

Management Report
for
City of Plymouth, Minnesota
December 31, 2012

To the City Council and Management
City of Plymouth, Minnesota

We have prepared this management report in conjunction with our audit of the City of Plymouth, Minnesota's (the City) financial statements for the year ended December 31, 2012. The purpose of this report is to provide observations and recommendations resulting from our audit process and to communicate information relevant to city finances in Minnesota. We have organized this report into the following sections:

- Audit Summary
- Funding Cities in Minnesota
- Governmental Funds Overview
- Enterprise Funds Overview
- Government-Wide Financial Statements
- Accounting and Auditing Updates

We would be pleased to further discuss any of the information contained in this report or any other concerns that you would like us to address. We would also like to express our thanks for the courtesy and assistance extended to us during the course of our audit.

The purpose of this report is solely to provide those charged with governance of the City, management, and those who have responsibility for oversight of the financial reporting process observations and recommendations resulting from our audit process and information relevant to city finances in Minnesota. Accordingly, this report is not suitable for any other purpose.

Malloy, Montague, Karnowski, Radosevich, & Co., P.A.

Minneapolis, Minnesota
June 14, 2013

AUDIT SUMMARY

The following is a summary of our audit work, key conclusions, and other information that we consider important or that is required to be communicated to the City Council, administration, or those charged with governance of the City.

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA, *GOVERNMENT AUDITING STANDARDS*, AND THE U.S. OFFICE OF MANAGEMENT AND BUDGET (OMB) CIRCULAR A-133

We have audited the financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of the City as of and for the year ended December 31, 2012. Professional standards require that we provide you with information about our responsibilities under auditing standards generally accepted in the United States of America, *Government Auditing Standards*, and OMB Circular A-133, as well as certain information related to the planned scope and timing of our audit. We have communicated such information to you verbally and in our audit engagement letter. Professional standards also require that we communicate the following information related to our audit.

PLANNED SCOPE AND TIMING OF THE AUDIT

We performed the audit according to the planned scope and timing previously discussed and coordinated in order to obtain sufficient audit evidence and complete an effective audit.

AUDIT OPINION AND FINDINGS

Based on our audit of the City's financial statements for the year ended December 31, 2012:

- We have issued an unqualified opinion on the City's basic financial statements.
- We reported no deficiencies in the City's internal control over financial reporting that we considered to be material weaknesses.
- The results of our testing disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.
- We noted that the Schedule of Expenditures of Federal Awards is fairly stated, in all material respects, in relation to the basic financial statements.
- We reported no deficiencies in the internal controls over compliance and its operation that we consider to be material weaknesses in our testing of major federal programs.
- The results of our tests indicate that the City has complied, in all material respects, with the requirements applicable to each major federal program.
- We reported no findings based on our testing of the City's compliance with Minnesota laws and regulations.

FOLLOW-UP ON PRIOR YEAR FINDINGS AND RECOMMENDATIONS

As a part of our audit of the City's financial statements for the year ended December 31, 2012, we performed procedures to follow-up on the findings and recommendations that resulted from our prior year audit. During our audit for the year ended December 31, 2011, the City had a reportable instance of noncompliance with Minnesota laws and regulations. The City had deposits in excess of federal insurance coverage that were not covered by corporate surety bonds or collateral that had a market value of at least 110 percent of such excess. This was not a finding for the current year.

SIGNIFICANT ACCOUNTING POLICIES

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 of the notes to basic financial statements. For the fiscal year ended December 31, 2012, the City implemented Governmental Accounting Standards Board (GASB) Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. This statement changed how governmental entities present a statement of net position, adding two new basic financial statement elements, and replacing “net assets” with “net position” as the terminology used to describe the difference between the other four elements. The two basic financial statement elements added are “deferred inflows of resources” and “deferred outflows of resources.” These new elements are differentiated from assets (deferred outflows of resources) and liabilities (deferred inflows of resources), but have similar effects on net position.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

ACCOUNTING ESTIMATES AND MANAGEMENT JUDGMENTS

Accounting estimates are an integral part of the financial statements prepared by management and are based on management’s knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected.

The most sensitive estimates affecting the financial statements were as follows:

- **Depreciation** – Management’s estimates of depreciation expense are based on the estimated useful lives of the assets.
- **Net Other Post-Employment Benefit (OPEB) Liabilities** – Actuarial estimates of the net OPEB obligation is based on eligible participants, estimated future health insurance premiums, and estimated retirement dates.
- **Compensated Absences** – Management’s estimate is based on current rates of pay and sick leave balances.
- **Self-Insurance Reserves** – Management’s estimates of self-insurance reserves are based on the estimated liability for incurred but not reported claims.

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the basic financial statements taken as a whole. The financial statement disclosures are neutral, consistent, and clear.

CORRECTED AND UNCORRECTED MISSTATEMENTS

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Where applicable, management has corrected all such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management, when applicable, were material, either individually or in the aggregate, to each opinion unit’s financial statements taken as a whole.

DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT

We encountered no significant difficulties in dealing with management in performing and completing our audit.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this report, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

MANAGEMENT REPRESENTATIONS

We have requested certain representations from management that are included in the management representation letter dated June 14, 2013.

MANAGEMENT CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

OTHER AUDIT FINDINGS OR ISSUES

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City's basic financial statements. Other information, including the introductory section, the supplementary information, and the statistical section accompanying the basic financial statements are presented for purposes of additional analysis and are not required parts of the basic financial statements.

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the basic financial statements or to the basic financial statements themselves.

With respect to the introductory section and the statistical section accompanying the basic financial statements, our procedures were limited to reading this other information, and in doing so we did not identify any material inconsistencies with the audited financial statements.

FUNDING CITIES IN MINNESOTA

LEGISLATION

The 2011 Legislative Session was very long and difficult. It featured a large budget deficit and a very contentious battle between the Democratic Governor and the Republican-led House and Senate; and resulted in numerous vetoes, a special session, and the longest shutdown of non-essential state government services in Minnesota history.

The outlook going into the 2012 Legislative Session was brightened somewhat by positive economic news. The November 2011 financial forecast projected a surplus of \$876 million in the state general fund for the biennium ending June 30, 2013, later revised to a surplus of almost \$1.2 billion in the February 2012 forecast. This meant that the Legislature would not have to pass a “supplemental budget” to deal with projected shortfalls for the second half of the biennium, as was the case in the previous short session.

The positive feeling was short-lived, however, as the 2012 Legislative Session quickly degenerated into more partisan squabbling. Once again, the Governor exercised his veto power a number of times to block Republican legislative initiatives. The Republican Legislature reacted by introducing several potential amendments to the state constitution, which once passed would be subject to a public vote and could not be vetoed by the Governor. Two potential amendments, addressing voter identification and the legal definition of marriage, made it on the ballot for the November 2012 election and were voted down by the public. In the end, the main accomplishment of the session was a hard-fought compromise on partial public funding for a Vikings stadium.

The 2012 Legislature did pass a state bonding bill, a technical tax bill (after two omnibus tax bills were vetoed), and a few other bills that impacted Minnesota cities. The following is a summary of recent legislative activity affecting the finances of Minnesota cities in 2012 and into the future:

Local Government Aid (LGA) – The state-wide LGA appropriation for fiscal 2012 was \$425.2 million. For fiscal 2012, cities received the lesser of their 2010 actual or 2011 certified LGA allocations. For fiscal 2013 and beyond, the state-wide LGA appropriation had been set to increase to \$426.4 million; however, the 2012 Legislature made some changes. LGA payments for 2013 are frozen at 2012 levels for cities with a population of 5,000 or more. For cities with populations below 5,000, 2013 LGA will be the greater of their 2012 aid or the amount they would have received for 2013 under existing law. The Legislature also froze the base for calculating the maximum increases and decreases for a city’s 2013 and 2014 LGA to their 2012 aid. Beginning in 2015, the previous year’s LGA payment will be used to calculate the minimum and maximum increases.

Market Value Homestead Credit (MVHC) – The 2011 Legislature eliminated the MVHC reimbursement program beginning in fiscal 2012. Rather than receiving a property tax credit, qualifying homeowner taxpayers had a portion of the market value of their house excluded from their taxable market value. This new system provides homeowners property tax relief by shifting a portion of their potential tax burden to other property classifications, rather than directly reducing their taxes through a state paid tax credit reimbursement. While this new homestead exclusion is calculated in a similar manner to the repealed MVHC, the actual tax relief to individual homeowner taxpayers varies depending on the makeup of the taxing jurisdictions that levy on their particular property.

Depositories Authorized to Redeposit City Funds – Banks designated as depositories of city funds are authorized to redeposit the funds in another bank, savings and loan, or credit union located within the United States, provide the redeposited funds are fully covered by federal depository insurance (FDIC or NCUA). This law change was enacted to make additional federal depository insurance available to cover municipal deposits in anticipation of the December 31, 2012 sunset of the temporary unlimited coverage for non-interest bearing municipal accounts provisions of the Dodd-Frank Act.

