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## MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

This section of the County's annual financial report provides a narrative overview and analysis of the financial activities of the County for the year ended June 30, 2004. We hope that the information presented here, in conjunction with the Letter of Transmittal, provides you 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

- Total net assets increased by \$236,599, or 7% as compared to last year's.
- Long-term debt decreased by \$75,572, or 5% during the current fiscal year.
- As of the end of the fiscal year, the County's governmental funds reported combined ending fund balances of \$1,840,106, an increase of \$25,824, or 1% in comparison with the prior year.
- At June 30, 2004, unreserved fund balance in the General Fund was \$123,979, or 5% of total FY 2003-04 expenditures and transfers of \$2,308,807.
- General Fund revenues and transfers ended the year 3% below budget.
- General Fund expenditures and transfers ended the year 11% below budget.

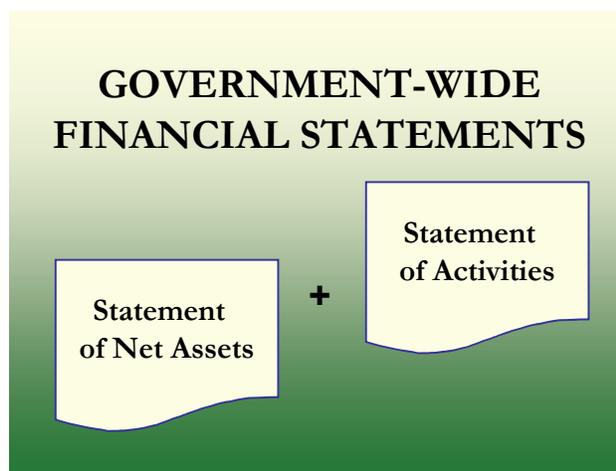
### OVERVIEW OF THE FINANCIAL STATEMENTS

The basic financial statements presented in the County's CAFR have been divided into three different sections:

- Government-wide Financial Statements
- Fund Financial Statements
- Notes to the Basic Financial Statements

#### **Government-wide Financial Statements**

The government-wide financial statements consist of the following two financial statements: the Statement of Net Assets and the Statement of Activities. Both of these statements were prepared using accounting methods similar to those used by private-sector companies, the economic resources measurement focus and the accrual basis of accounting. The **Statement of Net Assets** provides information regarding all of the County's 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**, on the other hand, provides information on how the government's net assets changed during the most recent fiscal year regardless of the period when the related cash or cash equivalent is received or paid. Therefore, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (for example, uncollected taxes and earned but unused vacation leave).

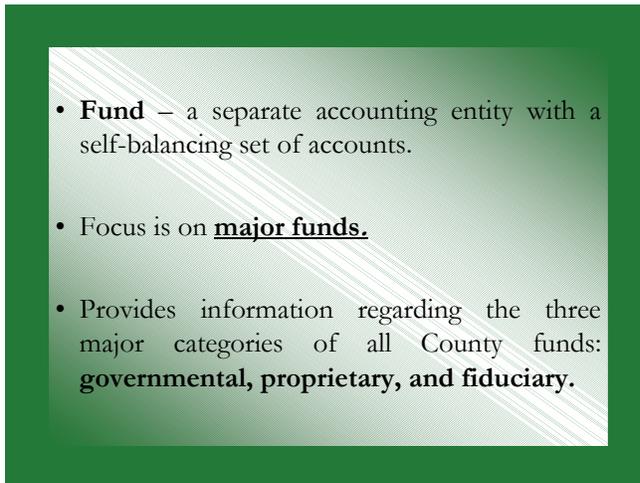


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The Statement of Net Assets and the Statement of Activities distinguish functions of the County that are principally supported by taxes (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities of the County include (1) general government, (2) public protection, (3) public ways and facilities, (4) health and sanitation, (5) public assistance, (6) education, and (7) recreation and cultural services. The business-type activities of the County include airport and waste management.

The government-wide financial statements also provide information regarding the County's component units, entities for which the County (the primary government) is considered to be financially accountable. Blended component units, although legally separate entities, are in substance, part of the County's operations, and therefore, data from these component units are combined with data of the primary government. Financial information for the Children and Families Commission of Orange County, a discretely presented component unit, is reported separately from the financial information presented for the primary government itself.

### Fund Financial Statements

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- **Fund** – a separate accounting entity with a self-balancing set of accounts.
  - Focus is on **major funds**.
  - Provides information regarding the three major categories of all County funds: **governmental, proprietary, and fiduciary**.

The fund financial statements report on groupings of related funds that are used to maintain control over resources that have been segregated for specific activities or objectives. A fund is a separate accounting entity with a self-balancing set of accounts. Like other state and local governments, the County uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The focus of governmental and proprietary fund financial statements is on major funds as determined by the criteria set forth in Governmental Accounting Standards Board (GASB) Statement No. 34 "*Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*," ("GASB 34"). All of the County

funds can be divided into three major categories of funds: governmental, proprietary, and fiduciary.

**Governmental funds** - Governmental funds include most of the County's basic services and 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 are prepared using the **current financial resources measurement focus** and **modified accrual basis of accounting**.

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. Reconciliations are prepared for both the governmental funds' Balance Sheet and the governmental funds' Statement of Revenues, Expenditures, and Changes in Fund Balances to facilitate comparisons between governmental funds and governmental activities. The primary differences between the government-wide and fund financial statements relate to noncurrent assets, such as land and structures and improvements, and noncurrent liabilities, such as bonded debt and amounts owed for compensated absences and capital lease obligations, which are reported in the government-wide statements but not in the fund financial statements.

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In FY 2003-04, an increase of \$180,085 in net assets in the government-wide financial statements was reported, while an increase of \$25,824 in fund balance was reported in the fund financial statements. Refer to the "Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities" for details on the factors contributing to this difference.

The County maintains several individual governmental funds organized according to their type (General Fund, Special Revenue, Debt Service, Capital Projects and Permanent Funds). Information is presented separately in the governmental funds Balance Sheet and in the Statement of Revenues, Expenditures, and Changes in Fund Balances for the General Fund, which is always a major fund, and all other major funds. Information for nonmajor funds is presented in the aggregate in these statements. Individual fund data for each of the nonmajor governmental funds is presented elsewhere in this report. The County adopts an annual appropriated budget for its governmental funds. Budgetary comparison statements and schedules have been provided for these funds to demonstrate compliance with the budget.

***Proprietary funds*** - The County maintains two different types of proprietary funds: Enterprise Funds and Internal Service 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 its Airport and Waste Management operations. **Internal Service Funds** are used to accumulate and allocate costs internally among the County's various functions such as insurance services, transportation, publishing, and information technology. Because these services predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary fund financial statements provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for the Airport and Waste Management operations, which are both considered to be major funds of the County. Conversely, the Internal Service Funds are combined into a single, aggregated presentation in the proprietary funds financial statements with the individual fund data provided in combining statements, which can be found elsewhere in this report.

***Fiduciary funds*** - Fiduciary funds include the **Trust** and **Agency** funds and are used to account for assets held on behalf of outside parties, including other governments. Financial information for fiduciary funds is not reported in the government-wide financial statements because the resources of these funds are not available to support the County's programs. The combining statements for fiduciary funds are included elsewhere in this report.

