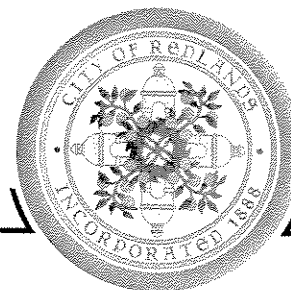


INTRODUCTORY SECTION

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City of Redlands



December 22, 2006

To the Members of the City Council and Citizens of the City of Redlands:

It is the policy of the City of Redlands to annually publish a complete set of financial statements presented in conformity with generally accepted accounting principles (GAAP) and audited in accordance with generally accepted auditing standards by a firm of certified public accountants. Pursuant to that requirement, we hereby issue the comprehensive annual financial statements of the City of Redlands ("the City") for the fiscal year ended June 30, 2006.

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

The City's financial statements have been audited by MAYER HOFFMAN MCCANN, P.C., an independent firm of certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of the City for the fiscal year ended June 30, 2006, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditor concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the City's financial statements for the fiscal year ended June 30, 2006, were fairly presented in conformity with GAAP. The independent auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the City was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited City's internal controls and legal requirements involving the administration of federal awards. These reports are available in the City's separately issued Single Audit Report.

GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis



(MD&A). This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. The City's MD&A can be found immediately following the report of the independent auditors.

PROFILE OF THE GOVERNMENT

The City of Redlands, incorporated in 1888, is located 63 miles east of Los Angeles, 110 miles north of San Diego, and 500 miles southeast of San Francisco. It is the third largest city in San Bernardino County, covering an area of 36 square miles, and lies within the San Bernardino Valley in the southwestern portion of the County, within the heart of the Inland Empire. It serves a population of 71,086 residents.

The City was incorporated under the general laws of the State of California and enjoys all the rights and privileges applicable to a General Law City. It is a municipal corporation governed by a five-member city council in which all policy-making and legislative authority is vested. The City Council is responsible, among other things for passing ordinances, adopting the budget, appointing committees, and hiring both the City Manager and City Attorney. The City Manager is the chief administrative officer of the City and as such is responsible for carrying out the policies and ordinances of the City Council, for overseeing the day-to-day operations of the City, and for recommending appointment of department heads to the Council for approval. The Council is elected on a non-partisan basis. Council members serve four-year staggered terms, with elections occurring every two years. The mayor is elected by a majority vote of the Council.

The City provides a full range of services, including police and fire protection, animal control, emergency medical aid, building safety regulation and inspection, street lighting, beautification, sewer and water utilities, solid waste collection and disposal, land use planning and zoning, housing and community services, maintenance and improvement of streets and related structures, traffic safety maintenance and improvement, and a full range of recreational and cultural programs for citizen participation, as well as being the home of the historic A. K. Smiley Public Library.

The annual budget serves as the foundation for the City's financial planning and control. Prior to the beginning of the fiscal year, the City Manager submits a budget for the upcoming year to the City Council. Public hearings are held before final approval of the budget. The City Manager is authorized to transfer budgeted amounts between departments within any fund; however, any revisions that alter the total expenditures of any fund must be approved by the City Council. The City maintains budgetary controls to ensure compliance with provisions embodied in the annual appropriated budget approved by the City Council. Activities of the general fund, special revenue funds, debt service funds, capital projects funds, enterprise funds and internal service funds are included in the annual budget. The level of control (level at which expenditures may not exceed budget) is the fund. The City also maintains an encumbrance accounting system as one technique of accomplishing budgetary control. Encumbered amounts lapse at year-end; however encumbrances are re-appropriated each year by separate action of the City Council. Budget-to-actual comparisons are provided in this report for each individual governmental fund for which an appropriated annual budget has been adopted. For the general fund and major special revenue funds, this comparison is presented as part of the required supplementary information in the accompanying financial statements. For governmental funds that have appropriated annual budgets, other than the general fund and major special revenue funds, this comparison is presented in the supplementary section of the accompanying financial statements.

ECONOMIC CONDITION AND OUTLOOK

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

Local economy. City of Redlands' economy is based largely in the service and trade sectors (health care, retail trade, government, and education) and light manufacturing. The region has a varied manufacturing and industrial base that adds to the relative stability of the unemployment rate which is at 3.8%. Since 2001, the annual unemployment rate for the City has ranged from a low of 3.8% to a high of 4.8%.

The City has significant land still available for industrial/commercial/office use with only a portion of these areas utilized. Major industries with headquarters or divisions located within the City's boundaries or in close proximity include computer hardware and software manufacturers, electrical controls and automobile component manufacturers, and several financial and insurance institutions. Major employers in the City or within the vicinity include the Redlands Unified School District, ESRI (Environmental Systems Research Institute), Loma Linda University Medical Center, the Jerry L. Pettis Veterans Hospital, the VA Loma Linda Healthcare System, Redlands Community Hospital, the United States Post Office and the University of Redlands. Several large warehouse distribution centers have been developed over the past few years, including Hershey (JENCO), Bechton-Dickenson, Stater Bros. and Salton, with each adding several hundred employees to the job mix.

