

**LOS ANGELES WORLD AIRPORTS**  
(Department of Airports of the City of Los Angeles, California)  
**LOS ANGELES INTERNATIONAL AIRPORT**

Annual Financial Report

For the Years Ended June 30, 2006 and 2005

**LOS ANGELES WORLD AIRPORTS**  
(Department of Airports of the City of Los Angeles, California)  
**LOS ANGELES INTERNATIONAL AIRPORT**

Annual Financial Report  
For the Years Ended June 30, 2006 and 2005

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The Members of the Board of Airport Commissioners  
of the City of Los Angeles, California

## **INDEPENDENT AUDITOR'S REPORT**

We have audited the accompanying financial statements of Los Angeles International Airport, a departmental component of Los Angeles World Airports (Department of Airports of the City of Los Angeles, California) (LAWA), an enterprise fund of the City of Los Angeles (City), as of and for the year ended June 30, 2006, as listed in the accompanying table of contents. These financial statements are the responsibility of LAWA management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Los Angeles International Airport as of and for the year ended June 30, 2005, were audited by other auditors whose report dated November 10, 2005, expressed an unqualified opinion on those statements.

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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Los Angeles International Airport's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements presented represent the financial position, changes in financial position and cash flows of Los Angeles International Airport only and are not intended and do not purport to present fairly the financial position, changes in financial position, or cash flows of LAWA or of the City in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated October 24, 2006 on our consideration of Los Angeles International Airport's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and

grant agreements and other matters for the year ended June 30, 2006. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The pension supplementary information on page 26 is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

*Macias Jini & O'Connell LLP*

Certified Public Accountants

Los Angeles, California  
October 24, 2006

**LOS ANGELES WORLD AIRPORTS**  
 (Department of Airports of the City of Los Angeles, California)  
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 Statements of Net Assets  
 June 30, 2006 and 2005  
 (Dollars in thousands)

	<b>2006</b>	<b>2005</b>
<b>ASSETS</b>		
Current assets:		
Cash and pooled investments held by the City Treasurer (Note 3)	\$ 501,393	\$ 552,847
Accounts receivable, net of allowance for uncollectible accounts of \$3,504 and \$3,779 in 2006 and 2005, respectively	19,139	23,782
Unbilled receivables	27,227	23,263
Accrued interest receivable	6,384	5,466
Due from other agencies (Note 8)	119,890	110,460
Prepaid expenses and inventories	2,973	2,377
Total current assets	677,006	718,195
Noncurrent assets:		
Restricted assets:		
Cash and pooled investments held by the City Treasurer (Note 3)	531,535	456,978
Investments with fiscal agents (Note 3)	27,374	28,148
Accrued interest receivable	3,894	3,119
Passenger facility charges receivable (Note 13)	19,387	14,730
Total restricted assets	582,190	502,975
Capital assets (Note 4):		
Land, land clearance, and air easements	600,417	597,755
Buildings, improvements, and equipment	1,383,920	1,308,432
Leased property	184,423	184,423
Less accumulated depreciation and amortization	(894,564)	(829,995)
Construction work in process	221,758	143,294
Net capital assets	1,495,954	1,403,909
Deferred bond issuance expense	2,774	3,139
Total noncurrent assets	2,080,918	1,910,023
Total assets	\$ 2,757,924	\$ 2,628,218

See accompanying notes to financial statements.

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 Statements of Net Assets (Continued)  
 June 30, 2006 and 2005  
 (Dollars in thousands)

	<b>2006</b>	<b>2005</b>
<b>LIABILITIES AND NET ASSETS</b>		
Current liabilities:		
Current liabilities payable from unrestricted assets:		
Contracts and accounts payable	\$ 45,003	\$ 36,501
Employee benefits and insurance claims payable (Notes 6 and 10)	5,761	9,117
Salaries payable	3,624	2,267
Commercial paper notes payable (Note 5)	-	15,500
Current obligations under capital leases (Notes 6 and 13)	1,026	912
Other liabilities (Note 6)	4,436	8,431
	<u>59,850</u>	<u>72,728</u>
Current liabilities payable from restricted assets:		
Obligations under securities lending transactions	154,013	143,649
Bonds payable, plus net deferred credits of \$763 and \$850 in 2006 and 2005, respectively (Note 5)	12,583	22,090
Contracts and accounts payable	32,259	37,410
Accrued bond interest payable	1,030	1,171
	<u>199,885</u>	<u>204,320</u>
Total current liabilities	<u>259,735</u>	<u>277,048</u>
Long-term liabilities:		
Bonds payable, plus net deferred charges and credits of \$7,498 and \$8,152 in 2006 and 2005, respectively (Note 5)	225,548	238,022
Obligations under capital leases - less current portion (Notes 6 and 12)	51,855	52,881
Employee benefits and insurance claims payable (Notes 6 and 10)	24,870	17,365
Other liabilities (Note 6)	18,833	18,366
	<u>321,106</u>	<u>326,634</u>
Total long-term liabilities	<u>321,106</u>	<u>326,634</u>
Total liabilities	<u>580,841</u>	<u>603,682</u>
Net assets:		
Invested in capital assets, net of related debt	1,204,942	1,090,005
Restricted:		
Capital projects	158	153
Debt service	26,438	27,071
Special purpose	368,292	227,849
Unrestricted	577,253	679,458
	<u>577,253</u>	<u>679,458</u>
Total net assets	<u>\$ 2,177,083</u>	<u>\$ 2,024,536</u>

See accompanying notes to financial statements.

**LOS ANGELES WORLD AIRPORTS**  
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 Statements of Revenues, Expenses, and Changes in Net Assets  
 For the Years Ended June 30, 2006 and 2005  
 (Dollars in thousands)

	<b>2006</b>	<b>2005</b>
Operating revenue:		
Aviation revenue:		
Landing fees	\$ 146,019	\$ 134,015
Building rentals	119,271	101,153
Other aviation revenue	51,428	49,876
Concession revenue	200,564	194,386
Airports sales and services	2,034	1,978
Miscellaneous revenue	1,451	1,234
Total operating revenue	520,767	482,642
Operating expenses:		
Salaries and benefits	231,313	199,238
Contractual services	148,606	135,313
Materials and supplies	34,043	37,692
Administrative expenses	1,787	3,970
Utilities	23,633	24,378
Advertising and public relations	9,843	8,820
Other operating expenses	2,099	(1,458)
Total operating expenses before depreciation and amortization	451,324	407,953
Income from operations before depreciation and amortization	69,443	74,689
Depreciation and amortization	(64,571)	(59,710)
Operating income	4,872	14,979
Nonoperating revenue (expenses):		
Passenger facility charges (Note 13)	114,694	113,739
Interest income	33,902	28,668
Change in fair value of investments	(15,292)	(2,978)
Interest expense	(12,155)	(16,998)
Bond expense	(364)	(302)
Gain on sale of securities	217	3,867
Other nonoperating expenses	(6,600)	(29)
Other nonoperating revenue	1,209	6,457
Total nonoperating revenue, net	115,611	132,424
Income before capital grants	120,483	147,403
Capital grant contributions (Note 14)	32,064	791
Inter-agency transfer, net	-	(3,410)
Change in net assets	152,547	144,784
Net assets, beginning of year	2,024,536	1,879,752
Net assets, end of year	\$ 2,177,083	\$ 2,024,536

See accompanying notes to financial statements.