### **Notes to the Basic Financial Statements**

The 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. To find a specific note, refer to the Table of Contents.

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**GOVERNMENT-WIDE FINANCIAL ANALYSIS**

As noted earlier, net assets may serve over time as a useful indicator of the County's financial position. At June 30, 2004, the County's combined net assets (governmental and business-type activities) totaled \$3,601,348, an increase of 7% from FY 2002-03.

The largest component of the County's net assets (71%) was **invested in capital assets, less any related outstanding debt** used to acquire those assets. Capital assets include land, structures and improvements, equipment, construction in progress, and infrastructure that are used to provide needed services to the citizens of the County. Since the capital assets themselves cannot be used to liquidate the associated debt, the resources needed to repay the debt must be provided from other sources.

**COMPONENTS OF NET ASSETS**

- Invested in Capital Assets,  
Net of Related Debt
- Restricted
- Unrestricted

\$1,307,541 of the County's net assets (36%) are **restricted**. This means that these resources 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, including those passed by the County itself.

The final component of net assets is **unrestricted net assets**. Unrestricted net assets are resources that the County may use to meet its ongoing obligations to citizens and creditors. As of June 30, 2004, governmental activities showed a negative amount of \$280,592 in unrestricted net assets. The deficit balance shown for unrestricted net assets was caused primarily by the County's election to settle bankruptcy-related debt according to the Modified Second Amended Plan of Adjustment, and is not a reflection of the County's lack of resources to meet its ongoing obligation to the citizens and creditors. Please refer to Note 9, Long-Term Obligations, for more details of this Plan.

The following table presents condensed financial information derived from the government-wide Statement of Net Assets.

**NET ASSETS – Primary Government**

June 30, 2004  
(In Thousands)

	Governmental Activities		Business-Type Activities		Total	
	2004	2003	2004	2003	2004	2003
<b>ASSETS</b>						
Current and other assets	\$ 2,635,324	\$ 2,552,793	\$ 555,986	\$ 524,901	\$ 3,191,310	\$ 3,077,694
Capital assets	2,320,885	2,271,150	499,987	489,045	2,820,872	2,760,195
<b>Total Assets</b>	<b>4,956,209</b>	<b>4,823,943</b>	<b>1,055,973</b>	<b>1,013,946</b>	<b>6,012,182</b>	<b>5,837,889</b>
<b>LIABILITIES</b>						
Long-term liabilities	1,650,412	1,677,495	363,678	382,780	2,014,090	2,060,275
Other liabilities	334,551	355,287	62,193	57,578	396,744	412,865
<b>Total Liabilities</b>	<b>1,984,963</b>	<b>2,032,782</b>	<b>425,871</b>	<b>440,358</b>	<b>2,410,834</b>	<b>2,473,140</b>
<b>NET ASSETS</b>						
Invested in capital assets, net of related debt	2,259,064	2,183,152	315,335	293,959	2,574,399	2,477,111
Restricted	992,774	982,861	314,767	279,629	1,307,541	1,262,490
Unrestricted	(280,592)	(374,852)	--	--	(280,592)	(374,852)
<b>Total Net Assets</b>	<b>\$ 2,971,246</b>	<b>\$ 2,791,161</b>	<b>\$ 630,102</b>	<b>\$ 573,588</b>	<b>\$ 3,601,348</b>	<b>\$ 3,364,749</b>

County of Orange  
 Comprehensive Annual Financial Report  
 For the Year Ended June 30, 2004

The following table provides summarized data of the government-wide Statement of Activities.

**CHANGES IN NET ASSETS – Primary Government**  
 For the Year Ended June 30, 2004  
 (In Thousands)

	Governmental Activities		Business-Type Activities		Total	
	2004	2003	2004	2003	2004	2003
<b>REVENUES</b>						
Program Revenues:						
Charges for Services	\$ 436,139	\$ 431,151	\$ 203,155	\$ 191,188	\$ 639,294	\$ 622,339
Operating Grants and Contributions	1,532,106	1,545,050	7,459	10,494	1,539,565	1,555,544
Capital Grants and Contributions	55,337	510,311	6,183	16,374	61,520	526,685
General Revenues:						
Property Taxes	342,412	303,436		--	342,412	303,436
Other Taxes	51,104	51,694		--	51,104	51,694
Grants and Contributions not Restricted to Specific Programs	11,969	22,707		--	11,969	22,707
State Allocation of Vehicle License Fees	189,732	178,446		--	189,732	178,446
Other General Revenues	69,776	64,453	965	537	70,741	64,990
<b>Total Revenues</b>	<b>2,688,575</b>	<b>3,107,248</b>	<b>217,762</b>	<b>218,593</b>	<b>2,906,337</b>	<b>3,325,841</b>
<b>EXPENSES</b>						
General Government	170,820	193,192		--	170,820	193,192
Public Protection	905,229	892,817		--	905,229	892,817
Public Ways and Facilities	78,454	74,561		--	78,454	74,561
Health and Sanitation	447,743	441,047		--	447,743	441,047
Public Assistance	731,698	740,794		--	731,698	740,794
Education	31,978	29,108		--	31,978	29,108
Recreation and Cultural Services	76,249	70,273		--	76,249	70,273
Interest on Long-Term Debt	78,474	53,853		--	78,474	53,853
Airport		--	78,235	75,770	78,235	75,770
Waste Management		--	70,858	79,217	70,858	79,217
<b>Total Expenses</b>	<b>2,520,645</b>	<b>2,495,645</b>	<b>149,093</b>	<b>154,987</b>	<b>2,669,738</b>	<b>2,650,632</b>
Excess (Deficit) before Transfers	167,930	611,603	68,669	63,606	236,599	675,209
Transfers	12,155	13,419	(12,155)	(13,419)	--	--
<b>Increase in Net Assets</b>	<b>180,085</b>	<b>625,022</b>	<b>56,514</b>	<b>50,187</b>	<b>236,599</b>	<b>675,209</b>
Net Assets - Beginning of the Year	2,791,161	2,166,139	573,588	523,401	3,364,749	2,689,540
<b>Net Assets - End of the Year</b>	<b>\$ 2,971,246</b>	<b>\$ 2,791,161</b>	<b>\$ 630,102</b>	<b>\$ 573,588</b>	<b>\$ 3,601,348</b>	<b>\$ 3,364,749</b>

As of June 30, 2004, the County's net assets increased by 7%, or \$236,599, during the current fiscal year. Revenues for the year totaled \$2,906,337, a decrease of \$419,504 from the previous year and expenses totaled \$2,669,738, an increase of \$19,106.

