

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the City of Portsmouth's (City) annual financial report presents management's discussion and analysis (MD&A) of the City's financial performance during the fiscal year ended June 30, 2004. The MD&A should be read in conjunction with the transmittal letter found in the Introductory Section of this report and the City's Financial Statements that follow this section.

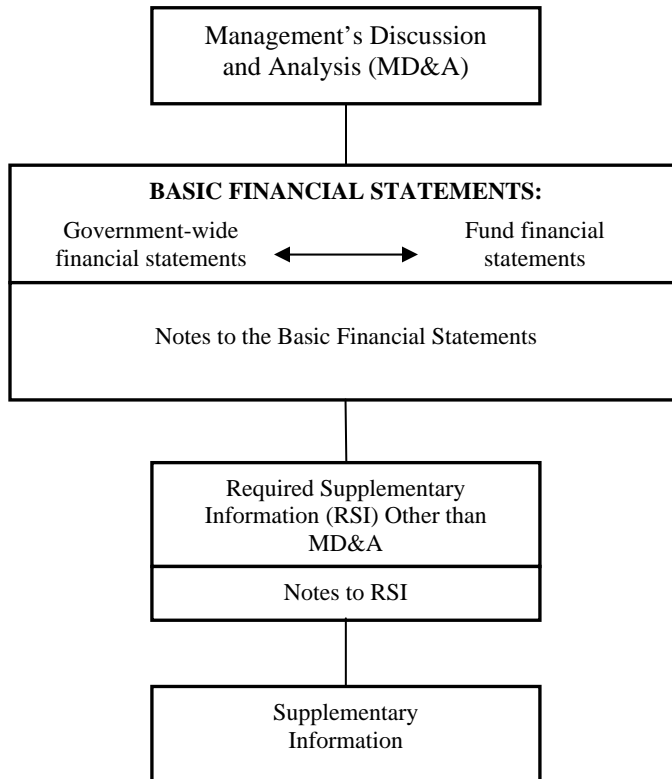
FINANCIAL HIGHLIGHTS

- ❖ The City's net assets totaled \$298.7 million at June 30, 2004, increasing \$16.5 million over June 30, 2003.
- ❖ The City's unrestricted net assets totaled \$11.2 million. The unrestricted net assets are comprised of a \$1.0 million deficit for governmental activities and \$12.2 million unrestricted net assets for business-type activities.
- ❖ The deficit in unrestricted net assets for governmental activities is attributed to deficits accumulated in the internal service funds totaling \$21 million: \$19.7 million from the Risk Management and Insurance Fund and \$1.3 million from the Information Technology Fund.
- ❖ Government-wide current assets were \$72.8 million: \$42.3 million for governmental activities and \$30.5 million for business-type activities; while current liabilities were \$43.8 million: \$34.8 million for governmental activities and \$9 million for business-type activities. The ratio of current assets to current liabilities was 1.66 overall: 1.21 for governmental activities and 3.39 for business-type activities.
- ❖ The City's general revenues and transfers of \$111.2 million were \$16.5 million more than expenses net of program revenues of \$94.7 million. 95% of general revenues and transfers were funded through taxes.
- ❖ The General Fund undesignated fund balance increased to \$18.7 million, up from \$14.9 million in the prior year, or 26%.
- ❖ Total net assets for the Public Utility Fund rose from \$97 million at June 30, 2003 to \$105 million at June 30, 2004, or 8.2%. This resulted from the \$10.8 million operating income, or \$9.6 million net income before transfers.
- ❖ Long-term indebtedness (including landfill closure and postclosure care of \$5.2 million and compensated absences of \$7 million) at June 30, 2004 totaled \$298.8 million, an increase of \$2.5 million from the prior year.

USING THE FINANCIAL SECTION OF THIS COMPREHENSIVE ANNUAL FINANCIAL REPORT

This Comprehensive Annual Financial Report consists of four sections: introductory, financial, statistical, and compliance. As the following chart shows, the financial section of this report has four components - *management's discussion and analysis* (this section), the *basic financial statements*, the *required supplementary information* and the *supplementary information*. The basic financial statements have three components – *government-wide financial statements*, *fund financial statements*, and *notes to the basic financial statements*.

Components of the Financial Section



The City's financial statements present two kinds of statements each with a different snapshot of the City's finances. The government-wide financial statements provide both long-term and short-term information about the City's overall financial status. The fund financial statements focus on the individual parts of the City government, reporting the City's operations in more detail than the government-wide statements. Both perspectives (government-wide and fund) allow the user to address relevant questions, broaden the basis of comparison and enhance the City's accountability.

