



**MID-YEAR BUDGET REPORT**

## **Staff Report**

**February 17, 2003**

**TO:** City Council

**FROM:** Robert Sousa, Finance Director

**SUBJECT:** Presentation of Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2002 and Mid-Year Budget Update.

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### **Recommendation**

1. Receive the Comprehensive Annual Financial Report (CAFR) and Memorandum on Internal Control Structure for the Fiscal Year Ended June 30, 2002.
2. Receive the Current Year Budget Update Report.

### **Fiscal Impact**

None from this item.

### **Background and Analysis**

The first part of this report discusses the results of General Fund operations presented in the CAFR from the previous fiscal year. The City Council will receive the annual CAFR with this report and members of the community may review copies at the following locations:

1. Davis City Clerk's Office.
2. Finance Division front counter.
3. Yolo County Library – Davis Branch
4. Shields Library – UCD.

The second part of this report summarizes the mid-year budget position of the City as of December 31, 2002. The primary focus will be restricted to an update of earlier estimates of the City's financial position now that the CAFR has been prepared and a glimpse of where the City is heading as we develop the preliminary budget for fiscal year 2003-2004.

### **2001/2002 Summary of General Fund Operations**

When the Fiscal Year 2001/2002 Budget was adopted in May, 2001, the General Fund operational deficit was projected to be \$265,151. In addition to the operational budgets, Council approved continuing a set-aside in designated reserves of \$350,000 in anticipation of future PERS retirement increases above the 0% employer rate, along with \$280,000 in generated

savings from a continued hiring freeze of unfilled positions. The combined effect of these figures indicated a draw down of General Fund balance of about \$600,000.

In looking back to the beginning of that year, revenues were anticipated to grow but not at a rate that would offset large expenditure increases that were beginning to impact the City. In order to address the imbalance, in the fall of 2001 the City Council undertook an outreach effort throughout the city in order to ask the community for assistance in identifying service priorities for the city of Davis.

In January 2002, the Budget Reduction options report was presented to the City Council. The beginning 2001-02 fiscal year budget assumed the passage of Measure S but, as a result of its failure, there was a need to balance the budget by the \$1.3 million in additional revenue that would have been received if it had passed. This was accomplished by transferring FY 2000-01 departmental savings to the General Fund reserve (\$900,000), freezing vacant positions during the year (\$250,000) and one time budget reductions spread across departments (\$250,000). Because some of the reductions were a temporary correction to balance the 2001-02 budget, the remaining shortfall of \$500,000 was to be addressed as the FY 2002-03 budget was prepared.

In February 2002 the Council was provided with a mid year budget update. It was reported the June 30, 2001 projected General Fund balance of approximately \$4.3 million had increased to approximately \$5.7 million. This increase in fund balance was a result of one-time revenues of \$500,000 from GASB accounting changes and \$300,000 in savings from departmental efforts to minimize spending, as well as a continued freeze on hiring unfilled positions citywide.

**Table 1** below displays the financial figures for three different periods: the Beginning Budget, the Ending Budget, and the Actual Results. As you can see from the wide variations, it is difficult to predict the results of the year within a narrow range when small percentage changes in revenues and expenditures significantly affect the Ending Unreserved Fund Balance.

**Table 1: General Fund Summary – FY 2001/2002** (CAFR p. 2/4)

Description	Beginning Budget	Ending Budget	2001/2002 Actual Results
Beginning Unreserved Fund Balance (6/30/01)	\$4,287,439	\$5,428,017	\$5,743,017
Revenues	25,156,115	25,375,107	25,979,971
Expenditures	(25,421,266)	(25,734,434)	(24,074,670)
Transfers	0	0	0
Change in Reserved Fund Balance *	(350,000)	(350,000)	(509,743)
<b>Ending Unreserved Fund Balance (6/30/02)</b>	<b>\$3,672,288</b>	<b>\$4,718,690</b>	<b>\$7,138,576</b>
Percentage (E.U.F.B./Revenues)	15%	19%	27%
Percentage (E.U.F.B./Expenditures)	14%	18%	30%
* This line item is included to link the Audited Financial Statements with Budget Estimates and also includes changes in encumbrance balances.			

At the bottom of *Table 1*, you will notice two percentages. The first percentage compares the Ending Unreserved Fund Balance (“EUFB”) to the total revenues received for the year. The second percentage evaluates the EUFB relationship to total expenditures. There is no set standard for determining which of these is more meaningful but previous City Councils have chosen to use the revenue-based comparison in its establishment of a standard percentage for future budgets, which is currently 15%.

During the last fiscal year, the overall health of the General Fund Unreserved Fund Balance improved from an early prediction of 15%, to nearly twice that amount or 27%. The following two tables will help in evaluating how this large improvement occurred.

