

THE CITIZEN'S GUIDE

The "Citizen's Guide to the Budget" is presented each year providing you with an update on the City's budget. This year we are taking this opportunity to not only talk about where we've been, but what the future holds for Modesto.

Throughout this document, we'll be talking about the "Fiscal Year." Modesto, like most governmental agencies, budgets on a fiscal year calendar which runs from July 1 through June 30 of the following year. So, for example, Fiscal Year 2006-07 refers to the period of time from July 1, 2006, through June 30, 2007.

THE GENERAL FUND

The General Fund is the primary operating fund of the City. General Fund dollars are discretionary in nature. This means that unlike water and sewer rates which must be spent on those particular services, General Fund dollars support a wide variety of general-governmental programs. These programs include police, fire, parks, tree maintenance and recreation, just to name a few.

The City's budget policies require the General Fund to set an amount equal to 8% of its operating costs as an unbudgeted reserve. This reserve level is critical, as you'll see when you read further, because it helps smooth out the inevitable changes in the economy and cover unanticipated expenditures.

General Fund revenues make up about 35.4% of the citywide revenues, and are estimated to grow at 4.6% from Fiscal Year 2006-07 to Fiscal Year 2007-08. The majority of the General Fund revenues come from Sales Tax, Property Tax, Motor Vehicle License Tax and the Utility User's Tax (UUT). Together these revenues account for 67% of all the revenue in the General Fund.

LOOKING BACK AT FISCAL YEAR 2006-07

After successive years of budget cuts, the beginning of Fiscal Year (FY) 2006-07 allowed conservative expansion of services and improved maintenance efforts at City parks and on the City's roadways. This was due in part to increases in property tax revenues and City departmental savings in the prior fiscal year.

By the end of FY 2006-07, the City's budget picture had changed. With the recent changes in the housing market, both property taxes and sales taxes are substantially reduced from earlier projections. By the time the books are closed on FY 2006-07 (around the end of August), we estimate there will be about \$2 million less in General Fund revenue than had originally been anticipated. Despite this downturn in the economy, the City will retain nearly \$12.5 million in the General Fund's unrestricted reserve. This is equal to 9.7% of the General Fund operating budget, or slightly more than the 8%, unallocated reserve level required by the City's budget policies.

2007-08 ADOPTED BUDGET

The City's budget is adopted the first week in June after a rigorous review process which begins in the preceding January. This process, led by Council's Finance Committee, culminates in televised budget workshops during the month of May where community residents have the opportunity to voice their thoughts about the budget. Supporting the Mayor and Council's policy of maintaining a long-term sustainable budget, the adopted budget for FY 2007-08 reflects a cautious financial approach. The adopted budget includes total operating expenditures of \$346,126,543 (from all funding sources), against projected revenues of \$358,243,538.

The FY 2007-08 budget also funds the following items that were not part of the previous year's budget:

- Ten new police officers
- One Fire Department Engine Company using existing resources
- Restructuring of current debt for Thurman Field and Tenth Street Place
- Set aside funding (\$300,000) to determine feasibility of Dennet Dam removal

In setting the spending levels for FY 2007-08, the City Council also approved using anticipated reserves in excess of the 8% reserve level for certain one-time and on-going expenditures. This additional funding pays for more street and road maintenance projects including curb

CONTINUED ON PAGE 2

THE CITIZEN'S GUIDE

and gutter repairs, as well as leaf collection, and improvements to park infrastructure, the police training facility and the City's golf courses.

CURRENT STATUS

With the information we now have, it is clear the adopted FY 2007-08 budget will need to be reduced if the City is to end FY 2007-08 with an 8% unallocated reserve in the General Fund. Departments are already looking at budgets to determine what needs to happen and what can wait. Vacant positions are being scrutinized and, in many cases, may not be filled until the revenue picture improves. City staff are closely monitoring both spending and revenues and will be providing the Council with regular updates throughout the year.

