



County of Santa Cruz

AUDITOR-CONTROLLER'S OFFICE

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November 22, 2005

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, 2005 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 is 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 Bartig, Basler, & Ray 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 the 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 are 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 challenging budget year in 2004-05 due to: the State of California's budget deficits, the cost 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 extracted \$2.4 million in additional Educational Revenue Augmentation Funds (ERAF) for schools in 2004-05 and has

again in 2005-06. The State is also relieving counties and cities of the Motor Vehicle In Lieu Taxes (VLF) 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 shift 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 and an additional \$1 million in 2005-06.

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 in each fiscal year 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 \$5.3 million for the VLF gap problem which was to be repaid by statute on August 15, 2006 but was actually repaid to the County on July 26, 2005, a year earlier. Because the County used \$4 million of its working capital reserve to fund the VLF Gap, that amount has been restored in the 2005-06 final budget. The County did receive a favorable judgment of \$7.2 million for construction damage caused by mold damage on a newly constructed facility of which \$2.4 million was reserved to reimburse other agencies for costs incurred prior to the settlement. In addition, the County issued a \$22 million judgment bond, securitized by the County Government Center to pay plaintiffs from the 1995 Pajaro River Flood damage.

The 2005-06 County budget is balanced but with borrowed funds from the redevelopment agency and one-time funds. The employee contracts have expired for our major representation group and middle management. These negotiations are being mediated. At issue are compensation, retirement cost, and health insurance costs. Additionally, the State did not appropriate funds for the property tax administrative costs of \$.5 million.

While the State of California's financial position has improved according to the Legislative Analyst's Office, the long term out look will continue to have budgetary structural problem-expenditures exceeding income. This means uncertainty for local agencies will persist. In addition, the California Public Employees Retirement System (CALPERS) is considering a rate smoothing policy to help prevent the increase of about 50% caused mostly by poor actuarial projections of the cost of plan amendments and the CALPERS investment losses of the prior years. Under the existing labor agreement, the employees would pick-up that added costs. However, the current contract expired in September of 2005 and this issue represents a challenge for management and representation organizations under the current negotiations.

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 as previously mentioned borrowed \$22 million to pay plaintiffs for damages sustained from the 1995 flood of the Pajaro River, which has added \$1 million to the annual debt service expenditures of the general fund.

In my opinion, the county's management has done an excellent job under these most difficult budget conditions. Due to budget constraints, no new capital projects were planned by the County for the 2005-06 fiscal year. Clearly, but for the State's impaired financial condition, the County could effectively manage its finance decisions at the local level.

In November 2005, 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:

- The Treasurer-Tax Collector's Office, in partnership with the County's Information Services Department, recently developed and implemented an online payment website that allows taxpayers to pay taxes online with an e-check or credit card.
- The County Recorder, as part of the mission to preserve official records, has an ongoing restoration project with a bindery firm to conserve official records. This process involves de-acidification, mending, and reinforcing old papers, and re-sewing and binding the large record books. The de-acidification process, which halts the inevitable self-destruction of records using acidic paper, is a key part of the conservation and long-term storage of the County's unique and historical records.
- The Auditor-Controller implemented new banking protocols to better protect the County against fraud through the use of an online ability to stop payment on checks and prevent payment of forged or counterfeit checks. The Auditor-Controller worked with the Department of Public Works and others to develop the database to account for the County's infrastructure capital assets, in accordance with the requirements of Government Accounting Standards Board Statement 34. The first phase of a major project was completed which modernizes the County's property tax distribution system managed by the Auditor-Controller's Office. A new web-based electronic timekeeping system was implemented, eliminating the need for paper timecards. Other significant programs which the Auditor-Controller initiated or participated in during the year include self-sealing vendor checks to reduce manual handling of cash disbursements, development of a policy on financial reporting for community programs that receive significant funding from the County, streamlined the annual financial reports required by

the State, assisted the County's Human Resources Agency in the State mandated program to standardize and integrate the CalWIN welfare system, and assisted the County's Child Support Services Department to transition the Child Support program to the State.

- The Assessor continued the use of new electronic tools to streamline the assessment process; for example, the use of electronic storage of all types of parcel related files, which permits the use of digital cameras to document parcels currently being reappraised, and the drawing and storage of building floor plans. Using Property Tax Administration Program (PTAP) grant funds, a new work-flow management system was acquired which enables the Assessor's office to better track work as it flows through the various processes required. The Assessor now receives building permits from the County planning department and the four cities in an electronic format, and these are automatically routed to the appropriate appraiser. The permits are age-dated for tracking, and when construction is completed, the system directs the appraiser to schedule a field inspection. This system will be configured to track and streamline the processing of approximately \$900,000,000 in property tax exemptions, including exemptions granted to homeowners, churches, veterans, and schools, and it will be used to streamline the Assessor-Recorder interface programs.
- The Information Services Department completed many projects intended to assist the work of County Departments, including the development and deployment of an electronic timecard application for County employees, defined requirements for a new records management/detention management systems for the Sheriff's office, and a new case management system for the Probation Department, developed and deployed an electronic purchasing order for General Services, and developed a prototype of an automated Board of Supervisors Agenda process. The Geographic Information Systems division completed a County-wide GIS Needs Assessment. The assessment provided an inventory of existing GIS uses and helped identify where additional GIS data and GIS application development could be targeted to benefit multiple departments.
- The Human Resources Agency under the current State economic climate continues to present challenges for human services. The financing and program initiatives provided in the past fiscal year and for the next fiscal year are designed to address challenges by focusing on performance outcomes and utilizing technology solutions. By incorporating performance outcome measures into all HRA programs, the Agency is staying attuned not only to the quantity and quality of services delivered, but also to whether families and individuals receiving these services are better off. Performance outcome measures are increasingly required of human services programs funded by federal, State and local dollars.
- The Personnel and Risk Management Department are engaged in negotiating labor contracts. The County has eleven bargaining units. Of those, six units reached agreements and five more will continue their negotiations into the 2005-06 fiscal year. Most of the six that reached agreement in 2004-05 will have their new terms ending within the 2005-06 fiscal year. As a result of the change in third party administrators in the workers compensation program, annual out of pocket costs for the program have decreased in spite of an increase in open claims.

