



Making Choices in Challenging Times

Message from the Mayor and City Council

As part of our continued effort to involve citizens in the process of governing our community, we are pleased to present the City of Modesto's "Citizen's Guide to the Adopted Budget".

Although the City's economy continues to improve and revenue growth is positive, preparing the 2005-06 budget was a challenge as costs continue to outpace the modest growth seen in revenues.

Faced with these budget challenges, the Council and staff moved quickly to reduce costs and improve revenues. This effort actually began in Fiscal Year (FY) 2004-05 with departments being asked to reduce spending by three percent (3%). This action helped to improve the General Fund's bottom line prior to the start of FY 2005-06.

This budget includes General Fund base budget cuts in the amount of \$3.56 million, approximately \$950,000 in on-going revenue enhancements and nearly \$800,000 in a one-time transfer adjustment totaling \$5.31 million in budget adjustments. Reductions were made across all departments including public safety. These include reductions in the spring/summer park recreation programs, community forestry and street and alley maintenance. These recommendations are particularly difficult since they come on the heels of several consecutive years of budget reductions for many departments. While every effort has been made to avoid cuts to core services, these reductions will be felt throughout the city. A detailed listing of these budget cuts can be found in the Budget Reductions 05-06 section of the adopted budget document.

While much of this budget process focused on reducing General Fund expenditures, efforts were also made to improve budget reporting

and monitoring. For example, the Fire Department participated in a pilot Zero-Based-Budgeting project, which allowed them to create a new budget structure to improve budget tracking. Additionally, each department prepared worksheets that show a programmatic view of departmental expenditures and revenues. These worksheets help to identify how funding is utilized on a program level.

The Big Picture – All Funds

The FY 2005-06 operating budget for all operating funds totals \$293.5 million not including transfers. Revenues for all funds, in FY 2005-06, are projected at \$298.8 million, not including transfers.

The General Fund

The budgeted General Fund operating expenditures for FY 2005-06 total \$110.7 million. This figure includes \$7.93 million in transfers out to other funds, which is a reduction from FY 2004-05. This reduction accounts for the one time elimination of a transfer for debt service on Tenth Street Place; a two year elimination of the RDA subsidy (\$479,000); and an on-going reduction of the subsidy to the Gas Tax Fund for \$80,000.

The General Fund budget also reflects the elimination of 40.125 full-time staff positions which includes 29.625 full-time General Fund positions and 10.5 Gas Tax funded positions.

General Fund revenues are projected at \$105.5 million and include \$2.3 million of transfers in from other funds. Of the \$105.5 million, \$950,000 is projected from on-going revenue enhancements.

State Fiscal Impacts

Perhaps the single most significant factor shaping this year's budget is the financial condition of the State of California and its effect on city

Message from the Mayor and City Council (cont.)

governments. Between fiscal years 1991 and 2004, the State of California diverted \$34.8 million in local revenues from the City of Modesto into its own coffers. By the end of FY 2004-05, the amount diverted by the State will total nearly \$37 million.

The recently passed Proposition 1A gives local governments a level of predictability related to their revenues that was not available previously.

However, support for Proposition 1A cost the City of Modesto \$2.1 million in FY 2004-05 and will cost the City another \$2.1 million in FY 2005-06. There also remains the possibility that FY 2004-05 "overpayments" of revenue from vehicle license fees (about \$1 million) will be withheld by the State in FY 2005-06. Thus, while conditions are looking more stable, there remains a significant level of uncertainty. No additional new state diversions are projected in future years.

Fiscal Policy Goals

The adopted budget strikes a balance between fiscal conservatism and preserving vital community services, in line with the City Council's policy. Specifically, this budget meets Council directed goals:

- The budget assumes a "most likely" scenario for calculating the undesignated balance of the City's General Fund as of June 30, 2005, estimated at \$15.5 million.
- The budget preserves a minimum reserve in the General Fund of approximately 8% of General Fund expenditures.
- By FY 2006-07, the City moves to a balanced budget whereby revenues meet or exceed expenditures.
- Grant-funded positions will be removed from the City's position allocation at the end of the grant's life unless specifically and separately approved by the City Council.