OTHER ITEMS OF INTEREST

Proposition 42 Funding

Proposition 42 passed in 2002 and dedicates revenues from the state's share of the sales tax on gasoline to local transportation projects. This sales tax on gasoline generates roughly \$1.3 billion a year, increasing annually of which the City receives \$867,172 annually. The Governor's spending proposal for FY 2007-08 again includes full-year funding of Proposition 42. In order to receive these funds, however, the Proposition 42 Maintenance of Effort (MOE) provision requires the City spend at least \$1,687,172 of the City's discretionary dollars on eligible road projects. As a matter of practice, the City spends about \$1.3 million more on road maintenance projects than is needed to meet the MOE requirement. The Council recognizes the need for additional road maintenance and is committed to continued funding of road repair and improvements.

Pruned Refuse Collection Service

The FY 2007-08 General Fund budget includes only six months of funding for the pruned refuse collection service. This is the program that allows residents to place their large tree and shrubbery trimmings in the street or alleyway for pick up by the City. Staff has recommended to the Council's Finance Committee that this program be discontinued. The full City Council is expected to consider this recommendation in September 2007. Similar to collection practices in neighboring cities of Stockton, Turlock, Livermore and Tracy, the recommendation is:

- The current fall leaf collection program would remain in place.
- The City would contract with the local garbage companies for pruned refuse collection.
- For households placing all their pruned refuse into their one existing green toter, the estimated additional cost is \$1.59 per month.
- For households that need an additional toter to place all their pruned refuse into, the cost for each new toter is estimated at \$4.16 per month.
- Residents choosing to not utilize the garbage company would have the option of hauling their pruned refuse to the transfer station themselves or they may choose to have a lawn care service handle this for them.

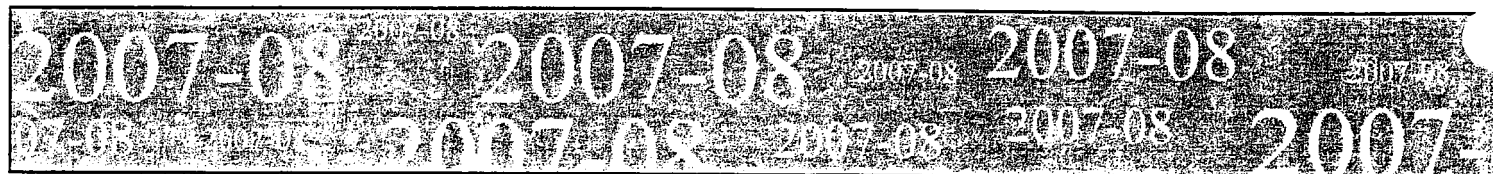
CONCLUSION

The Council's budget choices in the past have led Modesto through challenging financial times. In focusing resources on cost-effective programs and services, the Council continues to make Modesto a safer place to live, enhance the quality of life within neighborhoods and encourage economic development. Through conservative spending practices, the budget balances ongoing expenses with ongoing revenues while addressing many of the services and programs that make a community a home: beautiful parks, well-maintained recreational facilities and cultural activities. It also continues to provide and expand funding for police and fire services to protect the community.