**Governmental Activities**

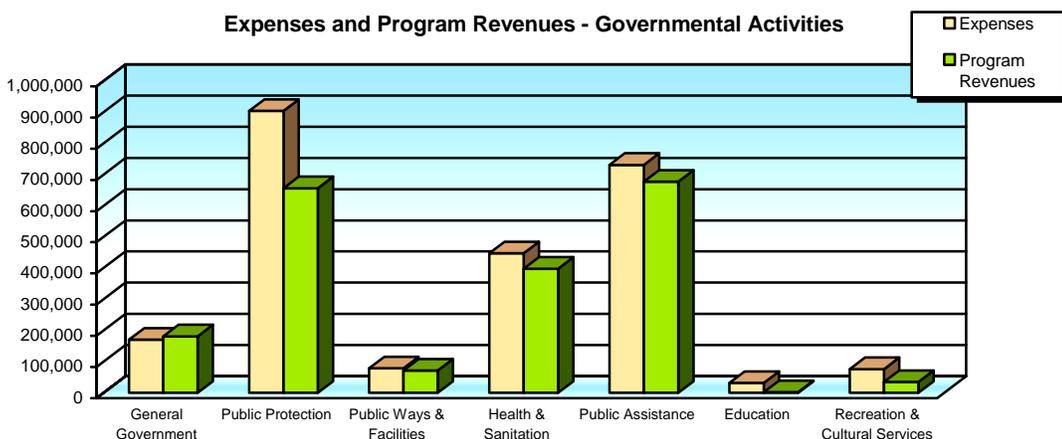
The County's governmental activities rely on several sources of revenue to finance ongoing operations. Operating Grants and Contributions comprised the largest revenue source for the County followed by Charges for Services. Operating Grants and Contributions are monies received from parties outside the County and are generally restricted to one or more specific programs such as the State and Federal revenues for public assistance and for health care. Charges for Services are revenues that arise from charges to customers or applicants who purchase, use, or directly benefit from the goods, services, or privileges provided. Examples of the types of services that fall under this category include engineering services provided to cities under contract, park and recreation fees, and law enforcement services provided to governmental agencies under contract.

At the end of FY 2003-04, total revenues for the governmental activities, including transfers from the business-type activities were \$2,700,730, a decrease of \$419,937 from the previous year. Expenses totaled \$2,520,645, an increase of \$25,000 from the prior year. The majority of these expense increases were in the Public Protection and Interest on Long-Term Debt functions. While revenues decreased and expenses increased from the prior year, the current year's revenues still exceeded expenses, therefore, governmental activities increased the County's net assets by \$180,085, accounting for 76% of the total growth in the net assets of the County. Key elements of the increase are as follows:

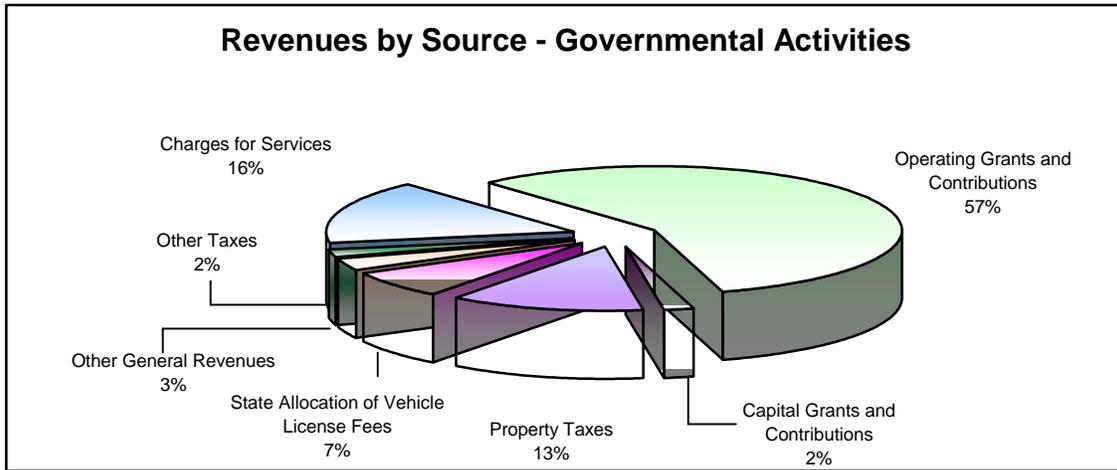
- Property taxes increased by \$38,976, or 13%, due to an increased number of home purchases as a result of low housing interest rates.
- State Allocation of Vehicle License Fees revenue increased by \$11,286, or 6%, due to the Motor Vehicle License Fee (VLF) backfill gap loan amount due from the State for FY 03-04.
- Charges for Services increased by \$4,988 due to an increase in reimbursement from the Ladera Ranch Community Facilities District (CFD) for the widening of Antonio Parkway.
- Capital Grants and Contributions decreased by \$454,974, mainly due to the one-time contribution of the Seven Oaks Dam from the US Army Corps of Engineers to the County in FY 2002-03.
- General Government expenses decreased by \$22,372, or 12%, primarily resulting from the disposition of capital assets reported in FY 2002-03 that no longer belong to the primary government.

In addition to the above, the County received \$4,000 of deferred pass-through tax incremental revenue from the City of Yorba Linda Redevelopment Agency. This is the first of three annual installment payments agreed to by the Yorba Linda Redevelopment Agency.

The following chart presents a comparison of expenses by function and the associated program revenues for governmental activities.

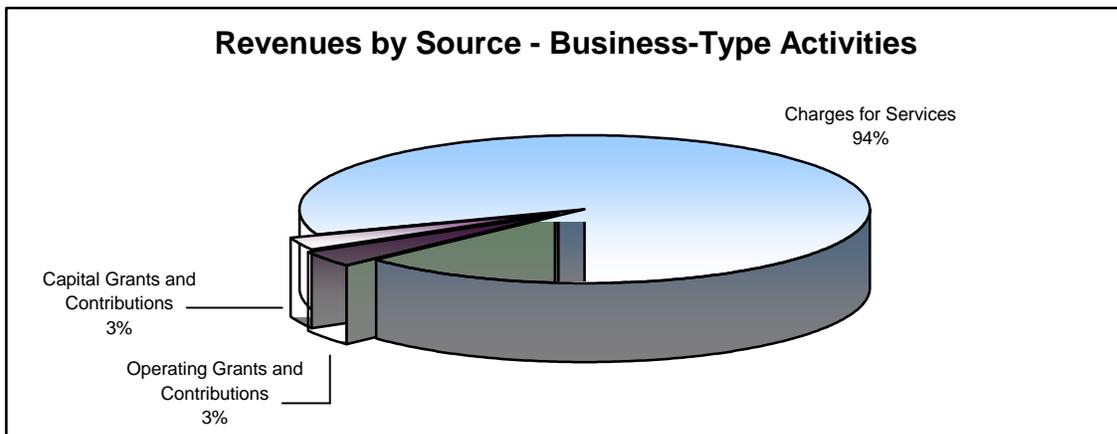


The chart below presents the percentage of total revenues by source for governmental activities.



### Business-Type Activities

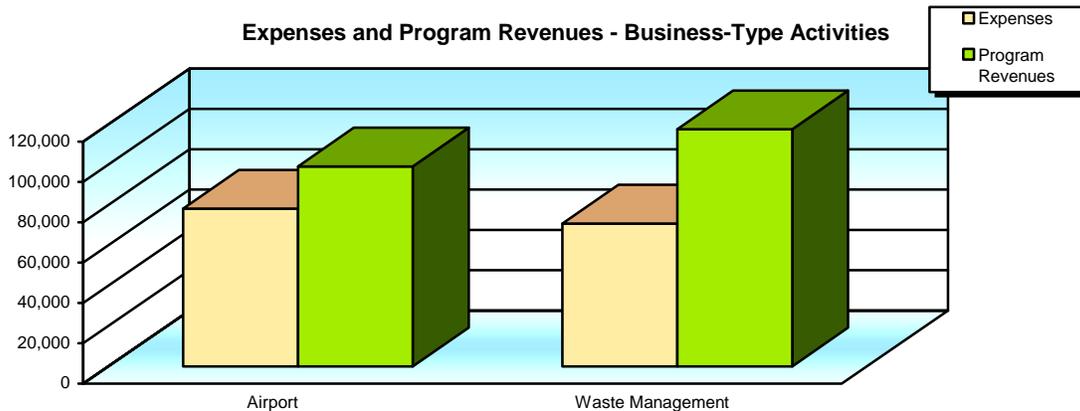
The County has two business-type activities: Airport and Waste Management. In keeping with the intent of recovering all or a significant portion of their cost through user fees and charges, business-type activities reported Charges for Services as their largest source of revenues. Operating Grants and Contributions, as well as Capital Grants and Contributions, were the other revenue sources for Airport and Waste Management activities. Capital Grants and Contributions include revenues received from the Federal Aviation Administration (FAA) for use in airport construction projects.



