

December 23, 2004

Honorable Mayor and City Council
Fred Meurer, City Manager
City of Monterey

I am pleased to present to you the 2003/2004 Comprehensive Annual Financial Report (CAFR) for the City of Monterey. This "comprehensive" report is intended to present information that goes beyond the basic financial statements required by generally accepted accounting principles.

This report is presented in three sections: Introductory, Financial, and Statistical:

The **Introductory Section** includes this transmittal letter, a schedule of the City's principal officials and an organizational chart;

The **Financial Section** includes the unqualified opinion of our independent auditors, basic financial statements with accompanying notes, and supplemental statements;

The **Statistical Section** includes relevant financial and demographic information depicting the City's historical trends and other significant facts.

This report has been prepared by the Finance Department in accordance with generally accepted accounting principles (GAAP), as set forth in the pronouncements of the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB). It consists of management's representations concerning the finances of the City. Consequently, responsibility for the accuracy of the data including all disclosures rests with the management of the City.

We believe that the data as presented is accurate in all material respects, that it is presented in a manner designed to fairly set forth the financial position and results of operations of the City as measured by the financial activity of the various funds, and that all disclosures necessary to enable the reader to gain the full understanding of the City's financial affairs have been included.

To support this representation, management has established a comprehensive internal control framework that is designed both to protect the City's assets from loss, theft, or misuses and to compile sufficient reliable information for the preparation of the City's financial statements in conformity with GAAP. Because of the cost of internal controls should not outweigh their benefits, the City's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatements.

This is supported by the letter from the City's independent auditor, included in this report, that states they believe that the basic financial statements present fairly the City's financial position as of June 30, 2004, in conformity with GAAP. Moreland and Associates, Inc., a firm of licensed certified public accountants, conducted the Financial Statement audit. Their goal and that of any independent auditor was to provide a reasonable assurance that the financial statements of the City of Monterey for the fiscal year ended June 30, 2004, are free of material misstatements. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting

principles used and significant estimates made by management; and evaluating the overall financial statement presentation.

This report includes all of the funds and account groups of the City of Monterey, the Redevelopment Agency of the City of Monterey and the Monterey Joint Powers Financing Authority.

GAAP require that management provide a narrative introduction, overview and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The City's MD&A can be found immediately following the report of the independent auditors

City History and Overview

Las Bahia de los Pinos (Bay of Pines) was first discovered by Juan Rodriguez Cabrillo on November 17, 1542. This Spanish claim to California was reaffirmed in December, 1602, when Sebastian Viscaino officially named the port Monterey in honor of the Viceroy of New Spain who had ordered the expedition.

Founded on June 3, 1770 when Spanish soldiers claimed the land for King Charles III of Spain, the City was officially incorporated on May 30, 1850. The City's historic Colton Hall was the site of California's first constitutional convention where our state's constitution was signed in 1849.

The natural beauty, mild climate and unique attractions of Monterey draw an estimated 4 million visitors each year making our City one of the most popular destinations in the country. The Monterey Bay Aquarium, Old Fisherman's Wharf and Cannery Row are among the many interesting places to visit in Monterey. The City is also home to the Army's Defense Language Institute and Naval Postgraduate school.

Economic Conditions and Outlook

The City of Monterey's economic growth began to slow during the 2000/2001 fiscal year and has declined significantly since that time. Although overall revenues began to show limited positive growth through 2003/2004, the significant increases in retirement and workers compensation costs and continued sluggish economy have resulted in a \$2 million projected budget deficit for 2005/2006.

Although the City is not expecting large revenue growth in the coming year for its two largest revenue sources, Transient Occupancy Tax and Sales Tax, at the time of this report, the Transient Occupancy Tax has increased 7.1% over this time last year. These forecasts continue to be linked to a large degree to the economy of the nearby Silicon Valley region, whose growth has still been slow.

In addition, the State continues to struggle with its massive multi-billion dollar budget imbalance. Their tendency to take resources from local government to balance their budget is perhaps the City's biggest budgetary unknown. The passage of Proposition 1A in this November's election will help to reduce the ability of the State to make up its shortfalls through revenue shifts away from local government. This law requires the state legislature to get a two-thirds vote before revenues can be borrowed and stipulates that the State can only borrow twice in a 10-year period. Nevertheless, it is still likely that the State would, when given the option of getting two-thirds of the legislature to vote for a tax increase, program cuts, or to borrow from local government revenues, opt to borrow from local governments.

To mitigate these factors, the City is again formulating a strategic financial plan to reduce on-going expenditures. This budget reduction plan will be designed to decrease net operating expenditures by \$2 million, either through a reduction in departmental expenditures or an increase in departmental/City revenues. A similar plan, which concludes in 2004/2005, reduced net operating expenditures by \$5 million, largely by reducing the size of the City's workforce.

Major Initiatives

Future Budget Imbalances. A continued initiative to insure a long-term revenue/expenditure balance in the City's operating budget, while attempting to maintain as many services to the community as possible, is atop the City's priority list. To date, a projected \$2 million budget deficit exists for the 2005/2006 fiscal year due to large expenditure increases (such as Retirement and Workers Compensation).