Municipal State Aid (MSA) Eligibility – Three changes were made that protect the MSA of cities dropping below a population of 5,000, which is the eligibility threshold for receiving MSA for street maintenance. Under previous law, if a city that formerly had a population of 5,000 or more fell below a 5,000 population at the 2010 decennial census, it would have been ineligible for MSA beginning in fiscal 2012. The first change enacted allows previously eligible cities falling below 5,000 population at a decennial census to continue to be considered to have a population of 5,000 for purposes of calculating MSA, thereby remaining eligible, until the end of the fourth year of the decade. The second change enacted states that for purposes of calculating MSA, which is based 50 percent on population, a city is deemed to have a population equal to the greater of 5,000 or as otherwise determined by statute. The final change requires that, for 2013 MSA only, the aid be allocated in a manner that backfills the MSA cities lost in 2012 due to population drops.

Contractor Bond Threshold – The threshold at which a municipality is required to obtain contractor performance and payment bonds for public construction contracts was increased from \$75,000 to match the current competitive bid law threshold of \$100,000.

Municipal Detachment of Parcels – A number of corrections and clarifications were made related to petitions for the detachment of parcels from a municipality. The changes affect petition requirements, the hearing process, and the sharing of associated hearing and mediation costs with the landowners.

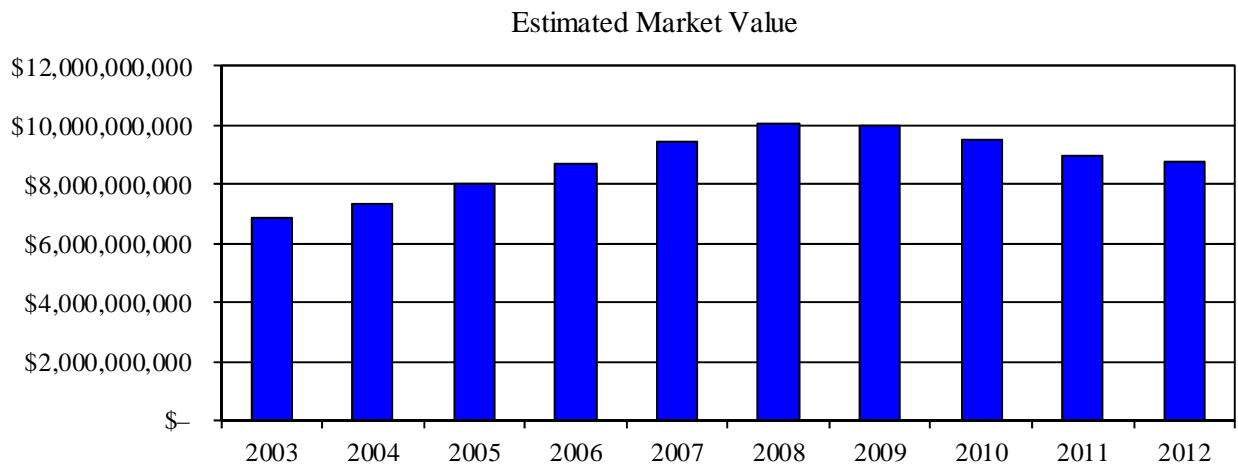
Tort Liability Limits for Cities Contracting With Certain Nonprofits – The liability limit on claims against cities involving nonprofit organizations that are engaged in or administer outdoor recreational activities that are funded or authorized by a municipality were lowered from \$1.5 million to \$1.0 million.

PROPERTY TAXES

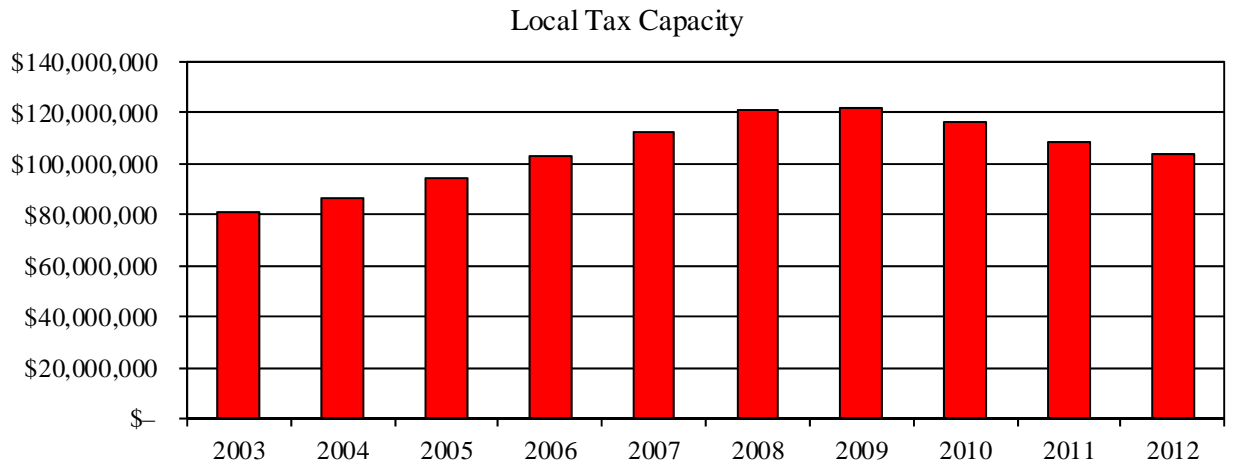
Minnesota cities rely heavily on local property tax levies to support their governmental fund activities. In recent years this dependence has been heightened due to reductions in state aids and fees from new development due to the struggling economy. As a result, many cities have repeatedly been faced with the difficult choice of either reducing services or increasing taxes on their already overburdened constituents.

Property values within Minnesota cities experienced average decreases of 5.7 percent and 8.8 percent for taxes payable in 2011 and 2012, respectively, as market values have continued to slide despite recent signs of improvement in other areas of the economy. In comparison, the City's taxable market value decreased 6.0 percent for taxes payable in 2011 and 1.9 percent for taxes payable in 2012. The market value for taxes payable in 2012 is based on estimated values as of January 1, 2011.

The following graph shows the City's changes in taxable market value over the past 10 years:



Tax capacity is considered the actual base available for taxation. It is calculated by applying the state's property classification system to each property's market value. Each property classification, such as commercial or residential, has a different calculation and uses different rates. Consequently, a city's total tax capacity will change at a different rate than its total market value, as tax capacity is affected by the proportion of the City's tax base that is in each property classification from year-to-year, as well as legislative changes to tax rates. The City's tax capacity decreased 6.4 percent and 4.4 percent for taxes payable in 2011 and 2012, respectively. The following graph shows the City's change in tax capacities over the past 10 years:



The following table presents the average tax rates applied to city residents for each of the last two levy years, along with comparative state-wide and metro area rates. The general increase in rates reflects both the increased reliance of local governments on property taxes and the recent decline in tax capacities.

| Rates expressed as a percentage of net tax capacity | | | | | | |
|---|--------------------------|---------------------|----------------------------|---------------------|----------------------------|----------------------------|
| | All Cities State-Wide | | Seven-County Metro Area | | City of Plymouth | |
| | <u>2011</u> | <u>2012</u> | <u>2011</u> | <u>2012</u> | <u>2011</u> | <u>2012</u> |
| Average tax rate | | | | | | |
| City | 42.5 | 46.3 | 40.0 | 43.4 | 26.9 | 28.2 |
| County | 43.7 | 46.8 | 42.1 | 45.0 | 45.8 | 48.2 |
| School | 25.2 | 27.3 | 26.8 | 28.5 | 26.3 | 26.9 |
| Special taxing | <u>6.4</u> | <u>6.8</u> | <u>8.1</u> | <u>8.7</u> | <u>10.5</u> | <u>10.8</u> |
| Total | <u><u>117.8</u></u> | <u><u>127.2</u></u> | <u><u>117.0</u></u> | <u><u>125.6</u></u> | <u><u>109.5</u></u> | <u><u>114.0</u></u> |

As the table displays, the City's average tax rate is significantly lower than state-wide averages. The City's lower than average tax rate has resulted in a total tax rate that is below both averages presented in the table above.

GOVERNMENTAL FUNDS OVERVIEW

This section of the report provides you with an overview of the financial trends and activities of the City's governmental funds, which includes the General, special revenue, debt service, capital project, and permanent funds. These funds are used to account for the basic services the City provides to all of its citizens, which are financed primarily with property taxes. The governmental fund information in the City's financial statements focuses on budgetary compliance, and the sufficiency of each governmental fund's current assets to finance its current liabilities.