At the end of FY 2003-04, business-type activities reported total revenues of \$217,764, a decrease of \$829 from the prior year. Expenses, including transfers to the governmental activities, totaled \$161,250, resulting in a decrease of \$7,156 from the previous year. The program revenues (Charges for Services, Operating Grants and Contributions, and Capital Grants and Contributions) financed the majority of expenses recorded for the business-type activities. Other factors concerning the finances of the County's two enterprise funds are discussed in the Proprietary Funds section of the "Financial Analysis of the County's Funds." At the end of FY 2003-04, there was an increase of \$56,514 in net assets as compared to an increase of \$50,187 in FY 2002-03. Key elements for the increase are as follows:

- A \$4,611 increase in the amount of "in-county" solid waste disposed at the landfills.
- A \$6,875 increase in rents and concession from airline rent, parking, and lease concessions due to the increased number of passengers and level of travelers' activities in the airport.
- A \$10,912 decrease in landfill site closure/postclosure costs resulting from increased capacity at the Prima Deshecha Landfill.

The following chart shows expenses by function and the associated program revenues for the business-type activities.



## **FINANCIAL ANALYSIS OF THE COUNTY'S FUNDS**

The County uses fund accounting to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities.

### **Governmental Funds**

Governmental funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and current liabilities generally are included on the balance sheet. Such information may be useful in evaluating the County's near-term financing requirements.

In particular, unreserved fund balance may serve as a valuable measure of the government's resources that are available for spending at the end of the fiscal year. This amount is available for spending at the discretion of the County's Board of Supervisors in order to achieve the established function of the respective funds. Other than the General Fund, all other County funds are restricted for the particular purpose that each fund was established for. For example, special revenue funds have either legal or operational requirements to restrict expenditures for specified purposes, and debt service funds are restricted for payment of principal and interest on general long-term debt. Commitments by the County related to executory contracts for goods or services are recorded and established as reservations of fund balances in the governmental funds.

County of Orange  
Comprehensive Annual Financial Report  
For the Year Ended June 30, 2004

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At June 30, 2004, the County's governmental funds reported total fund balances of \$1,840,106 with an increase of \$25,824 in comparison with the prior year. Of the total fund balances for the governmental funds, \$746,660 (41%) constitutes *unreserved fund balances*.

A significant amount of these unreserved fund balances are designated by the Board of Supervisors for the following uses in the next fiscal year and are deemed to be restrictions, commitments, or limitations, which affect the availability of fund resources in the next fiscal year:

<u>Funds</u>	<u>Planned Uses of Unreserved Fund Balances</u>
General Fund	- Deferred maintenance projects at various County facilities, Americans with Disabilities Act (ADA) improvement projects, and seismic retrofit improvements at the County Central Garage.
Roads	- Construction and maintenance of roadways, and for specialized engineering services to other governmental units and the public.
Public Library	- Library services for the unincorporated areas as well as some of the incorporated areas within the County.
Tobacco Settlement	- Specified health care services and for public safety.
Refunding Bonds and Recovery Certificates of Participation (COPs) and Debt Prepayment	- Bond redemption when a cost effective opportunity to redeem debt is available.
Flood Control District	- Planning, construction, operation, and maintenance of regional flood protection and water conservation works, such as dams, control channels, retarding basins and other flood control infrastructure.
Harbors, Beaches and Parks	- Development and maintenance of County harbors, tidelands and related aquatic recreational facilities, as well as the acquisition, operation and maintenance of County beaches, inland regional park recreation facilities and community park sites in the unincorporated areas.
Other Governmental	- Various capital projects in Ladera Ranch.

The remaining fund balances are *reserved*. Reserved fund balances primarily represent assets that are not available for spending or assets that are not yet available for expenditure due to restrictions imposed by parties outside the County. Note 12 of this report provides a complete list of the reserved fund balances which are titled "Assets Not Available for Appropriations," as well as Board reserves which are titled "Fund Balances Reserved by Board of Supervisors for a Future Purpose."

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**Comparative Analysis of Changes in Fund Balances**

The following schedule presents a summary of revenues and other financing sources, expenditures and other financing uses, and the net changes in fund balances for the governmental funds for the current and previous fiscal years.

**GOVERNMENTAL FUNDS  
COMPARATIVE SCHEDULE OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES**  
For the Year Ended June 30, 2004  
(In Thousands)

	Revenues and Other Financing Sources		Expenditures and Other Financing Uses		Net Change in Fund Balances	
	2004	2003	2004	2003	2004	2003
General Fund	\$ 2,291,343	\$ 2,170,606	\$ 2,308,807	\$ 2,206,647	\$ (17,464)	\$ (36,041)
Roads	47,973	44,110	39,856	38,813	8,117	5,297
Public Library	29,156	32,936	32,471	32,679	(3,315)	257
Tobacco Settlement	31,375	36,249	41,858	35,548	(10,483)	701
Refunding Bonds and Recovery COPs & Debt Prepayment	102,998	130,681	98,045	92,163	4,953	38,518
Flood Control District	72,870	87,075	75,936	58,721	(3,066)	28,354
Harbors, Beaches, and Parks	71,207	73,188	71,218	71,447	(11)	1,741
Other Governmental	476,960	445,297	429,867	388,984	47,093	56,313
<b>Total</b>	<b>\$ 3,123,882</b>	<b>\$ 3,020,142</b>	<b>\$ 3,098,058</b>	<b>\$ 2,925,002</b>	<b>\$ 25,824</b>	<b>\$ 95,140</b>

In the governmental funds, expenditure-driven grants are recognized as revenue when the qualifying expenditures have been incurred and all other grant requirements have been met. As expenditures increase, revenues increase proportionately. In addition to the effects of expenditure-driven grants, the following information provides significant reasons for the change in fund balance.

**General Fund**

The General Fund is the chief operating fund of the County. At the end of FY 2003-04, there was a decrease in fund balance of \$17,464. The decrease in fund balance can largely be attributed to higher Salaries and Employee Benefits (S&EB). Specifically, retirement costs increased by \$41,320, regular salaries increased by \$18,000, and health care insurance costs increased by \$17,870. The decrease to fund balance caused by the increased retirement costs would have been even greater had the County not been able to use its Investment Account with the Orange County Employees Retirement System (OCERS) to fund a portion of its Annual Required Contribution (ARC). Refer to Note 18 for more information on the OCERS Investment Account.