**Table 2** is a presentation of General Fund revenues in the order of their percentage contribution to the total. All in all, a pretty good year for revenue growth with final receipts coming in at \$604,863 more than expected. However, you will notice that only three revenues comprise 57% of the total receipts in this key City Fund: Property Taxes (24%), Sales & Use Taxes (20%), and Motor Vehicle In Lieu Fees (13%). This isn’t necessarily a problem for most Cities but, given the fact that the State is threatening to take away a huge portion of the Motor Vehicle In Lieu Fees, this very large concentration of revenues in such a small group could lead to drastic consequences if the other two suffer a shortfall of any kind.

**Table 2: General Fund Revenues – 2001/2002 Budget to Actual Comparison** (CAFR p. 4)

Revenue by Source	2001/2002 Final Budget	2001/2002 Actual	Difference Favorable / (Unfavorable)	Percentage of Actual
Property Taxes	\$6,198,825	\$6,309,738	\$110,913	24%
Sales & Use Tax	5,248,000	5,226,626	(21,374)	20%
Motor Vehicle In Lieu	3,142,000	3,401,971	259,971	13%
Parks Services	1,785,481	1,817,649	32,168	7%
Municipal Services Tax	1,700,000	1,700,738	738	7%
Business License Tax	1,010,000	996,017	(13,983)	4%
Construction Permits	818,413	927,035	108,622	4%
Transient Occupancy Tax	918,000	881,566	(36,434)	3%
Planning & Building Inspection	1,225,756	847,464	(378,292)	3%
Fire Dept. Services	573,947	582,883	8,936	2%
Franchise Fees (PG&E)	421,700	465,652	43,952	2%
Investment Earnings	69,282	341,466	272,184	1%
Property Transfer Tax	247,000	195,838	(51,162)	1%
All Other Sources	2,016,703	2,285,328	268,625	9%
<b>Total</b>	<b>\$25,375,107</b>	<b>\$25,979,970</b>	<b>\$604,863</b>	<b>100%</b>

Property taxes improved by 4.5% for last year and helped to overcome shortfalls in other areas. Property Tax has been one of the bright spots in the General Fund as the average sales price for a home in Davis has gone from \$267,000 in 2000 to \$416,000 in 2002. Over this same three year period, property taxes have increased by a combined 23%. This year’s appreciation is on track to reach about 6.5% according to a recent study by the Davis Enterprise.

Sales tax has been very difficult to predict for the last three years as the receipts have fluctuated greatly due to the economy and our growing sales tax base. This year's -5% drop is due to the accrual of an additional month last year and hides the fact that we collected \$1.1 million more in 2002 than we did in 2000. This important revenue source will be analyzed further during the annual budget cycle.

Development projections indicate a decline in new residential development from this point forward. Therefore, FY 2001/2002 may become known as the transition year as we throttle back from very large receipts in Construction Permits and Building Inspections. Construction Permits tend to generate net revenues for the General Fund, while Building Inspections is associated with actual costs for operating the Planning and Building Department. Barring any changes in the General Plan, future revenues will continue to taper off as we approach the build-out of available parcels.

Franchise Fees used to be fairly predictable until a couple of years ago when the State deregulated the energy markets. Last year's receipts show the lingering problems with the legislation as gas and electric prices held onto high-yielding contracts resulting in increased franchise fees for the City. The bitter-sweet bonus of \$43,952 last year will hopefully subside in the current year as rates return to more reasonable levels.

**Table 3** below illustrates the actual expenditure results for all departments in the General Fund. In retrospect, starting the year with a hiring freeze and an unpredictable election certainly set the pace for expenditure savings throughout the year. The year-end total of \$24,074,669 is only 94% of what had started out as a very thin budget.

**Table 3: General Fund Expenditures—2001/2002 Budget to Actual Comparison (CAFR p. 4)**

Expenditure by Department	2001/2002 Final Budget	2001/2002 Actual	Difference Favorable / (Unfavorable)	Percentage of Actual
City Council	\$110,717	\$107,673	\$3,044	0.4%
City Attorney	273,108	220,873	52,235	0.9%
City Manager	994,539	951,670	42,869	4.0%
Administrative Services	1,525,764	1,527,542	(1,778)	6.3%
Planning & Building	2,413,597	2,218,566	195,031	9.2%
Parks & Community Services	7,846,083	6,963,038	883,045	28.9%
Public Safety - Fire	4,601,498	4,420,458	181,040	18.4%
Public Safety - Police	7,467,519	7,145,454	322,065	29.7%
Public Works	436,609	517,695	(81,086)	2.2%
Capital Improvements	65,000	700	64,300	0.0%
<b>Total</b>	<b>\$25,734,434</b>	<b>\$24,074,669</b>	<b>\$1,659,765</b>	<b>100%</b>

The Parks and Community Services Department turned in the largest savings of \$883,045 primarily due to construction delays and operations savings in Parks and Open Space Management. Three other departments gave back huge savings, including Police - \$322,065,

Planning and Building - \$195,031, and Fire - \$181,040. The majority of these savings were due to vacant positions.