Conclusions

The FY 2005-06 budget represents a responsible and balanced approach to meeting the financial challenges confronting the City of Modesto. It preserves core municipal services, while maintaining adequate financial reserves for the future. Nevertheless, many critical needs remain unaddressed. More than one quarter of the City's streets are in poor or very poor condition with the cost to repair them estimated at over \$98 million. Police and Fire department staffing levels also lag. Increasing Police Department staffing to the level of 1.85 sworn officers per 1,000 population (as recommended by the Ad Hoc Safety Committee) would cost approximately \$16 million per year, with additional increases needed each year to keep pace with the growth in population. In the fire service, adding a needed engine company would cost about \$1.4 million for staffing and apparatus while adding a truck company would cost nearly \$2 million for both staffing and equipment.

The austere budget before you does not address many of the issues we would like it to – services and programs that make a community a home – beautiful parks, well maintained recreational facilities, and cultural activities. However, it does put the City on a solid financial path enabling the City to provide core services while moving towards financial stability in the future.

We wish to thank you, the citizens of Modesto, for your involvement and feedback during the development of this budget. We also extend an open invitation to all citizens to continue to participate in the government process by attending City Council meetings so that your voice can be heard concerning the issues that face your community.

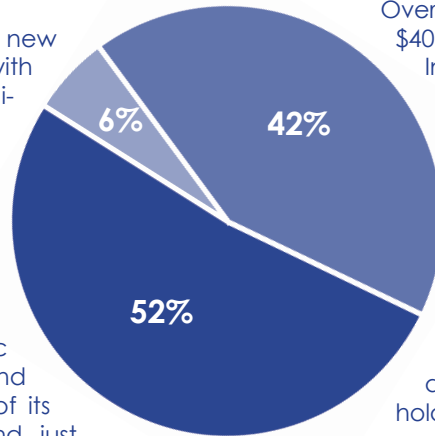
State Budget Crisis & Modesto's Funding Gap

Potential MOU, Workers' Compensation & Litigation Costs - 6%

The City of Modesto is currently negotiating new Memorandums of Understanding (MOU) with three of its bargaining units. The City anticipates that these new employment agreements, increased Worker's Compensation premiums and possible future litigations will have an impact on the General Fund.

CalPERS Rate Hike - 52%

City employees receive retirement benefits through the statewide California Public Employees Retirement System (CalPERS), and each year Modesto pays a percentage of its employees' salaries into the retirement fund, just like a private employer funding a pension plan. This year CalPERS has notified the city that its contribution rates will be significantly increased in 2005-06. Overall, Modesto's CalPERS payments will rise by more than 24%, a \$2.6 million impact to the General Fund. This rate hike is caused primarily by the lackluster performance of CalPERS's investments in recent years.



Proposition 1A - 42%

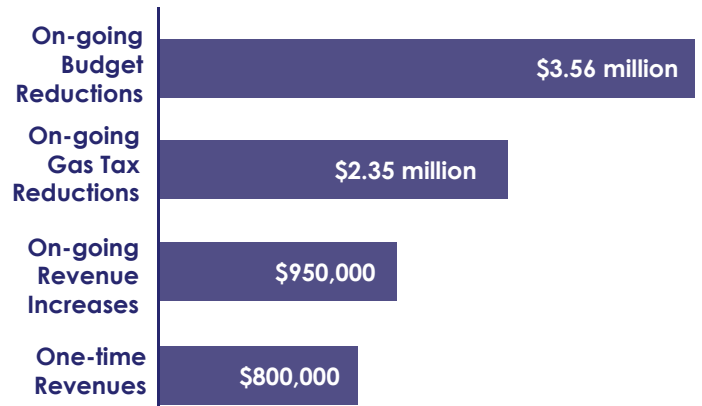
Over the last 12 years the State has taken more than \$40 billion from cities, counties and special districts. In the November 2004 election the people overwhelmingly approved Proposition 1A. Proposition 1A was a historic bipartisan agreement between Governor Schwarzenegger, local governments, legislators, public safety officials, healthcare advocates, taxpayers and community leaders. This proposition restricts the State Legislature's ability to raid local government funding, including local government share of existing sales taxes, property taxes and VLF revenues. However, as part of the agreement the State would withhold some local government funds during fiscal years 04/05 and 05/06. The impact to the City of Modesto's General Fund for fiscal year 05/06 will be \$2.1 million.

