



A C Wharton, Jr.
Mayor

Shelby County Government

December 1, 2005

To the Members of the Board of County Commissioners and the Citizens of Shelby County, Tennessee:

The comprehensive annual financial report of Shelby County, Tennessee (hereafter, Shelby County) for the year ended June 30, 2005 is hereby submitted as required by both local ordinances and state statutes. These require that Shelby County publish each fiscal year a complete set of financial statements as required by Generally Accepted Accounting Principles (GAAP) and audited by a firm of licensed certified public accountants.

Management assumes full responsibility for the completeness and reliability of all of the information presented in this report based upon a comprehensive framework of internal control that has been established for this purpose. Because the cost of internal controls should not exceed anticipated benefits, the objective is to provide reasonable rather than absolute assurance that the financial statements are free from any material misstatement.

Thompson Dunavant PLC, certified public accountants have issued an unqualified opinion on Shelby County's financial statements for the fiscal year ended June 30, 2005. The independent auditors' report is presented as the first component of the financial section of this report.

Management's Discussion and Analysis (MD&A) immediately follows the independent auditor's report and provides an analysis of the basic financial statements. MD&A complements this letter of transmittal and should be read in conjunction with it.

Profile of Shelby County, Tennessee

Shelby County, established in 1819, is the largest county in the State of Tennessee with Memphis as the County seat. The County is located in the extreme southwest corner of Tennessee on the east bank of the Mississippi River and is the hub of the 105 county Mid-South Region. Contained within the County's 783 square miles are seven incorporated municipalities, including Arlington, Bartlett, Collierville, Germantown, Lakeland, Memphis and Millington. The population of the County is 903,186. The County is empowered to levy, without limit, a property tax on both real and personal property located within its boundaries.

Since the implementation of the Restructure Act on January 1, 1976, the County has operated under the Mayor-Commission form of government. The Mayor, as the County's chief executive officer, oversees the operations of the County's six divisions. The thirteen members of the Shelby County Board of Commissioners (the Commission), the legislative branch of the government, review and approve the County's programs and budgets. The Mayor and each

Commissioner serves a four year term. The Sheriff, who oversees law enforcement, County Clerk, Assessor, Register, Trustee, Circuit Court Clerk, Criminal Court Clerk, General Sessions Court Clerk, Juvenile Court Clerk and Probate Court Clerk are also elected to four year terms.

Shelby County provides a full range of services, including law enforcement, judicial system, jail and corrections facilities, health services, community services, fire protection and recreational activities. Shelby County also is financially accountable for a legally separate school district, public hospital, agricultural center and emergency communications district, which are reported separately within the Shelby County financial statements. Additional information on these entities can be found in Note I. A. in the notes to the financial statements.

The annual budget serves as the foundation for Shelby County's financial planning and control. All departments and elected officials submit their requested budget to the County Mayor by early March. After a series of reviews, the County Mayor presents a proposed consolidated budget to the County Commission by April 30. The County Commission holds budget hearings and then adopts a final budget. This process is generally completed by July 1, the start of the fiscal year. However, the County Commission has the authority to adopt a continuing budget until a final budget can be adopted. The appropriated budget is prepared by fund, division (function such as public works), and department (e.g., parks). The Mayor may make transfers of appropriations within personnel or non-personnel categories within a department or between departments within a division. Any other transfers require approval of the County Commission.

Local economy

Shelby County experienced some growth in the local economy this past year as did most of the country. In recent years, the economy of the County has experienced notable success attracting new businesses along with the continued growth of existing businesses. The result has been relatively steady total employment in the County during periods of sluggish growth or decline in the national economy with substantial increases when the national economy improved. This success is due, in large part, to the County's location near the geographic center of the nation and its excellent transportation facilities. Also, the County benefits from serving as the trade center for the surrounding area.

The County is the major wholesale and retail center for western Tennessee, eastern Arkansas and northern Mississippi. The Memphis MSA is considered one of the top 100 suburban markets and ranks forty-third in total effective buying income according to Sales & Marketing management's September 2004 publication. The industrial economy of the County encompasses not one, but many industries. Twenty major industrial groups, as classified by the Bureau of the Budget, are listed in the Directory of Memphis Manufacturers. Major industries include chemicals, electronics, foods and beverages, paper products, hardwood lumber products, pharmaceuticals, soybean and cotton oil derivatives and fertilizers.

The major areas of employment in Shelby County are the services, government, and wholesale and retail trade. Comparatively, both the Southeast Region and the United States overall show a heavier concentration in manufacturing than does the County, but they also display lower employment in transportation and public utilities. According to the Tennessee Department of Labor, the unemployment rate for Shelby County as of September 30, 2005 was 5.7%, as compared to the state's rate of 4.9% and the national rate of 4.8%.

Long-term financial planning

During the past ten years, excluding capital projects, the County's governmental expenditures related to education, law enforcement and debt service have increased as a percent of total expenditures from 54.3% to 67.8%. Education expenditures increased by 8.3% to 37.6% in 2005.

During this same ten-year period, local taxes have increased as a percent of total revenue from 66.2% to 74.9% because the areas of relative increase in expenditures are primarily supported by local taxes. Elected officials fees and fines have only increased by 2.1% and, as a percent of total revenue have decreased from 11.7% to 6.4%. State revenue has also decreased as a percent of total revenue from 11.7% to 7.8%.

