

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, 2003. 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.

In the United States, financial reporting standards for governmental entities are established by the Governmental Accounting Standards Board (GASB). This is the second 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

- Total liabilities of Shelby County exceed total assets as of June 30, 2003 by \$1,292,454,285. 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.
- The decrease in net assets of \$95,289,598 results from the issuance of debt for school construction (\$76.1 million) and for capital assets of others, and from an operating deficit in both the general fund and the debt service fund.
- At the end of the current fiscal year, unreserved undesignated fund balance for the general fund was \$18,225,510, or 5.6 percent of total general fund expenditures.
- Fund balance for the debt service fund decreased \$9.1 million to \$10,702,422, which is 9.6% of total expenditures of the debt service fund.

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 Supplementary 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 include codes enforcement, nursing homes, 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, 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 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. 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 eleven 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 six governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the non-major 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 its Oakville Health Care Center, 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 long-term debt and capital assets, whereas the fund balance sheet includes neither. The government-wide statement of activities includes long-term debt incurred during the year and depreciation expense but not amounts expended for capital assets during the year; the fund statement of revenues, expenditures, and changes in fund balances includes amounts expended during the year to pay long-term debt but not long-term debt incurred and 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. The only such information Shelby County is required to present are budgetary comparison schedules for the general fund and other "major" special revenue funds (the education fund and the grants fund). A budgetary comparison schedule for each of these funds has been provided 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."

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 very condensed version of the Statement of Net Assets (see the government-wide financial statements for the full version as of June 30, 2003). This statement shows the financial position of the County as a whole at specific points in time – in this case as of June 30, 2003 and as of June 30, 2002.

Property taxes receivable is by far the largest portion of Shelby County's assets (61% at June 30, 2003 and 58% at June 30, 2002). The June 30, 2003 property taxes receivable includes \$556 million, offset by an equal deferred revenue amount in other liabilities, that became a property lien on January 1, 2003 but are levied for next fiscal year's operations. The similar amount at June 30, 2002 was \$520 million. The increase in property taxes receivable is proportional to the 6.6% increase in the tax rate for next year. Overall assets in governmental activities increased \$26 million, attributable to the increase in property taxes receivable.

Liabilities increased \$118 million during the year. This increase was due primarily to a net increase of \$109 million in long-term liabilities, most of which is an increase in bonds payable.

Table 1
Condensed Statement of Net Assets
As of June 30, 2003 and 2002

	June 30, 2003	June 30, 2002	Change
<u>Governmental Activities</u>			
Property taxes receivable	\$ 599,817,632	\$ 559,732,746	\$ 40,084,886
Current and other assets	151,525,256	188,933,068	(37,407,812)
Capital assets	191,225,684	167,687,444	23,538,240
Total assets	942,568,572	916,353,258	26,215,314
Long-term liabilities	1,398,976,333	1,289,636,210	109,340,123
Other liabilities	875,134,088	864,033,765	11,100,323
Total liabilities	2,274,110,421	2,153,669,975	120,440,446
Restricted	33,428,619	42,849,339	(9,420,720)
Unrestricted	(1,364,970,468)	(1,280,166,056)	(84,804,412)
Total net assets	(1,331,541,849)	(1,237,316,717)	(94,225,132)
<u>Business-Type Activities</u>			
Current and other assets	13,032,472	15,633,496	(2,601,024)
Capital assets	33,883,889	34,796,315	(912,426)
Total assets	46,916,361	50,429,811	(3,513,450)
Long-term liabilities	5,921,580	5,756,410	165,170
Other liabilities	1,907,217	4,521,371	(2,614,154)
Total liabilities	7,828,797	10,277,781	(2,448,984)
Invested in capital, net of related debt	33,372,974	34,285,400	(912,426)
Unrestricted	5,714,590	5,866,630	(152,040)
Total net assets	39,087,564	40,152,030	(1,064,466)
<u>Total Primary Government</u>			
Property taxes receivable	599,817,632	559,732,746	40,084,886
Current and other assets	164,557,728	204,566,564	(40,008,836)
Capital assets	225,109,573	202,483,759	22,625,814
Total assets	989,484,933	966,783,069	22,701,864
Long-term liabilities	1,404,897,913	1,295,392,620	109,505,293
Other liabilities	877,041,305	868,555,136	8,486,169
Total liabilities	2,281,939,218	2,163,947,756	117,991,462
Invested in capital, net of related debt	33,372,974	34,285,400	(912,426)
Restricted	33,428,619	42,849,339	(9,420,720)
Unrestricted	(1,359,255,878)	(1,274,299,426)	(84,956,452)
Total net assets	\$ (1,292,454,285)	\$ (1,197,164,687)	\$ (95,289,598)

