

December 20, 2005

Honorable Mayor, Councilmembers and Citizens of Manhattan Beach
Manhattan Beach City Hall
Manhattan Beach, California 90266

The Comprehensive Annual Financial Report (CAFR) of the City of Manhattan Beach for the Fiscal Year Ended **June 30, 2005 (FY2005)** is hereby submitted. This report has been prepared in accordance with generally accepted accounting principles as set forth in the pronouncements of the Governmental Accounting Standards Board (GASB). ***The FY2005 report marks the third year of GASB statement 34 (GASB 34) implementation.*** Transitioning to this new format involved several major steps including: completion of a citywide identification and assessment of infrastructure valuations; completion of a utility cost allocation study; development of new accounting models to facilitate the new reporting; a shift in audit planning; redesign of the published CAFR; and introduction of newly developed asset valuation and depreciation policies. In FY2005, these practices were continued in compiling this year-end report.

In accordance with the above-mentioned guidelines, the accompanying report consists of three sections. The ***Introductory Section*** contains this transmittal letter, a list of the City's principal elected and appointed officials, and an organizational chart. The ***Financial Section*** consists of the Independent Auditors' Report, the Management Discussion and Analysis, the Government Wide Financial Statements, notes to the financial statements, and combining financial statements and schedules. The ***Statistical Section***, which is not audited, contains selected financial and demographic information, generally presented on a multi-year basis.

SERVICE EFFORTS AND MAJOR INITIATIVES

Service Efforts

In FY 2005, the City of Manhattan Beach continued to provide a high level of service to its residents and citizens. The City adhered to its financial policies and adopted financial plan as evidenced by the budget-to-actual reporting presented within this document. \$58.7 million was originally budgeted to support the City's many services and programs. Additionally, \$29.8 million in capital projects was budgeted for the year. Budgetary limits were adhered to on a citywide basis with the General Fund reporting a healthy surplus once again. All funds performed as expected in line with the City's financial policy guidelines and reserves have been maintained.

Some of the key capital improvements expenditures in 2005 include the following:

- \$15.6 million of construction costs for the new Police & Fire facility beyond design and engineering costs bringing this project to over 60% completion.
- \$1.2 million for reconstruction of the El Porto parking lot.
- \$1.4 million of citywide street improvement projects, the bulk of which related to the Aviation resurfacing, Artesia Boulevard improvements, various traffic signal improvements, construction of the new 13th Street extension, and Strand Walkway improvements.
- \$534,000 towards the completion of the Metlox public plaza. With the completion of the parking structure in the prior year, the development is scheduled to open in December 2005.
- \$500,000 in Water, Storm and Wastewater system improvements mainly related line replacements and valve and control upgrades.

Major Initiatives

In FY 2005, the City of Manhattan Beach made significant progress on many of the key work plan items identified in the operating budget. A recap of these accomplishments follows:

Public Safety Facility Project: In the current year the City completed the financing plan to fund the construction of the new public safety facility. The project budget is valued at \$41 million including costs incurred to date. The City designated specific reserves of \$25 million in the Capital Projects Fund for this improvement. In December 2004, the City issued \$12.9 million in fixed rate Certificates of Participation which fully funds the construction of the new Police and Fire facility. The resulting debt service will be financed through dedicated revenues earmarked within the Capital Improvement Fund. \$25 million in costs have been incurred on this project through June 30, 2005 and the project remains within budget and is targeted for completion in 2006.

Metlox Improvements and Development: The City held a grand opening for the Metlox parking structure in January 2004 and another grand opening for the public plaza and retail phases in December 2005. The Metlox parking structure provides 460 spaces, serving the new development as well as the entire downtown. It was completed at a cost of \$14.6 million. The private retail development includes a hotel, retail, restaurant and office space elements. This multi-million dollar project is expected to have a positive economic impact, adding to the City's ground lease, property, hotel, and retail tax revenue base. In concert with this private phase, the City completed the construction of a 40,000 square foot town square and retains ownership of the underlying land, parking facilities and public open space. This public improvement was financed through the issuance of \$11.6 million in Certificates of Participation, issued in January 2003, and the resulting debt service will be paid through dedicated Parking Fund revenues. All debt and capital transactions have been recorded in the parking enterprise fund and are backed by the strength of the City's overall credit.

