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Mr. Thomas McCarthy, President
Modesto City Employees Association
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Re: Financial Analysis of the City of Modesto

Dear Tom:

Pursuant to your request, we have analyzed the Comprehensive Annual Financial Reports (CAFR) of the City of Modesto (City) for the years ended June 30, 2002 through June 30, 2007 for the purpose of rendering our basic report on the financial status of the City. Our basic report concentrates on the Government Wide Financial Statements, revenues, and the General Fund. You requested additional analysis of the following additional funds:

- Enterprise Funds:
 - The Water Fund, and
 - The Sewer Fund
- Internal Service Funds
 - The Self-Insurance Fund,
 - The Fleet Fund,
 - The Employee Benefit Fund, and
 - The General Services Fund.

Our overall conclusion from analyzing the Comprehensive Annual Financial Reports is that the City of Modesto financial position weakened in 2007. Its General Fund's financial strength declined due to actual deficits. Despite the General Fund's declining resources, the Enterprise Funds that finance the majority of the union's members' wages are strong, and most of the City's internal service funds may have excess moneys. We have prepared Exhibit I through Exhibit VIII to highlight our findings.



GOVERNMENTAL ACCOUNTING

Governmental accounting and reporting principles differ significantly from private sector accounting principles. These differences include:

- The use of mandatory budgets that become law,
- Two different measurement focuses,
- Two or possibly three different methods of accounting,
- Encumbrances,
- Management Discussion & Analysis (MD&A),
- Government-wide financial statements,
- Fund accounting,
- Two different terminologies for equity – “Net Assets” for government-wide financials statements and business-type funds, and “Fund Balances” for governmental funds.

USE OF MANDATORY BUDGETS

A budget is a financial plan of operations that provides a basis for planning, controlling, and evaluating the various governmental entities and activities. The budget process is a political activity that begins with the executive branch of the government and is approved by the legislative branch to reflect the spending priorities of the government for the fiscal year. The *Adopted (original) Budget* is usually approved before the beginning of the fiscal year. Budgets can be changed by legislative action through amendments during the year as economic conditions and spending priorities change. The *Final Budget* is the *Adopted Budget* plus all legislatively approved budget amendments during the fiscal year up to the date the financial reports are issued.

Government financial reports are required to present a Statement of Revenues, Expenditures, and Changes in Fund Balances – Budget to Actual Comparison that includes both the adopted budget and the final budget. The preferred method of presenting this statement is Required Supplementary Information (RSI); however it may also be presented as part of the basic financial statements.

Upon adoption, the expenditure estimates in the annual budget, as modified by the legislative body, are enacted into law through the passage of appropriation act(s) or ordinance(s). The appropriations constitute maximum expenditure authorization during the fiscal year, and cannot be legally exceeded unless subsequently amended by the legislative body. Unexpended and/or unencumbered appropriations may lapse at the end of the fiscal year or may continue as authority for subsequent period expenditures, depending upon the applicable legal provisions per the National Council on Governmental Accounting Statement No. 1 (NCGA-1) Paragraph 86. Appropriations that lapse at the end of the fiscal year are known as **lapsing appropriations** and those that do not lapse at the end of the year are known as **continuing appropriations**.



MEASUREMENT FOCUS AND METHODS OF ACCOUNTING

The nature of governmental accounting requires different measurement focuses depending on the type of fund and financial statement presented in the government’s financial report. The term “measurement focus” is defined as the object the financial statements measure. As such, measurement focus determines the method of accounting used by the fund and how it is reported in the financial report. The following table and discussion describes the various methods of accounting and whether they are Generally Accepted Accounting Principles (GAAP) or non-GAAP.

Analysis of Accounting Methods

	<i>Accrual Basis</i>	<i>Modified Accrual Basis</i>	<i>Cash Basis</i>
GAAP / Non-GAAP	GAAP for Government-wide Financial Statements and proprietary funds	GAAP for Governmental Funds	Non-GAAP - Used only for Budgetary Accounting
Revenue	Recorded when earned	Recorded when measurable and available (Max 60 Days)	Recorded when received
Expenses / Expenditures	Recognized when goods and services received	Recognized when goods and services received and paid in a timely manner from current resources	Recorded when paid
Equity	Invested in capital assets net of depreciation, restricted, and unrestricted	Reserved and Unreserved	Carry-over balance (record encumbrances at end of year)

The “**government-wide financial statements**” and **proprietary type fund’s statements** use the *flow of economic resources measurement focus* in order to determine the change in net assets. All assets, liabilities, revenues and expenses associated with the operation of the government as a whole and in the separate proprietary funds are included in the statement of net assets and the statement of activities under this measurement focus. Government-wide financial statements and all proprietary funds use the *Accrual Basis* of accounting as their GAAP accounting basis. **Under this method, revenues are recognized when earned and expenses are recorded at the time the liabilities are incurred regardless of timing of the related cash flows.**

It is imperative to note that the new model, promulgated by the Governmental Accounting Standards Board (GASB) 34, emphasizes the accrual basis of accounting for government-



wide financial statements. On page two of the preface to GASB 34, the GASB states the importance and reasons for using the accrual basis of accounting in the government-wide statements:

“Financial managers also will be in a better position to provide this analysis because for the first time the annual report will also include new government-wide financial statements, prepared using accrual accounting for all of the government’s activities. Most governmental utilities and private-sector companies use accrual accounting. It measures not just current assets and liabilities but also long-term assets and liabilities (such as capital assets, including infrastructure, and general obligation debt). It also reports *all* revenues and *all* costs of providing services each year, not just those received or paid in the current year or soon after year-end.”

The modified accrual basis of accounting and the budget (cash) basis of accounting, discussed below, do not report all assets, liabilities, revenues and expenses. As such, accrual basis accounting provides the most accurate portrayal of the government’s financial position and results of operations.

Governmental funds’ financial statements use the *current financial resources measurement focus* in order to determine the changes in financial position. With this measurement focus, generally only current assets and current liabilities are included on the balance sheets. The statement of revenues, expenditures, and changes in fund balances (deficit) of these funds present increases and decreases in net current assets. All Governmental Funds use the ***Modified Accrual Basis*** of accounting as their GAAP accounting basis. **Under this basis of accounting, revenues are recognized when they become both measurable and available, and expenditures are recorded when the liability is incurred.** *Measurable* means the amount of the transaction can be determined. *Available* means collectible within the current period or soon enough thereafter, usually sixty (60) days, to be used to pay liabilities of the current period.

The third method of accounting that may be presented in the government’s financial report is **budgetary accounting**. The financial statements of governmental funds are required to be reported using GAAP, which is the modified accrual basis of accounting discussed in the previous paragraph. However, when preparing their budget many governments use another method of accounting, budgetary accounting, also known as the ***Cash Basis*** of accounting. **Under this method, revenues are recognized when collected and expenses are recognized when paid.** In the CAFRs budgetary accounting is only presented in the Statement of Revenues, Expenditures, and Changes in Fund Balances – Budget to Actual comparison.

In situations where the governmental fund type’s basis of accounting differs from the required reporting modified accrual GAAP accounting basis, Section 2400.109 of the Codification of Governmental Accounting and Financial Reporting Standards requires that the budgetary



comparison schedules should be accompanied by information (either in a separate schedule or in notes to the financial statement) that reconciles budgetary information to GAAP information.

There are major differences between the budgetary accounting method used by the entity for governmental-type funds and the GAAP method of accounting, which cause significant differences in the results of operations and fund balance. The major differences between the two accounting methods are as follows:

1. *Basis Differences* – Certain accruals are excluded from the budget basis financial statement because such amounts are budgeted on a cash basis. Also, certain inventory type assets are excluded from fund balances because such amounts are considered expenditures in prior years.
2. *Timing Differences* – Encumbrances (discussed below) are included in budgetary statements but excluded from GAAP statements until recorded as actual expenditures. Also, revenues that were budgeted and recognized in prior years on budgetary basis statements but which were not susceptible to accrual until the current year are recognized by GAAP basis financial statements in the current year.

ENCUMBRANCES

Encumbrances represent commitments related to unperformed contracts for goods or services (executory contracts), and are used to control expenditures for the year and to enhance cash management. Encumbrances only appear in Governmental Fund types, not in Proprietary Fund types. Encumbrances do not represent expenditures for the period, only a commitment to expend resources in the future. Likewise, the reserve for an encumbrance is not a liability since a liability is only recognized when the goods are delivered or the services are provided. Only when the goods or services are provided is the expenditure or the liability recorded. As such, purchase orders, contracts, and other future commitments that are uncompleted at year end are recorded as a reserve in the applicable fund balance since they do not lapse at June 30. Instead, the commitments are considered encumbered and do not need to be appropriated in the succeeding year's budget. When a governmental unit allows an appropriation to lapse, the encumbrance must be re-appropriated in the following year's budget.

MANAGEMENT'S DISCUSSION & ANALYSIS

Management's Discussion and Analysis (MD&A) is Required Supplementary Information (RSI) that precedes the Basic Financial Statements. It is to provide an objective and easily readable analysis of the government's financial activities based on currently known facts, decisions or conditions. It is the financial manager's opportunity to provide both a short and long-term analysis of the government's activities. Primarily MD&A should:

1. Discuss the current year results in comparison to the prior year with emphasis on the current year,
2. Focus on the primary government,



3. Have managers effectively report on the relevant information and avoid “boilerplate” discussion.

GOVERNMENT-WIDE FINANCIAL STATEMENTS

Governmental financial reports are now required to present two government-wide financial statements, the **Statement of Net Assets** and the **Statement of Activities**. The purpose of these statements is to measure total government performance, present information on total program cost and program revenues, and present the changes of the government’s net assets from the prior year.

The Statement of Net Assets and a Statement of Activities presents information about the reporting government as a whole. The statements include the primary government and its component units, except for fiduciary funds. Eliminations are made to minimize double counting of internal activities. These statements distinguish between governmental activities and business-type activities of the government as well as the government’s discretely presented component unit, if any. Governmental activities generally are financed through taxes, intergovernmental revenues, and other non-exchange revenues. These activities are reported in governmental funds and internal service funds. Business-type activities are financed in whole or in part by fees charged to external parties for goods and services. These activities are reported in enterprise funds. The Statement of Net Assets and the Statement of Activities are prepared using the economic measurement focus and the accrual basis of accounting.

Discretely presented **component units** are also separately presented on the government-wide financial statement. A component unit is a legally separate entity in which the elected officials of the primary government are "financially accountable" for the entity, or the nature and significance of the relationship between the entity and the primary government are such that to exclude the entity from the financial reporting of the primary government would render the financial statements misleading or incomplete. The difference between a component unit and an enterprise fund is that an enterprise fund is not a legally separate entity. Financial accountability occurs when one of the following two conditions exists:

1. The primary government can impose its will on the other entity, or
2. The potential exists for the component unit to (1) provide specific financial benefits or (2) impose specific financial burdens on the primary government.

The **Statement of Net Assets** is required to report both the historical cost and the accumulated depreciation of all of the government’s capital assets. Capital assets include infrastructure such as streets, sewers, sidewalks, gutters, and government buildings as well as equipment. **By reporting infrastructure in this manner, the readers of the financial statements will be able to determine the extent of deferred maintenance and its future cost.** Besides reporting all capital assets, the Statement of Net Assets also presents all of the Government’s liabilities including long-term debt. The difference between assets and liabilities is called net assets. We will discuss the components of net assets later in our report.



The **Statement of Activities** presents a comparison between direct expenses and program revenues for each function of the governmental activities and for each segment of the business-type activities of the government entity. Direct expenses are those that are specifically associated with a program or function and, therefore, are clearly identifiable to a particular function or program. Program revenues include:

1. Charges paid by the recipients of goods or services offered by program, and
2. Grants and contributions from outside sources which are restricted to meeting the operational or capital requirements of a particular program.

Revenues that are not classified as program revenues, including all taxes for governmental type funds and capital contributions for business type assets are presented instead as general revenues. **By reporting changes in net assets in this manner, the true cost to the taxpayer for services can be determined by a reader of the government's financial report. Presenting multiple years of comparative Government-wide Financial Statements should provide valuable information concerning the financial health of the total government and not just the individual funds.**

FUND ACCOUNTING

In governmental accounting, because of legal restrictions imposed by various levels of government, there is no single entity that contains all the activities of a single government. Governmental activities and the related resources often have to be accounted for individually by the use of fund accounting. A fund is a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations. A governmental entity comprises numerous funds to account for the various activities it oversees. There are various types of funds that are divided into three categories: **Governmental Funds, Proprietary Funds, and Fiduciary Funds.**

Governmental Funds are those through which most governmental functions of the City are financed. Included in Governmental Funds are the following fund groups:

- The **General Fund** is the general operating fund of the City. It is used to account for all financial resources and expenditures except those that are required to be accounted for in another fund.
- **Special Revenue Funds** are funds used to account for the proceeds of specific revenues that are legally restricted to expenditures for specific purposes. Funds that are restricted by federal law, state law or ballot initiative can only be used for those purposes the law allows and therefore cannot be considered as potential sources of moneys for the General Fund. **Special Revenue Funds that were established by resolution of the government's**



legislature were established at a specific time to fund perceived current or future needs. The funding and uses of these Special Revenue Funds can be modified by resolution of the government's legislature.

- **Debt Service Funds** are funds created to account for resources that will be used to service general long-term debt. These funds should only be established when legally required; otherwise debt may be accounted for in the General Fund.
- **Capital Projects Funds** are funds used to account for the financial resources to be used for the acquisition or construction of major capital facilities. Upon completion of the project any excess funds, unless required by law to be transferred to the Debt Service Group of Funds, may be transferred to the General Fund.
- **Permanent Funds** are funds that are used to report resources that are legally restricted to the extent that only earnings, and not principle, may be used for purposes that support the reporting government's programs – that is, for the benefit of the government or its citizenry.

Governmental Funds have two types of financial statements; the **Balance Sheet** and the **Statement of Revenues, Expenditures, and Changes in Fund Balances (Deficit)**. Revenues for governmental funds include taxes, licenses and permits, fines, and investment income. Expenditures are grouped by function such as public safety. Other financing sources (uses) include transfers, both in and out, loans, and proceeds from the sale of governmental assets.

Proprietary Funds are used to account for the City's ongoing organizations and activities that are similar to those found in the private sector. Included in Proprietary Funds are the following two groups:

- **Enterprise Funds** are funds that are similar to businesses in the private sector since they are intended to be self-supporting through user charges to the public. Future plant acquisitions, debt service payments on bonds used to finance plant expansion, and expenses are to be paid from the revenues generated by the Enterprise's operations.
- **Internal Service Funds** are Proprietary Funds that are similar to the Enterprise Group of Funds since they are used to account for the income and expenses of government agencies that supply services to other government departments or agencies.

Besides the **Statement of Net Assets** discussed above, proprietary type funds are required to present two other statements. The **Statement of Revenues, Expenses and Changes in Net Assets** presents revenues and expenditures as either operating or non-operating. Non-operating revenue and expenses include interest income; interest expense; transfer in and out; and capital contributions from developers, other governments, and customers. The third statement is the **Statement of Cash Flows** which shows how the fund spent its money.

Fiduciary Funds are defined by paragraph 69 in GASB 34.



- Fiduciary funds should be used to report assets held in a trustee or agency capacity for others and **therefore cannot be used to support the government's own programs** (emphasis added).
- The fiduciary fund category includes pension (and other employee benefit) trust funds, investment trust funds, private-purpose trust funds and agency funds.
 - The three types of trust funds should be used to report resources held and administered by the reporting government when it is acting in a **fiduciary capacity for individuals, private organizations or other governments** (emphasis added).
 - These funds are distinguished from agency funds generally by the existence of a trust agreement that affects the degree of management involvement and the length of time the resources are held.

Fiduciary fund categories are defined as follows:

- **Pension (and other employee benefit) Trust Funds** are used to report resources that are required to be held in trust for the members and beneficiaries of defined benefit pension plans, defined contribution plans, other post-employment benefit plans, and other employee benefit plans.
- **Investment Trust Funds** are used to report the external portion of investment pools reported by the sponsoring government, as required by GASB Statement 31, paragraph 18.
- **Private-purpose Trust Funds** are used to report all the other trust arrangements under which principal and income benefit individuals, private organizations, or other governments.
- **Agency Funds** are defined by paragraph 73 in GASB 34.
 - Agency funds should be used to report resources held by the reporting government in a purely custodial capacity (assets equal liabilities). Agency funds typically involve only the receipt, temporary investment, and remittance of fiduciary resources **to individuals, private organizations, or other governments** (emphasis added).
- When Agency Funds hold moneys that should be held by other funds, they are considered clearing accounts as defined in GASB 34 paragraph 111.
 - **Sometimes an agency fund is used as a clearing account to distribute financial resources to other funds of the government** (emphasis added), as well as other entities. For example, county property tax collectors customarily collect and distribute property taxes to the county's funds as well as other governments within the county. **When this occurs, the portion of the clearing account balance that pertains to other funds of the county should not be reported in the agency funds. Rather, it should be reported as assets in the appropriate funds** (emphasis added).



TERMINOLOGY FOR FINANCIAL STATEMENT EQUITY

The terminology used in the equity section of the financial statements in the governmental financial report depends on the measurement focus of the statement. The equity section of the **new Government-wide financial statements, Proprietary funds and Component units** is titled *Net Assets*. The equity section of governmental funds is still titled *Fund Balance*. These equity sections of the Government-wide financial statements, the Proprietary Funds and the Governmental Funds represent both the accumulation of excess revenues over expenses since the inception of the government/fund, and difference between the government/fund's assets and liabilities.

In the Government-wide financial statements, Proprietary funds and Component units, "Net Assets" should be displayed using the following three components:

1. Invested in Capital Assets, Net of Related Debt. This component consists of all of the government's capital assets, including infrastructure, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
2. Restricted Net Assets (distinguishing between major categories of restrictions). Net Assets should be reported as restricted when constraints placed on net asset use are either:
 - a. Externally imposed by creditors (such as debt covenants), grantors, contributors, or laws or regulations of other governments, or
 - b. Imposed by law through constitutional provisions or enabling legislations. Enabling legislation of the reporting government is included in this definition.
 - c. However, designations of local governments that do not have enabling legislation are not included in this definition, and should not be reported on the face of the Statement of Net Assets.
 - i. Enabling legislation, as defined by GASB 34, paragraph 34, "authorizes the government to assess, levy, charge, or otherwise mandate payment of resources (from external resource providers) and includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation."
3. Unrestricted Net Assets consist of assets that do not meet the definition of "Invested in Capital Assets, Net of Related Debt" and "Restricted". Any debts that cannot be attributed to acquisition or construction of the capital assets are allocated to this component of net assets.

In **Governmental Funds**, the fund balance is segregated into two categories to show various legal or other restrictions on the use of fund resources. The first category, **Reserved Fund Balances**, is usually created to either:

1. Satisfy legal covenants that require a portion of the fund balance to be segregated, or
2. Identify the portion of the fund balance that is not appropriate for future expenditures.



The second category of the fund balance, **Unreserved Fund Balances**, represents the fund's equity that is not legally restricted or has not been appropriated for future expenditures. This section of the fund balance has two subcategories.

1. **Unreserved - Designated Fund Balances** are defined in paragraph 1800.144 of the Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2007.
 - a. Fund balance designation may be established to indicate tentative plans for financial resource utilization in a future period, such as for general contingencies or for equipment replacement. Such designations reflect tentative managerial plans or intent and should be clearly distinguished from reserves. **Such plans or intent are subject to change and may never legally authorized or result in expenditures. Designated portions of the fund balance represent financial resources available to finance expenditures other than those tentatively planned** (emphasis added).
 - b. Per the AICPA's *Audits of State and Local Governmental Units (GASB 34 Edition)*, Paragraph 10.17, "designations should not result in negative undesignated balances being reported on the financial statements at year end, regardless of the undesignated fund balance at the time the designation was made."
2. **Unreserved - Undesignated** portion of the fund balance represents that portion of the unreserved fund balance for which there are no legal restrictions and which can be appropriated for future expenditures.

BENCHMARKING THE FUND BALANCE

A "benchmark" is a standard that is used to measure performance and to compare an organization to other similar organizations. A benchmark is used by rating agencies and other stakeholders historically to compare the General Fund's fund balance to either its annual revenues or expenditures. The ratios calculated are intended to serve as a measure of resources available so they can be compared to a benchmark or standard to assist in determining the financial health of the General Fund. The word "standard" should not be confused with the reporting and accounting standards promulgated by the GASB. The GASB's standards govern what the government **is required to report and how it is to be reported** in the government's CAFRs. **The use of the word "standard" is not used as an accounting standard;** instead, it is **used as a benchmark measurement** to analyze the financial information presented in the CAFR to determine the financial health of the government, its ability to meet its current and future obligations, and to compare its performance to other governmental entities. The benchmark used in analyzing the health of a governmental fund is not an absolute. Different organizations have determined their benchmark based on their experience and needs.



History of the Benchmark

Historically, **Standard & Poors (S&P)** used as its benchmark the **total fund balance equaling 5% of expenditures**. The Government Finance Officers Association's (GFOA) November 1990 Research Bulletin entitled *Unreserved Fund Balance and Local Government Finance*, noted on page 6 that S&P considers 5% of annual operating expenditures to be an adequate fund balance level. In February 1999, S&P issued a report titled *Research: Benchmark General Obligation Ratios*, which published the benchmark ratios S & P uses in analyzing governmental units. These ratios, per page 1 of its February 1999 article, "represent benchmarks that S&P analysts usually consider high, low or moderate, regardless of rating category or point in the national economic cycle." S&P now bases its measurement benchmark as a percentage of operating revenues, not expenditures. S&P considers **5% to 15% of operating revenues to be "adequate" when benchmarking the General Fund's total ending fund balance, and 2% to 8% of operating revenues to be "adequate" for benchmarking the unreserved fund balance**. In discussions with David Hitchcock, the author of the *Research: Benchmark General Obligation Ratios*, in November 2002, **he said that S & P still uses these ratios from this article, and considers them adequate**. Greater emphasis is placed on the cash flow needs of the government in determining the adequacy of the fund balance.