GOVERNMENTAL FUND BALANCES

The following table summarizes the changes in the fund balances of the City's governmental funds during the year ended December 31, 2012, presented both by fund balance classification and by fund:

| Governmental Funds Change in Fund Balance | | | |
|--|------------------------------------|----------------------|------------------------|
| | Fund Balance as of December 31, | | Increase (Decrease) |
| | <u>2012</u> | <u>2011</u> | |
| Fund balances of governmental funds | | | |
| Total by classification | | | |
| Nonspendable | \$ 114,236 | \$ 55,430 | \$ 58,806 |
| Restricted | 19,475,003 | 15,288,520 | 4,186,483 |
| Assigned | 42,100,785 | 38,847,865 | 3,252,920 |
| Unassigned | <u>11,813,623</u> | <u>11,363,938</u> | <u>449,685</u> |
| Total governmental funds | <u>\$ 73,503,647</u> | <u>\$ 65,555,753</u> | <u>\$ 7,947,894</u> |
| Total by fund | | | |
| General | \$ 12,322,589 | \$ 12,007,962 | \$ 314,627 |
| Transit System | 4,235,596 | 4,656,717 | (421,121) |
| Community Development Block Grant | 40,676 | 51,579 | (10,903) |
| Improvement Projects | 8,030,274 | 7,784,820 | 245,454 |
| Infrastructure Replacement | 14,793,974 | 12,358,555 | 2,435,419 |
| Park Replacement | 4,469,706 | 3,907,590 | 562,116 |
| Nonmajor funds | <u>29,610,832</u> | <u>24,788,530</u> | <u>4,822,302</u> |
| Total governmental funds | <u>\$ 73,503,647</u> | <u>\$ 65,555,753</u> | <u>\$ 7,947,894</u> |

In total, the fund balances of the City's governmental funds increased \$7,947,894 during the year ended December 31, 2012. Restricted fund balances increased \$4,186,483, due mostly to the increase in the Nonmajor debt service funds as a result of the 2012A crossover refunding bond issued. Assigned fund balances increased \$3,252,920 from the prior year, with the largest increases in assignments for infrastructure replacements of \$2,435,419 and park improvement of \$562,116.

GOVERNMENTAL FUNDS REVENUE

The following table presents the per capita revenue of the City's governmental funds for the past three years, along with state-wide averages.

We have included the most recent comparative state-wide averages available from the Office of the State Auditor to provide a benchmark for interpreting your city's data. The amounts received from the typical major sources of governmental fund revenue will naturally vary between cities based on factors such as the City's stage of development, location, size and density of its population, property values, services it provides, and other attributes. It will also differ from year-to-year due to the effect of inflation and changes in the City's operation. Also, certain data on these tables may be classified differently than how they appear on the City's financial statements in order to be more comparable to the state-wide information, particularly in separating capital expenditures from current expenditures.

We have designed this section of our management report using per capita data in order to better identify unique or unusual trends and activities of your city. We intend for this type of comparative and trend information to complement, rather than duplicate, information in the Management's Discussion and Analysis. An inherent difficulty in presenting per capita information is the accuracy of the population count, which for most years is based on estimates.

| Governmental Funds Revenue per Capita | | | | | | |
|--|-------------------|----------------|------------------|---------------|---------------|--|
| With State-Wide Averages by Population Class | | | | | | |
| Year | State-Wide | | City of Plymouth | | | |
| | December 31, 2011 | | 2010 | 2011 | 2012 | |
| Population | 10,000–20,000 | 20,000–100,000 | 70,576 | 71,263 | 71,644 | |
| Property taxes | \$ 363 | \$ 406 | \$ 391 | \$ 386 | \$ 395 | |
| Tax increments | 48 | 51 | 15 | 15 | 15 | |
| Franchise fees and other taxes | 36 | 30 | – | – | – | |
| Special assessments | 56 | 56 | 1 | 1 | 1 | |
| Licenses and permits | 21 | 31 | 35 | 45 | 55 | |
| Intergovernmental revenues | 263 | 152 | 119 | 96 | 69 | |
| Charges for services | 79 | 78 | 58 | 65 | 59 | |
| Other | 75 | 65 | 36 | 54 | 39 | |
| Total revenue | <u>\$ 941</u> | <u>\$ 869</u> | <u>\$ 655</u> | <u>\$ 662</u> | <u>\$ 633</u> | |

The City's governmental funds have typically generated less revenue per capita in total than other Minnesota cities in its population class. A city's stage of development, along with the way a city finances various capital projects, will impact the mix of revenue sources.

Total revenues for the City's governmental funds for 2012 were \$45,317,659, a decrease of \$1.86 million (3.9 percent) from the prior year. On a per capita basis, the City's governmental funds revenue for 2012 was \$633, a decrease of \$29 from the prior year. The most significant change was in intergovernmental revenues, which were \$27 per capita less than the prior year due mostly to fewer state grants and municipal aid for construction projects.

GOVERNMENTAL FUNDS EXPENDITURES

The expenditures of governmental funds will also vary from state-wide averages and from year-to-year, based on the City's circumstances. Expenditures are classified into three types as follows:

- **Current** – These are typically the general operating type expenditures occurring on an annual basis, and are primarily funded by general sources such as taxes and intergovernmental revenues.
- **Capital Outlay and Construction** – These expenditures do not occur on a consistent basis, more typically fluctuating significantly from year-to-year. Many of these expenditures are project-oriented, and are often funded by specific sources that have benefited from the expenditure, such as special assessment improvement projects.
- **Debt Service** – Although the expenditures for debt service may be relatively consistent over the term of the respective debt, the funding source is the important factor. Some debt may be repaid through specific sources such as special assessments or redevelopment funding, while other debt may be repaid with general property taxes.

The City's expenditures per capita of its governmental funds for the past three years, together with state-wide averages, are presented in the following table:

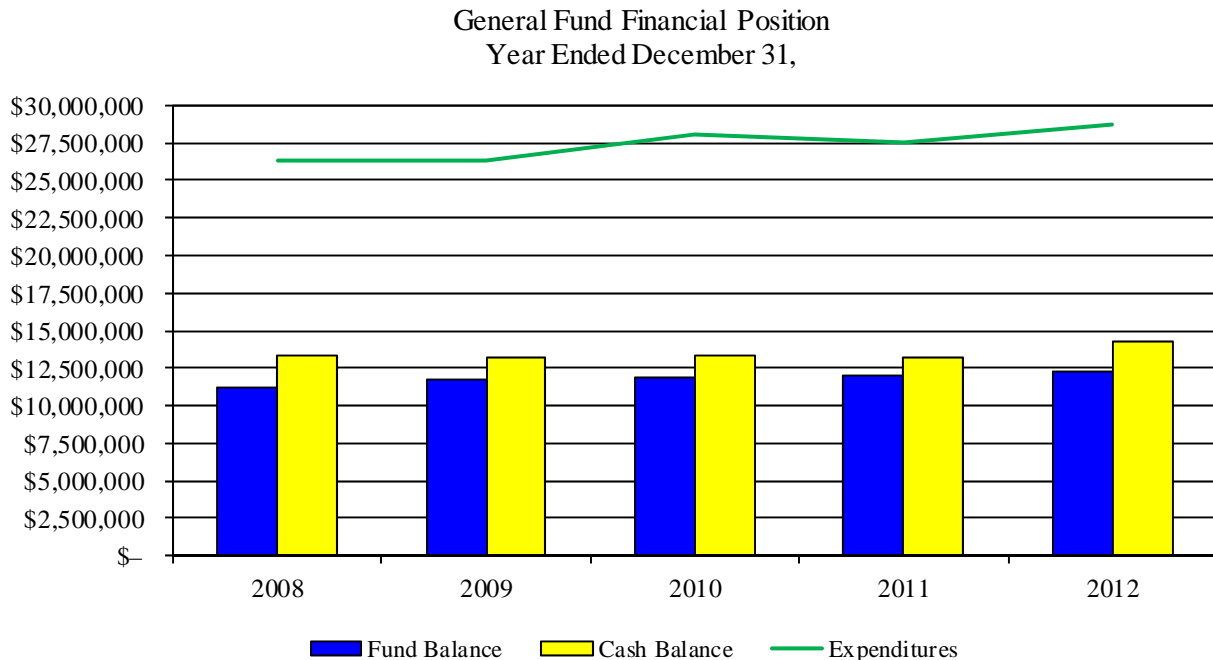
| Governmental Funds Expenditures per Capita With State-Wide Averages by Population Class | | | | | | |
|---|-------------------|----------------|------------------|---------------|---------------|--|
| Year | State-Wide | | City of Plymouth | | | |
| | December 31, 2011 | | 2010 | 2011 | 2012 | |
| Population | 10,000–20,000 | 20,000–100,000 | 70,576 | 71,263 | 71,644 | |
| Current | | | | | | |
| General government | \$ 99 | \$ 82 | \$ 62 | \$ 59 | \$ 65 | |
| Public safety | 225 | 238 | 196 | 189 | 198 | |
| Streets and highways | 108 | 89 | 72 | 72 | 68 | |
| Culture and recreation | 96 | 87 | 94 | 95 | 95 | |
| All other | 81 | 82 | 61 | 74 | 60 | |
| | <u>\$ 609</u> | <u>\$ 578</u> | <u>\$ 485</u> | <u>\$ 489</u> | <u>\$ 486</u> | |
| Capital outlay and construction | <u>\$ 272</u> | <u>\$ 233</u> | <u>\$ 169</u> | <u>\$ 144</u> | <u>\$ 115</u> | |
| Debt service | | | | | | |
| Principal | \$ 148 | \$ 109 | \$ 27 | \$ 20 | \$ 27 | |
| Interest and fiscal | 48 | 41 | 10 | 9 | 9 | |
| | <u>\$ 196</u> | <u>\$ 150</u> | <u>\$ 37</u> | <u>\$ 29</u> | <u>\$ 36</u> | |

The City's governmental funds current per capita expenditures are lower than state-wide averages for cities in the same population class. The City's per capita expenditures for capital and debt service are also much lower than state-wide averages.

