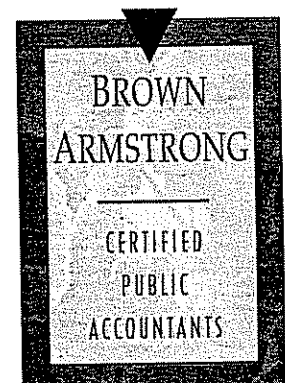


**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT**

**FINANCIAL STATEMENTS  
WITH  
INDEPENDENT AUDITOR'S REPORT**

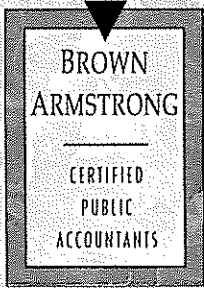
**JUNE 30, 2006 AND 2005**



**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
JUNE 30, 2006 AND 2005**

**TABLE OF CONTENTS**

|   | <u>Page</u> |
|---|-------------|
| <u>Financial Section</u>  |             |
| Independent Auditor's Report .....  | 1           |
| Management's Discussion and Analysis .....  | 3           |
| <u>General Purpose Financial Statements</u>   |             |
| Statements of Net Assets .....  | 7           |
| Statements of Revenues, Expenses, and Changes in Fund Net Assets .....  | 9           |
| Statements of Cash Flows .....  | 10          |
| Notes to Financial Statements .....   | 11          |
| <u>Supplementary Information</u>  |             |
| Statements of Operating Expenses .....  | 25          |
| <u>Other Schedules and Reports</u>  |             |
| Schedule of Expenditures of Federal Awards .....  | 26          |
| Notes to Schedule of Expenditures of Federal Awards .....   | 27          |
| Report on Internal Control over Financial Reporting and on Compliance<br>and Other Matters Based on an Audit of Financial Statements Performed<br>in Accordance with Government Auditing Standards and the Rules and<br>Regulations of the Transportation Development Act ..... | 28          |
| Report on Compliance with Requirements Applicable to Each<br>Major Program and Internal Control over Compliance in<br>Accordance with OMB Circular A-133 .....  | 30          |
| Report on Compliance with the Transportation Development Act .....  | 32          |
| <u>Findings and Questioned Costs Section</u>  |             |
| Schedule of Findings and Questioned Costs .....   | 33          |



BROWN ARMSTRONG
PAULDEN McCOWN STARBUCK THORNBURGH & KEETER
CERTIFIED PUBLIC ACCOUNTANTS

Main Office
4200 Truxtun Ave., Suite 300
Bakersfield, California 93309
Tel 661-324-4971 Fax 661-324-4997
e-mail: info@bacpas.com

Shafter Office
560 Central Avenue
Shafter, California 93263
Tel 661-746-2145 Fax 661-746-1218

- Andrew J Paulden, CPA
Peter C Brown, CPA
Burton H Armstrong, CPA, MST
Harvey J McCown, MBA, CPA
Steven R Starbuck, CPA
Aileen K Keeter, CPA
Chris M Thornburgh, CPA
Eric H Xin, MBA, CPA
Lynn R Krausse, CPA, MST
Bradley M Hankins, CPA
Rosalba Flores, CPA
Connie M Perez, CPA
M Sharon Jones, CPA, MST
Diana H Branthoover, CPA
Matthew R Gilligan, CPA
Michael C Olivares, CPA
Hanna J Sheppard, CPA
Ryan S. Johnson, CPA

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Santa Cruz Metropolitan Transit District
Santa Cruz, California

We have audited the accompanying basic financial statements of the Santa Cruz Metropolitan Transit District (the District), as of June 30, 2006 and 2005, as listed in the table of contents. These basic financial statements are the responsibility of the Santa Cruz Metropolitan Transit District's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

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. 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.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the financial position of the Santa Cruz Metropolitan Transit District, as of June 30, 2006 and 2005, and the results of its operations and the cash flows for the years 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 26, 2006 on our consideration of the Santa Cruz Metropolitan Transit District's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 3 through 6 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was performed for the purpose of forming an opinion on the basic financial statements of Santa Cruz Metropolitan Transit District, taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," and is not a required part of the financial statements. The accompanying statements of operating expenses by function are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

BROWN ARMSTRONG PAULDEN  
McCOWN STARBUCK THORNBURGH & KEETER  
ACCOUNTANCY CORPORATION



Bakersfield, California  
October 26, 2006

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
JUNE 30, 2006 AND 2005**

**Introduction**

This report provides a narrative and analytical overview of the financial activities of the Santa Cruz Metropolitan Transit District (the District) with selected comparative information for the years ended June 30, 2006 and 2005. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section

The District is an independent agency formed in 1969 by the legislature of the State of California for the purpose of providing transit service to the general public in Santa Cruz County. The District is governed by a Board of Directors composed of eleven members, and one ex-officio member as described in Note 1 A.

**The Financial Statements**

The District's basic financial statements are prepared using proprietary fund (enterprise fund) accounting that uses the same basis of accounting as private-sector business enterprises. The District reports its financial results using one enterprise fund under the accrual method of accounting which records revenue when earned and expenses when incurred.

The Statements of Net Assets present information on the District's assets and liabilities, with the difference between the two reported as net assets.

The Statements of Revenue, Expenses and Changes in Fund Net Assets report the *operating* revenues and expenses, *non-operating* revenues and expenses and *capital grant* revenues. *Capital grant* expenses are listed in the Schedule of Expenditures of Federal Awards and are included in the current year increase in fixed assets.

The Statements of Cash Flows report the sources and uses of cash for the fiscal years resulting from *operating* activities, *non-capital* financing activities (operating grants and sales tax revenue), *capital* financing activities (acquisitions and disposal) and *financing* activities (non-transportation revenues). The net result of these activities, added to the cash balances at the beginning of the year reconciles to the cash balances (current plus restricted) at the end of the current fiscal year on the Statement of Net Assets.

The Statements of Operating Expenses, located in the Supplementary Information section of the financial statements, reports expenditures in greater detail.

**Financial Highlights**

A strike called by United Transportation Union, Local 23, began on September 27, 2005, resulting in the immediate cessation of all fixed-route bus service. ParaCruz (complementary paratransit service) continued to operate. The strike significantly reduced revenues and expenses from September 27, 2005, to November 2, 2005. The District offered fare-free days to riders when service resumed on November 3, 2005, which impacted passenger revenue.

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)  
JUNE 30, 2006 AND 2005**

**Condensed Statement of Net Assets:**

|                   | 2006          | 2005          | Increase/(Decrease) |     |
|-------------------|---------------|---------------|---------------------|-----|
|                   |               |               | Amount              | %   |
| Total Assets      | \$ 71,935,684 | \$ 68,424,328 | \$ 3,511,356        | 5%  |
| Total Liabilities | \$ 24,151,964 | \$ 20,616,897 | \$ 3,535,067        | 17% |
| Total Net Assets  | \$ 47,783,720 | \$ 47,807,431 | \$ (23,711)         | 0%  |

Total Assets increased primarily due to sales tax and other receivables and construction in progress. Total Liabilities increased from accounts payable and the addition to restricted capital funds (STA).

An increase or decrease in net assets is an indicator of the financial health of the District's. For the fiscal year ended June 30, 2005, the District's net assets increased by \$1,261,781 due to federal, state and local capital contribution for capital acquisitions. For the fiscal year ended June 30, 2006, the District's net assets decreased by \$23,711, which is the equivalent of no change.

**Condensed Statement of Revenues, Expenses and Change in Fund Net Assets:**

|                                   | 2006         | 2005         | Increase/(Decrease) |       |
|-----------------------------------|--------------|--------------|---------------------|-------|
|                                   |              |              | Amount              | %     |
| Operating Revenues                | \$ 6,283,590 | \$ 7,120,869 | \$ (837,279)        | -12%  |
| Operating Expenses                | (35,021,591) | (34,994,171) | (27,420)            | 0%    |
| Operating Loss                    | (28,738,001) | (27,873,302) | (864,699)           | 3%    |
| Nonoperating Revenues             | 27,059,329   | 24,958,525   | 2,100,804           | 8%    |
| Capital Contributions             | 1,654,961    | 4,176,558    | (2,521,597)         | -60%  |
| Increase (Decrease) in Net Assets | \$ (23,711)  | \$ 1,261,781 | \$ (1,285,492)      | -102% |

Operating revenue decreased due to the 2005 strike and subsequent loss of riders. Non-operating revenues increased 8% due to higher interest income resulting from more favorable interest rates, along with higher sales tax revenue.

Operating expenses were flat due to the strike. Pension, healthcare and fuel costs continue to be a significant cause of a higher cost of operating. However, those increases were offset by decreases in other expense categories. The increase in absence with pay was due to the fact that most employees represented by Service Employees International Union, Local 415, were on paid status during the five-week strike. This increase was matched by a corresponding decrease in other salaries and wages.

Capital contributions are capital grant funds received for purchases of revenue vehicles and facilities improvement. Capital acquisitions were significantly reduced from the prior year because no buses were purchased during the year.

