

December 31, 2004

In compliance with the City of Knoxville Charter requirements, I am submitting the Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2004. This report discusses the financial results for the year, provides information on budgetary performance, and includes information on the financial condition of the City. I am also pleased to again report that the financial condition of the City remains strong.

The report has been prepared in conformance with the principles and standards for financial reporting as set forth by the Governmental Accounting Standards Board (GASB) and complies with the requirements of GASB Statement Number 34. The report also meets the requirements of the Single Audit Act of 1984 and related Office of Management and Budget (OMB) Circular A-133.

The City's financial statements have been audited by HG&A Associates, P.C., Certified Public Accountants, and prepared by the Finance Department. The City accepts the responsibility to insure that all information included in the Comprehensive Annual Financial Report is complete and accurate. We believe the enclosed data completely and accurately present the financial condition of the City.

REPORTING ENTITY

The City of Knoxville operates under the Mayor-Council form of government. Policy-making and legislative authority are vested in the nine member City Council, six of whom represent specific districts and three of whom are elected at large. The mayor and council members are elected on a non-partisan basis and are elected to four-year terms. The City Council is responsible, among other things, for passing ordinances, determining policies, and adopting the budget. The mayor is responsible for carrying out the policies and ordinances of the City Council, for overseeing the day-to-day operations of the City, and for appointing the heads of the City's departments.

This report covers all funds of the City of Knoxville. The City provides a full range of services, including, but not limited to, police and fire protection; solid waste collection and disposal; the construction and maintenance of highways, streets, and infrastructure; recreational activities; and cultural events. In addition, the City of Knoxville has financial accountability over the Knoxville Utilities Board (KUB), the Metropolitan Knoxville Airport Authority (MKAA), Knoxville Area Transit (KAT) and the City Employees' Pension Fund. The financial statements of KUB, MKAA and KAT are included in the body of this report, noted as Component Units on the Government Wide Statements. The financial statements of the City Employees' Pension Fund are included in the body of this report, noted separately as the sole Fiduciary Component Unit.

REPORT CONTENTS

This report, like previous reports, consists of three sections: Introductory, Financial, and Statistical. The *Introductory Section* includes the City's Letter of Transmittal, a listing of officials, an organization chart, and a facsimile of the Certificate of Achievement. Next, the *Financial Section* is composed of the independent auditor's opinion, Management's Discussion and Analysis, basic financial statements, informational notes, required supplemental information, and various combining and individual fund statements. Finally, the *Statistical Section* provides selected unaudited financial and demographic information on a multi-year basis.

Accounting principles generally accepted in the United States of America (GAAP) require that management provide a narrative introduction, overview and analysis to accompany the financial statements in the form of the Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. The City of Knoxville's MD&A can be found immediately following the report of the independent auditors.

ECONOMIC CONDITION AND OUTLOOK

The overall economic health of the metropolitan Knoxville area remains positive. The City serves as the economic hub of entire upper East Tennessee area, and its trade sector is one of the strongest in the state. Knox County has the fourth highest per capita sales tax rate in the state, at roughly 125% of the state average. Seventy-six percent of the taxable sales within the County occur inside the corporate limits of Knoxville. The following table displays local sales tax collections (in thousands) to the City over the past five years.

<u>Year</u>	<u>Collections</u>	<u>% Growth</u>
FY 99/00	\$29,478	2.53%
FY 00/01	\$29,953	1.61%
FY 01/02	\$28,819	-3.79%
FY 02/03	\$29,031	0.74%
FY 03/04	\$30,529	5.16%

The local sales tax is a situs based revenue. That is, the point of sale location determines the governmental entity receiving the proceeds. In recent years, there have been several situs reclassifications that have shifted revenues between the City of Knoxville and Knox County. In FY 98/99, the City of Knoxville benefited from a change, which shifted funds from the County, accompanied by a large one-time correction of prior revenues. In FY 01/02, the situation was reversed with a \$2.2 million shift from the City to the County. These shifts account for the large variations seen in the growth pattern for annual collections. A similar, albeit smaller, shift also occurred in FY 02/03 and FY 03/04. Were it not for these reclassifications, the City and County would tend to mirror each other. In FY 99/00, sales tax collections on a countywide basis increased by 5.30%. Growth in subsequent years was 1.69%, 1.34%, 0.68% and 5.53%.

As noted above, the City experienced a 5.16% growth in local sales tax. This compares to an overall growth of 5.53% in Knox County as a whole. Overall growth in state sales taxes, which factors out rate differentials, shows the overall County growth at 7.36%. This compares to a statewide growth rate of 7.56%.