Total expenditures for the City's governmental funds for 2012, were \$45,609,221, a decrease of \$1.57 million (3.3 percent) from the prior year. The City's per capita governmental funds expenditures for 2012 were \$637, a decrease of \$25 per capita from the prior year. Capital outlay and construction costs decreased \$29 per capita, which can vary each year due to the timing of various improvement projects ongoing in a given year. Debt service expenditures increased \$7 per capita, which is consistent with current year debt financing plans.

GENERAL FUND

The City's General Fund accounts for the financial activity of the basic services provided to the community. The primary services included within this fund are the administration of the municipal operation, police and fire protection, building inspection, streets and highway maintenance, and parks and recreation. The graph below illustrates the change in the General Fund financial position over the last five years. We have also included a line representing annual expenditures to reflect the change in the size of the General Fund operation over the same period.



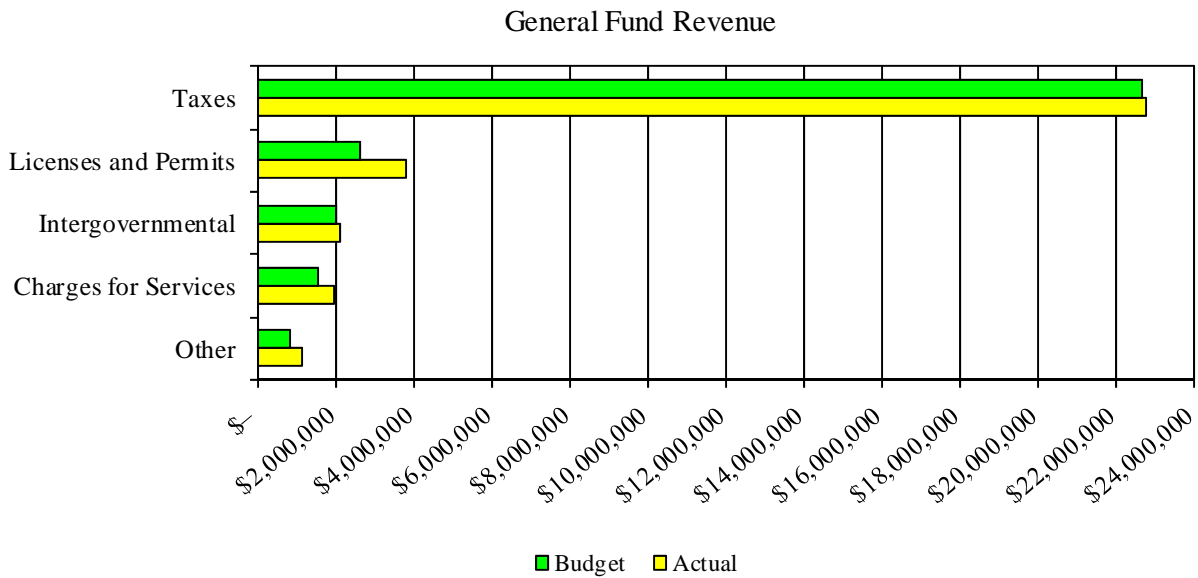
The City's General Fund cash and investments net of borrowing balance at December 31, 2012 was \$14,304,170, an increase of \$1,027,421. Total fund balance at December 31, 2012 was \$12,322,589, which is an increase of \$314,627 from the prior year, as compared to a break-even budget.

As the graph illustrates, the City has generally been able to maintain healthy cash and fund balance levels as the volume of financial activity has grown. This is an important factor because a government, like any organization, requires a certain amount of equity to operate. A healthy financial position allows the City to avoid volatility in tax rates; helps minimize the impact of state funding changes; allows for the adequate and consistent funding of services, repairs, and unexpected costs; and is a factor in determining the City's bond rating and resulting interest costs. Maintaining an adequate fund balance has become increasingly important given the reductions in state funding for cities in recent years.

A trend that is typical to Minnesota local governments, especially the General Fund of cities, is the unusual cash flow experienced throughout the year. The City's General Fund cash disbursements are made fairly evenly during the year other than the impact of seasonal services such as snowplowing, street maintenance, and park activities. Cash receipts of the General Fund are quite a different story. Taxes comprise almost 72 percent of the fund's total annual revenue. Approximately half of these revenues are received by the City in July and the rest in December. Consequently, the City needs to have adequate cash reserves to finance its everyday operations between these payments.

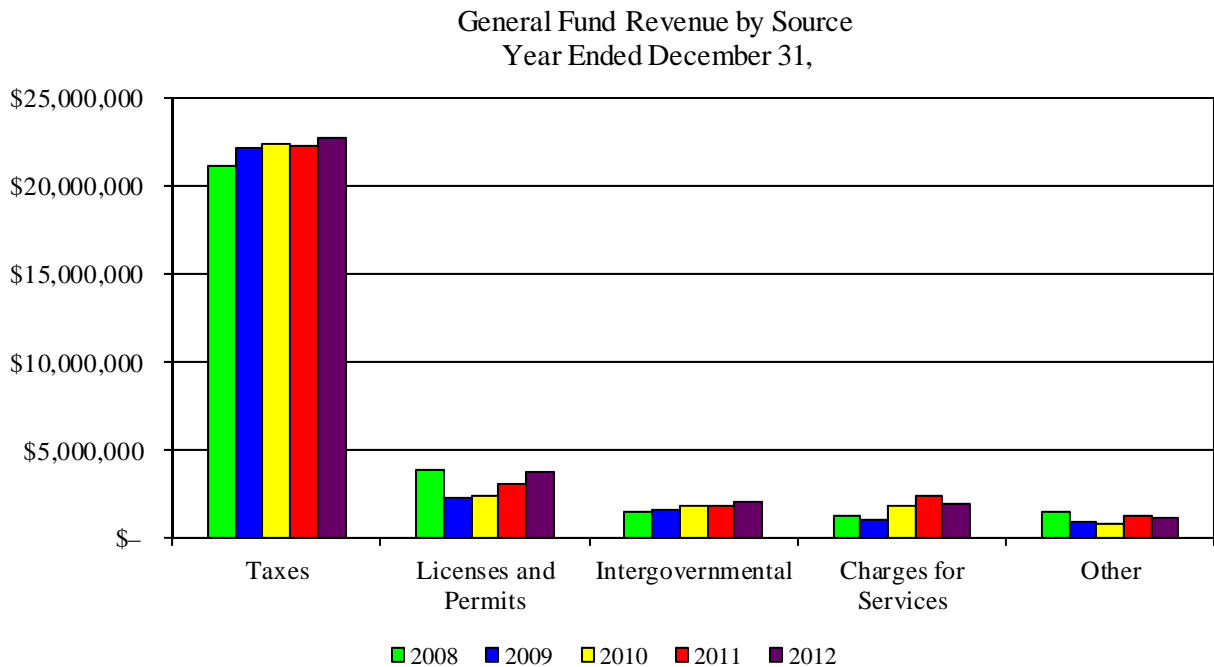
The City's General Fund balance at the end of the 2012 fiscal year represents approximately 42.9 percent of annual expenditures based on 2012 levels.

The following graph illustrates the City's General Fund revenue sources for 2012 compared to budget:



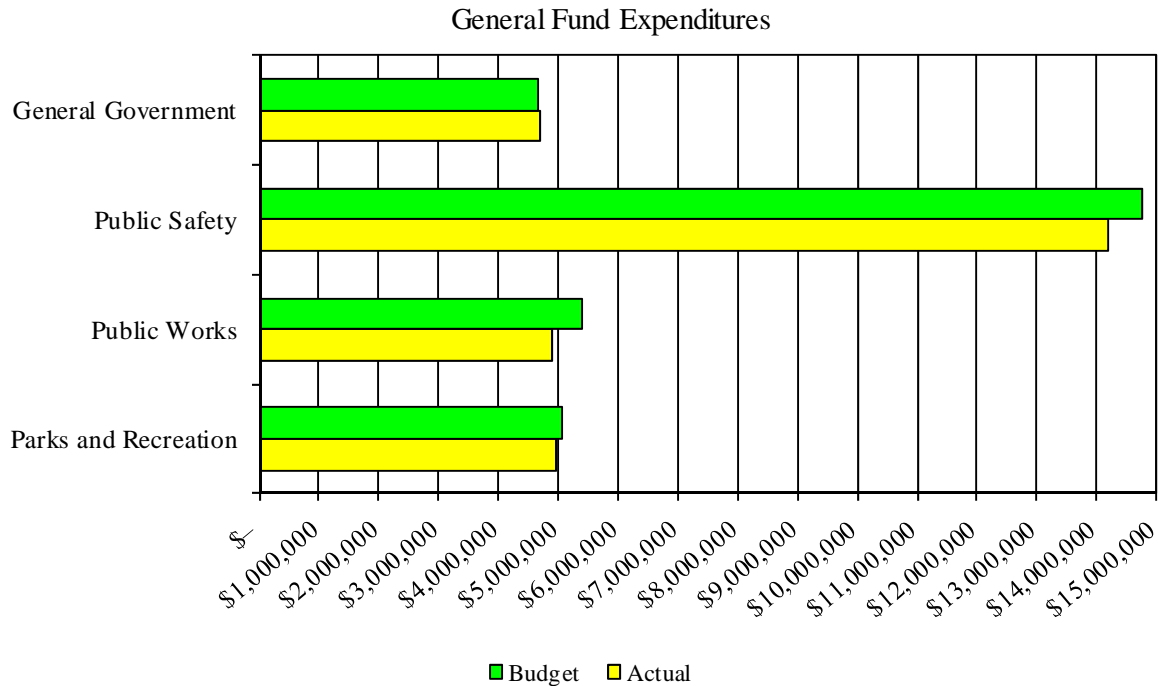
Total General Fund revenues for 2012 were \$31,777,141, which was \$2,024,163 (6.8 percent) more than budgeted. As presented in the graph above, all sources exceeded anticipated levels. Licenses and permits revenue and charges for services were \$1,162,386 and \$394,184, respectively, over budget mainly due to elevated development activity and completed projects in the current year.