**LOS ANGELES WORLD AIRPORTS**  
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 Statements of Cash Flows  
 For the Years Ended June 30, 2006 and 2005  
 (Dollars in thousands)

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Receipts from customers	\$ 521,721	\$ 508,251
Payments for goods and services	(222,148)	(177,231)
Payments to employees	(225,807)	(199,685)
Other payments, net	(13,803)	(18,593)
Net cash provided by operating activities	<u>59,963</u>	<u>112,742</u>
Cash flows from noncapital financing activities:		
Inter-agency transfer (out)	-	(3,410)
Net cash (used in) noncapital financing activities	<u>-</u>	<u>(3,410)</u>
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(156,614)	(157,100)
Receipts from passenger facility charges	110,037	113,435
Principal paid on bonds	(21,240)	(22,390)
Interest paid on bonds and commercial paper	(11,976)	(17,552)
Bond payment liability returned as escheated funds	467	-
Principal paid on capital leases	(912)	(855)
Interest paid on capital leases	(1,802)	(1,212)
Cash transferred from fiscal agent	774	1,886
Payments for commercial paper	(15,500)	-
Federal grants received	32,064	5,181
Net cash used in capital and related financing activities	<u>(64,702)</u>	<u>(78,607)</u>
Cash flows from investing activities:		
(Decrease) in fair value of investments	(14,948)	(2,978)
Interest received	32,426	31,680
Securities lending cash collateral received (paid)	10,364	(3,669)
Net cash provided by investing activities	<u>27,842</u>	<u>25,033</u>
Net increase in cash and cash equivalents	23,103	55,758
Cash and cash equivalents, beginning of year	<u>1,009,825</u>	<u>954,067</u>
Cash and cash equivalents, ending of year	<u>\$ 1,032,928</u>	<u>\$ 1,009,825</u>
The following is a reconciliation of cash and cash equivalents		
to the statement of net assets:		
Cash and pooled investments held by the City Treasurer - unrestricted	\$ 501,393	\$ 552,847
Cash and pooled investments held by the City Treasurer - restricted	531,535	456,978
	<u>\$ 1,032,928</u>	<u>\$ 1,009,825</u>

See accompanying notes to financial statements.

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 Statements of Cash Flows (Continued)  
 For the Years Ended June 30, 2006 and 2005  
 (Dollars in thousands)

	<b>2006</b>	<b>2005</b>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 4,872	\$ 14,979
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	64,571	59,710
Change in provision for uncollectible accounts	(275)	1,452
Other nonoperating revenue (expenses), net	(5,462)	6,428
Changes in assets and liabilities:		
Accounts receivable	4,918	6,292
Unbilled receivables	(3,964)	19,317
Due from other agencies	(9,430)	(33,084)
Federal grants receivable - current	-	6,363
Prepaid expenses and inventories	(596)	(497)
Contracts and accounts payable	3,351	31,475
Employee benefits and insurance claims payable	4,149	(1,409)
Salaries payable	1,357	962
Other liabilities	(3,528)	754
Total adjustments	55,091	97,763
Net cash provided by operating activities	\$ 59,963	\$ 112,742

Schedule of noncash investing, capital and financing activities:

- LAX acquired \$20,272 of capital assets by incurring outstanding payables as of June 30, 2006.

See accompanying notes to financial statements.

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Notes to Financial Statements

June 30, 2006 and 2005

**(1) Reporting Entity and Summary of Significant Accounting Policies**

**(a) *Organization and Reporting Entity***

The financial statements of the Los Angeles International Airport (LAX) have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The Los Angeles World Airports (Department of Airports of the City of Los Angeles, California) (LAWA) operates LAX. LAWA is an independent, financially self-sufficient department of the City of Los Angeles (the City) established pursuant to Article XXIV, Section 238 of the City Charter. LAWA operates Los Angeles International Airport (LAX), Ontario International Airport (Ontario), Van Nuys Airport and Palmdale Regional Airport (collectively, the Airport System).

LAWA is under the management and control of a seven-member Board of Airport Commissioners (the Board) appointed by the City Mayor and approved by the City Council. Under the City Charter, the Board has the general power to, among other things: (a) acquire, develop and operate all property, plant and equipment as it may deem necessary or convenient for the promotion and accommodation of air commerce; (b) borrow money to finance the development of airports owned, operated or controlled by the City; and (c) fix, regulate and collect rates and charges for use of the Airport System. An Executive Director administers LAWA and reports to the Board.

The financial statements presented herein represent the financial position and changes in financial position and cash flows of LAX only and are not intended to present fairly the financial position, changes in financial position, or cash flows of LAWA or the City in conformity with GAAP.

**(b) *Basis of Accounting***

LAX is reported as an enterprise fund and maintains its records on the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded when the related liability is incurred. Separate funds are used to account for each airport in the Airport System. Only the funds of LAX are included in the reporting entity. Bonds issued by LAX are payable solely from revenues of LAX and are not general obligations of the City. LAX applies all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins issued on or before November 30, 1989, unless such pronouncements conflict with or contradict GASB pronouncements.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(1) Reporting Entity and Summary of Significant Accounting Policies (continued)**

**(c) *Cash and Pooled Investments***

All cash collections are deposited with and all payments are withdrawn from the City Treasurer with the exception of certain bond financing activity of LAX's outstanding bonds. In order to maximize investment return, LAX pools its available cash with that of the City, which is invested by the City Treasurer (see Note 3).

LAX's investments, including its share of the City's pooled investments, are stated at fair value. Fair value is determined based upon market closing prices or bid/asked prices for regularly traded securities. The fair value of mutual funds, government-sponsored investment pools and other similar investments are stated at share value, or appropriate allocation of fair value of the pool, if separately reported. Certain money market investments with initial maturities at the time of purchase of less than one year are recorded at cost. The calculation of realized gains (losses) is independent of the calculation of the net increase (decrease) in the fair value of investments.

Interest income arising from such cash and pooled investments is apportioned to LAX based on the relationship of LAX's respective daily cash balances to aggregate cash and pooled investments.

**(d) *Accounts Receivable and Unbilled Receivables***

LAX recognizes revenue in the period earned. Receivables aged beyond 90 days are put into the collection process and then referred after 120 days to LAX's resident City Attorneys for possible write-off. An allowance for uncollectible accounts is set as a reserve by LAX policy. This policy requires that 2% of outstanding receivables plus all referrals to City Attorney be reserved as uncollectible through a provisional month-end charge to operating expense. Unbilled receivable balances are the result of revenue accrued for services that exceed \$5,000 each, but not yet billed as of year-end. This accrual activity occurs primarily at year-end when services provided in the current fiscal period might not get processed through the billing system for up to sixty days into the next fiscal year.

**(e) *Contracts Payable, Accounts Payable and Other Liabilities***

All transactions for goods and services obtained by LAX from City-approved contractors and vendors get processed for payment via its automated payment system. This procedure results in the recognition of expense in the period that an invoice for payment is processed through the system, or when a vendor first provided the goods and/or services. If the goods and/or services were received or if the invoice was received but not yet processed in the system, then an accrual is made manually by journal voucher into the general ledger to reflect the liability to the vendor. When LAX makes agreements that require customers to make cash deposits, these amounts are then reflected as other current liabilities. Reserves for claims and litigation are recorded as other long-term liabilities.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(1) Reporting Entity and Summary of Significant Accounting Policies (continued)**

**(f) *Securities Lending***

The City Treasurer engages in securities lending activities. LAX's share of assets and liabilities arising from the reinvested cash collateral has been recognized in the accompanying financial statements (see Note 3).

**(g) *Investments with Fiscal Agents***

LAX has funds that are held by fiscal agents and pledged to the payment or security of the 1995, 2002, and 2003 bonds (see Note 3).

**(h) *Federal Grants***

When a grant agreement is approved and eligible expenditures are incurred, the amount is recorded as a federal grant receivable and as capital grant contributions in the statements of revenues, expenses and changes in net assets.