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

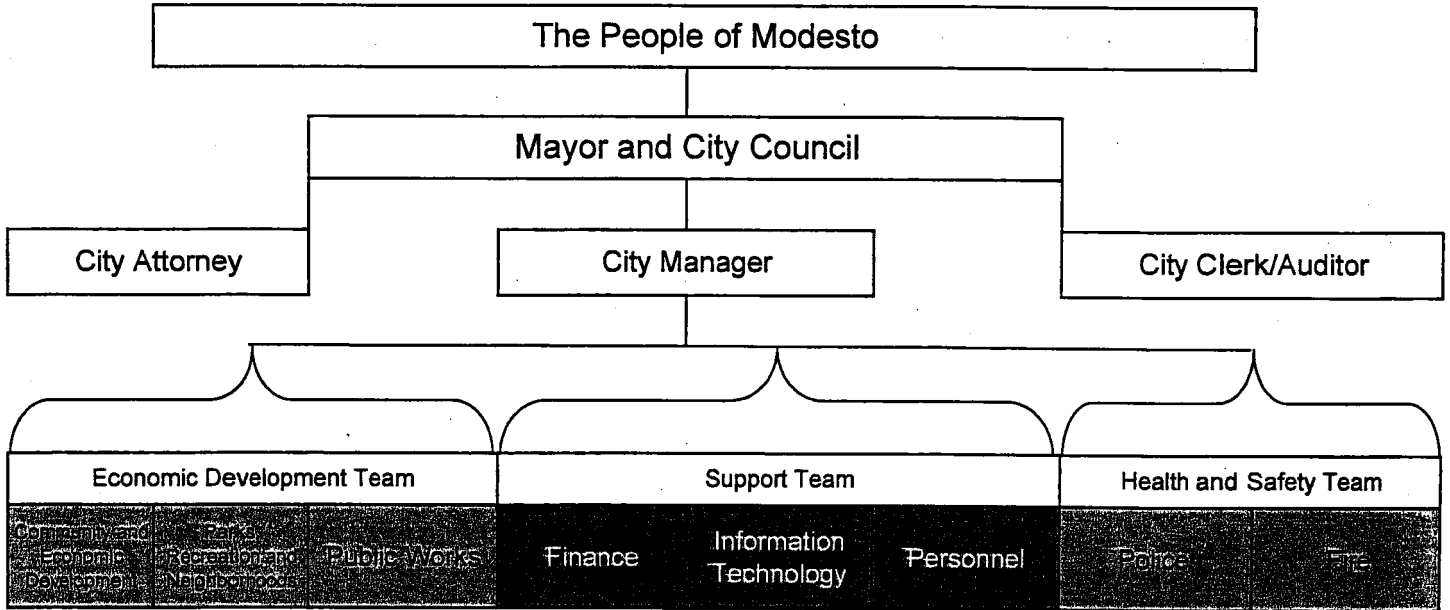
ACCESSING THE BUDGET

In September, the FY 2007-08 "Citizen's Guide to the Budget" will be available online at www.modestogov.com/fin or in hard copy at the Stanislaus County Library, located at 1500 "I" Street, Modesto. For questions or more information, please contact the City's Finance Department at (209) 577-5369.



Our Vision of Modesto:

A healthy, safe, attractive, economically vibrant, socially and culturally diverse city with a strong sense of identity and pride - a community engaged in the practice of citizenship with governance based on the principal of stewardship.



CITY NEWS...

Downtown Street Reconstruction- During FY 2007-08 9th Street, B-D Streets and L-MID Lateral No. 4 will be reconstructed. \$2.5 million is budgeted for this project. Federal participation is 88.53%, City gas tax match is 11.47%.

Tuolumne River Regional Parkway- In total, 72 acres of the Gateway Parcel is currently under construction, with the major portion complete. Construction of Phase 1.1 is scheduled for completion in late summer 2007 and is being funded by a \$1.14 million grant from Proposition 40. Phase 1.2 of the Gateway Parcel should begin construction in late fall 2007 and will include the removal of approximately 4,500 cubic yards of soil separating Dry Creek from the Backwater Channel, excavation and stockpiling of approximately 180,000 cubic yards of soil from along the Tuolumne River under the 9th Street Bridge creating various terraces throughout the park site and the planting of riparian plant material as part of the restoration of the Gateway Parcel. Phase 1.2 also is scheduled to include the construction of various trails and pathways, including a continuation of the Riverwalk Trail eastward from Confluence Point, installation of site furnishings and installation of irrigation. Construction of Phase 1.2 encompasses approximately 60 acres of park site and

is being funded by a \$1.5 million grant from Proposition 50 and is slated to be completed in late 2008.