While expenses for the General Fund increased, revenues from the State for Motor Vehicle License Fees (VLF) and Mandated Costs declined due to the State deferring payments to the County. For FY 03-04, the State deferred \$26,506 for VLF and \$30,485 for Mandated Costs. Furthermore, included in the preceding schedule of Revenues and Other Financing Sources were increased transfers from various Special Revenue Funds. The Designated Special Revenue Fund, a fund that was established to provide cash for interfund cash flow loans and to fund strategic priorities identified in the County's Strategic Financial Plan, transferred \$29,700 to finance County operations. The Public Safety Sales Tax Excess Revenue fund, a fund used to place surplus Public Safety Sales Tax revenues to meet future public protection needs, increased its transfer by \$8,464 over the previous year to the Sheriff Department to balance their base budget. Without the increased transfers, fund balance would have shown an even greater decline.

#### Roads

This fund accounts for the maintenance and construction of roadways, and for specialized engineering services to other governmental units and the public. At the end of FY 2003-04, there was an increase in fund balance of \$8,117. In addition to the discussion in the Government-Wide Financial Analysis for Charges for Services, the increase is also due to a \$1,006 reimbursement from the Flood Control District for additional services provided.

#### Public Library

This fund accounts for library services for the unincorporated areas as well as some of the incorporated areas within the County. There was a \$3,315 decrease to fund balance this fiscal year. The Public Library Fund had a decrease of \$4,999 in developer fee revenues, since there were no new construction projects in FY 2003-04 and a one-time contribution of \$1,425 to the City of Newport Beach for the annexation of Newport Coast.

#### Tobacco Settlement

This fund accounts for tobacco settlement monies allocated to the County from the State of California, pursuant to the Master Settlement Agreement between the major tobacco companies and 46 states (including California), the District of Columbia and four U.S. Territories. At the end of FY 2003-04, there was a decrease in fund balance of \$10,483 that can be primarily attributed to a \$12,100 increase in expenditures for the Theo Lacy Jail capital project as well as a \$5,546 reduction in revenues received from the State's 1998 Multi-State Settlement Agreement (MSA).

#### Refunding Recovery Bonds and Recovery Certificates of Participation and Debt Prepayment

This fund accounts for the debt service transactions handled by the trustee bank for the Orange County 1995 Refunding Recovery Bonds and the 1996 Recovery Certificates of Participation. This fund also accounts for early debt reduction of the County's outstanding bonds. At the end of FY 2003-04, there was an increase in fund balance of \$4,953. The increase is due primarily to an increase in the amount of VLF funds received from the State Controller to pay for the Recovery Bonds. In comparison to the prior year, the change in fund balance decreased by \$33,565 due to a transfer to the Debt Prepayment Fund in FY 2002-03, resulting from a change in funding source for the Theo Lacy Jail Expansion Project and a programmed transfer planned in the Strategic Financial Plan.

#### Flood Control District

This fund accounts for the planning, construction and operation of flood control and water conservation works, such as dams, basins, and trunk channels, and for the retardation, conservation and controlled discharge of storm waters. At the end of FY 2003-04, there was a decrease in fund balance of \$3,066. The following is a brief summary of the primary reasons for the net decrease in fund balance for the Flood Control District in FY 2003-04 as compared to the prior year:

- An \$18,016 decrease in revenue due to a reduction in subvention revenue from the State.
- A \$1,240 decrease in revenues due to the downward trend of interest rates.
- An \$8,570 increase in charges by the Army Corps of Engineers associated with the construction of the Prado Dam.

#### Harbors, Beaches and Parks

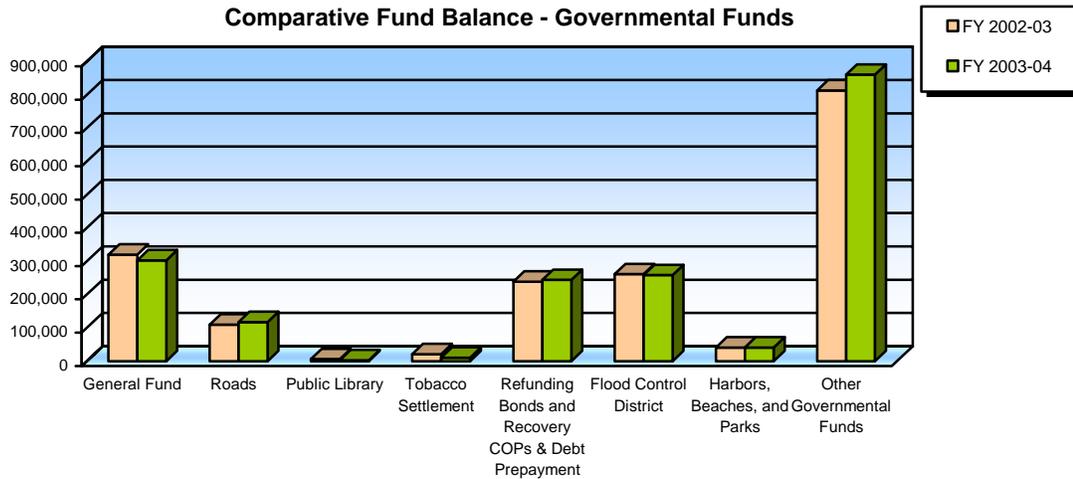
This fund accounts for the development of aquatic recreational facilities and the acquisition, operation and maintenance of County beaches, inland regional park recreational facilities and community park sites in the unincorporated areas. At the end of FY 2003-04, there was only a small decrease in fund balance of \$11 as compared to a decrease of \$1,751 in FY 2002-03. This decrease resulted from the final installment payment received by the County for the purchase of the Barham Ranch Property in FY 2002-03.

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**Other Governmental Funds**

At the end of FY 2003-04, there was an increase in fund balance of \$47,093. Revenues increased primarily due to the issuance of Tax Allocation Refunding Bonds Santa Ana Heights Project (SAHP) Area by the Orange County Development Agency (OCDA) and two new Special Revenue Funds that were created in the Health Care Agency (HCA). Expenditures decreased due to fewer capital expenditures in FY 2003-04.

The following chart shows the net change in fund balance for governmental funds for the current and previous fiscal year.



**Proprietary Funds**

The proprietary funds financial statements provide the same type of information as the government-wide financial statements, only in more detail. The proprietary funds financial statements provide separate information for the Airport and Waste Management operations, both of which are considered to be major funds of the County. Conversely, the Internal Service Funds are combined into a single, aggregated presentation in the proprietary fund financial statements with the individual fund data provided in combining statements, which can be found elsewhere in this report.

**Comparative Analysis of Changes in Fund Net Assets**

The following table presents the Enterprise Funds' actual revenues and other financing sources, expenses and transfers, and changes in fund net assets for the current and previous fiscal year.

