Management Report

for

City of Saint Peter, Minnesota

December 31, 2012

MMKR
CERTIFIED PUBLIC
ACCOUNTANTS

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To the City Council and Management
City of Saint Peter, Minnesota

We have prepared this management report in conjunction with our audit of the City of Saint Peter, Minnesota's (the City) financial statements for the year ended December 31, 2012. The purpose of this report is to provide comments 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 comments 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 20, 2013

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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 AND *GOVERNMENT AUDITING STANDARDS*

We have audited the financial statements of the governmental activities, the business-type activities, the discretely presented component units, each major fund, and the aggregate remaining fund information of the City as of and for the year ended December 31, 2012, and the related notes to basic financial statements. Professional standards require that we provide you with information about our responsibilities under auditing standards generally accepted in the United States of America and *Government Auditing Standards*, 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 to you the following information related to our audit.

AUDITOR'S RESPONSIBILITY FOR COMPONENT UNITS

Our responsibility is to express opinions on the City's financial statements based on our audit. We did not audit the discretely presented component units' financial statements. This includes the financial statements of the River's Edge Hospital and Clinic and the financial statements of the Housing and Redevelopment Authority (HRA). Those statements were audited by other auditors whose reports have been furnished to us. Our opinion on the basic financial statements, insofar as it relates to the amounts included for these organizations as component units of the City, is based solely on the reports of the other auditors.

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 issued an unqualified opinion on the City's financial statements.

- We reported one finding related to our testing of internal controls and compliance over financial reporting. We reported that due to the small number of office staff, the City has a limited segregation of duties in several areas, which we consider a significant deficiency in internal controls.

- The results of our testing disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

- We reported one instance of noncompliance with the City's compliance with Minnesota laws and regulations. The finding reported is as follows:

    1. Minnesota Statute § 471.665 requires that if a City has established an automobile allowance for any officer or employee, the allowance must be in lieu of all other mileage reimbursements to that officer or employee. It was noted that the employment contracts of the City Administrator and several other city employees allowed for both mileage reimbursement and a car allowance.

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. We reported the following findings that were corrected by the City in the current year:

- In our previous audit, we reported that the City did not have sufficient controls in place to ensure compliance with the cash management requirements relating to the Capitalization Grant for Drinking Water State Revolving Funds. As part of our follow-up procedures, we are pleased to report that the City implemented procedures to ensure the cash management requirements were being met, and this was not a current year finding.

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.

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.

We proposed two uncorrected audit adjustments to the financial statements. The adjustments are as follows:

- Net other post-employment benefit (OPEB) liability of $65,905.
- Federal Insurance Contributions Act (FICA) liability on the related compensated absences liability of $52,725.

Management has determined that its effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

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 of the City include the following:

- **Depreciation** – Management's estimates of depreciation expense are based on the estimated useful lives of the assets.
- **Self-Insurance Reserves** – Management's estimates of costs for unreported claims are based on the past history of claims reported.
- **Compensated Absences** – Management's estimate based on current rates of pay and sick leave balances.
- **Land Held for Resale** – Management's estimate is based on net realizable value (lower of cost or estimated sales price).
- **Allowance for Doubtful Accounts –** Management's estimate of the allowance for doubtful accounts is based on historical water and sewer revenues, historical loss levels, and an analysis of the collectability of individual accounts.

We evaluated the key factors and assumptions used by management in the areas discussed above in determining that they are reasonable in relation to the financial statements taken as a whole.

The financial statement disclosures are neutral, consistent, and clear.

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 20, 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 supplemental information, and the other information section accompanying the basic financial statements, is presented for purposes of additional analysis and is not a required part of the basic financial statements.

With respect to the supplemental 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 supplemental 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 other information section accompanying the 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.

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.