The Virginia Corridor is beginning to really take flight. With the Rotary Clubs of Modesto Centennial Junction portion of the trail (located at Roseburg Square) completed, the next phase of this 4.2-mile railway project is under construction. Once completed, the trail will extend from Granger Avenue to College Avenue – *creating one and one-half miles of usable trail.*

Ten New Police Officers- Full year funding for the police officers added during FY 2006-07 is included in the FY 2007-08 budget at a cost of \$1,040,700.

The Neighborhood Center at Marshall Park is under construction and is scheduled for completion this fall. This is a unique joint venture in which three departments (Police, Fire and Parks, Recreation and Neighborhoods) have teamed up to develop *a joint service facility* at the southwest corner of Sutter and Chicago Avenues, on the existing Marshall Park site. In addition to a fire station and police office, this will be a facility where citizens can conduct City business, such as enroll a child in a recreation program, pay sewer and water bills or ask questions about City programs and policies.

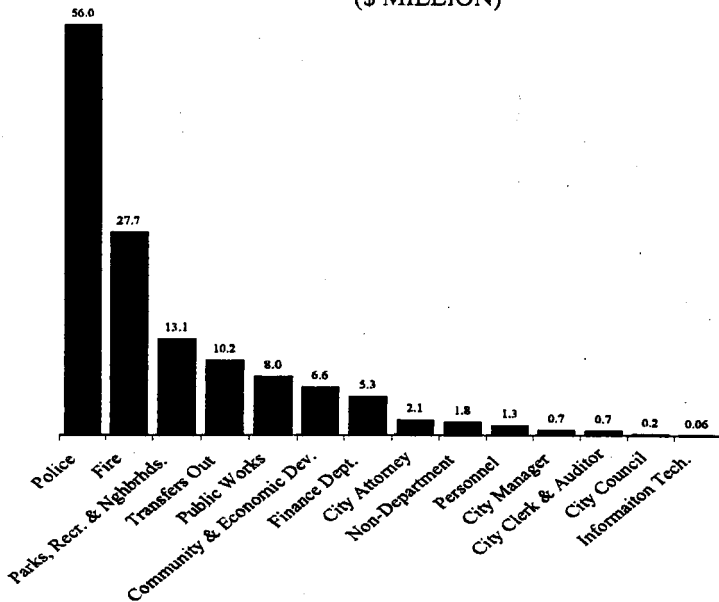
BUDGET AT A GLANCE

City of Modesto 2007-08 Operating Budget

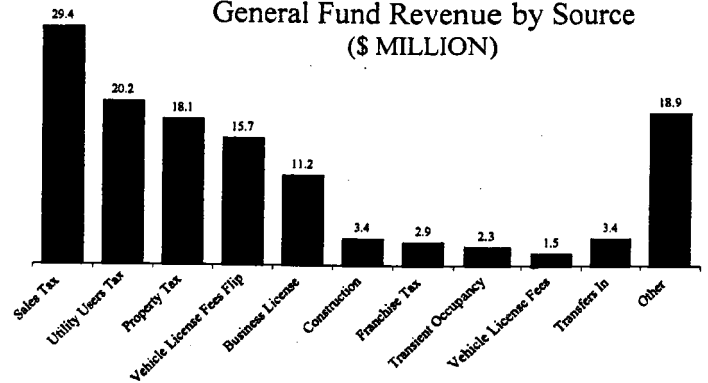
Fund (s)	Revenues	Expenditures	Difference
General Fund	\$126,904,417	\$133,715,896	(\$6,811,479)
Gas Tax Fund	\$9,628,014	\$8,956,031	\$671,983
Utilities	\$88,017,611	\$67,583,370	\$20,434,241
Internal Services	\$85,516,971	\$85,654,503	(\$137,532)
Debt Services	\$3,273,860	\$4,608,021	(\$1,334,161)
Other	\$44,902,665	\$45,608,722	(\$706,057)
Total (with transfers)	\$358,243,538	\$346,126,543	12,116,995

*\$6.8 million from reserves was approved to help fund street and road maintenance projects, curb, gutter and sidewalk repairs; park infrastructure, storm drain leaf collection efforts, improvements to the police training site and golf capital improvements.