**ENTERPRISE FUNDS  
COMPARATIVE SCHEDULE OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS**  
For the Year Ended June 30, 2004  
(In Thousands)

	Revenues, Contributions and Transfers		Expenses and Transfers		Change in Fund Net Assets	
	2004	2003	2004	2003	2004	2003
Airport	\$ 99,776	\$ 101,314	\$ 76,932	\$ 74,712	\$ 22,844	\$ 26,602
Waste Management	118,026	117,265	82,956	92,524	35,070	24,741
<b>Total</b>	<b>\$ 217,802</b>	<b>\$ 218,579</b>	<b>\$ 159,888</b>	<b>\$ 167,236</b>	<b>\$ 57,914</b>	<b>\$ 51,343</b>

#### Airport

This fund accounts for major construction and self-supporting aviation-related activities rendered at John Wayne Airport (JWA), Orange County. At the end of FY 2003-04, there was an increase in fund net assets of \$22,844 that can be attributed to the following factors:

- A \$6,875 increase in rents and concession from airline rent, parking, and lease concessions due to the increased number of passengers and level of travelers' activities at the airport.
- A \$1,334 decrease in interest expense due to the refunding of Airport Revenue Refund Bonds, Series 1993 and principal reduction of Airport Revenue Refund Bonds, Series 1997.

In comparison to the prior year, there was a decrease in fund net assets of \$3,758 due to a decrease of \$8,825 in capital contributions from the Federal Aviation Administration (FAA) and an increase of \$2,211 in professional services as a result of additional services incurred in FY 2003-04 to evaluate the feasibility of expansion alternatives.

#### Waste Management

This fund is used to account for the operation, expansion, and closing of existing landfills and the opening of new landfills. Monies are collected through gate tipping fees, which users pay based primarily on tonnage. At the end of FY 2003-04, there was an increase in fund net assets of \$35,070 compared to the prior year change of \$24,741 due to the following factors:

- A \$4,611 increase in charges for services due to an increase in the amount of "in-county" tonnage disposed at the landfills.
- A \$10,912 decrease in the closure and postclosure costs due to an increase of available capacity at the Prima Deshecha Landfill.
- A \$1,209 decrease in transfers to the General Fund due to a decrease of imported (out-of-county) solid waste disposed at the landfills.

### **GENERAL FUND BUDGETARY HIGHLIGHTS**

This section provides a summary of the primary factors involved in the variances between: 1) the Original Budget and the Final Amended Budget; and 2) the Final Amended Budget and the Actual Amounts for the General Fund. Refer to the Budgetary Comparison Statement for details on this budgetary comparison.

#### **Original Budget vs. Final Amended Budget**

The following provides a summary of the primary factors attributable to the increase in the General Fund final amended budget revenues compared to the original budget revenues:

#### Intergovernmental Revenues:

- An increased revenue budget in Sheriff-Coroner of \$11,334 for additional one-time grants, including the State Domestic Preparedness Grant, Homeland Security Grants and the Federal Bureau of Investigations and Joint Terrorism Task Force (FBI/JTTF) Reimbursement Agreement.
- An increase of \$10,473 in budgeted revenues in the Social Services Agency to reconcile actual allocations for the following programs: In-Home Supportive Services, Child Welfare Services, California Work Opportunities and Responsibility to Kids (CalWORKS), Medi-Cal, Foster Care and Adult Protective Services.
- A \$9,550 decrease in revenues in the County General Fund due to a reduction in VLF revenues from the State.

#### Transfers In:

- An increase of \$3,850 in the Watershed Management Program to ensure that the Net County Cost (NCC) target set by County Executive Office (CEO) would be met.
  - An increase of \$13,453 in the Health Care Agency (HCA) to allow for operating transfers from various health related Special Revenue funds.
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- A \$9,940 increase in the Sheriff-Coroner Department revenue budget for new positions, a new helicopter, information systems, and capital projects.

The following provides a brief summary of the primary factors attributable to the increase in the General Fund final amended budget expenditures compared to the original budget expenditures:

Capital Projects:

Budget appropriations decreased by \$10,114 due to the accelerated project schedule of the 60 Bed Expansion of Juvenile Hall that was encumbered in FY 2002-03.

Sheriff-Coroner:

A \$20,810 increase was appropriated to fund the annual transfer to the Public Safety Sales Tax Excess Revenue Fund pursuant to Proposition 172, a voter-approved measure passed in 1994 establishing a ½ percent (0.5%) sales tax on an ongoing basis for local public safety programs.

Social Services Agency:

An increase of \$13,046 to reflect the impacts of the final state budget for the following programs: In-Home Supportive Services, Child Welfare Services, CalWORKS, Medi-Cal, Foster Care and Adult Protective Services.

Provision for Contingencies:

An increase of \$22,917 because the County increased appropriations for contingencies due to the uncertainties surrounding the VLF revenue from the State and the costs of the special recall election.

**Final Amended Budget vs. Actual Amounts**

The following information provides a summary of the primary factors that caused the negative variance in the General Fund actual revenues compared to the final amended budget revenues:

Other Revenues:

- A \$6,330 negative variance in the Miscellaneous Agency due to a late implementation date of the FY 2003-04 retirement rates for County agencies and the Superior Court.
- A \$2,680 negative variance in the HCA because an anticipated one-time revenue did not materialize.
- A \$2,150 negative variance in the Aid to Families with Dependent Children (AFDC) – Foster Care because child support revenues were less than projected.

Charges for Services:

- A negative variance of \$7,179 in the Watershed Management Program for the National Pollutant Discharge Elimination System (NPDES) that was budgeted in "Charges for Service" but was recorded in account "Intergovernmental Revenues."
- A negative variance of \$8,475 in HCA due to lower than budgeted receipts of Medi-Cal based on reduced eligible expenditures in salaries, employee benefits, and contracted services.
- A negative variance of \$6,340 in the Resources and Development Management Department (RDMD) caused by the cancellation of the Orange County Red Imported Fire Ant Program.

Taxes:

- A positive variance of \$10,051 in Property Taxes due to higher than estimated housing sales caused by historically low interest rates.

Transfers In:

- A negative variance of \$20,319 in HCA because transfers from Tobacco Settlement Revenue (TSR) Fund, Medi-Cal Administrative Activities/Targeted Case Management (MAA/TCM), and HCA Special Revenue Funds were lower than budgeted.
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- A negative variance of \$6,070 in the Sheriff-Coroner's budget due to decreased funding for information systems and capital projects not completed in FY 2003-04 and for Mobile Data Computers (MDC) and Switcher Fees that were re-budgeted in FY 2003-04.
- A \$15,053 negative variance in transfers from the Real Estate Development Program Fund because planned sales of assets were not made.

The following provides a summary of the primary factors causing the significant positive variance in the General Fund actual expenditures as compared to the final amended budget expenditures:

Miscellaneous:

A positive variance of \$29,252 because there were no unexpected expenditures related to legal defense and settlements for County programs. This agency in the General Fund provides for such contingencies and is not anticipated to be spent unless the need arises.

Watershed Management Program:

An \$8,581 positive variance due to lower than anticipated expenditures for the NPDES program, consulting contracts and the deferral of two budgeted capital projects.

Capital Projects:

A \$19,698 positive variance due to unfinished capital projects, including energy efficiency projects, maintenance and repair projects and the Youth Leadership Academy at Juvenile Hall, all of which were re-budgeted in FY 2004-05.

Health Care Agency:

- A positive variance of \$7,842 due to savings from the County-wide hiring freeze, reduced use of extra help employees, employees taking time off rather than selecting a Performance Incentive Program (PIP) payoff and lower group insurance rates than anticipated.
- A \$38,117 positive variance due to lower than budgeted costs in TSR funded projects, Medi-Cal funded agreements, and Proposition 36 funded agreements, a voter-approved measure passed in 2000 that allows first and second time non-violent, simple drug possession offenders the opportunity to receive substance abuse treatment instead of incarceration.