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)  
JUNE 30, 2006 AND 2005**

**Supplemental Revenue, Expense and Performance Report:  
(based on FTA account grouping guidelines)**

|   | 2006                 | 2005                 | % Change    |
|---|----------------------|----------------------|-------------|
| <b>Revenues</b>   |                      |                      |             |
| Passenger Fares   | \$ 6,283,590         | \$ 7,120,869         | -11.8%      |
| Sales and Use Tax   | 16,583,132           | 15,848,098           | 4.6%        |
| Non-Operating Revenues <sup>(1)</sup>                       | 1,649,085            | 709,709              | 132.4%      |
| TDA <sup>(2)</sup>  | 5,740,612            | 5,413,251            | 6.0%        |
| Federal Operating Assistance                                | 3,087,031            | 3,203,659            | -3.6%       |
| <b>Total Operating Revenue</b>                              | <b>\$ 33,343,450</b> | <b>\$ 32,295,586</b> | <b>3.2%</b> |
| <b>Expenses</b>   |                      |                      |             |
| Route Operation   | \$ 19,010,849        | \$ 19,035,254        | -0.1%       |
| Vehicle Maintenance   | 4,855,236            | 4,684,140            | 3.7%        |
| Facilities Maintenance                                      | 1,227,780            | 1,325,515            | -7.4%       |
| General Administration                                      | 6,152,708            | 5,975,454            | 3.0%        |
| <b>Total Operating Expense<br/>(excluding depreciation)</b> | <b>\$ 31,246,573</b> | <b>\$ 31,020,363</b> | <b>0.7%</b> |
| <b>Performance Indicators <sup>(3)</sup></b>                |                      |                      |             |
| Total Passengers  | 4,850,405            | 5,581,328            | -13.1%      |
| Revenue Hours   | 237,645              | 247,464              | -4.0%       |
| Revenue Miles   | 3,400,955            | 3,701,940            | -8.1%       |
| <b>Farebox Recovery Ratio <sup>(4)</sup></b>                |                      |                      |             |
| Cost/Passenger  | \$ 6.44              | \$ 5.56              | 15.9%       |
| Cost/Hour   | \$ 131.48            | \$ 125.35            | 4.9%        |
| Cost/Mile   | \$ 9.19              | \$ 8.38              | 9.6%        |
| Full Time Equivalent Employees                              | 321                  | 305                  | 5.2%        |
| Active Fleet - Fixed Route                                  | 113                  | 111                  | 1.8%        |
| Active Fleet - Paratransit                                  | 33                   | 32                   |             |

<sup>(1)</sup> Non-Operating Revenues increased substantially due to higher interest rates and interest income in 2006

<sup>(2)</sup> Transportation Development Act (TDA) funding constitutes a significant percentage of the District's operating revenues. The funding the District receives fluctuates annually based on retail sales in the County and by the amount retained by the Santa Cruz County Regional Transportation Commission for other county-wide projects and overhead.

<sup>(3)</sup> Farebox Recovery Ratio is a standard transit performance indicator that is calculated by dividing passenger fares by operating expenses.

<sup>(4)</sup> Restated for 2005 to include paratransit ridership.

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)  
JUNE 30, 2006 AND 2005**

**Condensed Statement of Cash Flows:**

|   | <u>2006</u>          | <u>2005</u>          | <u>Change</u>       |
|---|----------------------|----------------------|---------------------|
| Net Cash (Used) in Operating Activities                                 | \$ (23,524,607)      | \$ (23,477,969)      | \$ (46,638)         |
| Net Cash Provided by Non-Capital Financing Activities                   | 24,410,619           | 24,319,820           | 90,799              |
| Net Cash Provided by (Used) in Capital and Related Financing Activities | 263,631              | (592,234)            | 855,865             |
| Net Cash Provided by Non-Transportation Activities                      | <u>1,217,371</u>     | <u>631,517</u>       | <u>585,854</u>      |
| Net Increase (Decrease) in Cash and Cash Equivalents                    | 2,367,014            | 881,134              | 1,485,880           |
| Cash and Cash Equivalents, Beginning of Year                            | <u>29,521,766</u>    | <u>28,640,632</u>    | <u>881,134</u>      |
| Cash and Cash Equivalents, End of Year                                  | <u>\$ 31,888,780</u> | <u>\$ 29,521,766</u> | <u>\$ 2,367,014</u> |

Cash and cash equivalents held by the District increased by \$881,134 or 3% during the year

**Contacting the District's Financial Management**

The District's financial report is designed to provide the District's Board of Directors, management, and public with an overview of the District's finances. For additional information about this report, please contact Elisabeth Ross, Finance Manager, at 370 Encinal Street, Suite 100, Santa Cruz, CA 95060



**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
STATEMENTS OF NET ASSETS  
JUNE 30, 2006 AND 2005**

| <u>ASSETS</u>                   | <u>2006</u>                 | <u>2005</u>                 |
|---------------------------------|-----------------------------|-----------------------------|
| <b>CURRENT ASSETS</b>           |                             |                             |
| Cash and Cash Equivalents       | \$ 20,258,964               | \$ 19,689,759               |
| Sales Tax and Other Receivables | 6,026,987                   | 3,996,933                   |
| Inventory                       | 928,026                     | 903,863                     |
| Prepays                         | 555,353                     | 155,792                     |
|                                 | <u>27,769,330</u>           | <u>24,746,347</u>           |
| <b>RESTRICTED ASSETS</b>        |                             |                             |
| Cash and Cash Equivalents       | <u>11,629,816</u>           | <u>9,832,007</u>            |
| <b>PROPERTY AND EQUIPMENT</b>   |                             |                             |
| Building and Improvements       | 10,452,483                  | 10,452,483                  |
| Revenue Vehicles                | 34,649,265                  | 34,555,916                  |
| Operations Equipment            | 2,687,228                   | 2,686,565                   |
| Other Equipment                 | 1,285,123                   | 1,285,123                   |
| Other Vehicles                  | 898,514                     | 829,537                     |
| Office Equipment                | 1,094,759                   | 1,152,497                   |
|                                 | <u>51,067,372</u>           | <u>50,962,121</u>           |
| Less Accumulated Depreciation   | <u>(30,324,213)</u>         | <u>(26,845,932)</u>         |
|                                 | 20,743,159                  | 24,116,189                  |
| Construction in Progress        | 4,816,956                   | 2,753,362                   |
| Land                            | <u>6,976,423</u>            | <u>6,976,423</u>            |
| Total Property and Equipment    | <u>32,536,538</u>           | <u>33,845,974</u>           |
| <b>TOTAL ASSETS</b>             | <u><u>\$ 71,935,684</u></u> | <u><u>\$ 68,424,328</u></u> |

The accompanying notes are an integral part of these financial statements

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT**  
**STATEMENTS OF NET ASSETS (Continued)**  
**JUNE 30, 2006 AND 2005**

| <u>LIABILITIES AND NET ASSETS</u>                 | <u>2006</u>          | <u>2005</u>          |
|---|----------------------|----------------------|
| <b>CURRENT LIABILITIES</b>                        |                      |                      |
| Accounts Payable and Accrued Liabilities          | \$ 1,449,500         | \$ 643,186           |
| Accrued Payroll and Employee Benefits             | 3,351,093            | 2,994,662            |
| Workers' Compensation Liabilities                 | 1,378,844            | 1,228,191            |
| Other Accrued Liabilities                         | 466,558              | 465,252              |
| Security Deposit                                  | 16,684               | 17,684               |
| Deferred Revenue                                  | 189,500              | 241,170              |
| <b>Total Current Liabilities</b>                  | <b>6,852,179</b>     | <b>5,590,145</b>     |
| <b>LIABILITIES PAYABLE FROM RESTRICTED ASSETS</b> |                      |                      |
| Deferred Revenue - Settlement Agreement           | 7,321,289            | 6,998,304            |
| Deferred Revenue - STA Grant                      | 4,308,527            | 2,833,703            |
| <b>LONG-TERM LIABILITIES</b>                      |                      |                      |
| Workers' Compensation Liabilities                 | 5,669,969            | 5,194,745            |
| <b>Total Liabilities</b>                          | <b>24,151,964</b>    | <b>20,616,897</b>    |
| <b>NET ASSETS</b>                                 |                      |                      |
| Invested in Capital Assets, Net of Related Debt   | 32,536,538           | 33,845,974           |
| Unrestricted Net Assets                           | 15,247,182           | 13,961,457           |
| <b>Total Net Assets</b>                           | <b>47,783,720</b>    | <b>47,807,431</b>    |
| <b>TOTAL LIABILITIES AND NET ASSETS</b>           | <b>\$ 71,935,684</b> | <b>\$ 68,424,328</b> |