“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 negative net asset amount is caused by two significant factors. The first factor and largest dollar amount relates to debt issued for capital assets (buildings, roads, etc.) where the capital asset values are *not* record 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 liabilities are reported by the County for which related capital assets are not recorded by Shelby County:

	<u>June 30, 2003</u>	<u>June 30, 2002</u>
Shelby County and City of Memphis schools	\$689,737,629	\$622,958,087
Shelby County Health Care Corporation (component unit)	102,484,913	87,049,010
Convention Center (joint venture)	77,095,552	78,451,086
Other	<u>77,505,978</u>	<u>68,579,336</u>
Total	<u>\$946,824,072</u>	<u>\$857,037,519</u>

The second factor that contributes to the negative net asset amount relates to “infrastructure” capital assets acquired prior to July 1, 2001. These are mostly roads and bridges. GASB Statement No. 34 referenced above requires that these infrastructure capital assets be reported not later than fiscal year 2006. The County will include these capital assets as soon as the historical records can be researched to determine the amounts for these previously unreported assets. Some of the long-term debt liability reported was used to acquire or construct these infrastructure capital assets. Since the debt is being reported but the assets have not yet been reported, a negative net asset amount results.

It should be noted that 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, it should be noted that 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.

Restricted net assets decreased by \$9 million, primarily because of the planned use of debt service funds to pay increased debt service costs, rather than increasing current revenues (taxes).

The County’s total net assets decreased by \$95 million, which is primarily due to issuing debt for schools’ capital assets as discussed above. There were other significant and somewhat offsetting changes within the funds that 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, 2003, with comparative amounts for the fiscal year ending June 30, 2002.

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 slightly (1%) during the year. 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 1.6% during the year. Overall revenues increased about 1.4% during the year.

Table 2
Shelby County Change in Net assets
Fiscal Years Ending June 30, 2003 and 2002

	FY 2003	FY 2002	Change
Governmental activities:			
<u>Revenues:</u>			
Program revenues:			
Charges for services	\$ 80,435,713	\$ 82,800,704	\$ (2,364,991)
Operating grants and contributions	110,997,403	108,115,963	2,881,440
Capital grants and contributions	7,703,724	6,092,830	1,610,894
Total program revenues	<u>199,136,840</u>	<u>197,009,497</u>	<u>2,127,343</u>
General revenues:			
Property taxes	559,384,367	549,809,147	9,575,220
Other taxes	65,481,890	65,175,367	306,523
Other	8,549,134	8,677,491	(128,357)
Total general revenues	<u>633,415,391</u>	<u>623,662,005</u>	<u>9,753,386</u>
Total revenues-governmental activities	<u>832,552,231</u>	<u>820,671,502</u>	<u>11,880,729</u>
<u>Expenses:</u>			
General government	78,453,282	94,819,350	(16,366,068)
Hospital	33,452,571	27,111,884	6,340,687
Planning & Development	7,310,134	6,327,928	982,206
Public Works	16,873,274	17,227,227	(353,953)
Corrections	937,223	948,137	(10,914)
Health Services	51,345,969	47,139,841	4,206,128
Community Services	39,535,231	38,304,694	1,230,537
Law Enforcement	141,356,464	127,238,606	14,117,858
Judicial	51,424,360	50,133,078	1,291,282
Other Elected Officials	29,382,392	27,737,764	1,644,628
Education	398,704,841	392,612,929	6,091,912
Interest on debt	71,847,109	66,824,357	5,022,752
Total expenses-governmental activities	<u>920,622,850</u>	<u>896,425,795</u>	<u>24,197,055</u>
Increase (decrease) in net assets before transfers	(88,070,619)	(75,754,293)	(12,316,326)
<u>Transfers</u>	<u>(6,154,513)</u>	<u>(6,165,492)</u>	<u>10,979</u>
Increase (decrease) in net assets	(94,225,132)	(81,919,785)	(12,305,347)
Net assets - beginning of year	<u>(1,237,316,717)</u>	<u>(1,155,396,932)</u>	<u>(81,919,785)</u>
Net assets - end of year	<u>(1,331,541,849)</u>	<u>(1,237,316,717)</u>	<u>(94,225,132)</u>

Business-type activities:

Revenues:

Operating revenues:

