



COUNTY OF SANTA CRUZ

AUDITOR CONTROLLER'S OFFICE
GARY A. KNUTSON, AUDITOR-CONTROLLER

December 7, 2004

The Honorable Board of Supervisors
County of Santa Cruz
701 Ocean Street
Santa Cruz, CA 95060

Members of the Board and Fellow Citizens:

The Comprehensive Annual Financial Report (CAFR) of the County of Santa Cruz for the fiscal year ended June 30, 2004 is hereby submitted, in accordance with the statutes of the State of California. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the government. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the County. All disclosures necessary to enable the reader to gain an understanding of the County's financial activity have been included. The independent auditors Vargas and Company, CPAs, who have rendered an unqualified opinion thereon, have audited these statements. Their report is provided herein.

In addition, the Governmental Accounting Standards Board 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 the MD&A and should be read in conjunction with it. The County of Santa Cruz's MD&A can be found immediately following the report of the independent auditors.

The CAFR represents the culmination of all budgeting and accounting activities engaged in during the year, covering all funds of the County, its component units and its financial transactions. The CAFR is organized into four sections: introductory, financial, statistical and glossary.

- **The Introductory Section** is intended to familiarize the reader with the organizational structure of the County, the nature and scope of the services it provides, and the specifics of its legal operating environment. The introductory section includes this transmittal letter, the County's organizational chart and a list of elected and appointed officials.
- **The Financial Section** includes the audited basic financial statements, disclosure notes, required supplementary information including the management's discussion and analysis, supporting statements and schedules necessary to fairly present financial position and the results of operations of the County in conformity with generally accepted accounting principles, and the independent auditor's report on the basic financial statements.

- **The Statistical Section** contains comprehensive statistical data on the County's financial, physical, economic, social and political characteristics. The statistical section includes selected financial and demographic information, generally presented on a multi-year basis.
- **The Glossary Section** provides definitions of the various specialized terms used in this document.

The County is required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984 as amended and U.S. Office of Management and Budget Circular A-133, **Audits of State and Local Governments**. Information related to this single audit, including the schedule of federal financial assistance, findings and recommendations, and auditor's reports on the internal control structure and compliance with applicable laws and regulations, are included in the single audit report, which is issued as a separate document. This report includes all funds and account groups of the County. The County provides the full range of services contemplated by statute or ordinance. These services include public protection, public ways and facilities, health and sanitation, public assistance, recreation and culture, education, and general government. In addition, various utility, maintenance, redevelopment and capital acquisition entities are included as part of the reporting entity based on financial accountability. School districts and autonomous special districts have not met the established criteria for inclusion in the reporting entity, and are therefore reported under the category of fiduciary fund types.

Santa Cruz County was established by an act of the State Legislature in 1850 as one of the original 27 counties of the State of California. The County is a general law county and is governed by a five-member Board of Supervisors who is elected by district to serve alternating four-year terms. The Board of Supervisors uses the appointed County Administrative Officer (Chief Executive) organizational structure to carry out its policies as set forth by County Ordinance. The Assessor-Recorder, Auditor-Controller, County Clerk, Treasurer-Tax-Collector, District Attorney and Sheriff-Coroner are elected officials (these elected offices reflect a reorganization that occurred in July 2004) and all other departments heads are appointed officials.

As required by County ordinance or by State or Federal law, the County's principal functions include seven major areas: general government, public protection, public ways and facilities, health and sanitation, public assistance, education, and recreation and cultural services. In the public assistance and health areas, the State and Federal governments mandate certain minimum levels of service.

Santa Cruz is the second smallest county in California in terms of land mass and the 23rd of 58 in terms of population. The County is located on the Central Coast of California, and is bordered by San Mateo County to the north, Santa Clara County to the east, San Benito and Monterey Counties to the South and the Monterey Bay National Marine Sanctuary to the West.

FINANCIAL INFORMATION

Management of the County is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the County are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable

assurance recognizes that: (1) The cost of a control should not exceed the benefits likely to be derived; and (2) the valuation of costs and benefits requires estimates and judgments by management.

In accordance with the County Budget Act codified in the Government Code, the County prepares and adopts a budget on or before October 2 for each fiscal year. Budgets are adopted for the General Fund and Special Revenue Funds. In addition to the controls mentioned above, the County maintains budgetary controls, whose objective is to ensure compliance with legal provisions embodied in the annual appropriated budget. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is at the character level of salaries and benefits, services and supplies for each budget unit within each budgeted fund. Other charges, land, plant and improvements, and equipment are controlled on a line item basis within each budget unit. The County also maintains an encumbrance accounting system as one technique for accomplishing budgetary control. At year-end encumbrances lapse, but are re-appropriated as part of the following year's budget. The encumbrance system is employed to record amounts committed for purchase orders or contracts. If appropriations are not sufficient, Board of Supervisors-approved appropriation transfers are required before commitments or expenditures are permitted. Encumbrances outstanding at year-end are shown as reservations of fund balance, except for grants. Grant encumbrances are canceled at year-end and re-budgeted with revenues in the new fiscal year.

