

December 11, 2003

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, 2003 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.

This report consists of management's representations regarding the finances of Shelby County. Consequently, management assumes full responsibility for the completeness and reliability of all of the information presented in this report. To provide a reasonable basis for making these representations, management of Shelby County has established a comprehensive internal control framework that is designed both to protect the government's assets from loss, theft, or misuse and to compile sufficient reliable information for the presentation of Shelby County's financial statements in conformity with GAAP. Because the cost of internal controls should not outweigh their benefits, Shelby County's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

The Shelby County financial statements have been audited by Thompson Dunavant PLC, a firm of licensed certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of Shelby County are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial presentation. The independent auditors concluded, based upon the audit, that there was reasonable basis for rendering an unqualified opinion that Shelby County's financial statements for the fiscal year ended June 30, 2003, are fairly presented in conformity with GAAP. The independent auditors' report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of Shelby County was a part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are available in Shelby County's separately issued Single Audit Report.

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

### **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, which include 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 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. Budget-to-actual comparisons are provided in this report for each individual governmental fund. For the general fund, education fund and grants fund, this comparison is presented in the required supplementary information section.

### **Factors Affecting Financial Condition**

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which Shelby County operates.

**Local economy.** Shelby County experienced a decline in the local economy this past year as did most of the country. However, 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 declines 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 industrial economy of Shelby County and the City of Memphis encompasses many industries. Twenty major industrial groups and over 425 sub-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. Approximately 6,000 manufacturing, wholesaling, and retailing firms are located in Memphis, Shelby County, and the surrounding area.

The major areas of employment in Shelby County are the services, governmental services and retail trade industries. Comparatively, both the Southeast Region and the United States 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 June 30, 2003 was 5.8%, as compared to the state's rate of 5.0% and the national rate of 6.1%.

**Economic Development.** The County and the City of Memphis have combined their development efforts into one unit under the Memphis-Shelby County Division of Planning and Development. In addition, two industrial development corporations have been established and staffed by the Center City Commission, which was formed in 1977. The first corporation, Center City Revenue Finance Corporation, promotes comprehensive redevelopment of the central business district. The second, the Center City Development Corporation, promotes industrial development throughout the County. Both are empowered under state law to issue tax-exempt industrial revenue bonds and the Center City Revenue Finance Corporation also issues tax freezes for certain projects.

Other economic development efforts are led in the County by the Memphis Regional Chamber, a private organization that receives financial support from its members. The Tennessee Department of Economic and Community Development is active in working to attract industrial and business prospects to the area as a part of its state-wide recruiting efforts. Also, several local governments have combined their efforts to form the Millington Base Reuse Committee to find alternative industrial and economic uses for certain facilities vacated by the Navy Memphis Complex.

One of the County's primary attractions for economic development is its central location in the United States combined with excellent transportation facilities, including air, rail, roads and water. Another attractive feature is the relatively low cost of living compared with other urban areas, including real estate prices.

**Education Funding.** Approximately 54% of Shelby County property taxes are allocated to operating expenses of schools. An additional 7% pays the debt service on bonds issued for schools. In 2003, Shelby County provided \$76.1 million for construction and renovation of schools under the \$655 million multi-year school funding agreement, that ends in 2006. There are

two school systems in Shelby County – the Shelby County Board of Education and the Board of Education of the Memphis City Schools. As of June 30, 2003, Shelby County has outstanding general obligation debt issued for schools of \$689,737,629, which is recorded as a liability in the Statement of Net Assets in the basic financial statements section. The assets constructed with these bonds are recorded in the two school systems' financial statements and not in the Primary Government column in the Statement of Net Assets.

**Debt Administration.** At June 30, 2003, Shelby County's net bonded debt outstanding totaled \$1,317,097,361 (this excludes accretion on zero coupon bonds and \$220.3 million issued in extendible municipal commercial paper) which represented approximately 8.73% of assessed value and approximately \$1,458.26 per capita. Debt, generally, may be issued without regard to any limit on indebtedness and the ad valorem tax levy is also without legal limit. Additional debt information is available in the statistical section of this report.

**Cash Management Policies and Practices.** The County's cash and investment management practices focus on matching seasonal revenue with relatively constant expenditures. The major challenge results from the need to maintain adequate liquidity while preserving the purchasing power of the County funds. Accordingly, the County's investment policies emphasize securities with a high degree of both safety and marketability. State law limits the investment of idle cash to U.S. treasury obligations, U.S. agency obligations, certificates of deposit, obligations of the State of Tennessee and various political subdivision thereof, repurchase agreements, commercial paper and a State of Tennessee sponsored local government investment pool.

**Risk Management.** During fiscal year 2003, Shelby County continued its strong risk management program. This includes third-party coverage of some exposures such as buildings and a self-insured plan for others such as liability and on-the-job injury claims. Tort liability is self insured with a statutory limit of \$400,000 per accident, as prescribed by state statute. Other liability exposures, such as employment practices and law enforcement liability, are also self-insured, but are not subject to statutory limits. On-the-job injuries are self insured with unlimited medical expenses and a statutory limit of \$216,400 on death and permanent disability claims. As part of its comprehensive plan, Shelby County maintains a strong loss control program that includes periodic inspections of all County buildings, work sites and vehicles and various types of employee training, including accident prevention and implementation of numerous risk-control techniques.