The following graph presents the City's General Fund revenue by source for the last five years. The graph reflects the City's reliance on property taxes in recent years.



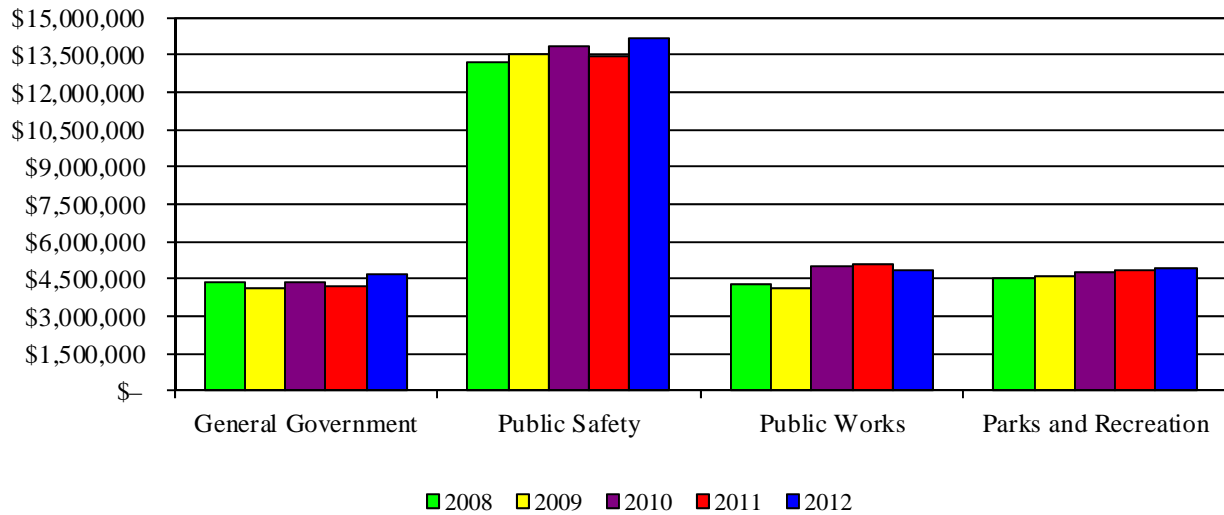
Total General Fund revenue for 2012 was \$1,014,372 (3.3 percent) higher than last year. Licenses and permits revenue increased by \$722,193 due to the elevated development activity discussed above. Property taxes increased by \$563,482, due to the elimination of the MVHC aid subtraction.

The following graphs illustrate the components of General Fund spending for 2012 compared to budget:



Total General Fund expenditures for 2012 were \$28,738,642, which was \$1,151,761 (3.9 percent) under the final budget. The largest variance was in public safety, which experienced savings of \$556,995 largely in personnel service due to unfilled vacancies. Public works expenditures were \$519,533 under budget due to construction project costs accounted for as a transfer of funds to various capital projects funds.

General Fund Expenditures by Function Year Ended December 31,



Total General Fund expenditures for 2012 increased \$1,182,693 (4.3 percent) over the prior year. Public safety and general government expenditures increased by \$725,158 and \$503,053, respectively, over the prior year, mainly due to a change in recording insurance and general risk management liability costs as expenditures rather than transfers.

ENTERPRISE FUNDS OVERVIEW

The City maintains a number of enterprise funds to account for services the City provides that are financed primarily through fees charged to those utilizing the service. This section of the report provides you with an overview of the financial trends and activities of the City's enterprise funds, which includes Water Sewer Utility, Ice Center, Water Resources, Solid Waste Management, and Field House funds.

ENTERPRISE FUNDS FINANCIAL POSITION

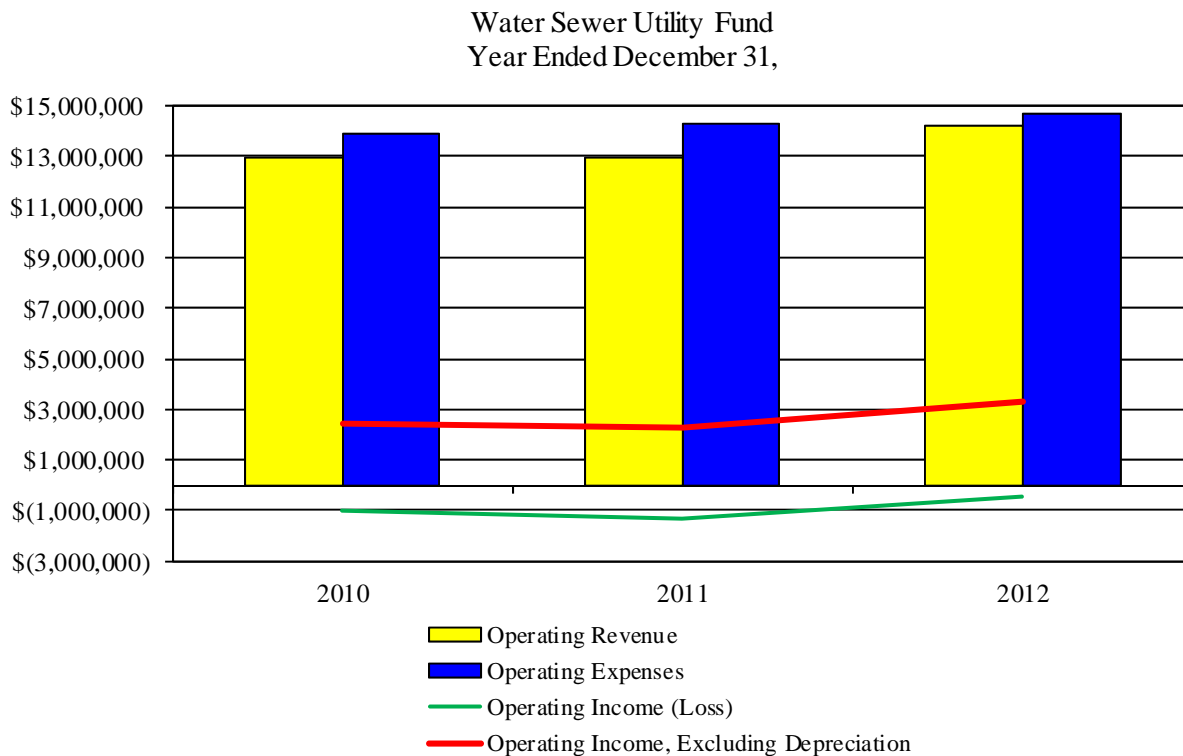
The following table summarizes the changes in the financial position of the City's enterprise funds during the year ended December 31, 2012, presented both by classification and by fund:

| Enterprise Funds Change in Financial Position | | | |
|--|------------------------------------|------------------------------|----------------------------|
| | Net Position as of December 31, | | Increase (Decrease) |
| | <u>2012</u> | <u>2011</u> | |
| Net position of enterprise funds | | | |
| Total by classification | | | |
| Net investment in capital assets | \$ 101,818,758 | \$ 98,946,733 | \$ 2,872,025 |
| Restricted | 24,362,393 | 22,496,065 | 1,866,328 |
| Unrestricted | <u>13,053,140</u> | <u>13,035,887</u> | <u>17,253</u> |
| Total enterprise funds | <u><u>\$ 139,234,291</u></u> | <u><u>\$ 134,478,685</u></u> | <u><u>\$ 4,755,606</u></u> |
| Total by fund | | | |
| Water Sewer Utility | \$ 113,984,765 | \$ 110,443,265 | \$ 3,541,500 |
| Ice Center | 9,764,334 | 9,992,738 | (228,404) |
| Water Resources | 11,160,702 | 9,524,091 | 1,636,611 |
| Nonmajor funds | <u>4,324,490</u> | <u>4,518,591</u> | <u>(194,101)</u> |
| Total enterprise funds | <u><u>\$ 139,234,291</u></u> | <u><u>\$ 134,478,685</u></u> | <u><u>\$ 4,755,606</u></u> |

In total, the net position of the City's enterprise funds increased by \$4,755,606 during the year ended December 31, 2012. The City's net investment in capital assets increased by \$2,872,025 due to city investment and capital contributions from developers in the Water Sewer Utility and Water Resources funds. The restricted portion of net position increased \$1,866,328, for utility trunk and water resources.

