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Re: Financial Analysis of the City of Vallejo

Dear Rocky:

Pursuant to your request, we have analyzed the Comprehensive Annual Financial Reports (CAFR) of the City of Vallejo's (City) for the years ended June 30, 2008 through June 30, 2012 for the purpose of rendering our comprehensive report on the financial status of the City. Our comprehensive report concentrates on the government-wide financial statements, revenues, the General Fund and other funds.

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 (MDA),
- Government-wide financial statements,
- Fund accounting,
- Two different terminologies for equity – "Net Assets" for government-wide financial statements and business-type funds, and "Fund Balances" for governmental funds.

The dissimilarities between governmental accounting and private sector accounting create different techniques in analyzing the financial health of a government as opposed to a business. These differences include:

- Variances, which we discuss in **Exhibit III**,
- Benchmarking the fund balance, and
- Other post-employment benefits (retiree health benefits).

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

	Accrual Basis	*Modified Accrual Basis*	*Cash Basis*
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 related debt, restricted, and unrestricted	Nonspendable, Restricted, Committed, Assigned, and Unassigned	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.

MANAGEMENT'S DISCUSSION & ANALYSIS

Management's Discussion and Analysis (MDA) 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 MDA 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. Each fund group is defined in the Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2010 (Code).**

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

- The **General Fund** is defined in Code Section 1300.104:
  - "The General Fund should be used to account for and report all financial resources not accounted for and reported in another fund."
- **Special Revenue Funds** are defined in Code Section 1300.105:
  - "*Special revenue funds* are used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt *service* or capital projects. The term *proceeds of specific revenue sources* establishes that one or more specific restricted or committed revenues should be the foundation for a special revenue fund. Those specific restricted or committed revenues may be initially received in another fund and subsequently distributed to a special revenue fund. Those amounts should not be recognized as revenue in the fund initially receiving them; however, those inflows should be recognized as revenue in the special revenue fund in which they will be expended in accordance with specified purposes. The restricted or committed proceeds of specific revenue sources should be expected to continue to comprise a substantial portion of the inflows reported in the fund.3 Other resources (investment earnings and transfers from other funds, for example) also may be reported in the fund if those resources are restricted, committed, or assigned to the specified purpose of the fund. A stabilization arrangement (as discussed in paragraphs .157 and .158 of Section 1800) would satisfy the criteria to be reported as a separate special revenue fund only if the resources derive from a specific restricted or committed revenue source. Governments should discontinue reporting a special revenue fund, and instead report the fund's remaining resources in the general fund, if the government no longer expects that a substantial portion of the inflows will derive from restricted or committed revenue sources."
- **Capital Projects Funds** are defined in Code Section 1300.106:
  - "*Capital projects funds* are used to account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays including the acquisition or construction of capital facilities and other capital assets. Capital projects funds exclude those types of capital-related outflows financed by proprietary funds or for assets that will be held in trust for individuals, private organizations, or other governments. Capital outlays financed from general obligation bond proceeds should be accounted for *through* a capital projects fund."
- **Debt Service Funds** are defined in Code Section 1300.107:
  - "*Debt service funds* are used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest. Debt service funds should be used to report resources if legally mandated. Financial resources that are being accumulated for principal and interest maturing in future years also should be reported in debt service funds. The debt service transactions of a special assessment issue for which the government is not obligated in any manner should be reported in an agency fund (see paragraph .114) rather than a

debt service fund to reflect the fact that the government's duties are limited to acting as an agent for the assessed property owners and the bondholders, as discussed in Section 540."

- **Permanent Funds** are defined in Code Section 1300.108:
  - "*Permanent funds* should be used to account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs-that is, for the benefit of the government or its citizenry.4 Permanent funds do not include private-purpose trust funds (defined in paragraph. **113),** which should be used to report situations in which the government is required to use the principal or earnings for the benefit of individuals, private organizations, or other governments."

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. Proprietary Funds are composed of the following two fund groups:

- **Enterprise Funds** are defined in Code Section 1300.109:
  - "Enterprise Funds may be used to report any activity for which a fee is charged to external users for goods or services. Activities are required to be reported as enterprise funds if any one of the following criteria is met. Governments should apply each of these criteria in the context of the activity's principal revenue source.
    - The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity. Debt that is secured by a pledge of net revenues from fees and charges and the full faith and credit of a related primary government or component unit, even if that government is not expected to make any payments, is not payable solely from fees and charges of the activity. (Some debt may be secured, in part, by a portion of its own proceeds but should be considered as payable "solely" from the revenues of the activity.)
    - Laws or regulations require that the activity's costs of providing services including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.
    - The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service)."
- **Internal Service Funds** are defined in Code Section 1300.110:
  - "Internal Service Funds may be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis.

Internal service funds should be used only if the reporting government is the predominant participant in the activity. Otherwise, the activity should be reported as an enterprise fund."

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 Code Section 1300.102 (C)
  - "Fiduciary Funds focuses on net assets and changes in net assets. 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 defined in Code Section 1300.111:
  - "Pension (and other employee benefit) Trust Funds should be 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 defined in Code Section 1300.112:
  - "Investment Trust Funds should be used to report the external portion of investment pools reported by the sponsoring government, as required by Section 150 "Investments," paragraph 116."
- **Private-purpose Trust Funds** are defined in Code Section 1300.113:
  - "Private-purpose Trust Funds should be used to report all the other trust arrangements under which principal and income benefit individuals, private organizations, or other governments."
- **Agency Funds** are defined in Code Section 1300.114:
  - "Agency Funds should be used 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 Code Section 2200.179:
  - **"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.

Net Asset Classifications

In the **Government-wide financial statements, Proprietary funds and Component units**, "Net Assets" are defined as the difference between assets and liabilities and should be displayed using the following three components:

- **Invested in Capital Assets, Net of Related Debt** is defined in Code Section 2200.118:
  - This component of net assets consists of capital assets, including *restricted* capital assets, 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. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds should not be included in the calculation of *invested in capital assets, net of related debt.* Rather, that portion of the debt should be included in the same net assets component as the unspent proceeds—for example; *restricted for capital projects.*
- **Restricted Net Assets** (distinguishing between major categories of restrictions) is defined in Code Section 2200.119:
  - "Net assets should be reported as restricted when constraints placed on net asset use are either:
    - Externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments
    - Imposed by law through constitutional provisions or enabling legislation."
  - Enabling legislation, as the term is used in this section, 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. The amount of the primary government's net assets at the end of the reporting period that are restricted by enabling legislation should be disclosed in the notes to the financial statements.

- Legal Enforceability is defined in Code Section 2200.120:
  - "Legal Enforceability means that a government can be compelled by an external party—such as citizens, public interest groups, or the judiciary—to use resources created by enabling legislation only for the purposes specified by the legislation. Generally, the enforceability of an enabling legislation restriction is determined by professional judgment, which may be based on actions such as analyzing the legislation to determine if it meets the qualifying criteria for enabling legislation, reviewing determinations made for similar legislation of the government or other governments, or obtaining the opinion of legal counsel. However, enforceability cannot ultimately be proven unless tested through the judicial process, which may never occur. The determination of legal enforceability should be based on the underlying facts and circumstances surrounding each individual restriction. The determination that a particular restriction is not legally enforceable may lead a government to reevaluate the legal enforceability of similar enabling legislation restrictions, but should not necessarily lead a government to conclude that all enabling legislation restrictions are unenforceable."

- **Unrestricted Net Assets** is defined in Code Section 2200.124:
  - "Unrestricted Net Assets consist of net assets that do not meet the definition of "Restricted" or "Invested in Capital Assets, Net of Related Debt".
  - Any debts that cannot be attributed to acquisition or construction of the capital assets are allocated to unrestricted net assets.

Fund Balance Classifications for Fiscal Years Beginning After June 15, 2010

For Governmental Fund Types, for fiscal years beginning after June 15, 2010, the terms reserved fund balance, unreserved-designated fund balance and unreserved-undesignated fund balance became obsolete and was replaced by the following new terminology.

- **Nonspendable Fund Balance** is defined in the Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2010, Code Section 1800.143 and 1800.144:
  - "The nonspendable fund balance classification includes amounts that cannot be spent because they are either (a) not in spendable form or (b) legally or contractually required to be maintained intact. The "not in spendable form" criterion includes items that are not expected to be converted to cash, for example, inventories and prepaid amounts. It also includes the long-term amount of loans and notes receivable, as well as property acquired for resale. However, if the use of the proceeds from the collection of those receivables or from the sale of those

properties is restricted, committed, or assigned, then they should be included in the appropriate fund balance classification (restricted, committed, or assigned), rather than nonspendable fund balance.

    - For purposes of reporting net assets, paragraph .138 requires amounts that are "required to be retained in perpetuity" to be classified as "nonexpendable" within the restricted net asset category. For fund balance reporting purposes, however, those amounts should be classified as nonspendable rather than restricted."

- **Restricted Fund Balance** is defined in the Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2010 Code Sections, 1800.145 and 1800.146.
    - "Except as provided for in paragraph 144, amounts that are restricted to specific purposes, pursuant to the definition of restricted in paragraph 134, should be reported as restricted fund balance. Fund balance should be reported as restricted when constraints placed on the use of resources are either:
        - Externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments; or
        - Imposed by law through constitutional provisions or enabling legislation.
    - Enabling legislation, as the term is used in this Statement, 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. Legal enforceability means that a government can be compelled by an external party—such as citizens, public interest groups, or the judiciary—to use resources created by enabling legislation only for the purposes specified by the legislation."
- **Committed Fund Balance** is defined in the Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2010 Code Sections, 1800.147 through 1800.149.
    - "Amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the government's highest level of decision making authority should be reported as committed fund balance. Those committed amounts cannot be used for any other purpose unless the government removes or changes the specified use by taking the same type of action (for example, legislation, resolution, ordinance) it employed to previously commit those amounts. The authorization specifying the purposes for which amounts can be used should have the consent of both the legislative and executive branches of the government, if applicable. Committed fund balance also should incorporate contractual obligations to the extent that existing resources in the fund have been specifically committed for use in satisfying those contractual requirements.
    - In contrast to fund balance that is restricted by enabling legislation, as discussed in paragraph .146, amounts in the committed fund classification may be redeployed for other purposes with appropriate due process, as explained in paragraph .147. Constraints imposed on the use of committed amounts are imposed by the government, separate from the authorization to raise the underlying revenues. Therefore, compliance with constraints imposed by the

government that commit amounts to specific purposes are not considered to be legally enforceable as defined in paragraph .146.
  - The formal action of the government's highest level of decision-making authority that commits fund balance to a specific purpose should occur prior to the end of the reporting period, but the amount, if any, which will be subject to the constraint, may be determined in the subsequent period."

- **Assigned Fund Balance** is defined in the Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2010 Code Sections 1800.150 to 1800.153.
  - "Amounts that are constrained by the government's intent to be used for specific purposes, but are neither restricted nor committed, should be reported as assigned fund balance, except for stabilization arrangements, as discussed in paragraph .158 Intent should be expressed by (a) the governing body itself or (b) a body (a budget or finance committee, for example) or official to which the governing body has delegated the authority to assign amounts to be used for specific purposes.
  - Both the committed and assigned fund balance classifications include amounts that have been constrained to being used for specific purposes by actions taken by the government itself. However, the authority for making an assignment is not required to be the government's highest level of decision making authority. Furthermore, the nature of the actions necessary to remove or modify an assignment is not as prescriptive as it is with regard to the committed fund balance classification. Constraints imposed on the use of assigned amounts are more easily removed or modified than those imposed on amounts that are classified as committed. Some governments may not have both committed and assigned fund balances, as not all governments have multiple levels of decision-making authority.
  - Assigned fund balance includes (a) all remaining amounts (except for negative balances, as discussed in paragraph .156) that are reported in governmental funds, other than the general fund, that are not classified as nonspendable and are neither restricted nor committed and (b) amounts in the general fund that are intended to be used for a specific purpose in accordance with the provisions in paragraph .150. By reporting particular amounts that are not restricted or committed in a special revenue, capital projects, debt service, or permanent funds, the government has assigned those amounts as to purposes of the respective funds. Assignment within the general fund conveys that the intended use of those amounts is for a specific purpose that is narrower than the general purposes of the government itself. However, government should not report an assignment for an amount to a specific propose if the assignment would result in a deficit in unassigned fund balance.
  - An appropriation of the existing fund balance to eliminate a projected budgetary deficit in the subsequent year's budget in an amount no greater than the projected excess of expected expenditures over expected revenues satisfies the criteria to be classified as an assignment of fund balance. As discussed in paragraph .152, assignments should not cause a deficit in unassigned fund balance to occur."
- **Unassigned Fund Balance** is defined in Code Section 1800.154.

- "Unassigned fund balance is the residual classification for the general fund. This classification represents fund balance that has not been assigned to other funds and that has not been restricted, committed, or assigned to, specific purposes within the general fund. **The general fund should be the only fund that reports a positive unassigned fund balance amount**. In other governmental funds, if expenditures incurred for specific purposes exceeded the amounts restricted, committed, or assigned to those purposes, it may be necessary to report a negative unassigned fund balance, as discussed in paragraph .156**." (Emphasis added).**

Fund Balance Classifications for Fiscal Years Beginning <u>Before</u> June 15, 2010

For fiscal years beginning before June 15, 2010, the fund balance was segregated into two categories as in defined in Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2007 Code Section 1800.142 to show various legal or other restrictions on the use of fund resources:

- "In governmental fund accounting and reporting, use of the term **reserve** should be limited to indicating that a portion of the fund balance is not appropriable for expenditure or is legally segregated for a specific future uses.... Where part of the fund balance is reserved, the remainder should be reported as ***Unreserved Fund Balance***."
- 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.
  - **Designated-Unreserved Fund Balances** are defined in Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2007 Code Section 1800.144. "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 be 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)**."**
    - Per the AICPA's *Audits of State and Local Governmental Units (March 1, 2008 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."
  - **Undesignated-Unreserved** 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.

STABILIZATION ARRANGEMENTS

To stabilize reserves, governments set aside amounts for emergency situations. In the past, these set asides were reported several different ways, as separate special revenue funds, reserved fund balances, or designated fund balances.

- The stabilization arrangement reporting standards are covered by Code Section 1800.157 and 158.
    - "Some governments formally set aside amounts for use in emergency situations or when revenue shortages or budgetary imbalances arise. Those amounts are subject to controls that dictate the circumstances under which they can be spent. Many governments have formal arrangements to maintain amounts for budget or revenue stabilization, working capital needs, contingencies or emergencies, and other similarly titled purposes. The authority to set aside those amounts generally comes from statute, ordinance, resolution, charter, or constitution. Stabilization amounts may be expended only when certain specific circumstances exist. The formal action that imposes the parameters for spending should identify and describe the specific circumstances under which a need for stabilization arises. Those circumstances should be such that they would not be expected to occur routinely. For example, a stabilization amount that can be accessed "in an emergency" would not qualify to be classified within the committed category because the circumstances or conditions that constitute an emergency are not sufficiently detailed, and it is not unlikely that an "emergency" of some nature would routinely occur. Similarly, a stabilization amount that can be accessed to offset an "anticipated revenue shortfall" would not qualify unless the shortfall was quantified and was of a magnitude that would distinguish it from other revenue shortfalls that occur during the normal course of governmental operations.
        - Throughout this section, the term *stabilization* is used to refer to economic stabilization, revenue stabilization, budgetary stabilization, and other similarly intended (including "rainy-day") arrangements.
- For the purposes of reporting fund balance, stabilization is considered a *specific purpose,* as discussed in paragraph .142. **Stabilization amounts should be reported in the general fund as restricted or committed if they meet the criteria set forth in paragraphs .145–.148, based on the source of the constraint on their use. Stabilization arrangements that do not meet the criteria to be reported within the restricted or committed fund balance classifications should be reported as *unassigned* in the general fund (emphasis added).** A stabilization arrangement would satisfy the criteria to be reported as a separate special revenue fund only if the resources derive from a specific restricted or committed *revenue* source, as required by paragraph .105 of Section 1300, "Fund Accounting."