**(i) *Capital Assets***

All capital assets are carried at cost, or at estimated fair value on the date received in the case of properties acquired by donation or by termination of leases, less allowance for accumulated depreciation. Such cost includes, where appropriate, interest capitalized as part of the cost of construction of capital assets. Maintenance and repairs are charged to operations in the period incurred. Renewals and betterments are capitalized in the asset accounts. LAX has a capitalization threshold of \$5,000 for all capital assets.

**(j) *Landing Fees***

Landing fee rates are used to determine what fees are to be charged to the airlines each time that a qualified aircraft lands at LAX. The type of landing fee method applied by LAX is compensatory. Under this fee methodology, the fees charged by LAX for a facility or service are based on costs attributable only to that facility or service. For example, the landing fees charged for using the airfield and apron are based on LAWA's actual costs of operating the airfield and apron. For control purposes, the landing fees are calculated twice each fiscal year.

**(k) *Concession Revenues***

Concession revenue is generated through LAX concessionaires or tenants, who pay monthly fees for using airport facilities to offer their goods and services to the general public and air traveling community. Payments to LAX are based on negotiated agreements with concessionaires to remit amounts based on either a Minimum Annual Guarantee (MAG) or on gross receipts. Amounts recorded to concession revenue are determined by the type of revenue category set up in the general ledger system and integrated with the monthly accounts receivable billing process. Concession revenue is recorded as it is earned. Some tenant agreements require self-reporting of concession operations and/or sales. The tenants' operations report and payment are due to LAX in the month following the activity.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(1) Reporting Entity and Summary of Significant Accounting Policies (continued)**

**(k) Concession Revenues (continued)**

The timing of concessionaire reporting and when revenue earned is recorded will determine when accruals are required for each tenant.

**(l) Depreciation and Amortization**

Depreciation expense includes amortization of assets under capital leases. Depreciation and amortization are computed on a straight-line basis. The estimated useful lives of the major property classifications are as follows: buildings and facilities, 10 to 40 years; landplane ports, 10 to 35 years; and equipment, 5 to 20 years. No depreciation is provided for construction work in process until construction is completed and/or the asset is placed in service.

**(m) Preliminary Costs of Capital Projects**

Preliminary costs of capital projects incurred prior to the finalization of formal construction contracts are capitalized. In the event the proposed capital projects are abandoned, the associated preliminary costs are charged to expense in the year of abandonment.

**(n) Operating and Nonoperating Revenue and Expenses**

Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with an enterprise fund's principal ongoing operations. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses. LAX derives operating revenues primarily from landing fees, terminal space rental, auto parking, and concessions. LAX's major operating expenses include salaries and employee benefits, fees for contractual services related to security and parking management, and other expenses such as maintenance, insurance, and utilities.

**(o) Interest Expense**

LAX capitalizes interest expense (net of interest earnings) for capital projects during construction. Interest expense was \$12,155,000 for the year ended June 30, 2006 and \$16,998,000 for the year ended June 30, 2005. There was no capitalized interest in 2006 and 2005.

**(p) Employee Benefits**

LAX employees accumulate annual vacation and sick leave in varying amounts based on length of service. Vacation and sick leave is recorded as earned. Upon termination or retirement, employees are paid the cash value of their accumulated leave.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(1) Reporting Entity and Summary of Significant Accounting Policies (continued)**

**(q) *Statements of Cash Flows***

Cash and cash equivalents as reported in the statements of cash flows include short-term, highly liquid investments that are both readily convertible to known amounts of cash and have maturities of three months or less at the time of purchase. Cash and investments (both restricted and unrestricted) held by the City Treasurer are, in effect, demand deposits and are, therefore, considered to be cash equivalents.

**(r) *Use of Estimates***

The preparation of the 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 amounts in the financial statements and accompanying notes. Actual results could differ from the estimates.

**(s) *Reclassifications***

Certain reclassifications have been made to fiscal year 2005 amounts in order to conform to the fiscal year 2006 presentation.

**(t) *Inventory***

LAX's inventory consists primarily of general office supplies and is recorded at cost on a first-in, first-out basis.

**(u) *Bond Premiums, Discounts, and Issuance Costs***

Bond premiums, discounts, issuance costs, and gains and losses on debt extinguishment are deferred and amortized over the life of the bonds. Bonds payable are reported net of the applicable bond premium or discount and deferred losses on extinguishment. Bond issuance costs are reported as deferred charges and amortized over the term of the related debt.

**(v) *Net Assets***

The financial statements utilize a net assets presentation. Net assets are categorized as follows:

- *Invested in Capital Assets, Net of Related Debt* – This category groups all capital assets into one component of net assets. Accumulated depreciation and the outstanding balances of debt that are attributable to the acquisition, construction, or improvement of these assets reduce the balance in this category.
- *Restricted Net Assets* – This category presents external restrictions imposed by creditors, grantors, contributors, or laws or regulations of other governments and restrictions imposed by law through constitutional provisions or enabling legislation. At June 30, 2006 and 2005, net assets of \$304.5 million and \$227.8 million, respectively, are restricted by enabling legislation.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(1) Reporting Entity and Summary of Significant Accounting Policies (continued)**

**(v) Net Assets (continued)**

- *Unrestricted Net Assets* – This category represents net assets of LAX, not restricted for any project or other purpose.

**(2) Accounting Changes and Recent Accounting Pronouncements**

**(a) Accounting Changes**

In November 2003, GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This statement establishes accounting and financial reporting standards for impairment of capital assets and is effective for fiscal periods beginning after December 15, 2004. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This statement also clarifies and establishes accounting requirements for insurance recoveries. LAX implemented the new reporting requirements for the years ended June 30, 2006 and 2005, with no fiscal impact.

In December 2004, GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation – an amendment of GASB No. 34*. This statement clarifies a legally enforceable enabling legislation restriction is one that a party external to a government, such as its citizens, public interest groups, or the judiciary, can compel a government to honor. This statement requires governments to disclose the portions of total net assets that are restricted by enabling legislation. Disclosing the amount of net assets restricted by enabling legislation will allow users of the financial statements to distinguish qualifying restrictions on resource use imposed through a government's own action from other types of net asset restrictions. The requirements of this statement are effective for the financial statements for the period beginning after June 15, 2005. LAX has implemented the new statement for the years ended June 30, 2006 and 2005 and has disclosed net assets restricted by enabling legislation. The implementation of this statement had no fiscal impact.

In June 2005, GASB issued Statement No. 47, *Accounting for Termination Benefits*. This statement provides guidance on accounting and financial reporting for termination benefits. These benefits include incentives for voluntary terminations, such as early retirement window programs and involuntary termination benefits, such as severance payments. The statement requires employers to disclose a description of the termination benefit arrangement, the cost of the termination benefits (required in the period in which the employer becomes obligated if that information is not otherwise identifiable from information displayed on the face of the financial statements), and significant methods and assumptions used to determine termination benefit liabilities. The requirements of this statement are effective in two parts. For termination benefits provided through an existing defined benefit OPEB plan, the provisions of this statement should be implemented simultaneously with the requirements of GASB Statement No. 45. As noted in the GASB Statement No. 45 discussion which is detailed below, LAX intends to implement this statement in the year ending June 30, 2008. For all

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(2) Accounting Changes and Recent Accounting Pronouncements (continued)**

**(a) Accounting Changes (continued)**

other termination benefits, this statement is effective for fiscal period beginning after June 15, 2005. LAX implemented GASB Statement No. 47 for the years ended June 30, 2006 and 2005 financial statements, with no fiscal impact.

