

CITY OF NEWPORT NEWS, VIRGINIA

Management's Discussion and Analysis

The following is a narrative overview and analysis of the financial activities of the City of Newport News, Virginia (the City) as of and for the fiscal year ended June 30, 2004. This discussion and analysis is intended to serve as an introduction to the City's basic financial statements, which have the following components: (1) management's discussion and analysis (MD&A), (2) government-wide financial statements, (3) fund financial statements, and (4) notes to the financial statements.

FINANCIAL HIGHLIGHTS FOR FISCAL YEAR (FY) 2004

- The assets of the City, on a government-wide basis excluding component units and business-type activities, exceeded its liabilities at the close of the FY 2004 by \$195.7 million (*net assets*). Of this amount, \$35.4 million is unrestricted.
- At the close of the current fiscal year, the City's governmental funds reported combined ending fund balances at \$117.6 million, an increase of \$8.1 million in comparison with the prior year. Approximately 85%, or \$100.3 million of this amount is unreserved.
- The General Fund, on a current financial resources basis, reported a deficiency of revenues and other financing sources under expenditures and other financing uses of \$0.7 million. The City's operations were in line with the budget.
- At the end of the current fiscal year, the undesignated fund balance for the General Fund was \$30 million, or 10.2% of total General Fund expenditures.
- The City's total bonded debt increased by approximately \$2.1 million during the current fiscal year, due to the issuance of \$99.6 million of General Obligation Bonds (\$71.6 million to refinance existing debt) and scheduled repayment of principal of \$25.9 million.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to the City's basic financial statements. The City's basic financial statements comprise three components: *government-wide financial statements, fund financial statements, and notes to the financial statements*. This report also contains other supplementary information in addition to the basic financial statements themselves.

- The first two statements are government-wide financial statements that provide both long-term and short-term information about the City's overall financial status.
- The remaining statements are fund financial statements that focus on individual parts of the City's government, reporting the City's operations in more detail than the government-wide statements.
 - *Governmental fund* statements tell how general government services like public safety were financed in the short term as well as what amounts remain for future spending.
 - *Proprietary fund* statements offer short- and long-term financial information about the activities the government operates like businesses, such as the public utilities (water) system.
 - *Fiduciary fund* statements provide information about the financial relationships in which the City acts solely as a trustee or agent for the benefit of others, to whom the resources in question belong.

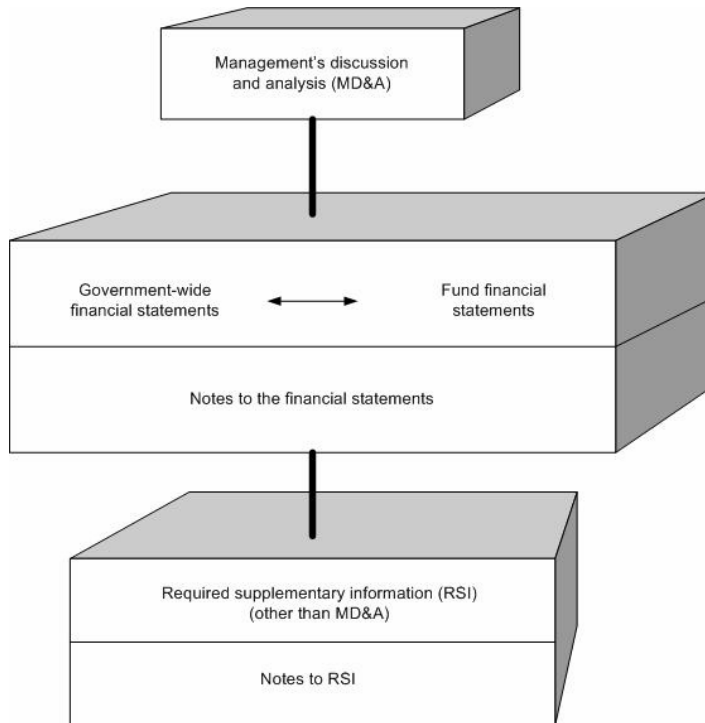
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The financial statements also include *notes* that explain some of the information in the financial statements and provide more detailed data. The statements are followed by a section of required supplementary information that further explains and supports the information in the financial statements. Figure A shows how the required parts of this Management's Discussion and Analysis and the City's basic financial statements are arranged and relate to one another.