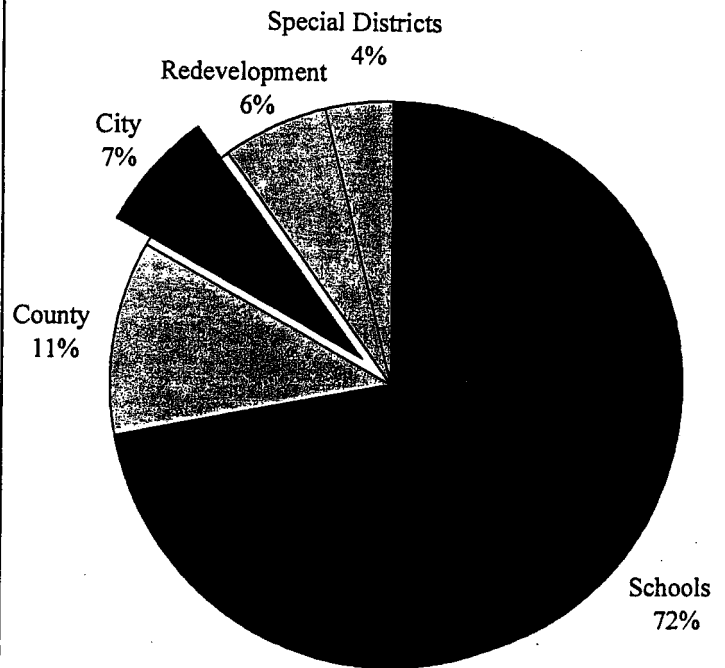
General Fund Expenditures by Department
(\$ MILLION)



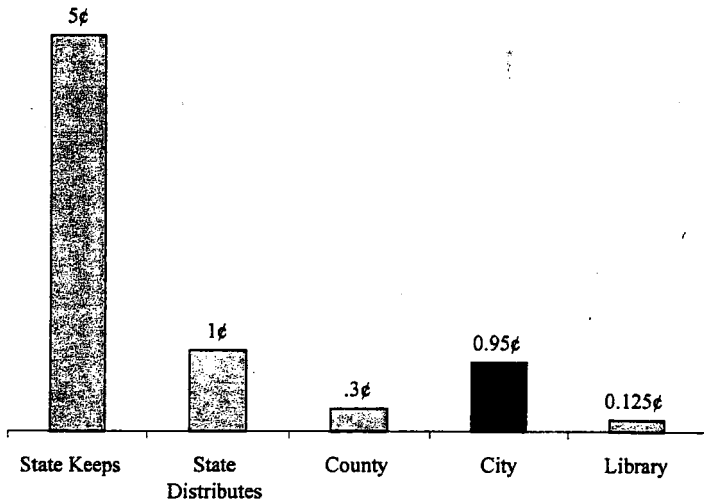
General Fund Revenue by Source
(\$ MILLION)



Where Your Property Tax Goes
(ROUNDED)



Where Your Sales Tax Goes
HOW YOUR 7.375 CENT TAX IS DISTRIBUTED



ACCESSING THE BUDGET • In September, the 2007-08 "Citizen's Guide to the Budget" will be available online www.modestogov.com/fin or at the Stanislaus County Library, located at 1500 "I" Street, Modesto. For questions or more information, please contact the City's Finance Department at (209) 577-5369.

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:

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 Council members, 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

The City’s fiscal year begins on July 1 and ends on June 30.

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 are to 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 repayments 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 twelve 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%.)

