

Management's Discussion and Analysis

The management of Shelby County Government (County) presents this narrative overview and analysis of the County's financial activities for the fiscal year ended June 30, 2006. We encourage readers to consider the information presented here in conjunction with information in the transmittal letter found at the front of this report and the basic financial statements, which follow in this section.

Accounting principles generally accepted in the United States of America for governmental entities are established by the Governmental Accounting Standards Board (GASB). This is the fifth annual financial report issued by Shelby County using the standards established by the GASB's Statement No. 34 *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*. Statement No. 34 made significant changes to financial reporting, including new "government-wide" financial statements. Shelby County follows all GASB standards in addition to Statement No. 34 as well as other authoritative literature known collectively within the accounting profession as "generally accepted accounting principles."

Financial Highlights

- At the end of the current fiscal year, unreserved undesignated fund balance for the general fund was \$41,147,243, or 13.3 percent of total general fund expenditures. This was an increase of \$3.6 million or a 9.6% increase.
- In addition to the general fund balance increase noted above, the County also by transfers from the general fund created a pay-as-you-go capital projects fund of \$13.9 million and an economic development fund of \$1.5 million.
- Fund balance for the debt service fund increased \$26.7 million to \$55,924,980, which is 40.0% of total expenditures of the debt service fund. The balance is well above our target minimum level of \$4 million and consistent with our plan to provide now for increasing debt service requirements through 2009.
- Total liabilities of Shelby County exceed total assets as of June 30, 2006 by \$990,334,242. The largest contributing factor causing this deficit is the fact that the County issues debt on behalf of entities not a part of the County's primary financial reporting unit and the related assets are not recorded by the County. These entities include the school systems of Shelby County and the City of Memphis, joint ventures with the City of Memphis, and others. Debt for these entities as of June 30, 2006 was \$1,296,570,718.
- Total net assets increased from the amount reported last year due to a restatement of beginning balance of \$336.7 million because of the capitalization of infrastructure assets acquired prior to July 1, 2001. Note IV (Q) explains this more fully.
- Total net assets increased \$37.4 million as a result of the fund balance increases noted above in the general and debt service funds, a \$12.7 million increase in net assets of the internal service funds and other smaller changes.

More details on these highlights and other information are in the remainder of this discussion and analysis.

Overview of the Financial Report

The Comprehensive Annual Financial Report includes three major sections – Introductory Section, Financial Section, and Statistical Section. The Introductory Section includes a transmittal letter and general information about the County. The Statistical Section includes financial and non-financial data, some from sources other than financial records and often covering up to ten years. The Financial Section is the major part of the financial report. The Independent Auditor's Report applies only to the Financial Section. This discussion and analysis applies only to the Financial Section.

The Financial Section includes the following statements and schedules:

- Basic Financial Statements
 - Government-wide financial statements
 - Fund financial statements
 - Notes to financial statements
- Required Supplemental Information (Budgetary Comparison Schedules)
- Combining Statements and Individual Fund Statements and Schedules

BASIC FINANCIAL STATEMENTS

Shelby County's basic financial statements are comprised of three components: 1) government-wide financial statements; 2) fund financial statements; and 3) notes to the financial statements.

Government-wide financial statements. The *government-wide financial statements* are designed to provide a broad overview of Shelby County's finances in a manner similar to a private-sector business. The two government-wide financial statements present highly summarized information for all of County government.

The *statement of net assets* presents information on all of Shelby 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 changes in the financial position of Shelby County. However, because the County issues substantial amounts of debt for capital assets of others, such as the Memphis City Schools, annual decreases in net assets are expected in years when such debt is issued.

The *statement of activities* presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying economic event giving rise to the change occurs, *regardless of the timing of related cashflows*. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both of the government-wide financial statements distinguish functions of Shelby 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 Shelby County include general government, hospital, planning & development, public works, corrections, health services, community services, law enforcement, judicial, other elected officials, education and interest on debt. The business-type activities of Shelby County consist of codes enforcement, fire services and corrections.