Figure A

Required Components of Newport News' Financial Statements



In the past, the primary focus of local government financial statements has been summarized fund type information on a current financial resources basis. However, with the implementation of Statement No. 34 of the Governmental Accounting Standards Board (GASB Statement No. 34) for June 30, 2002, the new focus is on both the City as a whole (government-wide) and the fund financial statements. Each view provides a different snapshot of the City's finances. The government-wide financial statements, which were new for fiscal year 2002, provide both long-term and short-term information about the City's overall financial status. The fund financial statements, which have been provided in the past, 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 (year-to-year or government-to-government) and enhance the City's accountability.

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Government-Wide Statements

The government-wide statements report information about the City as a whole using accounting methods similar to those used by private-sector companies. The Statement of Net Assets and the Statement of Activities, which are the government-wide statements, include all of the government's 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 government-wide statements report the City's net assets and how they have changed. Net assets—the difference between the City's 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 an indicator of whether its financial health is improving or deteriorating. Other non-financial factors, such as changes in the City's property tax base and the condition of the City's roads and other infrastructure, may need to be considered to assess the overall health of the City.

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

- *Governmental activities* – Most of the City's basic services are included here, such as the police, fire, public works, parks, and general administration. Taxes, state and federal grants finance most of these activities.
- *Business-type activities* – The City charges fees to customers to help cover the costs of certain services it provides. The City's water and parking facilities are included here.
- *Component units* – The City includes three separate legal entities in its report - the Peninsula Airport Commission, the Economic and Industrial Development Authorities, and the Newport News Public Schools. Although legally separate, these "component units" are important because the City is financially accountable for them, and provides operating funding.

Fund Financial Statements

The format of the fund financial statements will be more familiar to traditional users of government financial statements. The fund financial statements provide more detailed information about the City's most significant funds, not the City as a whole. Funds are accounting mechanisms 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; City Council establishes other funds to control and manage money for particular purposes or to show that it is properly using certain taxes and grants.

The City has three kinds 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 remaining at year-end that are available for spending. Consequently, the governmental fund 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 a subsequent page that explains the relationship (or differences) between the government-wide and fund statements.

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- *Proprietary funds* – The City maintains two different types of proprietary funds. (1) Enterprise funds are used to report the same functions presented as business-type activities in the government-wide financial statements. Enterprise funds include the Public Utility Fund and the Parking Authority Fund. (2) Internal service funds are an accounting device used to accumulate and allocate costs internally among the City's various functions. The City uses internal service funds to account for the operation of vehicles and equipment.
- *Fiduciary fund* – The City is the trustee, or fiduciary, for certain donated funds. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The City is responsible for ensuring that the assets reported in this fund are used for their intended purpose. The fiduciary funds include the Pension Trust Fund and Agency Funds. These activities are reported in a separate statement of fiduciary net assets. The City excludes this activity from its government-wide financial statements because the City cannot use these assets to finance its operations.

The Total Governmental Funds column requires reconciliation because of the different measurement focus from the government-wide statements (current financial resources versus total economic resources) which is reflected on the page following each statement. The flow of current financial resources will reflect bond proceeds and interfund transfers as other financing sources as well as capital expenditures and bond principal payments as expenditures. The reconciliation will eliminate these transactions and incorporate the capital assets and long-term obligations (bonds and others) into the Governmental Activities column (in the government-wide statements).