Strand Improvement Project: In FY 2005-2006 the City budget appropriated an additional \$1.5 million which sets aside all reserves necessary to fund this \$4.5 million project. This capital project has been cash funded in entirety. This project involved years of planning, community discussion and outreach before construction commenced in FY 2005. In the current year construction costs of approximately \$400,000 were incurred on this exciting improvement which spans the entire length of the Strand. The project involves the replacement of the cement walkways, upgrades of all lighting and electrical

elements, the renovation of drainage systems, the introduction of viewing alcoves, updates to trash receptacles, and replacement of exiting benches.

Utility Under-grounding: In the prior year the City successfully facilitated the creation of three beach front utility under-grounding districts valued at approximately \$5 million. Assessment District bonds were issued in August 2004 culminating several years of coordination by our City's Public Works department. Debt service for these bonds will be paid entirely through participating homeowner property tax assessments. The resulting bond proceeds reimbursed the City for all originating costs incurred in the project lifecycle. In the end result, the assessment district formation process was received extremely well with approval percentages in the 70% range for all districts. All project dollars have been deposited with assigned trustee depositories and construction began in FY 2005. In November 2005 an additional two districts were approved by the voters valued at approximately \$14 million. The debt financing process for these newest districts is in process and expected to be completed in January 2006.

Financial Credit Rating: The City obtained a financial credit rating in anticipation of issuing bonds for the construction of public improvements at the Metlox site as well as the new Police & Fire facility. The City received the highest possible rating, "AAA," from both S&P and Fitch. With this good news, the City proceeded to issue bonds for both facilities starting with Metlox Certificates of Participation in January 2003 at a size of \$13.3 million (including all issuance costs, reserve and capitalized interest requirements). The bond issuance for Police/Fire, took place in November 2004 at a value of \$12.9 million. The City realized a healthy General Fund surplus these past years and used these resources to increase cash funding and reduce the final debt sizing. FY 2004 surplus reserves were also used to increase the Police/Fire project budget contingency levels. The City's credit rating was updated with this latest bond issuance and again received a rating of "AAA" from S&P and Fitch. Furthermore, we are very pleased that a similar rating was received from Moody's as part of this bond sale.

Nearly all FY 2004-2005 City work plan items were completed including:

- Selection of a 9/11 memorial to be located at the new Police & Fire facility.
- Introduction of streaming video of City Council and Planning Commission meetings, thereby offering greater public access to those proceedings.
- Continued excellent day-to-day service delivery as shown by the resident satisfaction survey results. Once again, we ranked as one of the best cities in terms of satisfying our residents' needs. Our overall score of 94% is among the highest when compared with similar surveys of cities in the State which show an overall satisfaction rating of 76%;

FINANCIAL CONTROLS AND PROCEDURES

Financial Policies: Throughout the years, the City of Manhattan Beach has followed a fiscally conservative philosophy of building and maintaining healthy financial reserves. This practice has allowed the City to continue providing quality services to its residents in a time when many local agencies were being forced to cut back due to fiscal constraints. In 1997-1998, the City Council approved the City's first set of financial policies, designed to promote sound financial management and ensure that the City's fiscal integrity remains intact as staff and Councilmembers change. This Comprehensive Annual Financial Report reflects the implementation of these financial guidelines and presents all fund reserves and designations in an effort to define fund balance commitments and obligations as of the financial report date.

Internal Control Structure: City management is responsible for establishing and maintaining fiscal internal controls designed to safeguard the assets of the government from loss, theft or misuse, and to ensure that accounting data is accurately 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 controls should not exceed the benefits likely to be derived; and (2) the valuation of costs and benefits require estimates and judgments by management.