**(b) Recent Accounting Pronouncements**

In June 2004, GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This statement addresses how state and local governments should account for and report costs and obligations related to postemployment healthcare and other non-pension benefits (OPEB) and is effective for fiscal periods beginning after December 15, 2006. Annual OPEB cost for most employers will be based on actuarially determined amounts that, if paid on an ongoing basis, generally would provide sufficient resources to pay benefits as they come due. This statement's provisions may be applied prospectively and do not require governments to fund their OPEB plans. This statement also establishes disclosure requirements for information about the plans in which an employer participates, the funding policy followed, the actuarial valuation process and assumptions, and, for certain employers, the extent to which the plan has been funded over time. LAX is currently studying the impact to the financial statements that implementing GASB Statement No. 45 will impose. LAX intends to implement the new reporting requirements as required by the year ending June 30, 2008 financial statements.

**(3) Cash and Investments**

**(a) Cash and Pooled Investments**

Cash is deposited with the City Treasurer and generally invested in short-term investments under the City Treasurer's pooled investment program. The Los Angeles City Treasury Investment Procedures and Guidelines, established pursuant to the California Government Code and Los Angeles City Council action, govern the City's investment practices. The primary objectives of the City's investment policy are the safety of capital, the liquidity of the portfolio and the yield on the investments. Investments permitted by the City's investment policy include obligations of the U.S. Government and agencies, certain commercial paper, bankers' acceptances, medium-term corporate notes, negotiable certificates of deposit, repurchase agreements and state and local government pools (e.g., Local Agency Investment Fund) up to certain specified allowable percentages.

LAX's equity in the City Treasurer's general pooled investment and securities lending programs consists of the following cash and investments, based on the relative percentages of such equity to the total of the City Treasurer's general pooled funds and is not necessarily indicative of LAX's actual investments in the pooled funds (in thousands):

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**(3) Cash and Investments (continued)**

**(a) Cash and Pooled Investments (continued)**

<b>Description</b>	<b>2006</b>	<b>2005</b>
Deposits	\$ 5,165	\$ 21,206
U.S. Treasury securities	144,610	100,982
Federal agency securities	491,674	563,482
Commercial paper	185,927	147,435
Medium-term corporate notes	205,552	168,641
State Local Agency Investment Fund	-	8,079
Total	1,032,928	1,009,825
Less restricted portion	(531,535)	(456,978)
Unrestricted portion	<u>\$ 501,393</u>	<u>\$ 552,847</u>

The restricted portion represents cash and investments that are restricted as to use either by bond indenture requirements or the Federal Aviation Administration.

**(b) Investments Authorized by the City's Investment Policy**

The table on the following page identifies the investment types that are authorized for LAWA by the City's investment policy. The table also identifies certain provisions of the City's investment policy that address interest rate risk, credit risk, and concentration of credit risk.

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**(3) Cash and Investments (continued)**

**(b) Investments Authorized by the City's Investment Policy (continued)**

	<u>Maximum maturities</u>	<u>Maximum concentration</u>
U.S. Treasury and federal agency securities	5 years	100%
Bonds issued by local agencies	5 years	100
Registered state warrants and municipal notes	5 years	100
Bankers' acceptances	180 days	40
Commercial paper	270 days	40
Negotiable certificates of deposit or time deposits		
Yankee certificates of deposit		
CRA certificates of deposit or time deposits	180 days	30
Repurchase agreements	32 days	15
Reverse repurchase agreements	92 days	5*
Medium-term corporate notes	5 years	30
Shares of a money market mutual fund	N/A	20
Securities lending program	N/A	20
Asset-backed securities	5 years	20**
Collateralized mortgage obligations	5 years	20**
Local agency investment fund (LAIF)		(per state limit)***

\* The total of reverse repurchase agreements and the securities subject to a securities lending agreement may not exceed 20% of the total portfolio.

\*\* Combined total for mortgage-backed and asset-backed securities.

\*\*\* Current account limit is \$40 million.

At June 30, 2006 and 2005, LAX had \$1,032,928,000 and \$1,009,825,000, respectively, invested with the City Pools, which represents approximately 13.64% and 15.24%, respectively, of the City Treasury's General and Special Investment Pool.

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**(3) Cash and Investments (continued)**

**(c) City of Los Angeles Investment Pool**

At June 30, 2006, the investments held in the City Treasury's General and Special Investment Pool Programs and their maturities are as follows (in thousands):

<u>Type of Investments</u>	<u>Amount</u>	<u>Investment Maturities</u>			
		<u>1 to 30 Days</u>	<u>31 to 60 Days</u>	<u>61 to 365 Days</u>	<u>366 Days To 5 Years</u>
U.S. Treasury Notes	\$ 750,633	\$ -	\$ -	\$ -	\$ 750,633
U.S. Treasury Bills	7,193	7,193	-	-	-
U.S. Government Agencies	3,483,994	229,854	259,964	519,398	2,474,778
Medium Term Notes	1,077,004	-	-	125,689	951,315
Commercial Paper	1,298,356	1,173,459	52,464	72,433	-
State of California LAIF	2,204	2,204	-	-	-
Short Term Investment Funds	13	13	-	-	-
Securities Lending Cash Collateral					
U.S. Treasury Notes	607,597	-	-	-	607,597
U.S. Agencies	344,340	-	-	-	344,340
<b>Total General and Special Pools</b>	<b><u>\$ 7,571,334</u></b>	<b><u>\$ 1,412,723</u></b>	<b><u>\$ 312,428</u></b>	<b><u>\$ 717,520</u></b>	<b><u>\$ 5,128,663</u></b>

At June 30, 2005, the investments held in the City Treasury's General and Special Investment Pool Programs and their maturities are as follows (in thousands):

<u>Type of Investments</u>	<u>Amount</u>	<u>Investment Maturities</u>			
		<u>1 to 30 Days</u>	<u>31 to 60 Days</u>	<u>61 to 365 Days</u>	<u>366 Days To 5 Years</u>
U.S. Treasury Notes	\$ 526,446	\$ -	\$ 25,102	\$ 50,690	\$ 450,654
U.S. Agencies	3,446,885	244,830	113,766	373,801	2,714,488
Medium Term Notes	878,328	5,004	24,974	121,815	726,535
Commercial Paper	861,293	844,318	16,500	475	-
State of California LAIF	40,703	40,703	-	-	-
Short Term Investment Funds	9	9	-	-	-
Securities Lending Cash Collateral					
U.S. Treasury Notes	478,756	-	26,219	52,812	399,725
U.S. Agencies	395,396	-	-	-	395,396
<b>Total General and Special Pools</b>	<b><u>\$ 6,627,816</u></b>	<b><u>\$ 1,134,864</u></b>	<b><u>\$ 206,561</u></b>	<b><u>\$ 599,593</u></b>	<b><u>\$ 4,686,798</u></b>

*Interest Rate Risk.* The City's pooled investment policy limits the maturity of its investments to a maximum of five years for U.S. Treasury and federal agency securities, medium term corporate notes, and bonds issued by local agencies; 270 days for commercial paper; and 32 days for repurchase agreements. See Note 3(b).

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June 30, 2006 and 2005

**(3) Cash and Investments (continued)**

**(c) *City of Los Angeles Investment Pool (continued)***

*Credit Risk.* The City's pooled investment policy requires that for all classes of investments, except linked banking program certificates of deposits, the issuers must have minimum credit ratings as follows: Standard and Poor's Corporation (S&P) A-1/A; Moody's Investor Services (Moody's) P-1/A2; Fitch Ratings (Fitch), if available, F-1/A. The City's investments in medium term notes were rated A+ or better by S&P and A1 or better by Moody's, while investments in commercial paper were rated A-1+/A-1 by S&P, and P-1 by Moody's. As further required by the City's investment policy, issuers of medium term notes are corporations that have total assets in excess of \$500 million and are operating within the United States. In addition, issuers of commercial paper notes are corporations organized in the United States as special purpose corporations, trust or limited liability companies having program-wide credit enhancements. The State of California Local Agency Investment Fund is not rated.