WATER SEWER UTILITY FUND

The following graph presents three years of comparative operating results for the City's Water Sewer Utility Fund:



The Water Sewer Utility Fund ended 2012 with a total net position of \$113,984,765, an increase of \$3,541,500 from the prior year. Of this, \$83,450,335 represents the net investment in capital assets, and \$21,233,359 is restricted, leaving \$9,301,071 of unrestricted net position.

Water Sewer Utility Fund operating revenue was \$14,237,587 for 2012, an increase of \$1,320,982 (10.2 percent), due to increases in utility rates, and higher irrigation usage due to a long, dry summer in 2012.

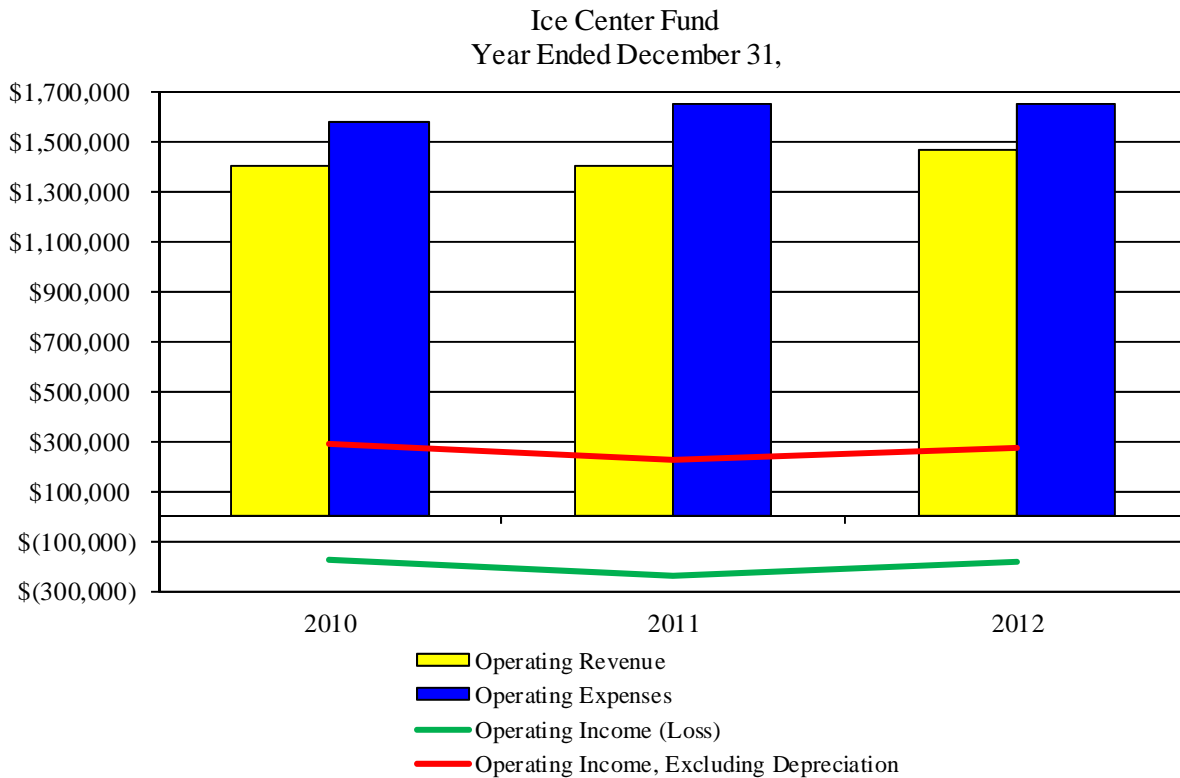
Operating expenses (including depreciation of \$3,808,735) were \$14,708,619, an increase of \$455,267 (3.2 percent); the increase was mainly due to an increase in water main repairs and maintenance.

As seen in the above table, this fund has experienced losses from operations in each of the past three years. It is important to note that a portion of the operating expenses in this fund is depreciation on assets paid for and contributed to the City by developers. In general, the City's utility rates have not been designed to fully recover depreciation costs on such assets. Utility rates are normally designed to cover current operating expenses and to provide for future repairs and replacement of these assets.

These operating losses, however, have generally been more than offset by amounts in other revenues and contributions over the same time period. Other revenues and contributions include a number of revenue sources that are normally one-time or inconsistent from year-to-year. It includes such things as interest income, grants, contributions from developers and residents, special assessments, and income from sales of assets.

ICE CENTER FUND

The following graph presents three years of comparative operating results for the City’s Ice Center Fund:



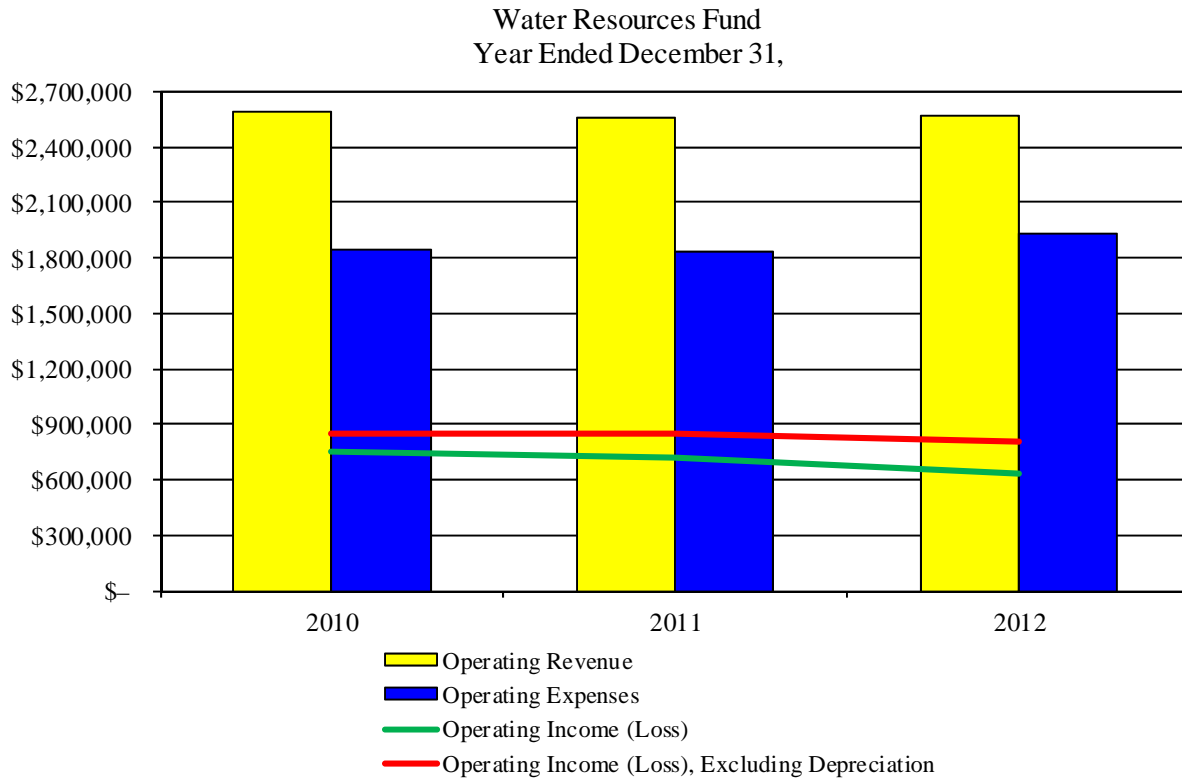
The Ice Center Fund ended 2012 with a net position of \$9,764,334, a decrease of \$228,404 from the prior year. Of this, \$9,802,799 represents the net investment in capital assets, leaving an unrestricted net position deficit of \$38,465. This unrestricted deficit is due to the application of interfund loans against the unrestricted component of net position as required by accounting principles generally accepted in the United States of America.

Operating revenue in the Ice Center Fund was \$1,465,434, an increase of \$58,660 from the prior year due to increased rates. Operating expenses for 2012 were \$1,651,453, an increase of \$1,239 from the previous year.

It is important to note that a significant portion of the operating expenses in this fund is depreciation on capital assets already funded. The fees charged in this fund are developed to cover operating expenses, repairs, and betterment of the ice center facilities.