Budgetary Controls and Changes: The City of Manhattan Beach maintains strong budget controls. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the City Council. Budget control is primarily maintained at the fund level in the governmental fund types. The City maintains a centralized purchasing function as one method of accomplishing budgetary controls. All purchase orders are reviewed by Purchasing and Finance management to assure adequate budget funding before binding commitments are finalized. Additionally, all machinery and equipment purchases are processed through centralized warehouse receiving to further strengthen internal controls. The City's financial software includes a full encumbrance purchasing accounting system with real time approval and budget checking capabilities. Full encumbrance accounting allows for the speedy identification of fund obligations at the time of requisition, providing tremendous budgetary control. The Comprehensive Annual Financial Report isolates all encumbrance obligations existing at June 30, 2005, related to governmental funds, and presents them as fund balance reserves on the respective balance sheets.

Cash Management: It is the City's policy to invest all temporarily idle short-term funds and longer-term reserves in a manner that will maximize return without sacrificing security and jeopardizing liquidity requirements. Idle funds are invested in accordance with the State's Government Code and a formal investment policy which is adopted annually by the City Council. The policy allows investments in a variety of specific instruments such as Certificates of Deposit, Bankers Acceptances, U.S. Government and Agency securities, Repurchase Agreements, Commercial Paper, and the State's Local Agency Investment Fund.

Risk Management. The City is a member of the Independent Cities Risk Management Authority (ICRMA), a joint powers authority consisting of twenty-eight medium-sized California municipalities, for the purpose of pooling the City of Manhattan Beach's risk for general liability losses with those of other member cities. The City's self-insured retention is \$500,000 per occurrence for Liability and \$750,000 for Worker's Compensation. Under ICRMA, insurance coverage in excess of the self-insured amount is provided up to a limit of \$100,000,000. Premiums for excess insurance coverage are set annually based upon actual claims experience as well as other factors.

EXECUTIVE FINANCIAL OVERVIEW

This top level overview is presented as a supplement to the more detailed and comprehensive analysis presented in the Management Discussion and Analysis (MDA). As such it serves to highlight key financial performance indicators for our major funds. We encourage all readers to review the MDA for a further analysis of the City's financial condition.

General Fund

The General fund is the primary operating fund of the City of Manhattan Beach and the 2005 year reflects very good financial results. The fund again outpaced expectations coming in with an operating surplus of \$3 million. We attribute this performance to our continued adherence to prudent financial planning and policy setting, conservative budgeting, and faithful monitoring and stewardship by all city staff. At the end of the current fiscal year the total General Fund balance equaled \$17.4 million after \$6.9 million of net transfers out primarily to the Capital Improvement and Police/Fire Construction Funds. These transfers, accumulated through prior year surplus amounts, were utilized to reduce the bond sizing for our new Police and Fire facility. Under the GASB 34 model this fund reports an unreserved fund balance of \$16.4 million before policy and City Council designations. On a governmental basis, including financial policy, liability and uncertainty reserve limits, an unreserved and undesignated fund balance of \$944,525 remains available for use at City Council's discretion as of year end.

During the current fiscal year, General Fund revenues exceeded expenses by approximately \$3 million. After transfer activity, the fund balance decreased by \$3.9 million. The transfer activity included:

- \$3,325,000 transfer out of the General Fund into the Police/Fire Construction Fund for the Public Safety Facility as planned for in the City budget. This amount also included an approved project budget contingency amount increase of \$1,325,000.
- \$2,463,164 transfer out of the General Fund into the Capital Improvement Fund to (1) increase the designated Strand Improvement Reserve by \$1,596,369 to the approved \$4.5 million level and (2) \$866,795 to prepay capitalized interest to reduce long term debt service payments for the Police/Fire bonds.
- \$695,000 out of the General Fund to the Pension Fund to fully fund the benefit liabilities resulting from newly awarded Police Retirement Health benefits.
- \$355,000 transfer out of the General Fund to the Insurance Fund to re-establish fund working capital policy levels.
- \$150,000 transfer out of the General Fund to the Storm Water Fund in support of fund levels required to maintain operations for the assessment fund. Increasing assessment levels in this particular fund are needed to cover rising utility and maintenance costs but local governments are precluded from doing so subject to a proposition 218 vote of the people.
- \$5,533,330 transfer out of the Capital Improvement Fund to the Police and Fire facility Construction Fund as part of a planned and budgeted funding of accumulated project reserves.
- \$293,000 transfer out of the El Porto County Lot Fund to the Capital Improvement Fund to pay for the costs associated with the reconstruction of El Porto parking lot.
- \$33,444 transfer out of the Underground Utility Construction Fund to the General Fund to reimburse the city for bond issuance costs.