*Concentration of Credit Risk.* The City's investment policy does not allow more than 10% of its investment portfolio, except U.S. Treasury and federal agencies, to be invested in securities of a single issuer including its related entities. The City's investment policy further provides for a maximum concentration limit of 30% on any individual federal agency or government-sponsored entity. The City's pooled investments comply with these requirements. GAAP requires disclosure of certain investments in any one issuer that represent 5% or more of total investments, the City does not have such investment.

**(d) *City of Los Angeles Securities Lending Program***

The Securities Lending Program (the SLP) is permitted and limited under provisions of California Government Code Section 53601. The City Council approved the SLP on October 22, 1991 under Council File No. 91-1860, which complies with the California Government Code. The objectives of the SLP in priority order are: safety of loaned securities; and prudent investment of cash collateral to enhance revenue from the investment program. The SLP is governed by a separate policy and guidelines, with oversight responsibility of the Investment Advisory Committee.

The City's custodial bank acts as the securities lending agent. In the event a counterparty defaults by reason of an act of insolvency, the bank shall take all actions which it deems necessary or appropriate to liquidate permitted investment and collateral in connection with such transaction and shall make a reasonable effort for two business days (Replacement Period) to apply the proceeds thereof to the purchase of securities identical to the loaned securities not returned. If during the Replacement Period the collateral liquidation proceeds are insufficient to replace any of the loaned securities not returned, the bank shall, subject to payment by the City of the amount of any losses on any permitted investments, pay such additional amounts as necessary to make such replacement.

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**(3) Cash and Investments (continued)**

**(d) City of Los Angeles Securities Lending Program (continued)**

Under the provisions of the SLP, and in accordance with the California Government Code, no more than 20% of the market value of the General Investment Pool (the Pool) shall be available for lending. The City receives cash as collateral on loaned securities, which is reinvested in securities permitted under the Policy. In accordance with the California Government Code, the securities lending agent marks to market the value of both the collateral and the reinvestments daily. Except for open loans where either party can terminate a lending contract on demand, term loans shall have a maximum life of 90 days. Earnings from securities lending shall accrue to the Pool and shall be allocated on a pro-rata basis to all Pool participants.

LAX's share of cash collateral received and corresponding liability aggregated approximately \$154,013,000 and \$143,649,000 at June 30, 2006 and 2005, respectively. During the fiscal year, collateralizations on all loaned securities were within the required 102% of market value. The City can sell collateral securities only in the event of borrower default. The lending agent provides indemnification for borrower default. There were no violations of legal or contractual provisions and no borrower or lending agent default losses during the year. There was no credit risk exposure to the City because the amounts owed to the borrowers exceeded the amounts borrowed. Loaned securities are held by the City's agents in the City's name and are not subject to custodial credit risk.

**(e) Investments with Fiscal Agents**

LAX also maintains investments with fiscal agents that are pledged to the payment or security of LAX's 1995, 2002, and 2003 bonds. These investments are also generally invested in short-term investments under the control of the fiscal agents.

The investment practices of the fiscal agents are these same as those of the City Treasurer, and have similar investment objectives. These investments are restricted as to their use and have maturities designed to coincide with required bond retirement payments.

These investments are uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in LAX's name.

LAX's investments with fiscal agents were as follows (in thousands):

<u>Description</u>	<u>2006</u>	<u>2005</u>
Money Market Funds	\$ 7,059	\$ 4,689
U.S. Treasury Securities	20,315	23,459
Total	<u>\$ 27,374</u>	<u>\$ 28,148</u>

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June 30, 2006 and 2005

**(4) Changes in Capital Assets**

Capital asset activity for the year ended June 30, 2006 was as follows (in thousands):

	<u>Balance at July 1, 2005</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at June 30, 2006</u>
Capital assets, not depreciated:				
Land	\$ 553,410	\$ 4,929	\$ (2,267)	\$ 556,072
Air easements	44,345	-	-	44,345
Construction work in process	143,294	113,300	(34,836) *	221,758
Total capital assets, not depreciated	<u>741,049</u>	<u>118,229</u>	<u>(37,103)</u>	<u>822,175</u>
Capital assets, depreciated:				
Buildings	512,693	1,566	-	514,259
Improvements	672,680	66,493	-	739,173
Equipment and vehicles	123,059	7,429	-	130,488
Leased property	184,423	-	-	184,423
Total capital assets, depreciated	<u>1,492,855</u>	<u>75,488</u>	<u>-</u>	<u>1,568,343</u>
Less accumulated depreciation and amortization:				
Buildings	(262,260)	(12,874)	-	(275,134)
Improvements	(381,205)	(41,558)	2	(422,761)
Equipment and vehicles	(100,748)	(5,107)	-	(105,855)
Leased property	(85,782)	(5,032)	-	(90,814)
Total accumulated depreciation and amortization	<u>(829,995)</u>	<u>(64,571)</u>	<u>2</u>	<u>(894,564)</u>
Total capital assets depreciated, net	<u>662,860</u>	<u>10,917</u>	<u>2</u>	<u>673,779</u>
Total capital assets, net	<u>\$ 1,403,909</u>	<u>\$ 129,146</u>	<u>\$ (37,101)</u>	<u>\$ 1,495,954</u>

\* Includes write-off of \$4,829 of costs incurred in prior periods for abandoned projects.

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June 30, 2006 and 2005

**(4) Changes in Capital Assets (continued)**

Capital asset activity for the year ended June 30, 2005 was as follows (in thousands):

	<u>July 1, 2004</u>	<u>Additions</u>	<u>Deductions</u>	<u>June 30, 2005</u>
Capital assets, not depreciated:				
Land	\$ 435,008	\$ 118,402	\$ -	\$ 553,410
Air easements	44,345	-	-	44,345
Construction work in process	140,809	131,433	(128,948)	143,294
Total capital assets, not depreciated	<u>620,162</u>	<u>249,835</u>	<u>(128,948)</u>	<u>741,049</u>
Capital assets, depreciated:				
Buildings	512,693	-	-	512,693
Improvements	643,639	29,041	-	672,680
Equipment and vehicles	115,887	7,172	-	123,059
Leased property	184,423	-	-	184,423
Total capital assets, depreciated	<u>1,456,642</u>	<u>36,213</u>	<u>-</u>	<u>1,492,855</u>
Less accumulated depreciation and amortization:				
Buildings	(249,596)	(12,664)	-	(262,260)
Improvements	(349,126)	(32,079)	-	(381,205)
Equipment and vehicles	(95,653)	(5,095)	-	(100,748)
Leased property	(75,910)	(9,872)	-	(85,782)
Total accumulated depreciation and amortization	<u>(770,285)</u>	<u>(59,710)</u>	<u>-</u>	<u>(829,995)</u>
Total capital assets depreciated, net	<u>686,357</u>	<u>(23,497)</u>	<u>-</u>	<u>662,860</u>
Total capital assets, net	<u>\$ 1,306,519</u>	<u>\$ 226,338</u>	<u>\$ (128,948)</u>	<u>\$ 1,403,909</u>

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June 30, 2006 and 2005

**(5) Bonds and Commercial Notes Payable**

LAX issued revenue bonds in 1995, 2002, and 2003 for various airport improvement projects. LAX's revenues are pledged as security for the bonds. In fiscal year 2003, LAX issued \$217,175,000 of revenue bonds to fund LAX airport improvement projects and advance refund a portion of the 1995 bonds.

The 1995 Revenue Bonds were issued in the amount of \$365,855,000 to finance capital improvements and repay certain indebtedness. The bonds are limited obligations of LAWA payable from and secured by a pledge of LAX revenues.

