

Management's Discussion and Analysis

As management of the City of Annapolis (the City), we offer readers of the City's basic financial statements this narrative overview and analysis of the financial activities of the City for the fiscal year ended June 30, 2011. We encourage readers to consider the information presented here in conjunction with the additional information that we have furnished in our letter of transmittal, which can be found on pages 1-4 of this report.

Financial Highlights

- The assets of the City exceeded its liabilities at the close of the most recent fiscal year by \$25,599,779 (*net assets*).
- The City's total net assets decreased by \$7,778,661. This decrease is attributable to escalating costs of services, and the City's unfunded annual required contribution for other post employment benefits and net pension obligation. Governmental activities saw a decrease by \$4,673,899 and business-type activities saw a decrease of \$3,104,762 net pension obligation.
- As of the close of the current fiscal year, the City's governmental funds reported a combined ending fund balance of \$16,231,706 an increase of \$7,574,599 in comparison with the prior year.
- The City's total net debt increased by \$1,616,861 through new debt issues and restructuring with a net of \$3,232,219, and normal principal payments to a year end balance of \$86,848,401, which is below the City's legal debt limit.

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 of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

Government-wide financial statements. The *government-wide financial statement* is designed to provide readers with a broad overview of the City's finances, in a manner similar to a private-sector business.

The *statement of net assets* presents information on all of the City's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the City is improving or deteriorating.

The *statement of activities* presents information showing how the City's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned and unused vacation leave).

Both of the government-wide financial statements distinguish functions of the City that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the City include general government, public safety, public works, community services, and community development. The business-type activities of the City include the water and sewer utilities, parking facilities, dock, market house, transportation, stormwater management, and refuse collection services.

The government-wide financial statements include only the City of Annapolis. The City does not have any *component units* to report. The government-wide financial statements can be found on pages 19-21 of this report.

Fund financial statements. A *fund* is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the City can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental funds. *Governmental funds* is used to account for essentially the same functions reported as *governmental activities* in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for *governmental activities* in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the City's near term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

The City maintains three individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for the general fund, capital projects fund, and special revenue fund, all of which are considered to be major funds.

The City adopts an annual appropriated budget for its general fund. A budgetary comparison statement has been provided to demonstrate compliance with this budget.

The governmental fund financial statements can be found on pages 22-24 of this report.

Proprietary funds. The City maintains eight different types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide financial statements. The City uses enterprise funds to account for its water and sewer utilities, parking facilities, dock, market house, transportation, stormwater management, and refuse collection services. *Internal service funds* are an accounting device used to accumulate and allocate costs internally for the City's self insurance activities. Because these services predominately benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for five of eight enterprise funds, which are considered to be major funds of the City and the remaining three funds are combined into a single, aggregated presentation. Individual fund data for the enterprise funds is provided in the form of *combining statements* elsewhere in this report. The internal service fund is presented in the proprietary fund financial statements. The proprietary fund financial statements can be found on pages 26-31 of this report.

Fiduciary funds. Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are *not* reflected in the government-wide financial statement because the resources of those funds are *not* available to support the City's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. The City uses a fiduciary fund to account for the police and fire pension plan. The fiduciary fund financial statements can be found on pages 32-33 of this report.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 35-61 of this report.

Other information. In addition to the basic financial statements and the accompanying notes, this report also presents certain *required supplementary information*, concerning the City's progress in funding its obligation to provide pension benefits to its police and fire employees. Required supplementary information can be found on page 62 of this report.

The combining statements referred to earlier in connection with non-major enterprise funds are presented immediately following the required supplementary information on pensions. Combining and individual fund statements and schedules can be found on pages 63-94 of this report.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the City, assets exceeded liabilities by \$25,599,779 at the close of the most recent fiscal year.

By far the largest portion of the City's net assets reflects its investment in capital assets (e.g., land, buildings, machinery, and equipment); less any related debt used to acquire those assets that is still outstanding. The City uses those capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the City's investment in its capital assets is reported net of related debt, it should be noted that resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities. The amounts for FY 2010 are presented as restated.