The government-wide financial statements include not only Shelby County itself - known as the *primary government* - but also four legally separate entities for which Shelby County is financially accountable. These entities are the Shelby County Board of Education, Shelby County Health Care Corporation (The Med), Agricenter International, and the Emergency Communications District. Financial information for these *component units* is reported separately from the financial information presented for the primary government itself. This discussion and analysis is devoted to Shelby County government rather than the component units.

Fund financial statements. A *fund* is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. Shelby 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 Shelby County can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental 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 fund 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 government's near-term financing requirements.

Because the focus of governmental funds is more narrow 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 fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

Shelby County maintains twelve individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures and changes in fund balances for the general fund, debt service fund, capital projects fund, education fund, and grants fund, all of which are considered to be major funds. Data from the other seven governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the nonmajor governmental funds combining statements elsewhere in this report.

Proprietary funds. Shelby County maintains two types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide

financial statements. Shelby County uses enterprise funds to account for Consolidated Codes Enforcement, Correction Center and Fire Services. *Internal service funds* are an accounting device used to accumulate and allocate costs internally among Shelby County's various functions. Shelby County uses internal service funds to account for its central services, group hospital, group life, tort liability and employer insurance funds. 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 funds 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 each enterprise fund. Internal service funds are combined into a single, aggregated presentation in the proprietary fund financial statements. Individual fund data for the internal service funds is provided in the form of a *combining statement* elsewhere in this report.

Fiduciary funds. 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 statement because the resources of those funds are *not* available to support Shelby County's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. The Shelby County Retirement System is the major fiduciary fund.

Component units combining statements. Component units are not "funds" of Shelby County as the primary government. However, the government-wide financial statements include one column for all component units as discussed above. In order to provide details on each component unit, a combining statement of net assets and a combining statement of activities are included in the fund financial statements section of the basic financial statements.

Differences between government-wide and fund financial statements. The government-wide financial statements are much more aggregated and summarized than the fund financial statements. The government-wide statement of net assets includes capital assets and long-term debt, whereas the fund balance sheets include neither. The government-wide statement of activities does not report the issuance or repayment of long-term debt during the year and reports depreciation expense but not amounts expended for capital assets during the year. The fund statement of revenues, expenditures and changes in fund balances includes as other financing sources the amount of long-term debt incurred during the year and as expenditures the amount of principal repaid. This statement also includes amounts expended for capital assets but not depreciation. These are some of the most common, significant differences but there are others. Following the fund balance sheet and the fund statement of revenues, expenditures and changes in fund balances is a reconciliation of those statements to the government-wide statement of net assets and the statement of activities.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. "Notes" is the traditional term applied to this information; however the term is misleading in that the notes can vary in length from one paragraph to several pages.

REQUIRED SUPPLEMENTARY INFORMATION

This section contains other information that financial reporting standards specify should be included under this caption. Shelby County is required to present information on budgetary compliance and the retirement system. Budgetary comparison schedules are presented for the general fund and other "major" special revenue funds (the education fund and the grants fund) to demonstrate compliance with their budget. Other budgetary comparison schedules not fitting the criteria defined for this section are presented under "Combining Statements and Individual Fund Statements and Schedules." For the Shelby County Retirement System (a fiduciary fund), the required supplementary information is a schedule of funding progress.

COMBINING STATEMENTS AND INDIVIDUAL FUND STATEMENTS AND SCHEDULES

Combining fund statements for the non-major special revenue funds and internal service funds are included in this section of the report. Supplemental schedules include general fund and grants fund budgetary comparisons by department, detail of constitutional officers' activities and schedules of debt by debt issue.

**Government-wide Financial Analysis
(Reporting the County as a Whole)**

FINANCIAL POSITION

Table 1 shows a condensed version of the Statement of Net Assets (see the government-wide financial statements for the full version as of June 30, 2006). This statement shows the financial position of the County as a whole at specific points in time – in this case as of June 30, 2006 and as of June 30, 2005. The 2005 amounts have been restated for items reported in Note IV (Q) of the Notes to Financial Statements.