\$5 Million Gap

Adopted Service Reductions

The adopted budget cuts will lead to service reductions which may be noticed by the public.

- A receptionist will no longer be available in the Tenth Street Place lobby or in the Finance Customer Service area.
- Six Police Officer positions, one Community Service Officer position, and three Police Clerk positions will be eliminated. All positions are currently vacant or will be absorbed by attrition.
- City Hall at the Mall will close.
- The Spring Park Program will be eliminated at all sites except Graceada Park, which will be open on the weekends.
- Six neighborhood park pools will be closed and removed. One pool per year will be replaced with a splash pool.
- The Summer Park Program would be eliminated at Standiford, Sylvan, Lakewood, Chrysler, Sherwood, and Marshall Park. A summer Park Program would open at George A. Rogers Park.



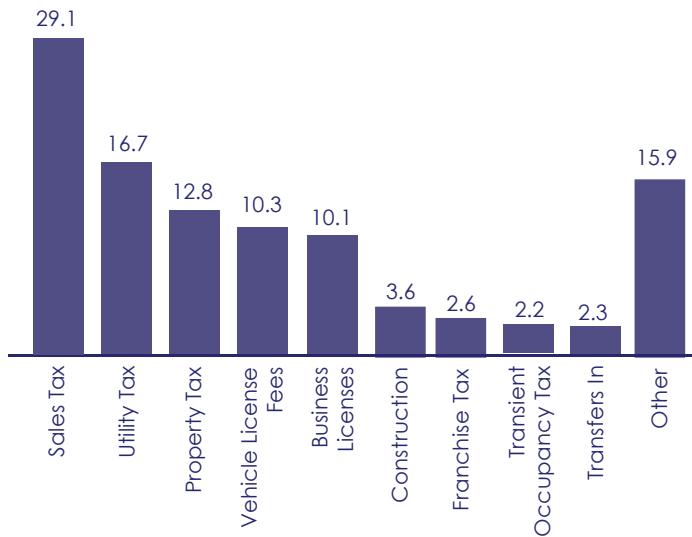
- Residential street paving will be reduced from eight miles to six miles.
- Tree replacements and removals will be reduced.
- Mistletoe abatement will be reduced.
- Forestry will no longer perform root cutting and barrier installations.
- Sidewalk repair and maintenance will be reduced.
- One engine company will be eliminated by leaving nine positions vacant. No fire stations will be closed.

Budget At A Glance

City of Modesto 2005-06 Operating Budget			
Fund(s)	Expenditures	Revenues	Variance
General Fund	\$ 110,677,515	105,643,515	-5,034,000
Streets/Traffic/Forestry	\$ 11,199,833	10,702,504	-497,329
Water/Wastewater/Storm	\$ 61,405,133	79,288,930	17,883,797
Debt Service	\$ 11,681,654	11,681,654	0
Other	\$ 118,458,572	111,354,036	-7,104,536
Total (with Transfers)	\$ 313,422,707	318,670,639	5,247,932

Revenue by Source

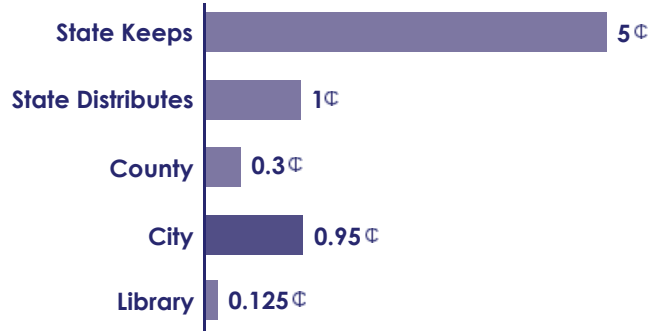
(\$ million)