ENCUMBRANCES

Under the old fund balance reporting standards, encumbrances represented commitments related to unperformed contracts for goods or services (executory contracts), and were used to control expenditures for the year and to enhance cash management.

- Encumbrances only appeared in Governmental Fund types, not in Proprietary Fund types. Encumbrances did not represent expenditures for the period, only a commitment to expend resources in the future.
    - This future could be the succeeding year or several years.
    - The resources used to fund the contract could be either reserves or future revenues.

- Likewise, the reserve for an encumbrance was 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 were uncompleted at year end under the old reporting standards were recorded as a reserve for encumbrances in the applicable fund balance since they did not lapse at June 30.
    - Instead, the commitments were considered encumbered and did 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.
- With the adoption of GASB 54, the term is now obsolete, and should not be used after the adoption of the new reporting standard.
    - **GASB realized that encumbrances are not a specific restriction on any identifiable assets. Instead, encumbrances are an indication of a future payment, the source of payment is from any source.**

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 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." Fitch affirmed its 5% benchmark on page six in its March 23, 2007 report titled *Local Government General Obligation Rating Guidelines* stated: "Because fund balance designations are discretionary and will vary among entities, Fitch looks at unreserved fund balances for national comparative purposes. Generally, as a cushion against potential revenue and expenditure volatility, an unreserved fund balance equal to 5% of expenditures and other fund uses is regarded as a sound level."

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 Association

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*, by Stephen Gauthier, 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.

Application of GASB 54 to the 5% Benchmark

The release of GASB 54 does not make the historic 5% benchmark irrelevant. Instead, it clarifies the City's reserves by changing the emphasis to the strength of the restrictions and limitations on the government's resources. In the GFOA's publication, *What Everyone Needs to Know About The New Fund Balance* by Stephen J. Gauthier, the Director of the GFOA's Technical Services

Center, Gauthier wrote that under the old fund balance components, the reserved fund balance "reflected three different types of resources:

- Resources that by their very nature cannot be spent (e.g., prepaid rent);
- Resources that are not yet available for spending (e.g., long-term portion of loans receivable); and
- Resources externally restricted to a purpose narrower than the fund."

Under the new reporting standards established by GASB 54, the first two items would be reported in the "nonspendable" portion of the fund balance. Only the third item would be classified in the "restricted" portion of the fund balance. Gauthier also noted that under the new reporting guidelines, restricted fund balances also includes those restricted resources that were not "narrower than the purpose of the fund" that, under the old reporting model, were reported as unreserved. In essence, the new "nonspendable" and "restricted" fund balances takes the place of the old reserved fund balance.

Gauthier classifies the committed fund balance, the assigned fund balance and the unassigned fund balance as the unrestricted fund balance. On page 23 of the New Fund Balance, Gauthier highlighted this classification with this example:

	Total Fund Balance
Less:	Nonspendable Fund Balance
Less:	Restricted Fund Balance
Equals	Unrestricted Fund Balance

With the fund balance classifications changing the emphasis from what is appropriable to the restrictions on resource availability, we can determine what is really available. The committed and assigned fund balance classifications are in essence *internal* restrictions on the fund's resources. Both the committed and the assigned classifications can be changed at any time during the budget process or during the fiscal year by the same process and/or procedures that created them. **As such, Gauthier equates the entire unrestricted fund balance to the old unreserved fund balance.** Thus, we can continue computing the 5% benchmark using the entire unrestricted fund balance consisting of the committed, assigned and unassigned fund balances.

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 unrestricted 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.

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 Vallejo's **Government-wide Financial Statements** for the years ended June 30, 2008 through June 30, 2012. We have only presented the governmental activities of the City as that is the funding source for the Police Department. 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. It does not include the Enterprise Funds, which are the business activities portion of the government-wide financial statements. **Not all of the resources in this exhibit are available for compensation purposes due to restriction of their use at the fund level.**

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
- How the government finances and acquires its infrastructure and capital assets.

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 six years since July 1, 2006, the City's net assets are $17.4 million higher as of June 30, 2012 growing from $374.7 million to $392.2 million.

General

- All of the increase in net assets is due to revenues, special items, and transfers exceeding program expenses during the past six years.
- Tax revenues exceeded expenses, net of program revenues twice, in three of the six years presented, in 2010, 2011 and 2012.
- Net assets increased in three of the six years presented, in 2010, 2011 and 2012.

Expenses and Program Revenues

There are significant differences between expenses as reported in the government-wide financial statements and expenditures as reported in the governmental fund statement. Expenditures represent the expenditure of cash and include the acquisition cost of capital assets and debt principle. Expenditures do not include depreciation expense. Expenses represent the use of an asset and include depreciation and amortization expenses, but do not include the acquisition of assets or the payment of principle on long-term debt.

The City allocates its government-wide expenses between twelve functions, five of which receive program revenues. Over the past six years, all twelve functions experienced declines in their annual expenses. Overall spending has declined substantially. The four largest expense functions are material, as each exceeded 10% of total expenses in the past five years. The eight smallest expense functions are immaterial, combined they are below 10% of total expenses. The City does not explain why large increases occur in expenses or revenues in its Management's Discussion and Analysis (MDA).

Revenues generated by a program or function are program revenues. Restrictions on the use of these revenues vary between the three types of program revenues.

- Revenues from **charges for services** generally are not restricted to finance future program services. There are exceptions.
    - These revenues usually can be used to finance wages and benefits.
    - Charges for services received by the General Fund usually can be used to finance all General Fund programs.
    - Charges for services revenues declined in four of the five years since 2007 from $29 million in 2008 to $17 million in 2012.
- **Operating grants and contributions** ranged from a low of $20.4 million in 2009 to a high of $34.6 million in 2007.
    - Operating grants and contributions for specific programs can only be spent for those specific purposes identified in the grant, and may be available to finance only those wages that provide the specific services.
    - Unspent operating grants for specific grants should be reported as restricted net assets if unspent at year end.
- **Capital grants and contributions** either represent infrastructure contributed by developers or moneys that can only be spent for specific capital projects.
    - These moneys cannot be spent on wages and benefits except for those directly related to the construction project and overhead.
    - Unspent capital grants should be reported as restricted net assets if unspent at year end.

Total governmental-activities expenses declined each year since 2007 from $159.1 million at June 30, 2007 to $112.8 million at June 30, 2012.

- **General government** expenses were allocated between six functions, which combined were less than 10% of 2012 annual expenses.
- **Community Development**, which appears to have included the City's Redevelopment Agency, was the largest expenditure function in four of the six years presented.
    - In 2012, the City's government activities suffered a $4.5 million extraordinary loss due to the dissolution of its Redevelopment Agency and the transfer of assets and liabilities to the successor agency.
    - With the dissolution of the City's Redevelopment Agency, the City also lost the incremental property tax revenues to the successor agency.
        - The loss of the incremental revenues will have no effect on the General Fund. **The incremental property tax revenues were used solely by the Redevelopment Agency.**
        - **The incremental property taxes will continue to be collected by the Successor Agency, to pay off all of the Redevelopment Agency's long-term construction contracts and bonded debt.**
        - **As the debt service is reduced, the incremental property taxes will be allocated to those governmental agencies the taxes were originally taken from, including the City.**
    - With the dissolution of the Redevelopment Agency, the City elected to be the "successor agency" to the redevelopment agency. The City established a private-purpose trust fund to be the "successor agency" to wrap up the affairs of the

redevelopment agency, and payoff all bonded debt and construction contracts owed by the Agency.

- The City also elected to retain the redevelopment agency's housing responsibilities and created a special revenue fund and a capital project fund to account for the housing activities.
- In closing the redevelopment agency, all of the long-term debt and significant cash and investments were transferred to the private purpose trust fund.
  - The assets, liabilities, revenues and expenditures of the private purpose trust are reported as an agency/trust fund in the City's CAFR.

- **As shown in the following table, Community Development received substantial program revenues that covered significant portions of the annual expenses, ranging from 50.3% of annual expenses to 115.32% of actual expenses.**

Community Development

Fiscal Year Ended June 30,	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Total Program Revenues	Total Program Expenses	% Expense Covered by Revenues
2007	7,896,852	29,756,924	0	37,653,776	44,540,545	84.54%
2008	4,004,685	19,687,441	0	23,692,126	33,498,889	70.73%
2009	2,972,439	16,288,433	0	19,260,872	38,289,355	50.30%
2010	1,759,719	29,005,497	0	30,765,216	39,370,106	78.14%
2011	2,260,317	28,655,919	0	30,916,236	36,122,330	85.59%
2012	2,208,176	29,344,902	0	31,553,078	27,382,802	115.23%

- **Fire Services** covers the fire department, and was the City's third or fourth largest expense function.
  - The Fire department's expenses fell from $29.7 million in 2007 to $15.8 million in 2010 due to draconian cuts made to the department during the City's bankruptcy.
  - Fire department expenses began to grow again in 2011, growing to $19.1 million in 2012.
  - Program revenues are mostly from charges for services, and have covered from 12.25% to 16.62% of fire expenses.

Fire Services

Fiscal Year Ended June 30,	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Total Program Revenues	Total Program Expenses	% Expense Covered by Revenues
2007	3,635,536	0	0	3,635,536	29,682,741	12.25%
2008	3,679,067	17,000	0	3,696,067	27,464,830	13.46%
2009	3,420,808	0	0	3,420,808	24,629,574	13.89%
2010	2,240,052	0	0	2,240,052	15,796,657	14.18%
2011	2,567,616	0	0	2,567,616	17,484,072	14.69%
2012	3,167,551	0	0	3,167,551	19,054,650	16.62%

- **Police Services** covers the police department, and was the City's first or second largest expense function during the last six years.
  - The Police department's expenses fell from $41.7 million in 2007 to $29.6 million in 2010 due to draconian cuts made to the department during the City's bankruptcy.
  - Police department expenses began to recover in 2011, growing to $32.2 million in 2012.
  - Program revenues are mostly from charges for services and operating grants, and have covered from 11.95% to 17.68% of police expenses.

Police Services

Fiscal Year Ended June 30,	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Total Program Revenues	Total Program Expenses	% Expense Covered by Revenues
2007	3,770,559	1,214,047	0	4,984,606	41,702,454	11.95%
2008	3,617,092	2,491,713	0	6,108,805	43,073,607	14.18%
2009	3,244,019	1,892,507	0	5,136,526	37,381,878	13.74%
2010	2,055,502	2,401,610	0	4,457,112	29,586,690	15.06%
2011	1,953,217	1,745,979	0	3,699,196	29,812,069	12.41%
2012	2,515,818	3,184,706	0	5,700,524	32,241,212	17.68%

- After growing to $26 million in 2008, **Public Works** expenses declined to $19 million in 2011, before growing to $20.9 million in 2012.
  - As shown in the following table, this function's program revenues have financed most if not all of the City's public works during the last six years.
  - The public works function receives revenues from all three program revenues, but capital grants and contributions are the largest and most important.
  - Public works' program revenues, covered between 50.25% and 219.29% of the function's annual expense.

- Furthermore, the moneys received as capital grants were capitalized when spent and not expensed.

Public Works

Fiscal Year Ended June 30,	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Total Program Revenues	Total Program Expenses	% Expense Covered by Revenues
2007	9,123,587	3,633,603	2,714,307	15,471,497	24,422,136	63.35%
2008	7,251,607	2,318,676	3,485,972	13,056,255	25,984,476	50.25%
2009	6,699,092	2,184,415	6,359,992	15,243,499	22,384,988	68.10%
2010	7,175,318	2,091,445	14,604,908	23,871,671	19,014,211	125.55%
2011	6,768,833	1,989,014	32,915,728	41,673,575	19,003,755	219.29%
2012	6,955,655	1,896,145	14,626,104	23,477,904	20,936,214	112.14%

General Revenues

General revenues fluctuated each year, due to changing interest income and investment revenues.

- The City's tax revenues exceeded the governmental activities' expenses net of program revenues in three of the six years presented.
- Total tax revenues declined each year from 2007 through 2011 from $70 million to $58.1 million.
    - The increase of tax revenues to $60.2 million in 2012 is due to increased sales taxes, franchise taxes, transit occupancy taxes, and other taxes that offset declines property taxes, incremental property taxes, and the utility users' tax.
- The most important tax revenue has been property taxes revenues.
- We will discuss the growth of general revenues in greater detail in our **Exhibit II.**

Change in Net Assets

The City's governmental activities' net assets declined in the first three of the six years covered by our report.

- Net assets fell from $374.7 million at July 1, 2006 to $324.6 million at June 30, 2009.
    - Net assets grew the next three years to $392.2 million at June 30, 2012.
    - As of June 30, 2012, net assets are $17.4 million higher at June 30, 2012 then at July 1, 2007.
- The increase in net assets the past three years is due to the expense cutting made during the City's bankruptcy.

EXHIBIT I-A

CITY OF VALLEJO

ANALYSIS OF GOVERNMENTAL ACTIVITIES' STATEMENT OF ACTIVITIES

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Expenses						
Legislative and advisory	277,713	285,594	230,008	125,753	181,654	220,581
Executive	1,443,648	686,783	515,508	922,039	513,771	2,442,285
Finance	2,061,912	1,216,526	1,843,470	1,631,483	1,654,657	798,688
Human resources	1,325,483	668,458	500,773	499,447	556,953	962,813
Law	860,128	867,418	907,159	760,735	719,025	503,754
Development services	2,839,027	3,252,585	2,612,545	1,986,757	2,616,595	2,346,911
Community development	44,540,545	33,498,889	38,289,355	39,370,106	36,122,330	27,382,802
Fire services	29,682,741	27,464,830	24,629,574	15,796,657	17,484,072	19,054,650
Police services	41,702,454	43,073,607	37,381,878	29,586,690	29,812,069	32,241,212
Public works	24,422,136	25,984,476	22,384,988	19,014,211	19,003,755	20,936,214
Nondepartmental	7,284,198	11,045,020	11,426,993	9,251,587	5,000,249	5,134,037
Interest on long-term debt	2,649,965	2,694,646	2,506,891	2,764,194	2,223,807	766,981
Total governmental activities expenses	159,089,950	150,738,832	143,229,142	121,709,659	115,888,937	112,790,928
Program revenues						
Charges for services	28,956,923	21,575,263	18,552,714	16,037,875	18,833,908	16,987,109
Operating grants and contributions	34,636,280	24,514,830	20,365,355	33,498,552	32,390,912	34,425,753
Capital grants and contributions	2,724,007	3,485,972	6,359,992	14,604,908	32,915,728	14,626,104
Total Program Revenues	66,317,210	49,576,065	45,278,061	64,141,335	84,140,548	66,038,966
Net (expense) revenues and change in net assets - Governmental Activities	(92,772,740)	(101,162,767)	(97,951,081)	(57,568,324)	(31,748,389)	(46,751,962)

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

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Net (expense) revenues and change in net assets - Governmental Activities	(92,772,740)	(101,162,767)	(97,951,081)	(57,568,324)	(31,748,389)	(46,751,962)
General revenues, special items and transfers						
Taxes						
Property taxes/In-lieu property tax	33,349,205	28,630,081	27,517,540	22,768,365	21,652,039	21,622,470
Incremental property taxes	4,302,203	4,908,635	3,591,154	3,280,994	3,061,230	1,790,418
Sales taxes	12,517,648	12,907,978	11,480,014	10,715,183	11,067,013	14,360,808
Utility User	12,746,862	13,501,146	13,057,518	12,916,339	12,890,539	12,792,738
Franchise	3,113,116	4,004,698	4,876,613	4,101,909	4,498,740	4,508,357
Transit occupancy	1,618,954	1,497,237	1,328,673	1,019,206	1,087,508	1,157,634
Other taxes	2,392,839	3,837,399	4,201,000	4,313,406	3,837,822	4,005,671
Total taxes	70,040,827	69,287,174	66,052,512	59,115,402	58,094,891	60,238,096
Mare Island CFD Assessments	0	5,311,886	5,022,136	3,499,675	2,099,096	2,351,533
Investment earnings	6,686,545	6,043,677	2,826,200	968,997	1,579,810	8,226,261
Miscellaneous	2,433,895	3,244,188	4,038,522	3,824,312	4,002,078	3,435,245
Total general revenues and special items	79,161,267	83,886,925	77,939,370	67,408,386	65,775,875	74,251,135
Transfers	72,871	1,352,629	(621,487)	2,270,320	(372,100)	438,038
Extraordinary items						
Debt Restructuring Adjustment	0	0	0	0	0	1,075,176
Assets transferred to/liabilities assumed by Successor Agency	0	0	0	0	0	(4,483,759)
Total General Revenues, special items, transfers, and extaordinary items	79,234,138	85,239,554	77,317,883	69,678,706	65,403,775	71,280,590
Change in Net Assets - increase (decrease)	(13,538,602)	(15,923,213)	(20,633,198)	12,110,382	33,655,386	24,528,628
Net Assets - beginning of year	374,714,684	361,176,082	345,252,869	324,619,671	336,730,053	367,633,439
Unexplained restatement	0	0	0	0	(2,752,000)	0
Net Assets - beginning of year - Restated	374,714,684	361,176,082	345,252,869	324,619,671	333,978,053	367,633,439
Net Assets - end of year	361,176,082	345,252,869	324,619,671	336,730,053	367,633,439	392,162,067

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.