Property taxes receivable is by far the largest portion of Shelby County's assets (45.7% at June 30, 2006 and 46.5% at June 30, 2005). The June 30, 2006 property taxes receivable includes \$688.4 million, offset by an equal deferred revenue amount in other liabilities, which became a property lien on January 1, 2006 but are levied for next fiscal year's operations. The similar amount at June 30, 2005 was \$641.9 million. Total assets increased \$134.2 million, attributable primarily to increases in property taxes receivable (\$50.6 million) and cash and cash equivalents (\$72.4 million).

Liabilities increased \$96.8 million during the year. This increase was due primarily to a net increase of \$184.4 million in long-term debt and \$67.2 million in deferred revenues, offset by decreases of \$131.0 million in notes payable and \$22.1 million in accounts payable and accrued liabilities.

Table 1
Condensed Statement of Net Assets

As of June 30, 2006 and June 30, 2005

	June 30, 2006	June 30, 2005	Change
Governmental Activities			
Property taxes receivable	\$ 734,035,950	\$ 683,388,277	\$ 50,647,673
Current and other assets	258,225,960	182,230,392	75,995,568
Capital assets	572,933,781	566,884,067	6,049,714
Total assets	<u>1,565,195,691</u>	<u>1,432,502,736</u>	<u>132,692,955</u>
Long-term liabilities	1,799,887,983	1,615,507,305	184,380,678
Other liabilities	788,278,259	876,309,709	(88,031,450)
Total liabilities	<u>2,588,166,242</u>	<u>2,491,817,014</u>	<u>96,349,228</u>
Invested in capital, net of related debt	156,764,887	171,608,508	(14,843,621)
Restricted	80,104,201	46,561,030	33,543,171
Unrestricted	<u>(1,259,839,639)</u>	<u>(1,277,483,816)</u>	<u>17,644,177</u>
Total net assets	<u>(1,022,970,551)</u>	<u>(1,059,314,278)</u>	<u>36,343,727</u>
Business-Type Activities			
Current and other assets	11,354,202	8,845,780	2,508,422
Capital assets	27,935,169	28,975,090	(1,039,921)
Total assets	<u>39,289,371</u>	<u>37,820,870</u>	<u>1,468,501</u>
Long-term liabilities	5,052,493	5,066,405	(13,912)
Other liabilities	1,600,569	1,126,468	474,101
Total liabilities	<u>6,653,062</u>	<u>6,192,873</u>	<u>460,189</u>
Invested in capital, net of related debt	27,213,452	28,180,902	(967,450)
Unrestricted	<u>5,422,857</u>	<u>3,447,095</u>	<u>1,975,762</u>
Total net assets	<u>32,636,309</u>	<u>31,627,997</u>	<u>1,008,312</u>
Total Primary Government			
Property taxes receivable	734,035,950	683,388,277	50,647,673
Current and other assets	269,580,162	191,076,172	78,503,990
Capital assets	600,868,950	595,859,157	5,009,793
Total assets	<u>1,604,485,062</u>	<u>1,470,323,606</u>	<u>134,161,456</u>
Long-term liabilities	1,804,940,476	1,620,573,710	184,366,766
Other liabilities	789,878,828	877,436,177	(87,557,349)
Total liabilities	<u>2,594,819,304</u>	<u>2,498,009,887</u>	<u>96,809,417</u>
Invested in capital, net of related debt	183,978,339	199,789,410	(15,811,071)
Restricted	80,104,201	46,561,030	33,543,171
Unrestricted	<u>(1,254,416,782)</u>	<u>(1,274,036,721)</u>	<u>19,619,939</u>
Total net assets	<u>\$ (990,334,242)</u>	<u>\$ (1,027,686,281)</u>	<u>\$ 37,352,039</u>

“Net assets” are the difference between assets and liabilities and, in a general sense, may be considered the recorded financial “net worth” of the County. The most obvious concern that can be noted about net assets is the large negative net asset amount. The major factor causing this negative net asset amount relates to debt issued for capital assets (buildings, roads, etc.) where

the capital asset values are *not* recorded in the County's financial records but the debt *is* on the County's records. Some of this debt has been issued to provide capital assets to component units of the County, including the Shelby County Board of Education and the Shelby County Health Care Corporation (The Med). These component units report the capital assets but not the debt. Other debt is issued for entities not a part of the County reporting entity, including the Memphis City Schools Board of Education and the Convention Center. As a result of reporting the debt liabilities without reporting the assets acquired with the proceeds of the debt, a negative net asset amount is reported in the County's statement of net assets.