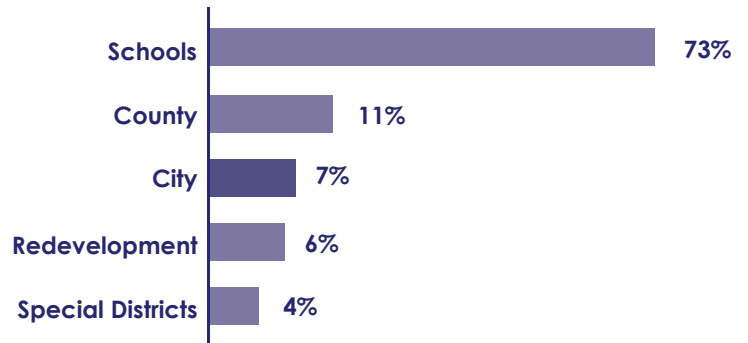
Tax Facts

Where Your Sales Tax Goes

How your 7.375 cent tax is distributed:

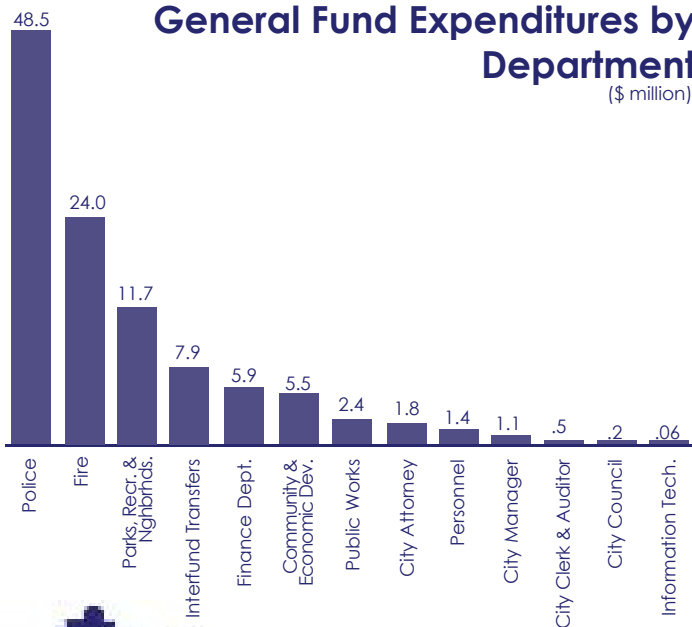


Where Your Property Tax Goes (Rounded)



General Fund Expenditures by Department

(\$ million)



City and State

This year the State of California is diverting \$2.1 million dollars in revenue from the City of Modesto. This is the latest in a series of diversions, which have cost the citizens of Modesto a total of \$36.9 million in services since 1990.

CITY STRUCTURE & ORGANIZATION

The City of Modesto is a "charter city," under California law, which means that the basic structure of city government is specified by a charter adopted by local voters. Modesto's charter was adopted in November 1962, and has been amended by the voters on eleven occasions. The city charter is available on the Internet at: <http://www.modestogov.com/council/charter>

Under the charter, the City is organized according to the "Council-Manager" form of government, in which the voters are represented by a City Council consisting of a Mayor and six Councilmembers, who in turn appoint a professional City Manager to act as the chief executive officer for the City. The City Council also appoints the City Attorney and the City Clerk/Auditor, who are referred to as "charter officers" since their positions are specifically defined within the City charter.

In addition to the departments overseen by the charter officers, the City of Modesto consists of eight departments, all under the jurisdiction of the City Manager:

- Personnel
- Information Technology
- Finance
- Community & Economic Development
- Fire
- Police
- Parks, Recreation & Neighborhoods
- Public Works

The City Council is divided into committees to address particular issues. Committee meetings are open to the public and committee recommendations are forwarded to the full City Council for final action. Currently, the following committees are utilized:

- Audit
- Economic Development
- Finance
- Safety & Communities

FISCAL POLICIES

Fiscal Year

The City's fiscal year begins on July 1st and ends on June 30th.

Accounting Basis of Budgeting

All City budgets are adopted on a modified accrual basis. Revenues are recognized when they become both measurable and available, and expenditures are recognized when the liability is incurred, except for such items as inventories and prepaid insurance. The

City prepares financial statements annually in accordance with Generally Accepted Accounting Principles for government entities ("Government GAAP"), which are audited by an independent certified public accounting firm. The annual financial report is generally available six months following the end of the fiscal year. The annual budget is legally adopted at each fund's total expenditure and revenue level.

General Fund Reserve

The City Council has directed that the City retain an undesignated, unreserved balance in the General Fund equal to at least 8% of the total annual General Fund expenditures (includes transfers). This 8% "contingency reserve" is intended to protect the General Fund from unanticipated fluctuations in major revenue sources.

