King County
Finance and Business Operations Division
Department of Executive Services
821 Second Ave.
Seattle, WA 98104-1598

June 30, 2006

Honorable County Executive, Members of the Metropolitan King County Council, and King County Residents

We are pleased to transmit to you the Comprehensive Annual Financial Report (CAFR) of King County, Washington, for the fiscal year ended December 31, 2005. The governmental financial reporting model provides a picture of the County as a single, unified entity, while continuing to provide traditional fund-based financial statements. Each perspective (government-wide and major fund) allows the reader to address relevant questions, provides a basis for comparison, and enhances the County's accountability.

The report is presented in three sections: Introductory, Financial, and Statistical. The Introductory Section includes this letter of transmittal. The Financial Section, beginning with the independent auditor's report, contains management's discussion and analysis (MD&A), government-wide financial statements, fund and component unit financial statements, notes to the financial statements, required supplementary information, combining financial statements, and schedules. The Statistical Section includes selected financial trends, revenue capacity, debt capacity, operating data, and demographic and economic data. This letter of transmittal is designed to complement the MD&A, which presents a narrative introduction, overview, and analysis of the financial statements.

The CAFR consists of management's representations concerning the finances of the County. Consequently, management assumes full responsibility for the completeness and reliability of all information presented in this report. To provide a reasonable basis for making these representations, management has established a comprehensive internal control framework designed to protect the government's assets from loss, theft, or misuse, and to compile sufficient reliable information for the preparation of the County's financial statements in conformity with Generally Accepted Accounting Principles (GAAP). Because the cost of internal controls should not outweigh their benefits, the County's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatements. As management, we assert that, to the best of our knowledge and belief, the CAFR is complete and reliable in all material respects.

The County's financial statements have been audited by the Washington State Auditor's Office. The goal of the independent audit was to provide reasonable assurance that the basic financial statements of the County for the fiscal year ended December 31, 2005, are free of material misstatements. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The auditor concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the County's financial statements for the fiscal year ended December 31, 2005, are fairly presented in conformity with GAAP. The auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the County was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports will be available in the County's separately issued 2005 Single Audit Report, due September 30 (available online at http://www.sao.wa.gov).

Profile of the County

The County ranks number one in population in the State of Washington and is the financial, economic, and industrial center of the Pacific Northwest Region. Located between the sparkling blue waters of Puget Sound and the snowcapped Cascade Mountains, the County consists of 2,131 square miles, ranking 11th in geographical size among Washington State's 39 counties. As of December 31, 2005, the County contained 39 incorporated cities, which accounted for approximately 80 percent of its population.

King County operates under a Home Rule Charter adopted by a vote of the citizens of King County in 1968 and is organized under the Executive-Council form of county government. The Metropolitan King County Council is the policy-determining legislative body of the County. The Council's nine members are elected by district to four-year staggered terms and serve on a full-time basis. The County Council sets tax levies, makes appropriations, and adopts and approves the annual operating and capital budgets for the County. Other elected county officials include the County Executive, Prosecuting Attorney, Sheriff, Assessor, and Superior and District Court Judges. All are partisan positions, elected to four-year terms, except for the Sheriff and Judges, which are nonpartisan positions.

The County Executive serves as the chief executive officer of the County. The County Executive presents to the County Council annual statements of the County's financial and governmental affairs, the proposed budget, and capital improvement plans. The County Executive signs, or causes to be signed on behalf of the County, all deeds, contracts, and other instruments, and appoints the director of each executive department.

King County provides some services on a countywide basis and other services only to unincorporated areas. Within appropriate jurisdictions, the County provides public

transportation, road construction and maintenance, wastewater treatment, flood control, agricultural services, parks and recreation facilities, law enforcement, criminal detention, rehabilitative services, court services, tax assessments and collections, land use planning and permitting, zoning, public healthcare, emergency medical services, election services, animal control, and the disposal of solid waste. In addition, the County has contracts with some cities to provide services to incorporated areas within the County.

The reporting entity "King County" includes four component units: (1) the Harborview Medical Center (HMC); (2) the Washington State Major League Baseball Stadium Public Facilities District (PFD); (3) the Cultural Development Authority of King County (CDA); and (4) the Flood Control Zone Districts. The Harborview Medical Center, with a history dating back to 1877, is a comprehensive 413-bed healthcare facility operated since 1967 by the University of Washington under a management contract. The general conditions of the management contract specify that King County retains title to all real and personal property acquired with HMC capital or operating funds. The PFD is responsible for overseeing the maintenance and operation of Safeco Field, the Seattle Mariners' baseball stadium. The CDA was created in 2003 to support the arts, heritage, historic preservation, and public art throughout the County. The Flood Control Zone Districts account for the development, operation and maintenance of flood control or storm water control projects that benefit specific areas of the County.