In 2003 the Mayor, with the support of the Commission, made it a priority to replenish the General Fund and to avoid unplanned withdrawals from that fund. A goal was established to increase the General Fund unreserved fund balance to approximately 10% of General Fund expenditures over 2 years. This goal was substantially accomplished in one year and exceeded in the second year. The General Fund unreserved fund balance at June 30, 2005 is 12.5% of General Fund expenditures. The County intends to maintain this ratio between 10% and 15%.

In 2004 the Administration, with the support of the Commission engaged Public Financial Management, Inc., a financial advisory firm, to conduct a study to determine whether Shelby County Government is operating efficiently and effectively. The result of this study was the issuance of a five-year strategic financial and management plan. The study found that Shelby County Government is relatively efficient compared to similar governments, but it also pointed to a number of areas where we can improve. All of the recommendations have been addressed, many have been adopted and we are currently working toward implementing additional recommendations.

Closer cooperation has been established between the Administration and the Commission including an open, thorough and timely budgeting process, which focuses on a clear understanding of debt funding, in addition to funding for operations. We have aggressively reduced our capital plan from over \$150 million in 2003 to under \$80 million annually starting in 2008 to stop the growth of debt. However, the City and County School Systems have identified needs well beyond the amounts provided in our capital plan. Through growth management and needs assessment as addressed below, school needs will be more clearly identified and alternative funding sources may be established. Should any increase to the capital plan be necessary, funding must also be provided.

Major initiatives

The Administration has identified a number of priorities designed to shore up the long-term financial position of the County as addressed above in long-term financial planning. We have established the following initiatives that focus on structural changes in areas that are costly to County Government.

- 1. Growth Management** – Shelby County has instituted a Smart Growth plan designed to manage development, particularly in the unincorporated areas. This plan is designed to insure that incentives are created that will encourage inner city redevelopment where infrastructure already is in place. Additionally, the Shelby County Mayor is seeking passage of legislation to ensure that new development pays for itself and is sustainable. These steps are necessary to relieve the increasing dependence on property taxes.

2. **Healthcare Funding** – Shelby County continues to pursue more equitable funding from the State of Tennessee for the Regional Medical Center at Memphis. The State has recently provided some increase in its funding level and we are continuing to pursue additional funding. Additionally, both Mississippi and Arkansas have begun to provide some funding for the services rendered to their residents by the MED. Presently, Shelby County Government contributes approximately \$25 million annually to The Med and pays another \$11 million in debt service for The Med. The funding to The Med is not only for the hospital itself, but for a network of community healthcare centers.
3. **Education Capital Needs** – The County established a Needs Assessment Committee to address the financial burden of the current capital funding mechanism for public schools, including both Memphis City Schools and Shelby County Schools. The Committee will: 1) Develop uniform standards and costs for school construction; 2) Annually assess capital needs of each school system and create a comprehensive plan for capital projects and funding; 3) Review, as necessary, capital requests of both school systems that fall outside of the comprehensive plan and make recommendations to the County Commission regarding those requests.
4. **Economic Development** – One of the County’s primary attractions for economic development is the combination of its central location in the United States and its excellent transportation facilities, including air, rail and water. Another attractive feature for certain companies is the relatively low cost of living compared with other urban areas, including real estate prices. In conjunction with the City of Memphis, a new “Mayor’s Office of Economic Development” is being formed to increase the emphasis placed on economic growth. This office will work with and coordinate the activities of many regional development groups, in addition to the local Industrial Development Board, Office of Planning and Development, Center City Commission and others.
5. **Real Estate Asset Management** - An effort is underway to incorporate best practices with regard to the management, utilization and disposal of our real estate assets. We have engaged Cushman & Wakefield, who in cooperation with Commercial Advisors, are evaluating procedures and processes regarding our real estate holdings in order to develop a revised business plan for utilization and disposal of these assets. A uniform decision approach will be adopted to evaluate the current inventory of real estate assets held by the county on broad based utilization criteria. These assets can then be assigned on a priority basis to program areas or disposed of at the completion of thorough analysis to determine highest and best use.

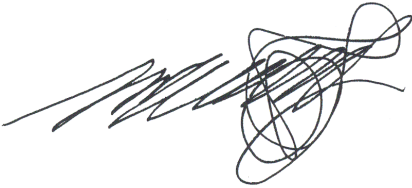
Awards and Acknowledgements

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to Shelby County, Tennessee for its comprehensive annual financial report (CAFR) for the year ended June 30, 2004. This was the twentieth consecutive year that Shelby County has received this prestigious award. In order to be awarded the Certificate of Achievement, a government had to publish an easily readable and efficiently organized CAFR that satisfied both generally accepted accounting principles and applicable legal requirements.

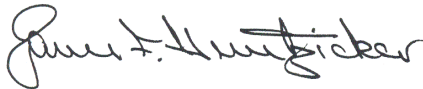
A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement program requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

The preparation of this report could not have been accomplished without the efficient and dedicated services of the entire staff of the Finance Department. We would like to express our appreciation to all members of the departments who assisted and contributed to the preparation of this report. Due credit also is given to all County Commissioners for their interest and support in planning and conducting the operations of Shelby County in a responsible and progressive manner.

Sincerely,

A handwritten signature in black ink, appearing to read "A C Wharton, Jr.", with a stylized, scribbled end.

A C Wharton, Jr.
Mayor

A handwritten signature in black ink, appearing to read "James F. Huntzicker", written in a cursive style.

James F. Huntzicker, Director
Division of Administration and Finance