The Public Works Department receives supplementary road maintenance and construction funding from the Transportation Development Act (“TDA”) ¼ Cent Sales Tax. Unfortunately, the stall in the regional economy caused a huge budget gap to develop in the valuable revenue source and an adjustment in the revenue transfer had to be made by SACOG. While the affect was recognized in Fiscal Year 2001-2002, the continuing economic recession has placed the Yolo County Transportation District and City of Davis at an increased risk of foregone income in Fiscal Year’s 2002/2003 and 2003/2004. Due to the revenue loss, the Public Works Department had to shift maintenance and construction costs over to the General Fund. Staff will continue to monitor this item and report back to the Council as soon as the revenue estimates are available from SACOG.

### **Mid-Year Budget Update and Revised Budget Projection**

It is absolutely impossible to predict what the State of California will do in the remaining four months of this fiscal year. In the last two months, for example, the Governor has recommended a number of budgetary assaults on local government revenues but has been unable to find support in the legislatures. The assaults are focused on the Motor Vehicle In Lieu Fee “Backfill,” State Mandate Reimbursements, Booking Fee Reimbursements, and Redevelopment Tax Increments.

So far, the Governor has only been successful at stalling the Mandate Reimbursements temporarily and canceling the Booking Fee Reimbursements. Luckily, each of these shortfalls will be absorbed by the departments involved and will not require mid-year budget adjustments.

If you ignore the State’s economic debacle, the City of Davis has been experiencing revenue and expenditure patterns fairly close to the beginning budget predictions. This is partially due to conservative revenue estimates caused by the lack of improvement in regional economic conditions and the continuance of the “soft hiring freeze” that has been in place for the last two fiscal years.

**Table 4** on the next page displays the strong results of the City’s major revenues through December, 2002. It appears that the local economy has improved at a higher level than anticipated leading to strong gains in taxes generated by the business sector. In addition, strong car sales in the summer and fall have led to a large jump in Motor Vehicle In Lieu Fees during the first half of the year. Unfortunately, if the State is successful in pruning this key revenue, our share of the loss will be now be higher as well.

Development revenue receipts in the General Fund are also on track for the year with revenues being received from the Cantrill Drive complex and the Olive Drive Apartments. As discussed earlier, this important source of revenues is going to be tapering off over the next several years as the City approaches build out.

Property values are continuing to escalate this year and should end the year in the 6% range. This is only half of what was realized last year but will once again provide healthy property tax

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gains as residential properties change hands and are reassessed at the higher values. Current housing resale rates have been in the 5% range, which is significantly lower than the state average of 12%.

**Table 4: 2002/2003 Midyear Revised Major General Fund Revenue Estimates**

Midyear Revenue Estimate Revisions (net changes)	Final Budget	Revised Estimate	Increase / (Decrease)	% Increase Over Budget
Property Taxes	\$6,744,200	\$6,797,803	\$53,603	0.8%
Sales Taxes	5,560,000	5,600,000	40,000	0.7%
Transient Occupancy Tax	884,200	942,000	57,800	6.5%
Business License Tax	977,000	1,060,000	83,000	8.5%
Municipal Services Tax	1,780,000	1,770,000	(10,000)	(0.6)%
Motor Vehicle In-Lieu	3,570,000	3,648,000	78,000	2.2%
<b>Totals</b>	<b>\$19,515,400</b>	<b>\$19,817,803</b>	<b>\$302,403</b>	<b>1.5%</b>

**Table 5** below displays the changes to the beginning budget estimates that we know of today. The greatest change is to the Beginning Unreserved Fund Balance, which increased from \$6,387,574 to \$7,138,576. This reflects the positive results of the previous fiscal year discussed earlier and allowed the City to start the year with a Fund Balance that is 25% of planned revenues and 26% of planned expenditures.