Notes to the Basic Financial Statements

The notes to the financial statements provide additional information that is essential for a full understanding of the information provided in the government-wide and fund financial statements. The notes also present certain required supplementary information concerning the City's progress in funding its obligation to provide pension benefits to its employees.

FINANCIAL ANALYSIS OF THE CITY AS A WHOLE

This is the second year that the City has presented its financial statements under the new reporting model required by GASB Statement No. 34. This reporting model changes significantly both the recording and presentation of financial data. Prior year information is shown in a comparative analysis of government-wide information.

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Statement of Net Assets

The following table reflects the condensed net assets:

Table 1 - Summary of Net Assets (in millions):

	Governmental Activities		Business-Type Activities		Total Primary Government	
	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>
Current and other assets	\$ 135.6	146.4	50.5	50.2	186.1	196.6
Capital assets, net (restated)	536.1	534.0	393.7	402.9	929.8	936.9
Total assets	<u>\$ 671.7</u>	<u>680.4</u>	<u>444.2</u>	<u>453.1</u>	<u>1,115.9</u>	<u>1,133.5</u>
Current and other liabilities	\$ 24.2	26.5	14.7	15.4	38.9	41.9
Long-term liabilities	441.7	458.2	192.0	185.6	633.7	643.8
Total liabilities	<u>465.9</u>	<u>484.7</u>	<u>206.7</u>	<u>201.0</u>	<u>672.6</u>	<u>685.7</u>
Net assets:						
Invested in capital assets, net of related debt	131.6	126.3	204.7	224.9	336.3	351.2
Restricted net assets	28.9	34.0	23.4	17.0	52.3	51.0
Unrestricted net assets	<u>45.3</u>	<u>35.4</u>	<u>9.4</u>	<u>10.2</u>	<u>54.7</u>	<u>45.6</u>
Total net assets	<u>205.8</u>	<u>195.7</u>	<u>237.5</u>	<u>252.1</u>	<u>443.3</u>	<u>447.8</u>
Total liabilities and net assets	<u>\$ 671.7</u>	<u>680.4</u>	<u>444.2</u>	<u>453.1</u>	<u>1,115.9</u>	<u>1,133.5</u>

Net assets (assets over liabilities) may serve over time as a useful indicator of a government's financial position. In the case of the City, assets exceeded liabilities by \$447.8 million at the close of fiscal year 2004. By far the largest portion of the City's net assets (78%) reflects its investment in capital assets (e.g., land, buildings, equipment, infrastructure), less accumulated depreciation and less any related outstanding 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. Although the City's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

Approximately 11% of the City's net assets are subject to external restrictions. The remaining balance of unrestricted net assets (\$45.6 million or 10%) may be used to meet the City's ongoing obligations to citizens and creditors.

Governmental Activities

Net assets of the City's governmental activities decreased from \$204.1 million at June 30, 2003 to \$195.7 million at June 30, 2004 as a result of the decrease in net assets of \$8.4 million as shown on the Statement of Activities.

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Business-Type Activities

The net assets of the City's business-type activities increased from \$237.5 million to \$252.1 million. 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 enterprise operations, which include the Public Utility and Parking Authority Funds.

Statement of Activities

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

Table 2 - Changes in Net Assets (in millions):