City of Annapolis Net Assets

	Governmental Activities		Business-type Activities		Total	
	FY2011	FY2010	FY2011	FY2010	FY2011	FY2010
Current assets	\$38,351,670	\$22,641,337	(\$13,277,558)	(\$12,945,969)	\$25,074,112	\$9,695,368
Noncurrent assets:						
Restricted water and sewer capital facility assessments	-	-	9,115,660	9,614,835	9,115,660	9,614,835
Net capital assets	79,853,227	80,741,973	60,779,123	62,783,834	140,632,350	143,525,807
Total noncurrent assets	79,853,227	80,741,973	69,894,783	72,398,669	149,748,010	153,140,642
Total assets	118,204,897	103,383,310	56,617,225	59,452,700	174,822,122	162,836,010
Current liabilities	25,222,929	19,364,351	4,277,552	5,607,791	29,500,481	24,972,142
Noncurrent liabilities	80,928,007	67,291,099	38,793,855	37,194,329	119,721,862	104,485,428
Total liabilities	106,150,936	86,655,450	43,071,407	42,802,120	149,222,343	129,457,570
Net assets:						
Invested in capital assets, net of related debt	22,408,170	29,665,999	35,243,832	37,003,541	57,652,002	66,669,540
Restricted	4,190,198	4,882,031	3,610,180	3,493,242	7,800,378	8,375,273
Unrestricted	(14,544,407)	(17,820,170)	(25,308,194)	(23,846,203)	(39,852,601)	(41,666,373)
Total net assets	\$12,053,961	\$16,727,860	\$13,545,818	\$16,650,580	\$25,599,779	\$33,378,440

The balance of *unrestricted net assets* normally may be used to meet the City's ongoing obligations to citizens and creditors.

At the end of the current fiscal year, the City is able to report a positive total net assets balance for the government as a whole as well as for its separate governmental activities and business-type activities. For its governmental activities and business-type activities, the unrestricted portion of net assets has a negative balance in the current year due to escalating costs and under funding of net pension obligation (NPO) and other post employment benefits (OPEB). The City is evaluating different ways to offset these decreases going forward.

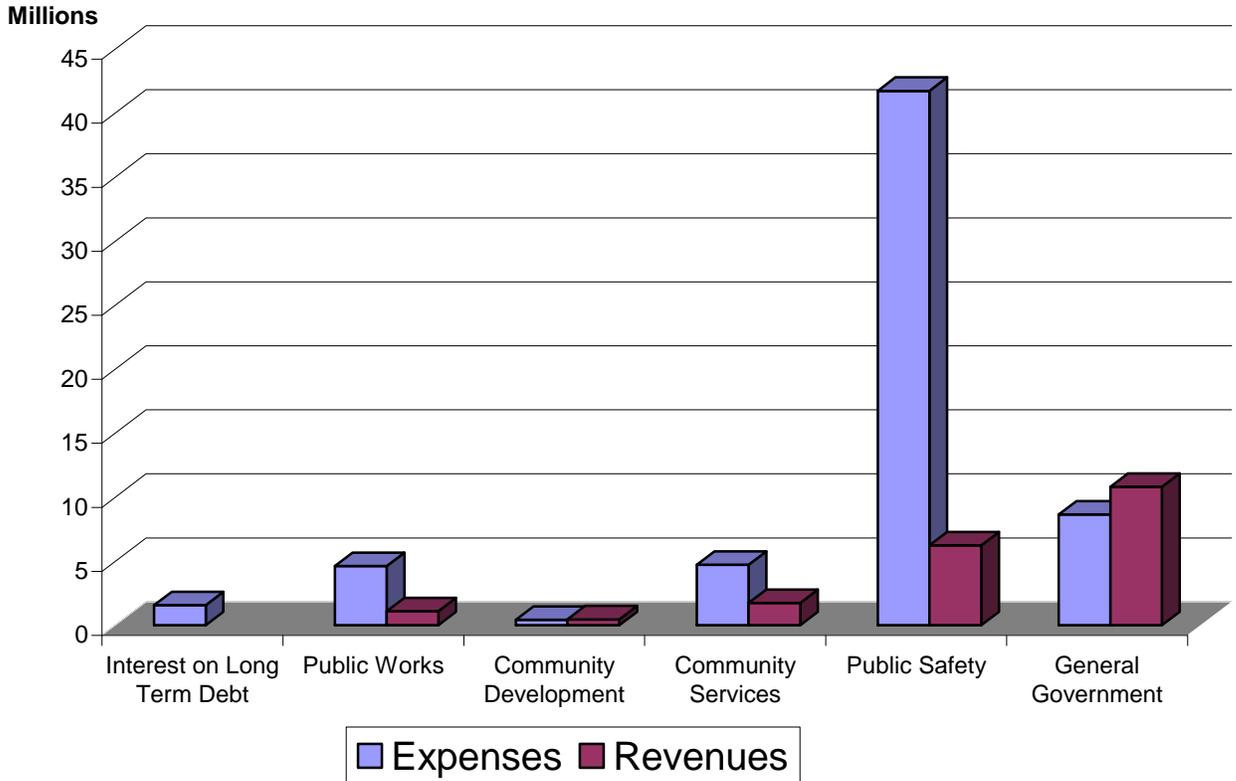
**City of Annapolis
Changes in Net Assets**