The presence of the University of Tennessee along with TVA lends stability to the area, making the local economy less cyclical than either the national or state economy. This contributes to a low unemployment rate, which averaged 3.6% (Knoxville MSA) and 3.0% (Knox County) in FY2004. This compares very favorably to the national unemployment rate of 5.8% and the state rate of 5.5% as well as the other major metropolitan areas of the state (Chattanooga – 3.7%, Memphis – 6.0%, and Nashville – 4.2%). The fiscal year end civilian labor force in the Knoxville MSA was 384,500 and the metropolitan area hopes to gain 35,000 new jobs over the next five years through its economic development initiative *Jobs Now!* Job growth has been positive in the recent past and is forecast to continue in the near term, although some shifting among sectors is anticipated. Trade and service sectors are forecasted to grow at a strong rate, and the finance, real estate, communication, and transportation sectors are also expected to do well, while manufacturing is expected to decline.

Knoxville is at the intersection of two major interstate highways (I-40 and I-75) and near the terminus of a third interstate (I-81). Because of its central location in the eastern United States, the Knoxville area serves thousands of industrial and commercial customers in a concentrated eight-state area. It is within 500 miles of approximately one-half of the population of the United States. The County for many years has been known as one of the South's leading wholesale markets. Located within the County are 922 wholesale establishments, 1,913 retail establishments and 5,022 service establishments.

In addition to being a manufacturing and distribution center, the County ranks second among the five metropolitan counties of Tennessee in agricultural production. The County's principal crops are barley, tobacco, corn, wheat, hay, vegetables and fruits. Beef and milk production are important farming activities. Meat packing and preparation of other food products have shown a steady increase in the County in the last several years.

The area also benefits from the State's high ranking in Alexander Grant and Company's *General Manufacturing Climates*. The study has consistently ranked Tennessee as one of the top areas in the nation for manufacturing. A great deal of this industrial growth has taken place in the community's eleven industrial parks, which are zoned as part of a planned industrial development program.

Tourism also plays a vital role in the economic development of area. In 2000, travelers spent more than \$549 million in Knox County, ranking it fifth in the state for visitor expenditures. Knoxville supports an active tourism and convention trade. The newly constructed 500,545 square foot convention center on the World's Fair Park site opened in June 2002. The center features spacious meeting rooms and a 400-seat lecture hall. Other facilities include a civic coliseum/auditorium, an exhibition hall/convention center, a 25,000-seat arena, and a conference center at the University of Tennessee. Knoxville's multitude of annual events include the Dogwood Arts Festival, Tennessee Valley Fair, Boomsday, Christmas in the City and many cultural activities.

Knox County is the principal Gateway to the Great Smoky Mountains National Park, located 40 miles to the southeast. There are over 500,000 acres that make up the nation's most visited National Park, extending over the States of Tennessee and North Carolina. More than 9.2 million people visited the National Park in 2003.

In addition to the natural beauty of the area, two of the major attractions in the Smoky Mountains are Gatlinburg and Pigeon Forge. Gatlinburg, a tourist town which has accommodations for over 60,000 people, features numerous restaurants, craft shops, and gift stores, along with a ski lodge, ski-lifts, convention center and tramway, making it a year-round resort town. Pigeon Forge, a tourist town and shoppers mecca at the foothills of the mountain, has accommodations for approximately 40,000 people. Its attractions include Dollywood - a country-style theme park, a waterslide park, a rodeo dinner theater, and numerous miniature golf courses, bumper boat rides, and theme museums.

Knoxville seeks to capitalize even more from its location through such projects as the Women's Basketball Hall of Fame, the Gateway Regional Visitor Center, Volunteer Landing, and the Knoxville Zoological Gardens.

Knoxville consistently is ranked among the best places to live in the country. According to the latest edition of Places Rated Almanac, Knoxville's quality of life ranked first among mid-sized urban regions and 13th among all 343 metropolitan areas rated in the book. Knoxville was ranked 13th for the "Best Places for Business and Careers" in Forbes magazine 2004 and 3rd on the best Cities for Relocating Families list of Worldwide ERC and Primary Relocation. Knoxville was also noted as "Top Mid-Market with populations between 250,000 and 750,000" by the Southern Business and Development Magazine

June 2003 and 14th among the “Top Logistic Cities in the Southeast”. The City has also been cited nationally for its low tax rate.

