

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the City of Portsmouth's (City's) Comprehensive Annual Financial Report (CAFR) presents Management's Discussion and Analysis (MD&A) of the City's financial performance during the fiscal year ended June 30, 2005. 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.

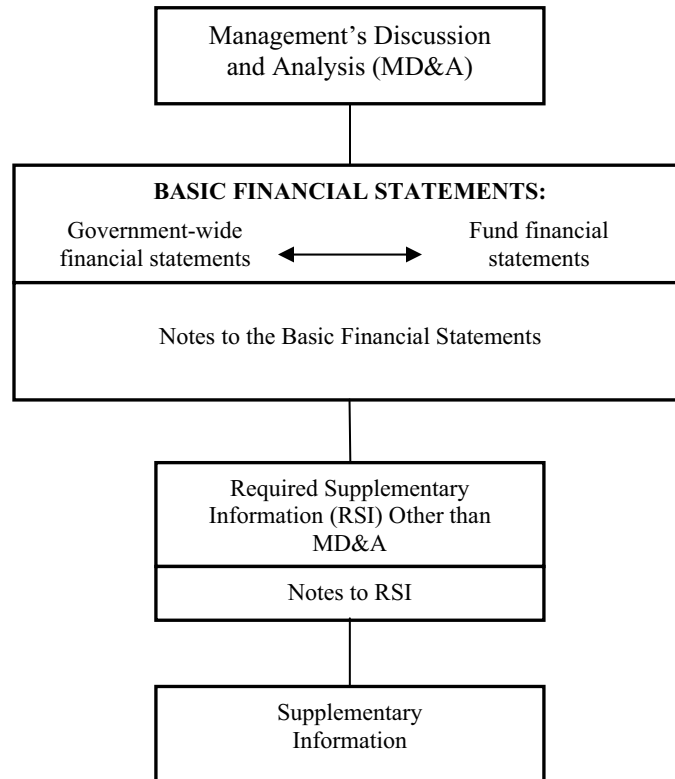
FINANCIAL HIGHLIGHTS

- ❖ The City's net assets totaled \$311.9 million at June 30, 2005, increasing \$14.1 million over June 30, 2004.
- ❖ The City's unrestricted net assets totaled \$25.1 million, which are comprised of \$10.1 million resulting from governmental activities and \$15.0 million resulting from business-type activities.
- ❖ Government-wide current assets totaled \$82.6 million, of which \$55.6 million was attributable to governmental activities and \$27.0 million was attributable to business-type activities; while current liabilities totaled \$64.2 million, with \$49.0 million from governmental activities and \$15.2 million from business-type activities. The ratio of current assets to current liabilities was 1.29 overall - 1.13 for governmental activities and 1.78 for business-type activities.
- ❖ The City's long-term indebtedness at June 30, 2005 (including landfill closure and postclosure care of \$5.4 million and compensated absences of \$7.2 million) totaled \$302.4 million, for an increase of \$3.5 million from the prior year.
- ❖ The City's general revenues and transfers of \$122.7 million were \$14.1 million more than expenses net of program revenues of \$108.6 million. Ninety-six percent of general revenues and transfers were funded through taxes.
- ❖ The General Fund undesignated fund balance increased 35% during the current year to \$25.3 million from \$18.7 million in the prior year.
- ❖ Total net assets for the Public Utility Fund rose 4.7% from \$104.8 million at June 30, 2004 to \$109.8 million at June 30, 2005. This \$5.0 million increase resulted from net income before transfers of \$14.0 million.

FINANCIAL SECTION OF THE 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 manner that provides an answer to 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 net assets. The City's net assets, which is the difference between assets and liabilities, is one way to measure the City's overall financial health and its current financial position. Over time, increases or decreases in the City's net assets are one indicator of whether its financial condition 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 - The City's basic municipal services, such as public safety (police and fire), public works, parks and recreation, and general administration, are reported herein. Property taxes, other local taxes, and state and federal grants finance most of these activities.

Business-type activities - The City charges fees to cover the full cost of services provided to customers. The City's water and sewer system, port facility and economic development fund, waste management services and golf courses are reported herein.