Cash and Investments

The rise or decline in cash and investments is influenced 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 affect cash and investments ending balance.

- The City's unrestricted cash and investments decreased from $80.1 million at June 30, 2007 to $66.8 million at June 30, 2010 due to the deficits.
- In 2009, the decrease in accounts receivables and the increase in liabilities almost offset the entire deficit, resulting in a cash and investment decline of only $664,000 as opposed to a deficit of $21 million.
- Cash and investments continued to decline in 2010 and 2011 due to increases in receivables and the payoff of liabilities that more than offset surpluses in those years.
- Cash and investments grew in 2012 due to the surplus that offset the effects of the dissolution of the redevelopment agency and the reduction in liabilities.

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 Vallejo has maintained a healthy current asset to current liability ratio.
    - At June 30, 2012 the ratio was 4.25, a healthy ratio, meaning that for every $1 liabilities, the governmental activities have $4.25 of liabilities.

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, 2007, this component of net assets grew from $291.3 million to $337.6 million at June 30, 2012.
    - Much of this growth is due to capital grants.
- In 2012, the transfer of long-term debt to the successor agency was a factor in the increase in this component of net assets.

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.

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, throughout the period the governmental activities unrestricted net assets have been negative.
- Negative unrestricted net assets ranged from a negative $26.9 million in 2009 to a negative $16.7 million in 2011.

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

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Assets						
Unrestricted cash and investments	80,103,036	67,420,338	66,755,863	65,906,458	64,704,215	66,842,122
Other current assets	17,805,458	14,743,002	9,167,313	17,091,990	33,128,236	26,926,512
Total current assets	97,908,494	82,163,340	75,923,176	82,998,448	97,832,451	93,768,634
Restricted cash and investments with fiscal agents	42,160,881	32,754,271	29,505,851	16,959,320	10,117,781	11,100,834
Non-current assets	25,209,776	26,354,563	26,298,955	26,942,566	27,907,674	24,131,625
Capital assets	291,347,081	295,454,375	295,080,205	302,312,727	329,171,987	337,638,300
Total assets	456,626,232	436,726,549	426,808,187	429,213,061	465,029,893	466,639,393
Liabilities						
Current liabilities	35,150,306	30,134,983	32,003,657	25,034,739	28,683,672	22,068,412
Non-current liabilities	60,299,844	61,338,697	70,184,859	67,448,269	68,712,782	52,408,914
Total liabilities	95,450,150	91,473,680	102,188,516	92,483,008	97,396,454	74,477,326
Current Asset to Current Liability Ratio	2.79	2.73	2.37	3.32	3.41	4.25
Net Assets						
Invested in capital assets, net of related debt	260,245,020	264,548,211	266,223,475	273,408,041	300,254,819	315,214,369
Restricted						
Debt service	0	0	0	0	0	836,183
Capital projects	40,807,898	32,501,355	31,601,627	30,963,586	35,902,137	21,746,141
Special projects and programs	78,934,067	70,372,948	53,662,062	50,331,589	48,174,702	77,170,777
Total restricted	119,741,965	102,874,303	85,263,689	81,295,175	84,076,839	99,753,101
Unrestricted	(18,810,903)	(22,169,645)	(26,867,493)	(17,973,163)	(16,698,219)	(22,805,403)
Net Assets - end of year	361,176,082	345,252,869	324,619,671	336,730,053	367,633,439	392,162,067

Exhibit I-C shows how the City's long-term debt affects the governmental activities unrestricted net assets. Long-term liabilities that are not related to the acquisition or construction of the City's capital assets are allocated to unrestricted net assets, hiding resources that are available to finance current operations. This exhibit calculates the long-term debt that was not allocated to the capital assets and instead applied to the unrestricted net assets in order to determine the unrestricted net resources.

- In order to determine the current resources available to finance governmental activities expenses, we have to remove non-current/non-monetary assets.
- As shown, after adjusting for long-term debt and non-current/non-monetary assets, total unrestricted net resources were negative by smaller than the unrestricted net assets.
    - In our opinion, the negative unrestricted resources are due the City's large restricted cash and investment balance that is substantially smaller than the restricted net assets.
    - In our opinion, restricted net assets should equal restricted assets minus liabilities to be paid from restricted assets.
    - As such, there appears to be an error in the restricted fund balance or a portion of the liabilities will be paid by the restricted fund balance.

Exhibit I-D is a graphic representation of the City's cash and investments and net assets.

Findings

- Several of the City's functions receive significant program revenues, and are not.
- The City's governmental activities net assets are weak, but have improved.

EXHIBIT I-C
CITY OF VALLEJO
COMPUTATION OF NET RESOURCES AND RATIO ANALYSIS OF GOVERNMENT ACTIVITIES

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Computation of Governmental Activities Net Resources Available						
1 Long-term debt - non-current portion	60,299,844	61,338,697	70,184,859	67,448,269	68,712,782	52,408,914
2 Capital assets	291,347,081	295,454,375	295,080,205	302,312,727	329,171,987	337,638,300
3 Less: net assets invested in capital assets, net of related debt	(260,245,020)	(264,548,211)	(266,223,475)	(273,408,041)	(300,254,819)	(315,214,369)
4 Related debt invested in capital assets (line 2 minus line3)	31,102,061	30,906,164	28,856,730	28,904,686	28,917,168	22,423,931
5 Debt unrelated to capital assets applied to unrestricted net assets (line 1 minus line 4)	29,197,783	30,432,533	41,328,129	38,543,583	39,795,614	29,984,983
6 Non-current assets	(25,209,776)	(26,354,563)	(26,298,955)	(26,942,566)	(27,907,674)	(24,131,625)
7 Unrestricted net assets	(18,810,903)	(22,169,645)	(26,867,493)	(17,973,163)	(16,698,219)	(22,805,403)
8 **Governmental Activities Unrestricted Resources (line 5 plus line 6)**	(14,822,896)	(18,091,675)	(11,838,319)	(6,372,146)	(4,810,279)	(16,952,045)
Ratio Analysis - Unrestricted Resources to Revenues and Expenses						
Total Revenues						
Program revenues - from Exhibit I-A	66,317,210	49,576,065	45,278,061	64,141,335	84,140,548	66,038,966
Total General Revenues, special items and transfers - from Exhibit I-A	79,161,267	83,886,925	77,939,370	67,408,386	65,775,875	74,251,135
	145,478,477	133,462,990	123,217,431	131,549,721	149,916,423	140,290,101
% of unrestricted resources to total revenues	(10.19%)	(13.56%)	(9.61%)	(4.84%)	(3.21%)	(12.08%)
Program expenses - from Exhibit 1-A	159,089,950	150,738,832	143,229,142	121,709,659	115,888,937	112,790,928
% of unrestricted resources to total expenses	(9.32%)	(12.00%)	(8.27%)	(5.24%)	(4.15%)	(15.03%)

EXHIBIT I-D
CITY OF VALLEJO
ANALYSIS OF NET ASETS

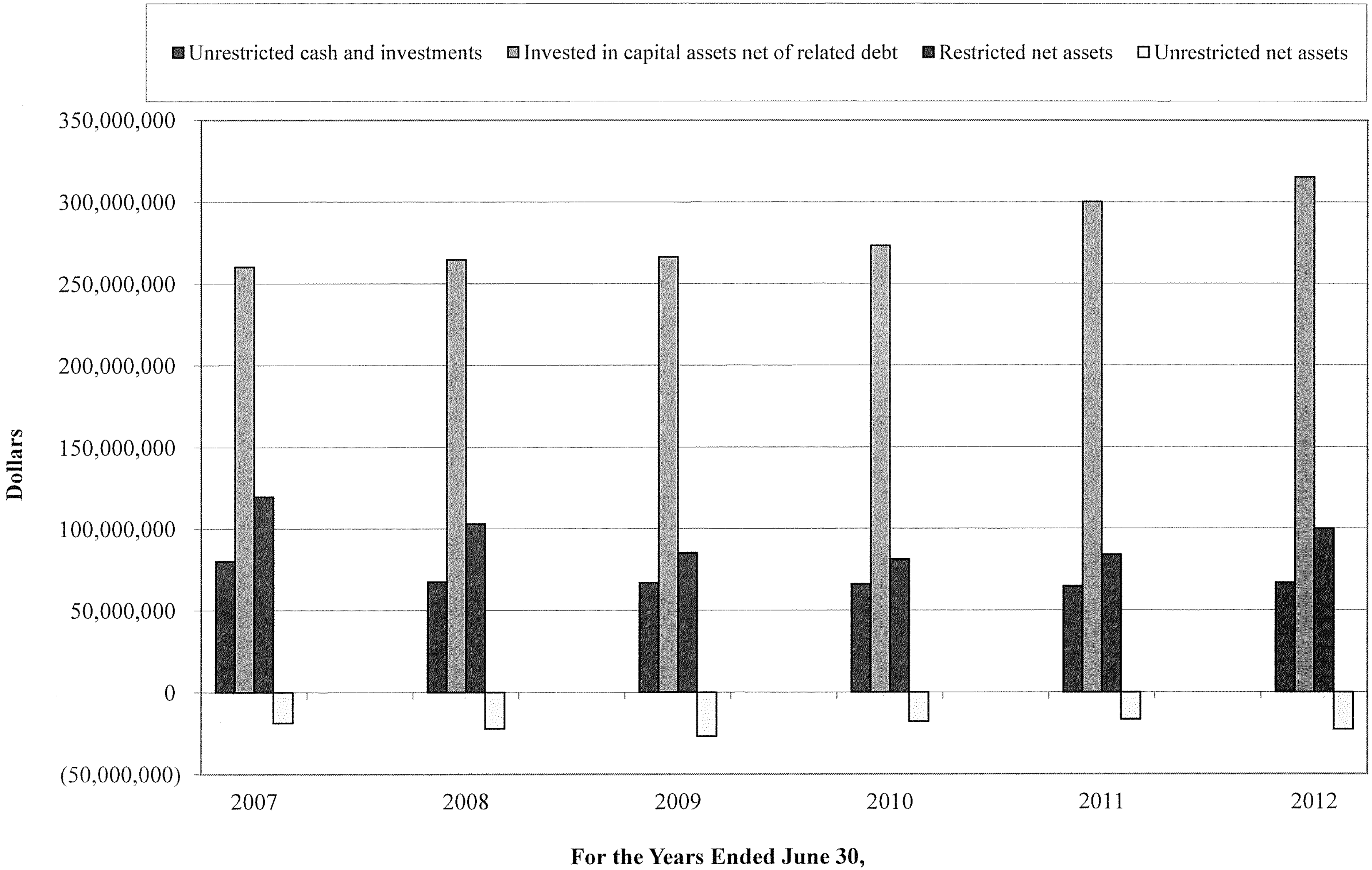


EXHIBIT II

Exhibit II analyzes the City's **revenues** since 2003. This information was obtained from the statistical section of the June 30, 2011 and June 30, 2012 CAFRs. The City, upon adoption of GASB 44, Economic Condition Reporting: The Statistical Section changed its report presentation. The City elected to present governmental fund revenues since it adopted GASB 34 in 2003. The City does not present a separate schedule for governmental funds tax revenues, but instead sums the total tax revenues in one column.

We have calculated both the annual increase from the prior year, and the internal rate of return (IRR) for periods since 2003. The IRR is the implied annual rate of change for an amount to increase/decrease from the beginning of a period to the end of a period.

Exhibit II-A is an analysis of the City's total revenues.

- Total revenues decreased in five of the eight years since 2003.
    - From its peak in 2003 of $173.5 million, total revenues declined in five of the next six years to $121.9 million at June 30, 2009.
        - Total revenues grew in 2010 and 2011, to $139.4 million before declining to $131.6 million in 2012.
    - Except for fines & forfeitures and charges for services, all of the components of the City's revenues have declined since 2003.
- Tax revenues peaked in 2004 at $69.5 million, and then declined in five of the next seven years to $49.4 million in 2011 before increasing $2.5 million to $51.9 million in 2012
    - We will analyze tax revenues in **Exhibit II-C** and **Exhibit II-D**.
- Besides tax revenues, the most important governmental revenue is intergovernmental revenues.
    - These revenues are inconsistent, ranging from a low of $36.7 million in 2009 to a high of $78.2 million in 2003.
        - Tax revenues and intergovernmental revenues exchanged places several times, both being one or two during the period covered by our report.
    - Governmental revenues increased to $66.5 million in 2011, but declined to $53.3 million in 2012.
        - These revenues are usually restricted for specific purposes, and cannot be used to fund general expenditures.
            - However, some jurisdictions treat certain tax revenues as governmental revenues.
        - Intergovernmental revenues, especially those from the State, are inconsistent, and subject to the financial health of the granting government.
- Charges for services grew from $5.2 million in 2003 to $20.2 million in 2008, and then declined the next three years to $14.3 million in 2011.
    - In 2012, charges for services grew to $14.7 million.
- The remaining revenue categories are relatively small, and, except for fines and forfeitures, at June 30, 2012 are below 2003's revenues.
    - Licenses and permits is an important revenue source, not for its size but because it is an indicator of financial health.

- All businesses require a license that is based on a business's revenues to operate within the City's borders.
- All construction within the City also needs a permit.
- Falling revenues from licenses and permits indicate declining business activity and construction, portending declines in other revenue sources.

Exhibit II-B is a graph of the City's revenues as shown in Exhibit II-A.