Moody's Investor Services (Moody's) has used as its benchmark **total fund balance equaling 5% of expenditures**. On page 27 of *Moody's on Municipals* published in 1991, "[t]he level of fund balance is related to the likelihood of drawing upon these accumulations. Generally, a fund balance of 5% of the budget is deemed prudent." Moody's still uses this total fund balance criteria as shown in its February 2002 Special Comment, *Your General Fund Balance – One Size Does Not Fit All!* In this four page report, Moody's states on page 3, "[d]epending on which vulnerabilities are more significant in each situation, should dictate whether to utilize a number of days of operating expenses or a flat percentage in formulating reserve levels. **In the former case a minimum of one to two months of operating expenses is considered reasonable, while in the latter instance a minimum level of between 5% and 10% should [be] targeted.**" The term "reserves" as used in this standard is defined on page 1 the February 2002 special comment, "[f]or the purpose of this comment; however we will focus on General Fund balance, or reserves." We discussed Moody's benchmark with two Moody's analysts in November 2002. Per Dari Barzil, Moody's uses the total fund balance in its analysis due to the varying nature of reserved fund balances (viz. a reserve for encumbrances is different from a reserve for contingencies). John Incorvaia, one of the writers of *Your Fund Balance – One Size Does Not Fit All*, said the 5% to 10% really should be applied to the "undesignated" fund balance. He defined "undesignated" fund balances as "free reserves", i.e., the portion of the fund balance that does not have restrictions. Per Mr. Incorvaia, it starts with the "unreserved-undesignated" fund balance, which is unrestricted and is then adjusted by analyzing the fund balance reserves and designations to determine if these should be included in the undesignated fund balance. **The appropriate percentage would depend on the overall financial strength, volatility of revenues and expenditures, and cash flow needs.** He said that this report was meant to encourage governments to establish a policy on the unreserved fund balance.



In past years, **Fitch IBCA (Fitch)** has used a 5% benchmark. In the GFOAs November 1990 research bulletin discussed above, the GFOA noted on page 6 that Fitch considers “**a fund balance of 5% of revenues....a reasonable benchmark.**” It is clear from the context in which this quote was taken that “fund balance” refers to the unreserved fund balance. In May 2000 Fitch issued a special report titled *Local Government General Obligation Rating Guidelines* in which they discussed their guidelines in rating local governments. Page 6 of this report states, “as a cushion against potential revenue and expenditure volatility, **an unreserved fund balance equal to 5% of expenditures and transfers or revenues and transfers is regarded as a sound level.**” In a phone conversation in November 2002 with Richard P. Larkin, the author of the May 2000 special report, Mr. Larkin said the **5% to 10% unreserved fund balance is a good benchmark.** However, of more importance is the volatility of the government’s revenues, expenditures, cash flow, and working capital needs. **A government with low volatility, with consistent revenues, expenditures, and cash flows could have an adequate unreserved fund balance of 3% to 5% percent of revenues. A government with large variability of revenues, expenditures, cash flows, and requires short-term financing would require a higher fund balance exceeding 10%.** Mr. Larkin also wrote Fitch’s November 2002 special report titled *The 12 Habits of Highly Successful Finance Officers*. Page 3 of these report states, “[t]he appropriate size of such a reserve depends on the potential variability of the entity’s revenues and expenses, as well as its working cash needs to handle seasonality of revenues or expenditures.”

The **most conservative benchmark** is promulgated by the GFOA. In February 2002, the GFOA issued its “Recommended Practice” on the *Appropriate Level of Unreserved Fund Balance in the General Fund*. In this three-page statement the GFOA changed its recommendation on the minimum level of the **unreserved fund balance**. This new minimum was incorporated in the GFOA’s September 2002 update of its elected official guide on fund balances, now titled *An Elected Officials Guide to Fund Balance and Net Assets*. **The GFOA now recommends for those governments that compare the unreserved fund balance to revenues, the minimum unreserved fund balance be no less than 5% to 15% of general fund revenues. For those governments that compare the unreserved fund balance to expenditures, the minimum unreserved fund balance should be no less the 8% to 17% (i.e. one to two months) of regular general fund operating expenditures.**

These new minimum unreserved fund balance levels are 60% greater than the GFOA’s old benchmark standard discussed in the GFOA’s November 1990 Research Bulletin entitled *Unreserved Fund Balance and Local Government Finance* on page 6 which states “a common standard of measuring **unreserved fund balance** (or resources available for contingencies) holds that an amount equal to **5% of annual operating expenditures is sufficient to guard against the effects of most types of uncertainty.**” On page 7 of this bulletin, the GFOA is even more emphatic when it states, “as a general rule, a local government should maintain an amount equal to 5% of annual operating expenditures. This should satisfy some of the credit rating agencies’ concerns regarding the adequacy of resources available for contingencies. Those governments facing greater uncertainty should maintain a higher level of unreserved fund balance. Those



governments that maintain an unreserved fund balance above 10% of annual operating expenses should be able to provide appropriate justification for maintaining that level.” This old standard was supported in the now superseded *An Elected Officials Guide to Fund Balance*, page 17.

Government Financial Officers Associations

In our opinion, the GFOA’s new minimum unreserved fund balance levels reflect the conservative bias of government financial officers. This is especially true when compared to the benchmarks used by all of the three ratings agencies, which is substantially lower than that of the GFOA. The new benchmarks issued by the GFOA are due to the unique political pressures government finance officers are under. Not only are they involved in the preparation of the budget, the spending plan of the government, which is influenced by the economic and political views of the executive and legislative branch, but they are under other pressures as well. The GFOA’s February 2002 recommended practice *Appropriate Level of Unreserved Fund Balance in the General Fund* notes that “(T)hose interested in a government’s credit worthiness or economic condition (e.g. rating agencies) are likely to favor increased levels of fund balance. **Opposing pressures often come from unions, taxpayers and citizens’ groups, which may view high levels of fund balance as excessive**” (emphasis added).

Furthermore, in this recommended practice, the GFOA references these new minimum levels of unreserved fund balance in a recommendation that “governments establish a formal policy on the level of unreserved fund balance that should be maintained in the general fund.” This recommendation that governments adopt a formal policy on the level of unreserved fund balances is an outgrowth of the National Advisory Council on State and Local Budgeting Practice report titled *A Framework for Improved State and Local Government Budgeting and Recommended Budget Practices*. Per page 13 and 14 of this report states, “A government should develop policies to guide the creation, maintenance, and use of resources for financial stabilization purposes.... Governments should maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures.” **The adoption of a policy based on the GFOA’s conservative minimum fund levels will provide support for large fund balances.**

The GFOA’s *An Elected Officials Guide to Fund Balance and Net Assets*, not only incorporates its new recommendations of minimum fund balances, but also discusses the nature of the General Fund’s fund balance. In discussing the new minimum recommended levels for the unreserved fund balance, **the new elected officials guide on page 24 notes “acceptable levels of unreserved fund balance (expressed as a percentage of revenues or expenditures) typically are less for larger governments than for smaller governments. One reason for this difference is simply the magnitude of the amounts involved in the case of larger governments. Also, larger governments typically have more diversified revenues and expenditures, thus requiring less unreserved fund balances to protect against volatility.”** Furthermore since “it is expected that the level of unreserved fund balance will fluctuate from period to period, the measures just described should be considered within the broader



context of long-term forecasting to avoid the risk of too much emphasis upon the level of unreserved fund balance in the general fund balance at any one time.” We accept the GFOA’s contention that the minimum unreserved fund balance should be viewed over a period of years, as displayed in our exhibit, and not to one year. Major decreases or increases in unreserved fund balance may be due to planned drawdowns, onetime projects, the accumulation of resources for a large project, or the accumulation of resources for economic downturns.

Unreserved Fund Balance Defined

The determination of substance over form should apply to the determination of the unreserved fund balance. Some cities, counties, and states create reserved fund balances that do not meet the two requirements discussed above. **A reserve for uncertainties does not satisfy the two requirements discussed above to qualify as a reserved fund balance.** Specifically, **uncertainties are not legal covenants** that require a portion of the fund balance to be segregated such as encumbrances, **nor do they identify the portion of the fund balance** that is not appropriate for future expenditures such as inventories. **These types of "reserved" fund balances are in essence designated unreserved balances.** Therefore reserves for uncertainties, and other reserves of a similar nature, should be included in the unreserved fund balance in determining the 5% benchmark. This approach is reinforced by the GFOA in its 2002 “Recommended Practice” on the *Appropriate Level of Unreserved Fund Balance in the General Fund* mentioned above on the appropriate level of the unreserved fund balance by Footnote 2, which states, **“Sometimes reserved fund balance includes resources available to finance items that typically would require the use of unreserved fund balance (e.g. a contingency reserve). In that case, such amounts should be included as part of unreserved fund balance for purposes of analysis.”** (Emphasis added.)

Determining Revenues and Expenditures

“Rules of Thumb” like the 5% benchmark of the fund balance to expenditures are used to determine if the fund’s revenues are sufficient to pay its ongoing operating expenditures and the degree of the fund’s health. In calculating the 5% level, determining the operating expenditures and revenues is essential. For instance, should transfers out be treated as expenditures? Should transfers in be treated as revenues? GAAP allows cities, counties, and states to choose between GAAP methods in presenting their financial data to users of the financial statements. Whether to include transfers as part of the fund’s operating expenditures or revenues **depends on the "nature" of the transfers; one must determine the substance of the transaction over the form in which it is presented.** One determining factor is the **regularity** of the transfer. Regular, annual transfers should probably be included either as an operating revenue or expenditure. As an example, annual transfers out to subsidize an enterprise fund such as a municipal bus system, should be considered part of the expenditures in determining the 5% benchmark. If the transfers are not regular, but are sporadic one-time occurrences or rare events,



they should not be included in the expenditures or revenues used to determine the 5% benchmark.

Another determining factor is the question of responsibility. Is the General Fund contractually required to pay the obligation from its revenues? For instance, if the fund's revenues are required to pay the debt service, the transfers out to the Debt Service Fund should be included in operating expenditures. If the General Fund's revenues are not contractually obligated to pay the debt service, but the fund is acting as a collection conduit for other funds, the expenditures/transfers for the debt service being reimbursed and the reimbursement for debt service are irrelevant to the health of the General Fund. The contractual obligation to pay the debt rests with the fund reimbursing the General Fund from the transferring fund's revenues. As such, neither the reimbursement nor the expenditure should be included in determining the 5% benchmark level, because the transfers in to reimburse the debt service payments offset the transfers out to the Debt Service Fund. In cases where the General Fund's transfers out for debt service exceed the reimbursement for debt service from other funds, only the net debt service transfers out should increase expenditures. We will include only those transfers that we can identify as originating exclusively from the General Fund in expenditures.

It is our belief that when applying the unreserved fund balance benchmark, that 5% of expenditures is the appropriate starting point for this benchmark. The expenditures should represent the GAAP expenditures, plus or minus regular transfers for which the fund has primary responsibility. The unreserved fund balance should include the undesignated amount as well as the designated fund balances. Reserved fund balances that do not meet the two criteria discussed earlier, such as reserved for emergencies or reserved for contingencies should also be included in the unreserved fund balance. Other factors to consider may include historical long-term view, entity size, other unreserved fund balances, and volatility of revenues and expenditures.

Applying the Benchmark to the Government-wide Financial Statement

As the 5% benchmark traditionally determines the health of the General Fund, we believe it can also be used to determine the health of the total governmental activities through the government-wide financial statements. A benchmark of the unrestricted net assets equaling 5% of the governmental activities total revenues or expenses will provide insight into the government's overall ability to provide services to its citizens that is funded by numerous governmental type funds and not just the General Fund.

The new reporting model requires that governmental long-term debt that cannot be allocated to fixed assets be offset against unrestricted assets. **This offset of long-term liabilities against current unrestricted assets skews unrestricted net assets, and can give a false impression on the true health of the governmental activities financial status.** This debt will be paid out of future revenues over the life of the bonds (up to 30 years), or in the case of the Redevelopment Bonds, the sale of redevelopment property. In essence the current unrestricted net assets are not



the only source of paying these long-term general obligations. Future revenues of the governmental activities will be the primary funding source for paying off these obligations under the theory that those who receive the primary future benefit for the assets acquired or services provided should pay for the their cost. Furthermore, the nature of the debt incurred may hide future benefits to the governmental activities. For instance, pension obligation bonds issued to reduce underfunded pension liabilities may in the long-term reduce future pension costs to the governmental activities. The difference between the long-term growth rates that exceed the interest rate on the bonds will substantially reduce future pension costs. As such, the negative unrestricted net assets of the governmental activities in government wide Statement of Net Assets is not indicative of the current unrestricted financial health of the governmental activities. **It is our belief that when determining ratio of unrestricted net assets to revenues or expenses to the 5% benchmark, we should only use the current resources available to the government. As such, we believe the ratio should use unrestricted net assets adjusted or increased by any long-term debt not applied against the governmental activities net assets invested capital assets net of related debt.**



EXHIBIT I

Exhibit I is an analysis of selected information from the City of Modesto's **Government-wide Financial Statements** for the years ended June 30, 2002 through June 30, 2007. We have only presented the governmental activities of the City. The business activities are the Enterprise Funds, which we will discuss later in our analysis. The governmental activities include not only the General Fund, but also the Special Revenue Funds, the Capital Project Funds, the Debt Service Funds and the Internal Service Funds. **Not all of the resources in this exhibit are available for General Fund compensation purposes due to restriction of their use at the fund level, but these resources may be available to those employees whose wages are financed by other funds.**

The purpose of this exhibit is not to show all of the City's resources that are available for wage and benefit increases. **Instead the purpose of this exhibit is three fold:**

- To determine the financial health of the government as a whole, and not the individual funds,
- To determine if the government's financial health is growing stronger or is declining, and
- To determine if there is a potential call on the immediate resources of the City's General Fund.

Exhibit I-A summarizes the components of the **governmental activities portion of the Statement of Activities**, which shows how the City's net assets changed during the fiscal year. In the five years presented, the City's net assets are \$110 million higher as of June 30, 2007 than at July 1, 2001, growing from \$304 million to \$414 million.

General

- The City's classifies its sales tax revenues and motor vehicle license fee (VLF) revenues as State grants and contributions not restricted to specific programs instead of tax revenues. We consider these two revenues to be tax revenues and will treat them as such in our analysis of this exhibit.
- Tax revenues exceeded the governmental activities' expenses net of program revenues for all years presented.
- Revenues exceed expenses by \$121.6 million during the six years covered by our report, \$10.6 million greater than the cumulative increase in net assets. The difference is due to a prior period adjustment that decreased net assets.
- Capital grants and contributions can only be used to acquire or construct capital assets, or represent the value of infrastructure contributed by developers. As such these revenues cannot be used for wages. At year end, these revenues will either represent increased net assets invested in capital assets net of related debt or, if unspent, restricted for capital improvements.
- Net assets increased in five years presented, with a decline only in 2007..



2002

- Governmental activities expense totaled \$119.7 million in 2002.
 - The largest functional expenses are public safety \$56.6 million (47.25% of expenses), highways and street \$18.3 million (15.27% of expenses) and parks and recreations \$15.4 million (12.9% of expenses).
- The largest category of program revenues was charges for services at \$35.3 million, of which \$12.2 million was collected for community development. Public works received \$8.8 million and public safety received \$5.7 million.
 - Most capital grants and contributions were allocated to highways and streets.
- The largest general revenues were sales tax revenues at \$27 million and the utility users tax revenues at \$12.5 million. Property taxes were the third largest general revenue source at \$11.3 million just followed by VLF of \$10.7 million.
- Governmental activities net assets increased \$20.8 million due to revenues exceeding expenses.

2003

- Except for interest expenses, all governmental activities expenses increased over the prior year.
 - Total governmental activities expenses increased \$18.9 million to \$138.6 million.
 - Increases in public safety expenses of \$7.8 million and community development of \$5.9 million accounted for two-thirds of the expense increase.
- Program revenues grew \$10.8 million, all of the increase is due to an \$11 million jump in capital grants and contributions offsetting decreases in charges for services and operating grants and contributions.
 - Highways and streets received \$22.7 million in capital grants and contributions.
- Even though total tax revenues increased \$3.3 million, the transient occupancy tax revenues and sales tax revenues declined a combined \$1.2 million from 2002.
- The governmental activities general revenue increased \$1.9 million. Declines in general grants and contributions, and investment earnings offset the increase in total taxes.
- Net assets increased \$13.3 million due to revenues exceeding expenses.
- A \$10.6 million prior period adjustment to correct governmental activities opening asset balances reduced the opening net asset balance.

2004

- Total governmental activities expenses increased \$896,295 to \$139.5 million.
 - Large decreases in community development, parks and recreation and small decrease in interest offset increases in the other governmental functions.
 - The largest increases occurred in public safety, and highways and streets.
- Total program revenues grew to \$69.3 million, an increase of \$1.3 million over the prior year.
 - All of the increase was due to a \$6.5 million increase in operating grants which offset decreased revenues in charges for services, and capital grants and contributions.



- Except for declines of \$1.3 million in community development and \$119,000 in public works, operating grants for all governmental functions increased with the largest increase in highways and streets.
- General revenues declined \$805,000 in 2004 due to two factors:
 - A decrease of \$2.6 million in unrestricted investment earnings due to falling interest rates.
 - VLF revenues declined \$2.7 million in part due to the loan of VLF revenues from cities and counties to the state that was part of the May 2004 budget deal between the governor, the League of California Cities and the California State Association of Counties.
 - Despite the decreased VLF, the City's total tax revenues increased \$1.3 million.
- Net assets increased \$12.9 million due to revenues exceeding expenses.

2005

- Total expenses increased \$8.4 million in 2005 to \$147.9 million.
 - Except for a \$1.2 million decline in public works expenses, all governmental activities expenses increased.
 - The largest increases occurred in community development and public safety.
- Program revenues increased \$10.7 million with charges for services increasing \$8.5 million, and capital grants and contributions growing \$4.4 million. Operating grants declined \$2.2 million.
 - Increases in charges for services of \$12 million in highways and streets, \$1.7 million in community development, \$1.3 million in public safety, and \$830,000 in parks and recreation offset a \$7.2 million decline in public works charges for services.
 - Highways and streets received all of the increase in capital grants and contributions.
- Tax revenues increased \$9 million from \$80.3 million to \$89.3 million, an increase of 11.15% over 2004's tax revenues.
 - The largest increase of \$7.4 million occurred in VLF revenues.
 - Part of the increase is due to the sale for \$3.2 million of the loan to the State of the 2004 VLF revenues.
 - The City's VLF may also have increased due to the receipt of additional property taxes that may be classified as VLF fees.
- The property tax revenues increased by \$22,095. However as stated above, the County may be classifying additional property tax receipts as VLF revenues, which increased \$7.4 million:
 - The passage of SB1096 in July 2004 permanently changed general revenues allocated between local governments and the state as follows:
 - First is the property tax swap for VLF taxes.
 - Beginning January 1, 2005 the VLF offset was repealed and the VLF rate was permanently reduced from 2% of market value to 0.65% of market value.



- Beginning in the fiscal year ended June 30, 2005, the loss of the VLF was replaced by additional property taxes.
- The affects of SB 1096 were not discussed in the 2005 MD&A.
 - Second, the State shifted certain property taxes from local government to the state in 2004-2005 and the 2005-2006 fiscal years, which are to be returned to local government in 2006-2007.
- Other general revenues increased \$5.2 million, with the largest increase of \$3.5 million in unrestricted investment earnings.
- Total general revenues increased \$14.2 million or 16.73% over the prior year.
- Net assets increased \$30 million due to revenues, special items and transfers exceeding expenses.

2006

- Governmental activities expenses increased \$3.8 million in 2006 to \$151.7 million.
 - Six of eight governmental expenses functions increased; with public safety having the largest increase of \$3.3 million, followed by highways and streets at \$2.3 million.
- Program revenues grew \$10.1 million due to a \$15.7 million increase in capital grants and contributions offsetting declines in charges for services and operating grants and contributions.
- Taxes increased from \$89.3 million in 2005 to \$97.4 million in 2006, an increase of \$8.1 million or 9.12%.
 - In terms of dollars, sales tax revenues experienced the largest growth over the prior year growing \$3 million.
 - Property taxes increased from \$11.3 million to \$14.3 million, an increase of \$3 million, in terms of dollars, slightly less than sales tax revenues, but it represented an increase of 26.53%.
 - Per page 9 of the 2006 CAFR, this increase was due to the increased tax base, not increased tax rates.
 - The utility users tax also experienced strong growth of \$2 million or 12.56%; according to MD&A, due to increases to the tax base.
- Motor vehicle in-lieu licenses fees declined \$1.4 million in 2006. This decline has two components not discussed in the City's CAFR's 2006 MD&A.
 - In 2005, the City received \$3.2 million from the sale of the State's VLF receivable, a one time revenue source.
 - Also in 2005, the State permanently reduced the VLF from 2% to 0.65%. In 2006, and thereafter the City will receive the reduced VLF rate and the increased property tax base will grow according to economic conditions.
- Net assets increased \$44.6 million due to revenues, special items and transfers exceeding expenses.

2007

- In 2007, governmental activities expenses experienced its largest increase of \$22 million in the six years covered by our report.



- Seven of eight governmental expenses functions increased; with public safety having the largest increase of \$9.3 million, followed by public works at \$6 million and parks and recreation of \$2.8 million.
 - \$4 million of the increase in public works was due to a transfer of City's Community Forestry operation to the Public Works function from Highways and Streets, resulting in a \$4 million expense shift between those functions.
- Program revenues declined \$33.3 million
 - The entire decline occurred in capital grants and contributions revenues which fell \$34.3 million to \$4 million from its 2006 revenues.
 - The decline is due to \$30 million bonds issued in 2006 in the Community Facilities District (CFD) that was not repeated in 2007. These CFD bonds have no City commitment, so the 2006 debt issue was not reported as long-term debt but were recorded as revenues in the 2006 financial statements.
 - Charges for services and operating grants and contributions experienced small increases.
- Tax revenues increased \$3.4 million from \$97.4 million in 2006 to \$100.9 million in 2007, an increase of 3.53%.
 - Two tax revenue sources declined from 2006, business licenses levied for general purposes fell a negligible \$15,000 and sales tax revenues declined \$1.7 million.
 - All other tax revenue sources increased with property tax revenues having the largest increase of \$2.1 million.
- Net assets declined \$1 million due to expenses exceeding revenues, special items and transfers. This is the only decrease in the six years covered by our report.

Other

- The City's utility users tax is the City's second largest tax revenue source behind sales taxes. **This tax source is a City imposed tax and is outside the control of the State; as such it is the City's most reliable tax revenue.** This revenue source grew from \$12.5 million at June 30, 2002 to \$18.3 million at June 30, 2007.

Exhibit I-B is an analysis of the ending balances of the **governmental activities assets, liabilities and net assets from the Statement of Net Assets.**

The increase in the governmental activities unrestricted cash and investments is affected by other factors besides the annual increases to net assets. The collection of receivables, the payment of liabilities, the purchase of inventory, and the acquisition of capital assets influence cash and investments ending balance.

- The City's unrestricted cash and investments increased from \$108.6 million at June 30, 2002 to \$179.4 million at June 30, 2006, then declined slightly to \$176.3 million in 2007



- The change in net assets is the primary cause for the increase or decrease in cash and investments.