Component units - The City includes four separate legal entities in its report - the School Board, the Parking Authority, the EDA, and the PPIC. Although legally separate, these "component units" are important in that the City is financially accountable for providing operating and capital funding to 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 demonstrate certain tax and grant revenues 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) the inflows and outflows of cash and other financial assets that can readily be converted into cash and (2) the balances remaining at year end that are available for future spending. Consequently, the governmental funds financial 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 financial statements, additional information is provided on the subsequent page of the governmental funds financial statements that explains the relationship (or differences) between these statements. 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 financial 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 business-type activities, but the fund financial statements provide more detailed and additional information, such as cash flows. The City has three major enterprise funds: the Public Utility Fund, the Waste Management Fund 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 and the Information Technology Fund.

Fiduciary funds - The City is the trustee, or fiduciary, for its employees' pension plans and is responsible for the plans' assets, which can be used only to benefit the trust beneficiaries as part of a trust arrangement. 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 in that the City cannot use these assets to finance its operations.

FINANCIAL ANALYSIS OF THE CITY ENTITY

Statements of Net Assets

The following table reflects the condensed Statements of Net Assets:

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2005	2004	2005	2004	2005	2004
Current and other assets	\$ 62	47	27	33	89	80
Capital assets	388	389	175	166	563	555
Total assets	450	436	202	199	652	635
Current and other liabilities	49	35	15	9	64	44
Long-term liabilities	209	218	67	74	276	292
Total liabilities	258	253	82	83	340	336
Net assets:						
Invested in capital assets, net of related debt	176	175	105	96	281	271
Restricted	6	9	-	8	6	17
Unrestricted	10	(1)	15	12	25	11
Total net assets	192	183	120	116	312	299
Total liabilities and net assets	\$ 450	436	202	199	652	635

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 \$312 million at June 30, 2005. By far, the largest portion of the City's net assets, 90%, 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 1.9% of the City's net assets are currently subject to various external restrictions. The remaining balance of unrestricted net assets (\$25 million or 8.3%) may be used to meet the City's ongoing obligations to citizens and creditors.

The net assets of the City's governmental activities increased by \$9 million from \$183 million to \$192 million, as reflected in the Statement of Activities.

The net assets of the City's business-type activities increased by \$5 million from \$115 million to \$120 million, as reflected in the Statement of Activities.

Statements of Activities

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

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2005	2004	2005	2004	2005	2004
Revenues						
<u>Program revenues:</u>						
Charges for services	\$ 16	21	39	33	55	54
Operating grants and contributions	68	66	1	7	69	73
Capital grants and contributions	2	2	-	-	2	2
<u>General revenues:</u>						
Taxes	117	106	-	-	117	106
Other	4	4	1	1	5	5
Total revenues	207	199	41	41	248	240
Expenses						
General government	13	11	-	-	13	11
Nondepartmental	6	5	-	-	6	5
Judicial	16	18	-	-	16	18
Public safety	47	41	-	-	47	41
Public works	28	28	-	-	28	28
Health and welfare	32	29	-	-	32	29
Parks, recreational & cultural	12	12	-	-	12	12
Community development	11	8	-	-	11	8
Education	33	29	-	-	33	29
Public utility	-	-	16	15	16	15
Golf	-	-	2	2	2	2
Waste management	-	-	9	16	9	16
Interest on long-term debt	9	9	-	-	9	9
Total expenses	207	190	27	33	234	223
Transfers	9	1	(9)	(1)	-	-
Change in net assets	9	10	5	7	14	17
Net assets, beginning of year	183	173	115	108	298	282
Net assets, end of year	\$ 192	183	120	115	312	299