Charges for services	69,891,427	72,270,809	(2,379,382)
Operating grants and contributions	47,175	78,620	(31,445)
Total operating revenues	<u>69,938,602</u>	<u>72,349,429</u>	<u>(2,410,827)</u>
Non-operating revenues	388,156	(916,965)	1,305,121
Total revenues	<u>70,326,758</u>	<u>71,432,464</u>	<u>(1,105,706)</u>

Expenses:

Codes Enforcement	7,571,869	6,722,355	849,514
Nursing Homes	15,372,131	16,928,491	(1,556,360)
Fire Services	10,727,950	11,142,638	(414,688)
Corrections	43,873,787	44,072,389	(198,602)
Total expenses	<u>77,545,737</u>	<u>78,865,873</u>	<u>(1,320,136)</u>

Increase (decrease) in net assets before transfers

(7,218,979)	(7,433,409)	214,430
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Transfer

6,154,513	6,165,492	(10,979)
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Increase (decrease) in net assets

(1,064,466)	(1,267,917)	203,451
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Net assets - beginning of year

40,152,030	41,419,947	(1,267,917)
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Net assets - end of year

<u>39,087,564</u>	<u>40,152,030</u>	<u>(1,064,466)</u>
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Total primary government:

Increase (decrease) in net assets	(95,289,598)	(83,187,702)	(12,101,896)
Net assets - beginning of year	<u>(1,197,164,687)</u>	<u>(1,113,976,985)</u>	<u>(83,187,702)</u>
Net assets - end of year	<u>\$ (1,292,454,285)</u>	<u>\$ (1,197,164,687)</u>	<u>\$ (95,289,598)</u>

Total expenses for the year in governmental activities increased \$24 million. The largest increase was in law enforcement (Sheriff's Office) of \$14 million. Increased interest due on debt accounted for \$5 million of the increase and education accounted for another \$6 million. Various other increases and decreases were basically offsetting.

Approximately 80% of the inmates at the Corrections Center are the responsibility of the State of Tennessee. The State pays the Corrections Center their share of actual cost per inmate day. The general fund provides an operating transfer for the costs not recovered from the state. Oakville Health Care Center operates at a deficit, which is funded by an operating transfer from the General Fund. Losses in these funds generally represent non-cash changes in long term assets and liabilities.

CHANGE IN FINANCIAL POSITION DURING YEAR

The overall change in the financial position of Shelby County during fiscal year 2003 was a decrease in net assets of \$95,289,598. This was mostly debt issued for component units, the City of Memphis Board of Education, 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 County's governmental activities, excluding capital asset and long-term debt transactions, operated at a deficit of approximately \$4 million. However, the general fund operated with a deficit of \$21 million. Shelby County's budget for the 2003 fiscal year was prepared just prior to County elections, which were in August 2002. The County Mayor, Sheriff and several

Commissioners were not running for re-election. The Commission adopted a balanced budget with the knowledge that the newly elected officials would most likely request changes and some use of fund balance was to be expected. Subsequently, the Sheriff requested and the Commission approved increased general fund expenditures and planned use of fund balance of \$13 million. Some additional increases were requested and approved. The revenue originally projected was also higher than the actual revenues.

The overall decrease in net assets also includes a \$9 million decrease in debt service funds because debt service payments were more than additions. This was a planned usage of these funds.

Most of the decrease in net assets occurred in governmental activities. The business-type activities had a net decrease of \$1.1 million. These occurred because of operating losses at the Corrections Center and Oakville Health Care Center, offset somewhat by operating profits in the Fire Services Fund and 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 deficit of \$158,794,974; the deficit grew by \$5,300,078 from the prior year. Shelby County uses short-term debt to finance capital projects. 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. Short-term debt outstanding at June 30, 2003 was \$220,300,000.

The major components of governmental fund balances are:

	<u>June 30, 2003</u>	<u>June 30, 2002</u>
Debt Service	\$ 10,702,422	\$ 19,777,038
Special Revenue	16,555,754	14,458,602
General Fund-reserved/designated	6,934,189	8,627,892
General Fund-Unreserved	<u>18,225,510</u>	<u>37,606,235</u>
Total, except capital projects fund	\$ 52,417,874	\$ 80,469,767
Capital projects fund	<u>(211,212,848)</u>	<u>(233,964,662)</u>
Total all governmental funds	<u>(\$158,794,974)</u>	<u>(\$153,494,895)</u>

The decrease in general fund balances results primarily from use of more funds than received during the year, as explained above under the "Change in Financial Position During Year" heading. The general fund unreserved amount is available for spending at the government's discretion. The remainder of fund balance has already been committed 1) to pay debt service, 2) for road repair and maintenance, 3) to liquidate contracts and purchase orders of the prior period, or 4) for a variety of other restricted purposes.