Although the rate of growth has slowed from early 2000 levels, the City’s General Fund revenue base continues to do well. This can be noted by the following trends:

Revenue	2004 Actual	2005 Actual	Variance
Property Tax	\$11.1 M	\$11.7 M	\$.6 M
Sales Tax	7.3 M	7.3 M	.0 M
Hotel Tax	1.9 M	2.1 M	.2 M
Business License Tax	2.1 M	2.3 M	.2 M
License and Permits	1.6 M	1.5 M	(.1 M)
Fines	2.2 M	1.8 M	(.4 M)
Interest and Rent	2.3 M	2.3 M	.0 M
Vehicle In-Lieu	1.6 M	2.3 M	.7 M
Services	6.1 M	7.3 M	1.2 M

On an overall basis, General Fund revenues increased moderately, 6%, and came in at 104% of our annual budget estimates with property tax being the clear front runner. Sales tax remained relatively flat while Hotel Tax showed a strong gain in contrast to the past two years. Charges for services were bolstered by the completion of a new utility cost allocation study in FY 2003 and robust recreation service activities. Additionally, vehicle registration fee collections are up after last year’s State deferral of such revenue. On the other side of the equation, interest income has fallen heavily as predicted given the large use of cash reserves, only to be offset by unrealized portfolio market value gains relative to last year. Although no dramatic increases were noted, these results are quite reassuring considering the challenges that faced us at the State level those past two years.

General Fund expenditures came in 4% below budget resulting in the surplus noted above. On the other hand, compared to last year, expenses have risen by 9%, or \$3.1 million, mostly driven by salary, pension, and insurance costs. Clearly, rising costs are a significant challenge that reinforces the need to maintain prudent, proactive and conservative planning while maintaining tight budgetary controls. Maintaining such controls is critical to assure healthy surplus margins in future years. Although the current year performance is strong, the rate of expense increase outweighs the rate of revenue growth which is a trend worthy of our attention.

Other Funds

Capital Improvement Funds

The past two years saw the introduction of two new funds to this category. In FY 2004 the Police and Fire Construction Fund (PFC) was added as well as the Utility Under-Grounding Fund (UAD). These funds were added to manage the construction of the two related major capital projects. The previously established Capital Improvement Fund (CIP) was originally created to drive capital planning for general government operations and continues in this same capacity.

In FY 2005, the CIP Fund performed as expected and is well positioned to fund our most important capital infrastructure projects. Dedicated revenues in this fund amounted to \$1.1 million, grants another

\$1 million, and capital expenditures equaled \$2.2 million. This fund transferred \$5.5 million to the newly create PFC Fund for the final planed contribution of reserves for the new safety facility.

At June 30, 2005 the total balance in the CIP Fund was \$7.4 million. Of this balance, \$6.1 million has been specifically earmarked for planned infrastructure projects and restricted bond cash leaving an unreserved and undesignated balance of \$1.3 million. Key designations at year end include:

- \$3.8 million for improvements to the Strand walkway
- \$1.3 million for the Police/ Fire facility cash bond reserves
- \$700,000 to complete the El Porto Wall
- \$100,000 for improvements to Artesia Boulevard

At the end of the current fiscal year the total fund balance in the PFC Fund was \$17.5 million which is completely dedicated for the construction of the new facility. This balance reflects the transfer in of \$5.5 million from the CIP fund, reduced by current year construction costs. \$25.2 million has been expended on this project from inception through June 30, 2005.

At the end of the current fiscal year the total fund balance in the UAD Fund was \$661,402 reflecting trustee held bond reserves resulting from bond issuance. Bonds were issued in the current year making up the balance of the \$5.1 million project cost beyond homeowner prepayments. The total amount of cash holdings in this fund is restricted in use.