The quality of life, low cost of living, convenient interstate access, along with other factors make the area an attractive location for many types of operations, particularly those in the growing field of telecommunications. Knoxville serves as home to numerous customer service centers, including Jewelry Television by ACN, Cendant Corporation, ClientLogic Corporation, G.C Services, Kimberly-Clark Corporation, Nova Information Systems, U.S. Cellular and Whirlpool Corporation. The City has worked with these firms, and others, to help foster relocation to Knoxville, or expansion of existing facilities. Companies having their corporate headquarters in Knoxville include Home and Garden Television (HGTV), Clayton Homes, CTI Molecular Imaging Corporation, DeRoyal Industries, Goody's Family Clothing, Pilot Corporation, and Sea Ray Boats.

The Metropolitan Knoxville Airport Authority (MKAA) has also contributed to area growth. McGhee Tyson Airport completed a \$70 million renovation and expansion project of its main terminal and concourses in the fall of 2000. The airport is served by two major and ten regional passenger airlines that combine for 61 daily departures connecting to fifteen hub airports with non-stop service. The direct and indirect economic impact of the airport is estimated by the MKAA to be approximately \$1 billion annually. This figure includes payroll, local spending, transportation cost savings, capital spending and other benefits.

In addition, Knoxville serves as the health, educational, and governmental center of East Tennessee. Knoxville is the home to the University of Tennessee's main campus with over 27,000 students, including its teaching hospital and veterinary school. Six other colleges operate in Knoxville, with thirty trade/vocational schools completing Knoxville's higher education system. Also operating within the area are six hospitals including the only two trauma centers for a 27-county area. The presence of the Tennessee Valley Authority, UT-Battelle, and BWXT-Bechtel serve as a magnet for technology-based corporations in the East Tennessee area. The growing trend toward allowing technology transfer to private industry is also benefiting the region. The development of the multi-billion dollar spallation neutron source project at the Oak Ridge National Laboratory is also expected to enhance economic activity and lure newer companies to the area.

MAJOR INITIATIVES

For the Year ended June 30, 2004:

Economic development has been the primary focus during the past year. The Market Square Redevelopment Plan has been the major capital project, resulting in the makeover of the square's public space and a facelift of the facades of its historic buildings. Capital funding was provided for downtown development, historic preservation, road improvements, numerous drainage projects, and parks and greenways,

For the Future:

The focus in FY 04/05 is continued economic development, and increased operational efficiency. Major projects include the implementation of a new financial system, the development of a 311 call center, improved training, and improvements designed to reduce energy costs. Capital projects scheduled for the year include the Market Square Development Phase 2, work on a new transit center, renovation of the World's Fair Park and surrounding areas, and the beginning of the Market Square Phase 3 project. Funding is also provided to increase job creation efforts in the City of Knoxville and the Knoxville MSA.

FINANCIAL INFORMATION

Management of the City of Knoxville is responsible for establishing and maintaining an internal control structure. This structure is designed to protect the assets of the government from loss, theft or misuse. The system also attempts to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (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.

BUDGETING CONTROLS

The objective of the City of Knoxville's budgetary controls system is to ensure compliance with the City Code and Charter, as well as with state and federal guidelines regarding use of funds. No authority is granted to any department to expend above their annual appropriation without council approval. Appropriations for all funds, excluding capital projects, included in the annual budget process lapse at year-end and must be reappropriated annually. Additional budgetary controls include the City's encumbrance accounting system, which is designed to ensure that departments do not exceed or commit to exceed any appropriation for the fiscal year. Furthermore, the Mayor and the Finance Director can reserve or impound appropriations if there appears to be insufficient revenues to cover expenditures, or for any other valid reason.

DEBT ADMINISTRATION

Total general obligation indebtedness of the City increased by \$21.6 million in fiscal year 2003/2004. The City issued \$83.5 million in general obligation debt during the year, of which \$34 million represented new money. The balance was a debt refunding designed to save costs. The City has no plans to issue additional debt in fiscal year 2004/2005.

The total amount of general obligation debt outstanding as of June 20, 2004 is \$261.3 million. Of this amount, \$158.2 million represents proprietary fund debt on the Convention Center and the Locust Street Garage. In addition to the above debt, the City has responsibility for \$1.4 million in debt relating to its portion of Animal Welfare Center, this debt being issued by Knox County.