EXHIBIT II-A
CITY OF VALLEJO
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	Fines & Forfeitures	% Change From Prior Year	Inter-governmental	% Change From Prior Year
2003	173,497,192	N/A	66,537,857	N/A	7,900,520	N/A	1,216,869	N/A	78,159,185	N/A
2004	159,274,877	(8.20%)	69,534,702	4.50%	9,133,758	15.61%	1,434,419	17.88%	53,864,845	(31.08%)
2005	147,718,673	(7.26%)	55,161,490	(20.67%)	11,852,968	29.77%	1,450,743	1.14%	55,423,739	2.89%
2006	139,695,983	(5.43%)	57,550,479	4.33%	6,000,434	(49.38%)	3,887,337	167.95%	49,780,261	(10.18%)
2007	145,363,280	4.06%	59,919,619	4.12%	4,677,963	(22.04%)	1,683,911	(56.68%)	48,824,041	(1.92%)
2008	131,389,500	(9.61%)	58,729,898	(1.99%)	3,327,060	(28.88%)	1,827,945	8.55%	38,546,090	(21.05%)
2009	121,948,379	(7.19%)	55,815,958	(4.96%)	2,440,614	(26.64%)	1,560,809	(14.61%)	36,743,052	(4.68%)
2010	130,354,621	6.89%	50,538,624	(9.45%)	3,479,468	42.57%	1,619,074	3.73%	54,205,823	47.53%
2011	139,373,017	6.92%	49,449,077	(2.16%)	2,758,651	(20.72%)	1,718,092	6.12%	66,450,139	22.59%
2012	131,638,994	(5.55%)	51,936,540	5.03%	2,356,064	(14.59%)	2,726,824	58.71%	53,299,532	(19.79%)
IRR since 2003		(3.02%)		(2.72%)		(12.58%)		9.38%		(4.16%)
IRR since 2007		(1.96%)		(2.82%)		(12.82%)		10.12%		1.77%

Fiscal Year Ended June 30,	Investment Income	% Change From Prior Year	Charges for Services	% Change From Prior Year	Contributions from Property Owners	% Change From Prior Year	Other	% Change From Prior Year
2003	4,663,955	N/A	5,159,696	N/A	0	N/A	9,859,110	N/A
2004	3,902,344	(16.33%)	9,485,786	83.84%	6,201,378	N/A	5,717,645	(42.01%)
2005	6,419,396	64.50%	14,692,748	54.89%	0	(100.00%)	2,717,589	(52.47%)
2006	6,702,584	4.41%	11,326,489	(22.91%)	0	N/A	4,448,399	63.69%
2007	7,789,616	16.22%	17,925,042	58.26%	0	N/A	4,543,088	2.13%
2008	6,891,090	(11.53%)	20,234,105	12.88%	0	N/A	1,833,312	(59.65%)
2009	4,520,458	(34.40%)	20,026,448	(1.03%)	0	N/A	841,040	(54.12%)
2010	3,114,627	(31.10%)	16,032,936	(19.94%)	0	N/A	1,364,069	62.19%
2011	3,391,067	8.88%	14,276,523	(10.96%)	0	N/A	1,329,468	(2.54%)
2012	3,328,151	(1.86%)	14,742,402	3.26%	0	N/A	3,249,481	144.42%
IRR since 2003		(3.68%)		12.37%		N/A		(11.60%)
IRR since 2007		(15.64%)		(3.83%)		N/A		(6.48%)

EXHIBIT II-B
CITY OF VALLEJO
ANALYSIS OF GOVERNMENTAL REVENUES

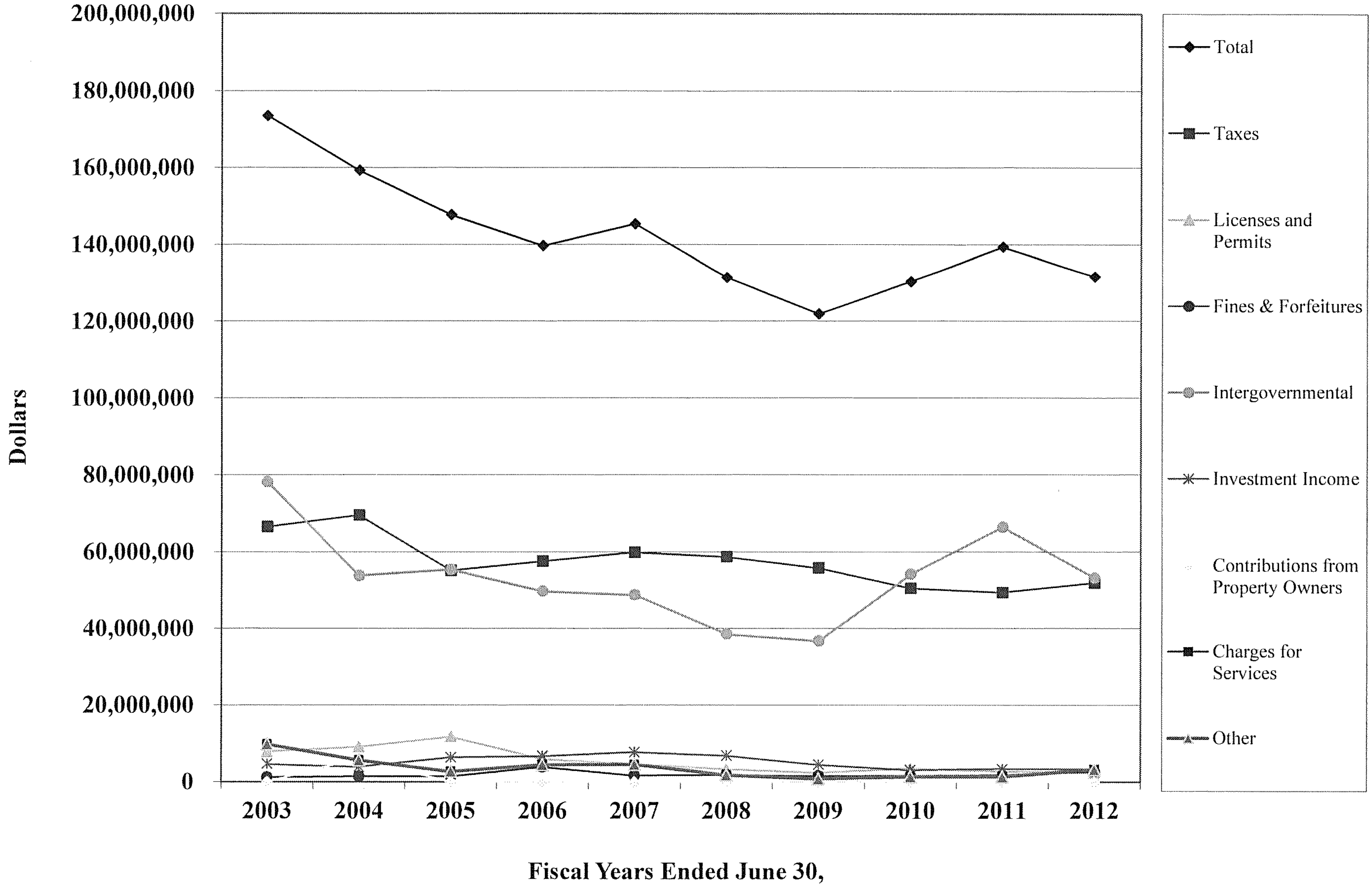


Exhibit II-C is an analysis of the City's tax revenues for the years 2003 through 2012.

- Past State budget crises have impacted the City's tax revenues dramatically.
  - The budget crisis of 2004-2005 resulted in local government exchanging sales taxes, and vehicle license fees for property taxes.
  - This resulted in local government becoming more reliant on property taxes, and the underlying assessed values.
- The most important tax revenue source is the City's **property taxes**.
  - After falling from $13.2 million to $12.6 million in 2004, property tax revenues grew in two of the next three years to $23.8 million in 2007 due to the increase in assessed values from the housing bubble, discussed below, and the exchange of sales taxes for property taxes in 2005.
    - Beginning in 2007, property tax revenues declined to $13.4 million at June 30, 2011 due to the collapse of the City's assessed values.
    - After five years of declining property tax revenues, property taxes increased approximately $750,000, or 5.61% in 2012.
  - Incremental property taxes were collected solely for the use of the City's former Redevelopment Agency.
    - The Redevelopment Agency received only the first installment of the incremental taxes prior to the dissolution of the Redevelopment Agency in February 2012, resulting in a decline of incremental property taxes of 41%.
    - The second installment of the incremental taxes and future collections will be allocated to the "surviving agency".
      - Any amounts not needed by the" successor agency" were allocated to the governments the redevelopment projects were located.
- The **following table** shows the growth and decline of the City's assessed property values from 2001 to 2014.
  - We obtained this information from the City's CAFR, the County of Solano's assessor's June 29, 2012 news release comparing the 2011-2012 gross secured assessed values to the 2012-2013 gross secured assessed values, and the County of Solano's assessor's July 1, 2013 news release comparing the 2012-2013 gross secured assessed values to the 2013-2014 gross secured assessed values.
    - Per the news releases, Vallejo's assessed values on secured (real property) declined 4.52% in the 2012-2013 fiscal year to $7.709 billion, and increased 8.13% in the 2013-2014 fiscal year to $8.335 billion.
    - We adjusted the gross assessed secured values to include the unsecured assessed property values, and exemptions to arrive at the estimated net assessed values.
      - We used the 2012 unsecured values, and exemptions when calculating the estimated net assessed values for 2013 and 2014.
  - The City's assessed values experienced strong growth from $4.959 billion in 2001 to $10.451 billion in 2008, but declined rapidly to $6.978 billion in 2013.
    - In the fiscal year 2013-2014, after five years of decline, assessed values increased in 2014,
    - The IRR of 2.71% since 2001 is due to the City's assessed values strong growth through 2008.

- The negative 4.33% IRR since 2007 is a reflection of the damage the collapse of the housing bubble had on the City's assessed values.

- The following table calculates the net assessed values for 2012 and 2014.

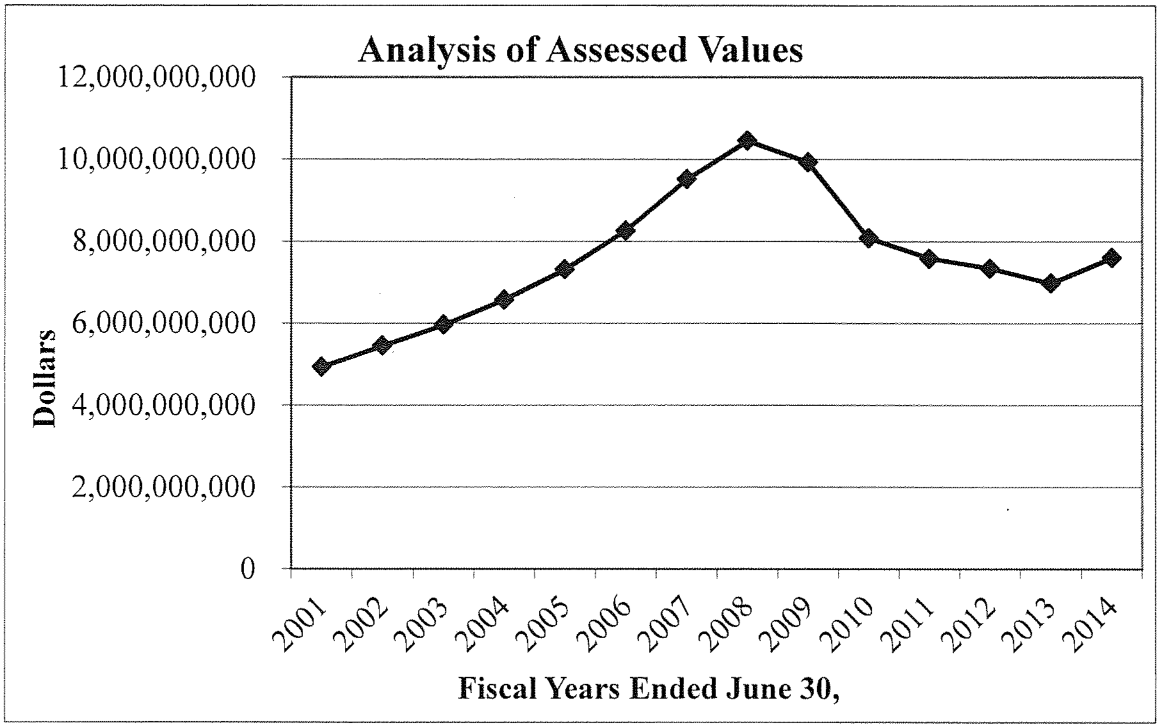
Calculation of Net Assessed Values for 2013 and 2014

	2013	2014
Gross assessed value per Assessor	7,709,240,124	8,335,920,790
2012 unsecured property	261,509,780	261,509,780
Less 2012 exemptions per CAFR	(991,842,666)	(991,842,666)
Net assessed value	6,978,907,238	7,605,587,904

Analysis of Assessed Values

Fiscal Year Ended June 30,	Net Assessed Value	% Change From Prior Year
2001	4,929,545,994	N/A
2002	5,449,704,713	10.55%
2003	5,959,838,121	9.36%
2004	6,575,695,721	10.33%
2005	7,316,598,740	11.27%
2006	8,266,095,693	12.98%
2007	9,517,003,246	15.13%
2008	10,451,620,344	9.82%
2009	9,923,223,528	(5.06%)
2010	8,084,307,064	(18.53%)
2011	7,585,800,052	(6.17%)
2012	7,344,311,921	(3.18%)
2013	6,978,907,238	(4.98%)
2014	7,605,587,904	8.98%
IRR since 2001		2.71%
IRR since 2007		(4.33%)

- The following is a graphic representation of the information in the above table:



- **Exhibit II-D** is an analysis of the median housing values in the City. We obtained housing market value information for Vallejo from Zillow.com. The following table presents the change in the housing values since the height of the housing market, the year to year change, the quarterly change, and the month to month change.

City of Vallejo Median Housing Value Changes

Median Value April 1997	$	120,300
Median Value January 2007	$	477,900
Median Value January 2010	$	185,200
Median Value January 2011	$	168,300
Median Value January 2012	$	151,900
Median Value April 2012	$	150,000
Median Value January 2013	$	167,300
Median Value September 2012	$	153,200
Median Value June 2013	$	196,300
Median Value August 2013	$	215,500
Median Value September 2013	$	216,600

$ Month to Month Change	$	1,100
% Month to Month Change		0.51%
$ Quarter to Quarter Change	$	20,300.00
% Quarter to Quarter Change		10.34%
$ Year to Year Change	$	63,400.00
% Year to Year Change		41.38%
$ Change from April 1996 to March 2007	$	357,600
% Change from April 1996 to March 2007		297.26%
$ Change from March 2007 to January 2012	$	(327,900)
% Change from March 2007 to January 2012		(68.61%)
$ Change from January 2010 to January 2011	$	(16,900)
% Change from January 2010 to January 2011		(9.13%)
$ Change from January 2011 to January 2012	$	(16,400)
% Change from January 2011 to January 2012		(9.74%)
$ Change from January 2012 to January 2013	$	15,400
% Change from January 2012 to January 2013		10.14%
$ Change from January 2013 to September 2013	$	49,300
% Change from January 2013 to September 2013		29.47%

- As shown in the table and exhibit, the median housing value experienced tremendous growth during the housing bubble from April 1997 to January 2007 growing from $120,300 to $477,900.
- Housing values declined sharply beginning February 2007, and did not stop until April 2012 when the median housing values appears to have bottomed out at $150,000.
  - After bottoming out in April 2012, median housing values have experienced rapid growth through September 2013.

- Slow at first, the increase in housing values accelerated dramatically beginning in September 2012.
- As of September 2013 per Zillow, the median housing price is 41.38% above the September 2012 median housing price.
  - We compared Zillow's September to September to DQ News, a real estate newsletter and data collection and their research indicates a 36.8% increase in housing values for Solano County.
- In California, the growth rate for the assessed value of most real property is limited the lower of 2% or the annual inflation rate. The only time properties can be reassessed is when they are sold, when they are reassessed that the purchase price.
  - This is not true of property that has been reassessed downward under proposition 8, and have not been sold.
    - These properties are not limited to the lower of 2% or the inflation rate.
  - Properties whose value was reassessed downward, when the market turns around, and their market values increase will have their assessed values increased at the market rate,
    - The will continue to grow at the market growth rate until the assessed values reach the assessed values they would have attained if their assessed values had continued to grow at 2% and had not been reassessed downward.
    - As such, many properties will see a substantial jump in their assessed values much greater than 2%, and will have their property tax revenues grow accordingly.
    - Some could see a 30% to 40% increase in their tax bill if the current growth trend continues.
- **Sales tax** revenues were either the second or third largest tax revenue for the City since 2003.
  - From its high of $14.6 million in 2003, sales tax revenues declined in four of the eight years to $11.1 million in 2011.
  - The overall decline that began in 2007 was due to the recession that began in 2006.
  - The following table shows the quarterly Bradley-Burns sales tax allocation the City received beginning with the quarter ended December 31, 2005, and ending in the quarter ended June 30, 2013.