WATER RESOURCES FUND

The following graph presents three years of comparative operating results for the City's Water Resources Fund:

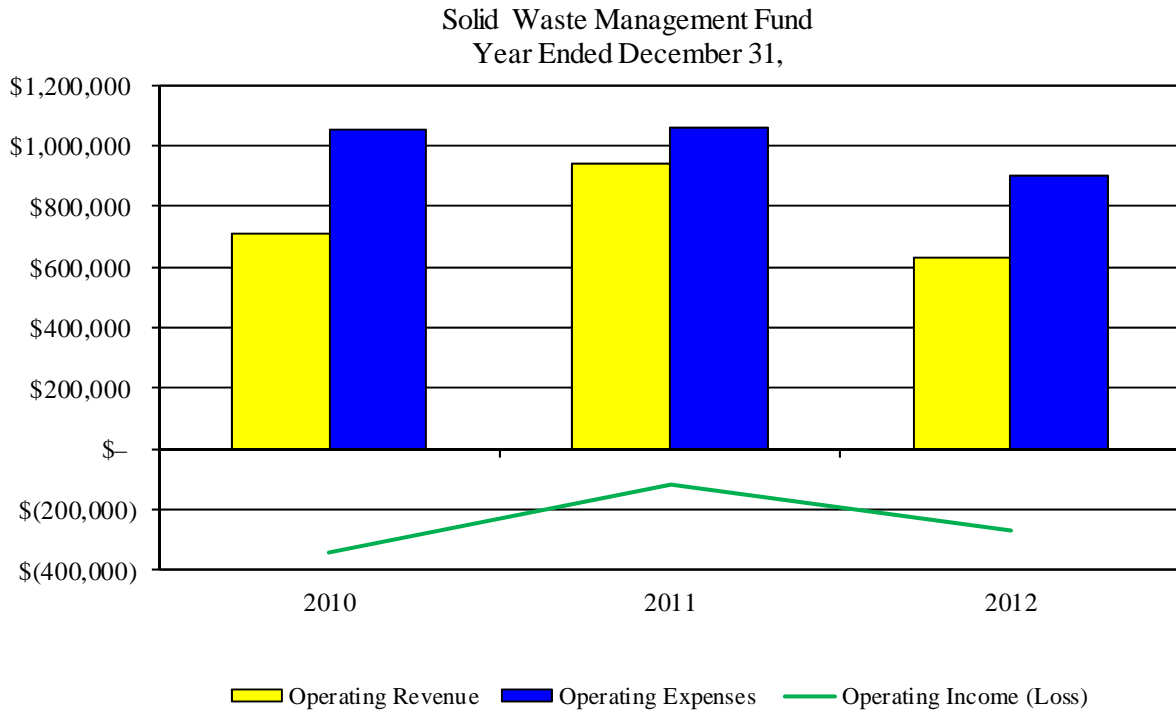


The Water Resources Fund ended 2012 with a net position of \$11,160,702, an increase of \$1,636,611 from the prior year. Of this, \$8,031,668 represents the net investment in capital assets, while the remaining \$3,129,034 is considered restricted.

Overall, activity of the Water Resources Fund was similar to operations experienced in the prior year. Operating revenues were \$2,572,894, an increase of \$11,306 from the previous year. Operating expenses for 2012 were \$1,935,510, an increase of 98,709, or 5.4 percent, over the previous year.

SOLID WASTE MANAGEMENT FUND

The following graph presents three years of comparative operating results for the City’s Solid Waste Fund:

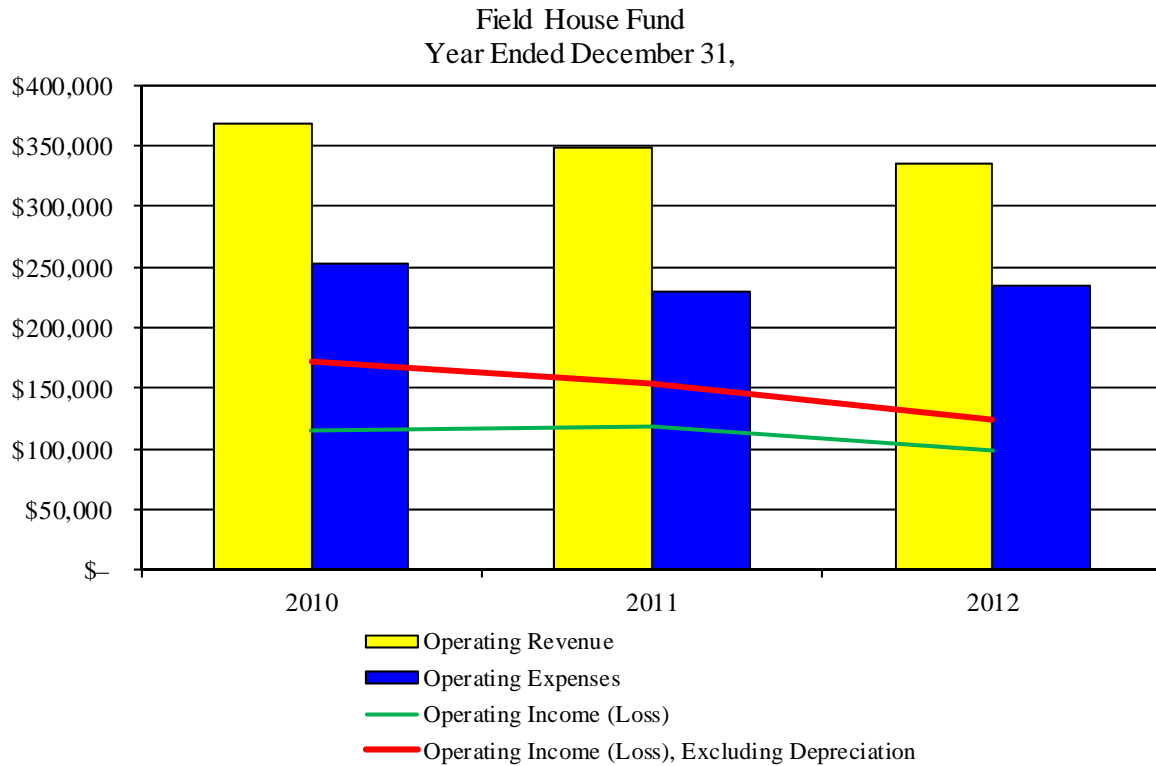


The Solid Waste Management Fund ended 2012 with a net position of \$2,658,328, a decrease of \$55,558 from the prior year. The entire net position in this fund is considered unrestricted.

Operating revenues in the Solid Waste Management Fund were \$632,251, a decrease of 308,411 from the prior year. A factor contributing to the change in operating revenue and resulting operations to consider is the impact of changes in the market for recyclable materials, which significantly impacts the shared revenue received from Allied Waste Services. Operating expenses for 2012 were \$902,478, a decrease of \$155,440 from the prior year due to a decrease in contractual services as a result of the City changing vendors.

FIELD HOUSE FUND

The following graph presents three years of comparative operating results for the City's Field House Fund:



The Field House Fund ended 2012 with a net position of \$1,666,162, a decrease of \$138,543 from the prior year. Of this, \$533,956 represents the net investment in capital assets, leaving \$1,132,206 of unrestricted net position.

As presented in the graph above, the Field House Fund experienced similar operations to the prior year and positive operating income for all years displayed. Operating revenue in the Field House Fund was \$334,990, a decrease of \$13,018 from the previous year. The fees charged in this fund are developed to cover operating expenses, repairs, and betterment of field house facilities. Field House Fund operating expenses for 2012 were \$235,487, an increase of \$6,121 from the previous year.

GOVERNMENT-WIDE FINANCIAL STATEMENTS

In addition to fund-based information, the current reporting model for governmental entities also requires the inclusion of two government-wide financial statements designed to present a clear picture of the City as a single, unified entity. These government-wide financial statements provide information on the total cost of delivering services, including capital assets and long-term liabilities.

STATEMENT OF NET POSITION

The Statement of Net Position essentially tells you what your city owns and owes at a given point in time, the last day of the fiscal year. Theoretically, net position represents the resources the City has leftover to use for providing services after its debts are settled. However, those resources are not always in spendable form, or there may be restrictions on how some of those resources can be used. Therefore, net position is divided into three components: net investment capital assets, restricted, and unrestricted.

The following table presents the components of the City's net position as of December 31, 2012 and 2011, for governmental activities, business-type activities, and the Housing and Redevelopment Authority (HRA) component unit:

| | As of December 31, | | Increase (Decrease) |
|--|-----------------------|-----------------------|------------------------|
| | 2012 | 2011 | |
| Net position | | | |
| Governmental activities | | | |
| Net investment in capital assets | \$ 166,157,665 | \$ 161,819,746 | \$ 4,337,919 |
| Restricted | 16,637,270 | 16,127,403 | 509,867 |
| Unrestricted | 79,439,266 | 76,772,980 | 2,666,286 |
| Total governmental activities | <u>262,234,201</u> | <u>254,720,129</u> | <u>7,514,072</u> |
| Business-type activities | | | |
| Net investment in capital assets | 101,818,758 | 98,946,733 | 2,872,025 |
| Restricted | 24,362,393 | 22,515,063 | 1,847,330 |
| Unrestricted | 12,869,826 | 12,781,287 | 88,539 |
| Total business-type activities | <u>139,050,977</u> | <u>134,243,083</u> | <u>4,807,894</u> |
| Housing and Redevelopment Authority | | | |
| Net investment in capital assets | (1,037,378) | (745,736) | (291,642) |
| Restricted | 4,350,619 | 4,494,253 | (143,634) |
| Unrestricted | 1,203,953 | 1,314,466 | (110,513) |
| Total Housing and Redevelopment Authority | <u>4,517,194</u> | <u>5,062,983</u> | <u>(545,789)</u> |
| Total net position | <u>\$ 405,802,372</u> | <u>\$ 394,026,195</u> | <u>\$ 11,776,177</u> |

The City (including the HRA) ended 2012 with combined total net position of \$405,802,372, an increase of \$11,776,177 from the prior year. Several factors contributed to this increase as discussed earlier in the report. Significant capital contributions recognized from developers in the current year with continued development activity also contributed to the increase over the prior year.

