreased by \$116 thousand due to \$181 thousand debt service payments on capital loans, offsets by an increase of \$65



thousand in compensated absences.

More detailed long-term obligation activity, including interest rates and maturity dates, can be found in Note IV-I through IV-I-5 of the notes to the basic financial statements.

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

Table 3

Credit Ratings	Moody's	Standard & Fitch Ratings	
		Poor's	
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 fiscal year 2007 General Fund budget utilized \$105.8 million out of \$435.8 million in unreserved undesignated fund balance and \$2.6 million out of \$190.5 million unreserved designated fund balance. Fund balance was used as a source of funds for one-time expenditures.
- The development of the fiscal year 2007 budget was based on current expectations for demand for services and availability of funding to support those services. The fiscal year 2007 General Fund budget contains total appropriations of \$3.289 billion. This is an increase of \$345.6 million or 11.7% from the fiscal year 2006 General Fund budget. A number of risk factors continue to be tracked: the U.S. economy, the State of California's ongoing budget imbalance for

fiscal year 2007, 2008 and beyond; significant weaknesses in the housing sector; uncertainty in short and long-term interest rates; continued pressure of high energy prices; and the impact of legislation and propositions on the State of California's budget.

- The U.S. economy's Gross Domestic Product (GDP) for 2005 showed an increase of 3.5% versus 4.2% growth in 2004. The projected GDP growth for 2006 is approximately 3.4%.
- The State of California's economy has been doing well for the last two years. Overall, 2005 was a good year for California: payroll jobs experienced healthy growth at 1.8%; the job growth also contributed to a solid personal income growth of 6.0%; and taxable sales grew by and adjusted 7.4%.
- The San Diego economy continues to show positive growth (i.e., gross regional product at 2.1% for 2001, at 4.9% for 2002, 4.5% for 2003, 4.4% for 2004, 4.6% in 2005, and slowing growth is forecasted at 2.7% for 2006 and 2.6% for 2007).
- The State's budget outlook continues to be strained by an ongoing structural imbalance between revenues and expenditures. According to a review of the Governor's budget by the State of California's Legislative Analyst (September 2006), the projected fiscal years 2008 and 2009 imbalances are estimated at \$4.5 billion and \$5.0 billion respectively.
- The 2006-07 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. The two-year shift of \$27.5 million of property taxes to the Educational Revenue Augmentation Fund (ERAF) to assist the State in meeting its funding obligations to schools was completed in fiscal year 2006.
- The 2005-06 Budget Act required counties to



transfer undesignated fees to the local trial court. This transfer was to occur for only 2004 and 2005, but was extended for four more years, albeit at declining amounts. The County's share was \$2.1 million for 2004 and 2005, and \$0.8 million in 2006. For fiscal years 2007 and 2008, the County's share each year is expected to be \$0.6 million and \$0.4 million, respectively. One-time resources will be used to fund this requirement.

- Since fiscal year 1996, the State Property Tax Administration Grant program has assisted counties maintain timely property assessments. The 2006-07 Budget Act continues the suspension for a second year. For the County, the revenue loss of \$5.4 million was not anticipated in the fiscal year 2006 Adopted Operational Plan and was offset mid-year by unanticipated additional general purpose revenues. For fiscal year 2007, general purpose revenues continue to replace the loss of these grant funds.

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

- The largest source of general purpose revenues is property taxes (\$499.3 million), representing 55% of the total. The housing boom that has been driving the California and U.S. economies is softening, and the "housing construction/real estate" slowing will contribute to slowing in the growth of the State economy in 2006 and 2007. For the last six years, local secured growth has been high (8.6% average annual growth excluding the State's 2005 property tax shift to schools) due to the County's strong overall economy and healthy real estate market. As noted above, the two-year ERAF shift was completed and the County is no longer relinquishing \$27.5 million in property tax revenues to ERAF. Current secured property tax revenues budgeted in the fiscal year 2007 Adopted Budget were based on the assumption that the net assessed value growth through June 30, 2006 would be 11%. Actual gross

assessed value growth exceeded 12%. The demand for housing in the County is also slowing, as evidenced by the reduction in residential building permits, flattening housing prices, and length of time of property listings. These factors are offset by relatively low interest rates and the area's population growth. Overall, property tax growth is expected to decelerate and property turnover and new construction are being watched closely.

- Property Taxes in Lieu of Vehicle License Fees (VLF) comprises 30.3% (an estimated \$274.5 million) of general purpose revenues in fiscal year 2007. This revenue source replaced the previous distribution of vehicle license fees to local governments by the state. In fiscal year 2005, the state established initial allocations from the VLF Property Tax Compensation Fund to cities and counties. The state released information on adjusted figures for 2005 and new budget figures for 2006 on October 14, 2005. Starting in 2006, growth on this distribution is based on the growth in gross taxable assessed value in each county. The certified growth rate for 2007 is 12.1554%.
- Real Property Transfer Tax Revenue (RPTT) for fiscal year 2007 was budgeted at \$30.7 million, which is 3.4% of general purpose revenues. RPTT is paid when any lands, tenements, or other realty exceeding \$100 in value are sold and granted, assigned, transferred or conveyed to the purchaser. The tax rate set by the State is \$1.10 per \$1,000 of assessed valuation. The County collects 100% of all transactions in the unincorporated area and 50% of the transactions in the incorporated areas.
- Sales & use tax revenue & in lieu local sales & use tax (\$23.5 million in fiscal year 2007) represents about 2.6% of general revenues and is derived from taxable sales by businesses located in unincorporated County areas. Its growth is generally impacted by population and income, but is primarily due



to economic development and new business formation in the County. These amounts reflect both the Sales Tax revenues and the in lieu local sales & use tax replacement funding that will be transferred from ERAF. Again, effective July 1, 2004, provisions of AB7 X1, one of the 2004 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, the lost revenues are replaced on a dollar-for-dollar basis with countywide property tax revenues shifted back from the ERAF. Retail sales remain relatively strong in the unincorporated area with a projected before-triple-flip-adjustment sales tax growth of \$2.3 million (10.7%) over the Fiscal Year 2006 Operational Plan.

- Other revenues budgeted for fiscal year 2007 total \$78.4 million. Various revenue sources make up this category including interest on deposits, fines, fees and forfeitures, redevelopment agency tax increment, prior year adjustments on property taxes, franchise revenue, payment from the City of San Diego in lieu of booking fees, and other miscellaneous revenues.

The County's *Operational Plan* for Fiscal Years 2007 and for Fiscal Year 2008 can be found on the internet at <http://www.sdcounty.ca.gov/auditor>.

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.