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

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
STATEMENTS OF REVENUES, EXPENSES, AND  
CHANGES IN FUND NET ASSETS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005**

|  | <u>2006</u>          | <u>2005</u>          |
|--|----------------------|----------------------|
| <b>OPERATING REVENUES</b>  |                      |                      |
| Passenger Fare   | \$ 3,837,280         | \$ 4,465,736         |
| Special Transit Fare   | 2,446,310            | 2,655,133            |
| Total Operating Revenues   | <u>6,283,590</u>     | <u>7,120,869</u>     |
| <b>OPERATING EXPENSES</b>  |                      |                      |
| Wages, Salaries and Employee Benefits                              | 24,659,059           | 23,853,713           |
| Purchased Transportation Services                                  | 142,892              | 977,899              |
| Material and Supplies  | 2,954,093            | 2,696,571            |
| Other Expenses   | 3,490,530            | 3,492,180            |
| Depreciation   | 3,775,017            | 3,973,808            |
| Total Operating Expenses   | <u>35,021,591</u>    | <u>34,994,171</u>    |
| Net Operating Loss   | <u>(28,738,001)</u>  | <u>(27,873,302)</u>  |
| <b>NON-OPERATING REVENUES (EXPENSES)</b>                           |                      |                      |
| Sales and Use Tax  | 16,583,132 ✓         | 15,848,098 ✓         |
| Transportation Development Act Assistance                          | 5,740,612            | 5,413,251            |
| Section 9/5307 Operating Assistance                                | 3,021,556            | 3,110,731            |
| Section 18/5307 Operating Assistance                               | 65,475               | 92,928               |
| Interest Income  | 1,035,565            | 472,279              |
| Rental Income  | 181,806              | 159,238              |
| Other Revenue  | 431,714              | 78,192               |
| Loss on Sale and Disposal of Property, Equipment,<br>and Inventory | <u>(531)</u>         | <u>(216,192)</u>     |
| Total Non-Operating Revenues                                       | <u>27,059,329</u>    | <u>24,958,525</u>    |
| Net Loss Before Capital Contributions                              | <u>(1,678,672)</u>   | <u>(2,914,777)</u>   |
| <b>CAPITAL CONTRIBUTIONS</b>                                       |                      |                      |
| Grants Restricted for Capital Expenditures                         | <u>1,654,961</u>     | <u>4,176,558</u>     |
| <b>NET ASSETS</b>  |                      |                      |
| Increase in Net Assets   | (23,711)             | 1,261,781            |
| Total Net Assets, Beginning of Year                                | <u>47,807,431</u>    | <u>46,545,650</u>    |
| Total Net Assets, End of Year                                      | <u>\$ 47,783,720</u> | <u>\$ 47,807,431</u> |

The accompanying notes are an integral part of these financial statements

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005**

|   | 2006                   | 2005                   |
|---|------------------------|------------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                        |                        |
| Receipts From Customers   | \$ 6,354,890           | \$ 7,059,543           |
| Payments to Employees   | (23,676,751)           | (23,249,767)           |
| Payments to Suppliers   | (6,202,746)            | (7,287,745)            |
|   | (23,524,607)           | (23,477,969)           |
| <b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:</b>                               |                        |                        |
| Operating Grants Received, Including Sales and Use Tax                                | 23,986,692             | 24,457,042             |
| Other Nonoperating  | 423,927                | (137,222)              |
|   | 24,410,619             | 24,319,820             |
| <b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:</b>                      |                        |                        |
| Proceeds From Sale of Property and Equipment  | 1,553                  | 74,463                 |
| Capital Grants Received   | 2,732,391              | 5,166,335              |
| Capital Expenditures  | (2,470,313)            | (5,833,032)            |
|   | 263,631                | (592,234)              |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                        |                        |
| Investment and Rental Income Received   | 1,217,371              | 631,517                |
|   | 2,367,014              | 881,134                |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>                                      | <b>2,367,014</b>       | <b>881,134</b>         |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>                                 | <b>29,521,766</b>      | <b>28,640,632</b>      |
| <b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>                                       | <b>\$ 31,888,780</b>   | <b>\$ 29,521,766</b>   |
| <b>RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES</b>      |                        |                        |
| Operating Loss  | \$ (28,738,001)        | \$ (27,873,302)        |
| Adjustments to Reconcile Net Operating Loss to Net Cash Used in Operating Activities: |                        |                        |
| (Gain) Loss on Sale / Disposal of Fixed Assets and Inventory                          | 3,179                  | 216,192                |
| Depreciation  | 3,775,017              | 3,973,808              |
| Changes in Assets and Liabilities:  |                        |                        |
| (Increase) Decrease in Receivables  | 71,300                 | (61,326)               |
| (Increase) in Inventory   | (24,163)               | (79,607)               |
| (Increase) Decrease in Prepaid Expenses   | (399,561)              | 15,678                 |
| Increase (Decrease) in Accounts Payable   | 806,314                | (273,678)              |
| Increase in Other Liabilities   | 981,308                | 604,266                |
|   | (23,524,607)           | (23,477,969)           |
| <b>Net Cash Used in Operating Activities</b>  | <b>\$ (23,524,607)</b> | <b>\$ (23,477,969)</b> |

The accompanying notes are an integral part of these financial statements

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2006 AND 2005**

**NOTE 1 – OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. Description of Organization**

The Santa Cruz Metropolitan Transit District (the District) was formed February 9, 1969, following a favorable election in conformity with Section 9800 *et. seq.* of the Public Utilities Code. The transit system serves the general public in the cities of Santa Cruz, Watsonville, Scotts Valley, Capitola and the unincorporated areas of Santa Cruz County. The District is governed by a Board of eleven directors, and one Ex-Officio director representing the University of California, Santa Cruz. At June 30, 2006, the directors were as follows:

|              |                   |                 |             |
|--------------|-------------------|-----------------|-------------|
| Chairperson: | Mike Rotkin       |                 |             |
| Vice Chair:  | Marcela Tavantzis |                 |             |
| Members:     | Dale Skillicorn   | Michelle Hinkle | Mark Stone  |
|              | Jan Beautz        | Emily Reilly    | Pat Spence  |
|              | Dene Bustichi     | Mike Keogh      | Kirby Nicol |
| Ex-Officio:  | Wes Scott         |                 |             |

The District also serves the Highway 17 corridor into Santa Clara County to provide commuter express service through a joint powers agreement with the Santa Clara County Transit District (known as Valley Transportation Authority (VTA)). Amtrak Thruway bus service is also provided by the District on the same corridor through a memorandum of understanding with the California Department of Transportation, the Capitol Corridor Joint Powers Authority and VTA.

**B. Reporting Entity**

The District and the Santa Cruz Civic Improvement Corporation (the Corporation) have a financial and operational relationship, which meets the reporting entity definition criteria of GASB Statement No. 14, as amended by GASB Statement No. 39, *The Financial Reporting Entity*, for inclusion of the Corporation as a component unit of the District. Accordingly, the financial activities of the Corporation have been included in the financial statements of the District. For the years ending June 30, 2006 and 2005, this activity was minimal.

**Scope of Public Service:**

The Corporation is a nonprofit, public benefit corporation incorporated under the laws of the State of California and recorded by the Secretary of State in July 1986. The Corporation was formed for the sole purpose of providing financial assistance to the District for the construction and acquisition of major capital facilities.

The following are those aspects of the relationship between the District and the Corporation, which satisfy GASB Statement No. 14/39 criteria:

**Accountability:**

1. The Corporation's Board of Directors was appointed by the District's Board of Directors.

**NOTE 1 – OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**B Reporting Entity (Continued)**

- 2 The District is able to impose its will upon the Corporation, based on the following:
  - All major financing arrangements, contracts, and other transactions of the Corporation must have the consent of the District
  - The District exercises significant influence over operations of the Corporation as it is anticipated that the District will be the sole lessee of all facilities owned by the Corporation. Likewise, it is anticipated that the District's lease payments will be the sole revenue source of the Corporation
- 3 The Corporation provides specific financial benefits or imposes specific financial burdens on the District based upon the following:
  - The District has assumed a "moral obligation", and potentially a legal obligation, for any debt incurred by the Corporation

**C Basis of Accounting and Presentation**

The District is accounted for as a Business Type Activity, as defined by Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – Management's Discussion & Analysis – for State and Local Governments* and its financial statements are presented on the accrual basis of accounting. Under this method, revenues are recognized when they are earned, and expenses are recognized when they are incurred.

The District adopted GASB Statement No. 34 as amended by GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments. Omnibus*, as of and for the year ended June 30, 2003, and applied those standards on a retroactive basis. GASB Statement No. 34 establishes standards for external financial reporting for state and local governments and requires that resources be classified for accounting and reporting purposes into three net asset categories; namely, those invested in capital assets, net of related debt, restricted net assets and unrestricted net assets.

**Contributed Capital/Reserved Retained Earnings:**

The District receives grants from the Federal Transit Administration (FTA) and other agencies of the U.S. Department of Transportation, state, and local transportation funds for the acquisition of transit-related equipment and improvements. Prior to July 1, 2001, capital grants were recognized as donated capital to the extent that project costs under the grant have been incurred. Capital grant funds earned, less amortization equal to accumulated depreciation of the related assets, were included in contributed capital. As required by GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, the District changed its method of accounting for capital grants from capital contributions to reserved nonoperating revenues. In accordance with GASB No. 33, capital grants are required to be included in the determination of net income resulting in an increase in net revenue of \$1,654,961 and \$4,176,558 for the fiscal years 2006 and 2005, respectively.