Current Asset to Current Liability Ratio

The asset to liability ratio is used to predict the ability of an entity to pay its current liabilities timely and is considered an indicator of financial health. Usually the higher the asset to liability ratio is, the healthier the entity. While the change in net assets will have an effect on these ratios, the largest influence on the growth or decline in these ratios are changes in liabilities. To offset an increase or decrease in liabilities, the change in assets must be proportionately greater to maintain these ratios. **Furthermore non-cash expenses such as depreciation, while it affects the change in net assets, has no effect on current assets and liabilities.**

- The City of Modesto has maintained a very healthy current asset to current liability ratio.
- The ratio increased in three of the four years since June 30, 2002 to a strong 8.57 at June 30, 2006 but declined to a still strong 6.9 at June 30, 2007, meaning for every \$1 of current liabilities the City has \$6.90 in current assets.

Net Assets Invested in Capital Assets, Net of Related Debt

The governmental activities' net assets invested in capital assets net of related debt reflects the City's governmental activities investment in capital assets such as building and streets, and as such is not available for future spending. Since June 30, 2002, this component of net assets grew from \$247.7 million to \$333.4 million after depreciation. This growth reflects the City's continuing capital asset acquisitions, mostly financed by capital grants and contributions.

Restricted Net Assets

The governmental activities' restricted net assets reflect those **resources whose uses are restricted by external agencies or by enabling legislation.** Again, these assets are not available for general day to day use.

- Since June 30, 2002 this component of the governmental activities' net assets grew from \$64.8 million to \$117.8 million at June 30, 2006 then declined to \$93.2 million in 2007.
- Most of the growth occurred in restricted for capital projects which grew to \$78.5 million before declining to \$58.4 million. This growth reflects capital grants and contributions program revenues that have not been spent.

Unrestricted Net Assets

The third component of net assets is the unrestricted portion that can be used for any purpose. The only restriction is at the fund level.

- As shown, the City's governmental activities unrestricted net assets declined from a positive \$12.5 million at June 30, 2002 to a negative \$11.4 million at June 30, 2004, it then grew to a positive net asset balance of \$804,612 at June 30, 2006. It declined to a negative \$12.6 million in 2007.



- The low unrestricted net asset balances during the period covered by our report is due to the City's long-term liabilities. Long-term debt that is not related to the acquisition or construction of the City's capital assets is applied against the City unrestricted net assets.

The lower part of **Exhibit I-B** shows how the City's long-term liability affects the governmental activities unrestricted net assets. This portion of the exhibit calculates the long-term liability that was not invested in the construction or acquisition of capital assets and instead was applied to unrestricted net assets.

- As shown in this exhibit, the City long-term debt that is allocated to net assets increased from \$59.6 million at June 30, 2002 to \$123.6 million at June 30, 2007.
 - Most of the growth occurred in compensated absences which grew from \$36.6 million at June 30, 2002 to \$67.9 million at June 30, 2007 and claims liability which increased from \$11.2 million to \$16.6 million during the same period.
- **Without this debt, unrestricted net asset would have had large positive balances all six years presented.**
- **This long-term debt will be paid from future revenues for periods up to 30 years, the life of the bonds.**

Exhibit I-C

The City's improving financial health is reflected in the strong positive ratios for governmental activities.

- The revenue to unrestricted net assets net of debt unrelated to the acquisition of capital assets ratio ranged from 46.43% at June 30, 2006 to 63.86% at June 30, 2007, a very strong ratio.
 - The large increase in the revenue ratio in 2007 is due to the decrease in revenues, principally due to the one time 2006 revenues of \$30 million.
- The expense to unrestricted net assets net of debt unrelated to the acquisition of capital assets ration mirrored the revenue ratio ranging from a low of 54.69% at June 30, 2004 to a high of 63.91% at June 30, 2007. **These are strong ratios.**

Findings

- The City's governmental activities net assets increased \$120.6 million due to revenues exceeding expenses, transfers out and special items since July 1, 2001
- Governmental activities' net assets increased the first five years presented before a small \$1 million decline in 2007.
- All of the growth in net assets occurred in net assets invested in capital assets net of related debt which increased \$21.7 million and in restricted net assets which grew \$53.3 million since June 30, 2002.
- Unrestricted net assets declined from \$12.5 million at June 30, 2002 to a negative \$11.4 million at June 30, 2004, then recovered to a positive \$804,612 at June 30, 2006. It since declined to \$12.5 million in 2007.



- The negative or small unrestricted net asset balances are due to the large long-term liability balances unrelated to the acquisition of capital assets.
 - If the long-term debt were removed from unrestricted net assets, the City's governmental net assets represented \$111 million of unrestricted resources.
- The governmental activities as presented in the government-wide financial statements are healthy and strong.

EXHIBIT I-A
CITY OF MODESTO
ANALYSIS OF GOVERNMENTAL ACTIVITIES' STATEMENT OF ACTIVITIES

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Expenses						
General government	12,084,695	12,557,259	13,954,909	15,273,174	15,529,735	17,227,876
Community development	7,961,413	13,823,955	10,517,243	14,105,411	12,241,213	12,025,105
Highways and streets	18,280,988	19,656,219	23,136,950	23,721,458	26,025,311	26,246,306
Public works	4,645,729	6,843,742	6,458,522	5,263,984	6,491,062	12,557,512
Parks and recreation	15,439,479	16,723,475	12,682,746	13,334,330	11,733,698	14,568,192
Public safety	56,563,084	64,410,214	68,258,235	71,239,341	74,500,043	83,793,361
Interest on long-term liabilities.	4,736,694	4,612,885	4,515,439	4,987,911	5,178,130	7,286,026
Total governmental activities expenses	<u>119,712,082</u>	<u>138,627,749</u>	<u>139,524,044</u>	<u>147,925,609</u>	<u>151,699,192</u>	<u>173,704,378</u>
Program Revenues						
Charges for Services	35,268,849	35,257,694	34,974,310	43,486,604	39,789,386	39,977,342
Operating Grants and Contributions	9,647,912	9,413,521	15,975,814	13,736,453	11,892,511	12,701,177
Capital Grants and Contributions	12,267,976	23,297,198	18,368,908	22,799,320	38,484,548	4,207,389
Total Program Revenues	<u>57,184,737</u>	<u>67,968,413</u>	<u>69,319,032</u>	<u>80,022,377</u>	<u>90,166,445</u>	<u>56,885,908</u>
Net (expense) revenues and change in net assets - Governmental Activities	<u>(62,527,345)</u>	<u>(70,659,336)</u>	<u>(70,205,012)</u>	<u>(67,903,232)</u>	<u>(61,532,747)</u>	<u>(116,818,470)</u>
General revenues, special items and transfers						
Taxes						
Utility users tax	12,516,962	13,732,571	14,659,986	15,621,566	17,583,690	18,319,573
Property taxes - general purposes	9,132,278	10,169,004	11,294,599	11,316,694	14,318,747	16,456,379
Tax increments - redevelopment agency	2,166,680	2,631,695	3,183,871	3,909,452	4,450,836	5,303,521
Transient occupancy tax	2,119,804	2,097,901	2,110,909	2,098,303	2,181,467	2,264,699
Franchise Tax	3,079,286	3,360,976	3,455,535	3,420,453	3,693,307	3,823,216
Business license tax, levied for general purposes	8,734,281	9,238,797	9,231,136	9,726,816	10,374,157	10,359,058
Business license tax, levied for downtown improvement districts	166,719	172,847	190,644	201,308	214,022	221,487
Subtotal	<u>37,916,010</u>	<u>41,403,791</u>	<u>44,126,680</u>	<u>46,294,592</u>	<u>52,816,226</u>	<u>56,747,933</u>
Taxes reported as grants and other contributions						
Sales tax	27,061,426	25,887,064	27,151,779	26,589,449	29,627,835	27,884,852
Motor vehicle license fees	10,735,611	11,746,283	9,052,449	16,403,864	14,986,883	16,233,262
Total taxes	<u>75,713,047</u>	<u>79,037,138</u>	<u>80,330,908</u>	<u>89,287,905</u>	<u>97,430,944</u>	<u>100,866,047</u>
Grants and contributions not restricted to specific programs	1,750,311	922,237	1,204,485	1,702,234	4,070,593	4,169,354
Unrestricted investment earnings	5,384,392	3,645,205	1,004,974	4,463,080	3,255,401	8,330,079
Miscellaneous revenues	1,111,982	2,220,976	2,479,871	3,792,340	2,827,161	3,582,325
Total general revenues and special items	<u>83,959,732</u>	<u>85,825,556</u>	<u>85,020,238</u>	<u>99,245,559</u>	<u>107,584,099</u>	<u>116,947,805</u>
Transfers	(671,690)	(1,824,890)	(1,902,932)	(1,306,914)	(1,416,790)	(1,153,632)
Total General Revenues, special items and transfers	<u>83,288,042</u>	<u>84,000,666</u>	<u>83,117,306</u>	<u>97,938,645</u>	<u>106,167,309</u>	<u>115,794,173</u>
Change in Net Assets - increase (decrease)	<u>20,760,697</u>	<u>13,341,330</u>	<u>12,912,294</u>	<u>30,035,413</u>	<u>44,634,562</u>	<u>(1,024,297)</u>
Net Assets - beginning of year	303,965,906	324,726,603	327,453,927	340,366,221	370,401,634	415,036,196
Prior period adjustments, net	0	(10,614,006)				
Net Assets - beginning of year as restated	<u>303,965,906</u>	<u>314,112,597</u>	<u>327,453,927</u>	<u>340,366,221</u>	<u>370,401,634</u>	<u>415,036,196</u>
Net Assets - end of year	<u>324,726,603</u>	<u>327,453,927</u>	<u>340,366,221</u>	<u>370,401,634</u>	<u>415,036,196</u>	<u>414,011,899</u>

EXHIBIT I-B
CITY OF MODESTO
ANALYSIS OF GOVERNMENTAL ACTIVITIES' STATEMENT OF NET ASSETS

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Assets						
Unrestricted Cash and Investments	108,622,782	123,757,181	125,211,205	144,589,534	179,383,700	176,305,862
Other Current assets	38,361,875	33,841,838	35,664,720	34,976,039	39,366,070	43,034,925
Total current assets	<u>146,984,657</u>	<u>157,599,019</u>	<u>160,875,925</u>	<u>179,565,573</u>	<u>218,749,770</u>	<u>219,340,787</u>
Investment in joint ventures	17,593,206	17,897,935	17,445,367	17,942,115	16,423,042	16,636,600
Capital Assets	317,132,687	324,840,552	343,924,335	355,069,868	362,971,175	376,422,992
Total assets	<u><u>481,710,550</u></u>	<u><u>500,337,506</u></u>	<u><u>522,245,627</u></u>	<u><u>552,577,556</u></u>	<u><u>598,143,987</u></u>	<u><u>612,400,379</u></u>
Liabilities						
Current liabilities plus current portion of long-term debt	27,956,468	24,188,075	25,431,817	23,238,621	25,534,945	31,798,394
Non-current liabilities	129,027,479	148,695,504	156,447,589	158,937,301	157,572,846	166,590,086
Total liabilities	<u>156,983,947</u>	<u>172,883,579</u>	<u>181,879,406</u>	<u>182,175,922</u>	<u>183,107,791</u>	<u>198,388,480</u>
Current Asset to Current Liability Ratio	<u>5.26</u>	<u>6.52</u>	<u>6.33</u>	<u>7.73</u>	<u>8.57</u>	<u>6.90</u>
Analysis of Net Assets						
Invested in capital assets, net of related debt	247,734,751	259,156,770	275,171,096	288,391,776	296,401,824	333,409,532
Restricted Capital projects	40,169,398	50,064,853	48,796,917	48,590,964	78,526,510	58,413,311
Housing and community development	0	14,039,393	18,748,098	19,807,913	18,188,683	22,222,295
Other purposes	24,309,054	1,662,330	9,032,111	20,326,464	21,114,567	12,533,058
Total restricted	<u>64,478,452</u>	<u>65,766,576</u>	<u>76,577,126</u>	<u>88,725,341</u>	<u>117,829,760</u>	<u>93,168,664</u>
Unrestricted	<u>12,513,400</u>	<u>2,530,581</u>	<u>(11,382,001)</u>	<u>(6,715,483)</u>	<u>804,612</u>	<u>(12,566,297)</u>
Net Assets - end of year	<u><u>324,726,603</u></u>	<u><u>327,453,927</u></u>	<u><u>340,366,221</u></u>	<u><u>370,401,634</u></u>	<u><u>415,036,196</u></u>	<u><u>414,011,899</u></u>
1 Long-term debt - non-current portion	129,027,479	148,695,504	156,447,589	158,937,301	157,572,846	166,590,086
2 Capital assets	317,132,687	324,840,552	343,924,335	355,069,868	362,971,175	376,422,992
3 Less: net assets invested in capital assets, net of related debt	<u>(247,734,751)</u>	<u>(259,156,770)</u>	<u>(275,171,096)</u>	<u>(288,391,776)</u>	<u>(296,401,824)</u>	<u>(333,409,532)</u>
4 Related debt invested in capital assets (line 2 minus line 3)	<u>69,397,936</u>	<u>65,683,782</u>	<u>68,753,239</u>	<u>66,678,092</u>	<u>66,569,351</u>	<u>43,013,460</u>
5 Debt unrelated to capital assets applied to unrestricted net assets (line 1 minus line 4)	59,629,543	83,011,722	87,694,350	92,259,209	91,003,495	123,576,626
6 Unrestricted net assets	<u>12,513,400</u>	<u>2,530,581</u>	<u>(11,382,001)</u>	<u>(6,715,483)</u>	<u>804,612</u>	<u>(12,566,297)</u>
7 Unrestricted net assets net of debt unrelated to capital assets (line 5 plus line 6)	<u><u>72,142,943</u></u>	<u><u>85,542,303</u></u>	<u><u>76,312,349</u></u>	<u><u>85,543,726</u></u>	<u><u>91,808,107</u></u>	<u><u>111,010,329</u></u>

EXHIBIT I-C
CITY OF MODESTO
RATIO ANALYSIS OF GOVERNMENTAL ACTIVITIES

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
	<i>(All figures in 000's of Dollars)</i>					
Total Revenues						
Program revenues - from Exhibit I-A	57,184,737	67,968,413	69,319,032	80,022,377	90,166,445	56,885,908
Total General Revenues, special items and transfers - from Exhibit I-A	<u>83,959,732</u>	<u>85,825,556</u>	<u>85,020,238</u>	<u>99,245,559</u>	<u>107,584,099</u>	<u>116,947,805</u>
	<u>141,144,469</u>	<u>153,793,969</u>	<u>154,339,270</u>	<u>179,267,936</u>	<u>197,750,544</u>	<u>173,833,713</u>
Program expenses - from Exhibit I-A	<u>119,712,082</u>	<u>138,627,749</u>	<u>139,524,044</u>	<u>147,925,609</u>	<u>151,699,192</u>	<u>173,704,378</u>
% of unrestricted net assets net of debt unrelated to capital assets to total revenues	51.11%	55.62%	49.44%	47.72%	46.43%	63.86%
% of unrestricted net assets net of unrelated debt to capital assets to expenses	60.26%	61.71%	54.69%	57.83%	60.52%	63.91%



EXHIBIT II

The amounts for **Exhibit II** were obtained from the statistical section of the 2005 and the 2006 CAFRs. This exhibit is an analysis of the **revenues** for the City's governmental type funds. The various revenues are shown as they were originally reported in the governmental fund financial statements in the year they occurred. **As such, these revenues are reported using the modified accrual method of accounting. Since the government-wide financial statements use the accrual method of accounting, there will be substantial differences between the revenues as shown in Exhibit I and the revenues shown in this exhibit.** Furthermore, during the ten years presented in our exhibits several of these components have changed what is included in their total and how it is computed. If possible, we will identify the changes in the computation of these components in our narrative.

Beginning with the June 30, 2006 CAFR, the City adopted GASB 44 – Economic Condition Reporting: The Statistical Section. **With the adoption of GASB 44, the City changed its presentation of and what it included in its general governmental ten-year revenues schedules.**

- Prior to 2006, the **governmental revenue schedules did not include capital project fund group revenues**, it only included the general fund, the special revenue fund group and debt service fund group revenues.
- Beginning in 2006, the City's ten-year revenue schedule include the revenues for all governmental fund groups; the general fund, the special revenue fund group, the capital projects fund group and the debt service fund group and increased the number of types of revenues it reported in this schedule.
- Due to these changes, the City elected to show five years of revenues in this schedule beginning with the year ended June 30, 2002.

We have calculated both the annual increase from the prior year and the internal rate of return (IRR) for both the ten year period since 1995 and the five year period since 2000 in Exhibit II-A and the six year period in exhibit II-B. The internal rate of return is the implied investment rate an investment would change from the beginning of a period to the end of a period.

Furthermore, the City did not and does not prepare a separate ten-year schedule analyzing the various tax revenues for its statistical section, but instead consolidates tax revenues into one column in the ten year revenue statistical schedule. This is true for the schedules the City prepared before and after it adopted GASB 44. **Also, in 2002, when the City adopted GASB 34, the City reclassified sales tax revenue and VLF revenues as intergovernmental revenue not restricted to specific programs from tax revenues.** This reclassification drastically reduced tax revenues and increased intergovernmental revenues in the ten-year schedules after 2001. For our analysis of our Exhibit I, we included sales tax revenues and VLF revenues in our discussion of tax revenues. **Our analysis of the ten-year schedules in this exhibit will conform to the City's presentation of its revenues.**



To provide greater insight, we have prepared two exhibits. **Exhibit II-A** analyzes the City's revenues from 1996 to 2005 prior to the adoption of GASB 44 as shown in the 2005 CAFR. **Exhibit II-B** analyzes the City's revenues from 2002 to 2007 after the adoption of GASB 44 as shown in the 2007 CAFR.

As shown in **Exhibit II-A**, tax revenues increased \$17.2 million from \$44.6 million in 1996 to \$61.8 million in 2001, the last year sales tax revenues and VLF revenues were classified as tax revenues. We calculated the IRR from 1996 to 2001 for taxes at 6.74%, a strong rate of return. Intergovernmental revenues experienced strong growth from 1996 to 2001 growing \$6.5 million. We also calculated the IRR for intergovernmental revenues from 1996 to 2001 at 6.14%, a strong rate of return. From 1996 to 2001, tax revenues included sales tax revenues and VLF revenues.

Other revenue categories that have experienced strong growth are fines and forfeitures and charges for services. Overall, the City's total revenues increased from \$73.3 million in 1996 to \$134.1 million at June 30, 2005, an increase of \$60.8 million in nine years. The IRR has been relatively consistent for the nine years since 1996 and the four years since 2001 at 6.94% and 6.76% respectively. Both are strong rates of return.

As shown in **Exhibit II-B**, our analysis of governmental revenues since 2002, there is strong annual growth for the City's total revenues which grew from \$141.4 million to \$194.4 million, an increase of \$53 million. In 2007, total governmental revenues were \$171.6 million.

- The large 2006 revenue increase is due to a one-time receipt of the \$30.5 million "contribution from property owners" we discussed in the previous exhibit.
 - Without this one time revenue, 2006 revenues would have declined by \$6.1 million to \$163.9 million, principally due to a \$9 million decline of intergovernmental revenues.
- The City's tax revenues, which do not include sales tax revenues and VLF revenues, grew from \$37.8 million to \$56.7 million, an increase of \$18.9 million, representing a very healthy IRR of 8.43%.
- The City's largest revenue source, intergovernmental revenues declined by 12.36% in 2006 after three years of strong growth.
 - Per page 10 of the 2006 CAFR, in its MD&A, "vehicle license fees were down \$1.4 million because 2005 included a one-time receipt of \$3.2 million due from the State of California for payments withheld in prior years.
 - The balance of the decline is due to lower grant revenues as several large capital projects were completed in the prior year."
 - In 2007 intergovernmental revenues increased \$1.4 million. Sales tax declined \$1.7 million, but vehicle license fees were up \$1.2 million. The balance of the overall increase is due to higher grant revenues from more aggressive grant billing during the year.



While the City does not present a schedule analyzing the various tax revenues, it did present a separate schedule analyzing the City's assessed property values. Beginning in 2006, the City stopped presenting this table in its statistical section of its CAFR. The change in assessed values is an important economic and revenue indicator for the City's governmental revenues. As such, we disagree with the City's decision to exclude this important economic indicator from its statistical section. We asked for and received the 2006 and 2007 assessed value information from the City.

Analysis of Increases in Assessed Values

Fiscal Year Ended June 30,	Net Assessed Value	% Change From Prior Year
1996	6,970,777,473	N/A
1997	6,997,736,965	0.39%
1998	7,047,953,089	0.72%
1999	7,178,029,378	1.85%
2000	7,487,781,627	4.32%
2001	8,750,391,917	16.86%
2002	9,640,976,604	10.18%
2003	10,305,000,427	6.89%
2004	10,949,571,883	6.25%
2005	11,909,466,329	8.77%
2006	13,247,578,476	11.24%
2007	15,517,700,431	17.14%
Internal rate of return since 1996		<u>7.55%</u>
Internal rate of return since 2001		<u>10.02%</u>

As shown:

- Assessed property values have shown strong annual growth beginning in 2000. In the seven years since 1999, assessed property values annual growth rate exceeded 6% in seven of the eight years and in four of the eight years it exceeded 10%.
- The IRR was 7.55% since 1996 and 10.02% since 2001.

Findings:

- The City's governmental revenues experienced strong growth between 1996 and 2005 with an IRR of 6.94%.



- Revenues increased in 2006 due to the \$30.5 million receipt of “contribution from property owners.” If not for this “contribution” the City’s governmental revenues would have experienced their only decline since 2002.
 - Excluding the “contribution from property owners”, the City’s revenues declined \$6.1 million in 2006 due to decreases in intergovernmental revenues.
- In 2007, total revenues were \$171.6 million. Excluding the \$30.5 million one time contribution from property owners in 2006, 2007 total revenues increased \$7.7 million.
- Tax revenues experienced strong growth since 2002 with an IRR of 8.43%.
- The City’s revenue growth has been healthy.
- The City’s assessed values have experienced strong growth since 1999 through 2007. This growth will modify the declines due to the sub-prime mortgage crisis and housing downturn.