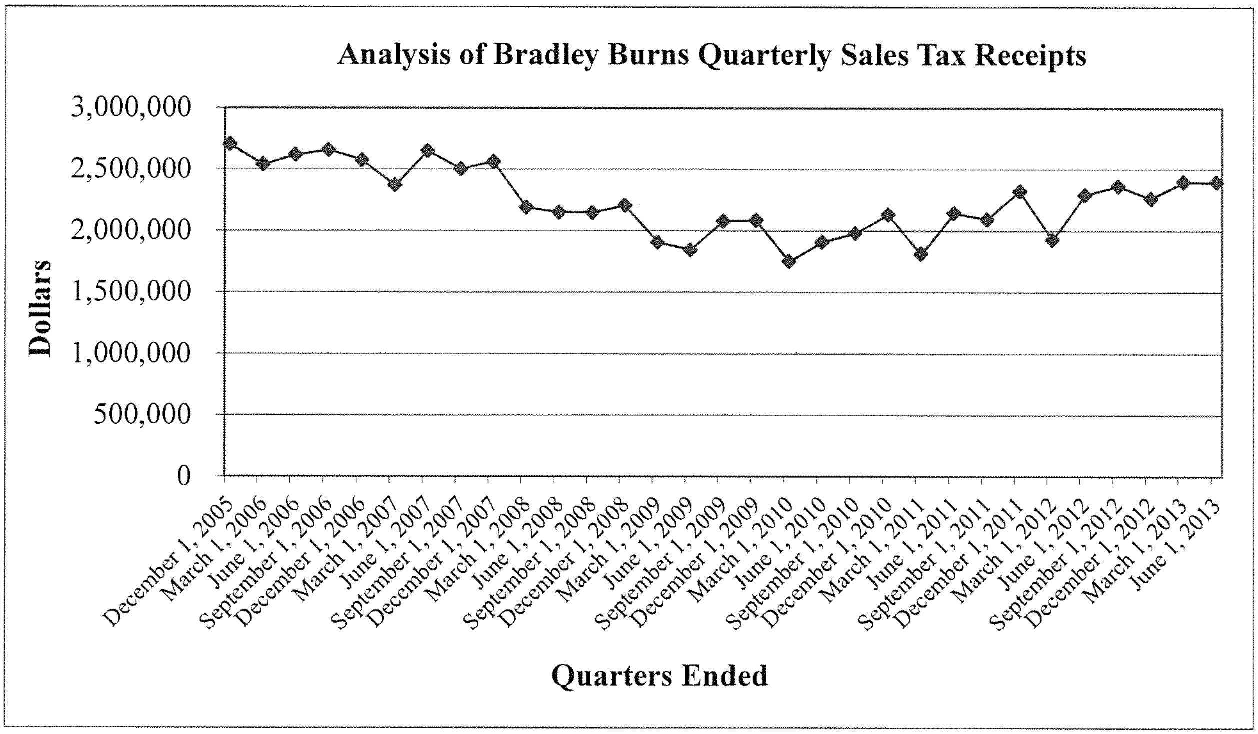
Quarterly Allocation Summary of Bradley Burns Local Tax Allocation
For the City of Vallejo

Quarter Ended	Total Local Sales Tax	$ Change	Quarterly % Change	Yearly $ Change	Yearly % Change
December 31, 2005	2,702,109	N/A	N/A	N/A	N/A
March 31, 2006	2,537,369	(164,740)	(6.10%)	N/A	N/A
June 30, 2006	2,616,251	78,882	3.11%	N/A	N/A
September 30, 2006	2,656,851	40,600	1.55%	N/A	N/A
December 31, 2006	2,574,364	(82,487)	(3.10%)	(127,745)	(4.73%)
March 31, 2007	2,370,495	(203,869)	(7.92%)	(166,874)	(6.58%)
June 30, 2007	2,649,032	278,537	11.75%	32,781	1.25%
September 30, 2007	2,502,828	(146,204)	(5.52%)	(154,023)	(5.80%)
December 31, 2007	2,562,044	59,216	2.37%	(12,320)	(0.48%)
March 31, 2008	2,188,232	(373,812)	(14.59%)	(182,263)	(7.69%)
June 30, 2008	2,149,469	(38,763)	(1.77%)	(499,563)	(18.86%)
September 30, 2008	2,147,212	(2,257)	(0.11%)	(355,616)	(14.21%)
December 31, 2008	2,204,788	57,576	2.68%	(357,256)	(13.94%)
March 31, 2009	1,906,441	(298,347)	(13.53%)	(281,791)	(12.88%)
June 30, 2009	1,844,455	(61,986)	(3.25%)	(305,014)	(14.19%)
September 30, 2009	2,078,451	233,996	12.69%	(68,761)	(3.20%)
December 31, 2009	2,084,978	6,527	0.31%	(119,810)	(5.43%)
March 31, 2010	1,750,893	(334,085)	(16.02%)	(155,548)	(8.16%)
June 30, 2010	1,908,816	157,923	9.02%	64,361	3.49%
September 30, 2010	1,981,153	72,337	3.79%	(97,298)	(4.68%)
December 31, 2010	2,132,428	151,275	7.64%	47,450	2.28%
March 31, 2011	1,811,726	(320,702)	(15.04%)	60,833	3.47%
June 30, 2011	2,143,968	332,242	18.34%	235,152	12.32%
September 30, 2011	2,094,010	(49,958)	(2.33%)	112,857	5.70%
December 31, 2011	2,322,464	228,454	10.91%	190,036	8.91%
March 31, 2012	1,927,656	(394,808)	(17.00%)	115,930	6.40%
June 30, 2012	2,294,393	366,737	19.03%	150,425	7.02%
September 30, 2012	2,363,550	69,157	3.01%	269,540	12.87%
December 31, 2012	2,263,895	(99,655)	(4.22%)	(58,569)	(2.52%)
March 31, 2013	2,398,920	135,025	5.96%	471,264	24.45%
June 30, 2013	2,396,302	(2,618)	(0.11%)	101,909	4.44%

- As shown, the City's quarterly sales tax revenues experienced year over year declines in fourteen of the sixteen quarters beginning in December 2006 through September 2010.
  - Beginning in the quarter ended December 2010, quarterly sales tax revenues have experienced year over year growth except for the quarter ended December 31, 2012.

- Since sales tax receipts began to grow, June 2010, quarterly sales tax receipts have not yet matched receipts for the quarter ended December 31, 2007.

o The following chart is a graphic description of the information in the above table.



o The following table calculates the year to year change not only for the quarters, but for the fiscal years ended June 30, 2011 and 2012.

o It is different from the above table in that it includes the amount allocated to the State per the deal made between the State and the Governor in 2004.

o The exchange of sales tax revenues for property taxes has ended, and future allocation of the Bradley-Burns 1% sales tax to Vallejo will be the entire amount.

o Besides the return of the state portion of the sales and use tax, which alone will increase sales tax revenues 33.33%, but the City is still recovering from the recession.
  - As such we expect sales tax revenues to continue to grow at rates similar to the past two years.

City of Vallejo
Sales and Use Tax Growth Rates

Quarter Ended	Gross Sales Tax	Admin Cost	Net Sales Tax	$ Year over Year Change	% Year over Year Change
June 30, 2013	3,195,070	33,771	3,161,299	132,572	4.38%
March 31, 2013	3,198,560	32,935	3,165,625	619,136	24.31%
December 31, 2012	3,018,526	29,131	2,989,395	(78,154)	(2.55%)
September 30, 2012	3,151,400	30,721	3,120,679	356,325	12.89%
Total Fiscal Year	12,563,556	126,558	12,436,998	1,029,879	8.94%
June 30, 2012	3,059,190	30,463	3,028,727	198,692	7.02%
March 31, 2012	2,570,208	23,719	2,546,489	154,049	6.44%
December 31, 2011	3,096,618	29,069	3,067,549	253,048	8.99%
September 30, 2011	2,792,014	27,660	2,764,354	151,287	5.79%
Total Fiscal Year	11,518,030	110,911	11,407,119	757,076	7.04%
June 30, 2011	2,858,623	28,588	2,830,035	N/A	N/A
March 31, 2011	2,415,634	23,194	2,392,440	N/A	N/A
December 31, 2010	2,843,237	28,736	2,814,501	N/A	N/A
September 30, 2010	2,641,537	28,470	2,613,067	N/A	N/A
Total Fiscal Year	10,759,031	108,988	10,650,043		
Total Payments	34,840,617	346,457	34,494,160		

	Growth Rate	
	2011	2012
2012-2013 Sales Taxes	12,563,556	12,563,556
	8.94%	7.04%
Potential 2013-2014 Sales Tax Revenue Increase	1,123,364	884,054

- The Bradley-Burns is not the City's only sales tax revenue source.
  - Besides the Bradley-Burns local tax allocation, the City also receives a share of the Proposition 172 public safety tax.
  - Per the transmittal letter on page ix of the 2012 CAFR, in November of 2011, the citizens of Vallejo voted for Measure B that provided for an additional 1% sales tax rate to go into effect on April 1, 2012and will sunset after ten years.
    - Per the transmittal letter, the new sales tax is "will generate nearly $11 million annually in additional sales tax revenues."
    - Per the *City of Vallejo's Q2 2013 City of Vallejo Sales Tax Update* prepared by HDL in the fall of 2013 and posted on the City of Vallejo's Finance Department's website, for the fiscal year ended June 30, 2013, Measure B revenues totaled $11.8 million, at least $800,000 above projections and $9.3 million more than 2012.

- The **Utility User** taxes, the second or third largest tax revenue during the period covered by our report, grew from 2003 through 2008, but began a four year decline in 2009.
    - The City did not comment on the reasons for the decline.

Exhibit II-E is a graph of the information in **Exhibit II-C**.

Findings:

- After declining for years, the City's revenues, especially sales tax revenues and property tax revenues are showing signs of a strong comeback.
- After declining for over 5 years, property values began to increase beginning in April 2012.
- Slow growth at first, but beginning in September, 2012 residential values shot up sharply.
    - September over September for Solano County per DQ News shows a 36.8% increase in residential values.
    - Zillow.com shows a 41.38% increase in Vallejo residential values.
    - This portends strong growth in assessed values for the 2014-2015 fiscal year.
- Sales tax revenues are also showing healthy growth.
    - Sales in Vallejo are still recovering from the recession, and should to grow at rates similar to the past two year, 7.04% in 2012 and 8.94% in 2013.
    - The end of the exchange of sales taxes for property taxes will see Bradley-Burns sales taxes increase 33.33%'
    - Since all sales taxes are based on sales, other sales tax revenues should increase at the rate sales increase.
- Other revenues are also showing improvement.

EXHIBIT II-C
CITY OF VALLEJO
ANALYSIS OF GENERAL GOVERNMENT TAX REVENUES

Fiscal Year Ended June 30,	**Total Tax Revenues**	**% Change From Prior Year**	Property taxes	% Change From Prior Year	Incremental property taxes	% Change From Prior Year	Special Assessments	% Change From Prior Year	Sales taxes	% Change From Prior Year
2003	**62,488,293**	**N/A**	13,242,560	N/A	2,489,068	N/A	3,548,185	N/A	14,581,035	N/A
2004	**79,746,464**	**27.62%**	12,612,335	(4.76%)	19,428,752	680.56%	2,877,767	(18.89%)	13,336,714	(8.53%)
2005	**67,794,228**	**(14.99%)**	20,900,386	65.71%	3,581,499	(81.57%)	0	N/A	13,913,459	4.32%
2006	**66,367,989**	**(2.10%)**	20,826,439	(0.35%)	4,466,603	24.71%	0	N/A	14,479,613	4.07%
2007	**70,040,827**	**5.53%**	23,812,446	14.34%	4,302,203	(3.68%)	0	N/A	12,517,648	(13.55%)
2008	**69,287,174**	**(1.08%)**	18,241,341	(23.40%)	4,908,635	14.10%	0	N/A	12,907,978	3.12%
2009	**66,052,512**	**(4.67%)**	17,612,113	(3.45%)	3,591,154	(26.84%)	0	N/A	11,480,014	(11.06%)
2010	**59,115,401**	**(10.50%)**	14,455,331	(17.92%)	3,280,994	(8.64%)	0	N/A	10,715,183	(6.66%)
2011	**58,094,891**	**(1.73%)**	13,392,935	(7.35%)	3,061,230	(6.70%)	0	N/A	11,067,013	3.28%
2012	**60,238,096**	**3.69%**	14,143,780	5.61%	1,790,418	(41.51%)	0	N/A	14,360,808	29.76%
IRR since 2003		**(0.41%)**		0.73%		(3.59%)		(100.00%)		(0.17%)
IRR since 2007		**(2.97%)**		(9.89%)		(16.08%)		N/A		2.79%

Fiscal Year Ended June 30,	Utility user taxes	% Change From Prior Year	Motor vehicles	% Change From Prior Year	Other taxes	% Change From Prior Year
2003	11,697,172	N/A	6,875,520	N/A	10,054,753	N/A
2004	11,707,588	0.09%	5,688,734	(17.26%)	14,094,574	40.18%
2005	11,882,250	1.49%	12,185,788	114.21%	5,330,846	(62.18%)
2006	12,711,868	6.98%	8,592,520	(29.49%)	5,290,946	(0.75%)
2007	12,746,862	0.28%	9,536,759	10.99%	7,124,909	34.66%
2008	13,501,146	5.92%	10,388,740	8.93%	9,339,334	31.08%
2009	13,057,518	(3.29%)	9,905,427	(4.65%)	10,406,286	11.42%
2010	12,916,339	(1.08%)	8,313,033	(16.08%)	9,434,521	(9.34%)
2011	12,890,539	(0.20%)	8,259,104	(0.65%)	9,424,070	(0.11%)
2012	12,792,738	(0.76%)	7,478,690	(9.45%)	9,671,662	2.63%
IRR since 2003		1.00%		0.94%		(0.43%)
IRR since 2007		0.07%		(4.75%)		6.30%