Under GASB Statement No. 34, contributed capital and reserved retained earnings are presented in the net asset section as invested in capital assets, net of related debt.

**Retained Earnings:**

Retained earnings which represented the residual value of operations and capital assets constructed with funds other than grants, were restated to reclassify the capital assets to invested in capital assets, net of related debt and the remaining assets resulting from operations as either restricted or unrestricted net assets.

**NOTE 1 – OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**C Basis of Accounting and Presentation (Continued)**

**Proprietary Accounting and Financial Reporting:**

As required under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the District will continue to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict or contradict GASB pronouncements. The District has elected under GASB Statement No. 20 to not apply all FASB Statements and Interpretations issued after November 30, 1989, due to the governmental nature of the District's operations

**Net Assets:**

Net assets represent the residual interest in the District's assets after liabilities are deducted. In accordance with GASB Statement No. 34, the Fund Equity section on the Statement of Net Assets was combined to report total net assets and present it in three broad components: invested in capital assets, net of related debt; restricted; and unrestricted. Net assets invested in capital assets, net of related debt include capital assets net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets. Net assets are restricted when constraints are imposed by third parties or by law through constitutional provisions or enabling legislation. All other net assets are unrestricted.

When both restricted and unrestricted resources are available for use, generally it is the District's policy to use restricted resources first, then unrestricted resources as they are needed.

**D Cash and Cash Equivalents**

The District considers all highly liquid investments with a maturity date within three months of the date acquired to be cash equivalents. The District deposits funds into an external investment pool maintained by the County of Santa Cruz. These deposits are considered cash equivalents. The County of Santa Cruz Pooled Investment Fund is authorized to invest in obligations of the U.S. Treasury agencies and instrumentalities, commercial paper rated A-1 by Standard and Poor's Corporation or P-1 by Moody's Commercial Paper Record, banker's acceptances, repurchase agreements, and the State Treasurer's investment pool. Cash and cash equivalents are stated at fair value. For purposes of the statement of cash flows, the District considers all highly liquid investments (including restricted assets) to be cash equivalents.

**E Inventory**

Inventory is carried at cost using the first-in/first-out (FIFO) method. Inventory held by the District consists of spare bus parts that are consumed by the District and are not for resale purposes.

**F Restricted Assets**

Certain assets are classified as restricted assets on the Statement of Net Assets because their use is subject to externally imposed stipulations, either by laws or regulations.

**NOTE 1 – OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**F Restricted Assets (Continued)**

The cash resulting from a settlement agreement as described in Note 9, represents proceeds restricted by the Federal Transit Administration. The State Transit Assistance grant is restricted for capital expenditures. Restricted assets at June 30, are as follows:

|                                      | <u>2006</u>          | <u>2005</u>         |
|--------------------------------------|----------------------|---------------------|
| Cash and Cash Equivalents            |                      |                     |
| Federal Transit Administration Grant | \$ 7,321,289         | \$ 6,998,304        |
| State Transit Assistance Grant       | <u>4,308,527</u>     | <u>2,833,703</u>    |
| Total Restricted Assets              | <u>\$ 11,629,816</u> | <u>\$ 9,832,007</u> |

**G Property and Equipment**

Property and equipment are recorded at cost. Depreciation for all such assets is computed on a straight-line basis. Estimated useful lives of assets are as follows:

|                              |             |
|------------------------------|-------------|
| Buildings and structures     | 20-30 years |
| Revenue vehicles             | 12 years    |
| Other vehicles and equipment | 3-10 years  |

Depreciation expense on assets acquired with capital grant funds are transferred to net assets - invested in capital assets, net of related debt after being charged to operations.

Major improvements and betterments to existing facilities and equipment are capitalized. Costs for maintenance and repairs which do not extend the useful life of the applicable assets are charged to expense as incurred. Upon disposition, costs and accumulated depreciation are removed from the accounts and resulting gains or losses are included in operations.

The District completed and capitalized the Scotts Valley Transit Center in fiscal 1999. The cost of this facility totaled \$4,063,634, which was funded by federal, state and local funds. The Scotts Valley Redevelopment Agency (the Agency), a political subdivision of the state of California, was one of the District's funding sources for this project and has retained an interest in the property. The title to the property is retained by both the District and the Agency as tenants in common with each party holding an individual interest in proportion to each party's financial participation in the project. The Agency's portion of the property is 13.87%. The Agency's portion is not recorded in the District's financial statements.

**H. Sales and Use Tax**

The District receives a 5% sales and use tax levied on all taxable sales in Santa Cruz County, which is collected and administered by the California State Board of Equalization. Additionally, the District is allocated, through the Santa Cruz County Regional Transportation Commission, a portion of the 25% sales and use tax levied by the Transportation Development Act.

**I. Operating Assistance Grants**

Operating assistance grants are recognized as revenue in the grant period earned.



**NOTE 1 – OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

**J** Self-Insurance

The District is self-insured for the first \$250,000 of general and vehicular liability. For settlements in excess of \$250,000, the District has total coverage up to \$20,000,000 per occurrence. Additionally, the District is self-insured up to \$350,000 for workers' compensation claims. The District has recorded a liability for estimated claims to be paid including incurred but not reported claims.

**K** Employee Benefits

Vacation and medical leave benefits are accrued when earned and reduced when used. Any paid medical leave accrued beyond 96 hours may, at the employee's option, be converted to annual leave and credited to the employee's annual leave schedule or paid in cash, depending on the bargaining unit, at 100% of the earned rate. Employees are paid accrued and unused annual leave at the time of separation from District service.

**L** Payroll

The District contracts with the Santa Cruz County Auditor-Controller to provide payroll processing services.

**M** Pension Costs

Pension costs are expensed as incurred. These costs equal the actuarially determined annual contribution amount.

**N** Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**NOTE 2 – CASH AND INVESTMENTS**

Cash and cash equivalents consists of the following at June 30, 2006 and 2005:

|  | <u>2006</u>          | <u>2005</u>          |
|--|----------------------|----------------------|
| Cash on Hand   | \$ 44,331            | \$ 47,558            |
| Demand Deposits                                      | 961,462              | 373,950              |
| Deposits in Santa Cruz County Pooled Investment Fund | <u>30,882,987</u>    | <u>29,100,258</u>    |
|  | <u>\$ 31,888,780</u> | <u>\$ 29,521,766</u> |

**NOTE 2 – CASH AND INVESTMENTS (Continued)**

Cash on Hand and Cash in Banks

**Investments Authorized by the California Government Code and the District's Investment Policy**

The table below identifies the **investment types** that are authorized for the District by the California Government Code (or the District's investment policy, where more restrictive) The table also identifies certain provisions of the California Government Code (or the District's investment policy, where more restrictive) that address **interest rate risk, credit risk, and concentration of credit risk**

| <u>Authorized Investment Type</u>   | <u>Maximum Maturity</u> | <u>Maximum Percentage Of Portfolio</u> | <u>Maximum Investment in One Issuer</u> |
|-------------------------------------|-------------------------|--|---|
| Local Agency Bonds                  | 5 years                 | None                                   | None                                    |
| U.S. Treasury Obligations           | 5 years                 | None                                   | None                                    |
| U S Agency Securities               | 5 years                 | None                                   | None                                    |
| Banker's Acceptances                | 180 days                | None                                   | None                                    |
| Commercial Paper                    | 270 days                | None                                   | None                                    |
| Negotiable Certificates of Deposit  | 5 years                 | None                                   | None                                    |
| Repurchase Agreements               | 1 year                  | None                                   | None                                    |
| Reverse Repurchase Agreements       | 92 days                 | None                                   | None                                    |
| Medium-Term Notes                   | 5 years                 | None                                   | None                                    |
| Mutual Funds                        | N/A                     | None                                   | None                                    |
| Money Market Mutual Funds           | N/A                     | None                                   | None                                    |
| Mortgage Pass-Through Securities    | 5 years                 | None                                   | None                                    |
| County Pooled Investment Funds      | N/A                     | 100%                                   | None                                    |
| Local Agency Investment Fund (LAIF) | N/A                     | None                                   | None                                    |

**Disclosures Relating to Interest Rate Risk**

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates

Information about the sensitivity of the fair values of the District's investments to market interest rate fluctuations is provided by the following table that shows the distribution of the District's investments by maturity:

| <u>Investment Type</u> | <u>Amount</u>        | <u>Remaining Maturity (in Months)</u> |                        |                        |                            |
|------------------------|----------------------|---------------------------------------|------------------------|------------------------|----------------------------|
|                        |                      | <u>12 Months Or Less</u>              | <u>13 to 24 Months</u> | <u>25 to 60 Months</u> | <u>More Than 60 Months</u> |
| County Investment Pool | <u>\$ 30,882,987</u> | <u>\$ 30,882,987</u>                  | <u>\$ -</u>            | <u>\$ -</u>            | <u>\$ -</u>                |

**Investments with Fair Values Highly Sensitive to Interest Rate Fluctuations**

The District's investments were not considered to be highly sensitive to interest rate fluctuations as of June 30, 2006 or 2005.