Special Revenue, Internal, and Enterprise Funds

All other Governmental and Business Type funds performed within budget and have met financial projections and expectations. As has been the trend in recent years, Workers Compensation claims and reserves continue to climb at alarming rates giving rise to the need to increase departmental charge outs and augment fund balances. Although this fund's balance remains within fiscal policy levels, long term liabilities cause a deficit in the total fund balance. Staff will be adjusting prospective estimates this coming budget year in response to this trend and continuing challenge. Our City, along with the State, has identified rising insurance costs as one of the financial challenges in future years. Ultimately the solution to this issue can only come through legislative change at the State and/or Federal level.

Trust and Agency Funds

In several cases, the City acts as a custodian of funds held for the benefit of others which mostly relates to the administration of employee pension and 401(a) deferred compensation plans. All such plans funding requirements have been maintained. City Plans include the supplemental retirement and single highest year programs - dormant plans which were previously offered by the City. It is significant to note that this financial report does not include the value of trust holdings in the employees' 457 deferred compensation plan valued at \$12.5 million at June 30, 2005. This recognizes enacted legislation establishing the City as a plan trustee and protecting these employee-owned assets from external creditors.

For the first time this year, the trust and agency fund group includes funds held in trust on behalf of the under-grounding assessment districts. This fund accounts for assessment collections and the related debt service payments.

THIRD PARTY ADMINISTERED PENSION PLANS

Defined Benefit Pension Plan: The City contracts with the California Public Employees Retirement System (CalPERS) for certain retirement, disability, death and survivor benefits for qualified employees. The annual actuarial valuation by CalPERS changes from year to year, and the City's contribution rates are modified accordingly.

Retirement Plan for Part-Time Employees: From 1990 to 1997, the City of Manhattan Beach provided its own retirement plan for part-time, seasonal and temporary employees not eligible for participation in the California Public Employees Retirement System. This plan was eliminated in June 1997, as the City opted to provide the Public Agency Retirement System (PARS) program instead.

Significance of GASB 34 on Capital Asset Presentation

Although many impacts of GASB 34 on these financial statements were discussed above, one would be remiss not to point out the tremendous reporting impact that this pronouncement has on the City's valuation and treatment of capital assets. In this regard we encourage the reader to review the notes and the Management Discussion and Analysis for this important information.

GASB 34 now requires that local governments quantitatively value and capitalize all owned asset including capital infrastructure. This infrastructure includes such highly visible and material items as streets, walkways, lights, signs, buildings, etc. Consequently this pronouncement requires that these assets be depreciated in full compliance with accrual accounting methodology. This presentation of capital assets was always required of our enterprise funds in the past and now it is required when reporting the government wide financial statements for all such funds.

In the end result a valuation of all City infrastructure was completed and these results have been included in the financial statements. Government wide capital assets have been valued on a gross basis at \$170 million and at \$128 million on a net basis after depreciation. These values are presented at original estimated cost and, as such, their replacement cost would be considerably higher. Increases over last year exceeded \$17 million after depreciation most of which results from the \$15.6 million capitalization of Police and Fire facility improvements. The remaining asset increase resulted from improvements to city roadways, parks, utilities, and completion of Metlox public improvements.

OTHER INFORMATION

Independent Audit: The accounting firm of Lance, Soll & Lunghard, LLP, was selected by the City to perform the annual audit. The auditors' report on the general purpose financial statements and combining and individual fund statements and schedules is included in the financial section of the City's Comprehensive Annual Financial Report. The City was not required to conduct a single-audit, an audit of Federal Grant Funding, and, as such, no separate single audit opinion and report is included.

Acknowledgments: Preparation of this report could not have been accomplished without the efficient and dedicated services of the Finance Department staff. We would like to express our appreciation to all members of the department, particularly Russell Morreale, Henry Mitzner, Sherry Morelan, Steve Charelian, Luisa Camba, Sande Johnson and Eugene Wee who assisted and contributed to its preparation. A special thanks is extended to Lance, Soll & Lunghard, LLP our independent auditors, for their professionalism and diligence in preparing this year end financial report and again to Russell Morreale and Henry Mitzner for coordinating this audit transition in this third year of GASB 34 implementation. We would also like to thank the Mayor, members of the City Council, and the City Treasurer for their leadership and support, without which the preparation of this report would not have been possible.

Geoff Dolan, City Manager

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