MERCED COMMUNITY COLLEGE DISTRICT MEASURES H AND J BOND FUNDS

County of Merced
Merced, California

FINANCIAL STATEMENTS WITH INDEPENDENT AUDITORS' REPORTS

June 30, 2006

Matson and Isom

Certified Public Accountants

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INDEPENDENT AUDITORS' REPORT

Board of Trustees
Merced Community College District
Merced, California

We have audited the accompanying statement of net assets of the Measures H and J Bond Funds (the Measures) of Merced Community College District (the District) as of June 30, 2006, and the related statements of revenue, expenses, and changes in net assets, and cash flows for the year then ended. These financial statements are the responsibility of the District's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the Measures and do not purport to, and do not, present fairly, the financial position of the District as of June 30, 2006, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Measures as of June 30, 2006, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 20, 2006, on our consideration of the District's internal control of the Measures over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance, and the results of the testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The District has not presented management's discussion and analysis that the Governmental Accounting Standards Board has determined is necessary to supplement, although not be required to a part of, the basic financial statements.

Matson and Isom

October 20, 2006

FINANCIAL SECTION

June 30, 2006

ASSETS	
CURRENT ASSETS	
Accounts receivable - net	$ 229
Total Current Assets	229
NONCURRENT ASSETS	
Restricted cash and investments	17,026,045
Deferred charges	724,436
Capital assets - net	20,477,897
Total Noncurrent Assets	38,228,378
Total Assets	$ 38,228,607
LIABILITIES AND NET ASSETS	
CURRENT LIABILITIES	
Accounts payable	$ 815,834
Accrued interest payable	510,683
Current portion long-term liabilities	1,546,358
Total Current Liabilities	2,872,875
NONCURRENT LIABILITIES	
Long-term liabilities	27,828,846
Due to other funds	35,886
Total Noncurrent Liabilities	27,864,732
Total Liabilities	30,737,607
NET ASSETS	
Restricted for Measures H and J Bonds	7,491,000
Total Liabilities and Net Assets	$ 38,228,607

The accompanying notes are an integral part of these financial statements.

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

Year Ended June 30, 2006	
OPERATING EXPENSES	
Depreciation	$ 151,018
Operating Loss	(151,018)
NONOPERATING REVENUES (EXPENSES)	
Supplies, materials, and other expenses and services - capital	34,762
Salaries and benefits	(12,040)
Investment income - capital	883,651
Amortization of deferred charges	(31,317)
Interest expense	(1,094,636)
Total Nonoperating Revenues (Expenses)	(219,580)
Loss Before Other Revenues, Expenses, Gains, or Losses	(370,598)
Local property taxes and revenues - capital	3,286,402
Increase in Net Assets	2,915,804
Net Assets - Beginning of Year	4,575,196
Net Assets - End of Year	$ 7,491,000

The accompanying notes are an integral part of these financial statements.

Year Ended June 30, 2006	
CASH FLOWS FROM OPERATING ACTIVITIES	$ -
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Proceeds from capital debt	6,851,327
Purchases of capital assets	(13,189,185)
Principal paid on capital debt	(1,705,000)
Interest paid	(1,495,480)
Interest on investments	883,651
Local property taxes and other revenues for capital purposes	3,408,669
Other payments	22,722
Net Cash Used by Capital and Related Financing Activities	(5,223,296)
Net Decrease in Cash and Investments	(5,223,296)
Cash and Investments - Beginning of Year	22,249,341
Cash and Investments - End of Year	$ 17,026,045
RECONCILIATION OF NET OPERATING LOSS TO NET CASH FLOWS FROM OPERATING ACTIVITIES	
Operating loss	$ (151,018)
Adjustments to reconcile net loss to net cash provided by operating activities:	
Depreciation expense	151,018
Net Cash Flows From Operating Activities	$ -

The accompanying notes are an integral part of these financial statements.

1. ORGANIZATION AND NATURE OF ACTIVITIES

Definition of the Reporting Entity Merced Community College District (the District) provides higher education in the greater Merced area, which consists of portions of three counties. The District consists of one community college with two branches located throughout the service area.

Measure H is a facilities and equipment bond measure for the School Facilities Improvement District No. 1 (Merced Campus Area) adopted by the Board of Trustees of the District and passed by voters on November 5, 2002, authorizing the issuance and sale of general obligation bonds of $53,500,000. Measure J is a facilities and equipment bond measure for the School Facilities Improvement District No. 2 (Los Banos Campus Area) adopted by the Board of Trustees of the District and passed by voters on November 5, 2002, authorizing the issuance and sale of general obligation bonds of $11,930,000. On June 19, 2003, the District issued current interest bonds in the amount $20,000,000 and $5,140,000 for the Merced and Los Banos Campus Areas, respectively. The $25,140,000 of current interest bonds are financed over 24 years with principal payments due annually on August 1 beginning August 1, 2004. Interest payments will be made semiannually on February 1 and August 1, beginning February 1, 2004. On August 1, 2005, the District issued serial and term bonds in the amounts of $3,025,000 and $3,765,000, respectively. The serial bonds are financed over 24 years with the principal payments due on August 1 beginning August 1, 2007. Interest payments will be made semi-annually on February 1 and August 1, beginning February 1, 2006. The $3,765,000 of term bonds are subject to five yearly mandatory sinking fund redemptions, each due on August 1 beginning in 2025.