Governmental Activities

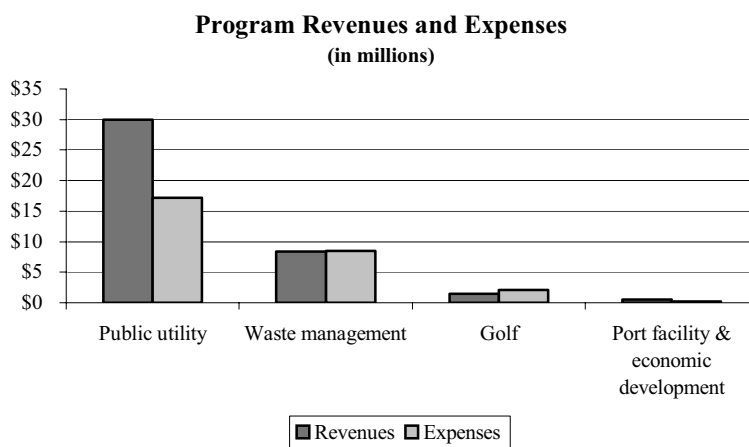
The City's total revenues from governmental activities were \$207 million for the fiscal year ended June 30, 2005. The largest source of revenue is taxes, which represents 57% of the total and is comprised of property taxes, other local taxes, and utility taxes. The City's assessed real property value increased 10% 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 \$86 million. The largest component of program revenues for governmental activities is operating grants and contributions totaling \$68 million, representing 33% of total revenues for governmental activities.

For the fiscal year ended June 30, 2005, expenses for the City's governmental activities totaled \$207 million. The City's expenses cover a wide range of services, with 23% related to public safety, 16% related to education, and 15% related to health and welfare.

Business-Type Activities

The total net assets for business-type activities increased by \$5.0 million, which is due primarily to the \$5.0 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 95% 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 FUNDS

Governmental Funds

The focus of the City's governmental funds is to provide information on current 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, 2005, the governmental funds reflected a combined fund balance of \$39.9 million. The General Fund's fund balance totaled \$29.5 million at June 30, 2005, an increase of \$7.4 million over the prior year. The General Fund's undesignated fund balance totaled \$25.3 million at June 30, 2005, an increase of \$6.6 million over the prior year's undesignated fund balance of \$18.7 million. The increase in the General Fund's fund balance is due primarily to actual expenditures being less than budgeted expenditures.

The City spent \$16.2 million in the Capital Improvements Fund to fund major projects, including the Midtown Corridor redevelopment project and various road improvement projects for Highland Biltmore, Simonsdale Street, and Lee Avenue. The Capital Improvements Fund has a \$1.3 million fund balance at June 30, 2005, all of which is reserved or designated for future capital project costs.

General Fund Budgetary Highlights
General Fund
Fiscal Year Ended June 30, 2005

	Original Budget	Final Budget	Actual
Revenues and Transfers			
Taxes	\$ 116	116	117
Intergovernmental	34	37	35
Other	20	20	22
Total	170	173	174
Expenditures and Transfers			
Expenditures	164	166	159
Transfers	6	7	7
Total	\$ 170	173	166

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 above the final budgeted revenues by \$1 million during fiscal year 2005. Actual General Fund expenditures and transfers to other funds were \$7 million less than the final budget.

During fiscal year 2005, City Council approved supplemental appropriation ordinances, amending the original budget, for the following purposes:

- To appropriate \$335,931 in additional state funds received for street and highway maintenance;
- To appropriate \$1,137,448 for FEMA reimbursement, of which \$434,800 represented a transfer to the Waste Management Fund;
- To appropriate \$437,987 for technology improvements, workplace improvements, and debt service; and
- To appropriate \$936,486 for a joint Financial System with Portsmouth Public Schools.

Proprietary Funds

Total net assets of the Public Utility Fund increased \$5.0 million during fiscal year 2005 from \$104.8 million to \$109.8 million. Of the total net assets, \$93.3 million is invested in capital assets, net of related debt. Unrestricted net assets totaled \$16.5 million, an increase of \$.3 million from the prior year. The increase in net assets is due primarily to the fund's net income before transfers of \$14.0 million.