The following long-term debt and notes payable are reported by the County for which related capital assets are not recorded by Shelby County:

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Shelby County and City of Memphis schools	\$ 1,052,751,140	\$ 996,948,343
Shelby County Health Care Corporation (component unit)	105,785,458	109,735,538
Convention Center (joint venture)	76,322,265	73,511,090
Other	61,711,855	64,391,999
Total	<u>\$ 1,296,570,718</u>	<u>\$ 1,244,586,970</u>

Shelby County, the component units, and other entities (such as Memphis City Schools) use these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although Shelby County's investment in its capital assets is reported net of related debt, the resources needed to repay this debt must be provided from other sources since the capital assets themselves cannot be used to liquidate these liabilities.

The County's total net assets increased by the net amount of \$37.4 million. Excluding the increase in debt for which the related capital assets are not recorded by Shelby County (schedule above) of \$52.0 million, the County's total net assets increased by \$89.4 million. Changes in net assets are discussed below.

CHANGES IN NET ASSETS – REVENUES, EXPENSES AND TRANSFERS

Table 2 summarizes the financial activity for the County as a whole for the fiscal year ending June 30, 2006, with comparative amounts for the fiscal year ending June 30, 2005.

For governmental activities, program revenues are those revenues generated by the department or program as a result of the activities engaged in by the department or program. Program revenues increased 19.4% during the year, mostly from grants and other special revenues. General revenues are those revenues not generated through the activities of the County; property taxes produce the largest amount of general revenues. General revenues increased 12.6% during the year, primarily from property tax increases. Overall revenues increased 14.2% during the year.

Table 2
Shelby County Change in Net assets
Fiscal Years Ending June 30, 2006 and 2005

	FY 2006	FY 2005	Change
Governmental activities:			
<u>Revenues:</u>			
Program revenues:			
Charges for services	\$ 96,032,811	\$ 87,079,570	\$ 8,953,241
Operating grants and contributions	138,189,459	119,186,843	19,002,616
Capital grants and contributions	12,460,564	277,257	12,183,307
Total program revenues	<u>246,682,834</u>	<u>206,543,670</u>	<u>40,139,164</u>
General revenues:			
Property taxes	654,551,938	587,164,493	67,387,445
Other taxes	95,321,849	85,517,893	9,803,956
Other	14,068,619	5,660,042	8,408,577
Total general revenues	<u>763,942,406</u>	<u>678,342,428</u>	<u>85,599,978</u>
Total revenues-governmental activities	<u>1,010,625,240</u>	<u>884,886,098</u>	<u>125,739,142</u>
<u>Expenses:</u>			
General government	32,850,485	46,228,263	(8,323,630)
Hospital	25,566,667	25,566,667	---
Planning & Development	6,558,085	6,084,407	473,678
Public Works	49,927,770	34,934,896	14,992,874
Corrections	505,384	371,598	133,786
Health Services	53,781,890	50,576,288	3,205,602
Community Services	43,060,057	41,010,999	2,049,058
Law Enforcement	130,666,941	128,391,275	2,275,666
Judicial	71,267,471	52,348,970	18,918,501
Other Elected Officials	24,573,915	31,109,337	(6,535,422)
Education	446,365,688	404,270,674	42,095,014
Interest on debt	83,880,247	75,944,617	2,881,482
Total expenses-governmental activities	<u>969,004,600</u>	<u>896,837,991</u>	<u>72,166,609</u>
Increase (decrease) in net assets before transfers	41,620,640	(11,951,893)	53,572,533
<u>Transfers</u>	<u>(5,276,913)</u>	<u>(7,146,688)</u>	<u>1,869,775</u>
Increase (decrease) in net assets	36,343,727	(19,098,581)	55,442,308
Net assets - beginning of year	<u>(1,059,314,278)</u>	<u>(1,040,215,697)</u>	<u>(19,098,581)</u>
Net assets - end of year	<u>\$ (1,022,970,551)</u>	<u>\$ (1,059,314,278)</u>	<u>\$ 36,343,727</u>