**NOTE 2 -- CASH AND INVESTMENTS (Continued)**

Cash on Hand and Cash in Banks (Continued)

**Disclosures Relating to Credit Risk**

Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. Presented below is the minimum rating required by (where applicable) the California Government Code, the District's investment policy, and the actual rating as of year end for each investment type. The column marked "exempt from disclosure" identifies those investment types for which GASB No. 40 does not require disclosure as to credit risk.

| Investment Type        | Amount        | Minimum<br>Legal<br>Rating | Exempt<br>From<br>Disclosure | Rating as of Year End |      |               |
|------------------------|---------------|----------------------------|------------------------------|-----------------------|------|---------------|
|                        |               |                            |                              | AAA                   | Aa   | Not<br>Rated  |
| County Investment Pool | \$ 30,882,987 | N/A                        | \$ -                         | \$ -                  | \$ - | \$ 30,882,987 |

**Concentration of Credit Risk**

The investment policy of the District contains no limitations on the amount that can be invested in any one issuer beyond that stipulated by the California Government Code. The District did not have any Investments in any one issuer (other than external investment pools) that represent 5% or more of total District's investments at June 30, 2006 or 2005.

**Custodial Credit Risk**

Custodial credit risk for *deposits* is the risk that, in the event of the failure of a depository financial institution, a government will not be able to recover its deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for *investments* is the risk that, in the event of the failure of the counterparty (e.g., broker-dealer) to a transaction, a government will not be able to recover the value of its investment or collateral securities that are in the possession of another party. The California Government Code and the District's investment policy do not contain legal or policy requirements that would limit the exposure to custodial credit risk for deposits or investments, other than the following provision for deposits: The California Government Code requires that a financial institution secure deposits made by state or local governmental units by pledging securities in an undivided collateral pool held by a depository regulated under state law (unless so waived by the governmental unit). The market value of the pledged securities in the collateral pool must equal at least 110% of the total amount deposited by the public agencies.

GASB Statement No. 40 requires that the following disclosure be made with respect to custodial credit risks relating to deposits and investments: none of the District's deposits with financial institutions in excess of federal depository insurance limits were held in uncollateralized accounts.

**Investment in County Investment Pool**

The District is a voluntary participant in the Santa Cruz County Investment Fund. The fair value of the District's investment in this pool is reported in the accompanying financial statements at amounts based upon the District's pro-rata share of the fair value provided by the County for the entire County portfolio (in relation to the amortized cost of that portfolio). The balance available for withdrawal is based on the accounting records maintained by the County, which are recorded on an amortized cost basis.

**NOTE 3 – RECEIVABLES**

Receivables at June 30, are as follows:

|                   | <u>2006</u>         | <u>2005</u>         |
|-------------------|---------------------|---------------------|
| Federal Grants    | \$ 1,156,558        | \$ 454,387          |
| State Grants      | 409,336             | 406,025             |
| Sales Tax Revenue | 2,541,900           | 2,613,200           |
| Other             | 1,919,193           | 523,321             |
|                   | <u>\$ 6,026,987</u> | <u>\$ 3,996,933</u> |

**NOTE 4 – CHANGES IN CAPITAL ASSETS**

Facilities, property and equipment at June 30, are summarized as follows:

June 30, 2006

|                                       | <u>Balance<br/>July 1, 2005</u> | <u>Additions and<br/>Transfers</u> | <u>Retirements<br/>and Transfers</u> | <u>Balance<br/>June 30, 2006</u> |
|---------------------------------------|---------------------------------|------------------------------------|--------------------------------------|----------------------------------|
| Non Depreciated Assets                |                                 |                                    |                                      |                                  |
| Land                                  | \$ 6,976,423                    | \$ -                               | \$ -                                 | \$ 6,976,423                     |
| Construction-in-Progress              | 2,753,362                       | 2,063,594                          | -                                    | 4,816,956                        |
| Total Non Depreciated Assets          | 9,729,785                       | 2,063,594                          | -                                    | 11,793,379                       |
| Depreciated Assets                    |                                 |                                    |                                      |                                  |
| Building and Improvements             | 10,452,483                      | -                                  | -                                    | 10,452,483                       |
| Revenue Vehicles                      | 34,555,916                      | 93,349                             | -                                    | 34,649,265                       |
| Operations Equipment                  | 2,686,565                       | 6,657                              | (5,994)                              | 2,687,228                        |
| Other Equipment                       | 1,285,123                       | -                                  | -                                    | 1,285,123                        |
| Other Vehicles                        | 829,537                         | 68,977                             | -                                    | 898,514                          |
| Office Equipment                      | 1,152,497                       | 224,541                            | (282,279)                            | 1,094,759                        |
| Total Depreciated Assets              | 50,962,121                      | 393,524                            | (288,273)                            | 51,067,372                       |
| Less Accumulated Depreciation         | <u>(26,845,932)</u>             | <u>(3,775,017)</u>                 | <u>296,736</u>                       | <u>(30,324,213)</u>              |
| Depreciated Assets Net of Accumulated | <u>24,116,189</u>               | <u>(3,381,493)</u>                 | <u>8,463</u>                         | <u>20,743,159</u>                |
| Total                                 | <u>\$ 33,845,974</u>            | <u>\$ (1,317,899)</u>              | <u>\$ 8,463</u>                      | <u>\$ 32,536,538</u>             |

Depreciation expense at June 30, 2006 was \$3,775,017

**NOTE 4 – CHANGES IN CAPITAL ASSETS (Continued)**

June 30, 2005

|                                       | Balance<br>July 1, 2004 | Additions and<br>Transfers | Retirements<br>and Transfers | Balance<br>June 30, 2005 |
|---------------------------------------|-------------------------|----------------------------|------------------------------|--------------------------|
| Non Depreciated Assets                |                         |                            |                              |                          |
| Land                                  | \$ 3,763,502            | \$ 3,212,921               | \$ -                         | \$ 6,976,423             |
| Construction-in-Progress              | 963,826                 | 1,842,766                  | (53,230)                     | 2,753,362                |
| <b>Total Non Depreciated Assets</b>   | <b>4,727,328</b>        | <b>5,055,687</b>           | <b>(53,230)</b>              | <b>9,729,785</b>         |
| Depreciated Assets                    |                         |                            |                              |                          |
| Building and Improvements             | 10,414,360              | 60,109                     | (21,986)                     | 10,452,483               |
| Revenue Vehicles                      | 36,299,525              | 481,951                    | (2,225,560)                  | 34,555,916               |
| Operations Equipment                  | 2,942,838               | 15,648                     | (271,921)                    | 2,686,565                |
| Other Equipment                       | 1,279,607               | 5,516                      | -                            | 1,285,123                |
| Other Vehicles                        | 855,238                 | 70,898                     | (96,599)                     | 829,537                  |
| Office Equipment                      | 1,093,534               | 184,049                    | (125,086)                    | 1,152,497                |
| <b>Total Depreciated Assets</b>       | <b>52,885,102</b>       | <b>818,171</b>             | <b>(2,741,152)</b>           | <b>50,962,121</b>        |
| Less Accumulated Depreciation         | (25,335,025)            | (3,973,808)                | 2,462,901                    | (26,845,932)             |
| Depreciated Assets Net of Accumulated | 27,550,077              | (3,155,637)                | (278,251)                    | 24,116,189               |
| <b>Total</b>                          | <b>\$ 32,277,405</b>    | <b>\$ 1,900,050</b>        | <b>\$ (331,481)</b>          | <b>\$ 33,845,974</b>     |

Depreciation expense at June 30, 2005 was \$3,973,808

**NOTE 5 – AVAILABLE NET ASSETS**

An analysis of the District's available (undesignated) net assets at June 30, follows:

|  | 2006                  | 2005                  |
|--|-----------------------|-----------------------|
| Current Assets   | \$ 27,769,330         | \$ 24,746,347         |
| Current Liabilities  | (6,852,179)           | (5,590,145)           |
| Working Capital  | 20,917,151            | 19,156,202            |
| Less:  |                       |                       |
| Inventory  | (928,026)             | (903,863)             |
| Prepaid Expenses   | (555,353)             | (155,792)             |
| <b>Total Available Net Assets</b>  | <b>19,433,772</b>     | <b>18,096,547</b>     |
| Net Assets Designated for the Following:   |                       |                       |
| Cash Flow  | (2,600,000)           | (2,600,000)           |
| Workers' Compensation Reserve  | (2,075,940)           | (1,641,128)           |
| Insurance Reserve  | (947,229)             | (804,008)             |
| Alternative Fuel Conversion Fund   | (462,000)             | (462,000)             |
| Bus Stop Improvements Reserve  | (400,000)             | (400,000)             |
| Carryover for fiscal year 2006-2007 Operating Budget   | (649,817)             | (1,296,236)           |
| Carryover for Sales Tax-Based UTU Wage Adjustment  | (77,697)              | -                     |
| Net Assets Required to Fund Transportation Improvement Programs for the Fiscal Years 2005-2009 | (13,969,000)          | (16,331,011)          |
| <b>Available Undesignated Net Assets (Deficits)</b>  | <b>\$ (1,747,911)</b> | <b>\$ (5,437,836)</b> |

**NOTE 6 – CAPITAL GRANTS**

The District receives grants from the Federal Transit Administration (FTA), which provides financing for the acquisition of rolling stock and construction of facilities. The District also receives grants under the State Transportation Development Act primarily for the acquisition of rolling stock and support equipment, and purchase of furniture and fixtures.