Outstanding revenue bonds at June 30, 2006 mature in varying amounts through 2026. Bond and commercial paper notes activity for the year ended June 30, 2006 was as follows (in thousands):

<u>Debt issue</u>	<u>Interest rate%</u>	<u>Balance at July 1, 2005</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at June 30, 2006</u>	<u>Due in one year</u>
Issue of 1995	5.00% to 8.38%	\$ 33,935	\$ -	\$ (21,240)	\$ 12,695	\$ 2,500
Issues of 2002 Series A	4.10 to 5.25	32,450	-	-	32,450	-
Issues of 2002 Series C	2.93*	57,400	-	-	57,400	-
Issues of 2003 Series A	2.92*	23,700	-	-	23,700	-
Issues of 2003 Series B	4.00 to 5.00	103,625	-	-	103,625	9,320
Subtotal		251,110	-	(21,240)	229,870	11,820
Commercial paper	2.65*	15,500	-	(15,500)	-	-
Deferred charges and credits, net	N/A	9,002	109	(850)	8,261	763
Total		<u>\$ 275,612</u>	<u>\$ 109</u>	<u>\$ (37,590)</u>	<u>\$ 238,131</u>	<u>\$ 12,583</u>

Bonds and commercial paper notes activity for the year ended June 30, 2005 was as follows (in thousands):

<u>Debt issue</u>	<u>Interest rate%</u>	<u>Balance at July 1, 2004</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at June 30, 2005</u>	<u>Due in one year</u>
Issue of 1995	5.00% to 8.38%	\$ 56,325	\$ -	\$ (22,390)	\$ 33,935	\$ 21,240
Issues of 2002 Series A	4.10 to 5.25	32,450	-	-	32,450	-
Issues of 2002 Series C	1.75*	57,400	-	-	57,400	-
Issues of 2003 Series A	1.77*	23,700	-	-	23,700	-
Issues of 2003 Series B	4.00 to 5.00	103,625	-	-	103,625	-
Subtotal		273,500	-	(22,390)	251,110	21,240
Commercial paper	1.80*	15,500	-	-	15,500	15,500
Deferred charges and credits, net	N/A	9,865	-	(863)	9,002	850
Total		<u>\$ 298,865</u>	<u>\$ -</u>	<u>\$ (23,253)</u>	<u>\$ 275,612</u>	<u>\$ 37,590</u>

\* Average variable rate.

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**(5) Bonds and Commercial Notes Payable (continued)**

Future annual debt service requirements as of June 30, 2006, are as follows (in thousands):

	<u>Principal</u>	<u>Interest</u> <sup>(1)</sup>	<u>Total</u>
Fiscal year ending June 30:			
2007	\$ 11,820	\$ 10,696	\$ 22,516
2008	12,415	10,101	22,516
2009	13,050	9,463	22,513
2010	13,705	8,811	22,516
2011	14,395	8,119	22,514
2012 – 2016	83,855	29,052	112,907
2017 – 2020	80,630	8,415	89,045
Total	<u>\$ 229,870</u>	<u>\$ 84,657</u>	<u>\$ 314,527</u>

<sup>(1)</sup>Interest requirements for variable-rate bonds were determined using 3.94%, 3.92%, and 4.02% for 2002 C1, 2002 C2, and 2003 A, respectively, the rates in effect at June 30, 2006.

**(6) Other Long-Term Liabilities**

Other long-term liabilities' activity for the year ended June 30, 2006 was as follows (in thousands):

	<u>Balance at July 1, 2005</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at June 30, 2006</u>	<u>Due in one year</u>
Employee benefits & insurance claims payable	\$ 26,482	\$ 13,266	\$ (9,117)	\$ 30,631	\$ 5,761
Obligations under capital leases	53,793	-	(912)	52,881	1,026
Other liabilities	26,797	4,903	(8,431)	23,269	4,436
Total	<u>\$ 107,072</u>	<u>\$ 18,169</u>	<u>\$ (18,460)</u>	<u>\$ 106,781</u>	<u>\$ 11,223</u>

Other long-term liabilities' activity for the year ended June 30, 2005 was as follows (in thousands):

	<u>Balance at July 1, 2004</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at June 30, 2005</u>	<u>Due in one year</u>
Employee benefits & insurance claims payable	\$ 27,891	\$ 5,750	\$ (7,159)	\$ 26,482	\$ 9,117
Obligations under capital leases	54,648	-	(855)	53,793	912
Other liabilities	26,043	11,888	(11,134)	26,797	8,431
Total	<u>\$ 108,582</u>	<u>\$ 17,638</u>	<u>\$ (19,148)</u>	<u>\$ 107,072</u>	<u>\$ 18,460</u>

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**(7) Related Party Transactions**

The City provides certain administrative, crash-fire-rescue, police services, and water and power to LAX. The payments for these services, included in operating expenses for the years ended June 30, 2006 and 2005, were \$48,250,000 and \$42,330,000, respectively. In addition, LAX collects parking taxes on behalf of the City of Los Angeles. For the years ended June 30, 2006 and 2005, parking taxes collected and remitted to the City of Los Angeles were \$6,913,000 and \$6,781,000, respectively.

**(8) Inter-Airport Funding Activity**

LAX controls the expense disbursement process for each of LAWA's other airports: Ontario, Van Nuys and Palmdale. LAX supports the payment activities for these airports by first processing their approved budgeted expenditures and then transferring this impact to the airport that ordered the goods and services in the form of an inter-airport cash transfer. The requesting airport then records the expenditure to the appropriate classification on its books of account at the time it reimburses LAX for the activity. Whenever a specific airport is unable to make a cash transfer to LAX, due to a lack of funds, the amount is then recorded as a Due To Other Agency transaction. Conversely, LAX will record the same amount owed to it as a Due From Other Agency transaction. As a result of this process, Van Nuys Airport and Palmdale Airport have accumulated a total of \$90,566,000 and \$29,324,000 in respective Due To Other Agency balances owed to LAX at June 30, 2006.

Upon combining the balance sheet of all four airports that comprise LAWA, the Due From Other Agency asset balance on LAX's balance sheet is fully offset against the Due To Other Agency liability on the respective balance sheets of Van Nuys Airport and Palmdale Airport. The amount of elimination for these combined balances at June 30, 2006 is \$119,890,000. With Van Nuys Airport and Palmdale Airport being part of the LAWA airport system, there is no near-term expectation for repayment of the Due To Other Agency balances to LAX.

**(9) Retirement System**

**(a) Retirement Plan Description**

All full-time employees of LAX are eligible to participate in the City Employees' Retirement System of the City of Los Angeles, California (the System), a single employer defined benefit pension plan. The System serves as a common investment and administrative agent for various City departments and agencies that participate in the System. LAX makes contributions to the System for its pro rata share of retirement costs attributable to its employees.

The System provides retirement, disability, death benefits, post-employment healthcare and annual cost-of-living adjustments based on the employees' years of service, age and final compensation. Employees with ten or more years of service may retire if they are at least 55 years old, or if the retirement date is between October 2, 1996 and September 30, 1999 at age 50 or older with at least 30 years of service. Normal retirement allowances are reduced for employees under age 60 at the time of retirement, unless they have more than 30 years of service and are age 55 or older. Employees aged 70 or above may retire at any time with no

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**(9) Retirement System (continued)**

**(a) Retirement Plan Description (continued)**

required minimum period of service. The System does not have a mandatory retirement age and none of LAX's employees are required to contribute to the System.