Total expenses for the year in governmental activities increased \$72.2 million (8.0%). The major cause of the expense increase was increased amounts paid to the two school systems because of tax increases and capital outlay amounts. Depreciation expense also increased due to the retroactive capitalization of infrastructure assets. The increase in judicial includes the reclassification of \$14.7 million from general government (\$8.0 million) and other elected officials (\$6.7 million).

Business-type activities:	FY 2006	FY 2005	Change
<u>Revenues:</u>			
Operating revenues:			
Charges for services	\$ 62,525,770	\$ 56,282,351	\$ 6,243,419
Operating grants and contributions	43,050	56,960	(13,910)
Total operating revenues	62,568,820	56,339,311	6,229,509
Non-operating revenues	374,704	283,040	91,664
Total revenues	62,943,524	56,622,351	6,321,173
<u>Expenses:</u>			
Operating expenses	66,486,101	66,540,589	(54,488)
Non-operating expenses and losses	726,024		726,024
Total expenses	67,212,125	66,540,589	671,536
Increase (decrease) in net assets before transfers	(4,268,601)	(9,918,238)	5,649,637
<u>Transfers</u>	5,276,913	7,146,688	(1,869,775)
Increase (decrease) in net assets	1,008,312	(2,771,550)	3,779,862
Net assets - beginning of year	31,627,997	34,399,547	(2,771,550)
Net assets - end of year	32,636,309	31,627,997	1,008,312
Total primary government:			
Increase (decrease) in net assets	37,352,039	(21,870,131)	59,222,170
Net assets - beginning of year	(1,027,686,281)	(1,005,816,150)	(21,870,131)
Net assets - end of year	\$ (990,334,242)	\$ 1,027,686,281	\$ 37,352,039

In business-type activities, total revenues increased by \$6.3 million. Most of this increase was in the Corrections Center (\$5.2 million). Fire services had an increase of \$1.2 million and Consolidated Codes had a small (\$.1 million) decrease. As a result of increased Corrections Center revenue, net transfers in decreased by \$1.9 million. Expenses increased by \$.7 million.

CHANGE IN FINANCIAL POSITION DURING YEAR

The overall change in the financial position of Shelby County during fiscal year 2006 was an increase in net assets of approximately \$37.4 million.

The County's governmental activities operated with an increase in net assets of approximately \$36.3 million. Net assets restricted for debt service increased by \$26.7 million and net assets of special revenue funds increased by \$6.8 million. Unrestricted net assets increased by \$17.6 million, offset by a \$14.8 million decrease in invested in capital assets net of related debt; this net increase of \$2.8 million resulted from revenue in excess of budget (mostly property taxes) and expenses below budgeted amounts, offset by debt issued for component units and others where the County retains liability for the debt but does not hold the related capital assets. This situation is discussed more at length above.

The business-type activities had a net increase of \$1.0 million. This resulted from increases in fire services and the corrections center, offset by a planned reduction in net assets of Consolidated Codes Enforcement.

Financial Analysis of the Government's Funds

As noted earlier, Shelby County uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds. The focus of Shelby County's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable resources*. Such information is useful in assessing Shelby 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.

As of the end of the current fiscal year, Shelby County's governmental funds reported a combined ending fund balance of \$153,821,000. The components of the balances are:

	June 30, 2006	June 30, 2005
General Fund-reserved/designated	\$ 4,150,637	\$ 4,158,337
General Fund-unreserved	41,147,243	37,539,543
Debt Service Fund	55,924,980	29,241,588
Special revenue funds	24,179,221	17,374,768
Total, except Capital Projects Fund	125,402,081	88,314,236
Capital Projects Fund	28,418,919	(136,651,444)
Total all governmental funds	<u>\$ 153,821,000</u>	<u>\$ (48,337,208)</u>

There was a \$37.1 million increase in fund balance excluding capital projects. Of this increase \$3.6 million was in the unreserved balance in general funds, \$26.7 million was in the debt service fund and \$6.8 million increase was in the special revenue funds. There was also an increase of \$165.1 million in the capital projects fund. Each of these changes is discussed below.

