

General Budget and Financial Policies

City of Phoenix budget and financial policies are governed by Arizona state law, the City Charter and generally accepted accounting standards. These laws and standards set budget calendar dates, provide for budget control, describe ways to amend the budget after adoption, and identify appropriate methods for budgeting, accounting and reporting. The Arizona Constitution establishes the property tax system and sets tax levy and assessed valuation limits. The constitution also provides annual expenditure limits and sets total bonded debt limits.

The city's budget policies are extensions of these basic laws and follow generally accepted governmental budgeting and accounting practices and standards.

A BALANCED BUDGET IS REQUIRED

Arizona law (Title 42 Arizona Revised Statutes) requires the City Council to annually adopt a balanced budget by purpose of public expense. State law defines this balanced budget as "the primary property tax levy, when added together with all other available resources, must equal these expenditures."

Therefore, no General Fund balances can be budgeted in reserve for subsequent fiscal years. Instead, an amount for contingencies (also commonly referred to as a "rainy day fund") can be included in the budget each year.

The City Charter also requires an annual balanced budget. The Charter further requires that "the total of proposed expenditures shall not exceed the total of estimated income and fund balances."

Annual Budget Adoption Requirements

The City Charter and state statutes contain legal deadlines and actions that must be followed in adopting the budget. In cases where the deadlines conflict, the city meets the earlier of the two dates. The deadlines and formal actions prescribed by both, as well as the actual or planned dates for the 2006-07 budget development process are as follows.

Action Required	City Charter Prescribed Deadline	Arizona State Statute Prescribed Deadline	2006-07 Budget Dates
City manager's recommended five-year Capital Improvement Program submitted to the City Council	At least 3 months prior to final date for submitting the budget or a date designated by the City Council.	Capital Improvement Program not required.	April 4
City manager's proposed budget for ensuing year presented to the Mayor and City Council.	On or before the first Tuesday in June or a date designated by the City Council.	City manager budget not required.	May 2
Publish general summary of budget and notice of public hearing that must be held prior to tentative budget adoption.	Publish in newspaper of general circulation at least two weeks prior to first public hearing.	No requirement.	Publish week of May 15
Publish notice of public hearing which must be held prior to adoption of five-year Capital Improvement Program by resolution.	Publish in newspaper of general circulation at least two weeks prior to first public hearing.	No requirement.	Publish week of May 15





Action Required	City Charter Prescribed Deadline	Arizona State Statute Prescribed Deadline	2006-07 Budget Dates
Public hearing immediately followed by tentative budget adoption with or without amendment.	On or before the last day of June.	On or before the third Monday of July.	May 31
Publish summary of tentatively adopted budget and notice of public hearing which must precede final adoption.	No requirement.	Once a week for two consecutive weeks following tentative adoption.	Publish weeks of June 5 and 12
Publish truth-in-taxation notice twice in a newspaper of general circulation.	No requirement.	First, at least 14 but no more than 20 days before required public hearing; then at least seven days but not more than 10 days before required hearing.	Publish on May 26 and June 5
Public hearing including truth-in-taxation hearing immediately followed by final budget adoption.	No requirement.	No later than second Monday in August.	June 14
Property tax levy adoption.	No later than the last regularly scheduled Council meeting in July.	No sooner than 14 days following final budget adoption and no later than the third Monday in August.	July 5

Amendments to the Budget After Final Adoption

Generally, by Arizona state statute, no expenditure may be made nor liability incurred for a purpose not included in the budget even if additional funds become available. Phoenix's level of legal budgetary control is by fund except for the General Fund for which control is by program.

In certain instances, however, the budget may be amended after adoption. All budget amendments require City Council approval. These are (1) transfers from any contingency appropriation, (2) increases in funds exempt from the Arizona State Constitution expenditure limit and (3) reallocations of amounts included in the original budget. An amount for contingencies is included in

the General Fund and in many other restricted funds. Informal reservations of contingencies are made throughout the fiscal year as approved by the City Council. Actual expenditures are recorded in the appropriate departmental budget. Then, at the end of the fiscal year, contingency amounts actually needed are transferred by City Council formal action to the appropriate departmental budget.