	<u>Governmental Activities</u>		<u>Business-Type Activities</u>		<u>Total Primary Government</u>	
	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>
Revenues:						
Program revenues:						
Charges for services	\$ 43.3	45.9	59.6	63.9	102.9	109.8
Operating grants and contributions	47.6	49.5	-		47.6	49.5
Capital grants and contributions	1.0	13.7	-		1.0	13.7
General revenues:						
Property taxes	154.6	159.8	-		154.6	159.8
Other taxes	74.8	80.1	-		74.8	80.1
Grants and contributions not restricted to specific programs	40.3	39.5	-		40.3	39.5
Investment earnings	3.0	4.2	0.4	0.3	3.4	4.5
Miscellaneous	4.4	5.8	5.2	4.8	9.6	10.6
Total revenues	<u>369.0</u>	<u>398.5</u>	<u>65.2</u>	<u>69.0</u>	<u>434.2</u>	<u>467.5</u>
Expenses:						
General government	57.1	75.7	-	-	57.1	75.7
Judicial administration	4.8	5.3	-	-	4.8	5.3
Public safety	77.9	87.9	-	-	77.9	87.9
Public works	46.4	49.3	-	-	46.4	49.3
Health and welfare	47.7	51.6	-	-	47.7	51.6
Education	92.2	95.8	-	-	92.2	95.8
Parks, recreation and culture	24.9	26.4	-	-	24.9	26.4
Community development	7.2	6.6	-	-	7.2	6.6
Public Utility	-	-	44.7	45.0	44.7	45.0
Parking Authority	-	-	0.3	0.3	0.3	0.3
Interest on long-term debt	18.4	19.1	-	-	18.4	19.1
Total expenses	<u>376.6</u>	<u>417.7</u>	<u>45.0</u>	<u>45.3</u>	<u>421.6</u>	<u>463.0</u>
Excess (deficiency) before transfers	(7.6)	(19.2)	20.2	23.7	12.6	4.5
Transfers	8.9	9.1	(8.9)	(9.1)	-	-
Increase (decrease) in net assets	1.3	(10.1)	11.3	14.6	12.6	4.5
Beginning Net Assets, as restated	195.2	205.8	226.2	237.5	421.4	443.3
Ending Net Assets	<u>\$ 196.5</u>	<u>195.7</u>	<u>237.5</u>	<u>252.1</u>	<u>434.0</u>	<u>447.8</u>

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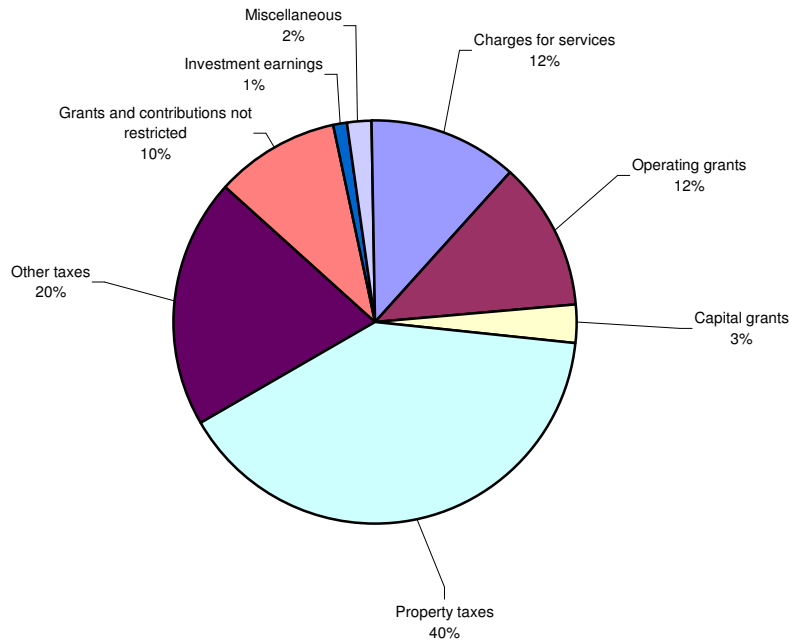
Governmental Activities

The City's total revenues from governmental activities were \$398.5 million for the fiscal year ended June 30, 2004. The largest source of revenue (\$159.8 million for fiscal year 2004) for the City is property taxes, composed of real estate and personal property taxes. The City's assessed real property tax base for fiscal year 2004 increased 6%. The City maintained the same real estate tax rate (\$1.27 per \$100 of assessed value) from 2003 to 2004.

Approximately 60% of the City's revenue from governmental activities comes from some type of tax, and 12% comes from fees charged for services.