Most funds in this report pertain to the entity King County Government. Certain Agency Funds pertain to the County's custodianship of assets belonging to independent governments and special districts. Under state statute and the County's Home Rule Charter, the King County Executive is the *ex officio* treasurer of all special purpose districts in King County, but not of cities and towns or the Port of Seattle. As provided by County ordinance, the Director of the Finance and Business Operations Division is responsible for the duties of the comptroller and treasurer. Money received from or for the special purpose districts is deposited in a central bank account. The Director of the Finance and Business Operations Division disburses money according to State and local regulations and invests cash balances based on standard agreements with the respective special purpose district's governing body or administrative officer.

Factors Affecting Financial Condition

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the County operates.

Local economy

Economic conditions have a direct impact on the County's revenues and the demand for County services. The County's revenue sources include taxes, charges for services, and intergovernmental revenues. The largest single source is taxes, comprising approximately one-third of total revenue and consisting primarily of taxes on real property. Property taxes tend to be quite stable since levy rates are calculated months in advance and King County establishes assessed value from four prior years of real estate sales. Other tax sources, such as the retail

sales tax, are much more volatile and directly influenced by economic conditions in the region.

The 2001 recession had a significant adverse effect on regional employment and income growth. Economic conditions stabilized in 2003, with expanded employment in 2004 and 2005 marking the first increases in four years. A robust construction sector has lead job growth, with renewed strength in aerospace and manufacturing employment in the past year. Personal income in the county has also rebounded, with an average annual increase of 5.2 percent between 2003 and 2005, versus average growth of 2.0 percent from 2001 to 2003.

County taxable retail sales were particularly hard hit by the recession. Current expense subfund collections declined in 2001 for the first time since the state of Washington instituted the local option sales tax in 1971. Between 2000 and 2003, current expense subfund sales tax receipts fell by an unprecedented 7.17 percent. This trend reversed itself with strong growth of 6.19 percent in 2004 and 7.45 percent in 2005.

Property assessment growth also accelerated in 2005, up 8.5 percent, compared with 5.6 percent growth in 2004, 4.8 percent growth in 2003, and 6.7 percent growth in 2002. It remains short of the meteoric growth experienced at the start of the decade — 12.1 percent and 13.4 percent in 2001 and 2000, respectively. The ailing commercial market has seen an almost complete turnaround, just in time to offset a forecasted, but as yet unseen, decline in the demand for residential property. The housing market has been buoyed in large measure by historically low interest rates; growth in housing prices should slow appreciably even if mortgage rates remain uncharacteristically low.

County general fund property tax collections increased by only 0.8 percent in 2005, compared with 3.6 percent growth in 2004, and 2.8 percent growth in 2003. These are still below the 4.5 percent growth in 2002, 4.6 percent growth in 2001, and 6.6 percent growth in 2000, the year before passage of Initiative 747, which caps annual tax levy increases at 1 percent plus new construction. Current year property tax delinquencies have continued their general downward trend — from 2.59 percent in 2002 to 2.22 percent and 2.25 percent in 2004 and 2005, respectively.

Economic outlook

For 2006 the national recovery is expected to continue to fuel a strong local improvement. Total regional employment in 2006 is forecast to outpace population growth 2.5 percent to 1.0 percent, as it did in 2005 by 2.7 percent to 0.9 percent, and in 2004 by 1.4 percent to 0.5 percent, respectively. Strong personal income growth is also anticipated.

King County will continue to face numerous challenges, including volatile energy prices, rising employee and programmatic healthcare costs, retirement plan contribution rate increases, and the need to raise sufficient revenues to support utility, transit system, and general government operations.

Long-term financial planning

For the first time since 1998, in the fall of 2005 the County transmitted a balanced three-year general fund financial plan that achieved a small surplus in each year without requiring service reductions. Attributable to aggressive financial planning and management, the structural deficit that has plagued county finances since the late 1990s appears to have been tamed by lower cost growth. The budget office continues to project cyclical deficits — that is, a downturn in regional economic conditions can be expected to result in the return of general fund deficits.