If funds are available, appropriations may be increased for certain funds specifically excluded from the limitations in the Arizona Constitution. These funds are bond proceeds, Arizona Highway User Revenue, debt service and grants. At the end of each fiscal year, the City Council adopts an amendment to the budget ordinance for any necessary increases in these funds. These increases are largely caused by federal grants that become available throughout the fiscal year and by timing changes in capital projects funded by bond proceeds.

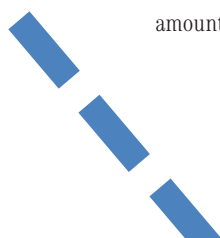
Finally, transfers of amounts within any specific fund or within General Fund programs can be made upon approval of the city manager.

PROPERTY TAXES AND BONDED DEBT LIMIT

Arizona's property tax system provides for two separate tax systems. A primary property tax is levied to pay current operation and maintenance expenses. Therefore, primary property tax revenue is budgeted and accounted for in the General Fund. A secondary property tax levy is restricted to the payment of debt service on long-term debt obligations. Therefore, secondary property tax revenue is budgeted and accounted for as a special revenue fund.

Primary Property Tax Restrictions

Primary property tax levies are restricted to an annual 2 percent increase plus an allowance for growth attributable to previously unassessed properties (primarily new construction). Growth in primary assessed valuation is restricted



annually to the greater of 10 percent, or 25 percent of the difference between primary and secondary values, plus an allowance for previously unassessed properties. The City Charter requires that 8 cents of the primary property tax levy be allocated to the Parks and Playground Fund.

Secondary Property Tax Restrictions

Secondary property tax levies are restricted in their use to the payment of annual debt service on long-term debt obligations. Any over-collection of the secondary levy or any interest earned by invested secondary property tax funds must be used to reduce the following year's levy. No restrictions limit the annual growth in secondary assessed valuations. Secondary assessed valuations are intended, therefore, to follow general market conditions.

Generally, Arizona counties assess property and collect all property taxes. Proceeds are distributed monthly to the appropriate jurisdictions.

Bonded Debt Limit

Arizona cities can issue general obligation bonds for purposes of water, sewer, artificial light, open space, preserves, parks, playgrounds and recreational facilities up to an amount not exceeding 20 percent of the secondary assessed valuation. General obligation bonds can be issued for all purposes other than those previously listed up to an amount not exceeding 6 percent of the secondary assessed valuation. An analysis of bonded debt limits is provided in the Debt Service chapter.

ANNUAL EXPENDITURE LIMITATION

Since fiscal year 1982-83, the city of Phoenix has been subject to an annual expenditure limitation imposed by the Arizona Constitution. This limitation is based upon the city's actual 1979-80

expenditures adjusted for interim growth in population and inflation as measured by the gross domestic product implicit price deflator.

The constitution exempts certain expenditures from the limitation. The principal exemptions for the city of Phoenix are debt-service payments, expenditures of federal funds, certain state-shared revenues and other long-term debt obligations. Exemptions associated with revenues not expended in the year of receipt may be carried forward and used in later years. The 1979-80 expenditure base may be adjusted for the transfer of functions between governmental jurisdictions.

The constitution provides for four processes to exceed the expenditure limitation: (1) a local four-year home rule option, (2) a permanent adjustment to the 1979-80 base, (3) a one-time override for the following fiscal year, and (4) an accumulation for pay-as-you-go capital. All require voter approval.

City of Phoenix voters have approved six local home rule options in 1981, 1985, 1991, 1995, 1999 and 2003. Before 1999, the home rule options generally excluded enterprise operations such as Aviation, Water, Wastewater and Solid Waste from the expenditure limitation. In 1999, and again in 2003, the voters approved establishing the city's annual budget as the spending limit. The current home rule option is in effect through fiscal year 2007-08. Finally, in 1981, the voters approved the permanent annual exclusion of the following amounts for pay-as-you-go capital: \$5 million for Aviation, \$6 million for Water, \$6 million for Wastewater and \$2 million for General Fund street improvements.