The County Board of Supervisors of Merced and Madera Counties are empowered and obligated to levy property taxes, without limitation as to rate or amount (except for certain property which is taxable at limited rates), for payment of principal and maturity value of and interest on the Merced Campus Area bonds. The County Board of Supervisors of Merced and Fresno Counties are empowered and obligated to levy property taxes, without limitation as to rate or amount (except for certain property which is taxable at limited rates), for payment of principal and maturity value of and interest on the Los Banos Campus Area bonds.

The accompanying financial statements present only the Measure H and Measure J Funds (the Measures) of the District. The District has established separate capital project funds and separate debt service funds to account for the activities of the Measures.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting For financial reporting purposes, the District is considered a special-purpose government engaged only in business-type activities. Accordingly, the financial statements have been presented using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned, and expenses are recorded when an obligation has been incurred. All significant interfund transactions have been eliminated.

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB) and, where applicable, Financial Accounting Standards Board (FASB) statements issued through 1989.

The budgetary and financial accounts of the District are recorded and maintained in accordance with the *Budget and Accounting Manual* issued by the Chancellor's Office of the California Community Colleges, which is consistent with generally accepted accounting principles.

Restricted Cash and Investments Cash and investments that are externally restricted for contractual obligations are classified as noncurrent assets in the statement of net assets.

In accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, highly liquid market investments with maturities of one year or less at the time of purchase are stated at amortized cost. All other investments are stated at fair value. Market value is used as fair value for those securities for which market quotations are readily available.

In accordance with *California Education Code*, Section 81963, the District maintains the debt service funds in the Merced County Treasury as part of the common investment pool. In accordance with *California Education Code*, Section 81965, the District maintains the bond capital project funds in the California Asset Management Program, a California common law trust. These funds are restricted by *California Government Code*, Section 53635 pursuant to Section 53601 to invest in time deposits, U.S. government securities, state registered warrants, notes, bonds, state Treasurer's investment pool, bankers' acceptances, commercial paper, negotiable certificates of deposit, and repurchase or reverse repurchase agreements.

Investments in the county pool are valued using the amortized cost method (which approximates fair value) and includes accrued interest. The pool has deposits and investments with a weighted-average maturity of less than one year. As of June 30, 2006, the fair value of the county pool is 99.27% of the carrying value and is deemed to not represent a material difference. Information regarding the amount of dollars invested in derivatives with the county was not available. The county investment pool is subject to regulatory oversight by the Treasury Oversight Committee as required by *California Government Code*, Section 27130. The District is considered to be an involuntary participant in the external investment pool.

The District participates in the California Asset Management Program (CAMP) as described further in note 8. As of June 30, 2006, the fair value of CAMP is 99.96% of the carrying value and is deemed to not represent a material difference. There are no CAMP funds invested in derivatives as of June 30, 2006. Oversight of CAMP is provided by the Board of Trustees, which consists of seven trustees. The trustees are appointed to the Board of Trustees from members of the governing body, officers, or full-time employees of a public agency that is a participant in the trust and approved annually by the participants. The District is considered to be a voluntary participant in the CAMP investment pool.

The calculation of realized gains is independent of the calculation of the net increase in the fair value of investments. Realized gains and losses on investments that had been held in more than one fiscal year and sold in the current year may have been recognized as an increase or decrease in the fair value of investments reported in the prior year. The change in the fair value of investments was insignificant during the year ended June 30, 2006, and there was no significant unrealized gain or loss on investments at June 30, 2006.

Deferred Charges Deferred charges are bond issuance costs and are deferred and amortized over the term of the bonds using the straight-line method since the results are not significantly different from the effective interest method.

Capital Assets Capital assets are recorded at cost on the date of acquisition, or fair market value at the date of donation. For equipment, the District's capitalization policy includes all items with a unit cost of $5,000 or more and an estimated useful life of greater than one year. Renovations to buildings and site improvements that significantly increase the value or extend the useful life of the structure are capitalized. Routine repair and maintenance are charged to operating expenses in the year in which the expense was incurred.

Depreciation is computed on a straight-line basis using the half-year convention over the estimated useful life of the assets; generally 50 years for buildings, 10 years for site improvements, 8 years for equipment, 5 years for library books, and 3 years for technology equipment.