The City's expenses cover a wide range of services, with 21%, or \$87.9 million for fiscal year 2004 related to public safety and 23%, or \$95.8 million for fiscal year 2004 for education (payments to the Public Schools, a component unit). The total decrease in net assets of \$10.1 million for governmental activities resulted partially from the recognition of pension obligation of \$10.5 million.

Revenues by Source – Governmental Activities



Business-Type Activities

Net assets for the City's business-type activities increased by \$14.6 million largely as a result of assets deeded over by developers. Charges for services, including water and parking fees, make up 93% of total revenues for business-type activities.

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FINANCIAL ANALYSIS OF THE CITY'S FUNDS

The City of Newport News uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

General Fund

The General Fund is the chief operating fund of the City. At the end of the current fiscal year, unreserved fund balance was \$73.4 million of which \$30.0 million represents undesignated fund balance of the General Fund. As a measure of the general fund's liquidity, it may be useful to compare both unreserved fund balance and total fund balance to total fund expenditures. Unreserved fund balances represent 25% of the total fund expenditures, while total fund balance represents 27% of that same amount.

Debt Service Fund

The debt service fund has a fund balance of \$2.5 million. During the current fiscal year, the net change in fund balance of \$0.02 million is a net result of bonds refunded.

Bond Fund

The bond fund accounts for the proceeds of all general obligation bond issues except those of the Proprietary Funds. At the end of the current fiscal year, the bond fund balance has a balance of \$20.0 million, resulting from recent bond proceeds.

Proprietary Funds

The City's proprietary fund statements provide the same type of information found in the government-wide financial statements, but in more detail.

Restricted net assets of the Public Utility Enterprise Fund at the end of the year amounted to \$16.7 million. Growth in net assets was \$14.6 million, resulting mainly from connection fees in the amount of \$3.5 million and an increase from operations of \$24 million.

The Parking Authority had \$0.2 million in restricted net assets at June 30, 2004.

GENERAL FUND BUDGETARY HIGHLIGHTS

General Fund (Budget Basis)

Fiscal Year 2004

	<u>Original Budget</u>	<u>Amended Budget</u>	<u>Actual</u>
Revenues:			
Taxes	\$ 239,673,894	239,673,894	240,006,709
Intergovernmental	37,969,395	38,110,349	39,206,291
Other	43,000,523	43,000,523	41,560,483
Total	<u>320,643,812</u>	<u>320,784,766</u>	<u>320,773,483</u>
Expenditures and Transfers:			
Expenditures	309,893,702	300,430,670	297,167,295
Transfers out	26,832,190	29,358,131	27,485,323
Total	<u>336,725,892</u>	<u>329,788,801</u>	<u>324,652,618</u>
Change in fund balance	<u>\$ (16,082,080)</u>	<u>(9,004,035)</u>	<u>(3,879,135)</u>

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The difference between the original budget and the final amended budget for the City's General Fund expenditures was approximately \$6.9 million (decrease in appropriations). Although it appears there has been a significant decrease from the original budget, the variance is mainly due to the accounting of special revenue funds:

- \$9.8 million reduced appropriation for street maintenance due to same appropriation adopted in the special revenue funds
- \$2.9 additional funding as follows:
 - \$1.4 million Vehicle Equipment Replacement Lease
 - \$0.9 million Capital Project Improvements
 - \$0.6 million Public Works Asphalt and Paving

Actual total revenues fell slightly below the amended budget by a difference of approximately \$11,000. Expenditures and transfers out were below budget by \$5.1 million. This positive budget variance helped to partially offset the planned use of undesignated fund balance.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

The City's investment in capital assets for its governmental and business-type activities as of June 30, 2004 amounts to \$937 million (net of depreciation). This investment includes land, buildings and improvements, drainage and water/sewer systems, machinery and equipment, roads, bridges, and construction in progress.