A summary of federal, state and local grant activity for the years ended June 30, are as follows:

|                          | <u>2006</u>         | <u>2005</u>         |
|--------------------------|---------------------|---------------------|
| Federal Grants           | \$ 1,650,311        | \$ 4,143,678        |
| State Grants             | <u>4,650</u>        | <u>32,880</u>       |
| Total Capital Assistance | <u>\$ 1,654,961</u> | <u>\$ 4,176,558</u> |

**NOTE 7 – COMMITMENTS**

The District leases a number of its facilities under operating leases extending through 2010. For the years ended June 30, 2006 and 2005, rental expense relating to the leases was \$737,829 and \$702,530, respectively. The District also leases to others retail space in their transit facilities under noncancelable agreements. Minimum lease payments and receipts for existing operating leases are as follows:

| <u>Year Ending<br/>June 30</u> | <u>Lease<br/>Commitments</u> | <u>Rental Income</u> | <u>Net</u>          |
|--------------------------------|------------------------------|----------------------|---------------------|
| 2007                           | \$ 747,768                   | \$ 123,433           | \$ 624,335          |
| 2008                           | 774,636                      | 122,707              | 651,929             |
| 2009                           | 307,137                      | 112,582              | 194,555             |
| 2010                           | 196,297                      | 93,755               | 102,542             |
| Thereafter                     | <u>-</u>                     | <u>12,951</u>        | <u>(12,951)</u>     |
|                                | <u>\$ 2,025,838</u>          | <u>\$ 465,428</u>    | <u>\$ 1,560,410</u> |

**NOTE 8 – JOINT VENTURES (Joint Powers Authority)**

The District participates in a joint powers authority (JPA), the California Transit Insurance Pool (CalTIP). The relationship between the District and the JPA is such that the JPA is not a component unit of the District for financial reporting purposes.

CalTIP arranges for and provides property and liability insurance for its 25 members. CalTIP is governed by a board that controls the operations of CalTIP, including selection of management and approval of operating budgets, independent of any influence by the member districts. Each member district pays a premium commensurate with the level of coverage requested and shares in surpluses and deficits proportionate to their participation in CalTIP.

**NOTE 8 – JOINT VENTURES (Joint Powers Authority) (Continued)**

Condensed audited financial information of CalTIP for the years ended April 30, (most recent information available) is as follows:

|                              | <u>2005</u>         | <u>2004</u>         |
|------------------------------|---------------------|---------------------|
| Total Assets                 | \$ 15,047,005       | \$ 11,796,205       |
| Total Liabilities            | <u>11,202,232</u>   | <u>9,620,106</u>    |
| Fund Balance                 | <u>\$ 3,844,773</u> | <u>\$ 2,176,099</u> |
| Total Revenues               | \$ 7,459,957        | \$ 8,329,709        |
| Total Expenditures           | <u>5,791,283</u>    | <u>7,325,335</u>    |
| Net Increase in Fund Balance | <u>\$ 1,668,674</u> | <u>\$ 1,004,374</u> |

The District's share of year-end assets, liabilities, or fund balance has not been calculated by CalTIP

**NOTE 9 – WATSONVILLE FLEET MAINTENANCE FACILITY**

The District's fleet maintenance facility in Watsonville was damaged in the Loma Prieta earthquake (the earthquake) in October 1989. An engineering study concluded that the demolition of the existing facility and construction of a new facility was the most practical course of action. Therefore, the net book value of the facility was written off the books in a prior year.

In addition, due to design and construction deficiencies by the design and building contractors involved in the original project, the District initiated litigation against the contractors and came to a settlement agreement with said contractors on May 30, 1995. In accordance with this agreement, the contractors remitted \$4,776,858 (including \$171,538 in costs) to the District during fiscal year 1996, representing damages less attorney fees. The use of these proceeds, and the interest earned thereon, is restricted by FTA Section 3/5309. Accordingly, the net restricted amount of \$7,321,289 and \$6,998,304 is reflected on the statements of net assets as deferred revenue at June 30, 2006 and 2005, respectively.

**NOTE 10 – CONTINGENCIES**

The District has received state and federal funds for specific purposes that are subject to review and audit by grantor agencies. Although such audits could generate expenditure disallowances under terms of the grants, the District believes that any required reimbursement will not be material.

Additionally, the District is party to various claims and litigation in the normal course of business. In the opinion of management and in-house counsel, any ultimate losses have been adequately provided for in the financial statements.

## NOTE 11 – DEFINED BENEFIT PENSION PLAN

### Plan Description

The District's defined benefit pension plan, the Miscellaneous Plan for Santa Cruz Metropolitan Transit District (the Plan), provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. The Plan is part of the Public Agency portion of the California Public Employees' Retirement System (CalPERS), an agent multiple-employer plan administered by CalPERS, which acts as a common investment and administrative agent for participating public employers with the State of California. A menu of benefit provisions as well as other requirements is established by State statutes within the Public Employees' Retirement Law. The District selects optional benefit provisions from the benefit menu by contract with CalPERS and adopts those benefits through Board action. CalPERS issues a separate comprehensive annual financial report. Copies of the CalPERS' annual financial report may be obtained from the CalPERS Executive Office, 400 P Street, Sacramento, CA 95814.

### Funding Policy

There are 321 active plan members in the Fund as of June 30, 2006, which are required to contribute a percent of their annual covered salary. In lieu of salary increases and for employees who agreed to salary reductions in certain prior years, the District agreed to pay a portion of the employee contribution, based on negotiated formulas. The District is also required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The actuarial methods and assumptions used are those adopted by the CalPERS Board of Administration. The required employer contribution rate for the fiscal year ended June 30, 2006 was 12.95%. The contribution requirements of the plan members are established by State statute and the employer contribution rate is established and may be amended by CalPERS.

### Annual Pension Cost

For fiscal year ended June 30, 2006, the District's annual pension cost of \$1,800,967 was equal to the District's required and actual contributions. This includes the District's contribution to the employee contribution requirement. The required contribution for fiscal year ended June 30, 2006 was determined as part of the June 30, 2004 actuarial valuation using the entry age normal actuarial cost method with the contributions determined as a percent of pay. The actuarial assumptions included (a) 7.75% investment rate of return (net of administration expenses); (b) projected salary increases that vary by duration of service ranging from 3.25% to 14.45% for miscellaneous members, and (c) 3.25% cost-of-living adjustment. Both (a) and (b) include an inflation component of 3.0%. The actuarial value of the Plan's assets was determined using a technique that smoothes the effect of short-term volatility in the market value of investments over a three year period. The Plan's excess assets are being amortized as a level percentage of projected payroll on a closed basis.

### Three-Year Trend Information for the Fund

Three-year trend information, with respect to the District's participation in CalPERS is as follows:

| <u>Fiscal Year<br/>Ending</u> | <u>Annual Pension<br/>Cost (APC)</u> | <u>Percentage of<br/>APC Contributed</u> | <u>Net Pension<br/>Obligation</u> |
|-------------------------------|--------------------------------------|--|-----------------------------------|
| 6/30/2004                     | \$ 1,024,064                         | 100%                                     | \$ -                              |
| 6/30/2005                     | \$ 1,392,098                         | 100%                                     | \$ -                              |
| 6/30/2006                     | \$ 1,800,967                         | 100%                                     | \$ -                              |



**NOTE 11 – DEFINED BENEFIT PENSION PLAN** (Continued)

Required Supplementary Information

Supplementary information is intended to show the progress made towards funding benefit obligations. Required three year supplemental information, available to date, for the District is as follows:

| <u>Valuation Date</u> | <u>Entry Age Normal Accrued Liability</u> | <u>Actuarial Value of Assets</u> | <u>Unfunded/ (Overfunded) Liability</u> | <u>Funded Ratio</u> | <u>Annual Covered Payroll</u> | <u>UAAL as a % of Payroll</u> |
|-----------------------|---|----------------------------------|---|---------------------|-------------------------------|-------------------------------|
| 6/30/2002             | \$ 50,823,042                             | \$54,728,235                     | \$ (3,905,193)                          | 107.70%             | \$13,697,134                  | (28.5%)                       |
| 6/30/2003             | \$ 60,913,062                             | \$56,208,723                     | \$ 4,704,339                            | 92.3%               | \$13,332,537                  | 35.3%                         |
| 6/30/2004             | \$ 66,923,612                             | \$59,816,757                     | \$ 7,106,855                            | 89.4%               | \$14,011,732                  | 50.7%                         |

**NOTE 12 – POST-RETIREMENT BENEFITS**

The District provides post-retirement benefits to its employees who have completed at least ten years of full-time service with the District, have reached the age of 50 and have retired under the provisions of CalPERS while an employee of the District. The District pays a portion of the premiums for medical insurance for retirees and eligible dependents. The District also provides dental, vision and life insurance plan coverage of retirees and eligible dependents until the retiree attains the age of 65. Bus operators who retired and reached the age of 65 prior to June 30, 1994, will continue to receive dental and vision coverage beyond age 65. Life insurance is not provided to management retirees who retired prior to July 1, 2005. The costs of providing these benefits are recognized when paid. The District has recognized approximately \$1,100,476 and \$925,740 of expense for these benefits for the years ending June 30, 2006 and 2005, respectively.