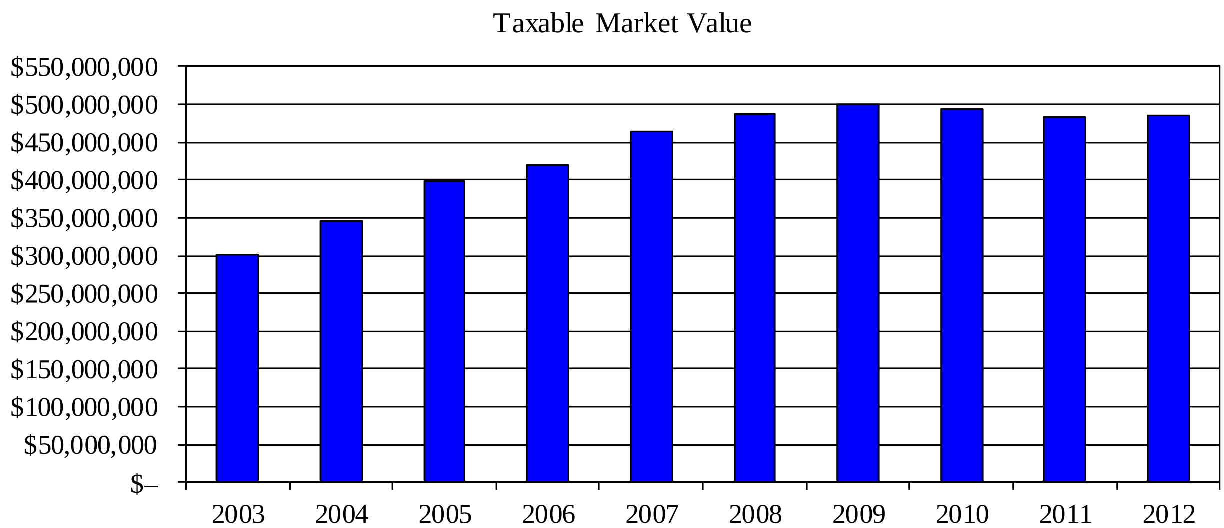
Tort Liability Limits for Cities Contracting With Certain Nonprofits – The liability limit on claims against cities involving nonprofit organizations that are engaged in or administer outdoor recreational activities that are funded or authorized by a municipality were lowered from $1.5 million to $1.0 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 2.1 percent for taxes payable in 2011 and increased 0.5 percent for taxes payable in 2012. The market value for taxes payable in 2012 is based on estimated values as of January 1, 2011.

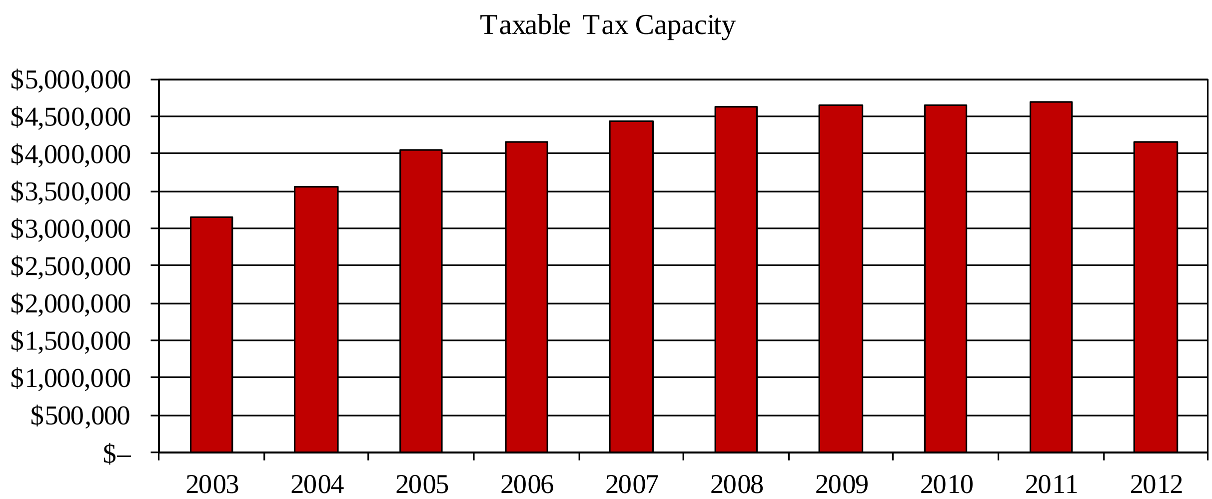
The following graph shows the City's changes in taxable market value over the past 10 years:



The data in this graph does not include the drop in taxable market value as a result of the legislative change to the MVHC program in fiscal 2012.