Bond Premium Bond premiums are deferred and amortized over the term of the bonds using the effective interest method. Bond premiums are presented as an increase of the face amount of the bonds payable.

Budgets and Budgetary Accounting By state law, the District's governing board must approve a tentative budget no later than July 1 and adopt a final budget no later than September 15 of each year. A hearing must be conducted for public comments prior to adoption. The District's governing board satisfied these requirements.

The budget is revised during the year to incorporate categorical funds which are awarded during the year and for miscellaneous changes to the spending plans. Revisions to the budget are approved by the District's governing board.

Property Tax Secured property taxes attach as an enforceable lien on property as of March 1. Taxes are payable in two installments on November 1 and February 1 and become delinquent if paid after December 10 and April 10. The counties of Merced, Madera, and Fresno bill and collect the taxes for the District. Tax revenues are recognized by the District when received.

Estimates Used in Financial Reporting In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements as well as revenues and expenses during the reporting period. Actual results could differ from those estimates.

Net Assets The District's net assets are classified as follows:

> *Restricted Net Assets* include resources which the District is legally or contractually obligated to spend in accordance with restrictions imposed by external third parties.

When an expense is incurred that can be paid using either restricted or unrestricted resources, the District's policy is to first apply the expense towards restricted resources and then towards unrestricted resources.

Classification of Revenues The District has classified its revenues as nonoperating revenues according to the following criteria:

Nonoperating Revenues include activities that have the characteristics of nonexchange transactions, such as capital gifts and contributions, and other revenue sources that are defined as nonoperating revenues, such as state appropriations and investment income, according to GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting* and GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*.

Risk Management The District retains risk for property damage on the first $100,000 of each claim. The District retains no risk for liability or workers' compensation claims, and coverage is provided by pooled insurance as a member of a joint powers authority.

Certain liability coverage in excess of $350,000 and up to $25,000,000 is provided by pooled insurance as a member of a joint powers authority of California community colleges and school districts. Property damage in excess of $5,000 and up to $100,000,000 is provided by pooled insurance as a member of a joint powers authority.

3. RESTRICTED CASH AND INVESTMENTS

The following is a summary of restricted cash and investments at June 30, 2006:

	Fair Value
INVESTMENTS THAT ARE NOT SECURITIES (1)	
County treasurer's investment pool	$ 3,599,986
California Asset Management Program	13,426,059
Total Restricted Cash and Investments	$ 17,026,045

(1) ***Investments That are Not Securities*** A "security" is a transferable financial instrument that evidences ownership or creditorship, whether in physical or book entry form. Restricted investments that are not securities do not have custodial credit risk because they do not involve a transferable financial instrument. Thus, they are not categorized into custodial credit risk categories.

Credit Risk – Investments

California Government Code, Section 53601 limits investments in commercial paper to "prime" quality of the highest ranking, or of the highest letter and numerical rating as provided by nationally recognized statistical rating organizations (NRSRO) and limits investments in medium-term notes to a rating of A or better. The District has no investment policy that would further limit its investment choices. The District's investment in the county investment pool is unrated. The District's investments in CAMP are rated AAA by Standard & Poor's indices.

Interest Rate Risk – Investments

California Government Code, Section 53601 limits the District's investments to maturities of five years. The District does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. The investments in the county treasurer's investment pool and CAMP mature in less than one year.

4. ACCOUNTS RECEIVABLE

Accounts receivable consisted of the following at June 30, 2006:

Local property taxes	$ 229

5. CAPITAL ASSETS

Changes in capital assets consist of the following:

	Balance July 1, 2005	Additions	Deductions	Balance June 30, 2006
NONDEPRECIATED CAPITAL ASSETS				
Construction in progress	$ 4,811,244	$ 13,192,541	$ 5,097,391	$ 12,906,394
DEPRECIATED CAPITAL ASSETS				
Buildings and improvements	2,651,728	5,119,632	-	7,771,360
Total Capital Assets	7,462,972	18,312,173	5,097,391	20,677,754
LESS ACCUMULATED DEPRECIATION				
Buildings and improvements	48,839	151,018	-	199,857
Total Capital Assets - Net	$ 7,414,133	$ 18,161,155	$ 5,097,391	$ 20,477,897

6. LONG-TERM LIABILITIES

The long-term liabilities activity for the year ended June 30, 2006, is shown below:

	Balance July 1, 2005	Additions	Deductions	Balance June 30, 2006	Current Portion
General obligation bonds payable	$ 23,675,000	$ 6,790,000	$ 1,705,000	$ 28,760,000	$ 1,460,000
Unamortized premiums	448,241	275,167	108,204	615,204	86,358
Total Long-Term Liabilities	$ 24,123,241	$ 7,065,167	$ 1,813,204	$ 29,375,204	$ 1,546,358