Each year, the city uses only those exemptions needed to comply with the expenditure limitation. Exemptions not needed are carried forward to future years and used for future spending capacity.

BUDGET BASIS OF ACCOUNTING

The city's budget basis of accounting differs from generally accepted accounting principles (GAAP) used for preparing the city's comprehensive annual financial report. The major differences between the budget basis and GAAP basis are listed below. A reconciliation of budgetary and GAAP fund balances is provided each year in the comprehensive annual financial report.

1. For budgetary purposes, encumbrances (contractual commitments to be performed) are considered the equivalent of expenditures rather than as a reservation of fund balance.
2. Grant revenues are budgeted on a modified cash basis. GAAP recognizes grant revenues on an accrual basis.
3. Fund balances reserved for inventories, bonded debt and unrealized gains or losses on investments are not recognized in the budget.
4. In-lieu property taxes and central service cost allocations (levied against certain enterprise and special revenue funds) are budgeted as interfund transfers rather than revenues and expenses.
5. For budgetary purposes, all fixed assets are fully expensed in the year acquired.

The differences between budgetary and GAAP accounting listed above are similar to those of many other local governments. These differences exist largely because they provide a more conservative view of revenues and expenditures and because they provide greater administrative controls.





GENERAL FINANCIAL POLICIES

In addition to the legal constraints outlined in the previous section, a number of administrative and City Council-approved policies provide guidance and direction to the budget development process.

Form of Budget Adoption

- 1. Ordinances** - Three budget ordinances are adopted each fiscal year: (1) the operating funds ordinance, (2) the capital funds ordinance and (3) the re-appropriated funds ordinance. The last ordinance is required because unexpended amounts, including those encumbered, lapse at the end of the fiscal year. Since all expended amounts must be included in the budget adoption ordinance, the city re-budgets all encumbrances outstanding at year's end.
- 2. Allocation of Appropriations** - Funds appropriated by the City Council are allocated to programs, offices, departments, divisions, sections, projects and type of expenditure by the city manager or as delegated to the Budget and Research director to provide managerial control and reporting of budgetary operations.

3. Contingency Amounts -

A contingency allowance (also known as a "rainy day fund") is appropriated to provide for emergencies, mid-year community service requests, unanticipated expenditures and revenue shortfalls. Expenditures may be made from contingencies only upon approval by the City Council with recommendation by the city manager. In 1995-96, the City Council adopted a policy to provide a contingency equal to 3 percent of operating expenditures in the General Fund. However, in 2003-04, the City Council reduced the General Fund contingency to 2.5 percent of operating expenditures in order to close a budget deficit. The 2004-05 and 2005-06 budgets maintained the General Fund contingency at 2.6 percent of operating expenditures, while the 2006-07 contingency will be at 2.7 percent. Enterprise and special revenue funds have varying levels of contingency funding consistent with the variability in revenues and expenditures associated with the services provided.

- 4. Budget Controls** - At the department level, control of expenditures is governed by Administrative Regulation. City departments prepare revised expenditure estimates twice a year. The Budget and Research Department keeps the city manager and the City Council advised on the status of the budget through periodic budget status reports. Mid-year revenue shortfalls and/or expenditure increases can result in the adoption of mid-year expenditure reductions.

Cost Allocation and Expenditure Policies

1. Central Services Cost Allocation -

The Finance Department annually calculates the full cost of central services provided to enterprise funds. Except for the Golf Fund, these allocated costs are recouped from the enterprise funds through fund transfers to the General Fund.