**EXHIBIT II-A
CITY OF MODESTO
ANALYSIS OF GENERAL GOVERNMENT REVENUES**

Fiscal Year Ended June 30,	Total	% Change From Prior Year	Taxes	% Change From Prior Year	Licenses and Permits	% Change From Prior Year	Inter-Governmental	% Change From Prior Year	Charges for Services	% Change From Prior Year
1996	73,333,043	N/A	44,607,144	N/A	207,969	N/A	18,837,062	N/A	4,291,429	N/A
1997	76,186,298	3.89%	44,796,523	0.42%	178,291	(14.27%)	20,842,290	10.65%	5,852,125	36.37%
1998	77,282,776	1.44%	47,574,649	6.20%	132,659	(25.59%)	19,405,954	(6.89%)	5,660,069	(3.28%)
1999	87,338,575	13.01%	51,775,542	8.83%	127,182	(4.13%)	24,112,359	24.25%	6,977,522	23.28%
2000	93,740,868	7.33%	55,897,017	7.96%	122,669	(3.55%)	25,250,266	4.72%	7,605,327	9.00%
2001	103,258,626	10.15%	61,810,784	10.58%	183,226	49.37%	25,373,037	0.49%	8,642,823	13.64%
2002	116,893,471	13.20%	37,189,157	(39.83%)	173,348	(5.39%)	58,715,696	131.41%	15,410,128	78.30%
2003	127,484,800	9.06%	40,581,244	9.12%	169,108	(2.45%)	63,361,617	7.91%	16,507,447	7.12%
2004	126,106,574	(1.08%)	43,158,243	6.35%	250,129	47.91%	58,202,271	(8.14%)	18,500,378	12.07%
2005	134,146,238	6.38%	45,152,186	4.62%	128,754	(48.52%)	61,886,143	6.33%	21,644,111	16.99%
Internal rate of return since 1996		<u>6.94%</u>		<u>0.14%</u>		<u>(5.19%)</u>		<u>6.14%</u>		<u>19.70%</u>
Internal rate of return since 2001		<u>6.76%</u>		<u>(7.55%)</u>		<u>(8.44%)</u>		<u>24.97%</u>		<u>25.80%</u>

Fiscal Year Ended June 30,	Special Assessments Levied	% Change From Prior Year	Interest and Rent	% Change From Prior Year	Fines and Forfeits	% Change From Prior Year	Miscellaneous	% Change From Prior Year
1996	251,880	N/A	2,126,551	N/A	661,675	N/A	2,349,333	N/A
1997	285,408	13.31%	1,987,852	(6.52%)	761,451	15.08%	1,482,358	(36.90%)
1998	235,558	(17.47%)	2,205,536	10.95%	965,941	26.86%	1,102,410	(25.63%)
1999	180,314	(23.45%)	1,961,020	(11.09%)	1,329,768	37.67%	874,868	(20.64%)
2000	284,317	57.68%	2,053,260	4.70%	1,280,123	(3.73%)	1,247,889	42.64%
2001	309,649	8.91%	2,738,665	33.38%	1,278,945	(0.09%)	2,921,497	134.12%
2002	823,091	165.81%	2,113,712	(22.82%)	1,055,966	(17.43%)	1,412,373	(51.66%)
2003	2,015,090	144.82%	2,171,490	2.73%	1,030,389	(2.42%)	1,648,415	16.71%
2004	386,368	(80.83%)	1,905,097	(12.27%)	1,294,193	25.60%	2,409,895	46.19%
2005	107,696	(72.13%)	2,085,993	9.50%	1,646,472	27.22%	1,494,883	(37.97%)
Internal rate of return since 1996		<u>(9.01%)</u>		<u>(0.21%)</u>		<u>10.66%</u>		<u>(4.90%)</u>
Internal rate of return since 2001		<u>(23.21%)</u>		<u>(6.58%)</u>		<u>6.52%</u>		<u>(15.42%)</u>

**EXHIBIT II-B
CITY OF MODESTO
ANALYSIS OF GENERAL GOVERNMENT REVENUES**

Fiscal Year Ended June 30,	Total	% Change From Prior Year	Taxes	% Change From Prior Year	Licenses and Permits	% Change From Prior Year	Inter-Governmental	% Change From Prior Year
2002	141,445,736	N/A	37,855,427	N/A	173,348	N/A	62,726,570	N/A
2003	148,231,979	4.80%	41,405,014	9.38%	169,108	(2.45%)	66,228,880	5.58%
2004	153,836,320	3.78%	44,185,552	6.72%	250,129	47.91%	70,583,373	6.57%
2005	170,052,391	10.54%	46,295,678	4.78%	128,754	(48.52%)	73,889,063	4.68%
2006	194,420,231	14.33%	52,816,596	14.09%	146,854	14.06%	64,759,658	(12.36%)
2007	171,615,967	(11.73%)	56,748,017	7.44%	187,289	27.53%	66,129,862	2.12%
Internal rate of return since 2002		<u>3.94%</u>		<u>8.43%</u>		<u>1.56%</u>		<u>1.06%</u>

Fiscal Year Ended June 30,	Charges for Services	% Change From Prior Year	Special Assessments Levied	% Change From Prior Year	Interest and Rent	% Change From Prior Year	Net Increase in FV of Investments	% Change From Prior Year
2002	33,633,119	N/A	823,091	N/A	3,418,440	N/A	647,793	N/A
2003	31,789,634	(5.48%)	2,015,090	144.82%	3,712,219	8.59%	(339,331)	(152.38%)
2004	33,203,507	4.45%	386,368	(80.83%)	2,911,392	(21.57%)	(1,458,065)	329.69%
2005	41,660,016	25.47%	107,696	(72.13%)	3,146,452	8.07%	186,515	(112.79%)
2006	37,802,149	(9.26%)	65,909	(38.80%)	3,755,169	19.35%	103,036	(44.76%)
2007	36,979,023	(2.18%)	51,634	(21.66%)	4,837,419	28.82%	1,168,857	1034.42%
Internal rate of return since 2002		<u>1.91%</u>		<u>(42.52%)</u>		<u>7.19%</u>		<u>12.53%</u>

Fiscal Year Ended June 30,	Fines and Forfeits	% Change From Prior Year	Contribution From Property owners	% Change From Prior Year	Miscellaneous	% Change From Prior Year
2002	1,055,966	N/A	0	N/A	1,111,982	N/A
2003	1,030,389	(2.42%)	0	N/A	2,220,976	99.73%
2004	1,294,193	25.60%	0	N/A	2,479,871	11.66%
2005	1,646,472	27.22%	0	N/A	2,991,745	20.64%
2006	1,675,926	1.79%	30,473,773	N/A	2,821,161	(5.70%)
2007	2,699,445	61.07%	0	N/A	2,814,421	(0.24%)
Internal rate of return since 2002		<u>20.65%</u>		<u>N/A</u>		<u>20.41%</u>



EXHIBIT III

The **budget** is an economic and political document that prioritizes a government's spending. As the year progresses, budgets are amended due to changing economic conditions, new information or shifting priorities. Amendments can occur up to the date the financial statements are issued. **Exhibit III** demonstrates the transitory and conservative manner in which budgets are made and amended versus what actually happens. A variance is the difference between the budget amounts and the actual amounts. A "favorable" revenue variance occurs when actual revenues exceed budgeted revenues and a "favorable" expenditure variance occurs when budgeted expenditures exceed actual expenditures. "Unfavorable" variances are the opposite of favorable variances.

Revenues

- The City increased the adopted budget revenues each year presented.
 - The amendments increasing the General Fund's budgeted **revenues** each year only reduced five final favorable variances, 2007 to an unfavorable variance, and increased the 2004 unfavorable variance.
 - Except for the \$7.6 million or 7.36% increase in 2006, the revenue increases have been minimal; 1.25% or less.
- The General Fund's adopted budgeted revenues experienced one unfavorable variance and five favorable variances.
 - The unfavorable variance of \$2.2 million occurred in 2004, the year the City loaned \$3.2 million of VLF revenues to the State as part of the budget deal between Governor Schwarzenegger, the cities and the counties.
 - Due to amendments increasing budgeted revenues, the final budget's unfavorable variance increased to \$3.3 million or 3.32% of the final budget revenues.
 - The smallest favorable variance of \$507,000 occurred in 2007, 0.43%. The largest favorable variances occurred in 2005 and 2006 of 4.62% and 11.21% respectively.
- The final budget's favorable variances were smaller than the adopted budgets favorable variances due to the amendments increasing budgeted revenues.

Expenditures

The City's amendments increased the adopted budget's expenditures all six years presented.

- The amendments increasing the General Fund's budgeted **expenditures** each year only increased favorable variances and eliminated the three unfavorable variances when the final budget was compared to actual expenditures.
- The largest adjustment to expenditures occurred in 2007 when budgeted expenditures increased \$5.6 million (4.93% of the adopted budget) and the smallest budgeted expenditures increase of \$1.4 million (1.5% of the adopted budget) occurred in 2002.
- The adopted budgets experienced three favorable variances and three small unfavorable variances.



- The largest favorable variance was 2.81% of the adopted budget in 2002 and the smallest at 2.21% in 2004.
- The unfavorable variances occurred in 2005, 2006 and 2007. The first two unfavorable variances were under 1.25% of the adopted budget and 2007 unfavorable variance was 2.09%.
- The final expenditure budgets experienced larger favorable variances all six years presented due to the amendments that increased the final budget.

Other Financing Sources (Uses)

- The City did not provide budget to actual information for other financing sources (uses). In order to calculate the annual change in the fund balance for the budgets and actual amounts, we used the net actual other financing sources (uses) for the adopted budget and the final budget figures. Both the adopted and final budget amounts for other financing sources (uses) are probably different from the actual amounts for other financing sources (uses).

General Fund Surplus (Deficit)

The City's General Fund experienced favorable variances in four of the six years for the adopted budget and all years for the final budget.

- The favorable variances of the final budget were larger than those of the adopted budget.
- For the adopted budget information, the annual total favorable variances represented the difference between the four large budgeted deficits and two actual surpluses and two smaller actual deficits.
 - The unfavorable variance represented the difference between a larger actual deficit in 2004 and a smaller budgeted deficit.
 - The loan of \$3.2 million of VLF revenues to the State was the cause for the larger actual deficit.
- The General Fund experienced two surpluses and four deficits.
 - The 2002 and 2005 actual deficits were smaller than those projected by the adopted budget.
 - The largest surplus of \$2.9 million occurred in 2006.

We have prepared **Exhibit III-B** to reconcile the General Fund's fund balance at the beginning of the year to its ending fund balance. As shown in this exhibit, changes to the General Fund's fund balance were due to the annual surpluses or deficits. During the period covered by our report, the total fund balance decreased from \$26.7 million at July 1, 2001 to \$14.4 million at June 30, 2007 due to the cumulative GAAP deficit of \$12.3 million.

Findings:

- Neither the adopted budget nor the final budget is predictive of actual results.



- The General Fund's fund balance has decreased \$12.3 million from \$26.7 million to \$14.4 million.
- The adopted budget total variance ranged from a unfavorable \$120,413 to a favorable \$10.3 million.
- The final budget total variance ranged from a favorable \$89,034 to a favorable \$7.3 million.

**EXHIBIT III-A
CITY OF MODESTO
TRANSITORY AND CONSERVATIVE NATURE OF THE BUDGET
GENERAL FUND**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>
REVENUE						
<i>Adopted</i> Budget	93,706,092	98,145,137	97,208,969	101,702,986	103,234,424	117,424,967
Total Amendments	851,285	30,237	1,082,993	1,267,619	7,593,545	3,673,000
<i>Final</i> Budget	<u>94,557,377</u>	<u>98,175,374</u>	<u>98,291,962</u>	<u>102,970,605</u>	<u>110,827,969</u>	<u>121,097,967</u>
% Change from <i>Adopted</i> Budget	<u>0.91%</u>	<u>0.03%</u>	<u>1.11%</u>	<u>1.25%</u>	<u>7.36%</u>	<u>3.13%</u>
<i>Actual</i> - Budgetary Basis	<u>96,503,353</u>	<u>99,156,038</u>	<u>95,029,721</u>	<u>106,397,889</u>	<u>114,810,175</u>	<u>117,932,681</u>
<i>Adopted</i> Revenue Variance	<u>2,797,261</u>	<u>1,010,901</u>	<u>(2,179,248)</u>	<u>4,694,903</u>	<u>11,575,751</u>	<u>507,714</u>
Variance as a % of <i>Adopted</i> Budget	<u>2.99%</u>	<u>1.03%</u>	<u>(2.24%)</u>	<u>4.62%</u>	<u>11.21%</u>	<u>0.43%</u>
<i>Final</i> Revenue Variance	<u>1,945,976</u>	<u>980,664</u>	<u>(3,262,241)</u>	<u>3,427,284</u>	<u>3,982,206</u>	<u>(3,165,286)</u>
Variance as a % of <i>Final</i> Budget	<u>2.06%</u>	<u>1.00%</u>	<u>(3.32%)</u>	<u>3.33%</u>	<u>3.59%</u>	<u>(2.61%)</u>
EXPENDITURES						
<i>Adopted</i> Budget	93,895,170	99,295,346	92,976,895	99,493,306	103,047,338	114,500,159
Total Amendments	1,409,784	3,059,276	3,249,278	2,471,376	4,573,641	5,644,563
<i>Final</i> Budget	<u>95,304,954</u>	<u>102,354,622</u>	<u>96,226,173</u>	<u>101,964,682</u>	<u>107,620,979</u>	<u>120,144,722</u>
% Change from <i>Adopted</i> Budget	<u>1.50%</u>	<u>3.08%</u>	<u>3.49%</u>	<u>2.48%</u>	<u>4.44%</u>	<u>4.93%</u>
<i>Actual</i> - Budgetary Basis	<u>91,261,948</u>	<u>96,500,186</u>	<u>90,918,060</u>	<u>99,623,770</u>	<u>104,287,942</u>	<u>116,890,402</u>
<i>Adopted</i> Expenditure Variance	<u>2,633,222</u>	<u>2,795,160</u>	<u>2,058,835</u>	<u>(130,464)</u>	<u>(1,240,604)</u>	<u>(2,390,243)</u>
Variance as a % of <i>Adopted</i> Budget	<u>2.80%</u>	<u>2.81%</u>	<u>2.21%</u>	<u>(0.13%)</u>	<u>(1.20%)</u>	<u>(2.09%)</u>
<i>Final</i> Expenditure Variance	<u>4,043,006</u>	<u>5,854,436</u>	<u>5,308,113</u>	<u>2,340,912</u>	<u>3,333,037</u>	<u>3,254,320</u>
Variance as a % of <i>Final</i> Budget	<u>4.24%</u>	<u>5.72%</u>	<u>5.52%</u>	<u>2.30%</u>	<u>3.10%</u>	<u>2.71%</u>

**EXHIBIT III-A
CITY OF MODESTO
TRANSITORY AND CONSERVATIVE NATURE OF THE BUDGET
GENERAL FUND**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
OTHER FINANCING SOURCES (USES)						
<i>Adopted</i> Budget	(7,423,036)	(727,637)	(9,534,481)	(7,338,429)	(7,627,777)	(9,902,911)
Total Amendments	0	0	0	0	0	0
<i>Final</i> Budget	<u>(7,423,036)</u>	<u>(727,637)</u>	<u>(9,534,481)</u>	<u>(7,338,429)</u>	<u>(7,627,777)</u>	<u>(9,902,911)</u>
% Change from <i>Adopted</i> Budget	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>
<i>Actual</i> - Budgetary Basis	<u>(7,423,036)</u>	<u>(727,637)</u>	<u>(9,534,481)</u>	<u>(7,338,429)</u>	<u>(7,627,777)</u>	<u>(9,902,911)</u>
<i>Adopted</i> Other Financing Sources (Uses)						
Variance	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Variance as a % of <i>Adopted</i> Budget	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>
<i>Final</i> Other Financing Sources (Uses) Variance	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Variance as a % of <i>Final</i> Budget	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>
TOTAL VARIANCE ADOPTED BUDGET						
Favorable (Unfavorable)	<u>5,430,483</u>	<u>3,806,061</u>	<u>(120,413)</u>	<u>4,564,439</u>	<u>10,335,147</u>	<u>(1,882,529)</u>
Variance as a % of Budgeted Expenditures	<u>5.78%</u>	<u>3.83%</u>	<u>(0.13%)</u>	<u>4.59%</u>	<u>10.03%</u>	<u>(1.64%)</u>
TOTAL VARIANCE FINAL BUDGET						
Favorable (Unfavorable)	<u>5,988,982</u>	<u>6,835,100</u>	<u>2,045,872</u>	<u>5,768,196</u>	<u>7,315,243</u>	<u>89,034</u>
Variance as a % of Budgeted Expenditures	<u>6.28%</u>	<u>6.68%</u>	<u>2.13%</u>	<u>5.66%</u>	<u>6.80%</u>	<u>0.07%</u>
EXCESS (DEFICIENCY) OF ADOPTED BUDGETED REVENUES OVER ADOPTED BUDGETED EXPENDITURES INCLUDING OTHER FINANCIAL SOURCES (USES)	<u>(7,612,114)</u>	<u>(1,877,846)</u>	<u>(5,302,407)</u>	<u>(5,128,749)</u>	<u>(7,440,691)</u>	<u>(6,978,103)</u>
EXCESS (DEFICIENCY) OF FINAL BUDGETED REVENUES OVER FINAL BUDGETED EXPENDITURES INCLUDING OTHER FINANCIAL SOURCES (USES)	<u>(8,170,613)</u>	<u>(4,906,885)</u>	<u>(7,468,692)</u>	<u>(6,332,506)</u>	<u>(4,420,787)</u>	<u>(8,949,666)</u>
EXCESS (DEFICIENCY) OF ACTUAL REVENUES OVER ACTUAL EXPENDITURES INCLUDING OTHER FINANCIAL SOURCES (USES)	<u>(2,181,631)</u>	<u>1,928,215</u>	<u>(5,422,820)</u>	<u>(564,310)</u>	<u>2,894,456</u>	<u>(8,860,632)</u>

**EXHIBIT III-B
CITY OF MODESTO
RECONCILIATION OF GAAP BASIS TO BUDGETARY BASIS OF ACCOUNTING
GENERAL FUND**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
EXCESS (DEFICIENCY) OF REVENUES AND OTHER SOURCES OVER EXPENDITURES, ENCUMBRANCES AND OTHER USES - GAAP BASIS	(2,181,631)	1,928,215	(5,422,820)	(564,310)	2,894,456	(8,860,632)
BEGINNING FUND BALANCE	26,655,605	24,473,974	26,402,189	20,979,369	20,415,059	23,309,515
ENDING FUND BALANCE	<u>24,473,974</u>	<u>26,402,189</u>	<u>20,979,369</u>	<u>20,415,059</u>	<u>23,309,515</u>	<u>14,448,883</u>



EXHIBIT IV

Exhibit IV is an analysis of **transfers to and from the General Fund**.

The City's 2006 footnote on interfund transfers has two errors. First, the transfers from the General Fund are shown as transfers to the General Fund footnotes and the transfers to the General Fund are shown as transfers from the General Fund in the footnote. Second, the transfers from the General Fund as shown in the footnote added are \$810,000 larger than the total in the footnotes and in the financial statements.

Other funds transferred moneys to the General fund over the period covered by our report. It appears that the transfers from the following funds to the General Fund represent revenues that fund expenditures that are the responsibility of the General Fund.

- Water Fund,
- Sewer Fund,
- Other Enterprise Funds.

The General Fund transferred moneys to other funds over the period covered by our report. It appears that the transfers from the General Fund to the following funds expenditures that are the responsibility of the General Fund.

- Sewer Fund,
- Other Enterprise Funds.

Findings:

- It appears that certain transfers to the General Fund represent revenues that fund expenditures that are the responsibility of the General Fund. As such these revenues should be included in the General Fund's revenues when computing the ratio of unreserved fund balance to revenues.
- It appears that certain transfers from the General Fund do represent expenditures that are the responsibility of the General Fund. As such, they should be included expenditures when computing the unreserved fund balance to r expenditures.

EXHIBIT IV
CITY OF MODESTO
ANALYSIS OF GENERAL FUND TRANSFERS

FOR THE YEARS ENDED JUNE 30,

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Funds Making Transfers To the General Fund						
Water	73,500	60,100	215,973	218,902	95,385	65,000
Sewer	73,500	60,000	105,977	131,670	171,932	65,000
Other Enterprise	18,000	18,000	124,270	24,519	18,829	18,000
Adjustments to Revenues	165,000	138,100	446,220	375,091	286,146	148,000
Other governmental	1,674,681	2,223,100	757,098	1,269,886	1,480,779	1,746,022
Internal Service - Employee Benefits	0	1,007,709	431,500	300	0	0
Special Gas Tax Street Improvement	2,797,837	2,693,160	0	0	0	0
Community Facilities Districts	0	0	0	0	0	190,000
Capital Facility Fees	0	326,500	330,500	337,110	345,000	353,000
	<u>4,637,518</u>	<u>6,388,569</u>	<u>1,965,318</u>	<u>1,982,387</u>	<u>2,111,925</u>	<u>2,437,022</u>
Funds Receiving Transfers From the General Fund						
Sewer	169,000	66,000	114,000	228,000	608,400	226,389
Other Enterprise	994,950	1,386,986	859,806	686,551	1,059,288	768,387
Adjustments to expenditures	1,163,950	1,452,986	973,806	914,551	1,667,688	994,776
Other governmental	9,084,909	5,042,820	5,418,033	7,282,515	6,120,902	10,083,447
Water	257,000	154,000	264,000	528,000	0	264,000
Special Gas Tax Street Improvement	760,000	466,400	4,694,050	0	0	0
Capital Facility Fees	0	0	0	127,000	565,772	0
Internal Service - Fleet Management	986,530	0	0	0	0	0
Internal Service - Information & Technology	0	0	150,000	0	0	0
Internal Service	0	0	0	468,750	1,386,150	997,710
	<u>12,252,389</u>	<u>7,116,206</u>	<u>11,499,889</u>	<u>9,320,816</u>	<u>9,740,512</u>	<u>12,339,933</u>



EXHIBIT V

Exhibit V-A analyzes the City's **General Fund's liquidity**. The cash and investments demonstrate the ability to "write the check", and fund balances available demonstrates the availability of funds (unreserved-undesignated), as well as those only designated for administrative priorities. **The cash and investments balance and the fund balances must be compared to each other with the lesser amount of the two being the portion truly available at June 30th of each year.** We have also summarized the General Fund's other assets and liabilities to aid in our analysis.

Assets and Liabilities

The cash and investment balance is affected by other factors besides actual surpluses and deficits. The increase in receivables and other current assets, and the decline in liabilities cause cash and investments to decline, which can offset an actual surplus or increase the effects of a deficit. The opposite is true for decreasing receivables and other current assets, and the growth of liabilities which increase cash and investment balances.

As shown in this Exhibit, after growing from \$17.3 million at June 30, 2002 to \$19 million at June 30, 2003, cash and investments dramatically decreased the next four years to \$1.9 million at June 30, 2007. The following factors affected the General Fund's cash and investment balances during the period covered by our report.

- The growth of cash and investments in 2003 was due to the operating surplus that year.
- The \$7.9 million cash and investments decrease in 2004 was due to the \$5.4 million deficit and the \$2.7 million decrease in accounts payable.
- Cash and investments declined in 2005, 2006 and 2007 for different reasons.
 - The 2005 and 2007 the actual operating deficits were the primary reasons for the declines.
 - The \$4.3 million growth of other assets in 2006 nullified that year's operating surplus resulting in the decline of cash and investments.
- Since 2002, the \$6.9 million growth in other assets has aided in the decline in cash and investments.
 - The largest increase occurred in due from other funds, short-term loans to other funds, which grew from \$1.7 million to \$4.3 million at June 30, 2007.
 - Taxes receivable grew from \$7.9 million to \$9.2 million.
- The decline in cash and investments to \$1.9 million is a serious financial concern.