Window on the Bay. Among the City's highest priorities is the "Window on the Bay" project. Its goal is to purchase, on an opportunity-buying basis, land and buildings along the bayside of Del Monte Avenue, between Camino El Estero and the east City limit, for the improvement of view sheds along Del Monte Avenue and the development of Monterey Bay Park. The first segment of the park was completed in December 1995 and includes beach volleyball courts, bikeways, walkways and open space.

The City has purchased two parcels totaling over 7 acres known as the Catellus West and East. These highly desirable waterfront parcels will enhance both the Parking operations of the City as well as offer an extension to the existing Window on the Bay project. The Catellus West parcel was purchased for \$3.2 million by the Parking Fund in 2000. The City exercised its option to purchase the East parcel for \$3.9 million in 2003, using proceeds from two large grants (Packard Foundation and Coastal Conservancy) and from the 2003 Lease Revenue Bonds issued by the Joint Powers Financing Authority of Monterey.

New Public Service Center. On October 7, 2003, the City Council approved a revised Public Service Center project, which was reduced by 20% in size. This facility will house the following departments: Planning, Building Safety, Engineering, Traffic Engineering, City Attorney, Personnel, Information Services and Finance. The purpose of this facility is to make it easier and more convenient for citizens to transact business with the City. In addition, it will resolve many significant office and meeting space shortage problems that exist with current building configurations. Early cost estimates projected a total project cost at \$13.3 million.

FINANCIAL INFORMATION

Accounting System and Budgetary Control

The City's accounting records for general government operations are maintained on a modified accrual basis, with the revenues being recorded when measurable and available. Expenditures are recorded when the services or goods are received and the liabilities incurred. Accounting records for the City's proprietary activities are maintained on the full accrual basis, with revenues recorded when earned and expenses when incurred.

In maintaining the City's accounting system, consideration is given to the adequacy of internal controls. As mentioned earlier, internal controls are designed to provide reasonable assurance regarding the safeguarding of assets and to ensure the reliability of financial records and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of control should not exceed the benefits likely to be derived. The evaluation of costs and benefits requires continuing estimates and judgements by City management. We believe that the City's system of internal accounting controls continues to adequately safeguard assets and provide reasonable assurance that financial transactions are properly recorded.

Formal budgetary integration is employed as a management control device. Commitments for materials and services, such as purchase orders and contracts, are recorded as encumbrances in order to reserve that portion of the applicable appropriation. Encumbrance accounting is employed as an extension of formal budgetary integration in the General, Special Revenue, and Capital Projects funds. Encumbrances lapse at year-end and are then added to the following year's budgeted appropriations. Encumbrances are reported at year-end as reservations of fund balances.

Risk Management

The City is self-insured for its general liability and workers' compensation liability for up to \$500,000 and \$400,000 per occurrence, respectively. Excess coverage for general liabilities is provided by Insurance Company of the State of Pennsylvania in a joint purchase through the Authority for California Cities Excess Liability (ACCEL), a joint powers authority of which the City is a member. The City has purchased insurance with a commercial carrier for workers' compensations claims above \$400,000. Property damage risks are covered on an occurrence basis up to \$500,000,000, with a \$50,000 deductible, by commercial insurance purchased from independent third parties.

Cash Management

The City maintains a cash and conservative investment pool that is available for the use of all funds. Cash temporarily idle during the year was invested in U.S. Government Securities, the California Local Agency Investment Fund (LAIF) and corporate notes. At June 30, 2004, 79.4% of the \$54.4 million pool was invested in U.S. Government Securities and 20.6% in LAIF. The weighted average rate of return on investments for 2003/2004 was 2.57%, down from 2.67% in the prior year and 4.54% two years ago.

OTHER INFORMATION

Independent Audit

Article 6 of the City Charter requires an annual audit of the City's financial records by independent certified public accountants. The accounting firm of Moreland & Associates, Inc. was selected by the City Council to perform the audit. They have completed their first year of a 3-year contract.

In addition to meeting the requirements of the City Charter, the audit was also designed to meet the requirements of the Federal Single Audit Act of 1984, Single Audit Act Amendments of 1996 and related OMB Circular A-133, "Audits of States, Local Governments and Non-profit Organizations."

The auditor's report on the basic financial statements and combining and individual non-major fund statements and schedules is included in the financial section of the report. The auditor's reports related specifically to the single audit are included in the Single Audit reports, which are separate documents.

Acknowledgments

The preparation of the Comprehensive Annual Financial Report on a timely basis was made possible by the dedicated service of the entire staff of the finance department through the fiscal year: Linda Bass, Linda Burns, Vicki Courtney, Loretta Curran, Thi Duong, Iris Enea, Pam Erlandson, Sherrell Freeman, Lorraine Franks, Tim Hickey, Barbara Humel, Melanie Martin, Toni McDaniel, Ann Pagan and Marc Pimentel. It is only through the year round effectiveness and efficiency of these valuable staff members that make the preparation and development of this report possible. Each member of the department has my sincere appreciation for their contributions.

In closing, without the leadership and support of the Council and City Manager, preparation of this report would not have been possible.

Sincerely,

Don Rhoads
Finance Director