**Pension and Other Post Employment Benefits.** Shelby County sponsors a defined benefit pension plan for its employees. Each year, an independent actuary engaged by the pension plan calculates the amount of the annual contribution that Shelby County must make to the pension plan to ensure that the plan will be able to fully meet its obligations. As a matter of policy, Shelby County fully funds each year's annual required contribution to the pension plan as determined by the actuary. The plan has an actuarial surplus of \$24 million or 103% of the actuarial value of assets at June 30, 2003.

Shelby County also provides post retirement health and life insurance benefits for certain retirees and their dependents. As of June 30, 2003, there were 1,840 retired employees receiving these benefits which are financed on a pay-as-you-go basis. GAAP does not require governments to report a liability in the financial statements in connection with an employer's obligation to provide these benefits.

#### **Administration Priorities**

The Administration has identified a number of priorities designed to shore up the long-term financial position of the County. These focus on structural changes in areas that are costly to County Government. They include:

1. **Better Debt Management** – Closer cooperation between the Administration and the Shelby County Commission – the county’s legislative body - including an open, thorough and timely budgeting process, which focuses on a clear understanding of capital funding as opposed to operations funding.
2. **Growth Management** – The Shelby County Mayor has instituted a Smart Growth plan designed to manage growth. This plan is designed to insure that incentives are created that will encourage development in the core city 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 because the Mayor believes that Shelby County is too reliant on the property tax for its operating revenues.
3. **Healthcare Funding** – The Shelby County Mayor is aggressively pursuing more equitable funding from the State of Tennessee for the Regional Medical Center at Memphis. Presently, Shelby County Government contributes approximately \$28 million annually to The Med in operating funds and pays another \$11 million in debt service for The Med. The funding to The Med is not only for The Med itself, but for a network of community healthcare centers. It is the Administration’s belief that Shelby County is not receiving its fair share of funding that comes to the State of Tennessee from the federal government.
4. **General Fund Balance** – The Mayor has made it a priority to replenish the General Fund and to avoid unplanned withdrawals from that fund. This is a priority of the coming budget year and will remain a priority until the General Fund reaches an acceptable level, approximately 10% of the General Fund expenditures.
5. **Pension Funding** – The County faces an increase in the contribution to its pension fund of approximately \$8.6 million in fiscal year 2004-2005. Because the Mayor is of the opinion that we may not be funding our pension plan as prudently as we should, we are conducting a review to see if the pension fund may be over-funded. It is presently funded at 103 percent, well above the acceptable minimal limits.
6. **Zero-based Budget** – The Shelby County Mayor is requiring all departments and divisions under his control to budget according to zero-based budgeting principles. This process is well underway and is far ahead of previous budget cycles.
7. **Needs Assessment Committee** – The Administration established a Needs Assessment Committee to address the financial burden that the current capital funding mechanism for schools created for county government. 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.

8. **Rural School Bonds** – The administration supported the first rural school bond issue in Shelby County’s history in an effort to stop the rapid increase in debt caused by the “ADA” system of funding the capital needs of our two school systems. The new method of funding allowed for construction of the Arlington High School and the expansion of Houston High School, while reducing the amount of debt by \$97 million that would have been required under “ADA” plan.
  
9. **Efficiency Study** – The Administration has selected Public Financial Management, Inc., a financial advisory firm, to conduct an Efficiency Study to determine whether Shelby County Government is operating efficiently and effectively. The PFM team consists of three other local firms that will bring additional expertise in the areas of debt management, human resources and process improvement/strategic planning. Under scrutiny will be all services provided by county government, why those services are provided, and whether an alternative way to provide them would be more efficient. There also will be a comparison of the county’s revenue stream with its service and debt requirements.

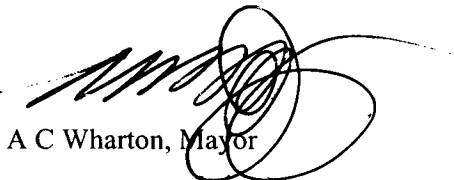
#### **Awards and Acknowledgements**

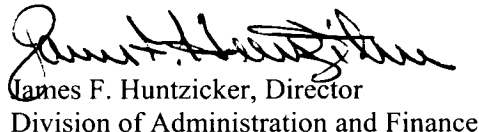
The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to Shelby County, Tennessee for its comprehensive annual financial report (CAFR) for the year ended June 30, 2002. This was the eighteenth consecutive year that Shelby County has received this prestigious award. In order to be awarded the Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, with contents conforming to program standards. Such CAFR must satisfy 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 the County Commission for their interest and support in planning and conducting the operation of the government in a responsible and progressive manner.

Sincerely,

  
A C Wharton, Mayor

  
James F. Huntzicker, Director  
Division of Administration and Finance