- The District Attorney's office implemented enhancements to the new case data management system including a new system to accept agency crime referrals via E-mail to streamline the transmittal process and allow the records to be attached to the automated case management system. The Department successfully completed 11 grant applications totaling \$1.4 million which significantly contributes to the Department's ability to maintain programs and meet its responsibility for prosecuting felony and misdemeanor crimes.
- The Sheriff's Office completed their new Open Query Message Switch Project. They have worked closely with the County Information Services Department on this project. The message switch allows all law enforcement agencies in the County to communicate with State and Federal law enforcement agencies. This new message switch is more user friendly and significantly faster in responding to queries for the officer in the field and has improved officer safety and the public they serve.
- Child Support Services completed the tasks necessary to meet the state timeline for conversion to statewide automation, to maintain performance levels at or above the rates for 2004 (collections and establishment of paternity and child support), and to continue our Court Education and Referral project.
- The Probation Department is recognized nationally in the areas of Juvenile Detention Alternatives and Disproportionate Minority Confinement. During 2004-05, the department implemented the SB163 program, which provides access to State funds that enable the Probation Department, the Human Resources Agency, and the Children's Mental Health division to provide enhanced wrap-around services to youth and their families to avoid foster care or other out of home placement.
- The General Services Purchasing Division has completed an upgrade to the purchase order system which will allow electronic purchase orders to be distributed both internally and externally via email. In addition, a new on-line vendor registration system has been put into operation.
- The Office of Emergency Services has focused a significant amount of staff time on the development and implementation of a variety of grants. During 2004-05, the OES was responsible for managing seventeen grant programs totaling \$10.7 million in the areas of homeland security, hazard mitigation and volunteers.
- The Agricultural Commissioner's Department was successful in incorporating the Northern portion of the County into the existing Mosquito Abatement and Vector Control programs. Approved by property owners, this action will generate over \$900,000 in revenues annually to pay for these new services. In addition, the Department is responsible for three main programs: Environmental Protection, Consumer Protection, as well Mosquito Abatement and Vector Control.

- The County Clerk fully transitioned to a stand-alone Department responsible for marriage licenses, fictitious business statements, passports and notary bond filings as well as registrar of voter's functions. The Department successfully conducted the November 2004 Presidential General Election where there were a record number of voter registrations, vote-by-mail ballots and turnout. Staff continues to work toward meeting the federal Help America Vote Act (HAVA) and California's Voting Modernization Act, which establishes voting system standards and new guidelines for accommodating persons with disabilities that go into affect January 1, 2006.
- The Health Services Agency continues to partner with other County departments as well as community-based organizations to deliver services efficiently to our most vulnerable populations while looking for increased revenue opportunities. One example of this work is the One-e-App solution. In conjunction with the Human Resources Agency, a single application process has been developed to maximize potential federal matching funds and streamline the application process. Over the past year, the HSA has developed an extensive process to solicit feedback from a broad group of stakeholders on the Mental Health Services Act plan. This Act, approved by voters, provides new funding for new and expanded mental health services. The Health Services Agency continues to participate on various commissions and groups who are focused on the health and viability of the hospital system in Santa Cruz County.
- The Planning Department, through its offices in Santa Cruz, Aptos and Felton, is responsible for providing comprehensive planning and permit processing services for the unincorporated County area. During the 2004-05 fiscal year, the department has continued its evaluation of its core services and has focused on improvements to the permit process and customer services. In addition, efforts have continued to strengthening the management team and a series of new policy and planning initiatives are underway.
- The Redevelopment Department provides overall coordination and administration of the Agency's various capital projects and activities as well as overall Agency administration. As the result of actions taken as part of the adoption of the 2004-05 budget, the Agency's housing programs have been transferred to the Planning Department providing for a more coordinated and integrated effort to address the Countywide affordable housing issues. Building on the results of past efforts, a number of projects were completed throughout the Live Oak/Soquel area. These include improvements to Gross Road and Seventh Avenue, and the construction of a new larger library, which is expected to be completed by the end of 2005. In addition, significant progress has taken place in a number of areas including the development of technical base studies and area wide plans, construction of public safety projects and parks, acquisition of key sites, installation of beautification improvements, and business support activities. Recently, the agency has received approval to issue \$70 million in new tax allocation bonds.

OTHER INFORMATION

Independent Audit – State statutes require an annual audit by independent Certified Public Accountants. The firm of Bartig, Basler & Ray, 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, 2004. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

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. The 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 Bartig, Basler & Ray, CPAs, for their contributions, assistance, and guidance in the preparation of this report.

Respectfully submitted.



Gary A. Knutson
County Auditor-Controller