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 increased 0.7 percent and decreased 11.2 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 significant drop in taxable tax capacity is the result of the legislative change to the MVHC program discussed earlier in this report.

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 rates. The general increase in rates reflects both the increased reliance of local governments on property taxes and the recent decline in tax capacities previously discussed.

Rates expressed as a percentage of net tax capacity

	All Cities State-Wide		**City of Saint Peter**	
	2011	2012	**2011**	**2012**
Average tax rate				
City	42.5	46.3	**43.5**	**49.0**
County	43.7	46.8	**52.8**	**53.7**
School	25.2	27.3	**15.6**	**16.7**
Special taxing	6.4	6.8	**0.5**	**0.6**
Total	117.8	127.2	**112.4**	**120.0**

The City's portion of the average property tax rate for city residents has historically been higher than state-wide averages, with average tax rate for the City as a whole increasing in fiscal 2012 due to the decline in the tax capacity in the City.

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 Fund, special revenue, debt service, and capital project 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, 2012	Fund Balance as of December 31, 2011	Increase (Decrease)
Fund balances of governmental funds			
Total by classification			
Nonspendable	$ 6,137	$ 7,585	$ (1,448)
Restricted	3,352,821	3,168,595	184,226
Committed	974,601	826,611	147,990
Assigned	774,320	389,947	384,373
Unassigned	2,665,755	2,457,701	208,054
Total governmental funds	$ 7,773,634	$ 6,850,439	$ 923,195
Total by fund			
General	$ 3,963,763	$ 3,397,334	$ 566,429
Capital Projects – Permanent Improvements	168,404	78,541	89,863
Nonmajor	3,641,467	3,374,564	266,903
Total governmental funds	$ 7,773,634	$ 6,850,439	$ 923,195

In total, the fund balances of the City's governmental funds increased by $923,195 during the year ended December 31, 2012. The majority of this increase was in the General Fund totaling $566,429.

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

	State-Wide			**City of Saint Peter**		
Year	December 31, 2011			**2010**	**2011**	**2012**
Population	2,500–10,000	10,000–20,000	20,000–100,000	**11,196**	**11,459**	**11,459**
Property taxes	$ 390	$ 363	$ 406	**$ 192**	**$ 183**	**$ 194**
Tax increments	40	48	51	**39**	**44**	**59**
Franchise and other taxes	27	36	30	**11**	**11**	**11**
Special assessments	70	56	56	**12**	**7**	**13**
Licenses and permits	23	21	31	**28**	**13**	**14**
Intergovernmental revenues	283	263	152	**279**	**414**	**393**
Charges for services	95	79	78	**35**	**29**	**32**
Other	65	75	65	**111**	**109**	**118**
Total revenue	$ 993	$ 941	$ 869	**$ 708**	**$ 810**	**$ 833**

The City's lower than average tax revenue is primarily the result of the City relying on enterprise fund activities to finance the City's activities. This is due to the large amount of non-taxable property within the City.

In 2012, governmental funds revenue per capita increased $23 per capita. The largest increases were in property taxes and tax increments, which accounted for $26 of the total increase.

It is important to note that this table does not include operating transfers, which are used by the City to support governmental fund activities. This information is not included in the table as the comparable information is not available.