EXHIBIT II-D
CITY OF VALLEJO
MEDIAN VALUE OF RESIDENTIAL PROPERTY PER ZILLOW.COM

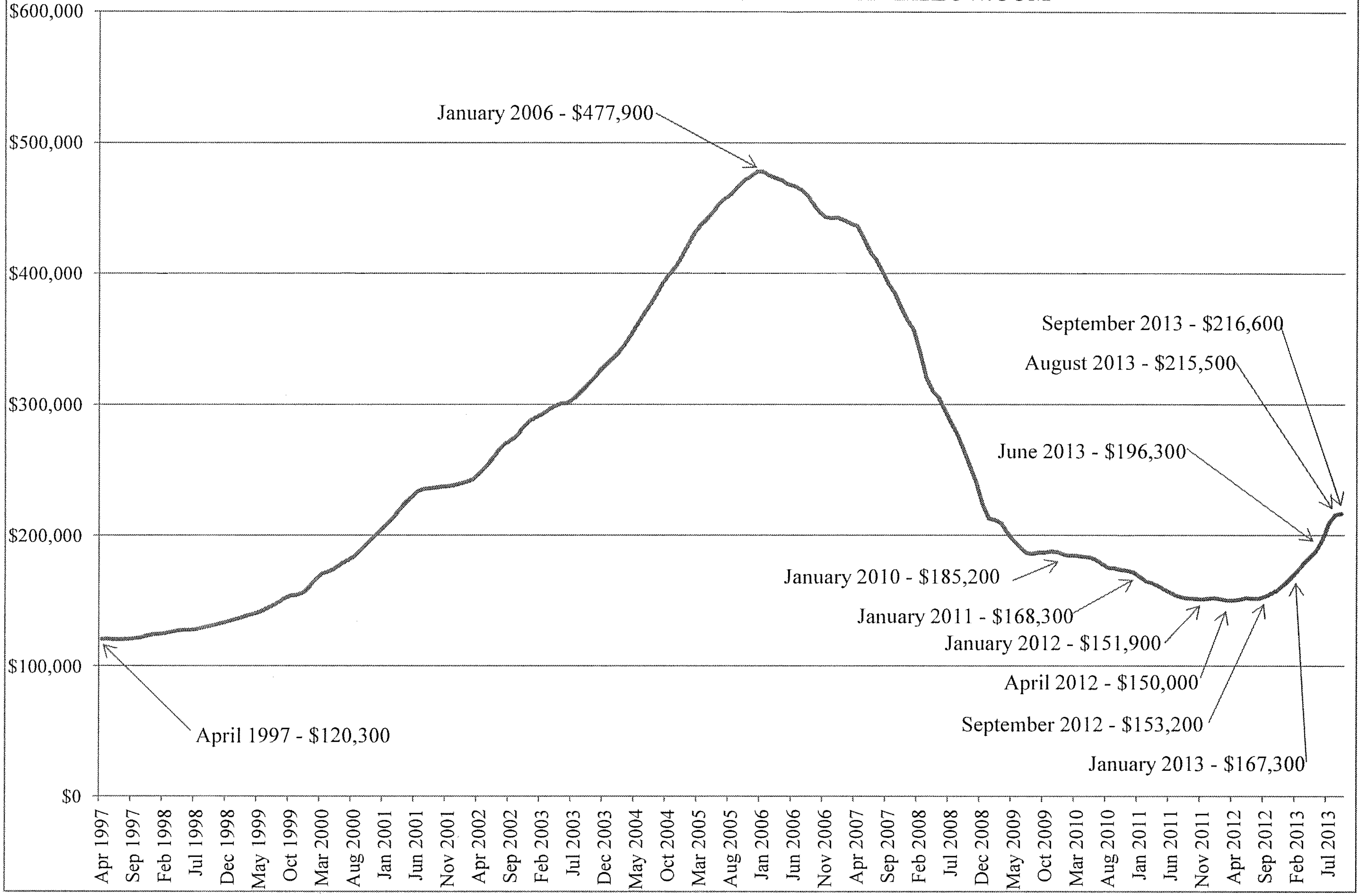


EXHIBIT II-E
CITY OF VALLEJO
GOVERNMENTAL TAX REVENUE ANALYSIS

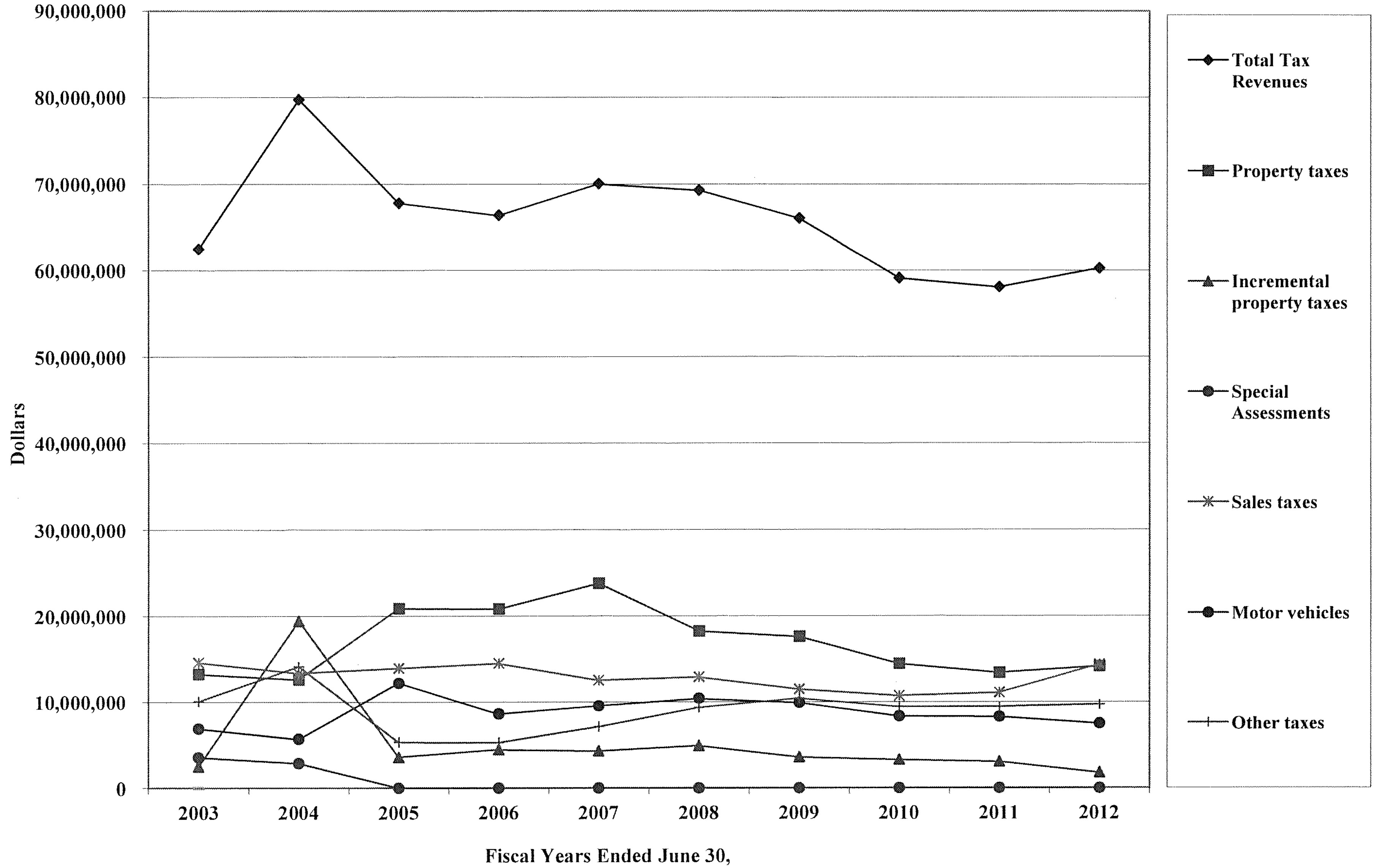


EXHIBIT III

Exhibit III is an analysis of the City of Vallejo's General Fund **budget** process.

- The City had unfavorable adopted revenue budget variances from 2007 through 2009, and favorable adopted revenue budget variances from 2010 through 2012.
  - Actual revenues have declined from 2007 from $80.6 million to $66.6 million in 2011.
    - In 2012, actual General Fund revenues increased for the first time during the period covered by our report, increasing $5.1 million to $71.7 million.
  - Amendments decreased budgeted revenues in 2008, and 2009, resulting in smaller unfavorable final variances.
  - Amendments increased budgeted revenues in 2007, 2010, 2011and 2012, resulting in a larger unfavorable variance in 2007, and smaller favorable variances in 2010, 2011 and 2012.
- The City has over estimated its adopted budget expenditures in four of the six years presented, resulting in favorable adopted budget variances of $3.2 million in 2009, $351,242 in 2010, $4.7 million in 2011 and $2.8 million in 2012.
  - The unfavorable variances occurred in 2007 and 2008
  - The City amended its budget upward in five of the six years presented and reduced expenditures once, in 2009.
  - The amendments increasing expenditures resulted in five larger final favorable variances.
  - The General Fund's actual expenditures decreased from $83.2 million in 2007 to $58.1 million in 2011 before increasing in 2012 to $61.9 million..
- The City's other financing sources (uses) are mainly transfers to, and from the General Fund.
  - The adopted budget had relatively large unfavorable variances in 2007, and 2010 and a large favorable variance in 2008.
    - In 2009, 2011, and 2012, the variances were relatively small.
  - There were large amendments in four of the six years presented.
    - In 2007, 2010, 0nd 2011, the amendments increased the net transfers out, while in 2008, 2009, and 2012 the amendments increased net transfers in.
  - As a result of the amendments, the final budget variances were much smaller except in 2011.
- The General Fund experienced large total favorable adopted budget variances in the last three of the six years presented.
  - The City's adopted budget projected no surplus or deficit in 2007, 2008, 2010, and 2011, a $1 million surplus in 2009 and a $521,000 deficit in 2012..
  - Instead, the General Fund had two deficits in 2007 and 2008, a smaller actual surplus in 2009, and actual surpluses in 2010, 2011, and 2012.
- The total final budget experienced total favorable variances all six years, since the final budget projected huge deficits in five of the six years presented.
  - The only final budget surplus was $7.2 million below the actual surplus.
- In a presentation dated February 26, 2013, page 14, in the section labeled "Final Report on the FY 2011-12 City Budget", it appears that the City attempted to obfuscate the actual 2012 results.

- Instead of referring to the budget, the City refers to "expectations', a nebulous term that means nothing.
  - The 2012 favorable budget variances are much larger than the differences between actual and "expectations" on page 14 of the "Final Report on the FY 2011-12 City Budget".
- Page 3 of Exhibit III-A reconciles the budget basis of accounting to the GAAP basis of accounting, and the beginning fund balance to the ending fund balance.
  - The City uses the GAAP basis of accounting for budgeting, and as such, there is no difference between the budget basis deficits or surpluses, and the GAAP basis deficits or surpluses.
  - As shown in this exhibit, the changes to the fund balance are entirely due to the actual surpluses or deficits.
  - The General Fund's fund balance is $12 million larger at June 30, 2012 at $22.9 million than at July 1, 2006 when the balance was $10.9 million.

Exhibit III-B is a graphic representation of the General Fund's variances and surpluses.

Findings:

- The City's budget process is conservative as the City has consistently performed better than its adopted budget.
- Instead of deficits, the City had two smaller deficits and four surpluses.
- The General Fund's fund balance has increased $12.million since July 1, 2006 and has attained its highest balance in years.at $22.9 million.
  - Most of the increase in the General Fund's fund balance occurred in 2010-2011 and 2011-2012 fiscal years due to actual surpluses of $7.9 million and $9.2 million respectively..
- General Fund revenues and expenditure increased in 2012, the only time during the period covered by our report.

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

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Revenue						
Adopted Budget	82,140,966	83,903,440	78,624,957	64,811,780	63,325,000	65,327,328
Total Amendments	1,008,234	(4,998,157)	(3,416,547)	2,031,000	1,725,000	4,661,027
Final Budget	83,149,200	78,905,283	75,208,410	66,842,780	65,050,000	69,988,355
% Change from *Adopted* Budget	1.23%	(5.96%)	(4.35%)	3.13%	2.72%	7.13%
Actual - Budgetary Basis	80,551,758	78,674,435	75,050,183	67,779,284	66,565,019	71,739,764
Adopted Revenue Variance	(1,589,208)	(5,229,005)	(3,574,774)	2,967,504	3,240,019	6,412,436
Variance as a % of *Adopted* Budget	(1.93%)	(6.23%)	(4.55%)	4.58%	5.12%	9.82%
Final Revenue Variance	(2,597,442)	(230,848)	(158,227)	936,504	1,515,019	1,751,409
Variance as a % of *Final* Budget	(3.12%)	(0.29%)	(0.21%)	1.40%	2.33%	2.50%
Expenditures						
Adopted Budget	82,468,644	83,975,498	76,429,308	64,302,780	62,794,000	64,688,759
Total Amendments	4,432,783	1,723,782	(1,558,174)	800,501	1,159,738	2,180,443
Final Budget	86,901,427	85,699,280	74,871,134	65,103,281	63,953,738	66,869,202
% Change from *Adopted* Budget	5.38%	2.05%	(2.04%)	1.24%	1.85%	3.37%
Actual - Budgetary Basis	83,178,534	85,323,347	73,214,912	63,951,538	58,139,823	61,853,101
Adopted Expenditure Variance	(709,890)	(1,347,849)	3,214,396	351,242	4,654,177	2,835,658
Variance as a % of *Adopted* Budget	(0.86%)	(1.61%)	4.21%	0.55%	7.41%	4.38%
Final Expenditure Variance	3,722,893	375,933	1,656,222	1,151,743	5,813,915	5,016,101
Variance as a % of *Final* Budget	4.28%	0.44%	2.21%	1.77%	9.09%	7.50%

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

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Other financing sources (uses)						
Adopted Budget	327,678	72,058	(1,195,650)	(509,000)	(531,000)	(1,159,947)
Total Amendments	(1,872,402)	2,140,000	86,593	(1,725,080)	(3,630,262)	50,947
Final Budget	(1,544,724)	2,212,058	(1,109,057)	(2,234,080)	(4,161,262)	(1,109,000)
% Change from *Adopted* Budget	(571.42%)	2969.83%	(7.24%)	338.92%	683.67%	(4.39%)
Actual - Budgetary Basis	(1,208,499)	3,140,555	(1,022,443)	(2,314,174)	(551,370)	(700,912)
Adopted Other Financing Sources (Uses) Variance	(1,536,177)	3,068,497	173,207	(1,805,174)	(20,370)	459,035
Variance as a % of *Adopted* Budget	(468.81%)	4258.37%	(14.49%)	354.65%	3.84%	(39.57%)
Final Other Financing Sources (Uses) Variance	336,225	928,497	86,614	(80,094)	3,609,892	408,088
Variance as a % of *Final* Budget	(21.77%)	41.97%	(7.81%)	3.59%	(86.75%)	(36.80%)
Total Variance Adopted Budget						
Favorable (Unfavorable)	(3,835,275)	(3,508,357)	(187,171)	1,513,572	7,873,826	9,707,129
Variance as a % of Budgeted Expenditures	(4.65%)	(4.18%)	(0.24%)	2.35%	12.54%	15.01%
Total Variance Final Budget						
Favorable (Unfavorable)	1,461,676	1,073,582	1,584,609	2,008,153	10,938,826	7,175,598
Variance as a % of Budgeted Expenditures	1.68%	1.25%	2.12%	3.08%	17.10%	10.73%
Excess (Deficiency) of Adopted Budget Revenues Over Adopted Budget Expenditures Including Other Financial Sources (Uses)	0	0	999,999	0	0	(521,378)
Excess (Deficiency) of Final Budget Revenues Over Final Budget Expenditures Including Other Financial Sources (Uses)	(5,296,951)	(4,581,939)	(771,781)	(494,581)	(3,065,000)	2,010,153
Excess (Deficiency) of Actual Revenues Over Final Actual Expenditures Including Other Financial Sources (Uses)	(3,835,275)	(3,508,357)	812,828	1,513,572	7,873,826	9,185,751

EXHIBIT III-A
CITY OF VALLEJO
RECONCILIATION OF BUDGET BASIS ACCOUNTING TO GAAP BASIS ACCOUNTING
GENERAL FUND

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Excess (Deficiency) of Actual Revenues Over Final Actual Expenditures Including Other Financial Sources (Uses) - Budget Basis	(3,835,275)	(3,508,357)	812,828	1,513,572	7,873,826	9,185,751
Total difference between Budget and GAAP basis of Accounting	0	0	0	0	0	0
Excess (Deficiency) of Actual Revenues Over Final Actual Expenditures Including Other Financial Sources (Uses) - GAAP Basis	(3,835,275)	(3,508,357)	812,828	1,513,572	7,873,826	9,185,751
Beginning Fund Balance	10,856,672	7,021,397	3,513,040	4,325,868	5,839,440	13,713,266
Prior period adjustment	0	0	0	0	0	0
Ending Fund Balance	7,021,397	3,513,040	4,325,868	5,839,440	13,713,266	22,899,017