At the end of the fiscal year, the City is able to present positive balances in all three categories of net position for the governmental activities and business-type activities. The same situation held true for the prior fiscal year.

STATEMENT OF ACTIVITIES

The Statement of Activities tracks the City's yearly revenues and expenses, as well as any other transactions that increase or reduce total net assets. These amounts represent the full cost of providing services. The Statement of Activities provides a more comprehensive measure than just the amount of cash that changed hands, as reflected in the fund-based financial statements. This statement includes the cost of supplies used, depreciation of long-lived capital assets, and other accrual-based expenses.

The following table presents the change in net position of the City and the HRA for the years ended December 31, 2012 and 2011:

| | 2012 | | 2011 | |
|---------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | Expenses | Program Revenues | Net Change | Net Change |
| Net (expense) revenue | | | | |
| Governmental activities | | | | |
| General government | \$ 4,735,573 | \$ 552,082 | \$ (4,183,491) | \$ (3,620,040) |
| Economic development | 354,241 | – | (354,241) | (346,005) |
| Parks and recreation | 8,043,979 | 3,467,254 | (4,576,725) | (3,452,538) |
| Public safety | 14,309,925 | 5,888,237 | (8,421,688) | (8,443,143) |
| Public service | 4,020,239 | 3,376,742 | (643,497) | (178,087) |
| Public works | 12,188,896 | 7,235,627 | (4,953,269) | (3,174,232) |
| Interest on long-term debt | 808,224 | – | (808,224) | (636,097) |
| Business-type activities | | | | |
| Water sewer utility | 15,045,483 | 18,291,983 | 3,246,500 | 8,812,398 |
| Ice center | 1,694,651 | 1,465,434 | (229,217) | (317,357) |
| Water resources | 1,931,510 | 3,671,714 | 1,740,204 | 79,945 |
| Solid waste management | 900,254 | 843,656 | (56,598) | 1,720,345 |
| Field house | 235,582 | 334,990 | 99,408 | 117,907 |
| Housing and Redevelopment Authority | 5,981,122 | 4,785,145 | (1,195,977) | (251,368) |
| Total net (expense) revenue | <u>\$ 70,249,679</u> | <u>\$ 49,912,864</u> | (20,336,815) | (9,688,272) |
| General revenues | | | | |
| Property taxes and tax increments | | | 29,786,267 | 29,074,567 |
| Unrestricted grants and contributions | | | 1,848,212 | 2,284,723 |
| Gain on sale of capital assets | | | 132,559 | – |
| Other | | | 345,954 | 66,069 |
| Total general revenues | | | <u>32,112,992</u> | <u>31,425,359</u> |
| Change in net position | | | <u>\$ 11,776,177</u> | <u>\$ 21,737,087</u> |

One of the goals of this statement is to provide a side-by-side comparison to illustrate the difference in the way the City's governmental and business-type operations are financed. The City's governmental operations tend to rely more heavily on general revenues, such as property taxes. In contrast, the City's business-type activities tend to rely more heavily on program revenues (service charges and program specific grants) to cover expenses. This is critical given the current external downward pressures on general revenue sources such as taxes and state aids.

ACCOUNTING AND AUDITING UPDATES

GASB STATEMENT NO. 61 – THE FINANCIAL REPORTING ENTITY: OMNIBUS

This statement amends the current guidance in GASB Statement No. 14, *The Financial Reporting Entity*, for identifying and presenting component units. Potential component units that meet the fiscal dependency criterion for inclusion in the financial reporting entity under existing guidance will only be included if there is also “financial interdependency” (an ongoing relationship of potential financial benefit or burden) with the primary government. This statement also clarifies the types of relationships that are considered to meet the “misleading to exclude” criterion for inclusion as a component unit; changes the criteria for blending component units; gives direction for the determination and disclosure of major component units; and adds a requirement to report an explicit, measurable equity interest in a discretely presented component unit in a statement of position prepared using the economic resources measurement focus. The requirements of this statement must be implemented for periods beginning after June 15, 2012, with earlier implementation encouraged.

GASB STATEMENT NO. 65 – ITEMS PREVIOUSLY REPORTED AS ASSETS AND LIABILITIES

This statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items previously reported as assets and liabilities; and recognizes, as outflows or inflows of resources, certain items previously reported as assets and liabilities. This statement also provides financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term *deferred* in financial statement presentations. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2012. Earlier application is encouraged.

GASB STATEMENT NO. 67 – FINANCIAL REPORTING FOR PENSION PLANS – AN AMENDMENT OF GASB STATEMENT NOS. 25 AND 50

The primary objective of this statement is to improve financial reporting by state and local government pension plans. GASB Statement No. 67 replaces the requirements of GASB Statement Nos. 25 and 50 for pension plans that are administered through trusts or equivalent arrangements that meet the following criteria: contributions from employers and nonemployer contributing entities to the pension plan and earnings on those contributions are irrevocable; pension plan assets are dedicated to providing pensions to plan members in accordance with the benefit terms; and pension plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the pension plan administrator. If the plan is a defined benefit pension plan, plan assets also are legally protected from creditors of the plan members. The requirements of GASB Statement Nos. 25 and 50 remain applicable to pension plans that are not administered through trusts covered by the scope of this statement and to defined contribution plans that provide post-employment benefits other than pensions. The statement makes a number of changes in the financial statement presentation, measurement, and required disclosures relating to the reporting of these types of pension plans. This statement is effective for financial statements for fiscal years beginning after June 15, 2013. Earlier application is encouraged.

GASB STATEMENT NO. 68 – ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS – AN AMENDMENT OF GASB STATEMENT NOS. 27 AND 50

The primary objective of this statement is to improve accounting and financial reporting by state and local governments for pensions. This statement replaces the requirements of GASB Statement Nos. 27 and 50, as they relate to pensions that are provided through pension plans administered as trusts or equivalent arrangements that meet certain criteria (as described earlier for GASB Statement No. 67). The requirements of GASB Statement Nos. 27 and 50 remain applicable for pensions that are not covered by the scope of this statement.

This statement establishes standards for measuring and recognizing liabilities, deferred outflows of resources, deferred inflows of resources, and expense/expenditures. In addition, this statement details the recognition and disclosure requirements for employers with liabilities (payables) to a defined benefit pension plan and for employers whose employees are provided with defined contribution pensions. This statement also addresses circumstances in which a nonemployer entity has a legal requirement to make contributions directly to a pension plan. This statement is effective for financial statements for fiscal years beginning after June 15, 2014. Earlier application is encouraged.

Included in this statement are major changes in how employers that participate in cost-sharing pension plans, such as TRA and PERA, account for pension benefit expenses and liabilities. In financial statements prepared using the economic resources measurement focus and accrual basis of accounting (government-wide and proprietary funds), a cost-sharing employer that does not have a special funding situation is required to recognize a liability for its proportionate share of the net pension liability of all employers with benefits provided through the pension plan. A cost-sharing employer is required to recognize pension expense and report deferred outflows of resources and deferred inflows of resources related to pensions for its proportionate share of collective pension expense and collective deferred outflows of resources and deferred inflows of resources related to pensions. In addition, the effects of (1) a change in the employer's proportion of the collective net pension liability and (2) differences during the measurement period between the employer's contributions and its proportionate share of the total of contributions from employers included in the collective net pension liability are required to be determined. These effects are required to be recognized in the employer's pension expense in a systematic and rational manner over a closed period equal to the average of the expected remaining service lives of all active and inactive employees that are provided with pensions through the pension plan.

GASB STATEMENT NO. 69 – GOVERNMENT COMBINATIONS AND DISPOSALS OF GOVERNMENT OPERATIONS

This statement provides accounting and financial reporting guidance, including disclosure requirements, for government combinations and disposals of government operations. Government combinations include mergers, acquisitions, and transfers of operations. Included within the scope of this statement are combinations of governmental entities or combinations of governmental entities, with nongovernmental entities (such as a nonprofit entity) as long as the new or continuing organization is a government. This statement does not apply to combinations in which a government acquires an organization that continues to exist as a separate entity, or acquires an equity interest in an organization that remains legally separate from the acquiring government. A disposal of operations occurs when a government either transfers or sells specific operations. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2013. Earlier application is encouraged.

PROPOSED CHANGES TO REQUIREMENTS FOR FEDERAL GRANTS

The U.S. Office of Management and Budget (OMB) has issued for comment *Proposed OMB Uniform Guidance: Cost Principles, Audit, and Administrative Requirements for Federal Awards*, which proposes broad revisions to OMB Circular A-133 and other key grant reforms. The proposed guidance includes a number of significant changes to the federal Single Audit process, including; an increase in dollar threshold for requiring a Single Audit, changes to the process for determining major programs, a reduction in the percentage of expenditures required to be covered by a Single Audit, revised criteria for determining low-risk auditees, a reduction in the types of compliance requirements to be tested, and an increase in the threshold for reporting questioned costs. The proposed guidance would also consolidate OMB circulars and cost principles; and change certain federal requirements related to indirect costs, time and effort reporting, and grant administration.