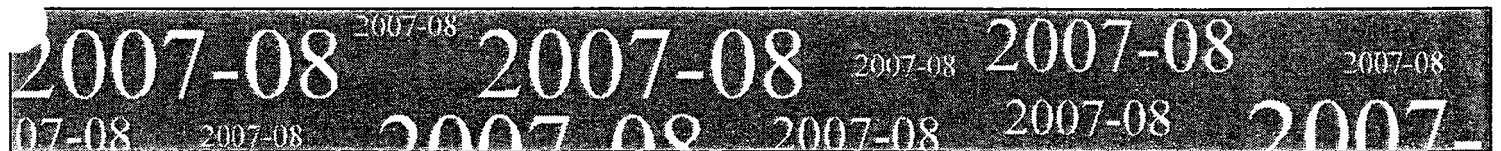
Interest Allocation

Interest is to be allocated monthly to all funds based upon month-end balances.

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.



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. The City sets 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.

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 an organizational effort. Staff in all City departments play critical roles in devising and implementing each year's budget.

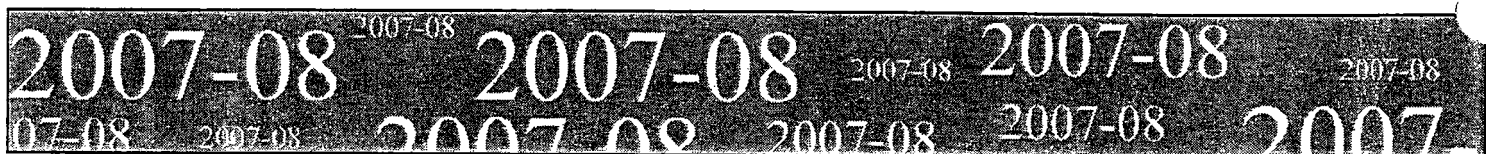
The budget process may vary somewhat from year to year. The following outlines the steps followed in the development and adoption of the Fiscal Year 2007--08 annual budget. Throughout this process, the City Manager briefed the Finance Committee and City Council on the status of the budget and solicited their policy guidance.

Operating Budget

1. Baseline Operating Budget: The Budget and City Manager staff estimates a "baseline" budget for each operating department. The baseline budget includes the pro-

jected 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. 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.
6. 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.
7. Proposed Budget: The City Manager reviews the back



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

8. 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.
9. 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.
10. 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 FY2007-08 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

3. CIP Balancing: The Budget staff compiles project-level information prepared by departments and determines whether any City funding sources are "overcommitted" - i.e. whether the amount earmarked for projects total more than the available revenues. If so, select projects may be deferred until future years when resources become available.
4. Planning Commission Presentation: Once the CIP program is completed, 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 ten-year capital program is presented to the Planning Commission within the first quarter of the Fiscal Year. The Finance Committee and Council are scheduled to review and adopt the Amended CIP in October.

Modifying the Annual and Multi-Year Budgets

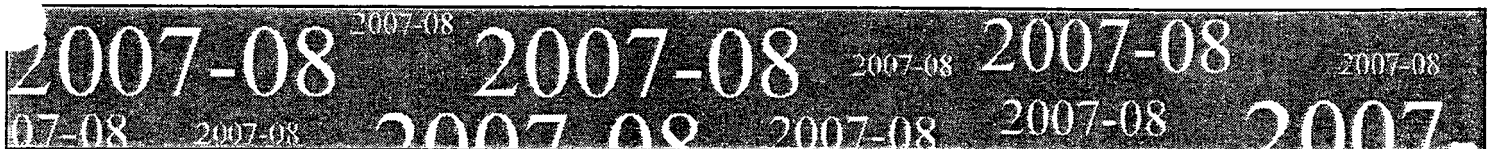
The annual budget ordinance specifies the procedural requirements for making changes to the budget during the year. Levels of budget authority are described in the City of Modesto Financial Policies located within the Appendix section of this document.

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 Guide, which presents the key budget issues facing the City in a user-friendly four-page format. The Citizen's Guide brochure is distributed to citizens as an insert to the utility bill.

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 expendi-

ture 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.