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 5.6 percent of total general fund expenditures, while total fund balance represents 7.7 percent of that same amount. General fund revenues were \$5.5 million below the prior year while expenditures were \$22.7 million more; the budget conditions that permitted this were explained above. Management has committed to increasing fund balance of the general fund by \$5 million each of the next two years.

The reduction in the fund deficit of the capital projects fund results from notes payable amounts converted to long-term general obligation bonds exceeding the amount of notes issued during the year for capital projects.

The debt service fund has a total fund balance of \$10,702,422, which is restricted for the payment of debt service. The net decrease in fund balance during the current year was \$9,074,616. The decrease resulted from the planned usage of some funds for capital projects rather than issuance of debt as explained above under the "Change in Financial Position During Year" heading.

Special revenue fund balances increased \$2,097,152 from the prior year. 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.

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 four business-type activities; these are essentially self-supporting activities. Two of the activities have consistently been able to support themselves; these are the Consolidated Code Enforcement Fund and the Fire Service Fund. Two other activities have consistently been unable to support themselves. The Oakville Health Care Center has a cost structure that is above industry averages and the general fund provides a subsidy excluding depreciation. The Corrections Center receives reimbursement from the State of Tennessee for housing State prisoners, which are about 80% of the prison population. The general fund provides the remaining cost, excluding depreciation. Unrestricted net assets of the Enterprise Funds at the end of the year amounted to \$5,714,590. Total net assets decreased \$1,064,466 during the year.

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, 2003, these funds combined had deficit net assets of \$7,282,697, an increase in the deficit of \$2,273,092 from the prior year. The accumulated deficits exist in the employer insurance fund and the group hospital insurance fund. The group hospital insurance fund had a deficit at June 30, 2003 of \$2,949,719. The deficit was accumulated in prior years but has been reduced \$1,986,105 over the past two years; it is expected to be further reduced in the coming fiscal year. The employer insurance fund has a deficit at June 30, 2003 of \$6,369,650. 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 on a claims paid basis. The larger overall deficit for FY 2003 was caused when significant transfers out were made from two funds with 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 original budget for law enforcement was not increased from the prior year, but it was anticipated that a budget adjustment would be needed after the new sheriff assumed office on September 1, 2002. An increase of \$13 million in the budget was approved, primarily for a salary increase (parity pay) for deputy jailers, an increase of over 300 new deputy jailers in fiscal 2002, and the general salary increases granted to all County employees. The offset for this budget adjustment was the planned use of fund balance.
- Only minor changes were made between the original and final budgets for revenue, an increase of \$469,250.
- The expenditure budget of general government was increased from original to final by \$8,978,065. The original budget included \$11.8 million of expenditure restrictions recorded in general government but expected to be accomplished by spending limitations throughout the general fund. As savings were accomplished, these restrictions were eliminated by reductions in specific expenditure budgets throughout the general fund. Also see below regarding transfers.
- The expenditure budget of public works was increased from original to final by \$921,825. About \$800,000 of this was to move the budget for rural ambulance service from an enterprise fund to this governmental activity.
- Budgeted net transfers out were reduced by \$7.0 million. This resulted primarily from transfers in being increased by approximately \$3 million for the transfer of excess balances in internal service funds to the general fund and increased by \$4 million to account for the proceeds of a debt swap transaction.

Significant differences between the final budget and actual occurred when actual revenues were \$15,676,459 below the budgeted amount. Property taxes, business taxes, State-provided resources and interest income were the principal revenues under budget. Actual expenditures were \$7,197,491 less than the final, revised budgets. This result was primarily the result of a hiring freeze and other actions taken after January by the incoming administration.

There were no significant adjustments to the Education Fund budget. The Grants Fund revenue and expenditure budgets were increased by approximately \$10 million, primarily for grants received after the budget was prepared.

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, 2003 amounts to \$225,109,573 (net of accumulated depreciation). This investment in capital assets includes land, buildings and system improvements, machinery and equipment, park facilities and roads. Infrastructure, primarily

roads, acquired prior to July 1, 2001 are not included. GASB Statement No. 34 currently only requires the inclusion of infrastructure acquired beginning July 1, 2001. Retroactive reporting of infrastructure is not required until the County's fiscal year ending June 30, 2006, although early implementation is permitted. The County is in the process of accumulating this historical data in order to implement retroactive reporting of infrastructure.