Beginning net assets of the Golf Fund were restated by \$900,000 during fiscal year 2005 to correct an overstatement of a gain recorded in fiscal year 2002. More detailed information about this restatement is presented in Note 18 to the basic financial statements. Total net assets of the Golf Fund remained substantially unchanged during fiscal year 2005 at \$5.9 million. Of the total net assets, \$4.1 million is invested in capital assets, net of related debt. Unrestricted net assets totaled \$1.8 million, an increase from the deficit of \$.7 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, 2005 decreased \$.1 million during fiscal year 2005 from \$1.3 million to \$1.2 million. Of the total net assets, \$5.1 million is invested in capital assets, net of related debt, and there is an unrestricted net assets deficit of \$3.9 million. The deficit in unrestricted net assets is primarily the result of the long-term landfill closure and post closure care liability of \$5.4 million, which is currently unfunded.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of fiscal year 2005, the City had invested \$563.2 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, 2005 (in millions)			
	Governmental Activities	Business-Type Activities	Total Primary Government
Land	24	15	39
Site improvements	1	-	1
Infrastructure	166	-	166
Buildings	121	2	123
Improvements other than buildings	-	90	90
Machinery, furniture and equipment	14	5	19
Construction in progress	62	63	125
Total	388	175	563

Major capital asset activity for the fiscal year ended June 30, 2005 included:

- Capital asset additions for governmental activities totaled \$28.5 million, including \$15.0 million for construction in progress and \$3.9 million from capital lease proceeds.
- Capital asset additions for business-type activities totaled \$13.7 million, including \$11 million for construction in progress.
- Depreciation expense totaled \$18.7 million and \$3.9 million for governmental and business-type activities, respectively.
- Construction in progress totaled \$62.4 million for governmental activities at June 30, 2005 (including certain school projects under construction).
- Construction in progress totaled \$63.1 million for business-type activities at June 30, 2005.

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

The City's fiscal year 2006 capital budget estimates spending another \$29.8 million for capital projects, including \$6.7 million for schools, \$9.9 million for water and sewer improvements, and \$6.6 million for municipal facilities. The City issued additional debt in the fall of 2005 to finance these capital projects.

Long-term Debt

At year-end, the City had \$290.0 million in outstanding debt, excluding landfill closure and post closure costs, and compensated absences. General obligation and revenue bonds outstanding represented \$184.7 million of this total, as reflected in the following schedule:

	Governmental		Business-Type		Total Primary	
	Activities		Activities		Government	
	2005	2004	2005	2004	2005	2004
General obligation and revenue bonds	120	122	65	68	185	190
General obligation notes payable	8	8	-	3	8	11
Obligations under capital leases	23	22	1	1	24	23
Obligations under cooperation agreements	51	53	-	-	51	53
Bond anticipation note	12	5	6	-	18	5
Literary loans	4	5	-	-	4	5
Total	218	215	72	72	290	287

On July 15, 2004, the Economic Development Authority of the City of Portsmouth issued its \$4,665,000 Lease Revenue Bond Series 2004 with a discount of \$49,926 through the Industrial Development Authority of the County of Stafford and the City of Staunton, Virginia as part of the Virginia Municipal League/Virginia Association of Counties (VML/VACO) Finance Program.

On October 29, 2004, the City extended the maturity on its \$15,800,000 General Obligation Bond Anticipation Note and on its \$2,000,000 General Obligation Taxable Bond Anticipation Note until October 31, 2005.

On April 30, 2004 the City entered into a Master Lease agreement totaling \$24 million to provide funds to finance the cost to acquire various types of equipment. During the fiscal year ending June 30, 2005, the total amount of equipment acquired through lease purchase financing was \$4,479,068. More detailed information about the City's long-term liabilities is presented in Notes 5 and 19 to the basic financial statements.

The state limits the amount of general obligation debt the City can legally 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.

More detailed information about the City's long-term liabilities is presented in Notes 5 and 19 to the basic financial statements.

ECONOMIC FACTORS

The City's unemployment rate for July 2005 was 6.1%, which compares to the national unemployment rate of 5.2% for July 2005. Per capita income as of December 31, 2003 was \$25,171, an increase of 6% over the previous year.

The fiscal year 2006 capital budget includes partial funding for several phased, multi-year projects to include funds for the Downtown Master Plan, Waterfront Hot Spots Development Study, Downtown Parking Strategy and Downtown Rezoning Plan. This budget also supports the Pinner's Point connector, an economic development project having a major impact on the City. The connector is a vital transportation link that will allow the ongoing enhancement of the City as a world-class maritime center.

FINANCIAL INQUIRIES

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.