2. Administrative Cost Recovery -

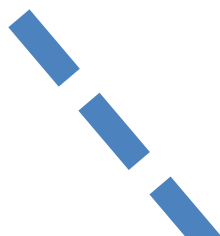
The Finance Department prepares an indirect cost allocation plan that conforms to federal guidelines for grant reimbursement of appropriate administrative costs. The allocated costs are charged to eligible federal grant funds through a fund transfer to the General Fund.

3. Internal Cost Accounting

Allocation - Interdepartmental services performed by one department for another are credited to the performing department and charged to the receiving department to reflect the accurate costs of programs. The rates used are intended to reflect full costs including appropriate overhead.

4. Enterprise Cost Recovery -

Aviation, Water, Wastewater and Solid Waste are fully self-supporting from rates, fees and charges and, as such, are budgeted and accounted for as enterprise funds. Cost recovery includes direct operation and maintenance expenses, capital expenditures, debt service, indirect cost allocation, and in-lieu property taxes, where allowable. The Convention Center, while accounted for using enterprise accounting principles, is partially financed from rental and parking fees with the remainder coming from earmarked



sales taxes. The Golf Fund, also accounted for using enterprise accounting principles, does not reimburse the General Fund for citywide indirect cost allocations. Finally, federal regulations preclude the Aviation Fund from paying in-lieu property taxes. By City Council policy, the Convention Center Fund does not pay in-lieu property taxes.

5. Employee Compensation Costs -

Costs for employee compensation including all wages, social security, industrial, health, life, unemployment, dental insurance and other personal allowances are allocated to each department. Annual amounts for cash conversion of vacation, compensatory time and sick leave are included in the budget. However, future values of compensated absences are not included in the budget but are disclosed in the notes to the comprehensive annual financial report at year's end.

6. Pension Funding - In addition to other employee compensation amounts, pension amounts are allocated to each department. The required employer contribution is determined actuarially to fund full benefits for active members and to amortize any unfunded actuarial liability as a level percent of projected member payroll over 20 years from the end of the current fiscal year.

7. Self-Insurance Costs - With a few exceptions, the city is fully self-insured for general and automotive liability exposures. The major exceptions to self-insurance include airport operations, police aircraft operations and excess general and automotive liability for losses in excess of \$5 million. An independent actuary determines the self-insurance costs, which are combined with purchased policy costs and allocated to department budgets based on the previous five years' loss experience of each department.

8. Maintenance and Replacement of Rolling Stock and Major Facilities -

A multiyear plan is used to project the need for, and costs of, significant street pavement, facility and equipment repair and replacement. The planning horizon for each asset category is matched to the life of the asset. Annually, that plan, combined with periodic physical inspections of streets, facilities, vehicles and other equipment, is used to develop funding levels for inclusion in the budget. During economic downturns, these amounts are debt-financed with a repayment schedule shorter than the expected life of the asset.

Revenue Management

All local governments struggle to generate the funds necessary to provide, maintain and enhance the service demands of their community. Due to the legal limitations on property taxes in Arizona, and due to the pre-emption of city-imposed income, luxury and gas taxes, Arizona cities and towns largely rely on local sales taxes and state-shared sales, income and vehicle license taxes. In Phoenix, 43 percent of the General Fund comes from the local sales tax. This reliance on sales tax collections results in a highly cyclical revenue base.

Given our reliance on sales taxes, developing personal income is an important step in managing our revenue base. In recent years, considerable effort has been devoted to attracting employers that will provide our residents with quality jobs and to developing a local workforce that will support the needs of quality employers. We also have worked to develop an employment base that is not as heavily concentrated in the highly cyclical construction industry.

Also important to managing our revenue base is the future growth expected in catalog and Internet sales. Our use tax is an important tool in reducing this potential future threat. The development of our tourism-related sales tax base (hotels, restaurants and short-term car rentals) is another important hedge against future revenue loss due to growth in Internet and catalog sales.

Finally, utility taxes that are levied against the sales of electricity, natural gas, telecommunications, water and sewer make up about 20 percent of our local sales tax base. Generally, utility taxes are not responsive to economic conditions and provide us with a fairly significant revenue source that remains stable during periods of economic downturn.





