

October 31, 2006

To the Citizens of Nashville and Davidson County, Tennessee:

FORMAL TRANSMITTAL OF THE COMPREHENSIVE ANNUAL FINANCIAL REPORT

We are pleased to submit the Comprehensive Annual Financial Report of the Metropolitan Government of Nashville and Davidson County, Tennessee (the Government) for the fiscal year ended June 30, 2006. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the management of the Government. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and component units of the Government in accordance with generally accepted accounting principles (GAAP). All disclosures necessary to enable the reader to gain an understanding of the Government's financial activities have been included.

The Government is required to undergo an annual single audit in conformity with the provisions of the Single Audit Act, as amended, and U. S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Information related to this single audit, including the schedules of federal and state financial assistance, findings and recommendations, and independent auditors' reports on the internal control structure and compliance with applicable laws and regulations, are not included herein but are reported separately.

In conformity with generally accepted accounting principles, as set forth in Governmental Accounting Standards Board (GASB) Statement No. 14, The Financial Reporting Entity, and Statement No. 39, Determining Whether Certain Organizations are Component Units, this report includes all funds of the primary government and all component units. For purposes of this report, the primary government includes all departments and agencies of the Government which are not separate legal entities, including the Department of Water and Sewerage Services and Metropolitan Nashville Public Schools. The component units include those separate legal entities whose relationships with the primary government meet the criteria for inclusion defined in GASB Statements No. 14 and No. 39.

The Comprehensive Annual Financial Report is presented in three main sections: introductory, financial and statistical. The introductory section includes this transmittal letter, a description of the form of government, the Government's organizational chart, a list of principal officials and an organizational chart for the Government's Finance Department. The financial section includes the independent auditors' report, management's discussion and analysis (MD&A), the basic financial statements, notes, required supplementary information, individual fund and component unit statements and schedules. The statistical section includes selected financial and demographic information, generally presented on a multi-year basis.

As noted previously, the Government is required to provide a narrative introduction, overview and analysis to accompany the basic financial statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The Government's MD&A can be found immediately following the report of the independent auditors.

PROFILE OF THE GOVERNMENT

Metropolitan Nashville and Davidson County is located in middle Tennessee at the hub of many air, rail and highway transportation routes. The Government provides a full range of services. These services include education; police and fire protection; waste management; construction and maintenance of highways, streets and infrastructure; traffic regulation and control; parking; health and social services; public housing; recreational and cultural activities; public libraries; planning and zoning; water and sewerage services; administration of justice; and general administrative services.

FACTORS AFFECTING ECONOMIC AND FINANCIAL CONDITION

The local economy is a well-balanced blend of financial, agricultural, wholesale, retail, manufacturing and service industries. The local mix of these industries roughly reflects the national economy, with no single industry being predominant in the region. Computer technology, automotive, medical, private prison management, insurance, banking, publishing, telecommunications and entertainment companies and private educational institutions all find a home in Nashville. With a rich economic, social and cultural environment, the city consistently scores high in national rankings of preferred business locations, best places to live and favorable environments for the creation and development of businesses.

The Nashville Metropolitan Statistical Area (MSA) economy has been slightly healthier than the national economy, with lower unemployment than the state and the nation.

The Government's two most significant locally generated revenue sources are sales and property taxes. The property tax base has shown moderate growth and Nashville continues to have the lowest effective property tax rate of the four major Tennessee cities. The Government has no income tax.

MAJOR INITIATIVES

The Government continues to emphasize delivery of focused public services in a way that provides efficiency, effectiveness and value to the citizens of Nashville. The Government's major initiatives for fiscal year 2006, for fiscal year 2007 and for the future are discussed below.

FOR FISCAL YEAR 2006: Substitute budget ordinance BL-2005-663 appropriated a balanced budget of \$1,440,369,800 in the budgetary funds, an overall increase of 6.8% from the budget for fiscal year 2005. The budget included increases in both property taxes and motor vehicle license fees to generate additional revenues.

The FY2006 budget continued to make improvements in the community's priority areas:

- **Public Education** – The Metro Board of Public Education saw standardized test scores for the district increase substantially in 2005, an indication that the effort behind the MNPS Strategic Plan is yielding results. The budget for MNPS increased to \$542.2 million, an increase of approximately 6.2%. With this budget MNPS remains the best-funded urban school system in the State of Tennessee, with a per-pupil spending level that is in the top 10 percent in the Southeast. This budget provided for teacher and support staff salary increases, funds to open new schools, and increased pension costs, to name just a few improvements.