The general fund operated with net revenue of \$3.6 million, resulting primarily from expenditures and transfers out being under budget. The general fund unreserved amount is available for spending at the government's discretion. The remainder of fund balance has been committed to liquidate contracts and purchase orders of the prior period and for advances to the Fire Services Fund.

The general fund is the chief operating fund of Shelby County. 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 13.3 percent of total general fund expenditures, while total fund balance represents 14.7 percent of that same amount. General fund revenues were \$21.3 million (6.9%) above the prior year, which resulted primarily from increased local taxes and elected officials' fines and fees. Expenditures were \$7.9 million more (2.6%) than the prior year and net transfers out were \$16.0 million more. The increased transfers out were primarily due to transfers of \$1.5 million to create an economic development fund and \$13.9 million to create a pay-as-you-go capital projects fund. Before the beginning of FY 2006 management committed to maintaining an unreserved fund balance of the general fund of at least 12.5% of general fund expenditures.

The debt service fund has a total fund balance of \$55,924,980 to be used for the payment of debt service. The net increase in fund balance during the current year was \$26,683,392. This increase resulted from the planned increase of \$8.6 million, revenue and net transfers in exceeding budget by \$13.6 million and expenditures being \$4.5 million less than budget. The increase in this fund balance is planned to somewhat smooth out the revenue requirements in future years as debt service requirements reach a peak projected amount in 2012.

The fund balance of the capital projects fund improved from a deficit of \$136,651,444 to a positive balance of \$28,418,919. This was primarily the result of issuing long-term debt for capital improvement projects of \$251.0 million (face amount plus premium) and paying off \$131.0 million of short-term notes payable. At the conclusion of each short-term borrowing program (generally two years), the short-term debt is refinanced with long-term general obligation debt. Short-term debt is recorded as a liability of the capital projects fund and, to the extent such borrowings have been spent, a fund deficit is created. The deficit is cleared when long-term debt is issued. Short-term debt outstanding at June 30, 2006 was \$10.0 million compared to \$141.0 million at June 30, 2005.

All special revenue balances are available only for the specific purposes designated by the provider of the funds or the legislation establishing the fees and charges that generate the revenue. Total fund balances of these funds increased to \$24.2 million at June 30, 2006 compared to \$17.4 million at June 30, 2005.

Proprietary funds. Shelby County's proprietary funds report financial information on the same basis as the government-wide financial statements (full accrual accounting based on the economic substance of transactions), but in more detail. Proprietary funds consist of two types of funds: business-type activities - enterprise funds and governmental activities - internal service funds.

The County has three business-type activities; these are essentially self-supporting activities. Two of the activities have consistently been able to support themselves; these are the Consolidated Codes Enforcement Fund and the Fire Services Fund. However, starting in last fiscal year a management decision was made to spend down the net asset balance in the Consolidated Codes Enforcement Fund. During this fiscal year the net asset balance decreased by \$2.6 million to a balance of \$7.4 million. The fire services fund operates entirely on user fees; the net asset balance increased during this fiscal year by \$2.1 million and the balance improved from a deficit of \$.3 million to a positive balance of \$1.8 million. The Corrections Center receives reimbursement from the State of Tennessee for housing State prisoners, which increase from about 75% of the prison population in FY 2005 to about 80% in FY 2006. The general fund provides the remaining cost, excluding depreciation. Unrestricted net assets of the enterprise funds at the end of the year amounted to \$5,422,857, an increase of 57.3%.

Total net assets of the enterprise funds increased \$1,008,312, or about 3.2%, during the year. This increase resulted from increases in fire services and corrections center revenue, offset by the planned use of fund balance in the Consolidated Codes Enforcement Fund.