Government-wide Financial Statements

The government-wide statements report information about the City as a whole using accounting methods similar to those used by private-sector companies. One of the most important questions asked about the City's finances is, "Is the City as a whole better off or worse off as a result of the year's activities?" The Statement of Net Assets and the Statement of Activities, which are the government-wide statements, report information about the City as a whole and about its activities in a way that helps answer this question. These statements include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by most private-sector companies. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the City's net assets and changes in them. The City's Net Assets – or the difference between assets and liabilities - is one way to measure the City's financial health, or financial position. Over time, increases or decreases in the City's net assets are one indicator of whether its financial health is improving or deteriorating. Other non-financial factors will need to be considered, however, such as changes in the City's property tax base and the condition of the City's roads, to assess the overall health of the City.

In the Statement of Net Assets and the Statement of Activities, the City is divided into the following:

Governmental activities - Most of the City's basic services are reported here: police, fire, public works, parks and recreation, and general administration. Property taxes, other local taxes, and state and federal grants finance most of these activities.

Business-type activities - The City charges fees to customers to help it cover the costs of certain services it provides. The City's water and sewer system, port facility and economic development fund, waste management services and golf courses are included here.

Component units - The City includes four separate legal entities in its report - the School Board, the Parking Authority, the IDA, and the PPIC. Although legally separate, these "component units" are important because the City is financially accountable, by providing operating and capital funding, for them.

Fund Financial Statements

The focus of the fund financial statement presentation is on the City's most significant funds. The fund financial statements provide more information about the City's most significant funds - not the City as a whole. Funds are accounting units that the City uses to keep track of specific sources of funding and spending for particular purposes. Some funds are required by State law and by bond covenants. Other funds are established to control and manage money for particular purposes or to show that certain taxes and grants are properly used.

The City has three types of funds:

Governmental funds - Most of the City's basic services are included in governmental funds, which focus on (1) how cash and other financial assets that can readily be converted to cash flow in and out and (2) the balances left at year end that are available for spending. Consequently, the governmental funds statements provide a detailed short-term view that helps the reader determine whether there are more or fewer financial resources that can be spent in the near future to finance the City's programs. Because this information does not encompass the additional long-term focus of the government-wide statements, additional information is provided on the subsequent page of the governmental funds statement that explains the relationship (or differences) between them. The City has two major governmental funds: the General Fund and the Capital Improvements Fund.

Proprietary funds - Services for which the City charges customers a fee are generally reported in proprietary funds. Proprietary funds, like the government-wide statements, provide both long- and short-term financial information.

In fact, the City's enterprise funds (one type of proprietary fund) are the same as its business-type activities, but the fund financial statements provide more detail and additional information, such as cash flow. The City has three major enterprise funds: the Public Utility Fund, Waste Management and the Golf Fund.

The City uses internal service funds (another type of proprietary fund) to report activities that provide supplies and services for other City programs and activities – such as the Garage Fund.

Fiduciary funds - The City is the trustee, or fiduciary, for its employees' pension plans. It is also responsible for other assets that, as part of a trust arrangement, can be used only for the trust beneficiaries. The City is responsible for ensuring that the assets reported in these funds are used for their intended purposes. All of the City's fiduciary activities are reported in a separate statement of fiduciary net assets and a statement of changes in fiduciary net assets. The City excludes these activities from the City's government-wide financial statements because the City cannot use these assets to finance its operations.

FINANCIAL ANALYSIS OF THE CITY AS A WHOLE

Statements of Net Assets

The following table reflects the condensed Statements of Net Assets:

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2004	2003	2004	2003	2004	2003
Current and other assets	\$ 47	37	33	30	80	67
Capital assets	389	391	166	159	555	550
Total assets	\$ 436	428	199	189	635	617
Current and other liabilities	\$ 35	35	9	8	44	43
Long-term liabilities	218	220	74	72	292	292
Total liabilities	253	255	83	80	336	335
Net assets:						
Invested in capital assets, net of related debt	175	179	96	94	271	273
Restricted	9	6	8	5	17	11
Unrestricted	(1)	(12)	12	10	11	(2)
Total net assets	183	173	116	109	299	282
Total liabilities and net assets	\$ 436	428	199	189	635	617

Net Assets (assets in excess of liabilities) may serve over time as a useful indicator of a government's financial position. In the case of the City of Portsmouth, assets exceeded liabilities by \$299 million at June 30, 2004. By far, the largest portion of the City's Net Assets, 91%, reflects its investment in capital assets (land, buildings, infrastructure, etc.) net of accumulated depreciation and related debt used to acquire those assets. The City uses these assets to provide services to its citizens and, consequently, these assets are not available for future spending. The resources needed to repay the debt related to these capital assets must be provided from other sources. Approximately 5.5% of the City's Net Assets is subject to various external restrictions.