**Table 5: Estimate of Changes in General Fund Balance (2002/2003)**

<b>7/1/02 Unreserved Fund Balance (actual)</b>	<b>\$7,138,576</b>
2002/03 Budgeted Expenditures	(27,934,453)
2002/03 Budgeted Revenues (Including Fees & Grants)	27,025,186
Frozen Position Savings	0
PERS Set-aside	(370,000)
<b>Subtotal – Preliminary 6/30/03 Fund Balance</b>	<b>5,859,309</b>
<b>Budget Adjustments</b>	
Approved Budget Adjustments (as of 1/31/03)	(37,726)
<b>Subtotal – Budget Adjustments</b>	<b>(37,726)</b>
<b>Midyear Revenue Estimate Revisions (net changes)</b>	
Property Taxes	53,603
Sales Taxes	40,000
Transient Occupancy Tax	57,800
Business License Tax	83,000
Municipal Services Tax	(10,000)
Motor Vehicle In-Lieu	78,000
<b>Subtotal - Net Revenue Change</b>	<b>302,403</b>
<b>Estimated 6/30/03 Fund Balance</b>	<b>\$6,123,986</b>
<b>Estimated 6/30/03 Fund Balance as % of Revenue (Budget plus revised estimate)</b>	<b>22.4%</b>

While it is difficult to predict the results of departmental expenditures this year, the salary savings experienced to date may lead to overall expenditure reductions if they follow past fiscal year trends. If so, these savings could amount to 2% of total General Fund expenditures by the end of the year or approximately \$500,000.

Overall, the General Fund revised budget indicates that the City should finish the year with around \$6.12 million in unreserved fund balance or 22.4% of current year revenues. In examining these figures, it is important to remember that the ending fund balance can change by as much as \$280,000 for every 1% change in revenues and/or expenditures. In fiscal year 2001/2002, this amounted to a swing of \$2.4 million between anticipated budgets and actual results.

**Preliminary 2003/2004 Budget Projections**

We are now well under way with the development of the preliminary 2003/04 budget. Departments have been directed to prepare relatively flat budgets with allowances to accommodate current contractual obligations with employee bargaining groups and city service providers. Although the preliminary revenue projections for 2003/04 show some growth, projected expenditures will continue to out-pace revenues and will probably require drawing down the General Fund unreserved fund balance once again. Obviously, this shortfall could be exacerbated by any action taken by the State that reduces our revenues.

One of the largest cost increases for next year will be for CalPERS retirement benefits. Due to the prolonged economic slump, the CalPERS system has sustained two years of heavy investment losses that will lead to significant increases in employer costs in the coming years ahead. **Table 6** below displays the results of a study performed by AON Consultants that indicates what the rates will be for the next five years, barring any significant changes in the economy. The actual dollar amounts resulting from the rate increases will not be known until the conclusion of employee negotiations in the early summer.

**Table 6: Estimated PERS Rates for the Next Five Years\***

Formula	02/03	03/04	04/05	05/06	06/07	07/08
Misc. 2%@55	0.0%	0.0%	2.1%	5.7%	6.6%	7.1%
Fire 3%@ 50	6.4%	15.3%	24.7%	30.3%	31.7%	32.4%
Police 3%@50	4.2%	6.4%	16.3%	22.0%	34.1%	34.8%

\* Assuming 0% Investment Earnings for Fiscal Year 2002/2003.

Health Insurance costs have suffered over the last several years from changing medical industry conditions and will increase by 23% for the 2003 calendar year. The City contracts for medical insurance coverage through the CalPERS Health Benefits Program and is seeing major changes in the number and types of plans that are available. Citywide costs for health insurance will be approximately \$3.6 million for the 2003 calendar year with the current contribution to employees and retirees set at \$673.95 per month.

Significant costs for new facility maintenance requirements (e.g., Walnut Park and Mace Ranch Park) are anticipated in the coming year. Measure D revenues are not enough to cover expenses for these additional facilities maintenance and operations. As Council considers new programs or facilities, the necessity to analyze ongoing maintenance and operation costs and find new revenue sources is critical.

In January, 2002 the Finance and Budget Commission recommended to the City Council a budget strategy that included 13 different recommendations. The Commission discussed various alternative revenues at that time and recommended that the Council investigate a Sales Tax Override Measure and a Utility User Tax Measure for future ballots. These revenues need to be developed because the parks tax will sunset in June, 2006 and an alternative revenue needs to be in place to continue the same level of service.

As a result of interest in looking at an increased sales tax, legislation (AB 7) was introduced and passed by the State legislatures and will allow the city to consider placing an increased sales tax measure on the ballot. The legislation allows a 1/2-cent sales tax or 1/4-cent sales tax to be placed before the voters.

Another alternative revenue the Commission recommended is a utility user tax. Various utilities and various alternate rates of tax were reviewed by the FBC and Staff has continued to investigate several scenarios and assumptions to show the impact of each on future budgets. Staff will return in late spring to discuss these two revenue options in detail with the City Council.

### **Summary**

Although we have entered fiscal year 2002-2003 with a fund balance higher than our goal of 15%, it is important to remember the implications of pending circumstances at the State level and the overall uncertainty of the current economic environment. Hopefully, as we continue through the budget cycle, staff will be able to adequately evaluate several of the unknowns and return an accurate financial prediction of next year for the Council to consider.

### Attachments:

1. Pages 2 and 4 from the Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2002.