Asset to Liability Ratio

As a rule, financial health would dictate that both total assets and this ratio increase or maintain over time. If the ratio is already healthy, it should remain relatively constant. Though this ratio can vary widely due to the timing of tax, grant collections or the payment of bills, any large drop should be explained. A ratio barely over 1 leaves very little fund balances, and a ratio below 1 is a serious problem. The City of Modesto's General Fund's Asset to Liability ratio fluctuated



during the six years covered by our report ranging from a high of 4.83 at June 30, 2002 to a low of 2.82 at June 30, 2007, meaning that for every \$1 of liability, the General Fund has \$2.82 of assets. The City's ratios have been strong in all years presented.

Fund Balance

While the rise and decline of cash and investments are affected by several factors, as shown in Exhibit III the change in the total fund balance is primarily due to the fund's actual surpluses or deficits. Other important highlights:

- The reserved portion of the fund balance fluctuated during the period covered by our report between \$2 million at June 30, 2002 and \$3.7 million at June 30, 2007.
- Since 2002, the total fund balance declined \$10 million with the entire decline occurring in the unreserved fund balance.
- Since 2002, the unreserved fund balance fell \$11.8 million, with \$9.9 million of the decline occurring in 2007.

Exhibit V-B is a graphic representation of the General Fund's cash and investments and fund balances.

Findings:

- The City's General Fund cash and investment balance declined significantly from its high of \$19 million in 2003 to \$1.9 million in 2007.
 - The decline was due to the cumulative deficit and increases in receivables and due from other funds.
- The unreserved fund balance declined from 2002 through 2007 by \$10 million.
- These declines represent a weakening of the City's General Fund's resources, and cause serious concerns regarding the City's financial health.
- The City's General Fund is declining toward the City Council's 8% reserve level.

**EXHIBIT V-A
CITY OF MODESTO
GENERAL FUND**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Assets						
Cash and investments	17,355,651	19,053,785	11,110,511	10,840,532	9,141,367	1,900,218
Other assets	13,510,680	15,603,666	15,749,560	17,373,241	21,639,145	20,490,084
Total Assets	<u>30,866,331</u>	<u>34,657,451</u>	<u>26,860,071</u>	<u>28,213,773</u>	<u>30,780,512</u>	<u>22,390,302</u>
Liabilities	<u>6,392,357</u>	<u>8,255,262</u>	<u>5,880,702</u>	<u>7,798,714</u>	<u>7,470,997</u>	<u>7,941,419</u>
Asset to liability ratio	<u>4.83</u>	<u>4.20</u>	<u>4.57</u>	<u>3.62</u>	<u>4.12</u>	<u>2.82</u>
Fund Balance						
Reserved for:						
Encumbrances	1,199,977	1,394,218	1,067,205	985,474	965,905	1,433,483
Petty cash	6,800	8,780	14,180	0	0	0
Loan programs	92,283	92,283	92,283	92,283	92,283	0
Interfund advances	662,001	1,898,279	2,153,901	1,877,297	1,644,193	2,301,490
Total reserved	<u>1,961,061</u>	<u>3,393,560</u>	<u>3,327,569</u>	<u>2,955,054</u>	<u>2,702,381</u>	<u>3,734,973</u>
Unreserved						
Unreserved - designated for						
Pending projects	730,000	730,000	1,556,340	825,000	0	0
Subsequent year expenditures	3,200,000	4,839,586	4,434,359	5,412,000	5,900,886	0
Departmental savings	1,646,555	1,238,410	0	0	0	0
Unreserved - Undesignated	<u>16,936,358</u>	<u>16,200,633</u>	<u>11,661,101</u>	<u>11,223,005</u>	<u>14,706,248</u>	<u>10,713,910</u>
Total Unreserved Balance	<u>22,512,913</u>	<u>23,008,629</u>	<u>17,651,800</u>	<u>17,460,005</u>	<u>20,607,134</u>	<u>10,713,910</u>
Total Fund Balance	<u>24,473,974</u>	<u>26,402,189</u>	<u>20,979,369</u>	<u>20,415,059</u>	<u>23,309,515</u>	<u>14,448,883</u>

**EXHIBIT V-B
CITY OF MODESTO
ANALYSIS OF GENERAL FUND'S FUND BALANCE**

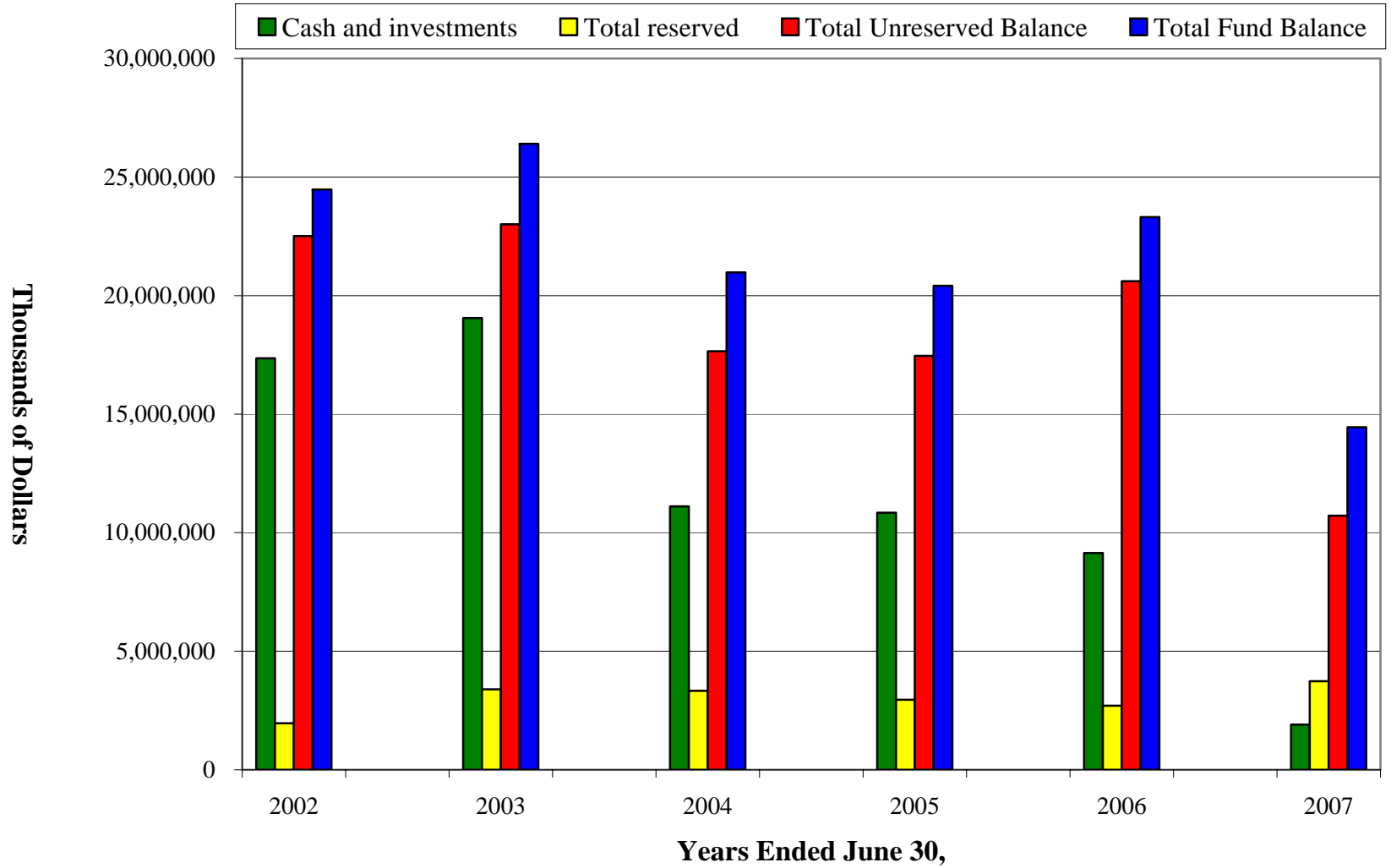




EXHIBIT VI

Exhibit VI calculates two ratios, the **General Fund’s unreserved fund balance to its annual revenues** and **General Fund’s unreserved fund balance to its annual expenditures**, and compares them to historical benchmarks. The ratios calculated in this exhibit are intended to serve as a measure of resources available so they can be compared to a benchmark or standard in determining the financial health of the General Fund. Historically, a 5% ratio of the unreserved fund balance to either its annual revenues or expenditures has been considered the minimum ratio in determining a healthy fund balance.

Cities sometimes classify as reserves to fund balances items that more properly should be classified as designations to the unreserved fund balances. In these instances, the improperly classified reserves should be included in the unreserved fund balance in order to calculate the ratios of the unreserved fund balance to either revenues or expenditures. We have reviewed the General Fund’s reserved fund balance and in our opinion the reserved fund balances meet the criteria of a reserved fund balance. As such, no adjustments are needed to the unreserved fund balance.

Transfers to or from the General Fund should be analyzed to determine if they are regular, continuing, and whether they are a funding responsibility of the General Fund. Transfers to the General Fund that meet these criteria should be included in revenues and transfers from the General Fund should be included in expenditures.

We have determined in our analysis of transfers in **Exhibit IV** that the several transfers to the General Fund should be included in revenues. The following table shows our calculation of adjusted revenues.

Computation of Adjusted Revenues

Fiscal Year Ended June 30,	Revenues	Adjustments From Exhibit IV	Adjusted Revenues
2002	96,503,353	165,000	96,668,353
2003	99,156,038	138,100	99,294,138
2004	95,029,721	446,220	95,475,941
2005	106,397,889	375,091	106,772,980
2006	114,810,175	286,146	115,096,321
2007	117,932,681	148,000	118,080,681



We have also determined that certain transfers from the General Fund should be included in expenditures in order to compute the 5% benchmark. The following table shows our calculation of the adjusted expenditures.

Computation of Adjusted Expenditures

Fiscal Year Ended June 30,	Expenditures	Adjustments From Exhibit IV	Adjusted Expenditures
2002	91,261,948	1,163,950	92,425,898
2003	96,500,186	1,452,986	97,953,172
2004	90,918,060	973,806	91,891,866
2005	99,623,770	914,551	100,538,321
2006	104,287,942	1,667,688	105,955,630
2007	116,890,402	994,776	117,885,178

Exhibit VI-A computes the ratio of the unreserved fund balance to adjusted revenues and the unreserved balance to adjusted expenditures ratio and compares them to the 5% benchmark for both revenues and expenditures for each year presented in our report. The unreserved/undesignated balance of \$10,713,910 represents 9.07% of General Fund's revenues and 9.09% of the expenditures. The City Council has adopted a goal of maintaining an 8% reserve level of unreserved fund balance to expenditures.

Findings:

- From June 30, 2002 the revenue ratio declined from 23.29% at June 30, 2002 to 16.35% at June 30, 2005, and then increased to 17.9% at June 30, 2006. The large deficit in 2007 reduced the revenue ratio to 9.07%.
- The movement of General Fund's expenditure ratio mirrored that of the revenue ratio; declining from 24.36% at June 30, 2002 to 17.37% at June 30, 2005 then growing to 19.45% at June 30, 2006. In 2007 this ratio fell to 9.09%.
- Both ratios are still above the 8% level required by the City Council and the 5% historical benchmark, but the declining trend over the six year period covered by our report is disturbing.

Exhibit VI-B and **Exhibit VI-C** are graphic representations of Exhibit V-A data.

**EXHIBIT VI-A
CITY OF MODESTO**

% OF FUND BALANCE TO GENERAL FUND REVENUES AND EXPENDITURES

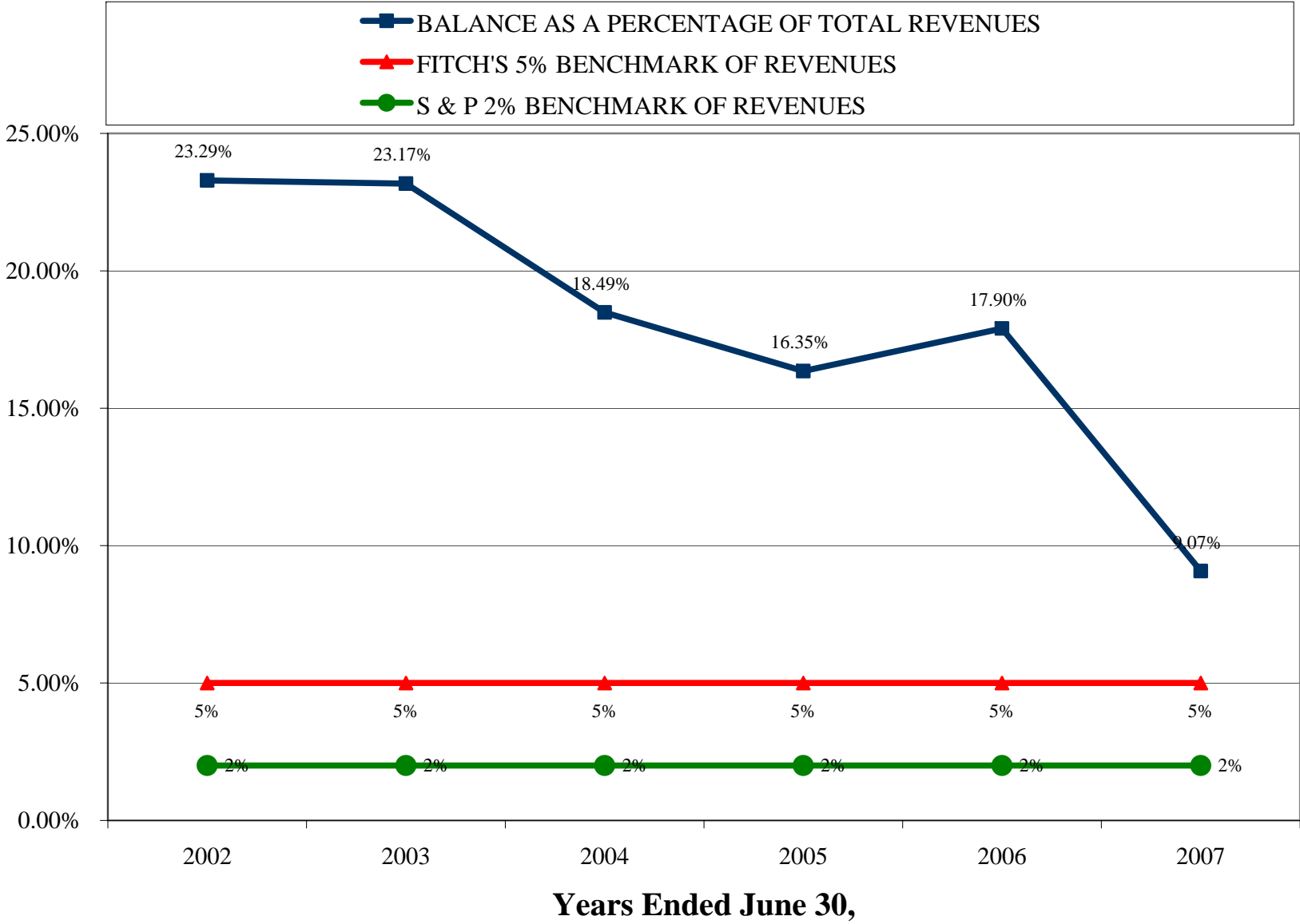
UNRESERVED FUND BALANCE TO REVENUES

<i>YEAR ENDED JUNE 30,</i>	<i>UNRESERVED FUND BALANCE</i>	<i>ADJUSTED GAAP REVENUES</i>	<i>BALANCE AS A PERCENTAGE OF TOTAL REVENUES</i>	<i>5% OF REVENUES</i>	<i>UNRESERVED FUND BALANCE IN EXCESS OF 5% OF REVENUES</i>
2002	22,512,913	96,668,353	23.29%	4,833,418	17,679,495
2003	23,008,629	99,294,138	23.17%	4,964,707	18,043,922
2004	17,651,800	95,475,941	18.49%	4,773,797	12,878,003
2005	17,460,005	106,772,980	16.35%	5,338,649	12,121,356
2006	20,607,134	115,096,321	17.90%	5,754,816	14,852,318
2007	10,713,910	118,080,681	9.07%	5,904,034	4,809,876

UNRESERVED FUND BALANCE TO EXPENDITURES

<i>YEAR ENDED JUNE 30,</i>	<i>UNRESERVED FUND BALANCE</i>	<i>ADJUSTED GAAP EXPENDITURES</i>	<i>BALANCE AS A PERCENTAGE OF TOTAL EXPENDITURES</i>	<i>5% OF EXPENDITURES</i>	<i>UNRESERVED FUND BALANCE IN EXCESS OF 5% OF EXPENDITURES</i>
2002	22,512,913	92,425,898	24.36%	4,621,295	17,891,618
2003	23,008,629	97,953,172	23.49%	4,897,659	18,110,970
2004	17,651,800	91,891,866	19.21%	4,594,593	13,057,207
2005	17,460,005	100,538,321	17.37%	5,026,916	12,433,089
2006	20,607,134	105,955,630	19.45%	5,297,782	15,309,352
2007	10,713,910	117,885,178	9.09%	5,894,259	4,819,651

**EXHIBIT VI-B
CITY OF MODESTO
UNRESERVED FUND BALANCE AS A % OF TOTAL REVENUES**



**EXHIBIT VI-C
CITY OF MODESTO
UNRESERVED FUND BALANCE AS A % OF TOTAL EXPENDITURES**

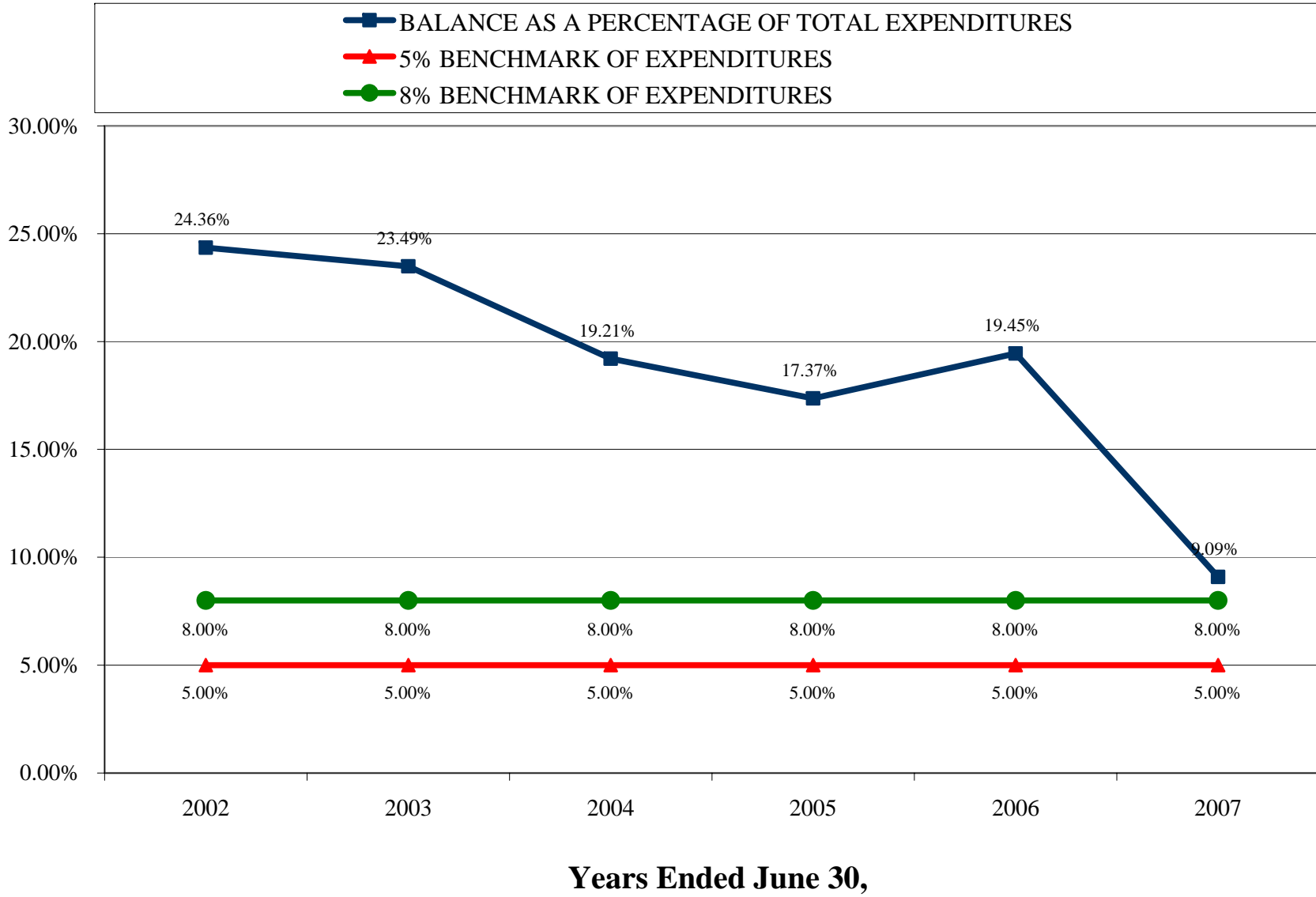




EXHIBIT VII

Enterprise Funds are funds that are similar to businesses in the private sector since they are intended to be self-supporting through user charges to the public. Future plant acquisitions, debt service payments on bonds used to finance plant expansion, and expenses are to be paid from the revenues generated by the business operations. Enterprise Funds are the business-type activities on the Government-wide financial statements.

This Exhibit VII-A analyzes the City of Modesto two major Enterprise Funds, the **Water Fund** and the **Sewer Fund**, and the nonmajor enterprise funds as a group.

The **Water Fund** is the City's largest enterprise fund and accounts for all revenues collected by the City for the purpose of financing the construction, operation, and maintenance of the City water distribution system. Revenues are derived from water service charges and various installation fees.

Since July 1, 2001, this fund's net assets increased from \$61.5 million to \$102.7 million at June 30, 2007, due to revenues exceeding expenses and transfers out.

- After increasing \$2 million in 2002 to \$63.5 million, the net assets declined to \$58.6 million at June 30, 2003 due a \$5.3 million prior period adjustment.
 - If not for this prior period adjustment, this fund's net assets would have increased \$437,156.
- Net assets grew the next two years to \$64.7 million at June 30, 2005 then jumped \$17.6 million to \$82.3 million in 2006 and another \$20.4 million in 2007 due to the annual revenues exceeding expenses.
 - The large 2006 net asset increase was due, per page 9 of the CAFR, to a 20% water rate increase that took affect on July 1, 2005 which caused charges for service to grow from \$31.3 million in 2005 to \$42.6 million in 2006.
 - Water revenue grew to \$49.3 million in 2007.

Since 2005, the Water Fund's cash and investments have recovered from the large decline from \$24.1 million at June 30, 2002 to \$11.7 million at June 30, 2005.