Major capital asset events during the fiscal year included the following:

- Construction in progress totaled \$31.5 million for governmental activities at the end of the fiscal year (including certain Public Schools projects under construction).
- Construction in progress totaled \$113.5 million for business-type activities at the end of the fiscal year and relates to the following projects: regional raw water supply costs, Lee Hall Treatment Plant modifications, Lee Hall Operations and Maintenance Center costs, Harwoods Mill Dam Spillway improvements and Colonial Pipeline.

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City of Newport News' Capital Assets (net of depreciation):

	Governmental		Business-Type		Total	
	Activities		Activities			
	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>
Land	\$ 74,969,669	74,856,232	5,858,724	6,393,724	80,828,393	81,249,956
Construction in progress	43,646,988	31,469,492	102,830,006	113,516,518	146,476,994	144,986,010
Buildings	182,198,739	197,603,054	15,328,049	15,315,183	197,526,788	212,918,237
Water systems	-	-	261,714,715	259,984,606	261,714,715	259,984,606
Improvements	52,674,732	53,817,809	1,894,394	1,753,884	54,569,126	55,571,693
Machinery and equipment	35,080,291	31,829,526	6,126,338	5,903,263	41,206,629	37,732,789
Infrastructure	147,534,815	144,432,288	-	-	147,534,815	144,432,288
Total	\$ 536,105,234	534,008,401	393,752,226	402,867,178	929,857,460	936,875,579

Additional information on the City's capital assets can be found in note 4 to the basic financial statements.

Long-Term Debt

At the end of the current fiscal year, the City had total bonded debt outstanding (including literary loans) of \$581,492,178. Capital leases, landfill liability, accrued vacation and claims payable are not included in these figures.

City of Newport News' Outstanding Debt, General Obligation Bonds and Literary Loans (in millions):

	Governmental		Business-Type		Total	
	Activities		Activities			
	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>
General obligation bonds	\$ 397.1	399.2	189.1	178.0	586.2	577.2
Literary loans	4.9	4.2	-	-	4.9	4.2
Total	402.0	403.4	189.1	178.0	591.1	581.4

At year end the City had \$581 million in bonds and loans outstanding, a decrease of 2% over last year, as shown in the above table.

New debt resulted mainly from issuing general obligation bonds and refunding bonds totaling \$97.2 million and \$0.7 million of for water systems improvements. Refunding bonds were issued as part of the new debt in order to improve cash flow and to take advantage of lower interest rates. The City management decided to refinance \$112.0 million (\$70.5 million of three general obligation issues and \$41.5 million of Public Utilities Bond) by issuing refunding bonds. The advance refunding resulted in a cash flow savings from fiscal years 2004 – 2020 totaling \$4.4 million.

The City maintains an Aa rating from Standard & Poor's Corporation. Under Moody's Investors Service, the City maintains an Aa2 rating.

Additional information on the City's long-term debt can be found in Note 7 to the basic financial statements.

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ECONOMIC FACTORS AND NEXT YEAR'S BUDGETS

The unemployment rate in June 2004 for the City of Newport News was 5.2%, which is an increase from the average for 2003 of 4.9%.

The City's annual population growth rate has remained stable over the last two years, from approximately 181,640 at the end of fiscal year 2003 to 185,200 at the end of fiscal year 2004.

The combined new construction value for residential and commercial decreased by 47% from the prior year.

The Commonwealth of Virginia budget shortfall will have a direct impact on revenues in support of City programs. Effective July 1, 2002, the City increased its real estate tax from \$1.24 to \$1.27 per \$100 of assessed value.

All of these factors were considered in preparing the City's budget for the 2004 fiscal year.

CONTACTING THE CITY'S FINANCIAL MANAGEMENT

This financial report is designed to provide citizens, taxpayers, customers, investors, and creditors with a general overview of the City's finances and to demonstrate the City's accountability for the funds it receives. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Director of Finance, 2400 Washington Avenue, Newport News, Virginia 23607.