- Public Safety – This budget included funds for a variety of enhancements to Metro Nashville’s public safety. They include additional fire inspectors and training for firefighters; additional Police staff for technology and crime lab positions, as well as overtime for police officers working on special events; operational funds for a backup site for the E-911 call center; additional funds for inmate health care and for the forensic medical examiner; additional funds for the Sheriff’s community service program; and support for both the Mental Health Court and the Drug Court, as well as for traffic school instructors and an online traffic school option.
- Neighborhood and Community Support – The FY2006 budget continued to direct resources to those services that have a direct impact on the quality of life for all Nashvillians. The continuing implementation of the Parks Master Plan led to the opening of three new and improved community centers for FY06. This budget provided additional funds for the purchase of influenza vaccine, medication for the uninsured, the reopening of the Lentz Dental Clinic, and more resources for Animal Control. The budget also provided direct contributions to several community non-profits, including the Second Harvest Food Bank, the African-American History Museum, and Neighborhood Aftercare, among others.
- Valuing Our Employees – The budget provided funds for 3% overall pay increases, normal pay increments, and increased benefit costs, such as health insurance and pension costs.

FOR FISCAL YEAR 2007: Substitute budget ordinance BL-2006-1090 appropriated a balanced budget of \$1,507,433,800 in the budgetary funds, an overall increase of 4.7% from the budget for fiscal year 2006. The property tax rate remained the same.

The FY2007 budget continued to make improvements in the Nashville community’s priority areas:

- Public Education – The budget for Metro Nashville Public Schools (MNPS) increased to \$563.2 million, an increase of approximately 3.9%. With this budget MNPS remains among the best-funded urban school systems in the Southeast. This budget provided for teacher and support staff salary increases, funds to open new schools, increased pension costs, and a number of other improvements.
- Public Safety – This budget includes funds for a variety of enhancements to Metro Nashville’s public safety. They include additional overtime funding for firefighters, funds for fire prevention education, additional overtime for Police working on special events, additional funds for inmate health care, and additional funds for security for the Sheriff’s operations.
- Neighborhood and Community Support – The FY2006 budget continues to direct resources to those services that have a direct impact on the quality of life for all Nashvillians. The continuing implementation of the Parks Master Plan will lead to the opening of new and improved community centers for FY07. This budget provides additional funds for the operation of a mobile pediatric clinic. The budget also provides direct contributions to several community non-profits, including the Second Harvest Food Bank, United Way Family Resource Centers, and Neighborhood Aftercare, among others.
- Valuing Our Employees – The budget provides funds for 2% overall pay increases, normal pay increments, and increased benefit costs, such as health insurance and pension costs.

These initiatives have all been addressed while ensuring the Government meets its fundamental objectives of maintaining a balanced budget, keeping taxes low, and investing in Nashville’s future. Details of all improvements included in the fiscal year 2006 and 2007 budgets are described in the annual *Operating Budget* books published by the Department of Finance, Office of Management and Budget. They are also available on the GFOA-award-winning Citizen’s Guide to the Budget at the web site www.nashville.gov/citizens_budget.

FOR THE FUTURE: The Metropolitan Government of Nashville and Davidson County will maintain as its primary focus:

- Supporting public education through the work of our schools by encouraging our community to devote its attention, time, and financial resources to the public school system.
- Improving public safety through the combined efforts of the Mayor's Office, the Police department, and other departments of the Government.
- Addressing issues underlying our quality of life, including economic and community development, parks, the arts, libraries, adequate public transportation and affordable housing.
- Striving for excellence in the management of the Government to ensure the most effective and efficient services are provided to its citizens.

These issues will be successfully addressed through the continued teamwork of business, government, citizen groups and other involved parties. The Government's budget continues to stress sound financial management and efficiency, effectiveness, and equity in public services. It remains committed to building a future in which all citizens of Davidson County can enjoy economic prosperity and a high quality lifestyle.

FINANCIAL INFORMATION

CASH MANAGEMENT: Cash temporarily idle during the year was primarily invested in demand deposits, certificates of deposit, obligations of the U. S. Treasury, commercial paper and the State of Tennessee Local Government Investment Pool. Investments are made either directly or through the Metro Investment Pool. Investments in the pension trust funds also include common stocks, corporate bonds and other holdings.

The Government's investment policy is to preserve principal, minimize credit and market risks and maintain adequate liquidity while maximizing the rate of return on its portfolio. The investment policy encourages conservative, low risk investments and does not permit more risky methods to enhance investment returns. The majority of the cash deposits are held by financial institutions participating in the bank collateral pool administered by the State of Tennessee, thus ensuring that they are collateralized. Earnings continue to be realized as a result of the banking service agreement, which in part provides for the daily investment of demand deposit balances.