- From \$24.1 million at June 30, 2002, cash and investments declined in each of the next three years to \$11.7 million at June 30, 2005.
- The annual decreases are due to the acquisition and construction of capital assets. From 2002 capital assets grew after depreciation from \$63.1 million to \$72.4 million at June 30, 2005, and to the payoff of liabilities which declined from \$28 million to \$25.5 million.
- Cash and investments increased to \$23.8 million in 2006, due to the \$17.6 million net asset increase.
- In 2007, cash and investments increased \$17.8 million due to the 2007 net asset increase.



In 2007 the Water Fund issued \$46.3 million of Certificates of Participation (COPs). The proceeds from this new debt will be used to construct new downstream water facilities and various water distribution system improvements in connection with Modesto Irrigation District's expansion of the regional water treatment plant. As of June 30, 2007, most of the proceeds from this debt issue were recorded as restricted cash and investments in non-current assets.

The Water Fund's strong financial ratios rebounded from the declines of 2002 to 2004.

- This fund's current asset to current liability ratio, though it declined, remained strong and has recovered.
 - As of June 30, 2006 this ratio was 24.86, meaning that for every \$1 of liability this fund had \$24.86 of current assets.
- The fund maintained a strong ratio of the unrestricted net assets to expenses that at June 30, 2007 stood at 1.35, representing more than 15 months of liquidity.
- The cash and investments to expenses is also strong at 1.19, means that this fund's cash and investments exceed fourteen months of the fund's 2007's expenses.

The Water Fund has substantial financial resources and is very healthy.

Many of the MCEA members wages are employed by the Water Fund, and as such their wages are paid by the Water Fund strong financial resources and revenues derived from charges to the public for water service, not by taxes. **This fund can afford wage increases for its MCEA employees.**

The **Sewer Fund** accounts for revenues collected by the City for the purpose of financing the construction, operation, and maintenance of the City sewer system. Revenues include, but are not limited to, sewer service charges and sewer lateral charges.

The rise and decline of this fund's net assets and the cash and investments is due to the annual increase or decrease in net assets.

- Both cash and investments, and net assets declined in the year ended June 30, 2002 by \$1.2 million due to expenses exceeding revenues.
- Since July 1, 2002, net assets increased from \$105.9 million to \$130 million at June 30, 2007. Cash and investments grew from \$13.5 million at June 30, 2002 to \$27.4 million at June 30, 2006 before a small decline to \$26.8 million in 2007.
 - The increase is due to the annual increase in net assets.
 - Since June 30, 2002 revenues exceeded expenses and transfers out by \$24.1 million.
- From June 30, 2002 to June 30, 2006, the fund's total liabilities, principally long-term liabilities, declined \$7.2 million.
 - In 2007, the City issued \$16.5 million of Wastewater Revenue Bonds. Most of these proceeds have not been spent and have been classified as restricted cash and investments in non-current assets.



This fund has maintained strong financial ratios that have improved substantially through 2006, but declined slightly in 2007.

- This fund's already strong current asset to current liability ratio improved in each of the first five years since June 30, 2002 from 5.44 to 12.62 at June 30, 2006. The decline to 6.01 is due to current liabilities more the doubling in 2007.
- This fund's cash and investments to expenses ratio and unrestricted net assets to expenses ratio has increased during the period covered by our report.
 - The cash and investments to expenses ratio grew from 0.59 at June 30, 2002 to 1.19 at June 30, 2006, declining slightly to 1.15 at June 30, 2007. This means that this fund's cash in investments exceeded over fourteen months of expenses.
 - The unrestricted net assets to expenses ratio experienced greater growth since 2002 from a ratio of 0.43 to 1.31 at June 30, 2006 before declining to 1.17 in 2007, meaning a liquidity of almost fourteen months.

The Sewer Fund has strong financial reserves and is very healthy.

Many of the MCEA members wages are employed by the Sewer Fund, and as such their wages are paid by the Sewer Fund strong financial resources and revenues derived from charges to the public for water service, not by taxes. **This fund can afford wage increases for its MCEA employees.**

From June 30, 2002 to June 30, 2006 the City had seven nonmajor funds: the **Parking Fund**, the **Storm Drain Fund**, the **Compost Fund**, the **Airport Fund**, the **Bus Fund**, the **Golf Fund** and the **Community Center Fund**. In 2007, the Bus Fund became a major fund. For consistency, we included the Bus Fund in our analysis of the City's nonmajor funds. We did not prepare separate schedules to analyze these funds due to their size. The Golf Fund is the only fund that does not have employees. Furthermore two funds, the Golf Fund and the Community Center Fund, receive subsidies from the General Fund. These nonmajor funds have healthy cash and investments and unrestricted net asset balances relative to their size. This includes the Golf Fund which has a negative net asset balance due to a large negative net assets invested in capital assets net of related debt. **These funds are healthy and can afford wage increases for their employees.**

Exhibit VII-B to Exhibit VII-D are graphic representations of the Enterprise Funds' cash and investments and net assets.

Finding:

- The Water Fund and the Sewer Fund have strong reserves and cash balances and can afford to pay wage increases for union members.
- The 20% water rate increase has strengthened the financial health of the Water Fund.

**EXHIBIT VII-A
CITY OF MODESTO
SELECTED ENTERPRISE FUNDS**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Water Assets						
Unrestricted cash and investments	24,104,080	16,771,817	12,551,612	11,656,070	23,822,691	41,572,247
Other current assets	3,496,031	3,340,895	3,715,222	5,316,522	6,424,895	7,490,638
Total current assets	<u>27,600,111</u>	<u>20,112,712</u>	<u>16,266,834</u>	<u>16,972,592</u>	<u>30,247,586</u>	<u>49,062,885</u>
Non-current assets	812,651	784,628	770,262	755,711	904,723	43,660,040
Capital assets	63,122,285	65,465,384	68,876,220	72,397,332	76,069,691	79,907,135
Total Assets	<u><u>91,535,047</u></u>	<u><u>86,362,724</u></u>	<u><u>85,913,316</u></u>	<u><u>90,125,605</u></u>	<u><u>107,222,000</u></u>	<u><u>172,630,060</u></u>
Liabilities						
Current liabilities	1,790,862	2,381,651	2,188,640	1,952,103	2,236,821	1,973,344
Non-current liabilities	26,232,688	25,340,447	24,440,646	23,507,802	22,688,465	67,943,177
	<u>28,023,550</u>	<u>27,722,098</u>	<u>26,629,286</u>	<u>25,459,905</u>	<u>24,925,286</u>	<u>69,916,521</u>
Current Assets to Liability Ratio	<u>15.41</u>	<u>8.44</u>	<u>7.43</u>	<u>8.69</u>	<u>13.52</u>	<u>24.86</u>
Net Assets						
Invested in capital assets net of related debt	39,442,590	42,493,054	46,331,584	50,641,533	55,148,573	55,702,450
Unrestricted (deficit)	24,068,907	16,147,572	12,952,446	14,024,167	27,148,141	47,011,089
Net Assets	<u>63,511,497</u>	<u>58,640,626</u>	<u>59,284,030</u>	<u>64,665,700</u>	<u>82,296,714</u>	<u>102,713,539</u>
Annual expenses	<u>27,410,520</u>	<u>29,229,673</u>	<u>28,149,234</u>	<u>30,575,372</u>	<u>29,981,234</u>	<u>34,835,157</u>
Ratio of cash and investments to expenses	<u>0.88</u>	<u>0.57</u>	<u>0.45</u>	<u>0.38</u>	<u>0.79</u>	<u>1.19</u>
Ratio of unrestricted net assets to expenses	<u>0.88</u>	<u>0.55</u>	<u>0.46</u>	<u>0.46</u>	<u>0.91</u>	<u>1.35</u>

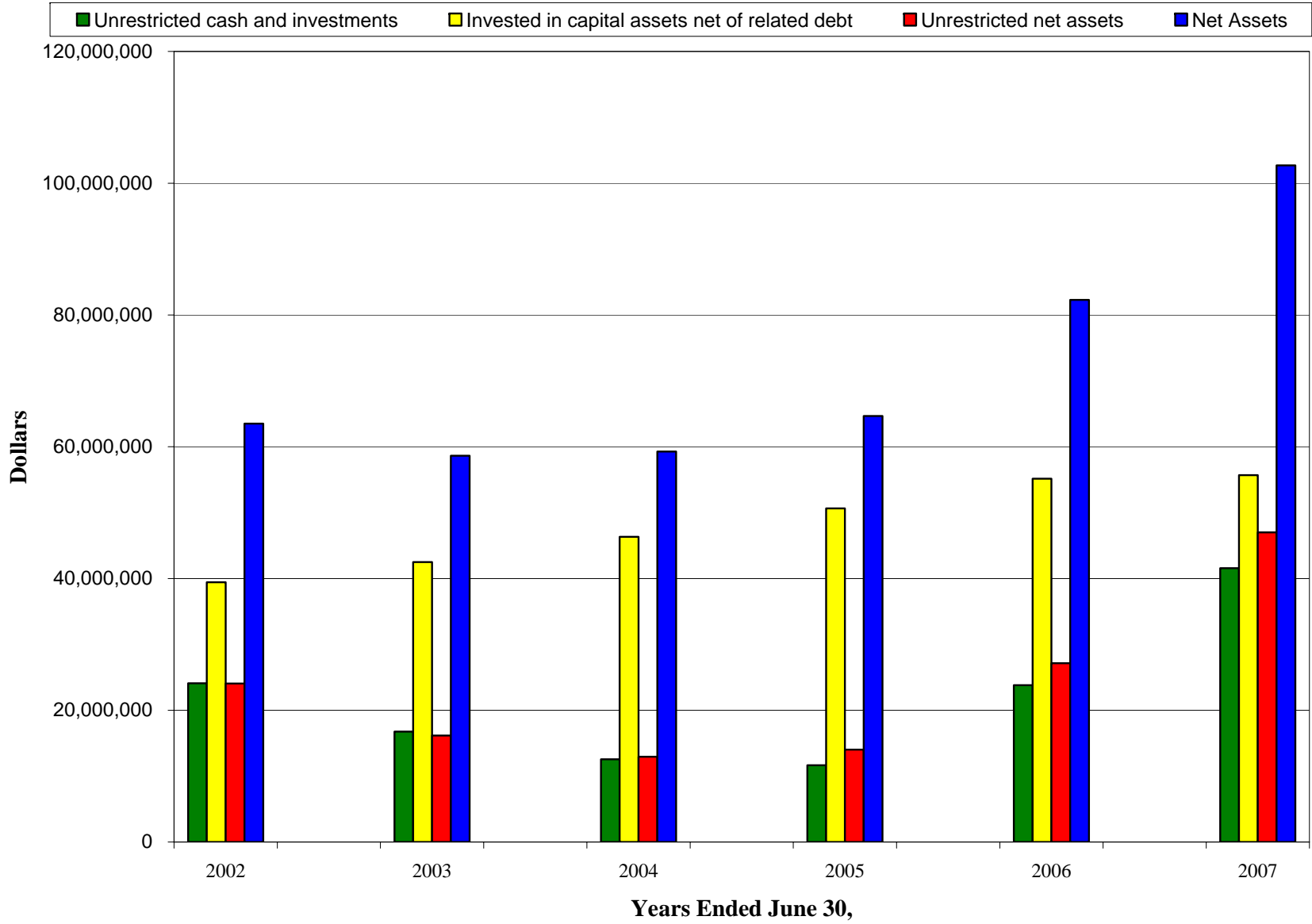
**EXHIBIT VII-A
CITY OF MODESTO
SELECTED ENTERPRISE FUNDS**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Sewer						
Assets						
Unrestricted cash and investments	13,467,498	13,858,835	15,687,983	22,578,123	27,386,019	26,822,584
Other current assets	2,645,455	2,589,033	3,126,041	2,836,219	2,834,682	2,852,313
Total current assets	<u>16,112,953</u>	<u>16,447,868</u>	<u>18,814,024</u>	<u>25,414,342</u>	<u>30,220,701</u>	<u>29,674,897</u>
Non-current assets	2,106,631	1,634,452	1,609,976	950,009	962,613	17,325,437
Capital assets	132,858,605	135,566,318	133,235,220	131,546,324	130,867,701	138,242,415
Total Assets	<u><u>151,078,189</u></u>	<u><u>153,648,638</u></u>	<u><u>153,659,220</u></u>	<u><u>157,910,675</u></u>	<u><u>162,051,015</u></u>	<u><u>185,242,749</u></u>
Liabilities						
Current liabilities	2,959,616	2,466,331	2,566,297	2,070,347	2,394,234	4,935,148
Non-current liabilities	42,182,956	41,084,549	39,920,673	37,235,248	35,555,121	50,273,043
	<u>45,142,572</u>	<u>43,550,880</u>	<u>42,486,970</u>	<u>39,305,595</u>	<u>37,949,355</u>	<u>55,208,191</u>
Current Assets to Liability Ratio	<u>5.44</u>	<u>6.67</u>	<u>7.33</u>	<u>12.28</u>	<u>12.62</u>	<u>6.01</u>
Net Assets						
Invested in capital assets net of related debt	94,965,168	98,739,562	92,354,603	93,568,409	94,025,681	102,691,913
Restricted:						
Capital projects	1,202,475	756,245	763,190	0	0	0
Total Restricted	<u>1,202,475</u>	<u>756,245</u>	<u>763,190</u>	<u>0</u>	<u>0</u>	<u>0</u>
Unrestricted (deficit)	9,770,974	10,601,951	18,054,457	25,036,671	30,075,979	27,342,645
Net Assets	<u><u>105,938,617</u></u>	<u><u>110,097,758</u></u>	<u><u>111,172,250</u></u>	<u><u>118,605,080</u></u>	<u><u>124,101,660</u></u>	<u><u>130,034,558</u></u>
Annual expenses	<u>22,960,129</u>	<u>26,745,391</u>	<u>22,879,169</u>	<u>22,619,978</u>	<u>22,970,581</u>	<u>23,340,842</u>
Ratio of cash and investments to expenses	<u>0.59</u>	<u>0.52</u>	<u>0.69</u>	<u>1.00</u>	<u>1.19</u>	<u>1.15</u>
Ratio of unrestricted net assets to expenses	<u>0.43</u>	<u>0.40</u>	<u>0.79</u>	<u>1.11</u>	<u>1.31</u>	<u>1.17</u>

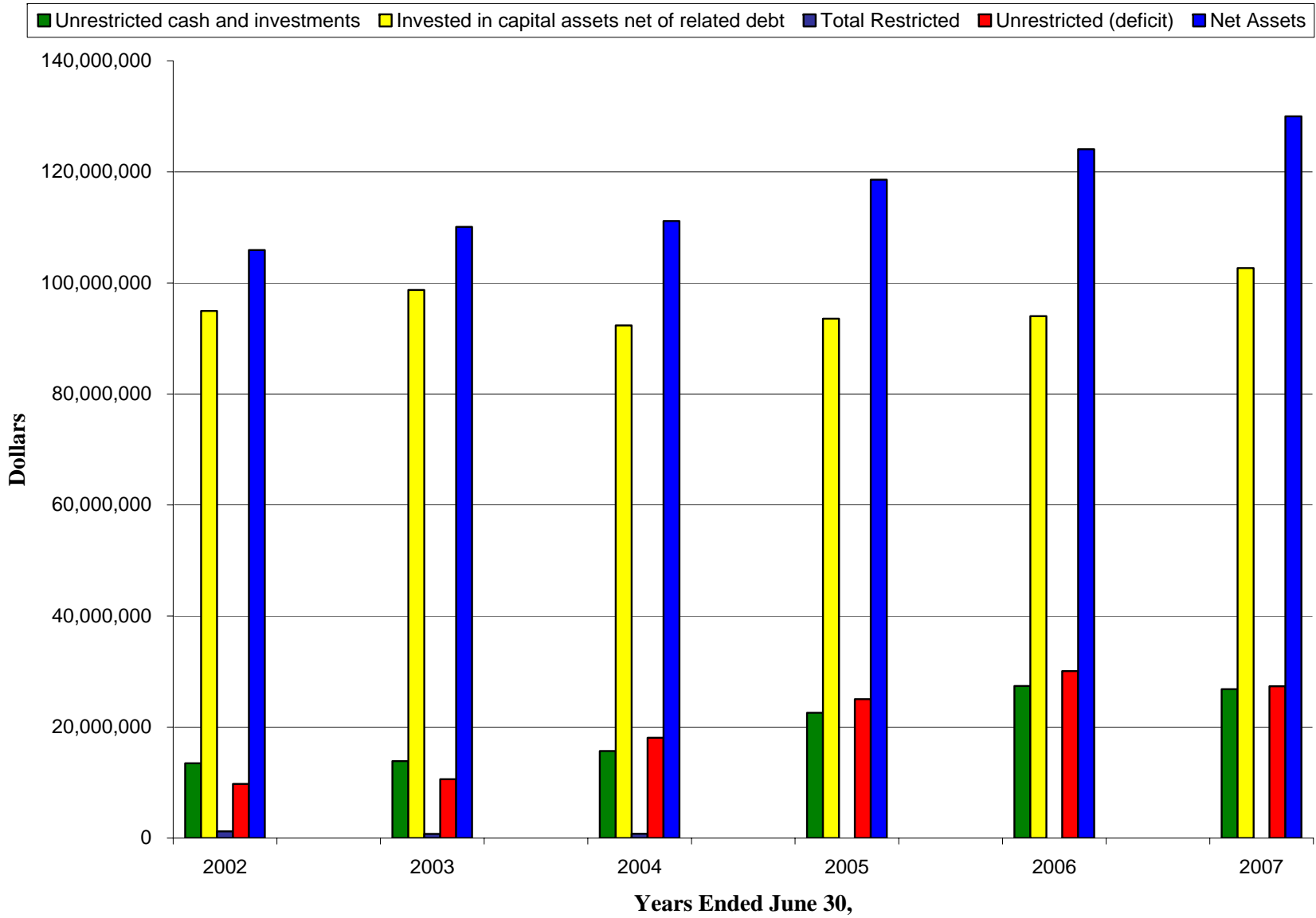
**EXHIBIT VII-A
CITY OF MODESTO
SELECTED ENTERPRISE FUNDS**

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Nonmajor Enterprise Funds						
Assets						
Unrestricted cash and investments	9,762,283	8,744,294	9,416,338	7,223,241	6,859,831	9,795,974
Other current assets	3,717,031	4,431,754	3,379,847	2,896,081	5,124,702	4,084,698
Total current assets	<u>13,479,314</u>	<u>13,176,048</u>	<u>12,796,185</u>	<u>10,119,322</u>	<u>11,984,533</u>	<u>13,880,672</u>
Non-current assets	57,604,389	71,381,153	76,190,344	77,809,278	77,785,025	76,316,561
Total Assets	<u><u>71,083,703</u></u>	<u><u>84,557,201</u></u>	<u><u>88,986,529</u></u>	<u><u>87,928,600</u></u>	<u><u>89,769,558</u></u>	<u><u>90,197,233</u></u>
Liabilities						
Current liabilities	6,965,713	6,083,372	5,343,149	3,329,964	3,771,533	5,274,046
Non-current liabilities	6,747,300	6,277,538	6,050,000	5,855,000	5,801,633	6,391,189
Total Liabilities	<u>13,713,013</u>	<u>12,360,910</u>	<u>11,393,149</u>	<u>9,184,964</u>	<u>9,573,166</u>	<u>11,665,235</u>
Current Assets to Liability Ratio	<u>1.94</u>	<u>2.17</u>	<u>2.39</u>	<u>3.04</u>	<u>3.18</u>	<u>2.63</u>
Net Assets						
Invested in capital assets net of related debt	51,613,319	65,560,083	70,544,274	72,348,208	71,707,437	70,592,413
Unrestricted (deficit)	5,757,371	6,636,208	7,049,106	6,395,428	8,488,955	7,939,585
Net Assets	<u>57,370,690</u>	<u>72,196,291</u>	<u>77,593,380</u>	<u>78,743,636</u>	<u>80,196,392</u>	<u>78,531,998</u>
Annual expenses	<u>20,477,834</u>	<u>21,533,479</u>	<u>22,399,007</u>	<u>24,156,030</u>	<u>26,600,537</u>	<u>29,786,453</u>
Ratio of cash and investments to expenses	<u>0.48</u>	<u>0.41</u>	<u>0.42</u>	<u>0.30</u>	<u>0.26</u>	<u>0.33</u>
Ratio of unrestricted net assets to expenses	<u>0.28</u>	<u>0.31</u>	<u>0.31</u>	<u>0.26</u>	<u>0.32</u>	<u>0.27</u>

**EXHIBIT VII-B
CITY OF MODESTO
ANALYSIS OF THE WATER FUND'S NET ASSETS**



**EXHIBIT VII-C
CITY OF MODESTO
ANALYSIS OF THE SEWER FUND'S NET ASSETS**



**EXHIBIT VII-D
CITY OF MODESTO
ANALYSIS OF THE NONMAJOR ENTERPRISE FUNDS' NET ASSETS**

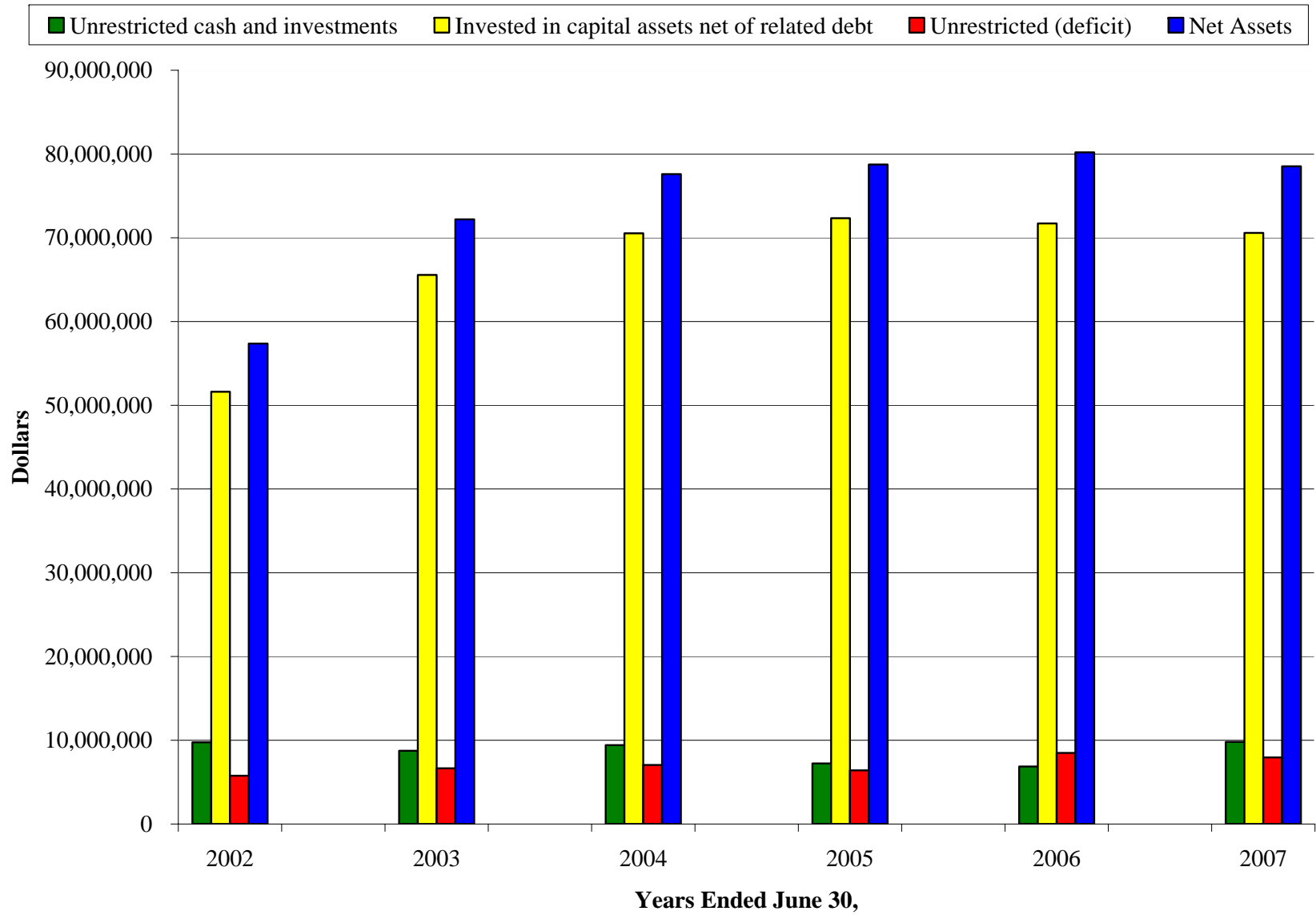




EXHIBIT VIII

The purpose of this exhibit is to show in greater detail the financial health of the **Internal Service Fund Group** and determine if there are excess moneys that could be returned to the General Fund. The City of Modesto has six Internal Service Funds.