**NOTE 13 – DEFERRED COMPENSATION PLAN**

The District offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 and provisions of the Government Code of the State of California. The plan, available to all district employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, or unforeseeable emergency. The District employees participate in two such plans, the Great-West Life and Annuity Insurance (Great-West) plan and the other through CalPERS.

At June 30, 2006, all amounts held under the Great-West plan and the CalPERS plan are held in trust and are not reflected on the accompanying balance sheet as required under Statement No. 27 of the Governmental Accounting Standards Board, *Accounting Standards for Pensions by State and Local Governmental Employers*.

**NOTE 14 – RISK MANAGEMENT**

The District is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; and natural disasters for which the District carries commercial insurance. The District has established limited risk management programs for workers' compensation, and general and vehicular liability, as described in Note 1, as well.

**NOTE 14 – RISK MANAGEMENT (Continued)**

Liabilities are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported (IBNR). The IBNR for workers' compensation was based on an actuarial study dated June 28, 2004. Claim liabilities are calculated considering the effects of inflation, recent claim settlement trends including frequency and amount of pay-outs and other economic and social factors. Changes in the balances of claims liabilities are as follows:

|   | <u>2006</u>         | <u>2005</u>         |
|---|---------------------|---------------------|
| Unpaid Claims, Beginning of Fiscal Year | \$ 6,422,936        | \$ 5,822,739        |
| Incurred Claims (Including IBNR's)      | 475,224             | 784,970             |
| Claim Payments                          | <u>150,653</u>      | <u>(184,773)</u>    |
| Unpaid Claims, End of Fiscal Year       | <u>\$ 7,048,813</u> | <u>\$ 6,422,936</u> |

**NOTE 15 – TRANSPORTATION DEVELOPMENT ACT/CALIFORNIA ADMINISTRATIVE CODE**

The District is subject to compliance with the Transportation Development Act provisions, Sections 6634 and 6637 of the California Administrative Code and Sections 99267, 99268.1 and 99314.6 of the Public Utilities Code.

Section 6634

Pursuant to Section 6634, a Transit claimant is precluded from receiving monies from the Local Transportation Fund and the State Transit Assistance Fund in an amount which exceeds the claimant's capital and operating costs, less the required fares, and local support. The District did not receive Transportation Development Act or State Transit Assistance revenues in excess of the prescribed formula amounts.

Section 6637

Pursuant to Section 6637, a claimant must maintain its accounts and records in accordance with the Uniform System of Accounts and Records for Transit Operators adopted by the State Controller. The District did maintain its accounts and records in accordance with the Uniform System of Accounts and Records for Transit Operators.

Sections 99267 and 99268.1

Pursuant to the Transportation Development Act, the District is defined as an older operator and is not required to meet the fare box ratio requirement of the Act. The District has met the 50% expenditure limitation requirement.

**NOTE 16 – SUBSEQUENT EVENT**

On September 7, 2006, the District sold property at 25 Sakata Lane in Watsonville, California to Don Houpt with net proceeds of \$2,974,520. The proceeds from the sale will be applied to the construction of the MetroBase facility.

**SUPPLEMENTARY INFORMATION**

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
STATEMENTS OF OPERATING EXPENSES  
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005**

|   | 2006          | 2005          |
|---|---------------|---------------|
| Labor   |               |               |
| Operators' salaries and wages                     | \$ 6,453,163  | \$ 6,692,531  |
| Other salaries and wages                          | 4,979,939     | 5,481,662     |
| Overtime  | 1,792,415     | 1,422,856     |
| Fringe Benefits                                   |               |               |
| Absence with pay                                  | 3,152,479     | 2,708,466     |
| Pension plans                                     | 1,800,967     | 1,392,098     |
| Vision, medical, and dental plans                 | 4,376,694     | 3,861,507     |
| Workers' compensation insurance                   | 1,587,745     | 1,768,897     |
| Disability insurance                              | 353,466       | 386,017       |
| Other fringe benefits                             | 162,191       | 139,679       |
| Services  |               |               |
| Accounting  | 54,869        | 84,285        |
| Administrative and banking                        | 204,987       | 209,743       |
| Professional and technical services               | 461,007       | 419,642       |
| Security  | 435,724       | 357,997       |
| Outside repairs                                   | 304,913       | 390,684       |
| Other services                                    | 141,049       | 191,618       |
| Materials and Supplies Consumed                   |               |               |
| Fuels and lubricants                              | 1,923,832     | 1,719,807     |
| Tires and tubes                                   | 159,324       | 194,318       |
| Vehicle parts                                     | 547,291       | 428,117       |
| Other materials and supplies                      | 323,646       | 354,329       |
| Utilities   | 321,561       | 316,170       |
| Casualty and Liability Costs                      | 665,125       | 680,760       |
| Taxes and Licenses                                | 36,287        | 36,758        |
| Purchased Transportation Services                 |               |               |
| Paratransit                                       | 142,892       | 977,899       |
| Miscellaneous Expenses                            | 87,568        | 84,480        |
| Equipment and Facility Lease                      | 777,440       | 720,043       |
| Depreciation                                      |               |               |
| Property acquired with operator funds             | 653,897       | 657,671       |
| Property acquired by federal, state, or TDA funds | 3,121,120     | 3,316,137     |
| Total Operating Expenses                          | \$ 35,021,591 | \$ 34,994,171 |

**OTHER SCHEDULES AND REPORTS**

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
FOR THE YEAR ENDED JUNE 30, 2006**

| <u>Federal Grantor / Program Title</u>              | <u>Federal<br/>CFDA No.</u> | <u>Pass-Through<br/>Grantor's<br/>Number</u> | <u>Total<br/>Federal<br/>Expenditures</u> |
|---|-----------------------------|--|---|
| U S. DEPARTMENT OF TRANSPORTATION                   |                             |  |   |
| Direct Programs:                                    |                             |  |   |
| Federal Transit Administration (FTA)                |                             |  |   |
| Cluster Defined by the Department of Transportation |                             |  |   |
| Section 3/5309 Consolidation                        |                             |  |   |
| Final Engineering                                   | 20 500*                     | CA-03-0413                                   | \$ 211,518                                |
| Land Acquisition                                    | 20 500*                     | CA-03-0413                                   | 49,621                                    |
| Construction  | 20 500*                     | CA-03-0505                                   | 1,380,697                                 |
| Fixed Route Buses                                   | 20 500*                     | CA-03-0505                                   | <u>8,475</u>                              |
|   |                             |  | <u>1,650,311</u>                          |
| Section 9/5307                                      |                             |  |   |
| Operating Assistance ParaCruz                       | 20 507*                     | CA-90-Y285                                   | 63,820                                    |
| Operating Assistance                                | 20 507*                     | CA-90-Y375                                   | <u>3,021,556</u>                          |
|   |                             |  | <u>3,085,376</u>                          |
| Section 18/5311                                     |                             |  |   |
| Operating Assistance                                | 20 509                      | 649068                                       | <u>65,475</u>                             |
| Total Expenditures of Federal Awards                |                             |  | <u><u>\$ 4,801,162</u></u>                |

\* Major federal financial assistance program

See accompanying notes to schedule of federal financial assistance

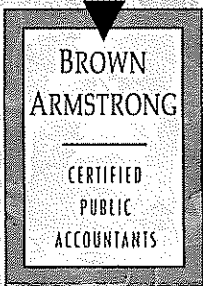
**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS  
FOR THE YEAR ENDED JUNE 30, 2006**

**NOTE 1 – GENERAL**

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the Santa Cruz Metropolitan Transit District (the District). Federal financial assistance received directly from federal agencies, as well as federal financial assistance passed through other governmental agents, is included on the schedule.

**NOTE 2 – BASIS OF ACCOUNTING**

The accompanying Schedule of Expenditures of Federal Awards has been prepared on the accrual basis of accounting. Federal capital grant funds are used to purchase property, plant, and equipment. Federal grants receivable are included in capital and operating grants receivable, which also includes receivables from state and local grant sources.