ECONOMIC CONDITIONS AND OUTLOOK

The County of Santa Cruz has experienced another difficult budget year in 2003-04 due to: the State of California's budget deficits, the implementation of labor agreements, higher retirement costs, and an economy still in recovery.

In July 2004, the financing of the State's deficit went into effect. To repay the up to \$15 billion deficit, counties have shifted ¼% of their sales tax, which the State pledged to repay with their multi-billion dollar deficit bond issue. In return, the State will return an equal amount of property taxes that were previously shifted to schools. In addition, the State is extracting \$2.4 million in additional Educational Revenue Augmentation Funds (ERAF) for schools in 2004-05 and again in 2005-06. The State is also relieving counties and cities of the Motor Vehicle In Lieu Taxes (VLT) and replacing it from property taxes previously shifted to the ERAF for schools. So again, Counties bail the State out and in return, give up monthly flows of revenue to improve the State's cash flows, which in turn shifts another part of its fiscal imbalances to the County. Because of this cash flow shift, the County of Santa Cruz had to increase its working capital borrowing by \$8 million for 2004-05.

Constitutional Amendment 1A, which was approved on the November 2004 ballot, redefines the State's fiscal policy toward local government. This Proposition, under specified conditions, limits the State's ability to extract more local property taxes and requires payment for future and past mandated costs of Counties, Cities, and Districts. It further provides for the return of a portion of local property tax revenues by the year 2006-07 and repayment of unpaid State mandated programs over three years commencing in the 2006-07 fiscal year. This may not be a cure all but should halt or slow the State's repeated budget policy of targeting local government revenues as a source to offset its revenue losses or transfer expenditure obligations. In order to finance the additional ERAF property tax shift, the County borrowed \$2.4 million from the Santa Cruz County Redevelopment Agency as allowed by law, to be repaid with interest in 2006-07 and 2007-08. This repayment is less than the expected repayment

from the loan made to the State last fiscal year of \$4 million for the VLF gap problem to be repaid by statute on August 15, 2006.

How will the State resolve its carry-over deficit estimated at \$6-8 billion in the budget for 2005-06? We expect more State program reductions for the County thereby creating ongoing uncertainty. Additionally, the County has received new retirement rates from the California Public Employees Retirement System (CALPERS). The rates for the miscellaneous bargaining unit reflect an increase of about 50% caused mostly by poor actuarial projections of the cost of plan amendments and the CALPERS investment losses of the past 3 prior years. Under the existing labor agreement, the employees would pick-up that added costs. However, the current contract expires in September of 2005 and this issue represents a challenge for management and representation organizations even before the contract expires.

Beyond this, the County continues to have budgetary structural challenges. Since the County budgets carry-over undesignated fund balance available to offset the budget deficit, it is imperative that management realizes sufficient salary savings through hiring controls and maximizes revenues to avoid further budgetary problems. Salary savings becomes more difficult since the County's workforce has been reduced by nearly 250 positions since 2001-02. The County also borrowed \$22 million to pay plaintiffs for damages sustained from the 1995 flood of the Pajaro River, which will add to the annual debt service expenditures.

In my opinion, the last, the current and the next fiscal year reflect the most difficult budget conditions in the past two decades. Due to budget constraints, no new capital projects were planned by the County for the 2004-05 fiscal year. Clearly, but for the State's impaired financial condition, the County could effectively manage and finance decisions made at the local level.

In November 2004, the voters approved the continuation of the telephone 911 fee in the unincorporated area protecting about \$1.5 million in annual revenue to fund the 911 emergency response center.

MAJOR INITIATIVES

During the past fiscal year, the following major initiatives included:

- **Auditor Controller** Successfully managed through another significant budget challenge and implemented a number of process improvement projects including a new interface to the County's accounting system, broadened the acceptance of credit cards over the Internet and at point of sale, and implemented new banking protocols to better protect the County against fraud.
- **County Administrative Office** Successfully managed through another significant budget challenge and concluded negotiations with the City of Watsonville to partner with that City and the Superior Court to construct Court facilities in downtown Watsonville to improve services to South County families.
- **General Services Department** The implementation of major energy projects at two County sites including: the replacement of the cogeneration system at the Main Jail and the installation of a new cogeneration system at the Simpkins Swim Center. These projects have produced significant energy savings through the on-site generation of electricity with the recovery of waste heat for further use in the facilities. The cogeneration units produce electricity at far lower rates than existing utility rates. The recovery of waste heat is used at the main Jail for

domestic water use and to heat the main pool at the Simpkins Swim Center. It is anticipated that these projects will pay for themselves within five years. Both projects received significant rebates from PG&E.