	Governmental Activities		Business-type Activities		Total	
	FY2011	FY2010	FY2011	FY2010	FY2011	FY2010 (As Restated)
Revenues:						
Program revenues:						
Charges for services	\$8,686,595	\$7,246,550	\$17,294,912	\$17,160,981	\$25,981,507	\$24,407,531
Operating grants and contributions	11,524,253	13,319,721	1,526,800	1,378,198	13,051,053	14,697,919
Capital grants and contributions	190,892	344,667	334,290	1,808,382	525,182	2,153,049
General revenues:						
Property taxes	35,335,848	34,681,916	-	-	35,335,848	34,681,916
Other	708,262	337,613	2,146,880	1,737,238	2,855,142	2,074,851
Total revenues	<u>56,445,850</u>	<u>55,930,467</u>	<u>21,302,882</u>	<u>22,084,799</u>	<u>77,748,732</u>	<u>78,015,266</u>
Expenses:						
General government	8,664,250	14,756,325	-	-	8,664,250	14,756,325
Public safety	41,748,358	40,104,232	-	-	41,748,358	40,104,232
Community services	4,720,789	2,215,107	-	-	4,720,789	2,215,107
Community development	439,922	979,789	-	-	439,922	979,789
Public works	4,638,091	9,315,202	-	-	4,638,091	9,315,202
Interest	1,572,589	2,312,840	-	1,161,665	1,572,589	3,474,505
Water	-	-	4,961,399	4,990,021	4,961,399	4,990,021
Sewer	-	-	6,696,317	6,859,636	6,696,317	6,859,636
Off street parking	-	-	2,701,164	1,962,161	2,701,164	1,962,161
Transportation	-	-	4,784,164	6,358,322	4,784,164	6,358,322
Other	-	-	4,600,350	6,045,545	4,600,350	6,045,545
Total expenses	<u>61,783,999</u>	<u>69,683,495</u>	<u>23,743,394</u>	<u>27,377,350</u>	<u>85,527,393</u>	<u>97,060,845</u>
Changes in net assets before transfers	(5,338,149)	(13,753,028)	(2,440,512)	(5,292,551)	(7,778,661)	(19,045,579)
Transfers	664,250	1,105,040	(664,250)	(1,105,040)	-	-
Change in net assets	<u>(4,673,899)</u>	<u>(12,647,988)</u>	<u>(3,104,762)</u>	<u>(6,397,591)</u>	<u>(7,778,661)</u>	<u>(19,045,579)</u>
Net assets at beginning of year	<u>16,727,860</u>	<u>29,375,848</u>	<u>16,650,580</u>	<u>23,048,171</u>	<u>33,378,440</u>	<u>52,424,019</u>
Net assets at end of year	<u>\$12,053,961</u>	<u>\$16,727,860</u>	<u>\$13,545,818</u>	<u>\$16,650,580</u>	<u>\$25,599,779</u>	<u>\$33,378,440</u>

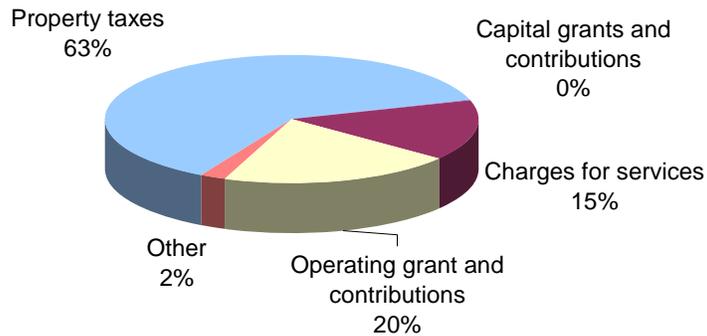
Governmental activities. Governmental activities decreased the City's net assets by \$4,673,899. Key elements of this net decrease are as follows:

- Property taxes increased by only \$653,932 (1.8 percent) during the year. This increase is the result of a minimal rise in assessed values from new growth, rather than from assessments.
- The City modified its allocation policy for expenses related to public works and general government, thus leaving the respective differences.
- Included in expenses are unfunded net pension obligation and other post employment benefits costs of approximately \$6.1million and \$4.6 million respectively. The City cut various costs and various personnel positions to offset the increase caused by OPEB as well as decline in revenues. Other factors such as the continued recession contributed to the overall decrease in both revenues and expenses.