The City's property tax base has shown steady growth since fiscal year 2000-2001 with an average annual increase in assessed valuation of 11.1%. In fiscal year 2005-2006, assessed valuation increased by 18.4%, almost double the growth experienced between tax years last year. Assets owned by a major utility company were valued \$210 million higher than reported last year and accounted for 25% of the growth enjoyed by the City. From fiscal year 2000-2001 to 2005-2006 assessed valuation for the City of Redlands increased by a gross of 61% and reached \$5.4 billion by fiscal year 2005-2006.

Development activity occurring in fiscal year 2005-2006 remained strong although growth in residential development experienced a slow down beginning in the Spring of 2006. There has been a reduction in the number of single family detached residences and an increase in the number of attached condominium units. Even with the slowdown, activity remains steady with 166 units that are under construction, 231 units that are in plan check, 632 units that are approved but have not initiated the plan check process and another 389 units that are in the planning process. Some of the significant residential projects include: Beazer Homes, located north of Pioneer, has 14 units under construction and another 125 homes in plan check; Quantum Structures, a 64 unit residential condominium has 55 units under construction and 9 in plan check; Granite Homes, an 80 lot single family residential planned unit development located on Wabash Avenue; Walton Development (Tracts 16465 and 16627) a 107 lot single family residential planned unit development north of San Bernardino Avenue; Standard Pacific Homes, a 201 unit single family residential project located south of San Bernardino Avenue; Mark Utzinger, a 160 unit senior housing project on Orange Avenue; and Quantum Structures, a 77 unit residential town-home development on the northeast corner of Alabama and Orange.

From July 2005 to June 2006, 787 single-family homes/condos were sold in Redlands at an average price of \$440,846

Other development activity within the City remains strong, with over 2 million square feet of commercial and industrial development under construction and another 1.8 million square feet in plan check at June 30, 2006.

Retail development grew steadily with 22,799 square feet of retail development under construction and 86,848 square feet in plan check at June 2006. The most significant of these projects is the development of a new 69,666 square foot Toyota of Redlands automobile dealership located just north of the I-10 freeway. Another 14,798 of retail space had all planning approvals and another 53,846 square feet of retail development was in the planning process.

Redlands has seen a significant jump in the amount of office space being developed over the past several years. A large component of the office development is centered on the medical and technical industries within the community. By the end of June 2006, there was 145,188 square feet under construction, 324,398 square feet in plan check, and over 180,000 square feet that had been approved and/or was in the planning process. Some of the key office projects include GMID, a two story 45,646 square foot development on Orange Tree Lane; Edward Anderson, a two story 39,178 square foot medical office condominium project on Terracina; James Didion, a three building medical complex with a building area of 52,559 square feet on Park Avenue; ESRI, a two-story 32,251 square foot addition to their existing office complex on New York; Afshari, a medical office complex of three two-story buildings totaling 122,604 square feet at the southwest corner of Alabama Street and Park Avenue; and Citrus Packing LLC, a four building commercial/office complex with 110,512 square feet located on the northeast corner of Texas Street and San Bernardino Avenue.

Industrial development in the City continues to be significant. At June 30, 2006 the City had 1.9 million square feet under construction and another 1.3 million square feet in plan check. Industrial development includes the larger warehouse distribution facilities as well as smaller facilities. Significant industrial projects still in process include: WMF Designs, an 8 building 89,640 square foot industrial park on Alabama; AMB Property Corporation, a 1,313,470 square foot regional distribution center; MKJ-McCalla an 8 building business park with a combined square footage of 135,570 square feet on Nevada Street; Thrifty Oil Company, a 140,380 square foot industrial complex on the southeast corner of Park and Kansas; and PGP Partners, a six building industrial park with 711,000 square feet of floor area on 38 acres on the west side of Mountain View Avenue.

In addition to the development projects noted above, the City has the following other major projects in process at June 30, 2006: Redlands Sports Park Phase I, a 45 acre park with eight lighted soccer fields, two concessions and restroom buildings, and a large multipurpose field is expected to be completed in June 2007; Alabama and Orange Street Bridges, both four lane bridges crossing the Santa Ana River that allow all weather access between the City of Redlands and the City of Highland, were completed in December, 2006. A major project for fiscal year 2006-2007 is the Civic Center ADA Improvements project that will remove barriers to the disabled at City Hall. ADA improvements are expected to be completed in March 2007.

Long-term financial outlook/planning. Over the last few years the City has faced financial challenges as a result of the State Budget crisis, increases in PERS rates, increases in employee contracts, and employee retirements. As a result, the City's General Fund expenditures have exceeded revenues, thereby causing a steady reduction in unreserved fund balance. Although the City has experienced significant growth in property taxes, sales taxes and development in recent years, its revenues still were not able to keep pace with its expenditures. Furthermore, the City does not expect the growth over the next few years to continue at the same record levels that it has over the last few years. Accordingly, the City will need to focus on financial policy decisions that may include a reduction in service levels and/or enhanced revenue opportunities. Innovation and teamwork by the Council, staff and the citizens of Redlands will be critical to the City's financial future.