Sheriff-Coroner:

Of the total \$15,702 variance, a positive variance of \$3,064 is due to lower than anticipated expenditures, deleted positions based on Blue Ribbon Committee recommendations, and the deferral of some capital projects that were re-budgeted in FY 2004-05.

Social Services Agency:

Of the total \$28,967 variance, a positive variance of \$16,338 is due to lower than anticipated costs related to salaries and benefits, office expense, professional and specialized services, and CalWorks, In-Home Supportive Services, and Child Welfare Services.

Aid to Families with Dependent Children (AFDC) – Foster Care

A \$17,079 positive variance due to lower than projected Foster Care caseloads and costs per case due to placement of children in less costly, more family-like placements.

Resources and Development Management Division:

Of the total \$19,184 variance, a \$5,492 positive variance is due to reduced spending on professional service contracts as a result of the cancellation of the Red Imported Fire Ant Program and the cancellation or deferral of projects to FY 2004-05.

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Provision for Contingencies:

A positive variance of \$27,917 occurred because the County increased appropriations for contingencies due to the uncertainties surrounding the VLF revenue from the State and the costs of the special recall election but these additional appropriations were ultimately not required to be spent.

**CAPITAL ASSET AND DEBT ADMINISTRATION**

**Capital Assets**

At June 30, 2004, the County's capital assets for both the governmental and business-type activities amounted to \$2,820,872 net of accumulated depreciation. The investment in capital assets includes land, structures and improvements, equipment, infrastructure (roads, bridges, flood channels, trails, traffic signals, and harbors), and construction in progress. The total increase in the County's investment in capital assets for the current year was 2% (a 2% increase for governmental activities and a 2% increase for business-type activities).

Capital assets for the governmental and business-type activities are presented below to illustrate changes.

**CAPITAL ASSETS**  
(Net of Depreciation)  
June 30, 2004  
(In Thousands)

	Governmental Activities		Business-Type Activities		Total		Increase (Decrease)
	2004	2003	2004	2003	2004	2003	% Change
Land	\$ 481,048	\$ 475,695	\$ 34,108	\$ 34,108	\$ 515,156	\$ 509,803	1%
Structures and Improvements	501,778	463,557	196,110	178,563	697,888	642,120	9%
Equipment	102,418	108,691	24,422	24,607	126,840	133,298	(5)%
Infrastructure	817,294	833,461	182,510	189,733	999,804	1,023,194	(2)%
Construction in Progress	418,347	389,746	62,837	62,034	481,184	451,780	7%
<b>Total</b>	<b>\$ 2,320,885</b>	<b>\$ 2,271,150</b>	<b>\$ 499,987</b>	<b>\$ 489,045</b>	<b>\$ 2,820,872</b>	<b>\$ 2,760,195</b>	<b>2%</b>

The following lists the significant expenditures for capital assets in FY 2003-04:

- \$13,578 for the construction of the Theo Lacy Jail Expansion Project (Building B).
- \$9,594 for the improvements of several flood channels to carry out the 100-year design flow in cooperation with the Orange County Flood Control District (OCFCD) and the Federal Emergency Management Agency (FEMA).
- \$9,318 for the construction of an equipment maintenance facility at the Frank R. Bowerman Landfill.
- \$5,909 for the construction of housing unit "Q" at Juvenile Hall, which will increase the capacity by 60 beds.
- \$5,919 for the mass excavation project at the Prima Deshecha Landfill.
- \$4,268 for structural security modifications at John Wayne Airport (JWA).
- \$3,088 for the remodeling of Fire Station #33 at JWA.
- \$2,859 for the construction of the easterly side of the Huntington Beach Channel that runs from Atlanta to Indianapolis.
- \$2,676 for the purchase of MDC systems for the Sheriff Department.
- \$1,845 for the rehabilitation of floors nine through eleven of the Central Justice Center, including the replacement of ceiling, lighting, heating and air-conditioning systems and asbestos removal.

County of Orange  
 Comprehensive Annual Financial Report  
 For the Year Ended June 30, 2004

- \$1,389 for the construction of the Youth Leadership Academy at Juvenile Hall, which will increase the capacity by 120 beds for a new Youth Leadership Program.

Additional information on the County's capital assets can be found in Note 4 of this report.

Commitments for Capital Expenditures. At the end of FY 2003-04, significant commitments for capital expenditures include the following:

- \$181,000 for the Santa Ana River (SAR) Mainstream Project.
- \$18,721 for the construction of Laguna Canyon Road, State Route 73 to Interstate 405.
- \$15,009 for replacement of three existing housing units at the Juvenile Hall.
- \$8,048 for flood control channel projects.
- \$6,730 for the remodeling of Fire Station #33 at JWA.

Additional information on the County's commitments for capital expenditures can be found in Note 14 of this report.

### Long-Term Debt

At June 30, 2004, the County had a total debt obligation outstanding of \$1,415,861, excluding capital lease obligations, compensated absences and other liabilities. During the year, \$115,585 of the bonds were retired, while \$38,465 was added, which resulted in a net decrease of 5% on the County's outstanding bond obligation. The County is limited by law in issuing general obligation bonded debt to 1.25 percent of the last equalized property tax roll. However, this does not affect the financing of any of the County's planned facilities or services because as of the end of the fiscal year, the County had no net general obligation bonded debt. The County's debt obligations are in the form of revenue bonds, certificates of participation, and other forms of debt not covered by the general obligation debt limitation law.

The following table summarizes the County's outstanding bonds at June 30, 2004:

#### LONG-TERM DEBT BOND OBLIGATIONS

June 30, 2004  
 (In Thousands)

	Governmental Activities		Business-Type Activities		Total		Increase (Decrease)
	2004	2003	2004	2003	2004	2003	% Change
Revenue Bonds	\$ 268,607	\$ 287,282	\$ 196,300	\$ 208,490	\$ 464,907	\$ 495,772	(6)%
Certificates of Participation	619,394	647,409		--	619,394	647,409	(4)%
Pension Obligation Bonds	116,772	120,772		--	116,772	120,772	(3)%
Recovery Bonds	225,870	240,110		--	225,870	240,110	(6)%
Add: Premium on Bonds Payable	5,045	3,445	5,082	5,777	10,127	9,222	10%
Less: Deferred Amount on Refunding	(6,110)	(4,597)	(15,099)	(17,255)	(21,209)	(21,852)	(3)%
<b>Total</b>	<b>\$ 1,229,578</b>	<b>\$ 1,294,421</b>	<b>\$ 186,283</b>	<b>\$ 197,012</b>	<b>\$ 1,415,861</b>	<b>\$ 1,491,433</b>	<b>(5)%</b>

The following summarizes the County's long-term debt activity during FY 2003-04:

- Tax Allocation Refunding Bonds, Series 2003 (Santa Ana Heights Project Area). On November 13, 2003, the Orange County Development Agency (OCDA) issued in the principal amount of \$38,465 Tax Allocation Refunding Bonds (Santa Ana Heights Project Area) Series 2003 at a premium of \$1,660. The proceeds of the bonds and other available monies were used to (1) refund and defease the outstanding 1993 Tax Allocation Revenue Bonds at a redemption price equal to 102% of the aggregate principal amount, (2) fund a reserve account for the new bonds, and (3) pay all the cost of issuing the bonds.