The primary government earned investment income of \$63.4 million for the year ended June 30, 2006.

RISK MANAGEMENT: The Government continued to operate a risk management program, which was initiated in 1978. As part of its comprehensive plan, resources are being accumulated in various internal service funds to meet potential losses. Accepted risk control techniques, including employee accident prevention training, have been implemented to minimize potential liability losses. In addition, the Government has elected to come under the Tennessee Tort Liability laws in order to limit its potential liability.

PENSION TRUST FUNDS: The pension system of the Government covers substantially all full-time employees. It consists of one pension plan that is open to new members and five pension plans that are closed to new members but are still used by some employees of the former City of Nashville, the former Davidson County and Metropolitan Nashville Public Schools.

After recognizing contributions from other funds, employees, and the State of Tennessee, the General Fund is responsible for amounts necessary to fund the Metropolitan Employees' Benefit Trust Fund (which includes Division A, the closed plan, and Division B, the open plan) and the following four closed plans:

The County Plan - Davidson County Employees' Retirement Fund
The County Education Plan - Employees' Pension and Insurance Fund
The City Plan - Closed City Plan Fund
The City Education Plan - Teachers' Civil Service and Pension Fund

After recognizing contributions from employees and the State of Tennessee, Metropolitan Nashville Public Schools is responsible for funding the Metro Education plan – The Teachers' Retirement Plan Fund. The total assets of all pension (and other employee benefit) trust funds were \$2.0 billion at June 30, 2006.

INTERNAL CONTROL STRUCTURE: Management of the Government establishes and maintains an internal control structure designed to ensure that the assets of the Government are protected from loss, theft, or misuse and to ensure that adequate accounting data is compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

BUDGETARY CONTROLS: The Government maintains budgetary controls in order to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Government's governing body, the Metropolitan Council. Activities of the General Fund, General Purpose School Fund and the General Purposes and School Purposes Debt Service Funds are included in the annual appropriated budget. The Government maintains an encumbrance accounting system to provide management with information regarding obligations against appropriations. Budgetary compliance is based on expenditures during the period (GAAP), rather than expenditures and encumbrances (non-GAAP). Because appropriations lapse at June 30, encumbrances outstanding at June 30, 2006 are disclosed in the notes to the financial statements. Appropriations for fiscal year 2007 will provide authority to complete those transactions.

SINGLE AUDIT: As a recipient of federal and state financial assistance, the Government is responsible for ensuring that an adequate internal control structure is in place to ensure compliance with applicable laws and regulations related to those programs. As part of the Government's single audit, tests are performed to determine the adequacy of the internal control structure, including that portion related to federal and state financial assistance programs, as well as to determine that the Government has complied, in all material respects, with applicable laws and regulations. The results of the Government's single audit for fiscal year 2006, including any reported instances of weaknesses in the internal control structure or any violations of applicable laws and regulations, are reported separately.

INDEPENDENT AUDIT: Section 6.15 of the Metropolitan Charter requires an annual audit of accounts and other evidences of financial transactions of the Government and of its departments, offices and agencies by independent certified public accountants. The audit is performed by a firm chosen by a three-member audit board consisting of the Vice-Mayor, the Chair of the Budget and Finance Committee of the Metropolitan Council, and the Chair of the Metropolitan Nashville Public School Board. The Government has complied with this requirement. The independent auditors' report and the non-major governmental, non-major enterprise, internal service and fiduciary funds' statements and schedules are included in the financial section of this report.

AWARDS AND ACKNOWLEDGEMENTS

AWARDS: The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Government for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2005. This was the 23rd consecutive year that the Government has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current CAFR continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

The GFOA presented a Distinguished Budget Presentation Award to the Government for its annual budget for the fiscal year beginning July 1, 2005. In order to receive this award, a governmental unit must publish a budget document that meets program criteria as a policy document, as an operations guide, as a financial plan and as a communications device. The award is valid for a period of one year only. It is the Government's 15th year to receive this award.

ACKNOWLEDGMENTS: Many individuals and organizations throughout the Government assisted in preparing this CAFR. To each of them we gratefully express our sincere appreciation for their dedicated contributions.

In conclusion, we acknowledge and express our appreciation for the strong support of the Metropolitan Council. The Council's support will continue to be vital as we work to further strengthen the financial management of the Metropolitan Government.

Sincerely,

Bill Purcell
Mayor

David L. Manning
Director of Finance