Progress on the unincorporated area initiative continues. The Washington State Legislature enacted a credit against the state sales tax for cities with a population of less than 400,000 that annex an area consistent with its comprehensive plan. This is expected to greatly aid the County's efforts to move all urban unincorporated areas into cities by 2010. Cities that commence annexation of an area with over ten thousand residents prior to January 1, 2010, may impose a sales or use tax that must be taken as a credit against the sales tax so it will not be an additional tax to a consumer. The rate of the tax is 0.1 percent for each annexation area with a population over ten thousand, and 0.2 percent for an annexation area with a population over twenty thousand. All revenue from the tax must be used to provide, maintain, and operate municipal services for the annexation area and must continue for no more than ten years from the date it is imposed.

The first of ten major potential annexation areas, Klahanie (located on the northeast corner of the City of Issaquah and the southeast corner of the City of Sammamish), approved annexation in November 2005. This annexation is on hold pending resolution of the City of Issaquah's insistence that area residents assume a portion of the city's debt. Though this measure was narrowly rejected on the same ballot, a new election is possible. In addition, the City of Sammamish has also expressed interest in annexing the area. Another nearby neighborhood, South Cove, also on the same ballot, approved the debt measure and became a part of Issaquah on March 2, 2006.

King County still faces substantial difficulties in balancing limited revenues with the ever-growing demand for services. Property tax growth remains capped at approximately 3 percent annually over the coming years (1 percent plus the value of new construction). While costs since 2003 have been held well under historic growth rates of 5 to 6 percent, it will clearly be a challenge to continue to rein in expenditures in the face of labor cost drivers and service demands.

The County reaffirms its steadfast commitment to maintain a 6 percent undesignated reserve policy and also its willingness to make often painful decisions in order to reduce expenditures to match revenue levels while retaining prudent reserves. At the state level, the County also continues to pursue statutory enhancements to local government revenues to more flexibly balance revenues with long-term cost pressures.

Major Initiatives in 2005

Health Reform Initiative

In 2005 King County launched the Health Reform Initiative. This program represents an innovative approach to address the continued double-digit increases in healthcare costs that employers are facing nationally and locally. The approach involves a two-pronged strategy to work regionally with the broad spectrum of interests that can impact healthcare service delivery and to design a new health plan for King County employees that rewards and reinforces accountability for health and healthcare-related decisions and actions.

In 2005, backed by strong support from our labor partners, King County established pilot programs to help reduce the long-term trend of increases in healthcare costs. In 2006 King County will begin the Wellness Assessment Program and, in 2007, the Healthy Incentives℠ Program will encourage employees and their spouses/domestic partners to improve or maintain their health.

The biggest successes of this first year of the Health Reform Initiative have been the expansion of a strong partnership with King County's labor unions and the establishment of an effective communications and outreach effort. This has resulted in extremely high levels of participation in the new pilot programs which translates into increased savings for the County.

Pandemic Influenza Response Plan

Severe influenza pandemics represent one of the greatest potential threats to the public's health. On December 7, 2005, the King County Council appropriated $5.96 million for pandemic flu preparedness. Of this funding, $1.20 million is designated for development of the Pandemic Influenza Response Plan for King County through public outreach and information campaigns and development of a medical surge plan. The remainder of the appropriation is designated for the purchase of antiviral medications.

The Pandemic Influenza Response Plan for King County provides guidance to Public Health – Seattle and King County (PHSKC) and regional partners to assist in detection, response, and recovery in the event of an influenza pandemic. During an influenza pandemic, PHSKC and regional partners will utilize the guidelines, technical support, and information in the Plan to achieve the following goals: (1) limit the number of illnesses and deaths; (2) preserve continuity of essential governmental functions; (3) minimize social disruption; and (4) minimize economic loss. The Plan will be coordinated with other PHSKC preparedness plans and activities and will be coordinated with the plans of community, state and federal partners.

Ten-Year Plan to End Homelessness in King County

King County has a long history of providing housing and support services to people who are homeless. With the 2005 publication of "A Roof Over Every Bed: Our Community's Ten-Year Plan to End Homelessness in King County" (available at http://www.cehkc.org), King County is a leader in the region's comprehensive response to ending homelessness. This involves identifying key strategies to be employed and target populations to be served, aligning current

activities to more closely follow the Ten-Year Plan, and planning and implementing innovative and creative projects that reach out to help homeless individuals or break down barriers to creating housing and other supporting programs.