Internal Service Funds are created to provide services to other departments or funds of the government. The creation of an Internal Service Fund is not mandatory, but is a voluntary decision on the part of management in order to match the liability to the period it arose and to accumulate resources to fund ongoing operations. Furthermore, the government itself controls the size of both the annual revenues and the fund's net assets as the government sets the rate structure charged to the various departments and manages the collection of revenues. **As such, the size of an internal service fund's net assets is not indicative of financial health.** These funds should maintain its unrestricted net assets at a minimum positive balance. **Internal Service Funds that contain both large cash balances and large unrestricted net assets have excess resources that could be returned to the General Fund.**

Exhibit VIII-A is an analysis of four of the City's six internal service funds. We did not analyze the **Central Services Fund** and the **Building Services Fund** due to their small size; both have cash and investment less than \$300,000. Both of these funds are healthy.

The **Fleet Management Fund** provides and accounts for the maintenance necessary for the City's equipment pool, which serves the needs of all City departments.

- As shown in this Exhibit, this fund has maintained large cash and investments balances that ranged from a low of \$7.6 million in 2003 to a high of \$14.2 million at June 30, 2007.
 - **Cash and investments declined from \$8.9 million in 2002 to \$7.5 million in 2003 due to a \$2 million advance to the General Fund.**
 - **As of June 30, 2007, this advance to the General Fund totaled \$1.8 million.**
 - Cash and investment declined again in 2006 due to the increase in non-current assets, principally capital assets.
- While the cash and investments balance fluctuated during the period covered by our report, this fund's net assets increased each year from \$20.6 million at July 1, 2001, per the 2002 CAFR, to \$33.3 million at June 30, 2007.
 - Most of the increase occurred in unrestricted net assets which grew from \$8.7 million at June 30, 2002 to \$15.6 million at June 30, 2007.

This fund has maintained strong financial ratios that have improved substantially.

- This fund's current ratio has been extremely strong the last five years ranging from a low of 41.12 in 2002 to a high of 111.89 in 2005.



- As of June 30, 2007 this ratio was an extremely strong 51.28; meaning for every \$51.28 dollars of current assets there is \$1 of current liabilities.
- The ratios of cash and investments to expenses and unrestricted net assets to expenses have also remained strong during the period.
 - Cash and investments exceeded 1.3 for all years covered and was 1.88 at June 30, 2007, meaning this fund had enough cash and investment to cover twenty-two-months of expenses. The unrestricted net asset ratio was even stronger, with a 2.07 ratio at June 30, 2007, slightly over two years of expenses.

This fund is extremely healthy and it may have excess moneys.

The **Information & Technology Services Fund** finances and accounts for the replacement, upgrade and maintenance of the City's network and technology infrastructure; and develops and implements a coordinated citywide information technology plan.

- This fund's cash and investments increased each year from \$956,654 on at July 1, 2001 to \$3.4 million at June 30, 2007.
- After net assets declined from \$3 million in 2002 to \$2.8 million at June 30, 2002, it then grew to \$5.5 million at June 30, 2007.
 - Most of the increase occurred in unrestricted net assets that grew from \$808,907 to \$3.3 million.
- Both the increase in cash and investments, and in the net asset balances are due to the annual revenues exceeding annual expenses.

This fund has maintained strong financial ratios that have improved substantially.

- This fund's current ratio has increased from 4.27 at June 30, 2002 to 46.56 at June 30, 2007.
- The ratios of cash and investments to expenses and unrestricted net assets to expenses increased over the same period from 0.33 to 0.76 and 0.26 to 0.74 respectively.

This fund is healthy and may have excess moneys.

The **Insurance Fund** finances and accounts for the City's insurance and risk management programs for workers compensation, general liability and current employee medical insurance.

- After a small decline from \$9.6 million, per the 2002 Statement of Cash Flows, to \$8.9 million at June 30, 2003, this fund's cash and investment balance increased to \$16.5 million at June 30, 2006. It declined to \$15.9 million in 2007.
- This fund's net assets declined from a negative \$2 million at June 30, 2002 to a negative \$4 million at June 30, 2004 then improved to a positive \$814,304 as of June 30, 2006. As of June 30, 2007 this fund's net assets were \$92,800.
 - This fund's net assets are divided into two components, a small net assets invested in capital assets net of related debt that declined from \$64,002 to \$19,942 and unrestricted net assets.



- Unrestricted net assets have improved significantly; after decreasing from a negative \$2 million at June 30, 2002 to a negative \$4 million at June 30, 2004 it improved to a positive \$785,553 at June 30, 2006.
 - As of June 30, 2007, unrestricted net assets totaled \$72,858.

As stated earlier, an internal service fund's net asset balance is not indicative of financial health due to the government's complete control of revenues. This is especially true of insurance funds.

As shown in this exhibit, two of the fund's ratios are strong.

- After declining from 2.06 at June 30, 2002 to 1.95 at June 30, 2004, the current ratio grew to a strong 3.59 at June 30, 2007, or \$3.59 for every \$1 of current liability.
- Since this fund includes the current employees' medical insurance payments, this fund's expenses are large, and as such cash and investment to annual expenses and unrestricted net assets to expenses ratios should be small.
 - Even though the ratio of cash and investments to expenses ratio fluctuated over the past six years from a low of 0.58 at June 30, 2003 to a high of 0.87 at June 30, 2005.
 - With a June 30, 2007 ratio of 0.65, cash and investments can cover approximately eight months of expenses.
- The ratio of the unrestricted net assets to expenses has been negligible, but due to the nature of an insurance fund, it is irrelevant to analyzing the health of insurance funds due to the large claims liabilities.

One of the most important factors in determining the liquidity of a fund's net assets is the fund's liabilities. For insurance funds, the most important factor in determining liabilities is insurance claims. The following table traces the growth and decline of the City's combined general liability and workers compensation insurance liability. This information was obtained from the notes to the financial statements in City's 2002 through 2007 CAFRs.



Total Insurance Liability

Fiscal Year Ended June 30,	Liability at Beginning of Year	Current Year Claims and Changes In Estimates	Claim Payments	Liability at End of Year
2002	10,160,869	5,890,806	(4,889,198)	11,162,477
2003	11,162,477	6,680,187	(5,567,789)	12,274,875
2004	12,274,875	9,382,084	(5,567,653)	16,089,306
2005	16,089,306	2,874,266	(5,001,771)	13,961,801
2006	13,961,801	7,458,436	(5,089,127)	16,331,110
2007	16,331,110	9,231,869	(8,936,742)	16,626,237
		<u>41,517,648</u>	<u>(35,052,280)</u>	

As shown in this table, claim payments exceeded new claims and changes in estimates once during the six years presented.

- Total insurance claims liability increased from \$10.2 million at June 30, 2001 to \$16.1 million June 30, 2004.
- In 2005, the claims' liability declined \$2.1 million to \$14 million.
 - The decline is due to a \$6.5 million decrease in current year claims and changes in estimates.
 - As stated on page 51 of the 2006 CAFR: "workers' compensation and general liability claims liabilities are estimated on an actuarial basis...These claim estimates are based on the requirements of Governmental Accounting Standards Board Statement 10, and include estimated claims incurred but not yet reported and allocated loss adjustment expenses."
 - The amount of current year claims and changes in estimates are calculated to adjust the claims liability to the actuarial reports.
 - In 2005, the increase in new claims and the change in estimate was substantially smaller than the actual claim payments, indicating the June 30, 2004 liability was overstated and the ending liability after claim payments had to be reduced.
- In 2006, current year claims and change in estimates increased to \$7.5 million while claims payments were \$5.1 million as liabilities increased to \$16.3 million.
- Prior to 2007 claims payments never exceeded \$5.6 million and were below \$5.1 million the in three years.
 - In 2007 claim payments increased to \$8.9 million.

In our opinion, the Insurance Fund may have excess moneys that can be returned to the General Fund.



The **Employee Benefits Management Fund** accounts for all compensated absences and other employee non-insurance benefits. Insurance benefits for current employees are accounted for in the Insurance Fund.

In addition to the pension benefits, the City provides health care benefits to employees who retire from the City, under contractual agreements with all employee groups. All full-time employees, except firefighters who receive a cash payout, are eligible to set aside a percentage of accumulated sick leave upon retirement, to be used for payment of future health care premiums to a choice of four insurance plans. The City has no obligation to pay premiums for retirees with no accumulated sick leave. The estimated liability for current retirees' future premiums is \$16,341,924 as of June 30, 2007 up from \$14,534,598 as of June 30, 2006. The estimated current portion of \$1,969,375 is fully funded. The long-term portion \$14,372,549 is partially funded, with the balance being funded over time by charges to the City's operating funds. **The current and long-term portions are reported in the Employee Benefits Management Fund as part of the compensated absences liability balances.**

This fund is similar to insurance funds in that the financial health of the fund cannot be determined by the strength of its net asset balance since. This fund has large negative total net asset balances and unrestricted negative net assets that increased over the five years covered by our report due to the increase in the long-term liability of compensated absences.

- This fund's large negative net asset balances for both the unrestricted net assets and the total net assets are due to expenses exceeding revenues the first four years covered by this report.
- From 2002 through 2005 it appears the rates this fund charged other departments did not cover this fund's annual expenses.
 - Only in 2006 did the revenues exceed expenses.
- Between 2002 and 2005 the liability for compensated absences, which includes retiree healthcare, increased substantially growing \$30.1 million from \$30.1 million to \$60.2 million. The liability declined in 2006 to \$58.8 million, but increased to \$64.6 million in 2007.
 - The annual increase in the liability for compensated absences represents that portion of the employee benefits expense that will be paid in future years.
 - Unused sick-leave will be paid in the future (when sick or at retirement) or used to pay health care premiums after retirement.
- \$16.3 million of the compensated liability is for current retirees' future medical insurance premiums.
 - The 2007 CAFR did not discuss whether this liability is in conformity with GASB 45 standards regarding other post employment benefits (OPEB).
 - As noted above, the long-term portion of this liability is partially funded. This partial funding will reduce the negative aspects of financing OPEB when GASB 45 is implemented.



- If the City decides to create an irrevocable trust or to join CalPERS's multiply employer trust, the discount rate could substantially increase. Any increase in the discount rate would substantially lower the OPEB liability,

The financial health of this fund is determined by its cash and investment balances and its ability to meet current year expense and current liabilities.

- Even though this fund had large negative net assets each year covered by our report, it maintained large cash and investment balances.
 - From 2002 though 2004 it appears the rates this fund charged other departments did not cover this fund's cash flow as cash and investments declined by \$2.6 million to \$13.1 million.
 - Beginning in 2005, this fund's cash and investments increased to \$19.3 million at June 30, 2007, its highest balance.
- This fund has maintained a strong current ratio all six years covered by our report.
 - Though this ratio declined the last four years, it is still strong at 4.80, meaning it has \$4.80 of assets for every \$1 of liability.
 - Though current assets have increased the last two years, in proportion to their size, current liabilities had the larger increase, resulting in the declining ratio.

This fund is healthy due to its strong cash and investment balance, and it has sufficient revenues to meet its current expenses and its liabilities.

Exhibit VIII-B through **Exhibit VIII-E** are graphic representations of the Internal Service Funds' cash and investments and net assets.

Findings:

- The four largest internal service funds we analyzed above have large cash and investments.
- A portion of the Employee Benefits Management cash balance includes pre funding of the OPEB liability. This pre funding should alleviate the budget pressure when the City adopts the new reporting standards of GASB 45.
- Most of the internal service funds may have excess moneys that could be transferred to the General Fund.
 - Any excess funds in the **Central Stores Fund** and the **Public Buildings Fund**, due to their small size, are immaterial.
 - **The Fleet Management Fund, the Information & Technology Services Fund, the Insurance Fund and the Employee Benefits Management Fund have large cash and investments.**
- Due to the nature of internal service funds, the funds' net assets are not indicative of financial health.



- The Insurance Fund's negative net asset balances in the early years of our report have improved to small positive balances. This fund is healthy.
- Even though the Employee Benefits Management Fund has a negative net asset balance, it is still healthy.

EXHIBIT VIII-A
CITY OF MODESTO
SELECTED INTERNAL SERVICE FUNDS

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Fleet Management						
Assets						
Unrestricted cash and investments	8,878,933	7,555,107	10,250,217	12,271,369	12,073,921	14,186,997
Other current assets	21,113	2,043,377	2,029,635	2,011,593	1,961,881	1,842,620
Total current assets	<u>8,900,046</u>	<u>9,598,484</u>	<u>12,279,852</u>	<u>14,282,962</u>	<u>14,035,802</u>	<u>16,029,617</u>
Non-current assets	15,661,708	17,062,479	16,576,854	16,153,509	17,093,694	17,677,610
Total Assets	<u><u>24,561,754</u></u>	<u><u>26,660,963</u></u>	<u><u>28,856,706</u></u>	<u><u>30,436,471</u></u>	<u><u>31,129,496</u></u>	<u><u>33,707,227</u></u>
Liabilities						
Current liabilities	216,461	193,080	189,518	127,653	178,107	312,585
Non-current liabilities	241,880	219,663	196,076	171,034	144,446	116,220
	<u>458,341</u>	<u>412,743</u>	<u>385,594</u>	<u>298,687</u>	<u>322,553</u>	<u>428,805</u>
Current Assets to Liability Ratio	<u>41.12</u>	<u>49.71</u>	<u>64.80</u>	<u>111.89</u>	<u>78.81</u>	<u>51.28</u>
Net Assets						
Invested in capital assets net of related debt	15,398,901	16,820,599	16,357,191	15,957,400	16,922,661	17,649,384
Unrestricted net assets	8,704,512	9,427,621	12,113,921	14,180,351	13,884,282	15,629,036
Net Assets	<u>24,103,413</u>	<u>26,248,220</u>	<u>28,471,112</u>	<u>30,137,751</u>	<u>30,806,943</u>	<u>33,278,420</u>
Annual expenses	5,388,174	5,815,909	6,164,249	6,678,577	7,223,131	7,544,789
Ratio of cash and investments to annual expenses	<u>1.65</u>	<u>1.30</u>	<u>1.66</u>	<u>1.84</u>	<u>1.67</u>	<u>1.88</u>
Ratio of unrestricted net assets to annual expenses	<u>1.62</u>	<u>1.62</u>	<u>1.97</u>	<u>2.12</u>	<u>1.92</u>	<u>2.07</u>

EXHIBIT VIII-A
CITY OF MODESTO
SELECTED INTERNAL SERVICE FUNDS

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Information & Technology Services						
Assets						
Unrestricted cash and investments	1,028,431	1,377,756	1,701,114	1,974,400	2,217,145	3,433,307
Other current assets	1,661	0	0	5,584	6,681	10,283
Total current assets	<u>1,030,092</u>	<u>1,377,756</u>	<u>1,701,114</u>	<u>1,979,984</u>	<u>2,223,826</u>	<u>3,443,590</u>
Non-current assets	2,070,857	2,110,708	1,936,148	1,895,242	2,352,511	2,409,428
Total Assets	<u><u>3,100,949</u></u>	<u><u>3,488,464</u></u>	<u><u>3,637,262</u></u>	<u><u>3,875,226</u></u>	<u><u>4,576,337</u></u>	<u><u>5,853,018</u></u>
Liabilities						
Current liabilities	240,968	226,734	96,463	118,584	98,377	73,962
Non-current liabilities	67,598	45,416	20,545	0	0	137,392
	<u>308,566</u>	<u>272,150</u>	<u>117,008</u>	<u>118,584</u>	<u>98,377</u>	<u>211,354</u>
Current Assets to Liability Ratio	<u>4.27</u>	<u>6.08</u>	<u>17.63</u>	<u>16.70</u>	<u>22.61</u>	<u>46.56</u>
Net Assets						
Invested in capital assets net of related debt	1,983,476	2,043,110	1,890,732	1,874,697	2,352,511	2,198,074
Unrestricted net assets	808,907	1,173,204	1,629,522	1,881,945	2,125,449	3,331,082
Net Assets	<u>2,792,383</u>	<u>3,216,314</u>	<u>3,520,254</u>	<u>3,756,642</u>	<u>4,477,960</u>	<u>5,529,156</u>
Annual expenses	3,132,169	3,139,694	3,376,430	3,997,680	4,255,379	4,490,258
Ratio of cash and investments to annual expenses	<u>0.33</u>	<u>0.44</u>	<u>0.50</u>	<u>0.49</u>	<u>0.52</u>	<u>0.76</u>
Ratio of unrestricted net assets to annual expenses	<u>0.26</u>	<u>0.37</u>	<u>0.48</u>	<u>0.47</u>	<u>0.50</u>	<u>0.74</u>

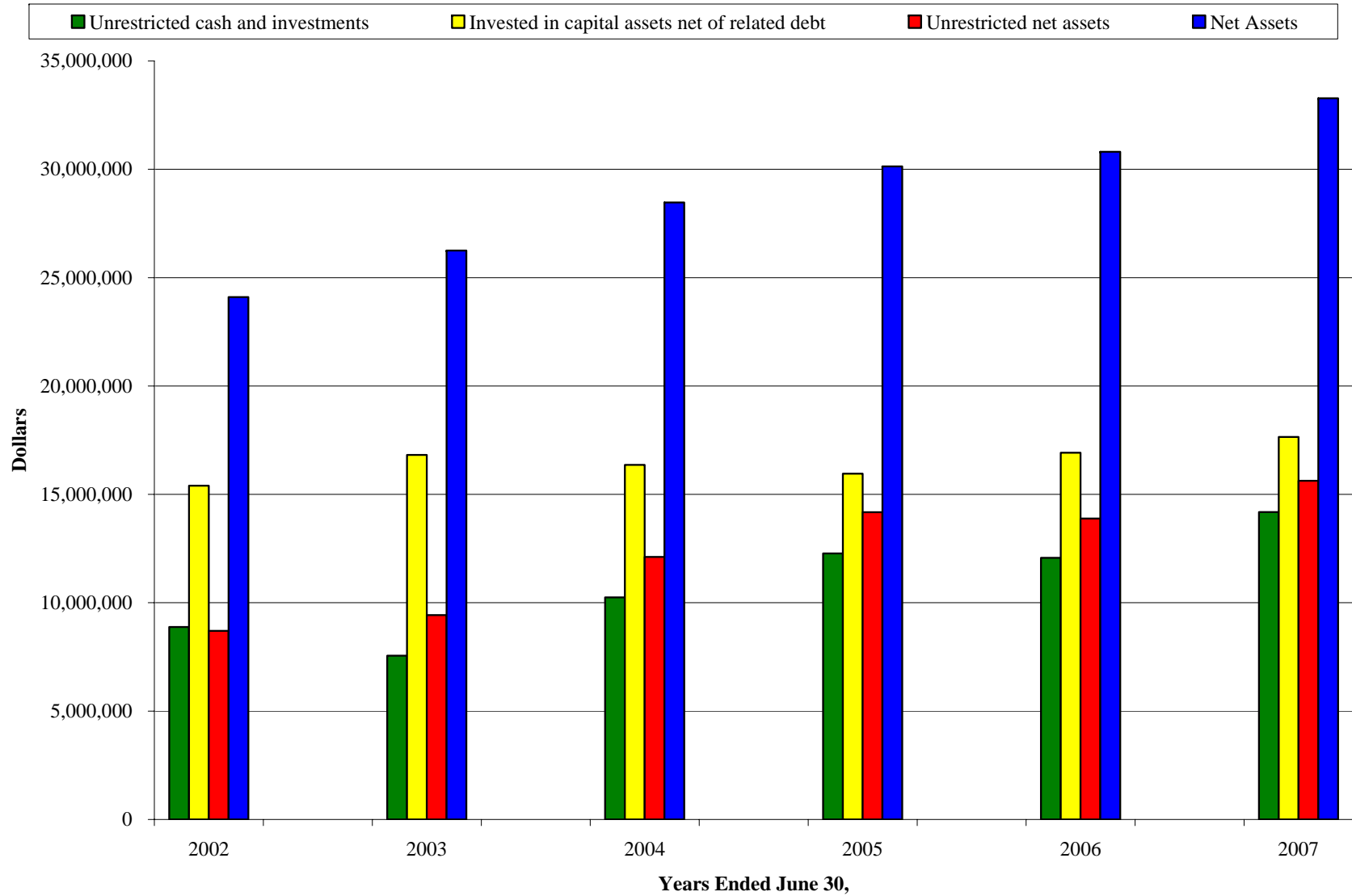
EXHIBIT VIII-A
CITY OF MODESTO
SELECTED INTERNAL SERVICE FUNDS

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Insurance						
Assets						
Unrestricted cash and investments	9,515,586	8,928,357	12,383,126	13,280,037	16,514,047	15,944,621
Other current assets	172,737	1,318,883	381,362	427,367	964,888	839,799
Total current assets	<u>9,688,323</u>	<u>10,247,240</u>	<u>12,764,488</u>	<u>13,707,404</u>	<u>17,478,935</u>	<u>16,784,420</u>
Non-current assets	64,002	55,199	46,367	37,559	28,751	19,942
Total Assets	<u><u>9,752,325</u></u>	<u><u>10,302,439</u></u>	<u><u>12,810,855</u></u>	<u><u>13,744,963</u></u>	<u><u>17,507,686</u></u>	<u><u>16,804,362</u></u>
Liabilities						
Current liabilities	4,695,116	4,405,983	6,555,688	5,166,235	5,518,832	4,668,969
Non-current liabilities	7,020,360	7,959,981	10,240,340	9,129,900	11,174,550	12,042,593
	<u>11,715,476</u>	<u>12,365,964</u>	<u>16,796,028</u>	<u>14,296,135</u>	<u>16,693,382</u>	<u>16,711,562</u>
Current Assets to Liability Ratio	<u>2.06</u>	<u>2.33</u>	<u>1.95</u>	<u>2.65</u>	<u>3.17</u>	<u>3.59</u>
Net Assets						
Invested in capital assets net of related debt	64,002	55,199	46,367	37,559	28,751	19,942
Unrestricted (negative) net assets	<u>(2,027,153)</u>	<u>(2,118,724)</u>	<u>(4,031,540)</u>	<u>(588,731)</u>	<u>785,553</u>	<u>72,858</u>
Net Assets	<u><u>(1,963,151)</u></u>	<u><u>(2,063,525)</u></u>	<u><u>(3,985,173)</u></u>	<u><u>(551,172)</u></u>	<u><u>814,304</u></u>	<u><u>92,800</u></u>
Annual expenses	<u>14,100,801</u>	<u>15,343,110</u>	<u>19,493,651</u>	<u>15,208,151</u>	<u>20,309,090</u>	<u>24,479,746</u>
Ratio of cash and investments to annual expenses	<u>0.67</u>	<u>0.58</u>	<u>0.64</u>	<u>0.87</u>	<u>0.81</u>	<u>0.65</u>
Ratio of unrestricted net assets to annual expenses	<u>(0.14)</u>	<u>(0.14)</u>	<u>(0.21)</u>	<u>(0.04)</u>	<u>0.04</u>	<u>0.00</u>