The Net Assets of the City's governmental activities increased \$9.9 million from \$173.3 million to \$183.2 million as reflected in the Statement of Activities.

The Net Assets of the City's business-type activities increased \$6.6 million from \$108.8 million to \$115.4 million as reflected in the Statement of Activities. However, these resources cannot be used to make up for any net asset deficit in governmental activities. The City generally can only use these net assets to finance the continuing

operations of its business-like enterprise activities, which include the Public Utility, Golf, Waste Management and Port Facility and Economic Development enterprise funds.

Statements of Activities

The following table shows the revenues and expenses of the governmental and business-type activities:

Table 2							
Summary of Changes in Net Assets							
Years ended June 30, 2004 and 2003 (in millions)							
	Governmental Activities		Business-Type Activities		Total Primary Government		
	2004	2003	2004	2003	2004	2003	
Revenues							
<u>Program revenues:</u>							
Charges for services	\$ 21	17	33	30	54	47	
Operating grants and contributions	66	62	7	-	73	62	
Capital grants and contributions	2	4	-	1	2	5	
<u>General revenues:</u>							
Taxes	106	102	-	-	106	102	
Other	4	4	1	1	5	5	
Total revenues	199	189	41	32	240	221	
Expenses							
General government	11	12	-	-	11	12	
Nondepartmental	5	8	-	-	5	8	
Judicial	18	16	-	-	18	16	
Public safety	41	43	-	-	41	43	
Public works	28	27	-	-	28	27	
Health and welfare	29	31	-	-	29	31	
Parks, recreational & cultural	12	10	-	-	12	10	
Community development	8	9	-	-	8	9	
Education	29	29	-	-	29	29	
Public utility	-	-	15	14	15	14	
Golf	-	-	2	2	2	2	
Waste management	-	-	16	8	16	8	
Interest on long-term debt	9	11	-	-	9	11	
Total expenses	190	196	33	24	223	220	
Transfers	1	1	(1)	(1)	-	-	
Change in net assets	10	(6)	7	7	17	1	
Net assets, beginning of year	173	179	109	102	282	281	
Net assets, end of year	\$ 183	173	116	109	299	282	

Governmental Activities

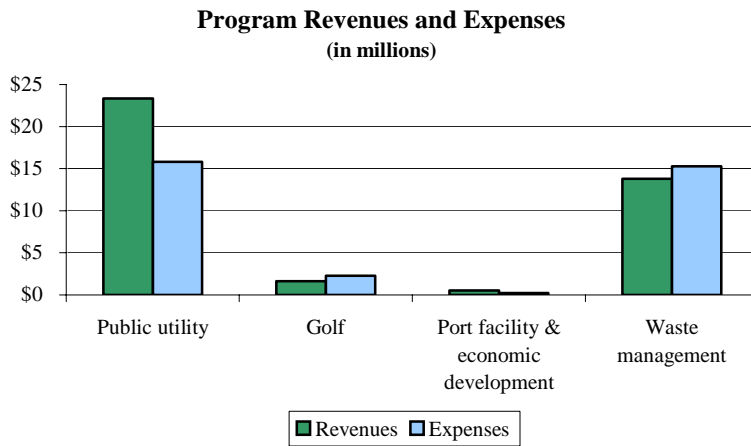
The City's total revenues from governmental activities were \$199 million for the fiscal year ended June 30, 2004. The largest source of revenue, representing 53% of the total, is taxes, which is composed of property taxes, other local taxes and utility taxes. The City's assessed real property value increased 9.7% from the prior year due in part to new commercial and residential construction.

Program revenues are derived from the program itself and reduce the cost of the function to the City. Total program revenues for governmental activities were \$89 million. The largest component of program revenues for governmental activities is operating grants and contributions totaling \$66 million, representing 33% of total revenues for governmental activities.

For the fiscal year ended June 30, 2004, expenses for the City's governmental activities totaled \$190 million. The City's expenses cover a wide range of services, with 21% related to public safety, 16% related to education, and 15% related to health and welfare.