In 2005 King County managed over $31 million in programs designed to prevent homelessness and provide housing and services to homeless people, or those in danger of becoming homeless. King County has been recognized for providing some of the highest quality homeless services through innovative and creative practices. In 2006 King County will continue to work towards this imperative to end homelessness through sustained management of programs and services that directly aid the homeless, and through funding partnerships, projects and programs to prevent homelessness.

Veterans and Regional Human Services Levy

In November 2005 King County voters overwhelmingly approved the establishment of the Veterans and Regional Human Services Levy. The levy will raise approximately $13.3 million per year of additional property tax revenue for six years. Fifty percent of the proceeds will be used to support health and human services for veterans, military personnel, and their family members. The remaining 50 percent of the levy will be used to provide services to other individuals in need. Two citizen advisory boards will be established to oversee the implementation of the levy.

2005 Capital Program Highlights

Several significant capital projects were completed in 2005. The Wastewater Treatment Division completed two combined sewer overflow projects for $218 million. Together these projects serve to reduce sewage and stormwater overflow that are released into water bodies during storms. These projects help to protect water quality in Elliot Bay, Lake Union, Lake Washington, and the Duwamish River. The Metro Transit Division completed the $17.8 million Redondo Heights Park-and-Ride featuring 700 parking stalls. The Road Services Division completed two road widening projects for $43 million at South 277th Street and NE 124th Street. Facilities Management Division also completed the Courthouse lobby renovation and elevator modernization capital project.

Debt Rating Upgrades

During 2005 King County obtained an upgrade on its bond ratings from Standard & Poor's of "AA+" to "AAA" for its non-voter-approved and voter-approved general obligation bonds. Subsequently, Standard & Poor's also upgraded the Sewer Revenue bonds rating from "AA-" to "AA." In addition, in its first year being rated by Fitch, the County obtained a rating of "AA+" and "AAA" for its non-voter-approved and voter-approved general obligation bonds, respectively.

Cash Management Policies and Practices

King County managed a $3.3 billion (annual average) investment pool (the Pool) during 2005 and distributed $104.7 million in interest earnings to a combination of county agencies and 99 other special districts and public authorities participating in the Pool. In accordance with RCW

36.48.070, the County's Executive Finance Committee reviews the Pool's investment practices and policies on a regular basis. The Pool seeks to obtain a market rate of return while preserving and protecting capital. The Pool pursues its objectives by investing in high quality securities, including US Treasuries, US Agency notes and mortgage-backed securities, taxable municipal notes, commercial paper, certificates of deposit, repurchase agreements, and the State of Washington's Local Government Investment Pool. In 2005 the Pool became the first local government investment pool in Washington State to be rated by Standard & Poor's Rating Services, receiving its highest rating of "AAAf" for its extremely strong protection against losses from credit defaults.

With the exception of one fund, all County money is invested in the Pool. During 2005 the County's Pool realized an average yield of 3.2 percent, up from 2.3 percent in 2004. Interest earnings of County funds in 2005 were over $47 million, including over $14.9 million for the General Fund.

Risk Management

As a municipal organization, the County has a wide range of loss exposures. The County uses three internal service funds to account for and finance property/casualty, workers' compensation, and employee medical and dental benefits self-insurance programs. Note 10 – Risk Management discloses the specific programs and claims liability changes during 2005 for each insurance program.

Pension Benefits

Qualifying County employees participate in the Public Employees' Retirement System (PERS), the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF), or the Seattle City Employees' Retirement System (SCERS). PERS and LEOFF are statewide local government retirement systems administered by the State of Washington's Department of Retirement Systems under cost-sharing, multiple-employer defined benefit and defined contribution public employee retirement systems. Note 8 – Defined Benefit Pension Plans presents plan descriptions and information on funding policies.

Awards and Acknowledgements

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to King County for its comprehensive annual financial report for the fiscal year ended December 31, 2004. This was the 24th consecutive year that the County 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 preparation of this report would not have been possible without the efficient and dedicated services of the Financial Accounting staff of the Finance and Business Operations Division. We would like to express our appreciation to all members of the division who assisted and contributed to the preparation of this report. Credit must also be given to the Executive and County Council for their support for maintaining the highest standards of professionalism in the management of the County's finances.

Respectfully submitted,

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