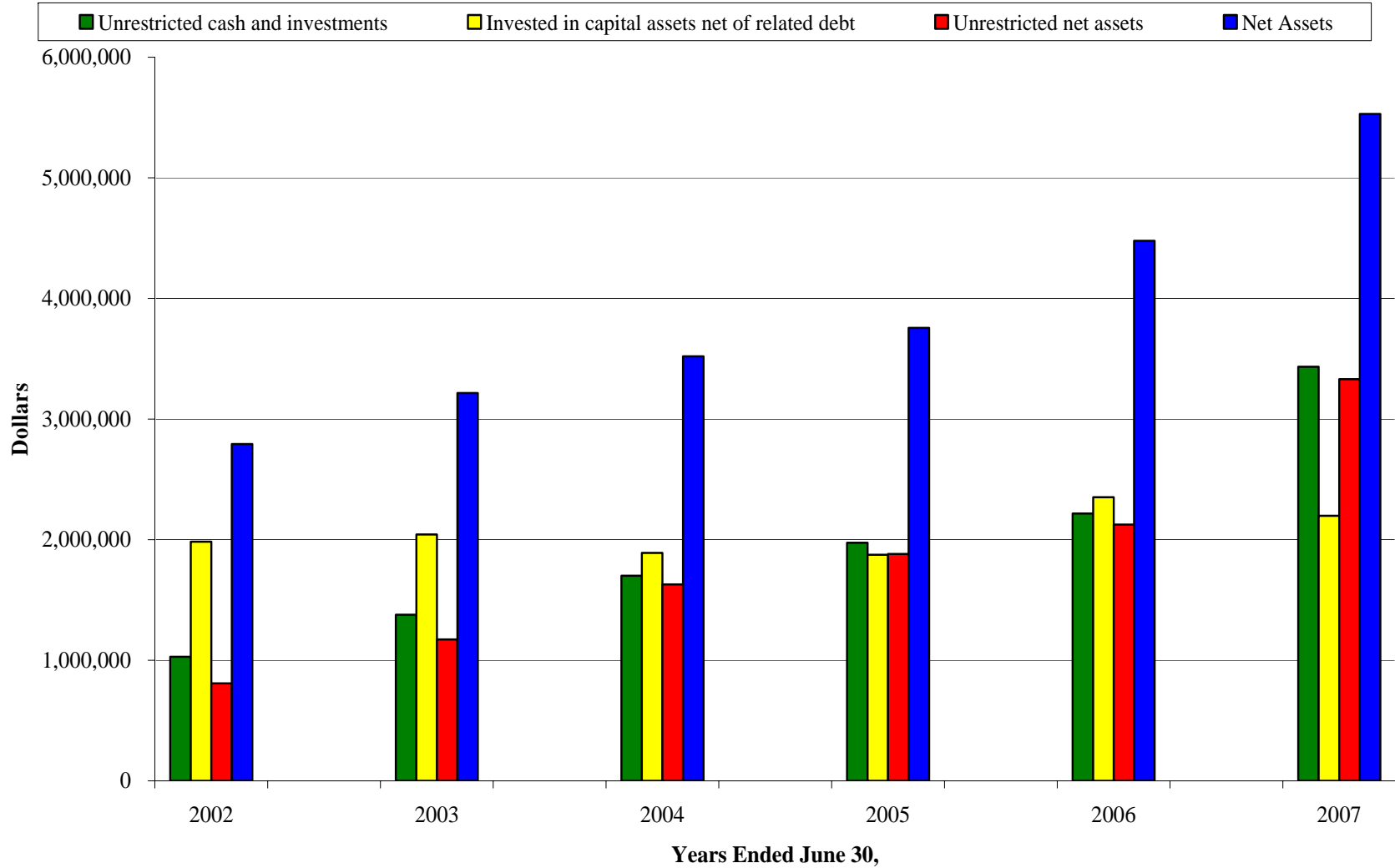
EXHIBIT VIII-A
CITY OF MODESTO
SELECTED INTERNAL SERVICE FUNDS

	<i>FOR THE YEARS ENDED JUNE 30,</i>					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Benefits Management						
Assets						
Unrestricted cash and investments	15,672,867	14,111,347	13,099,243	14,960,709	16,905,858	19,306,031
Other current assets	0	0	0	48,927	61,081	88,398
Total current assets	<u>15,672,867</u>	<u>14,111,347</u>	<u>13,099,243</u>	<u>15,009,636</u>	<u>16,966,939</u>	<u>19,394,429</u>
Non-current assets	101,123	96,939	41,263	10,063	5,405	3,931
Total Assets	<u><u>15,773,990</u></u>	<u><u>14,208,286</u></u>	<u><u>13,140,506</u></u>	<u><u>15,019,699</u></u>	<u><u>16,972,344</u></u>	<u><u>19,398,360</u></u>
Liabilities						
Current liabilities	6,715,281	1,561,944	2,144,239	2,802,411	3,527,079	4,038,865
Non-current liabilities	30,096,040	52,199,556	54,674,263	60,221,829	58,847,850	64,628,743
	<u>36,811,321</u>	<u>53,761,500</u>	<u>56,818,502</u>	<u>63,024,240</u>	<u>62,374,929</u>	<u>68,667,608</u>
Current Assets to Liability Ratio	<u>2.33</u>	<u>9.03</u>	<u>6.11</u>	<u>5.36</u>	<u>4.81</u>	<u>4.80</u>
Net Assets						
Invested in capital assets net of related debt	13,982	11,648	9,304	6,967	5,405	3,931
Unrestricted (negative) net assets	<u>(21,051,313)</u>	<u>(39,564,862)</u>	<u>(43,954,300)</u>	<u>(48,011,508)</u>	<u>(45,407,990)</u>	<u>(49,273,179)</u>
Net Assets	<u><u>(21,037,331)</u></u>	<u><u>(39,553,214)</u></u>	<u><u>(43,944,996)</u></u>	<u><u>(48,004,541)</u></u>	<u><u>(45,402,585)</u></u>	<u><u>(49,269,248)</u></u>
Annual expenses	<u>21,430,550</u>	<u>40,084,363</u>	<u>32,146,098</u>	<u>39,528,848</u>	<u>36,396,053</u>	<u>9,239,967</u>
Ratio of cash and investments to annual expenses	<u>0.73</u>	<u>0.35</u>	<u>0.41</u>	<u>0.38</u>	<u>0.46</u>	<u>2.09</u>
Ratio of unrestricted net assets to annual expenses	<u>(0.98)</u>	<u>(0.99)</u>	<u>(1.37)</u>	<u>(1.21)</u>	<u>(1.25)</u>	<u>(5.33)</u>

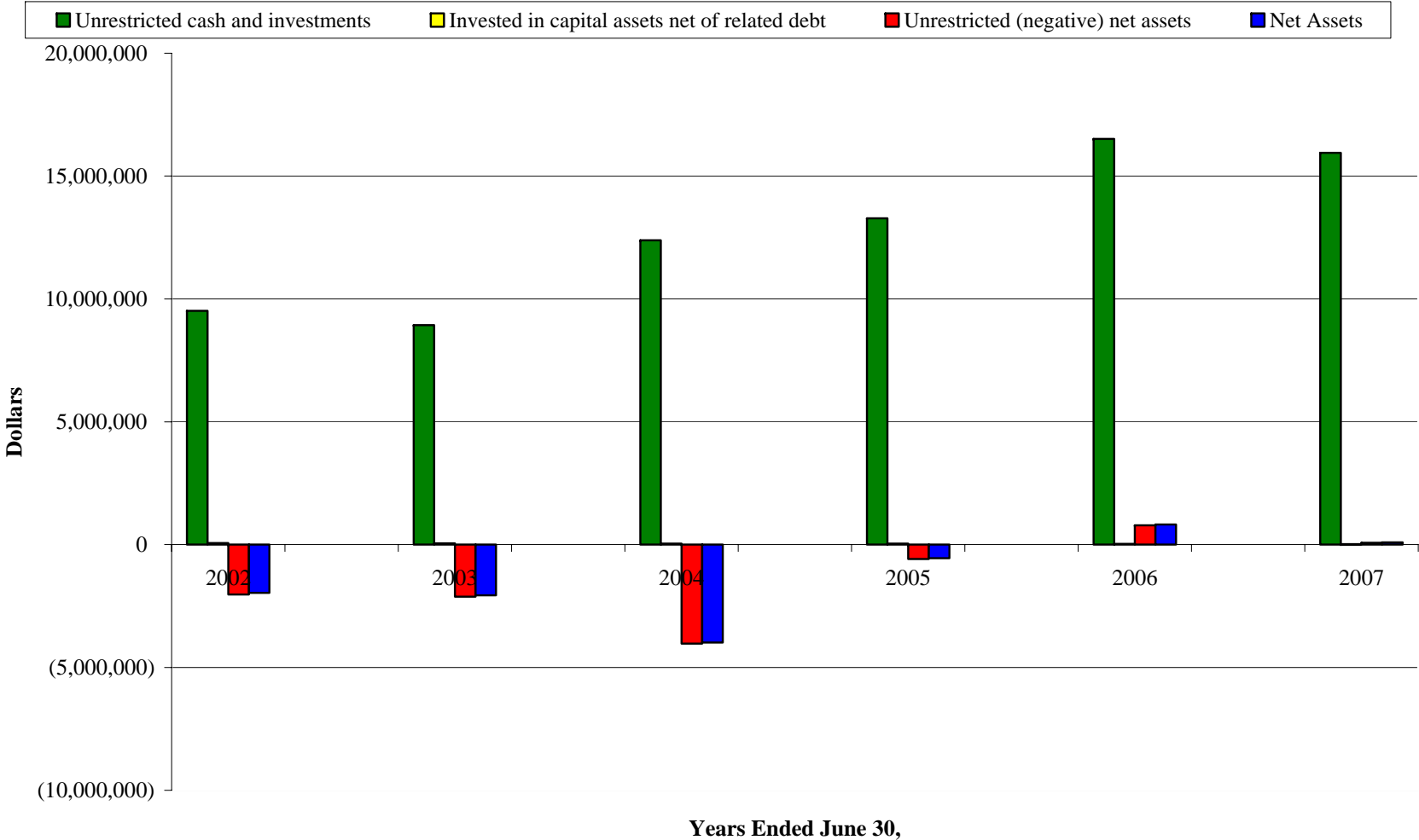
**EXHIBIT VIII-B
CITY OF MODESTO
ANALYSIS OF THE FLEET MANAGEMENT FUND'S NET ASSETS**



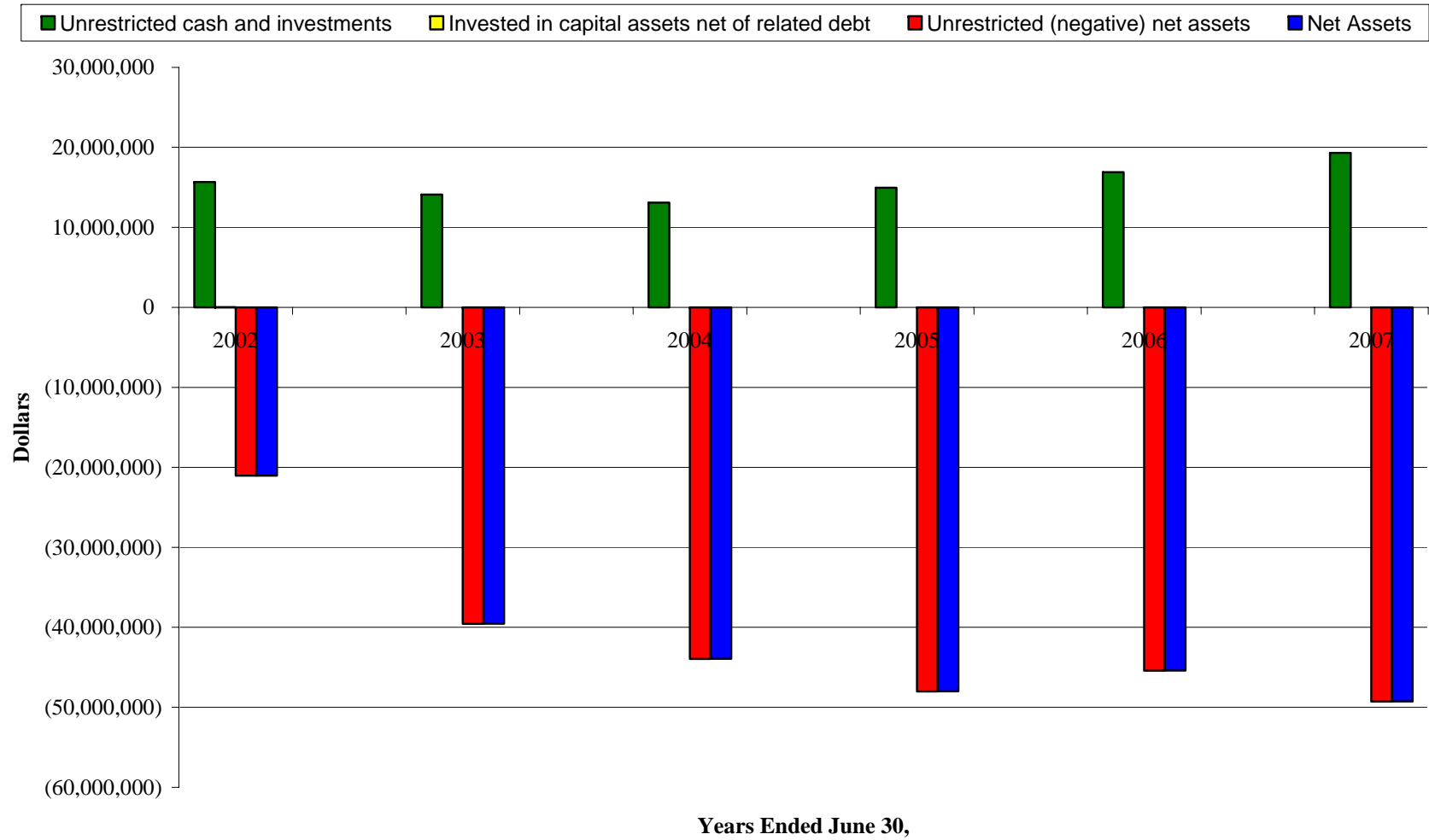
**EXHIBIT VIII-C
CITY OF MODESTO
ANALYSIS OF INFORMATION AND TECHNOLOGY SERVICES FUND'S NET ASSETS**



**EXHIBIT VIII-D
CITY OF MODESTO
ANALYSIS OF INSURANCE FUND'S NET ASSETS**



**EXHIBIT VIII-E
CITY OF MODESTO
ANALYSIS OF BENEFITS MANAGERMENTS FUND'S NET ASSETS**





GASB 45 – OTHER POST EMPLOYMENT BENEFITS (OPEB)

The City of Modesto provides health insurance to its retirees as we noted in our analysis of the Employee Benefit Management Fund. The City has partially funded its long-term liability portion. This partial funding of the OPEB liability improves the financial health of the City. Furthermore, if the City establishes an irrevocable trust, the OPEB liability could be reduced due to higher discount rates. The discount rate is based on the investment rate of return the City could earn on its OPEB investments. Establishing an irrevocable trust allows a City to invest in riskier investments with a higher rate of return, thus a larger discount rate.

HOUSING CRISIS AND CREDIT CRISIS

The State recently announced that its three primary tax revenues; income taxes, sales taxes and property taxes have declined during the first quarter of the 2007-2008 fiscal year. Sales tax and property tax revenues are important local government revenues. **If actual collections of these two taxes are below projections for the State, they may be below budgeted revenues at the local level.** Furthermore, many local governments impose large transfer fees on the sale or transfer of real estate. A large decrease in housing sales will substantially reduce this local government revenue. **The loss of sales tax revenues, property tax revenues and transfer fees will stress 2007-2008 budgets and negatively impact current year negotiations on wage and benefit increases.**

CONCLUSIONS

The City provided the MCEA with a schedule breaking down the cost of a 1% wage increase to its members between the City's various funds. The schedule showed the fund number and the cost of a 1% wage increase for each of the funds employing MCEA members. We modified this schedule to include the names of the funds, the percent of the increase financed by each fund, the cost of a 3% wage increase for the first year and a 4.5% wage increase the second year and we segregated them into the fund groups.

As shown in the following table, the cost of a 1% wage increase for MCEA members employed by the City is \$330,865 for the first year. Of this amount, only \$100,884 or 30.49% is directly financed by the General Fund. Even though the General indirectly pays for a portion of the internal service funds' wages, it does not pay all as other funds are also charged for services. As such, at most, the General Fund finances 38% of the MCEA's members' wages. Other funds, principally the enterprise funds, finance over 60% of MCEA wage increase. Most of the wage increase will be funded by enterprise funds (44% of the wage increase) and special revenue funds (16.63% of the wage increase). A 3% wage increase would increase a 1% wage increase in the second year to \$340,791. As shown in the following table, a 3% wage increase would only cost \$992,595 in the first year and \$1,533,560 in the second year. Most of these costs would be paid by funds other than the General Fund, which would finance \$302,652 of the increase the



first year and \$467,597 in the second year. Even though the General Fund resources declined in 2007, we believe the City can afford the MCEA's proposal.

**Modesto City Employees' Association
Analysis of a Wage and Benefit Increase**

Fund Numbers	Fund Name	1% Wage Increase	% of Increase Financed by Fund	MCEA's Proposal	
				Cost of 3% Wage Increase for First Year	Cost of 4.5% Wage Increase for Second Year
100	General Fund	100,884	30.49%	302,652	467,597
Special Revenue Funds					
300 and 310	Operating Grants	17,134	5.18%	51,402	79,416
700	Streets, Traffic & Forestry	34,683	10.48%	104,049	160,756
1130	Community Development	3,208	0.97%	9,624	14,869
		55,025	16.63%	165,075	255,041
Capital Projects Fund					
2900	Community Facility District	608	0.18%	1,824	2,818
Enterprise Funds					
6000	Parking Fund	2,872	0.87%	8,616	13,312
6100	Water Fund	47,445	14.34%	142,335	219,908
6210	Wastewater Fund	63,179	19.10%	189,537	292,835
6280	Strom Drain Fund	14,707	4.45%	44,121	68,167
6290	Compost Fund	3,934	1.19%	11,802	18,234
6310	Airport Fund	2,802	0.85%	8,406	12,987
6540	Bus Fund	8,846	2.67%	26,538	41,001
6700	Events Services	1,802	0.54%	5,406	8,352
		145,587	44.00%	436,761	674,796
Internal Service Fund					
7110, 7120, and 7130	Central Stores Fund	3,395	1.03%	10,185	15,736
7200	Fleet Maintenance Fund	12,573	3.80%	37,719	58,276
7800	Building Services Fund	10,653	3.22%	31,959	49,377
		26,621	8.05%	79,863	123,389
Agency Fund					
8500	JPA Tenth Street Place	1,761	0.53%	5,283	8,162
8850	Tuolumne River	379	0.11%	1,137	1,757
		2,140	0.65%	6,420	9,919
Total		330,865	100.00%	992,595	1,533,560



Our conclusion is based on our finding in our report which include the following:

- The governmental activities as presented in the government-wide financial statements are healthy and strong.
- The City's governmental revenues experienced strong growth over the pre GASB 44 ten year period of 1996 through 2005, but the rate of return declined slightly between 2001 and 2005.
- The decline in the IRR for governmental revenues reported in the statistical section under GASB 44 decreased due to declines in non-tax revenues.
- The General Fund cash and investments declined precipitously from its high of \$19.1 million at June 30, 2003 to \$1.9 million at June 30, 2007.
- The General Fund has maintained a strong current ratio the past five years between a low of 3.62 and a high of 4.83.
- The General Fund's fund balance decreased from \$26.7 million at July 1, 2001 to \$14.5 million at June 30, 2007 due to expenditures exceeding revenues.
 - Most of decline occurred in the unreserved fund balance which fell from \$22.5 million at June 30, 2002 to \$10.7 million in 2007.
 - The unreserved fund balance fell \$9.9 million in 2007.
- The ratios of the General Fund's unreserved fund balance to revenues and expenditures experienced substantial declines in 2007.
 - The revenue to unreserved fund balance ratio fell more than 49% in 2007 from 17.9% to 9.07%. This benchmark is still healthy, almost twice the 5% benchmark.
 - The expenditure to unreserved fund balance ratio experienced a larger decline, over 53% falling from 19.45% to 9.09%, a healthy balance.
 - Though these ratios are still healthy, the decline in these ratios indicates weakening financial health in the General Fund.
- The enterprise funds are strong and can afford wage increases for MCEA members.
- The internal service funds are strong and may have excess resources.

Sincerely,

Bachecki, Crom, & Co, LLP

BACHECKI, CROM & CO., LLP