Debt Financing

The City seeks to match the maturity its bonds and other debt instruments with the useful life span of the corresponding debt-financed assets.

Inter-fund Loans

Loans between funds shall be documented and reported in the City's annual financial report. Each inter-fund loan should be associated with a realistic repayment plan, and loan re-payments should be incorporated into the annual budget. Inter-fund loans should be re-paid with interest at a rate corresponding to the interest the lending fund would have earned on the balance, based upon the return earned by the City cash reserves for the six months prior to the payment date. (Loans to the Redevelopment Agency prior to 1992 bear an interest rate of 8%. Loans to the Redevelopment Agency after 1992 shall bear an interest rate of 7%.)

Interest Allocation

Interest should be allocated monthly to all funds based upon month-end balances. Interest, which would accrue to the following funds, should be allocated instead to the General Fund: the Fleet Fund and special revenue & grant funds where the City receives funding on a reimbursement basis.

Inter-fund Service Charges

Charges for direct services performed by one fund on behalf of another (referred to as "service credits") are budgeted based on estimates and past experience, and charged during the year based on actual services delivered and costs incurred.

Internal Service Fund (ISF) charges are budgeted and charged based on estimates (actuarially determined, where possible) and allocation formulas intended to reflect the association of costs with operating departments and services.

City Structure and Organization (cont.)

Indirect costs – the cost of general overhead services paid for by the General Fund and not directly chargeable as service credits – are calculated and charged based on an Indirect Cost Allocation Plan, which is updated with the assistance of an outside consulting firm.

Self-Insurance Reserves

The City of Modesto is self-insured for general liability and workers compensation liability. The City sets aside reserve funds to offset these liabilities, based on actuarial estimates of outstanding liabilities and of liabilities to be incurred in the current year. Currently, the City's reserve levels match the "expected" level of liability in these areas. The City should strive to increase these reserves to the "75% Confidence" level, to provide greater security against the possibility of unexpected high claims in future years.

The City also obtains excess liability coverage through multi-jurisdictional pools (which may, in turn, purchase commercial insurance) to cover extraordinary claims.

Post-Retirement Benefits

Current City labor contracts provide some employees the ability to convert unused sick leave balances into City-paid health insurance benefits for a number of months upon retirement. Beginning in 2004-05, the City will set aside an amount based on an estimate of the current-year cost of providing this benefit. This is expected to stabilize the unfunded liability associated with this benefit in the City's financial statements. The City is developing plans to reduce the existing unfunded liability over time.

BUDGET PROCESS

Although the City Manager has the lead responsibility for the development of the annual budget with staff support from the Finance Department, the annual budget process is a City-wide effort. Staff in all City departments play critical roles in devising and implementing each year's budget.

The budget process may vary somewhat from year to year. The following outlines the steps followed in the development and adoption of the Fiscal Year 2005-06 annual budget. Throughout this process, the City Manager briefed the Finance Committee and City Council on the status of the budget and solicited their policy guidance.

Operating Budget

1. Baseline Operating Budget: The Budget and City Manager staff estimate a "baseline" budget for each operating department. The baseline budget includes the projected cost of staff positions plus materials &

services for the upcoming budget year. It reflects spending impacts due to contracted increases in salaries and benefits, as well as any changes in internal service charges (such as set-asides for liability insurance). In principle, the baseline reflects the cost of current operations at next year's wage and price levels. The baseline is initially calculated in December or January.

2. Initial Revenue Forecast & Gap Estimate: Around the same time, the budget analysts and department budget coordinators forecast the City's major revenue sources. Comparing expected revenues with the baseline for expenditures yields the initial gap estimate. If revenues exceed baseline expenditures, the City can consider improving service levels and expanding programs. If anticipated revenues fall short of baseline, the City will need to make cuts to balance its budget.

3. Department Funding Requests: Department directors have the authority to "re-arrange" their baseline budgets to reflect their priorities and the needs of the community, as long as the total does not increase. Additional funding requests, outside the baseline, can be submitted after the actual revenues and expenditures are recognized.