- **Sheriff's-Coroner's Office** Completed the Mobile Data Communications Project, working closely with staff from the Technical Services Division of General Services, the Information Services Department and the Emergency Communications Center. This major technological advance provided for the installation of equipment in approximately thirty-three patrol vehicles, thus providing computer-aided dispatch, car-to-car communication, criminal data and report writing to Sheriff's staff in the field. Computers in patrol vehicles enable the deputies to retrieve important information immediately, without time-consuming radio traffic or telephone calls to dispatch or records clerks.
- **Assessor-Recorder** Continued the use of new electronic business flow tools to streamline the assessment process, financed with State-County Property Tax Administration Program Grant Funds. The County completed a consolidation of the Assessor and Recorder departments under a single elected department head to streamline the processes between the recording and assessment functions.
- **County Clerk** Completed a consolidation plan to merge the registrar of voters function with the other Clerk functions, such as fictitious business statements, marriage licenses, passports, and notary bond filings in a stand-alone department. The County developed grant applications for Voting Modernization Bond Act (2002) and Help American Vote Act (HAVA) funds to modernize the County's voting processes and improve accessibility.
- **Animals Services Authority** Concluded the purchase of property and buildings to site an animal care and control shelter facility in the Live Oak area. After re-modeling, it is anticipated that the Santa Cruz County Animal Services Authority will consolidate North and Mid County services at the location by 2006.
- **District Attorney** Implemented a new case data management system.
- **Office of Emergency Services** The office is using an award of Anti Terrorism Approval Authority grant funds to coordinate the work of a planning team to develop or update the Operational Area's multi-hazard and multi-jurisdictional response, communication, mutual aid, training and exercise plans.
- **Health Services Agency** Applied for over 30 grants totaling over \$12 million, which significantly contributes to the Agency's ability to sustain programs in difficult financial conditions. Over the past year the agency worked with a broad coalition of health leaders on the expansion of alternatives to the emergency departments of the County's two main hospitals, and continues to work with major stakeholder to address the challenges to community health through the Health Improvement Partnership Council. The Council works to advocate for changes to Medicare reimbursement levels, emergency department support, county-wide disease management approaches, and the Healthy Kids Insurance Plan which became available in July 2004.
- **Information Services Department** Focused on expanding networked based services to customer departments and on developing policies and procedures to support the County's increasingly complex computing environment. Accomplishments include expanding the e-commerce services offered to County residents, created a Web-based Agenda Management System to assist the

Planning Department to allow increased public access to Agendas and Minutes for the various Commissions and Committees they staff, completed the project to migrate the County's Geographic Information System to a new platform, restructured the hardware and software platforms for the mainframe to reduce overall costs, and developed and implemented a Project Management Policy to ensure success with technology development and implementation efforts.

- **Parks** Constructed and opened Hestwood Park in Live Oak. This small neighborhood park contains a play structure, restroom, small turf area, picnic tables, a chess/checker table and benches.
- **Department of Public Works** Completed the reconstruction of the twin bridges on Kings Creek Road in Boulder Creek. This work was the last portion of an eight-year project during which department designed and retrofitted fifteen County bridges to bring them into compliance with current seismic standards.
- **Treasurer-Tax Collector** Completed a re-organization effort creating a stand alone department.
- **Child Support Services** In mid September, Child Support Services' clients accessing the State Department of Child Support Services website noticed a new home page feature: an "e-Pay" button that allowed internet payment for child support. Following the link enabled a credit or debit cardholder to make a current child support payment, set up a recurring payment, pay off past due child support, or simply obtain an electronic statement. Since our first "E" payment, the Department has seen steady growth and acceptance of this convenient way to fulfill child support payment obligations.
- **Personnel** Managed layoffs by placing staff into about 90 vacant positions out of a reduction of about 180 positions of which 90 were filled. As a result, only a few persons were actually laid off.
- **Risk Management** Retained a new third party administrator, to manage the Worker's Compensation program. This company has helped the County to improve services to claimants and better manage our costs.

OTHER INFORMATION

Independent Audit – State statutes require an annual audit by independent Certified Public Accountants. The firm of Vargas and Company, CPAs was selected to audit the financial statements of the County's various funds and account groups, and has issued an unqualified opinion thereon. In addition to meeting the requirements of state law, the audit was also designed to comply with the federal Single Audit Act of 1984, and related OMB Circular A-133. The auditors' report on the financial statements is included in the financial section of this report. The auditors' reports related specifically to the single audit are included in a separate Single Audit Report.

Award - The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the County of Santa Cruz for its comprehensive annual financial report for the fiscal year ended June 30, 2003. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an

easily readable and efficiently organized comprehensive annual financial report whose contents conform 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.

AUDITOR-CONTROLLER ACKNOWLEDGMENTS

I wish to express my appreciation to my Accounting and Audit Divisions, the County departments that participated, and Vargas and Company, CPAs, for their contributions, assistance, and guidance in the preparation of this report.

Respectfully submitted,


Gary A. Knutson
County Auditor-Controller