In addition, several detailed revenue policies are listed below.

1. City Sales and Use Taxes (Privilege License Taxes) -

The City Council may set the city sales tax rate by ordinance. The city sales tax rate on retail sales and most other categories is 1.8 percent. The rate varies for certain other specialized taxing categories as outlined in the Operating Fund Revenues section of this document.

2. Property Taxes - By City Council policy, the combined city property tax rate is \$1.82 per \$100 of assessed valuation. The primary property tax levy is annually set at the previous year's levy amount plus an amount associated with new construction and an amount to partially provide for the operating costs of new capital facilities. The secondary levy is then set at an amount necessary to achieve a total \$1.82 tax rate.

3. In-Lieu Property Taxes -

In-lieu property taxes are charged to the Water, Wastewater, Solid Waste and Public Housing funds based upon acquisition or construction cost with the appropriate assessment ratio and current property tax rate applied. These amounts are calculated annually by the Finance Department.

4. Annual User Fee Review -

The city auditor conducts a comprehensive user fee review to project cost recovery rates, and then compares the projections to the established cost recovery policy. The rates are based upon generally accepted full-cost accounting standards. The city manager recommends expenditure reductions or fee adjustments to the City Council to maintain the established cost recovery policy.

5. Fines and Forfeitures -

The Municipal Court has jurisdiction over establishing many of the fine and forfeiture fee schedules.

6. Parks and Recreation Fees and Charges -

The Parks and Recreation Board has jurisdiction over establishing charges for miscellaneous recreational facilities and advising the City Council on fees to be set for golf courses, tennis centers and swimming pools.

7. Interest Earnings - Interest earnings from the investment of temporarily idle funds are credited to the fund generating the earnings.

FUND STRUCTURE

The budget presented here is made up of three distinct fund groups: general, special revenue and enterprise funds.

All planned uses of these fund types are included in the annual budget. Fiduciary funds, which are described later in this section, are not included in the annual budget.

General Funds

General – These revenues come from four major sources: local sales (privilege license) taxes, local primary property taxes, state-shared revenues, and user fees and other revenues. State-shared taxes include state-shared sales, vehicle license and income taxes. User fees and other revenues include cable and ambulance fees as well as interest earnings and fines. General funds are used to provide the most basic of city services: police, fire, parks, library, municipal court and neighborhood services.

Parks – The City Charter requires that a portion of the primary property tax levy be used to support parks programs. To demonstrate compliance with this requirement, all parks revenues and expenditures are segregated in a separate fund.

Library – State law requires that funds received for library purposes are segregated in a separate library fund. Revenues include library fines and fees, which are used to help offset library expenditures.

Cable Communications – Included in this fund are the revenues and expenditures associated with administering cable television licensing and programming the government and education access channels.

Special Revenue Funds

Excise Tax – The excise tax fund is used to account for tax revenues ultimately pledged to pay principal and interest on various debt obligations.

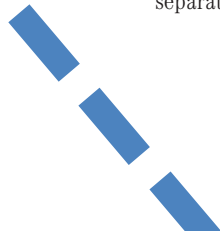
Police and Fire Neighborhood Protection

– These funds are used to account for the revenues and expenditures associated with a voter-approved 0.1 percent increase in the sales tax in 1993. Revenue from the tax increase is earmarked for police and fire neighborhood protection programs, and police Block Watch programs.

Police and Fire Public Safety Enhancement

– These funds are used to account for the revenues and expenditures associated with a voter-approved 2.0 percent increment of the 2.7 percent privilege license (sales) tax on utilities with franchise agreements in March 2005. The Police Department, including the Office of Emergency Management will be allocated 62 percent and the Fire Department 38 percent of revenues with the interest earnings going to the General Fund.

