

November 30, 2005

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

I am pleased to present to you the 2004/2005 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, an organizational chart and, a schedule of the City's principal officials;

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, 2005, 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, 2005, 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 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

After several years of decline and uncertainty, the City of Monterey's revenues appear to have recovered somewhat and show signs of stability. The City's top revenue, Transient Occupancy Tax has grown modestly over the last two fiscal years and is projected to grow 5% in the coming fiscal year. However, if the projection is met, it will still be below its 2000/2001 level. Other major revenues like Property and Sales tax have also shown positive growth over the past 2 years and show signs of continued growth. Property tax finished 2004/2005 at its highest level in 10 years and Sales Tax is projected next year to finally return to its 2000/2001 level.

However, this good economic news is tempered by the fact that employment costs have been increasing faster than revenues and we have been significantly underfunding key reserves. There is hope going forward as PERS retirement rates, due to improved PERS portfolio returns and changes to smooth the rate fluctuations, will stabilize and early projections shown marginal decreases for 2006/2007.

The City's preliminary 2006/2007 estimate projects an operational deficit of \$800,000 in the General Fund. After funding necessary reserves, this deficit would increase to \$1.9 million. Once again, the City will continue to formulate plans to resolve this budgetary deficit while mitigating the impact to existing primary City services. A larger reduction plan concluded in 2004/2005 that reduced net operating expenditures by \$5 million, largely by reducing the size of the City's workforce.

At this time, next year's budget (2005/2006) is balanced, albeit without necessary funding for strategic reserves. The reserve for economic uncertainty is currently short 4.8% from the level required by the City's policies. In addition, the City has insufficient capital reserves available for the renewal of its key "flagship" facilities that include the world renowned wharves and conference center, sports center and library.

A major risk factor, State raids of City funds to balance its budget shortfalls, appears to have been significantly reduced. Although the State's independent Legislative Analysts office (LAO) still show

continued State budget shortfalls through 2010/2011, the LAO has projected that excess reserves in 2005/2006 will cover and balance the State's budget in 2006/2007, assuming neither an economic decline or substantial increase in State spending occur. Their budget deficit over the next 5 years is projected to bottom out at \$4.3 billion before ending at \$600 million in 2010/2011.

Also, the passage of Proposition 1A in November 2004 has added constitutional protection to the City's revenues from State takeaways. However, the State still has the ability to, with a two-thirds vote by the legislature, borrow additional City funds subject to certain conditions (i.e., can only borrow twice in a 10-year period and must repay prior funds borrowed first).

Major Initiatives

Future Budget Imbalances. Atop the City's priority list is a plan to insure a long-term revenue/expenditure balance in the City's operating budget, while attempting to minimize the impact to City services.

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.

New Public Service Center. 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. This facility is expected to house the following departments: Planning, Building Safety, Engineering, Traffic Engineering, Personnel, and Finance. The most recent cost estimates were projected to be \$13.9 million. However, on October 4, 2005, the City Council sent the project back to staff for a second time to reduce its overall size.

Commercial projects. Several commercial and retail projects are underway within the City of Monterey. A new Infinity Auto dealership has been granted occupancy and is expected to open to the public in 2005/2006. Also in 2005/2006, a new hotel is expected to break ground on Cannery Row. It is expected to be opened to the public during the 2007/2008 year. Another Cannery Row project mixed use retail/residential project (Ocean View Plaza) has been approved by the City Council and will next be going to the Local Agency Formation Commission (LAFCO) and to the State Coastal Commission for approval. Once completed, these three projects would provide new substantial resources that can be used to further fund City initiatives including capital renewal.

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 and the California Local Agency Investment Fund (LAIF). At June 30, 2005, 75% of the \$56.1 million pool was invested in U.S. Government Securities (Federal Agency) and 25% in LAIF. The weighted average rate of return on investments for 2004/2005 was 2.58%. It was 2.57% and 2.67% in the two prior years.

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 second 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 throughout the fiscal year: Linda Bass, Linda Burns, Vicki Courtney, Loretta Curran, Thi Duong, Pam Erlandson, Sherrell Freeman, Lorraine Franks, Tim Hickey, Barbara Humel, Melanie Martin, Toni McDaniel, Ann Pagan, Marc Pimentel and Lynn Zwagerman. 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 City Council, Mayor Dan Albert, Council Members Chuck Della Sala, Libby Downey, Jeff Haferman and Clyde Roberson and the City Manager, Fred Meurer, and Assistant City Manager, Fred Cohn, preparation of this report would not have been possible.

Sincerely,

Don Rhoads
Finance Director