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

- The \$28.6 million jail annex facility opened in July 2002. The new jail kitchen is scheduled to open in 2004.
- Renovation phases completed at the Shelby East Complex during the year included space for the Assessor's East Office and the County Clerk's Office.
- Renovation work continued at the Criminal Justice Complex. Projects completed during FY 2003 were the detention lighting retrofit, metal roofing and water proofing for the planter, and jail door retrofit.
- For the Sheriff's Office, a major upgrade was purchased to the fingerprint identification system (the Livescan Workstation).
- Playground equipment was purchased for two parks.
- Roadway improvement continued on Holmes Road with an estimated cost of approximately \$6.0 million (including right-of-way acquisition), Shelby Drive and Forest Hill-Irene with an estimated cost of approximately \$4.1 million is expected to be completed in 2004, and \$7.2 million was appropriated for Houston Levee roadway improvements with work expected to begin in 2004.
- Funding for radio frequency and equipment upgrades were appropriated in the amount of \$8.3 million with implementation expected in 2004.

Construction in progress as of the end of the current fiscal year was \$30,235,656.

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

Long-term Debt. At June 30, 2003, Shelby County's general obligation bonded debt (bonds payable) outstanding totaled \$1,354,259,107 which represented approximately 8.8 percent of assessed value. In addition, the County has short-term notes payable of \$220,300,000, which will be converted to long term debt during the next two years. Debt, generally, may be issued without regard to any limit on indebtedness. The ad valorem tax levy is also without legal limit.

The County's bonds payable increased by approximately \$102.5 million (7.5 percent) during the current fiscal year. The key factor in this increase was the conversion of \$146.6 million of notes payable to bonds payable.

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. In fiscal 2002, a \$149 million notes payable program was authorized that has notes payable of \$138.3 million outstanding at June 30, 2003. In fiscal year 2003 a \$134 million notes payable program was authorized that has notes payable of \$82 million outstanding at June 30, 2003.

In 1999, the County signed a funding agreement with the Shelby County and the City of Memphis School boards of education to provide \$655,250,000 of capital funding over eight years. Under this agreement, the County is committed to provide approximately \$77 million of capital funding to the schools each of the next three years.

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	Standard & Poor's	Fitch IBCA, Inc.
Aa2	AA+	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 describes 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(I) of the Notes to Financial Statements of this report.

Economic Factors and Next Year's Budgets and Rates

- The August 2003 unemployment rate for Shelby County was 5.8 percent, compared to the state's rate of 5.0 percent and the national average unemployment rate of 6.1 percent.
- Inflationary trends in the region compare favorably to national indices.

After being elected in August 2002, Mayor Wharton, along with the County Commission, quickly committed to addressing the County's finances. A major focus was put on the fiscal year 2004 budget to reduce spending and start rebuilding fund balance of the general fund. Budgeted general fund expenditures were reduced by almost \$13 million compared to the fiscal year 2003 budget while absorbing a \$5 million increase in retirement contributions and a 15% increase in the cost of employees health insurance. The property tax rate was increased 18 cents (\$24,750,000) for the general fund and 7 cents (\$9,625,000) for debt service. The general fund budget projects no growth in revenue and provides an increase in fund balance of \$3.5 million. The County announced an intent to increase fund balance of the general fund approximately \$5 million each of the next two years.

Because of the school capital needs, debt service expenditures are increasing an average of \$10 million per year. In FY 2003 the County used \$9.1 million of accumulated debt service funds and plans the use of about \$10 million in FY 2004 to help support the debt service requirements. Historically when the County issued bonds for the capital needs of schools, the proceeds were distributed to the two school systems (Shelby County and City of Memphis) based on each system's student average daily attendance. Due to suburban growth, the County school system has experienced a much greater immediate need for capital funds for the past decade or more. While the share of funds distributed to the City school system has permitted the City system to undertake renovation or replacement of deteriorating facilities, the required sharing has been a major factor in the escalating County debt. The County Commission has recently approved the financing of a new County school to be repaid from a separate part of the property tax rate that is assessed only to property outside the City of Memphis. This required issuing debt only for the one new school with no sharing of funds with the City school system.

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 end the growth of debt and the debt service requirements. Capital outlays were reduced from \$154 million in 2002 to \$130 million in 2003. The five-year capital improvement plan was updated with reductions from the prior plan of \$15 million from 2004 and \$40 million from 2005.

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.