Business-Type Activities

The Net Assets for business-type activities increased \$6.6 million due primarily to a \$8.1 million increase in net assets for public utility activities. Charges for services, including water and sewer utility fees, waste management fees and golf fees, represent 80% of total revenues for business-type activities. The following graph compares the program revenues and expenses of the business-type activities:



FINANCIAL ANALYSIS OF THE CITY'S FUNDS

Governmental Funds

The focus of the City's governmental funds is to provide information on near-term inflows, outflows and balances of available resources. Such information is useful in assessing the City's financing requirements. For the fiscal year ended June 30, 2004, the governmental funds reflected a combined fund balance of \$34.1 million. The General Fund's fund balance totaled \$22 million at June 30, 2004, an increase of \$5 million over the prior year. The General Fund's undesignated fund balance totaled \$18.7 million at June 30, 2004, an increase of \$3.8 million over the prior year's undesignated fund balance of \$14.9 million. The increase in the General Fund's fund balance is due primarily to actual expenditures being less than budgeted expenditures.

The Capital Improvements Fund had a \$4.1 million fund balance at June 30, 2004, all of which is reserved or designated for future costs associated with capital projects.

General Fund Budgetary Highlights

General Fund			
Fiscal Year Ended June 30, 2004			
	Original Budget	Final Budget	Actual
Revenues and Transfers			
Taxes	\$ 105,592,625	105,592,625	105,968,051
Intergovernmental	34,665,032	35,962,444	34,915,195
Other	21,751,345	23,096,403	22,731,324
Total	\$ 162,009,002	164,651,472	163,614,570
Expenditures and Transfers			
Expenditures	\$ 153,464,340	155,803,904	152,276,182
Transfers	8,544,662	8,847,568	8,153,639
Total	\$ 162,009,002	164,651,472	160,429,821

Actual expenditures in the above chart are shown on the budgetary basis, which differs from the generally accepted accounting principle basis (see Schedule I-3).

Actual General Fund revenues and transfers from other funds were below the final budgeted revenues by \$1,036,902 during fiscal year 2004. This is attributable in part to a decrease in intergovernmental revenue recognized due to state budget constraints. Actual General Fund expenditures and transfers to other funds were \$4,221,651 less than the final budget.

During fiscal year 2004, City Council approved three supplemental appropriation ordinances, amending the original budget, for the following purposes:

- To appropriate \$223,147 of additional state funds received for street and highway maintenance; and
- To appropriate \$1,074,265, of which \$68,360 was transferred from the Waste Management Fund, received for FEMA reimbursement,
- To appropriate \$1,345,058 for legal fees, mosquito control, and purchase of property.

Proprietary Funds

Total Net Assets of the Public Utility Fund increased \$8.0 million during fiscal year 2004 from \$96.7 million to \$104.7 million. Of the total Net Assets, \$84.4 million is invested in capital assets, net of related debt, and \$3.5 million is restricted. Unrestricted Net Assets totaled \$16.8 million, an increase of \$4.9 million from the prior year. The increase in Net Assets is due to the net income before transfers of \$9.5 million.

Total Net Assets of the Golf Fund decreased \$.5 million during fiscal year 2004 from \$7.4 million to \$6.9 million. Of the total Net Assets, \$3.1 million is invested in capital assets, net of related debt, and \$4.4 million is restricted. Unrestricted Net Assets deficit totaled \$.7 million, an increase in the deficit of \$.6 million from the prior year. The decrease in Net Assets is due to the net loss before transfers of \$.6 million.

Total Net Assets of the Waste Management Fund at June 30, 2004 decreased \$1.2 million during fiscal year 2004 from \$2.5 million to \$1.3 million. Of the total net assets, \$5.6 million is invested in capital assets, net of related debt, and there is an unrestricted net assets deficit of \$4.3 million. The deficit in unrestricted net assets is primarily a result of the long-term landfill closure and post closure care liability of \$5.2 million, which is unfunded.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of fiscal year 2004, the City had invested \$555 million in a broad range of capital assets, including vehicles and equipment, buildings, park and golf facilities, roads, bridges and water and sewer lines, as reflected in the following schedule:

Capital Assets (net of depreciation)			
As of June 30, 2004 (in millions)			
	Governmental Activities	Business-Type Activities	Total Primary Government
Land	\$ 25.5	14.5	40.0
Site improvements	1.2	-	1.2
Infrastructure	177.8	-	177.8
Buildings	116.4	2.2	118.6
Improvements other than buildings	-	93.6	93.6
Machinery, furniture and equipment	12.0	3.2	15.2
Construction in progress	56.0	53.2	109.2
Total	\$ 388.9	166.7	555.6

Major capital asset activity for the fiscal year ended June 30, 2004 included:

- Capital asset additions for governmental activities totaled \$16.3 million, including \$12.5 million for construction in progress, \$1.6 million from capital lease proceeds, and \$1.8 million of donated infrastructure.
- Capital asset additions for business-type activities totaled \$11.7 million, including \$9 million for construction in progress.
- Depreciation expense totaled \$18.3 million and \$3.9 million for governmental and business-type activities, respectively.
- Construction in progress totaled \$55.8 million for governmental activities at June 30, 2004 (including certain school projects under construction).
- Construction in progress totaled \$53.1 million for business-type activities at June 30, 2004.