The County has five internal service funds. These funds are reported using full accrual accounting. *For the government-wide financial statements, these funds are combined with governmental activities.* At June 30, 2006 these funds combined had net assets of \$20,597,343, an improvement of \$12,736,280 over the balance of \$7,861,063 from the prior year. The employer insurance fund had a deficit at June 30, 2005 of \$3,114,027; this was reduced to a deficit of \$959,015 at June 30, 2006. This deficit is the result of claims that will be paid over a period of years being recorded when the claim occurs. The County's policy is to provide funding for long term claims on a claims paid basis. All the other funds have positive net assets.

Fiduciary funds. Shelby County reports two fiduciary funds. The largest is the Shelby County Retirement System. The funds in this trust are available only for retirement benefits of current and retired County employees. The accumulated funds in the retirement system are equal to the currently calculated actuarial liability, meaning the system is properly funded. The County provides funding as required each year for the increased liability for benefits being earned by current employees.

The County also maintains agency funds for a number of the County's elected "constitutional officers" (those officials designated by the State's constitution). These funds do not belong to the County, but are funds held for others. There are no "fund balances" for agency funds.

Governmental Fund Budgetary Highlights

Differences between the original budget and the final amended budget for the general fund can be briefly summarized as follows:

- The revenue budget was increased during the year by \$15.8 million, or 5.0% from the original budget. Property taxes exceeded estimates about \$7.4 million, elected officials fines and fees increased by \$3.7 million and investment income increased by \$3.8 million.
- Budgeted net transfers out were increased by \$17.9 million, mostly to permit the transfers to the economic development fund and the pay-as-you-go capital projects fund as discussed above.
- Overall the expenditure budget decreased during the year by \$2.2 million, or about seven-tenths of one percent. There were changes among several programs as budgets were adjusted to permit the increase in transfers out as noted above; this included adjustments for anticipated expenditures below budgeted amounts and to shift anticipated salary lapse and restriction budgets to the programs where they were realized.
- Actual expenditures were \$3.4 million below the amended budget, or 1.1%.
- Actual expenditures for judicial were \$1.6 million below the amended budget, or 3.0%.

Capital Asset and Debt Administration

Capital Assets. Shelby County Government's investment in capital assets for its governmental and business type activities as of June 30, 2006 amounts to \$600,868,950 (net of accumulated

depreciation). This investment in capital assets includes land, buildings and system improvements, machinery and equipment, park facilities and roads. Retroactive reporting of infrastructure, primarily roads, acquired prior to July 1, 2001 was completed in the County's fiscal year ending June 30, 2006, as required by GASB Statement No. 34 and as explained more fully in Note IV (Q).

Additional information on Shelby County Government's capital assets can be found in note IV (E) of the Notes to Financial Statements of this report.

Major capital asset events during the current fiscal year included the following:

- Roadway improvements, drainage improvements, and sanitary sewer upgrades continued within the County with an estimated cost of \$6.1 million.
- Renovation work continued at the Criminal Justice Complex, with projects including centralization of the floor pod control, jail door retrofit, and jail control center.

Construction in progress as of the end of the current fiscal year was \$26,532,542.

Long-term Debt. At June 30, 2006 Shelby County's general obligation bonded debt (bonds payable) outstanding totaled \$1,753,166,331 which represented approximately 10.18% of assessed value. The County's bonds and notes payable increased by approximately \$53 million (3.1%) during the year. Debt, generally, may be issued without regard to any limit on indebtedness. The ad valorem tax levy is also without legal limit.

The County uses notes payable programs to initially finance capital projects. This allows the County to borrow only as the proceeds are actually needed and to take advantage of lower short-term interest rates. Annually, the County adopts a five-year capital projects plan. Based on this plan for the current year and capital projects cash flow projections, a notes payable program is established with a maximum borrowing amount. Borrowing occurs as needed for up to two years. After completion of each program, the notes payable are converted to bonds payable to be repaid within 25 years. On March 28, 2005 the County authorized the issuance of \$275 million of extendible municipal commercial paper ("EMCP"). In February 2006 the County refunded and ultimately retired \$135 million of \$145 million of issued EMCP, leaving \$10 million outstanding at June 30, 2006.