The general obligation bonds payable at June 30, 2006, with their outstanding balances are comprised of the following issuances:

Series 2003 general obligation bond for School Facilities Improvement District No. 1, due in annual installments of $310,000 to $1,500,000, beginning August 1, 2004, through August 1, 2027, at interest from 2.50% to 5.00%.	$ 17,565,000
Series 2003 general obligation bond for School Facilities Improvement District No. 2, due in annual installments of $45,000 to $440,000, beginning August 1, 2004, through August 1, 2027, at interest from 2.50% to 4.50%.	4,405,000
Series 2005 general obligation bond for School Facilities Improvement District No. 2, due in annual installments of $25,000 to $1,185,000, beginning August 1, 2007, through August 1, 2029, at interest from 3.625% to 5.00%.	6,790,000
Total	$ 28,760,000

The amount of interest cost incurred during the year ended June 30, 2006, was $1,094,636, all of which was charged to expenses.

The annual requirements to amortize the general obligation bonds payable are as follows:

	Principal	**Interest**	**Total**
2007	$ 1,460,000	$ 1,203,178	$ 2,663,178
2008	600,000	1,173,703	1,773,703
2009	670,000	1,157,378	1,827,378
2010	755,000	1,138,928	1,893,928
2011	835,000	1,112,265	1,947,265
2012-2016	11,390,000	3,763,815	15,153,815
2017-2021	3,580,000	2,642,565	6,222,565
2022-2026	5,315,000	1,512,810	6,827,810
2027-2030	4,155,000	434,300	4,589,300
Totals	$ 28,760,000	$ 14,138,942	$ 42,898,942

7. COMMITMENTS AND CONTINGENCIES

The District entered into several construction commitments during the year ended June 30, 2006, for a total of $48,143,915 with $30,461,424 outstanding at June 30, 2006. Subsequent to June 30, 2006, the District entered into several additional construction commitments for a total of $1,546,275.

8. JOINT POWERS AGREEMENT

The District participates in joint ventures under joint power agreements with the following joint powers authorities (JPAs): Valley Insurance Program (VIP), Schools Excess Liability Fund (SELF), and Self-Insured Schools of California (SISC III). The relationship between the District and the JPAs is such that the JPAs are not component units of the District for financial reporting purposes. The JPAs arrange for and provide property, liability, workers' compensation, dental, vision, and excess liability coverage for their members. Each JPA is governed by a board consisting of representatives from the members. The boards control the operations of the JPAs, including selection of management and approval of operating budgets, independent of any influence by the members beyond their representation on the boards. Each member pays a premium commensurate with the level of coverage requested and shares surpluses and deficits proportionate to its participation in the JPA.

The District participates in investment of certain bond proceeds and surplus funds organized by the California Asset Management Program (CAMP). The CAMP is a JPA created to provide investment management services for surplus funds and comprehensive investment management, accounting, and arbitrage rebate calculation services for proceeds of tax-exempt financings.

Separately issued financial statements can be requested from each JPA. Condensed audited financial information for each JPA is as follows:

	June 30, 2005	September 30, 2005		December 31, 2005
	SELF	**VIP**	**SISC III**	**CAMP**
Total assets	$ 177,635,435	$ 12,453,320	$ 128,700,034	$ 701,025,000
Total liabilities	174,412,337	10,647,423	68,541,093	79,346,000
Net Assets	$ 3,223,098	$ 1,805,897	$ 60,158,941	$ 621,679,000
Total operating revenues	$ 38,195,479	$ 4,480,771	$ 586,148,243	$ 13,543,000
Total operating expenditures	60,768,157	(7,828,439)	549,272,961	856,000
Nonoperating income	-	235,336	-	132,969,000
Excess Revenues (Expenses)	$ (22,572,678)	$ (3,112,332)	$ 36,875,282	$ 145,656,000

9. SUBSEQUENT EVENTS

On August 1, 2006, the District issued general obligation bonds (Series 2006 bonds), authorized by the 2002 election totaling $24,000,000 for the Merced Campus Area. The bonds included $9,870,000 of serial bonds and $14,130,000 of term bonds. The serial bonds are financed over 19 years with principal payments due each August 1 beginning August 1, 2007. The term bonds are subject to six annual mandatory sinking fund redemptions due each August 1 beginning August 1, 2026. Interest payments will be made semiannually on February 1 and August 1 beginning February 1, 2007.

OTHER REPORT

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Board of Trustees
Merced Community College District
Merced, California

We have audited the financial statements of the Measure H and J Bond Funds (the Measures) of Merced Community College District (the District) as of and for the year ended June 30, 2006, and have issued our report thereon dated October 20, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the District's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Measures' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit; and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Citizens' Oversight Committee, Board of Trustees, management, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Matson and Isom

October 20, 2006