The Board of Administration of the System establishes and may amend the contribution requirements of System members and the City. Covered employees contribute to the System at a rate (8.20% to 11.34%) established through the collective bargaining process for those whose membership began prior to January 1, 1983 and at a fixed rate of 6% of salary for those who entered membership on or after January 1, 1983. The City subsidizes member contributions as determined by the actuarial consultant of the System. LAX's actuarially required and actual contributions made to the System, which are based on LAX's salaries relative to total salaries for LAWA as a whole, were approximately \$33,492,000, \$22,378,000 and \$16,250,000 for the years ended June 30, 2006, 2005, and 2004, respectively.

**(b) Actuarially Determined Contribution Requirements and Contributions Made**

The System's funding policy provides for actuarially determined periodic contributions at rates such that sufficient assets will be available to pay benefits when due. The contribution rate for normal cost is determined by using the projected-unit-credit-cost method, assuming a closed group, to amortize the unfunded actuarial accrued liability over multiple layers for various periods. The current year actuarially determined contribution requirement was determined based on the June 30, 2004 actuarial valuation, using the following actuarial assumptions:

- Assumed rate of return on the valuation value of assets is 8.00%
- Inflation rate of 4.00%
- Projected salary increases range from 8.00% to 5.50% for members with less than 5 years of service. For members with 5 or more years of service, the increase is 5.00% per year
- Cost of living adjustments of 3.00%

Total annual pension costs for the City were approximately \$183,200,000, \$159,100,000 and \$51,600,000 for the years ended June 30, 2005, 2004, and 2003, respectively, representing 86.3%, 63.1%, and 100% of annual required contributions for each year, respectively.

Other contribution information and ten-year historical trend information can be found in the System's Comprehensive Annual Financial Report. Copies of the System's Comprehensive Annual Financial Report can be obtained from the Los Angeles City Employees' Retirement System (LACERS), 360 East Second Street, 2<sup>nd</sup> Floor, Los Angeles, California 90012.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(9) Retirement System (continued)**

**(c) Required Supplemental Information (Unaudited)**

Based upon available data, the following represents the Los Angeles City Employees' Retirement System Schedule of Funding Progress, separate information for LAWA is not available (in thousands):

<u>Valuation date (June 30)</u>	<u>Actuarial accrued liability (AAL)</u>	<u>Actuarial value of assets</u>	<u>Unfunded AAL</u>	<u>Funded ratio</u>	<u>Covered payroll</u>	<u>Unfunded AAL as a % of covered payroll</u>
2005	\$ 9,321,525	\$ 7,193,142	\$2,128,383	77.2%	\$ 1,589,306	133.9%
2004	8,533,864	7,042,108	1,491,756	82.5%	1,575,285	94.7%
2003	7,659,846	6,999,647	660,199	91.4%	1,405,058	47.0%

**(d) Other Post-employment Benefits**

LAX, as a participant in the System, also provides a Retiree Health Insurance Premium Subsidy. Under Division 4, Chapter 11 of the City's Administrative Code, certain retired employees are eligible for this health insurance premium subsidy. This subsidy is to be funded entirely by the City. Employees with ten or more years of service who retire after age 55, or employees who retire at age 70 with no minimum service requirement, are eligible for a health premium subsidy with a City-approved health carrier. The System is advance funding the retiree health benefits on an actuarial-determined basis. Amounts contributed specifically to the Retiree Health Insurance Premium Subsidy by LAX alone are not available.

From the most recent data made available by the City, as of June 30, 2005, LACERS membership consists of 27,333 active plan participants and 14,322 retired members. Also as of June 30, 2005, the date of the latest actuarial valuation of the City's Retiree Health Insurance Premium Subsidy, the total unfunded health benefit subsidy applicable to the System as a whole was approximately \$826,000,000 as follows (in thousands):

Total health benefit liability	\$ 1,719,000
Reserved for health benefits	(893,000)
Unfunded benefit liability	<u>\$ 826,000</u>

**(10) Self-Insurance**

LAX is part of the City's self-administered and self-funded workers' compensation system. Claims and judgments are recorded when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. The liability for workers' compensation claims includes a provision for incurred but not reported claims and loss adjustment expenses. Payment to the Workers' Compensation Division of the City Personnel Department has been made based on cash payments for workers' compensation claims. LAX's accrued total

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**(10) Self-Insurance (continued)**

liability for workers' compensation has been based on the results of an actuarial study and has been allocated to LAX based on a ratio of LAX salaries to total LAWA salaries. A reconciliation of the accrued workers' compensation liability (included in employee benefits and insurance claims payable) is as follows (in thousands):

Liability at June 30, 2004	\$	23,428
Provisions for claims		5,001
Claim payments		(4,778)
Liability at June 30, 2005		23,651
Provisions for claims		11,218
Claim payments		(6,393)
Liability at June 30, 2006		28,476
Current portion		(3,606)
Long-term liability at June 30, 2006, net of current portion	\$	24,870

The LAWA Risk Management Division oversees a sophisticated, self-administered Risk and Claims Management program. Claims are administered in-house by a dedicated team of Analysts who will manage and direct a claim/ lawsuit until resolved. LAWA Risk Management (in cooperation with its contracted broker of record) is responsible for placing General Liability insurance policies (including a War & Terrorism policy) up to the policy limits of \$1 billion. Additional lines of insurance include General Property Insurance, with policy limits of \$1,500,000, Boiler and Machinery coverage and Earthquake insurance. These insurance limits are in excess of LAWA's self-insured retention (deductible) which for general liability insurance is \$10,000/ claim with a \$300,000 annual aggregate and \$100,000/ per occurrence and annual aggregate on Property insurance. The self-insured retention for both Property and Liability insurance as well as the purchase of all insurance policies is budgeted and funded annually by the Risk Management Division. Historically, no liability or property claims have reached or exceeded the stated policy limits. LAWA also continues to maintain a catastrophic loss fund that is held in reserve to fund claims or losses that may conceivably exceed insurance policy limits. The transference of risk exposure through the procurement of liability and property insurance has proven to be a very effective program for LAWA.

For other types of claims, commercial insurance is used when it is either legally or contractually required, or judged to be the most effective way to finance risk. LAWA's Risk Management Division estimates the risk exposure and uses the estimate together with past loss experience to determine maximum insurance coverage.

For fiscal years 2006, 2005, and 2004, no claims were in excess of LAWA's insurance coverage. LAWA maintains approximately \$2.5 billion coverage of property, casualty and other insurance. LAWA also maintains an insurance trust fund to pay the deductible for property damage and any claims in excess of the insurance coverage.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(11) Commitments and Contingencies**

As of June 30, 2006, a number of claims and lawsuits are pending against LAX that arose in the normal course of operations. LAX recognizes a liability for claims and judgments when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. The following is a summary of certain matters related to LAX's operations.

**(a) Inverse Condemnation**

Amounts that may be paid in inverse condemnation actions would result in the acquisition of air easements, which would be capitalized and, therefore, would not materially affect the change in net assets or equity of LAX. The amounts that may be paid pursuant to noise tort actions would be charged against revenues as an expense.

**(b) Environmental Issues**

Through the normal course of operations, LAWA and its facilities are subject to potential environmental contamination and other environmental concerns. Accordingly, LAWA has established a comprehensive hazardous materials management plan for all facilities under its control. This plan calls for the evaluation of all property utilized by LAWA and the environmental cleanup of any sites found to be contaminated. This evaluation has not been completed to date.

LAWA bears the financial responsibility for the cleanup of environmental contamination on property owned by it. However, LAWA believes that if the contamination originated based on contractual arrangements, the primary responsibility for any such cleanup would be borne by the tenants, even if they declare bankruptcy. LAWA, as property owner, however, assumes the ultimate responsibility for cleanup of such contamination in the event that the tenant is unable to make restitution. As a result of the hazardous materials management plan noted above, LAWA has already begun cleanup on several sites, is in the process of implementing additional safeguards to prevent additional hazardous substance contamination and is completing the environmental evaluation of LAWA's facilities. However, the extent of the cleanup and/or the ability of the original tenants to reimburse LAWA for such cleanup cannot be determined at the present time. Therefore, under the circumstances, it is reasonably possible that losses could be incurred; however, until such matters are resolved, the range of loss, if any, cannot be reasonably estimated.