**BROWN ARMSTRONG**  
**PAULDEN McCOWN STARBUCK THORNBURGH & KEETER**  
 CERTIFIED PUBLIC ACCOUNTANTS

■ Main Office  
 4200 Truxtun Ave., Suite 300  
 Bakersfield, California 93309  
 Tel 661-324-4971 Fax 661-324-4997  
 e-mail: info@bacpas.com

■ Shafter Office  
 560 Central Avenue  
 Shafter, California 93263  
 Tel 661-746-2145 Fax 661-746-1218

- Andrew J Paulden, CPA
- Peter C Brown, CPA
- Burton H Armstrong, CPA, MST
- Harvey J McCown, MBA, CPA
- Steven R Starbuck, CPA
- Aileen K Keeter, CPA
- Chris M Thornburgh, CPA
- Eric H Xin, MBA, CPA
- \_\_\_\_\_
- Lynn R Krausse, CPA, MST
- Bradley M Hankins, CPA
- Rosaiva Flores, CPA
- Connie M Perez, CPA
- M Sharon Jones, CPA, MST
- Diana H Branthoover, CPA
- Matthew R Gilligan, CPA
- Michael C Olivares, CPA
- Hanna J Sheppard, CPA
- Ryan S Johnson, CPA

**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 AND THE RULES AND  
 REGULATIONS OF THE TRANSPORTATION DEVELOPMENT ACT**

To the Board of Directors  
 Santa Cruz Metropolitan Transit District  
 Santa Cruz, California

We have audited the financial statements of the business-type activities of Santa Cruz Metropolitan Transit District as of and for the year ended June 30, 2006, which collectively comprise Santa Cruz Metropolitan Transit District's basic financial statements and have issued our report thereon dated October 26, 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 Santa Cruz Metropolitan Transit District's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion 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 over financial reporting 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. However, we noted other matters involving internal control over financial reporting that we have reported to management of Santa Cruz Metropolitan Transit District in a separate letter dated October 26, 2006.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Santa Cruz Metropolitan Transit District's basic 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*.

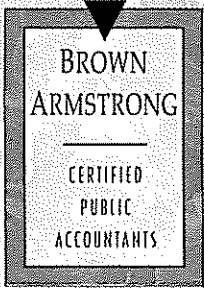


This report is intended solely for the information and use of management, the Board of Directors, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

BROWN ARMSTRONG PAULDEN  
McCOWN STARBUCK THORNBURGH & KEETER  
ACCOUNTANCY CORPORATION

A handwritten signature in black ink, appearing to be "A.A. Paulden", written in a cursive style.

Bakersfield, California  
October 26, 2006



BROWN ARMSTRONG
PAULDEN McCOWN STARBUCK THORNBURGH & KEETER
CERTIFIED PUBLIC ACCOUNTANTS

Main Office
4200 Truxtun Ave., Suite 300
Bakersfield, California 93309
Tel 661-324-4971 Fax 661-324-4997
e-mail: info@bacpas.com

Shafter Office
560 Central Avenue
Shafter, California 93263
Tel 661-746-2145 Fax 661-746-1218

- Andrew J Paulden, CPA
Peter C Brown, CPA
Burton H Armstrong, CPA, MST
Harvey J McCown, MBA, CPA
Steven R Starbuck, CPA
Aileen K Keeter, CPA
Chris M Thornburgh, CPA
Eric H Xin, MBA, CPA
Lynn R Krausse, CPA, MST
Bradley M Hankins, CPA
Rosalva Flores, CPA
Connie M Perez, CPA
M Sharon Jones, CPA, MST
Diana H Branthoover, CPA
Matthew R Gilligan, CPA
Michael C Olivares, CPA
Hanna J Sheppard, CPA
Ryan S. Johnson, CPA

REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE
TO EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

To the Board of Directors
Santa Cruz Metropolitan Transit District
Santa Cruz, California

Compliance

We have audited the compliance of Santa Cruz Metropolitan Transit District with the types of compliance requirements described in the U S Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to its major federal program for the year ended June 30, 2006 Santa Cruz Metropolitan Transit District's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs Compliance with the requirements of laws, regulations, contracts and grants applicable to its major federal program is the responsibility of Santa Cruz Metropolitan Transit District's management Our responsibility is to express an opinion on Santa Cruz Metropolitan Transit District's compliance based on our audit

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations." Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred An audit includes examining, on a test basis, evidence about Santa Cruz Metropolitan Transit District's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances We believe that our audit provides a reasonable basis for our opinion Our audit does not provide a legal determination on Santa Cruz Metropolitan Transit District's compliance with those requirements

In our opinion, the Santa Cruz Metropolitan Transit District complied, in all material respects, with the requirements referred to above that are applicable to its major federal programs for the year ended June 30, 2006

Internal Control Over Compliance

The management of Santa Cruz Metropolitan Transit District is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered Santa Cruz Metropolitan Transit District's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

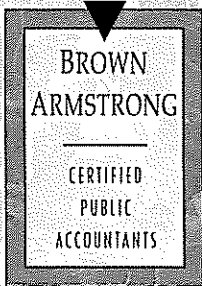
Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants that would be material in relation to a major federal program 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 compliance and its operation that we consider to be material weaknesses.

This report is intended for the information of management, the Board of Directors, and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.

BROWN ARMSTRONG PAULDEN  
McCOWN STARBUCK THORNBURGH & KEETER  
ACCOUNTANCY CORPORATION



Bakersfield, California  
October 26, 2006



**BROWN ARMSTRONG**  
**PAULDEN McCOWN STARBUCK THORNBURGH & KEETER**  
CERTIFIED PUBLIC ACCOUNTANTS

**Main Office**  
4200 Truxtun Ave., Suite 300  
Bakersfield, California 93309  
Tel 661-324-4971 Fax 661-324-4997  
e-mail: info@bacpas.com

**Shafter Office**  
560 Central Avenue  
Shafter, California 93263  
Tel 661-746-2145 Fax 661-746-1218

- Andrew J Paulden, CPA
- Peter C Brown, CPA
- Burton H Armstrong, CPA, MST
- Harvey J McCown, MBA, CPA
- Steven R Starbuck, CPA
- Aileen K Keeter, CPA
- Chris M Thornburgh, CPA
- Eric H Xin, MBA, CPA

**REPORT ON COMPLIANCE WITH THE  
TRANSPORTATION DEVELOPMENT ACT**

To the Board of Directors  
Santa Cruz Metropolitan Transit District  
Santa Cruz, California

- Lynn R Krausse, CPA, MST
- Bradley M Hankins, CPA
- Rosalva Flores, CPA
- Connie M Perez, CPA
- M Sharon Jones, CPA, MST
- Diana H Branthoover, CPA
- Matthew R Gilligan, CPA
- Michael C Olivares, CPA
- Hanna J Sheppard, CPA
- Ryan S Johnson, CPA

We have audited the basic financial statements of the Santa Cruz Metropolitan Transit District (the District), as of and for the year ended June 30, 2006, and have issued our report thereon dated October 26, 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts and grants applicable to the District is the responsibility of the management of the District. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the District's compliance with certain provisions of the Transportation Development Act, including Public Utilities Code Section 99245 as enacted and amended by statute through June 30, 2006, and the allocation instructions and resolutions of the Santa Cruz County Regional Transportation Commission as required by Section 6667 of the California Code of Regulations. However, our objective was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicated that, with respect to the items tested, the District complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the District had not complied, in all material respects, with those provisions.

This report is intended for the information of management, the Board of Directors, the State Controller's Office, the U S Department of Transportation, and officials of applicable grantor agencies. However, this report is a matter of public record and its distribution is not limited.

BROWN ARMSTRONG PAULDEN  
McCOWN STARBUCK THORNBURGH & KEETER  
ACCOUNTANCY CORPORATION

Bakersfield, California  
October 26, 2006

**FINDINGS AND QUESTIONED COSTS SECTION**

**SANTA CRUZ METROPOLITAN TRANSIT DISTRICT  
SCHEDULE OF FINDINGS AND QUESTIONED COSTS  
JUNE 30, 2006**

**I. Summary of Auditor's Results**

**Financial Statements**

Type of auditors' report issued: Unqualified

Internal control over financial reporting:

|   |     |                                     |               |
|---|-----|-------------------------------------|---------------|
| Material weakness identified?   | Yes | <input checked="" type="checkbox"/> | No            |
| Reportable conditions identified that are not considered to be material weaknesses? | Yes | <input checked="" type="checkbox"/> | None reported |

Noncompliance material to financial statements noted? Yes  No

**Federal Awards**

**Internal control over major federal programs:**

|   |     |                                     |               |
|---|-----|-------------------------------------|---------------|
| Material weakness identified?   | Yes | <input checked="" type="checkbox"/> | No            |
| Reportable conditions identified that are not considered to be material weaknesses? | Yes | <input checked="" type="checkbox"/> | None reported |

Type of auditors' report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with Circular A-133, Section 510(a)? Yes  No

Identification of major programs:

CFDA Number(s)

20 500  
20 507

Name of Federal Program or Clusters

Federal Transit Administration-Section 3  
Federal Transit Administration-Section 9

Dollar threshold used to distinguish Type A & B programs: \$300,000

Auditee qualified as low risk auditee?  Yes  No

**II. Findings Relating to Financial Statements Required Under GAGAS**

None.

**III. Federal Award Findings and Questioned Costs**

None

**IV. State Award Findings and Questioned Costs**

None

**V. A Summary of Prior Audit (all June 30, 2005) Findings and Current Year Status Follows**

None