EXHIBIT III-B
CITY OF VALLEJO
ANALYSIS OF GENRAL FUND BUDGET VARIANCES AND SURPLUSES

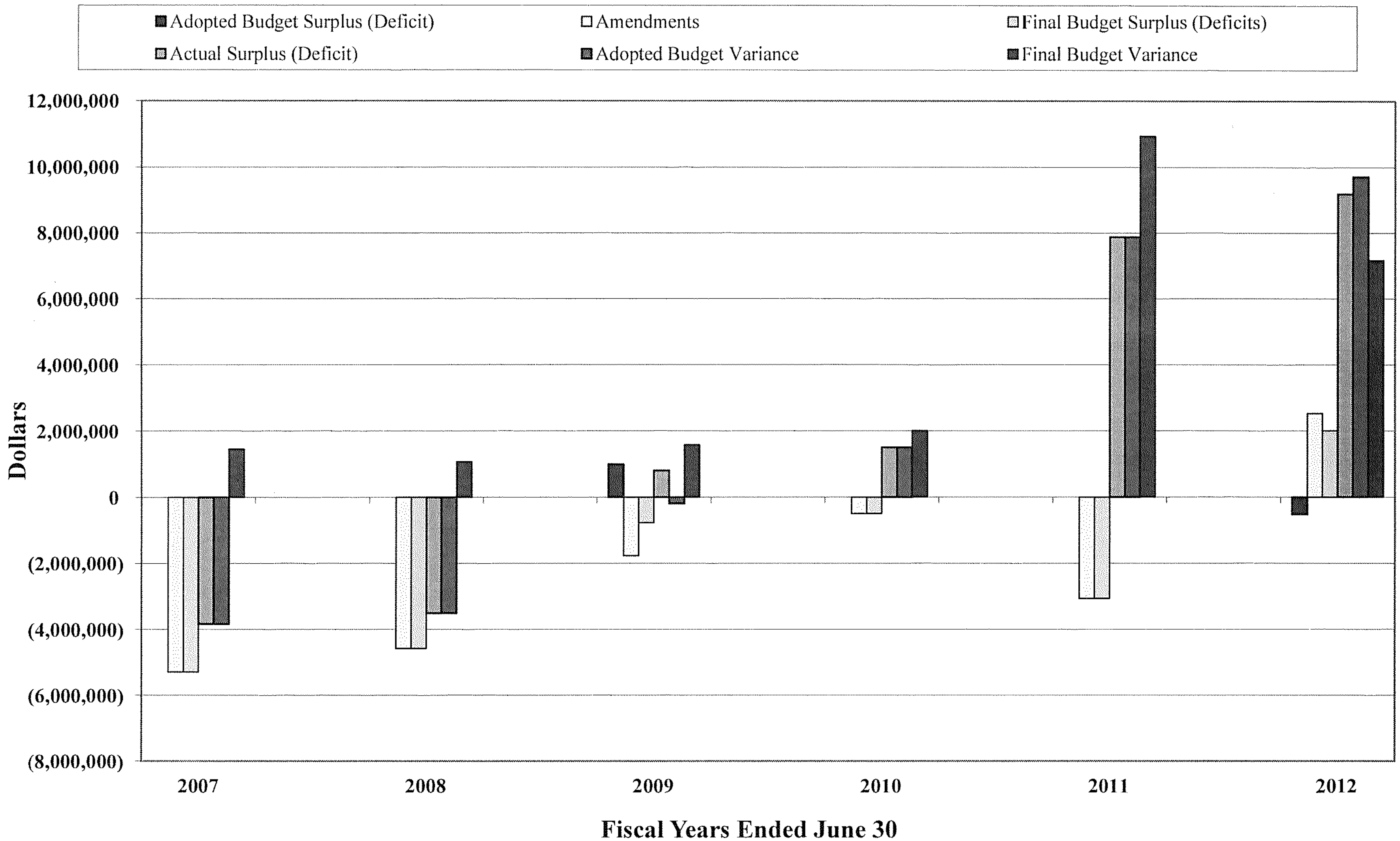


EXHIBIT IV

Exhibit IV is an analysis of transfers to the General Fund as the General Fund did not transfer resources to other funds.

Other funds transferred moneys to the General fund over the period covered by our report and the General Fund transferred moneys to other funds. Due to the financial nature of Vallejo, we will include all transfers to the General Fund as revenues when computing the 5% benchmark and al transfers from the General Fund as expenditures.

EXHIBIT IV
CITY OF VALLEJO
ANALYSIS OF GENERAL FUND TRANSFERS

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Funds Making Transfers To the General Fund						
Nonmajor governmental funds						
Marine World Revenue Sharing	1,454,098	1,675,251	0	0	0	0
Police Grant	285,000	0	0	0	0	0
FEMA Disaster Recovery	62,083	0	0	0	0	0
Admin Trust	32,957	32,801	25,465	14,013	15,343	0
Outside Funded Services	63,540	0	22,640	3,977	437	0
Solid Waste Disposal	29,292	430,000	64,159	0	0	113,403
Repair and Demolition	9,700	0	50,577	589	353	24,968
Hazmat Revolving Fund	19,151	0		0	0	0
Financing Authority	0	90,785	44,327	0	0	0
Redevelopment Agency Debt Service	0	400,000	300,000	250,000	700,433	400,000
Arts & Convention Center	0	200,000	115,000	115,000	115,000	0
Local Transportation	0	300,000	0	0	0	0
Equipment Replacement	0	1,700,000	0	0	0	0
Insurance	0	0	1,000,000	0	0	0
Other	0	125,429	0	0	2,301,567	28,272
	1,955,821	4,954,266	1,622,168	383,579	3,133,133	566,643
Funds Receiving Transfers From the General Fund						
COPS Debt Service Fund	1,452,387	1,713,908	1,182,524	1,174,175	452,799	367,771
Redevelopment Administration	333,531	0	0	0	0	0
Gas Tax	375,000	0	0	0	0	0
Capital Projects	578,402	0	226,567	753,249	989,878	899,784
Local Transportation	425,000	99,803	0	0	0	0
Marina Enterprise Fund	0	0	343,102	151,656	0	0
Fleet Maint/Replacement Internal Service Fund	0	0	0	0	36,500	0
Bankruptcy Claims Internal Service Fund	0	0	892,418	1,000,000	2,328,409	0
	3,164,320	1,813,711	2,644,611	3,079,080	3,807,586	1,267,555
	(1,208,499)	3,140,555	(1,022,443)	(2,695,501)	(674,453)	(700,912)

Exhibit V-A is an analysis of the General Fund's **cash and investments and fund balance.**

- The City's General Fund's cash and investment balance has ranged from a low of zero in 2008 to a high of $17.2 million in 2012.
    - The General Fund's cash and investment balance was low from 2007 through 2011.
    - The cash and investments balance at June 30, 2011, a weak $172,205, was down $2.7 million from 2010 due to an increase of $11.2 million in other assets, mostly receivables.
- The City's General Fund has maintained a strong asset to liability ratio, but these strong ratios are due to the small amounts of liabilities, and assets when compared to the fund's revenues and expenses.
- In 2011, the City adopted the new fund balance reporting standard for government funds as established by GASB 54.
    - The General Fund's fund balance is now classified as follows:
        - **Nonspendable** are assets that by their nature cannot be spent.
            - During the years from 2007 to 2010, the City classified $777,221 of the General Fund's notes and loans receivables as reserved. In 2011, this same portion of the notes, and loans receivable were classified as nonspendable.
            - For the City of Vallejo, the other nonspendable assets include prepaid expenses; materials, parts, and supplies; and land held for redevelopment.
        - **Restricted** fund balance represents assets that are restricted for a specific project by an outside agency, can be imposed on the government by the court, or imposed by enabling legislation such as a proposition.
            - We believe the reserve for "program restrictions – unappropriated" in prior years is now identified as the General Fund's restricted assets.
        - The **Committed** fund balance represents those assets that are set aside at the government's highest level. For the City of Vallejo, these are projects approved and assets set aside by the highest level of the City Council, and the mayor.
        - **Assigned** fund balance represents assets that have been segregated for a purpose at a managerial level below the City Council and signed by the mayor. These are managerial priorities that may never come to fruition.
        - **Unassigned** fund balance represents those assets that can be used for any purpose.
    - In our opinion, how a government classifies its fund balance when it adopts GASB 54 indicates the restrictive nature of prior years' fund balances, and how the government would have classified the prior years' fund balance under the new GASB 54 reporting model.
        - Under the new reporting model, encumbrances should not be reported as they are not a real restriction on specific resources.
        - The committed fund balance, the assigned fund balance, and the unassigned fund balance combined, are known as the unrestricted fund balance.

- The unrestricted fund balances represent the General Fund's "budget reserves."

- The following tables compute the unrestricted fund balance.

Computation of Unrestricted Fund Balance Under GASB 54

Fiscal Year Ended June 30,	Committed	Assigned	Unassigned	Unrestricted Fund Balance
2011	350,685	304,729	6,340,374	6,995,788
2012	304,729	6,340,374	13,713,266	20,358,369

Computation of Unrestricted Fund Balance

Fiscal Year Ended June 30,	Unreserved / Unrestricted Fund Balance	Reserved Encumbrances	Notes & Loans Receibable	Less Long-term Notes Receibable	Unrestricted Fund Balance
2007	5,246,450	339,682	781,119	(777,221)	5,590,030
2008	1,453,476	206,947	804,499	(777,221)	1,687,701
2009	2,397,227	259,581	827,816	(777,221)	2,707,403
2010	3,834,873	167,601	851,132	(777,221)	4,076,385
2011	6,995,788	0	0	0	6,995,788
2012	20,358,369	0	0	0	20,358,369

- As shown in the above tables, the unrestricted fund balance is greater than the unreserved fund balances in prior years.

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

Findings:

- The General Fund's cash and investments and the fund balance have improved dramatically the past two years.

EXHIBIT V-A
CITY OF VALLEJO
GENERAL FUND

	For the Years Ended June 30,					
	2007	*2008*	*2009*	*2010*	*2011*	*2012*
Assets						
Cash and investments	2,609,264	0	2,026,473	2,955,388	172,205	17,232,754
Other assets	8,817,639	7,422,774	6,447,912	7,130,245	18,339,870	10,531,022
Total Assets	11,426,903	7,422,774	8,474,385	10,085,633	18,512,075	27,763,776
Liabilities	4,405,506	3,909,734	4,148,517	4,246,193	4,798,809	4,864,759
Asset to liability ratio	2.59	1.90	2.04	2.38	3.86	5.71
Fund Balance						
Reserved for:						
Encumbrances	339,682	206,947	259,581	167,601		
Materials, parts, supplies	1,577	2,355	2,403	33,731		
Prepaids	156,783	55,975	48,383	0		
Notes and Loans	777,221	777,221	777,221	777,221		
Land held for redevelopment	499,684	499,684	499,684	499,684		
Program restrictions - Unappropriated	0	517,382	341,369	526,330		
Total reserved balance	1,774,947	2,059,564	1,928,641	2,004,567		
Unreserved						
Unreserved - designated for						
General Fund	244,472	0	235,000	652,000		
State budget impact/SB1096	759,722	656,281	628,750	612,617		
Unreserved - Undesignated	4,242,256	797,195	1,533,477	2,570,256		
Total unreserved balance	5,246,450	1,453,476	2,397,227	3,834,873		
Nonspendable					6,509,043	1,315,581
Restricted					208,435	242,919
Committed					350,685	381,709
Assigned					304,729	9,874,285
Unassigned					6,340,374	11,084,523
Total Fund Balance	7,021,397	3,513,040	4,325,868	5,839,440	13,713,266	22,899,017
Total Liabilities and Fund Balance	11,426,903	7,422,774	8,474,385	10,085,633	18,512,075	27,763,776

EXHIBIT V-B
CITY OF VALLEJO
ANALYSIS OF THE GENERAL FUND'S FUND BALANCE

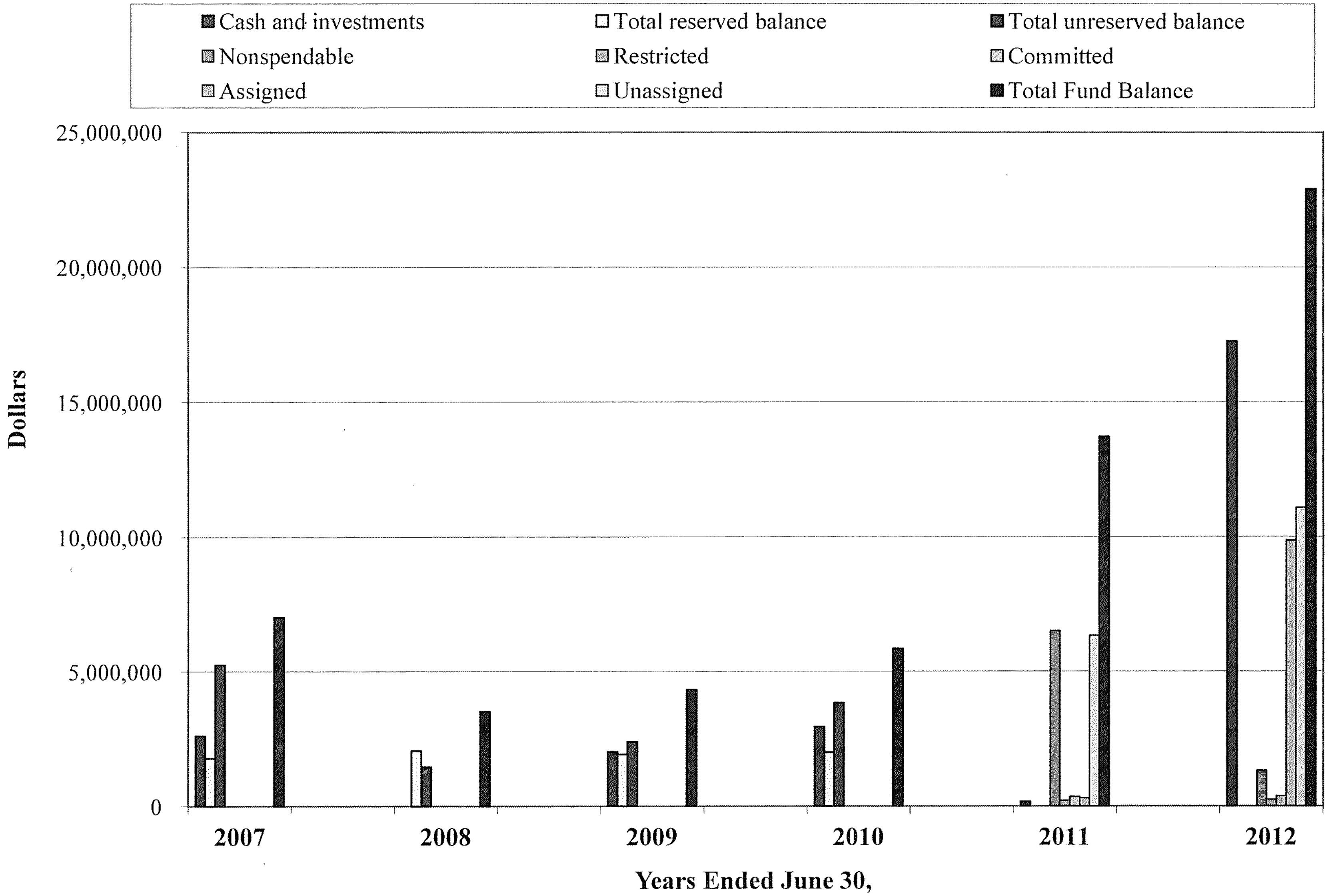


Exhibit VI computes the **unrestricted fund balance to revenue ratio** and the **unrestricted fund balance to expenditures ratio** and compares them to historical benchmarks.