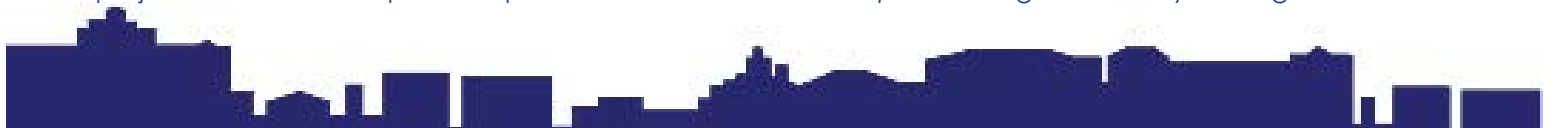
4. Gap Update: The update reflects any new information that has been received relating to likely revenue levels and other costs authorized by the City Manager. If expenditures still exceed revenues, the process proceeds to the Cutback step.

5. Program Worksheets: Departments review their budgets related to the services or "programs" they provide. Operating programs budgets are identified and entered into the Citywide database.

6. Unmet Needs: Departments identify their "unmet needs", by describing the background, current status, impacts, options and estimated costs of the improvements. These unmet needs are reviewed with the Finance Committee during the budget workshops. Once "actuals" are known (September/October), and there are sufficient funds available, the City Manager could recommend to the City Council that certain unmet needs be incorporated into the department budgets.

7. Cutbacks (if needed): The City Manager asks departments to identify possible spending cuts. Generally, they are assigned a "target" based on a formula (such as a fixed percentage of the department budget). In addition, specific programs may be slated for reduction or elimination, based upon the City's overall service priorities.

8. Proposed Budget: The City Manager reviews the



City Structure and Organization (cont.)

cutback proposals developed by the departments and makes the final determination on how to balance the budget. Based on his decisions, the Budget Staff compiles the Proposed Budget document, which is presented by the City Manager to the Finance Committee.

9. *Finance Committee Workshops:* The Finance Committee holds a series of public workshops to discuss the Proposed Budget. These workshops are also carried on cable television and are open to the public. The format of the workshops varies from year to year at the discretion of the Committee Chair, but they will usually include presentations by staff to explain the provisions of the Proposed budget and its likely effects on the community. The Committee may recommend changes to the Proposed Budget, and their recommendations are forwarded to the full City Council for a formal public hearing.

10. *Public Hearing:* The City Council conducts a public hearing on the budget as recommended by the Finance Committee. The Council may accept the budget as recommended or may vote to amend it further.

11. *Adoption:* Under the charter, the City Council adopts the budget by ordinance. The ordinance adopts the operating budget, an interim capital improvement program (CIP), and multi-year non-capital projects, as well as appropriating funds to cover unpaid encumbrances carried forward to the next budget year.

Capital Improvement Program (CIP)

The process of developing the CIP has changed during the last two years. Previously, the CIP was adopted at the same time as the operating budget. This process has been re-scheduled to allow a more thorough review by staff. The FY2005-06 budget includes an "interim CIP," which authorizes continuation of projects already underway, as well as initiation of a few new projects, which must get underway in the first quarter of the fiscal year.

The following details the major steps in the CIP process.

1. *Resource Estimation:* The Finance department, in coordination with other departments, develops available revenue resource estimates for spending on capital improvements and other projects.

2. *Project & Funding Source Identification:* Departments identify projects to be included in the CIP document. The goal is to include both current projects and any projects that should commence within the ten-year timeframe of the CIP plan. Departments also identify likely project-specific funding sources (primar-

– such as City revenues or borrowing – are identified to cover the remaining costs of projects.

3. *CIP Balancing:* The Budget Staff compiles project-level information prepared by departments and determines whether any City funding sources are "over-committed" – i.e. whether the amount earmarked for projects total more than the available revenues. If so, departments are asked to select projects to defer until future years when resources may become available.

4. *Planning Commission Presentation:* Once the CIP program is balanced, it is presented to the Planning Commission, which determines whether the CIP is consistent with the City's comprehensive land use plan. The document is then forwarded to the City Council for adoption.

5. *City Council Action:* An interim CIP identifies existing and new projects for the upcoming fiscal years and is adopted in June along with the operating budget. The comprehensive 10-year capital program is presented to the Planning Commission in September. The Finance Committee and Council are scheduled to review and adopt the Amended CIP in October.