Expenses and Program Revenues - Governmental Activities
For the year ended June 30, 2011



Revenues by Source - Governmental Activities
For the year ended June 30, 2011



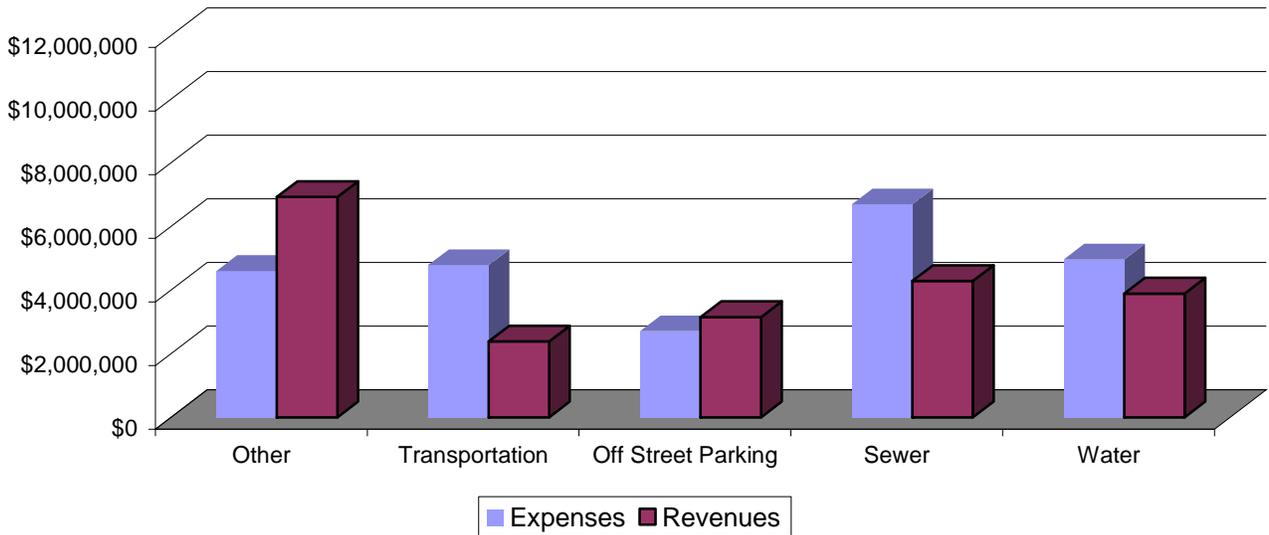
Business-type activities. Business-type activities net assets decreased by \$3,104,762. The key elements of this decrease were the increase in expenditures for the waste water treatment plant, the net affect of transfers, and unfunded other post employment benefits.

Financial Analysis of the Government's Funds

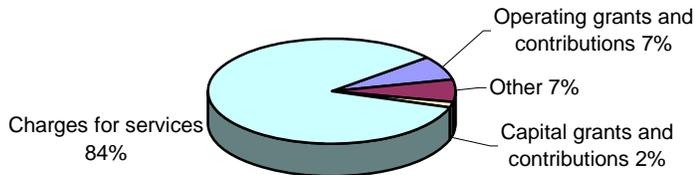
As noted earlier, the City uses fund accounting to ensure and demonstrate compliance with finance related legal requirements.

Governmental funds. The focus of the City's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the City's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

Expenses and Program Revenues - Business-type Activities For the year ended June 30, 2011



Revenues by Source - Business-type Activities For the year ended June 30, 2011



As of the end of the current fiscal year, the City's governmental funds reported a combined ending fund balance of \$16,231,706, a net increase of \$7,574,599. The fund balance has been committed to liquidate contracts, capital projects and purchase orders of the prior period of \$7,726,505 and for inventories and other prepaid items of \$225,660, leaving an *unreserved fund balance* of \$8,279,541.

The general fund is the chief operating fund of the City and its fund balance increased by \$8,248,522 during the current fiscal year. At the end of the current fiscal year, the unreserved fund balance of the general fund accounted

for \$8,279,541 of the total fund balance of \$12,041,508. 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 balance represents 14 percent of total general fund expenditures, while total fund balance represents 20 percent of that same amount.

The capital projects fund had a decrease in its fund balance of \$673,923 from the reallocation of operating revenue as well as the expenditure of general obligation bonds issued in FY2008. During FY2011, the City expended \$1,812,456.

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

The total decrease in net assets of the eight enterprise funds was \$3,104,762, with an ending balance of \$13,545,818. Unrestricted net assets of the major enterprise funds were negative overall as a result of large negative balances of \$8,921,840 for the parking facilities, \$3,976,496 for the transportation system, and \$8,200,947 for the Non Major funds. The negative unrestricted net assets are the result of expenses exceeding operating revenues. Other factors concerning the finances of those funds have already been addressed in the discussion of the City's business-type activities.