The new fund balance reporting method does not nullify the benchmark. In the GFOA's publication, *What Everyone Needs to Know About the New Fund Balance* by Stephen J. Gauthier, Director of the GFOA's Technical Services Center, the restricted fund was equated with the old reserved fund balance, with certain important exceptions, and the unrestricted fund balance to the unreserved fund balance, again with important exceptions.

In **Exhibit V**, we computed the unrestricted fund balance based on our analysis of the 2011 and 2010 fund balance allocations.

We computed adjusted revenues adding the GAAP transfers from other funds to the General Fund's revenues. The following table presents the adjusted revenues:

Computation of Adjusted Revenues

Fiscal Year Ended June 30,	Revenues	GAAP Transfers In Per CAFRs	Adjusted Revenues
2007	80,551,758	1,955,821	82,507,579
2008	78,674,435	4,954,266	83,628,701
2009	75,050,183	1,622,168	76,672,351
2010	67,779,284	383,579	68,162,863
2011	66,565,019	3,133,133	69,698,152
2012	71,739,764	566,643	72,306,407

We computed adjusted expenditures as follows:

Computation of Adjusted Expenditures

Fiscal Year Ended June 30,	Expenditures	GAAP Transfers Out Per CAFRs	Adjusted Expenditures
2007	83,178,534	3,164,320	86,342,854
2008	85,323,347	1,813,711	87,137,058
2009	73,214,912	2,644,611	75,859,523
2010	63,951,538	3,079,080	67,030,618
2011	58,139,823	3,807,586	61,947,409
2012	61,853,101	1,267,555	63,120,656

- As shown in **Exhibit VI-A**, after declining from 6.78% in 2007 to 2.02% in 2008, an unhealthy ratio well below the minimum healthy ratio of 5%, the unrestricted fund balance to revenue ratio grew to 10.04% at June 30, 2011.
  - In 2012, the ration almost tripled to 28.16%, a very healthy ratio almost 6 times the minimum 5% ratio.
- The expenditure ratio has mirrored the rise and decline of the revenue ratio, declining from a healthy ratio of 6.47% in 2007 to 1.94% in 2008, significantly below the minimum 5% healthy ratio.
  - In 2009, the ratio grew to 3.57%, and exceeded 5% in 2010.
  - In 2011, the ratio improved to 11.29%.
  - The ratio improved dramatically in 2012 to 32.25%, more than six times the 5% benchmark.

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

Findings:

- The unrestricted fund balance to revenues and the unrestricted fund balance to expenditures ratios are the highest they have been in years.
- Both are close to six times the minimum 5% benchmark.
- The growth in these ratios indicates a vast improvement in the City's health.
- Both the unrestricted fund balance to revenues and the unrestricted fund balance to expenditures ratios have significantly improved.
- Both ratio are very healthy.

EXHIBIT VI-A
CITY OF VALLEJO
% OF UNRESTRICTED FUND BALANCE TO GAAP REVENUES AND EXPENDITURES
GENERAL FUND

Unrestricted Fund Balance to GAAP Revenues

Year Ended June 30,	*Unrestricted Fund Balance*	*GAAP Adjusted Revenues*	*Balance as a % of Adjusted Revenues*	*5% of Adjusted Revenues*	*Unrestricted Fund Balance in Excess of 5% of Adjusted Revenues*
2007	5,590,030	82,507,579	6.78%	4,125,379	1,464,651
2008	1,687,701	83,628,701	2.02%	4,181,435	(2,493,734)
2009	2,707,403	76,672,351	3.53%	3,833,618	(1,126,215)
2010	4,076,385	68,162,863	5.98%	3,408,143	668,242
2011	6,995,788	69,698,152	10.04%	3,484,908	3,510,880
2012	20,358,369	72,306,407	28.16%	3,615,320	16,743,049

Unrestricted Fund Balance to GAAP Expenditures

Year Ended June 30,	*Unrestricted Fund Balance*	*GAAP Adjusted Expenditures*	*Balance as a % of Adjusted Expenditures*	*5% of Adjusted Expenditures*	*Unrestricted Fund Balance in Excess of 5% of Adjusted Expenditures*
2007	5,590,030	86,342,854	6.47%	4,317,143	1,272,887
2008	1,687,701	87,137,058	1.94%	4,356,853	(2,669,152)
2009	2,707,403	75,859,523	3.57%	3,792,976	(1,085,573)
2010	4,076,385	67,030,618	6.08%	3,351,531	724,854
2011	6,995,788	61,947,409	11.29%	3,097,370	3,898,418
2012	20,358,369	63,120,656	32.25%	3,156,033	17,202,336

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

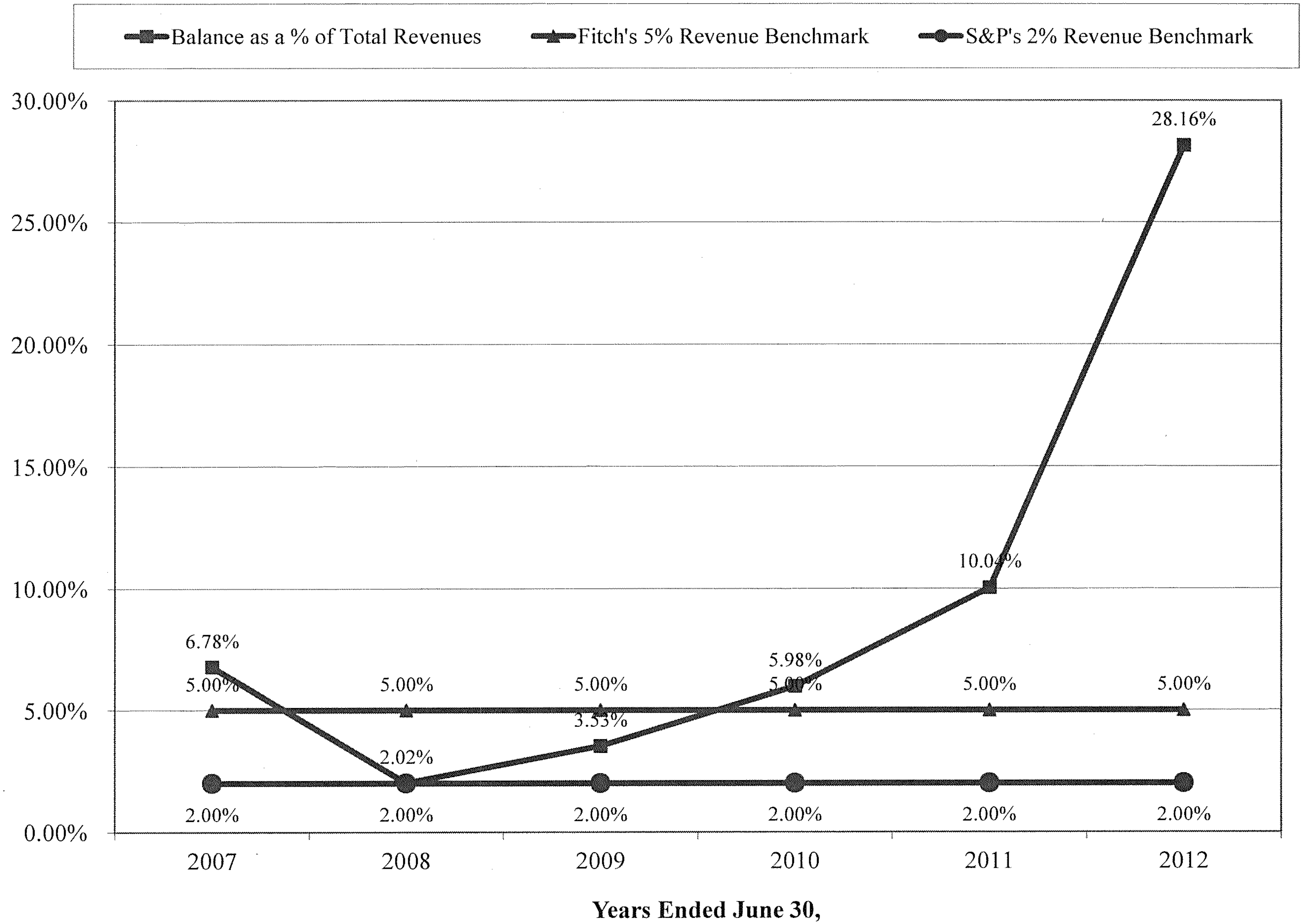
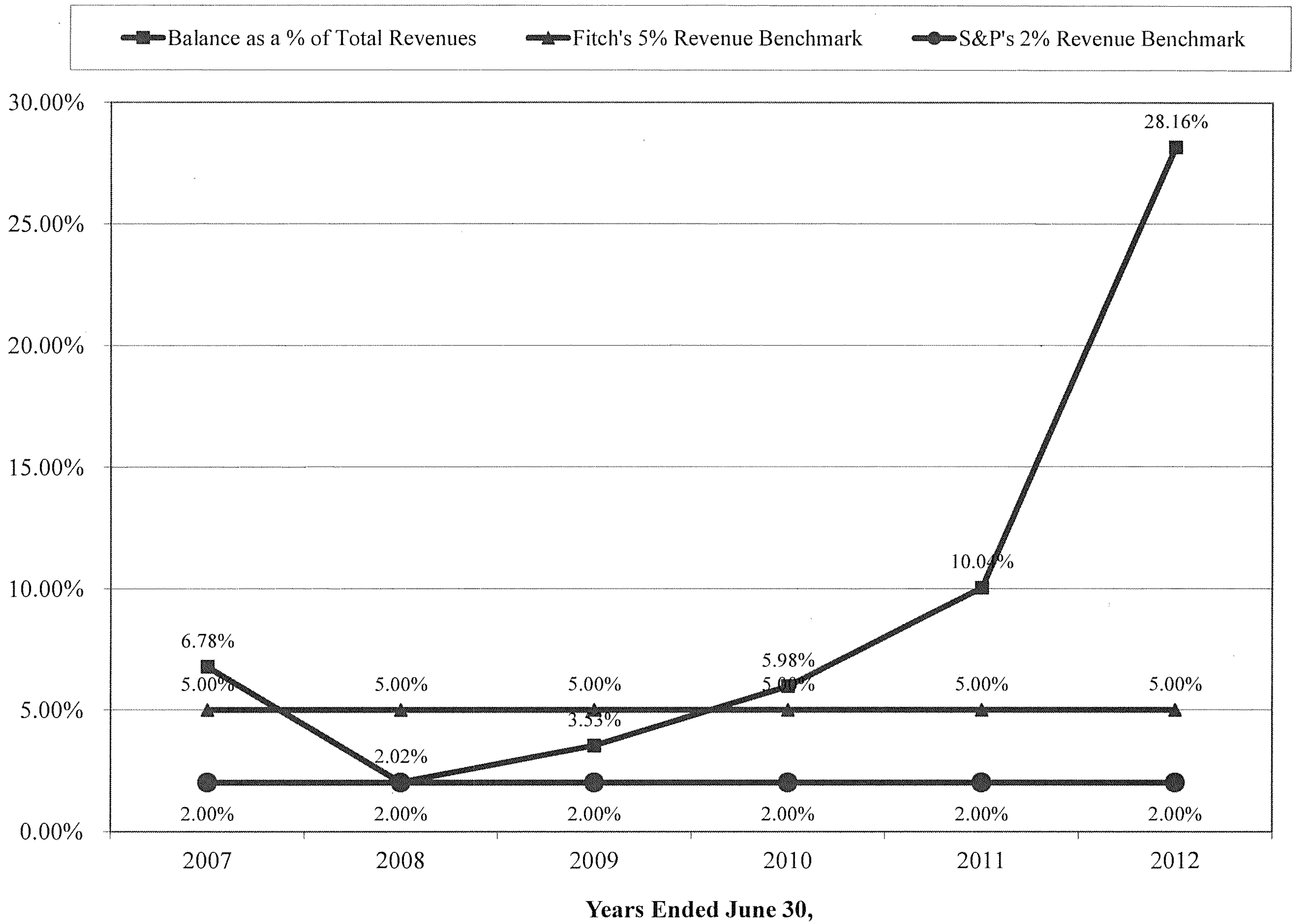


EXHIBIT VI-B
CITY OF VALLEJO
UNRESERVED FUND BALANCE AS A % OF TOTAL REVENUES



CONCLUSIONS

Our findings include:

- The City's total revenues have increased in 2010, 2011, and 2012.
  - The growth is due to increasing intergovernmental revenues which are usually restricted to specific purposes.
  - Sales tax revenues have also contributed to the revenue growth, as they began their recovery.
- Total tax revenues have experienced four consecutive year over year declines beginning in 2008 and ending in 2011.
  - The last two years of decline has all tax revenues sources, and has not been concentrated in one or two tax revenues.
- However, in 2012, based on information gathered from the 2012 CAFR and from outside sources, revenue growth has accelerated due to several factors.
  - Residential housing values have recovered at an accelerating rate beginning in May 2012 after bottoming out in 2012.
  - Secured assessed values for the 2013-2014 fiscal year increased 8.13%, and an estimated 8.94% if unsecured property and exemptions are included.
  - For the current fiscal year, from January 1, 2013 to September 30, 2013, residential values are up over 23% in Vallejo portending a large increase in assessed values and related property taxes.
    - Property assessed down under Proposition 8 and not by sale are not limited under proposition 13 to 2% increase, but will recover their assessed values at actual residential property value growth rate.
- The City's General Fund reserves have increased, due to transfers from other funds, and the City cutting expenditures faster than the City's revenues declined through 2011, but that changed in 2012.
  - The General Fund experienced its largest surplus in years $9.2 million due to increasing revenues.
    - The General Fund's 2012 revenues increased $5.2 million over 2011 revenues.
    - The General Fund's 2012 revenues were $6.4 million above the adopted budget revenues.
    - The General Fund's 2012 revenues were $1.7 million greater than the final budgeted revenues.
  - The General Fund's expenditures are still down, and only increased for the first time in 2012, a healthy sign.
    - General Fund expenditures for 2012 increased $3.7 million over 2012 to $61.9 million.
    - Actual expenditures were $2.8 million below the adopted budget expenditures.
    - Actual expenditures were $5 million below the final budget expenditures.
  - Over 2011 and 2012, the General Fund's fund balance has grown $17.1 million due to surpluses.
- The improved health of the General Fund is shown in the increase cash and investments and the healthy ratios that have improved the last two years.

- Cash and investment balances have attained new highs,
    - As of June 30, 2012, they are over six times greater than any previous year covered by this report.
    - At June 30, 2012, the cash and investment balance is over 100 times the June 30, 2011 balance.
    - The asset to liability ratio, which was healthy throughout the period covered by this report, grew to new highs in 2012.
- The unrestricted fund balance to revenues ratio and the unrestricted fund balance to expenditures ratio have improved dramatically.
    - Both were below the 5% minimum healthy balance in 2009, and both improved tremendously the last three years.
        - The revenue ratio improved to 28.16%, nearly six times the 5% benchmark.
        - The expenditure ratio improved to 32.25%, more than six times the 5% benchmark.

Our overall conclusion from analyzing the City's Comprehensive Annual Financial Reports and other data is that the City of Vallejo financial position has improved tremendously. Revenues experienced strong growth in 2012 due to improved property tax and sales tax revenues resulting in a surplus exceeding $9 million. Even more important are the revenue indicators for the year ended June 30, 2013, the current fiscal year ended June 30, 2014, and in the fiscal year ended June 30, 2015. All indicate that revenues will experience strong growth the next few years..

Please call if you have any questions or you can email me directly at treilly@bachcrom.com.

Sincerely,

Bachecki, Crom & Co, LLP

Bachecki, Crom & Co., LLP