**(c) Other**

Commitments for construction, the purchase of real property, equipment and materials and supplies amounted to \$49,200,000 and \$29,000,000 as of June 30, 2006 and 2005, respectively. The change in commitments is due to the following projects: \$16,000,000 for inspection testing, and surveying for the center taxiway and runway projects; and, \$19,500,000 for land acquisition.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(11) Commitments and Contingencies (continued)**

**(d) High-Security Environment**

LAWA, like the rest of the North American air transportation system, has been adversely affected by the terrorist attacks that occurred in the United States on September 11, 2001 (the September 11 Events). Since the September 11 Events, due in part to the September 11 Events and in part to the slowdown in the national economy, significant declines have been experienced in aviation activity and enplaned passenger traffic, as well as in activity-based revenues consisting primarily of landing fees, passenger facility charges, concession revenues, and parking revenue. During fiscal year 2006, LAWA's passenger volume was 3.2%, or 2.2 million, below its pre-September 11<sup>th</sup> Events level.

As part of its program of proactively addressing heightened security concerns and requirements, LAWA has engaged in a review of its rates and charges, and has implemented revenue enhancements and expenditure controls that affect a variety of operating expenses. LAWA's capital improvement program was also reevaluated and several planned expenditures were suspended, except where the affected projects were near completion or essential from a security or safety standpoint.

Reductions in operating levels at LAX from those which existed prior to the September 11 Events may continue for a period of time and to a degree that is uncertain. The future level of aviation activity and enplaned passenger traffic at LAX will depend upon several factors directly and indirectly related to the September 11 Events, including, among others, the financial condition of individual airlines and the viability of continued service. A number of airlines are recovering from the economic difficulties they experienced immediately following the September 11 Events.

LAX is unable to predict (i) the duration of current reduced air traffic volume, (ii) the long-term impact of the above-described events on costs and revenues of LAX, (iii) the future financial condition of the airlines using LAX, or (iv) the likelihood of future incidents of terrorism or other air transportation disruptions.

**(12) Capital Lease Agreements**

LAWA has entered into various lease agreements with certain airlines. These agreements are classified as capital leases and are for certain public areas at LAX. The agreements generally provide for the payment of amounts over various terms between 27 and 35 years, with interest at the rate incurred by the lessor on their related borrowings, which include improvement bonds. However, LAWA terminated the capital leases with American, Continental, Delta, and United airlines in 2002 and 2003. LAX Two Corporation is the only remaining capital lease. The property capitalized under these lease agreements amounted to \$184,423,000 at June 30, 2006 and 2005. Accumulated depreciation with respect to such property for the respective years was \$90.8 million and \$85.8 million, respectively.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(12) Capital Lease Agreements (continued)**

Estimated future minimum lease payments under these agreements are as follows (in thousands):

Fiscal year ending June 30,		
2007	\$	2,985
2008		3,061
2009		3,076
2010		3,146
2011		3,268
2012 – 2016		17,694
2017 – 2021		21,112
2022 – 2026		24,175
Total minimum lease payments		78,517
Less interest portion		(25,636)
Present value of minimum lease payments	\$	52,881

LAX currently uses rental credits to finance its obligations on capital leases with LAX Two Corporation. These rental credits are applied as an offset of amounts owed to LAX by the corporation for terminal leases and landing fees.

**(13) Passenger Facility Charges**

In 1990, Congress approved the Aviation Safety and Capacity Expansion Act, which authorized domestic airports to impose a Passenger Facility Charge (PFC) on enplaning passengers. In May 1991, the FAA issued the regulations for the use and reporting of PFC's. PFC's may be used for airport projects that must meet at least one of the following criteria: (1) preserve or enhance safety, security or capacity of the national air transportation system; (2) reduce noise or mitigate noise impacts resulting from an airport; or (3) furnish opportunities for enhanced competition between or among carriers.

Since 1990, the following activities have taken place:

- In April 1993, the FAA granted LAWA's authority to collect PFC's at LAX in the amount of \$360,000,000 for 5 years for specifically approved airport improvement projects. Effective July 1, 1993, LAWA began collecting PFC's in the amount of \$3 per passenger.
- In 1996, LAWA received approval to transfer a portion of PFC revenue collected at LAX to fund projects at Ontario. Effective January 1, 1996, the FAA approved LAWA's amended application to cease PFC collections at LAX after collecting approximately \$152,600,000.
- In May 1996, the FAA approved LAWA's request to transfer a portion of PFC revenues collected at LAX to fund approved projects at ONT. Accordingly, PFC charges totaling \$126,100,000 collected at LAX were transferred.

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Notes to Financial Statements (Continued)

June 30, 2006 and 2005

**(13) Passenger Facility Charges (continued)**

- In November 1997, the FAA approved LAWA's application to impose \$3 per passenger PFC's at LAX, respectively, for noise mitigation projects. Approved collections of \$150,000,000 at LAX were to be used for the soundproofing of City of Los Angeles residences and sound insulation of nearby city residences.
- On October 2, 1998, the FAA approved LAWA's application to amend PFC's at LAX for noise mitigation projects. The amendment increased the total approved PFC revenue from \$150,000,000 to \$440,000,000.
- Effective August 1, 2003, the FAA approved an increase to the PFC charge at LAX from \$3.00 to \$4.50.

The PFC funds are recognized on the accrual basis of accounting, and the funds collected are restricted and may be used only on specifically approved projects. Due to their restricted use, PFC's are categorized as nonoperating revenues. All funds collected must be maintained in an interest-bearing account with the City Treasurer prior to disbursement. Cumulative PFC collections and the related interest earned as reported to the FAA were as follows (in thousands):

	<b>2006</b>	<b>2005</b>
Amount collected	\$ 866,440	\$ 756,402
Interest received	75,367	68,062
Cumulative PFC collections	\$ 941,807	\$ 824,464

Collected but unexpended PFC revenue is included on the statement of net assets as restricted cash and pooled investments held by the City Treasurer. Related accrued interest income and PFC receivables are also reported as restricted assets.

**(14) Capital Grant Contributions**

Contributed capital related to governmental grants and other aid increased by \$31.3 million to \$32.1 million during the year ended June 30, 2006. Capital grant funds were used for projects under the Airport Improvement Program and Transportation Security Administration security-related capital projects. During fiscal year 2005, capital grant contributions decreased from fiscal year 2004 by \$3.6 million to \$0.8 million, due to accounting adjustments of grant accruals made in prior years.

## **COMPLIANCE SECTION**



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The Members of the Board of Airport Commissioners  
of the City of Los Angeles, California

**INDEPENDENT AUDITOR'S 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***

We have audited the financial statements of the Los Angeles International Airport, a departmental component of Los Angeles World Airports (Department of Airports of the City of Los Angeles, California) (LAWA), an enterprise fund of the City of Los Angeles, California, as of and for the year ended June 30, 2006, and have issued our report thereon dated October 24, 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 Los Angeles International Airport'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 that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

*Compliance and Other Matters*

As part of obtaining reasonable assurance about whether Los Angeles International Airport's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants 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*.

We noted certain matters that we have reported to the management of LAWA in a separate letter dated October 24, 2006.

This report is intended solely for the information and use of LAWA's Board of Airport Commissioners, management, 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.

*Macias Fini & O'Connell LLP*

Certified Public Accountants

Los Angeles, California

October 24, 2006