Cash management policies and practices. During the year, temporarily idle cash was invested in demand deposits, certificates of deposits, obligations of the U.S. Treasury and its agencies, commercial paper, mutual funds, and the state of California Local Agency Investment Fund. The City's current investment policy is to keep its portfolio as liquid as possible, minimize credit and market risks, and still maintain an acceptable yield. Accordingly, most city funds are invested in the State's Local Agency Investment Fund or in Federal Agency securities. All investments were held by the City or held in the City's name by Bank of New York's safekeeping department. The maturities of the investments range from 1 day to 2.25 years, with an average weighted maturity of 379 days. The average yield on investments was 3.169 percent at June 30, 2006.

Risk management. The City is self-insured for both worker's compensation and general commercial and automobile liability for the first \$1,000,000 and \$500,000 per occurrence, respectively. The City has purchased excess coverage of \$25,000,000 per occurrence with a \$25,000,000 aggregate for worker's compensation and \$10,000,000 per occurrence with a \$10,000,000 aggregate for liability. Liability claims are administered internally by the Finance Department and City Attorney, while Worker's Compensation claims are monitored by the Administrative Services Department and a third party administrator. Both self-insurance programs are being accounted for in separate internal service funds in which resources are being accumulated to meet current and potential losses. Additional information on the City's risk management activity can be found in the Notes to the Basic Financial Statements.

Pension and other postemployment benefits. The City contributes to the California Public Employees Retirement System, an agent multiple-employer public employee defined benefit pension plan for its employees. Each year, an independent actuary engaged by the pension plan calculates the amount of the annual contribution that the City must make to the pension plan to ensure that the plan will be able to fully meet its obligations to retired employees on a timely basis. As a matter of policy, the City fully funds each year's annual required contribution to the pension plan as determined by this funding policy. A discussion of the amortization of the unfunded actuarial liability associated with employee services rendered to date is discussed in Note 10 of the Notes to the Financial Statements.

The City also provides postretirement health care benefits, in accordance with applicable Memoranda of Understanding and the California Government Code, to all employees who retire from the City of Redlands. As of the end of the current fiscal year, there were 225 retirees eligible to receive these benefits, which are financed on a pay-as-you-go basis. Additional information regarding the City's pension arrangements and postemployment benefits can be found in the Notes to the Financial Statements.

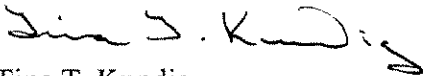
Awards and Acknowledgements

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement of Excellence in Financial Reporting to the City of Redlands for its comprehensive annual financial reports for the fiscal years ended June 30, 2003, June 30, 2004 and June 30, 2005. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

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

The preparation of the comprehensive annual financial report was made possible by the dedicated service of the entire staff of the Finance department. Special recognition is due to the Assistant Finance Director, Tom Steele, and Senior Accountant, Nicolette Kay, for their extraordinary effort in overseeing the compilation of the accounting data and interfacing with our auditors, to accounting staff members Kim Braun and Mary Ellen Lambert for their support, to the accounting firm of MAYER HOFFMAN MCCANN, P.C. and to Teresa Ballinger, Reprographics Technician.

Respectfully submitted,



Tina T. Kundig
Finance Director

Certificate of Achievement for Excellence in Financial Reporting

Presented to

City of Redlands,
California

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2005

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



Carla E. Perry

President

Jeffrey R. Emer

Executive Director

CITY OF REDLANDS
PRINCIPAL OFFICERS

| | |
|----------------------------------|---|
| CITY COUNCIL (ELECTED) | Jon P. Harrison, Mayor Patricia L. Gilbreath, Mayor Pro Tem Pete Aguilar, Councilmember Mick Gallagher, Councilmember Gilberto Gil, Councilmember |
| CITY MANAGER | John Davidson |
| CITY CLERK (ELECTED) | Lorrie Poyzer |
| CITY TREASURER (Elected) | Michael Reynolds |
| CITY ATTORNEY | Daniel J. McHugh |
| COMMUNITY DEVELOPMENT DIRECTOR | Jeffrey L. Shaw |
| FINANCE DIRECTOR | Tina T. Kundig |
| FIRE CHIEF | James J. Drabinski |
| LIBRARY DIRECTOR | Larry E. Burgess |
| MUNICIPAL UTILITIES DIRECTOR | Gary G. Phelps |
| ADMINISTRATIVE SERVICES DIRECTOR | Marjie Pettus |
| POLICE CHIEF | James R. Bueermann |
| PUBLIC WORKS DIRECTOR | Ronald C. Mutter |
| REDEVELOPMENT DIRECTOR | Donald M. Gee |

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