General Fund Budgetary Highlights

Differences between the original expense budget and the final amended expense budget were \$1,766,901 See Exhibit 5, (increase in appropriations).

Capital Assets and Debt Administration

Capital assets. The City's investment in capital assets for its governmental and business-type activities as of June 30, 2011, amounts to \$140,632,350 (net of accumulated depreciation). This investment in capital assets includes land, buildings and improvements, machinery and equipment, park facilities, roads, highways, and bridges. The total decrease in the City's investment in capital assets for the current fiscal year was 2 percent (a 1 percent decrease for governmental activities and a 3 percent decrease for business-type activities).

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

- Annual road improvement projects.
- Equipment Purchase
- Building and other improvements
- Non-Profit funding

City of Annapolis Capital Assets (net of depreciation)

	Governmental Activities		Business-type Activities		Total	
	FY2011	FY2010	FY2011	FY2010	FY2011	FY2010
Land	\$4,260,493	\$4,260,493	\$3,243,441	\$3,243,441	\$7,503,934	\$7,503,934
Buildings	36,873,537	37,733,105	23,944,805	25,062,075	60,818,342	62,795,180
Improvements/infrastructure other than buildings	31,162,940	31,907,338	27,657,936	28,058,500	58,820,876	59,965,838
Equipment	4,429,473	5,426,709	1,964,692	1,773,540	6,394,165	7,200,249
Construction in progress	3,126,784	1,414,328	3,968,249	4,646,278	7,095,033	6,060,606
Total	\$79,853,227	\$80,741,973	\$60,779,123	\$62,783,834	\$140,632,350	\$143,525,807

Additional information on the City's capital assets can be found in note 6 on pages 46-47 of this report.

Long-term debt. At the end of the current fiscal year, the City had total general obligation bond debt outstanding of \$85,360,001, excluding premium and refunding losses. Other debt outstanding was a Capital Lease and State of Maryland loan for \$569,945 and \$482,544, respectively.

City of Annapolis
Outstanding Debt

	Governmental Activities		Business-type Activities		Total	
	<u>FY2011</u>	<u>FY2010</u>	<u>FY2011</u>	<u>FY2010</u>	<u>FY2011</u>	<u>FY2010</u>
General obligation bonds	\$56,733,851	\$55,026,790	\$28,626,150	\$28,648,357	\$85,360,001	\$83,675,147
Other debt	<u>569,945</u>	<u>7,931,215</u>	<u>482,544</u>	<u>625,178</u>	<u>1,052,489</u>	<u>8,556,393</u>
Total	<u>\$57,303,796</u>	<u>\$62,958,005</u>	<u>\$29,108,694</u>	<u>\$29,273,535</u>	<u>\$86,412,490</u>	<u>\$92,231,540</u>

The City's net total debt decreased \$5,819,050 (7 percent) during the current fiscal year from issuance of new general obligation bonds, refunding and scheduled repayment of principal.

The City's short term debt increased \$11,000,000. during the current fiscal year.

The City maintains ratings of "AA+" from Fitch, and "Aa3" from Moody's for its bonds. Additional information on the City's long-term debt can be found in note 7 on pages 48-49 of this report.

Economic Factors and Next Year's Budgets and Rates

The unemployment rate for the City area is currently 7.0 percent, which is an increase from the rate of 6.4 percent from a year ago. This compares favorably to the state's average unemployment rate of 7.4 percent and the national average rate of 9.6 percent.

Inflationary trends in the region compare favorably to national rates.

The median increase of only 3.6 percent in taxable property valuation over the three years beginning July 1, 2009 continues.

Moderate increase in revenue as a result of the impact of the overall economic recession.

Continued need for infrastructure enhancement and replacement.

These and other economic factors were considered when preparing the fiscal year 2012 General Fund budget. In anticipation of continued revenue shortfalls, expenditures will be carefully monitored and trimmed. Since 2010, the City's workforce has been reduced through a combination of retirement incentives and not filling certain vacant positions. This reduction, when combined with staffing changes brought about by the retirement incentive offered, will result in reduced salary costs in fiscal year 2012.

All of these factors were considered in preparing the City's budget for the 2012 fiscal year.

Rates in effect for all utilities will remain unchanged in the 2012 fiscal year, but a water and sewer rate study has begun.

Requests for Information

This financial report is designed to provide a general overview of the City's finances for all those with an interest in the City's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of Finance, City of Annapolis, 160 Duke of Gloucester Street, Annapolis, Maryland, 21401.