An agreement was signed in 2005 with the Shelby County and City of Memphis Schools boards of education to provide \$100 million to be divided equally between the two school systems to provide a new high school for the County schools and to provide funding for renovations for the City of Memphis schools. In addition, this agreement provides for capital funding to the schools of \$60 million per year for fiscal years 2007, 2008 and 2009, to be divided based on average daily attendance.

The County maintains ratings from Moody's Investors Service ("Moody's"), Standard & Poor's Corporation ("Standard & Poor's") and Fitch IBCA, Inc. ("Fitch") on its previously issued general obligation bonds not secured by letter of credit as follows:

Moody's
Aa2

Standard & Poor's
AA+

Fitch IBCA, Inc.
AA

Moody's issues ratings from Aaa to C to designate the relative investment qualities of bonds. The Aa rating is in the second highest of the rating categories. The modifier 2 indicates that the Bonds are in the middle range of the Aa category. Moody's describes its Aa ratings as "Bonds which are rated Aa are judged to be a high quality by all standards. They are rated lower than the best bond because margins of protection may not be as large as in Aaa or fluctuation of protection elements may be of greater amplitude or there may be other elements present which make the long term risk appear somewhat larger than Aaa securities."

Standard & Poor's and Fitch issue ratings from AAA to D to designate the relative investment qualities of bonds. The AA rating is the second highest of the ten such ratings. Standard & Poor's and Fitch describe their rating as "Debt rate AA+ has a very strong capacity to pay interest and repay principal and differs from the highest rated issues only in small degree. Plus or minus signs are used to show relative standing within the major rating categories."

Additional information on Shelby County Government's long-term debt can be found in note IV(H) of the Notes to Financial Statements of this report.

Economic Factors and Next Year's Budgets and Rates

- The July 2006 unemployment rate for Shelby County was 6.9 percent, compared to the state's rate of 6.0 percent.
- Inflationary trends in the region compare favorably to national indices.

For 2007 the property tax rate was maintained at the same amount as 2006. As a result of growth, current property taxes are budgeted to increase 3.0% or \$18.4 million in 2007 over the 2006 budget. Education was provided an increase of \$9.1 million (3.0%) and debt service was provided an increase of \$3.8 million (3.1%) to meet debt service growth as discussed below. The general fund was allocated an increase of \$5.5 million or 3.0%.

For fiscal 2007 general fund revenue growth is budgeted to be 4.4% over the 2006 budget. Actual revenue for 2006 exceeded the amount budgeted so that no growth in actual revenue will be necessary to reach the budget. General fund expenditures were also budgeted to increase by 4.4% compared to 2006. The County Mayor and Commission are committed to holding general fund expenditures in line with general fund revenue growth. With a substantial portion of the County incorporated and annexations decreasing the unincorporated area, County government is shifting responsibilities to the cities and focusing on our primary mission of education, criminal justice and health. A consulting firm was engaged in 2004 to perform an efficiency study and assist us in preparing a five year strategic plan which was completed in October 2004. Substantial efficiencies have been identified and implemented. In 2007, we are updating the efficiency study and five year strategic plan.

Because of the school capital needs and converting notes payable to long term-debt to take advantage of low interest rates, debt service expenditures are increasing \$6 million in 2007. Property reappraisal as of January 1, 2005 allowed us to transfer 10 cents of the property tax rate in 2006 to the debt service fund to provide for debt service projected increases through fiscal 2009.

Debt service requirements will continue to increase for the next several years because of the school funding commitment previously noted and the current debt structure. However, various steps are being taken to move towards ending the growth of debt and the debt service requirements. Capital outlays have been reduced from \$154 million in 2002 to \$106 million in 2006. The five-year capital improvement plan was updated with reductions in new debt requirements except for the additional \$100 million commitment for schools noted above to be split equally between 2006 and 2007. Starting in 2008, the capital improvement plan provides for expenditures of less than \$75 million per year.

Requests for Information

This financial report is designed to provide a general overview of Shelby County's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Administrator, Department of Finance, Shelby County Government, 160 North Main Street, Memphis, Tennessee 38103.