Modifying the Annual and Multi-Year Budgets

The annual budget ordinance specifies the procedural requirements for making changes to the budget during the year. Levels of budget authority are described in the Budget Ordinance (Exhibit B) located within the Appendix section of this document.

BUDGET DOCUMENT

The City of Modesto's Adopted Budget document consists of the following sections:

- Budget Message/Transmittal
- Policies & Issues
- Financial Summaries
- Forecasts
- Staffing
- Departments
- Budget Reductions
- Capital Improvement Program
- Redevelopment Agency
- Index

In addition, the City produces a proposed budget document, which is submitted to the City Council in the course of the budget process, and a Citizen's Budget, which presents the key budget issues facing the City in a user-friendly four-page format. The Citizen's Budget brochure is distributed to citizens as an insert to the utility bill.

City Structure and Organization (cont.)

FINANCIAL STRUCTURE

The City of Modesto's finances are organized into several distinct "funds." From an accounting and budgetary perspective, each fund is an entirely separate entity. Each fund has its own self-balancing assets and liabilities, and transactions between funds must be explicitly budgeted and strictly accounted for.

This system of "fund accounting" originated as a Progressive-era reform intended to increase government accountability. Today, fund accounting is a requirement of Generally Accepted Accounting Principles for Governments ("Government GAAP"), and is used by essentially all U.S. cities of significant size.

Fund accounting can create the appearance that the City is spending considerably more money than it actually is. A sort of double counting occurs when one City fund makes a payment to another. The transaction creates an expenditure in one fund, and a revenue in another, despite the fact that the City as a whole has exactly the same amount of money that it started with. To help readers understand the true level of City spending, certain summaries in the budget document are presented on a "consolidated" basis, with inter-fund transactions eliminated.

Fund Types & Basis of Accounting

Each City fund employs either the full or modified accrual basis of accounting. Full accrual accounting is essentially identical with the accounting practices used in private business, and it applies to funds which are "business-like" in nature – that is, funds that account for services paid for by their customers, rather than by taxpayers at large. Modified accrual accounting applies to governmental fund types – funds that account for taxes, grants, and similar governmental resources.

As a practical matter, the primary difference between full and modified accrual is the treatment of fixed assets (such as buildings, equipment, and vehicles). Under full accrual, a fund that acquires a fixed asset incurs no expense at the time of acquisition; instead, it will be charged depreciation over the lifetime of the asset. Under modified accrual, an expenditure is recorded when the asset is acquired, and depreciation is not charged.

The modified accrual basis of accounting is considered appropriate for governmental fund types, in which the focus is on compliance with the authorized budget, i.e. ensuring that expenditures do not exceed authorized levels, regardless of what was purchased. The City's funds can be classified into the following fund types:

- **General Fund:** a fund type unto itself, the General Fund accounts for City revenues, which are not required to be accounted for in a different fund. In practice, the General Fund accounts for the City's major discretionary tax revenues, such as sales and property taxes, and for tax-supported services such as police and fire. The general fund employs the modified accrual basis of accounting.
- **Special Revenue Funds:** these funds account for taxes, grants, and similar revenue sources, which are dedicated by law, contract, or Council policy to a specific purpose. Examples include the Gas Tax Fund and the Local Transportation Fund, which are both dedicated to street maintenance and improvements. Special revenue funds employ the modified accrual basis of accounting.
- **Debt Service Funds:** these funds account for amounts set aside by the City to pay current and future debt service (principal and interest). Debt service funds employ the modified accrual basis of accounting.
- **Capital Projects Funds:** these funds account for resources set aside for the acquisition and/or construction of major capital assets. Capital projects funds employ the modified accrual basis of accounting.
- **Enterprise Funds:** these funds account for operations that provide services to external customers (i.e. the public) in return for payment, much like a business. Examples include the utility funds (water, wastewater, stormdrain, etc.). Enterprise funds employ the full accrual basis of accounting.
- **Internal Service Funds:** these funds account for operations that provide services to internal customers (i.e. City departments) in return for payments, much like a business. Examples include the Fleet Fund and the Building Services Fund. Internal service funds employ the full accrual basis of accounting.

Additional information on the City's principal funds is described in the Glossary of Budget Terms located in the Appendix section of this document.