Additional information on the County's long-term debt activity can be found in Note 9 of this report.

### **Bond Ratings**

The County continues to maintain the issuer ratings of Aa2 from Moody's Investors Service and A+ from Standard & Poor's. The rating report cited the County's continued prudent fiscal management, evidenced by a strong fiscal position and disciplined adherence to its strategic plan, focusing on debt reduction, as well as the diversified and healthy local economy, as the basis for the rating. There were no changes in the County's underlying debt ratings as compared to the previous year.

The County maintains the following long-term underlying debt ratings:

#### **LONG-TERM DEBT RATINGS** June 30, 2004

	Moody's	Fitch	Standard and Poor's
Airport Revenues Bonds	Aa3	A+	A+
Waste Management Revenue Bonds	A2	A+	--
Pension Obligation Bonds	Aa2	AA-	A
Recovery Bonds	Aa3	--	--
2002 Lease Revenue Bonds	A1	AA-	A
2001 Equipment Lease	A2	--	--
1996 Recovery Certificates of Participation	A1	AA-	--
1991 Parking Certificates of Participation	A1	--	--

### **OTHER POTENTIALLY SIGNIFICANT MATTERS**

The County's management has determined that the following are significant matters that have a potential impact on the County's financial position or changes in financial position.

#### **Governmental Activities**

- State Budget: The Governor signed the FY 2004-05 State Budget on July 31, 2004. The \$105,000,000 spending plan addresses budget shortfalls through program savings, borrowing, funding shifts, and local government contributions. A summary of the significant components of the FY 2004-05 State Budget are as follows:

Local Government Property Tax

- In exchange for contributing \$1,300,000 in each of the next two years, local governments will receive protection from future state borrowing of local government revenue through a Constitutional amendment approved by the voters on the November ballot. Orange County's share of the contribution is estimated at \$27,731 per year.
- During fiscal emergencies, the state is allowed to borrow local revenues with a two-thirds vote of the Legislature and Governor's signature.
- FY 2008-09 is the first year the state may borrow.
- Legislature cannot borrow more than 8% of local property tax revenue.
- Loan has to be repaid within 3 years with interest.
- The borrowing can take place twice during a 10-year period and only after the first loan has been repaid.
- Enterprise special districts will contribute 40% of their property tax revenues, not to exceed 10% of their total revenues. Special districts will contribute 10% of their property tax revenues. In FY 2006-07, regular property tax allocations to special districts will resume. Orange County's estimated additional special district contributions total \$7,600 for FY 2004-05.

Vehicle License Fees

- The local government package includes the swapping of vehicle license fee backfill for constitutionally protected property tax revenue.
- Establishes a new .65% VLF rate.

State Mandates

- Legislature must appropriate funds for state reimbursable mandates or suspend the provision for the mandate.
- Established a repayment plan for deferred mandate reimbursements commencing in FY 2006-07 and concluding in FY 2011-12.

In-Home Supportive Services (IHSS)

- Requires the state to match provider wages up to \$9.50 (in absolute dollar amount) per hour plus \$.60 (in absolute dollar amount) per hour for benefits. The May Revise budget assumed that the State would match only up to the minimum wage. Assuming that the County maintains the current provider wages, this change is estimated to add an additional \$3,000 to the State General Fund obligation for the IHSS program.
- Retirement: On August 24, 2004, the Board of Supervisors approved a Memorandum of Understanding (MOU) with a number of employee bargaining units, except for the American Federation of State, County and Municipal Employees (AFSCME), which will provide for increased retirement benefits based on a 2.7% at 55 formula beginning July 1, 2005. Additional information on this topic can be found in Note 20 of this report.
  - County Accounting and Personnel System (CAPS) Upgrade: CAPS is a vital part of the County's infrastructure that is needed for business processes such as financial planning and budget development, maintaining the County's financial records, collecting costs for federal and state billing, procuring goods and services, making vendor payments, processing the County's payroll, and administering enterprise-wide human resource functions. CAPS maintains financial records for the County's budget of \$4,800,000 and maintains human resource records and processes payroll for a work force of over 17,000 employees.

CAPS is based on 1980s technology and is becoming costly to maintain and operate. In addition, it is expected that the vendor will discontinue support of its Advantage products, implemented at the County, within three to five years. If the County does not take some action with the

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Advantage products after the vendor discontinues support system operations and maintenance costs will grow, the risk of the systems not functioning properly will increase and ultimately the system will become technologically obsolete and unsupported.

The County is in the process of conducting a strategic assessment to identify the County's business processes to be included in the assessment, develop a strategic-level needs assessment for these business processes, identify the problems with the current system in meeting the County's business needs, develop a business case for taking action, and identify/analyze the viable alternative(s) (e.g., pro/cons, risks, costs).

The process is expected to take approximately five months. Based on the alternative(s) selected, Requests for Proposals will be issued to source the solution(s). Costs are expected to vary greatly and are expected to range from as little as \$5,000 to over \$50,000 depending on the selected alternative(s). Implementation of a solution could take from four to five years.

- Assessment Tax System (ATS) Upgrade: The County's property tax assessment, collection and allocation system processes approximately \$3,600,000 annually in property taxes for the cities, school districts and special districts within the County. The system was developed in the late 1980s and early 1990s in what is now an obsolete programming language that is becoming increasingly difficult to support. Given the critical nature of the application, its replacement is considered a strategic priority. This effort is under way and a request for proposals for a needs assessment has been finalized.

The needs assessment is expected to last one year and will result in a requirements document which will be used for sourcing services to develop the replacement application. The development and deployment of the application is expected to take from three to four years at a cost of approximately \$12,000 to \$15,000.

- Proposition 172: On September 14, 2004, the Registrar of Voters certified to the Orange County Board of Supervisors the *Initiative Reallocating a Portion of the County's Proposition 172 Funds from the County Sheriff-Coroner and District Attorney to the Orange County Fire Authority (OCFA)* petition. The Board completed a fiscal impact analysis of the Initiative pursuant to Elections Code Section 9111 and on September 28, 2004 placed the initiative on the next statewide general election to be decided in June 2006. If approved by the voters, the initiative would allocate 50% of any increase over a base year amount in FY 2004-05 of Proposition 172 Public Safety Sales Tax revenue to OCFA, subject to a maximum allocation of 10% of the County's annual Proposition 172 revenue.

The use of this funding is restricted to public safety purposes, which is defined by Government Code 30052(b)(1) as "sheriffs, police, fire protection, county district attorneys, county corrections, and ocean lifeguards." For purposes of allocating the County's share of Proposition 172 revenue, the Board of Supervisors designated the Sheriff-Coroner and the District Attorney as public safety services and allocated 80% of the revenue to the Sheriff-Coroner and the remaining 20% to the District Attorney. In FY 2004-05, this funding is budgeted to provide \$191,600 in revenue to the Sheriff and \$47,900 in revenue to the District Attorney.

### Requests for Information

We hope that the preceding information has provided you with a general overview of the County's overall financial status. For questions or comments concerning information contained in this report, please contact the Auditor-Controller's Office, County of Orange, 12 Civic Center Plaza, Santa Ana, CA 92702 or you can access our Web site at <http://www.oc.ca.gov>.

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