More detailed information about the City's capital assets is presented in Note 4 to the basic financial statements.

The City's fiscal year 2005 capital budget estimates spending another \$25.6 million for capital projects, including \$5.2 for schools, \$5.3 million for water and sewer improvements, and \$10.9 for municipal facilities. The City plans to issue additional debt in the fall of 2005 to finance some of these projects. More detailed information about the City's long-term liabilities is presented in Note 5 to the basic financial statements.

Long-term Debt

At year-end, the City had \$286.7 million in outstanding debt. General obligation and revenue bonds outstanding represented \$190 million of this total, as reflected in the following schedule:

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2004	2003	2004	2003	2004	2003
	General obligation and revenue bonds	\$ 122.1	128.9	67.9	71.0	190.0
General obligation notes payable	8.0	-	2.8	-	10.8	-
Obligations under capital leases	22.3	22.9	0.6	0.3	22.9	23.2
Obligations under cooperation agreements	53.1	55.2	-	-	53.1	55.2
Bond anticipation note	5.1	2.2	-	-	5.1	2.2
Literary loans	4.8	5.3	-	-	4.8	5.3
Total	\$ 215.4	214.5	71.3	71.3	286.7	285.8

On November 14, 2003 the City issued a \$5.4 million General Obligation Note to provide financing for the acquisition of the property know as Mid-City Shopping Center. On April 30, 2004 the City entered into a Master Lease agreement totaling \$24 million to provide funds to finance the cost of acquisition of various pieces of equipment. On June 30, 2004 the City issued a \$2.5 million Taxable General Obligation Note to provide funds to pay the costs, in whole or in part, of the acquisition and installation of the replacement canopy for the NTelos Pavilion at Harbor Center.

On December 16, 2003, the City issued \$103,915,000 of General Obligation Refunding Bonds with a premium of \$7,849,183. The Refunding Bonds were issued pursuant to City Council resolution to advance refund \$64,365,000 of outstanding Public Improvement bonds (various series), \$30,470,000 of Public Utility bonds, \$1,145,000 of Port bonds, and a \$7,500,000 Parking Note maturing on February 26, 2004. More detailed information about the City's long-term liabilities is presented in Notes 5 and 18 to the basic financial statements.

The state limits the amount of general obligation debt the City can issue to ten percent of the assessed value of real property within the City. The City's outstanding debt, not all of which is applicable to the state limits, is significantly below this limit - which is currently \$396.1 million.

The City maintains bond ratings on general obligation debt of "A1", "AA-," and "AA-," from Moody's Investors Service, Standard & Poor's Public Finance Ratings and Fitch, Inc., respectively.

ECONOMIC FACTORS

The City's unemployment rate for July 2004 was 6.9%, which compares to the national unemployment rate of 5.5% for July 2004. Per capita income as of December 31, 2002 was \$23,835, an increase of 7% over the previous year.

The Commonwealth of Virginia budget shortfall, related cuts and unfunded commitments had a direct impact on revenues in support of City programs. The City attempted to minimize the effects of these cuts by reducing the expenditures in the departments affected. Overall, the General Fund's actual revenues from the Commonwealth for fiscal year 2004 were \$1,448,561 less than the final budget.

Despite continued sluggish national and state economic conditions, locally the City's revenues continue to increase as a result of the major economic development initiatives undertaken within the last five years: the new Portsmouth Renaissance Hotel and Waterfront Conference Center, the Performing Arts Center at Harbor Center, major redevelopment at Victory Crossing, PortCentre Commerce Park, Victory Crossing Business Park, the Cox Property,

and Scotts Creek. The major investments in these areas are beginning to yield dividends in the form of new taxable property, new jobs, and increased tourism.

CONTACTING THE CITY'S FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors and creditors with a general overview of the City's finances and to demonstrate the City's accountability for the money it receives. Questions concerning this report or requests for additional financial information should be directed to the Chief Financial Officer, 801 Crawford Street, Portsmouth, VA 23704.