Parks and Preserves – This fund is used to account for the funds generated by the 0.1 percent increase in the sales tax approved by voters in 1999. The funds are to be used for the purchase of state trust lands for the Sonoran Desert Preserve Open Space, and the development and improvement of regional and neighborhood parks to enhance community safety and recreation.



City Improvement – This fund is used to account for lease/purchase payments incurred as a result of facilities built by the Civic Improvement Corporation.

Capital Construction – This fund is used to account for the utility taxes (2 percent) on telecommunication services that are to be used for pay-as-you-go capital projects.

Transit 2000 – This fund is used to account for the 0.4 percent sales tax dedicated to transit approved by voters on March 14, 2000. Also included in this fund are fare box collections and DASH (Downtown Area SHuttle) revenues.

Development Services – Fee revenues and expenditures associated with permitting and inspection services provided by the Development Services Department are maintained in this fund.

Court Awards – This fund includes revenue resulting from court awards of confiscated property under both the federal and state Organized Crime Acts. Expenditures are restricted to additional law enforcement programs in the Police and Law departments.

Secondary Property Tax and General Obligation Bond Redemption – In Arizona, property taxes are divided into two separate levies: primary and secondary. The primary levy can be used for general operating and maintenance expense. The secondary levy can only be used for payment of general obligation bond interest and redemption. Because of this restriction, secondary property tax funds are segregated in a special revenue fund.

Arizona Highway User Revenue (AHUR) – AHUR funds are made up of state-collected gas taxes and a portion of other state-collected fees and charges such as registration fees, driver's licenses and motor carrier taxes. These funds can only be used for street maintenance and construction, and street-related debt service.

Local Transportation Assistance (LTA) – This fund includes the Phoenix share of Arizona State Lottery proceeds distributed to cities and towns. These funds are to be used for mass transit operating and capital expenses. In addition, if \$23 million is distributed, then up to 10 percent may be used for cultural, educational, historical, recreational, or scientific facilities or programs. LTA funds used for non-transit purposes must be matched on a 50/50 basis with non-public cash.

Sports Facilities – This fund accounts for revenues generated from a 1 percent hotel/motel tax and a 2 percent tax on short-term vehicle rentals. These funds are designated for payment of debt service and other expenditures related to the downtown sports arena.

Public Transit – This fund is used to account for transit services that are paid by and provided for other cities or funded by the Regional Public Transportation Authority.

Community Reinvestment – Revenues and expenditures associated with economic redevelopment agreements are maintained in this fund.

Other Restricted Funds – This is a combination of funds used to segregate restricted revenues and related expenses. Included are Court Technology Enhancement Fees, Parks revenues such as Heritage Square and Tennis Center, and various other receipts and contributions received in small amounts and earmarked for restricted purposes.

Grant Funds

Grant funds include Community Development Block Grant funds, Public Housing funds, Human Services funds and various other smaller grant allocations. Grant funds can be applied only to grant-eligible expenditures.

Enterprise Funds

Enterprise funds include Water, Wastewater, Aviation, Solid Waste, Golf and Convention Center funds. With the exception of Convention Center funds, these funds come entirely from the fees and rents paid by those who use the services and facilities provided. Enterprise funds are “self-contained” and can only be used to pay for the costs associated with enterprise fund-related services and programs. Therefore, fees are set to recover all costs associated with providing these services. These costs include day-to-day operations and maintenance, in-lieu property taxes, pay-as-you-go capital improvements and debt service.

Convention Center funds come from a combination of rental and parking income and earmarked sales taxes. These earmarked taxes include a portion of the hotel, restaurant and bar, construction contracting and advertising taxes levied by the city. This tax stream has been earmarked to repay the debt issue for the Convention Center facility and to provide for operations and maintenance costs.

Fiduciary Funds

Fiduciary funds, including trust and agency funds, represent funds held for others. As such, these funds are not included in the annual budget. Also, reserves and expenditures for fiduciary funds are not presented in the comprehensive annual financial report (CAFR). However, the year-end balances held in fiduciary funds are provided in the CAFR.