Several indicators are useful in evaluating the City's debt position. These include the ratio of net general obligation bonded debt to assessed valuation and the amount of general obligation debt per capita. The debt ratio for the City of Knoxville (excluding component unit debt) at the end of fiscal year 2004 is as follows:

<u>General Obligation Debt</u>	<u>Amount (in thousands)</u>		<u>Ratio of Amount to Assessed Valuation 100%</u>		<u>Ratio of Amount to Estimated Actual Value</u>		<u>Debt per Capita</u>	
	<u>FY 03/04</u>	<u>FY 02/03</u>	<u>FY 03/04</u>	<u>FY 02/03</u>	<u>FY 03/04</u>	<u>FY 02/03</u>	<u>FY 03/04</u>	<u>FY 02/03</u>
Net direct bonded debt	\$234,489	\$225,451	7.98%	7.71%	2.50%	2.48%	\$1,348	\$1,296
Overlapping debt of Knox County	\$177,989	165,084	6.05%	5.64%	2.29%	1.82%	\$1,023	949
Total	\$412,478	\$390,535	14.03%	13.35%	4.79%	4.30%	\$2,371	\$2,255

The City's current and prior bond ratings are as follows:

<u>Debt Type</u>	<u>Fitch/ICBA</u>		<u>S & P</u>		<u>Moody's</u>	
	<u>FY 03/04</u>	<u>FY 02/03</u>	<u>FY 03/04</u>	<u>FY 02/03</u>	<u>FY 03/04</u>	<u>FY 02/03</u>
General Obligation Bonds	AA+	AA+	AA	AA	Aa2	Aa2
Revenue Bonds:						
Water and Electric (KUB)	N/A	N/A	AA	AA	Aa3	Aa3
Gas (KUB)	N/A	N/A	AA	AA	Aa3	Aa3

CASH MANAGEMENT

The City of Knoxville operates a cash management program under a master banking service agreement with a major Tennessee banking institution. Idle funds are invested in accordance with the City's Investment Policy on the basis of security, liquidity and, lastly, yield. Investments are governed by state statute and City ordinances, which limit both the type and length of investments. Maturities are generally limited to two years and investments are restricted to treasury bonds and notes, agencies and instrumentalities guaranteed by the federal government, various money market instruments such as certificates of deposit, high-grade commercial paper, and bankers acceptances, and various state or local bonds. The policies also allow for participation in the State of Tennessee managed Local Government Investment Pool (LGIP).

As required by statute and ordinance, all deposits and certificates of deposit are secured by similar grade collateral pledges at 105% of market value for all amounts in excess of that guaranteed through federally sponsored insurance programs or are collateralized by participation of depository institutions in the Tennessee collateral pool.

The average yield on investments, excluding the pension fund investments, was 1.25%. Average weighted maturities in days ranged between 49 and 100 days. Duration was very short.

The City Charter mandates that portfolio management and control of the City's Pension Fund be vested in the City Pension Board. The Board is advised by Summit Strategies and engages professional investment firms in an advisory capacity.

RISK MANAGEMENT

The City of Knoxville's risk management program is responsible for the administration of the City's self-insured liability and worker's compensation programs. The risk management division is also responsible for the administration of the City's commercial insurance and OSHA programs. An increase in net assets

of \$211 thousand was reported for the Risk Management fund as of June 30, 2004, due mainly to supplemental funding coming from the City's General Fund. Total net assets in this fund equal \$216 thousand as of June 30, 2004.

OTHER INFORMATION

Independent Audit

The State of Tennessee requires an independent audit performed by independent certified public accountants. The City's audit committee selected HG&A Associates, P.C., Certified Public Accountants to perform the fiscal year 2004 audit.

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 City of Knoxville for its comprehensive annual financial report for the fiscal year ended June 30, 2003. This was the eighteenth consecutive year that the City has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. 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 comprehensive annual financial report 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 City of Knoxville received GFOA's Distinguished Budget Presentation Award for the annual operating budget dated July 1, 2004. This marks the sixteenth consecutive year that the City has won this Award. The Distinguished Budget Presentation Award recognizes that the City's budget document is a proficient policy document, financial plan, operation guide and communications medium.

Acknowledgments

The preparation of this report results from the combined efforts of many people. Special recognition and appreciation goes to Jim York, Katherine Latvala, and Jerry Campbell of the City's Finance Department, Melissa Peters, the City's Internal Auditor, the City's independent auditors, HG&A Associates, P.C., and the City Council audit committee comprised of Marilyn Roddy, Rob Frost, Barbara Pelot, Bob Becker and Joe Hultquist. The national recognition afforded the City of Knoxville could not have been achieved without the increasing participation and enthusiasm of the citizens of this community. Their exceptional response to the annual survey has served as the foundation for many programs and projects developed during the budgetary process which strengthen and benefit the lives of all Knoxvilleans.

Sincerely,

Christopher P. Kinney
Sr. Director of Finance & Accountability