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

	State-Wide			**City of Saint Peter**		
Year	December 31, 2011			**2010**	**2011**	**2012**
Population	2,500–10,000	10,000–20,000	20,000–100,000	**11,196**	**11,459**	**11,459**
Current						
General government	$ 126	$ 99	$ 82	**$ 105**	**$ 123**	**$ 99**
Public safety	231	225	238	**205**	**203**	**209**
Street maintenance and lighting	114	108	89	**99**	**107**	**104**
Parks and recreation	79	96	87	**122**	**124**	**127**
All other	74	81	82	**51**	**93**	**58**
	$ 624	$ 609	$ 578	**$ 582**	**$ 650**	**$ 597**
Capital outlay and construction	$ 258	$ 272	$ 233	**$ 82**	**$ 215**	**$ 176**
Debt service						
Principal	$ 186	$ 148	$ 109	**$ 82**	**$ 107**	**$ 109**
Interest and fiscal	60	48	41	**36**	**30**	**27**
	$ 246	$ 196	$ 150	**$ 118**	**$ 137**	**$ 136**

The City's governmental funds current per capita expenditures in fiscal 2012 were less than state-wide averages for cities in the same population class when compared to fiscal 2011 The departments that were lower than state-wide averages include public safety, street maintenance and lighting, and other.

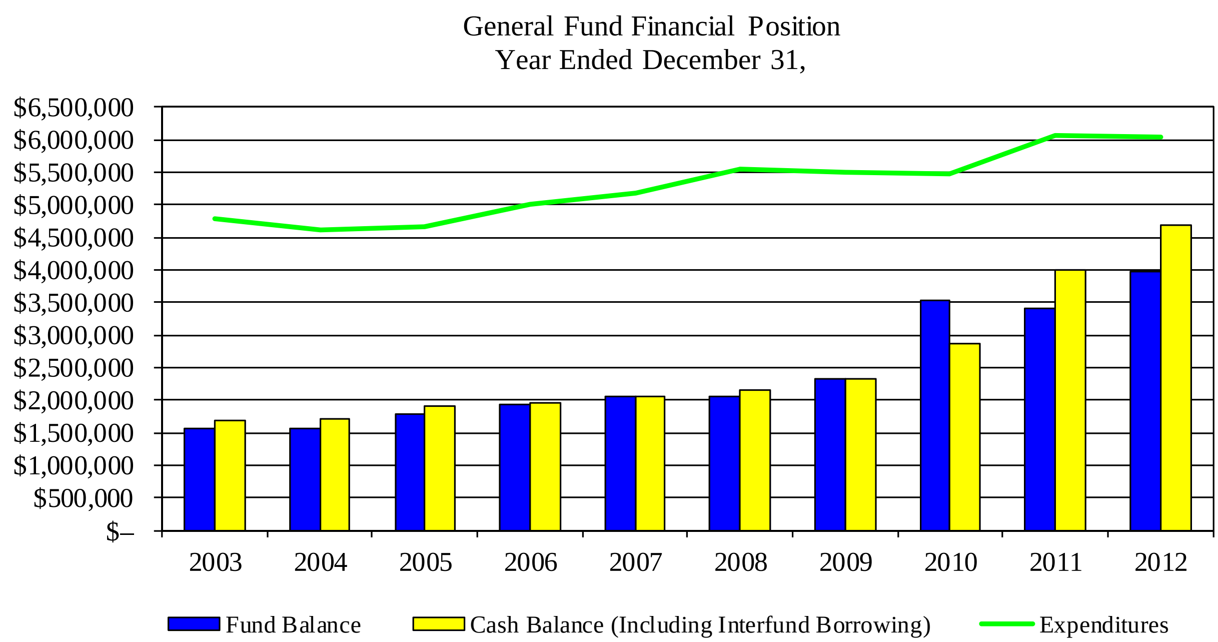
The City's governmental funds current per capita expenditures decreased by $53 per capita in fiscal 2012. General government expenditures decreased by $24 primarily due to the demolition of the old hospital and nursing home facility totaling about $25 per capita in the prior year. The "all other" category fluctuates significantly from year-to-year in the City as expenditures change each year based on the level of economic development revolving loans being issued. In fiscal 2012, loans issued decreased $21 per capita. The "all other" category includes tax increment district activity that can also vary each year based on changes in yearly activity.

FINANCIAL TRENDS AND CONDITIONS

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, street and highway maintenance, parks and recreation, and economic development.

The following graph displays the City's General Fund trends of financial position and changes in the volume of financial activity. Fund balance and cash balance are typically used as indicators of financial health or equity, while annual expenditures are often used to measure the size of the operation.



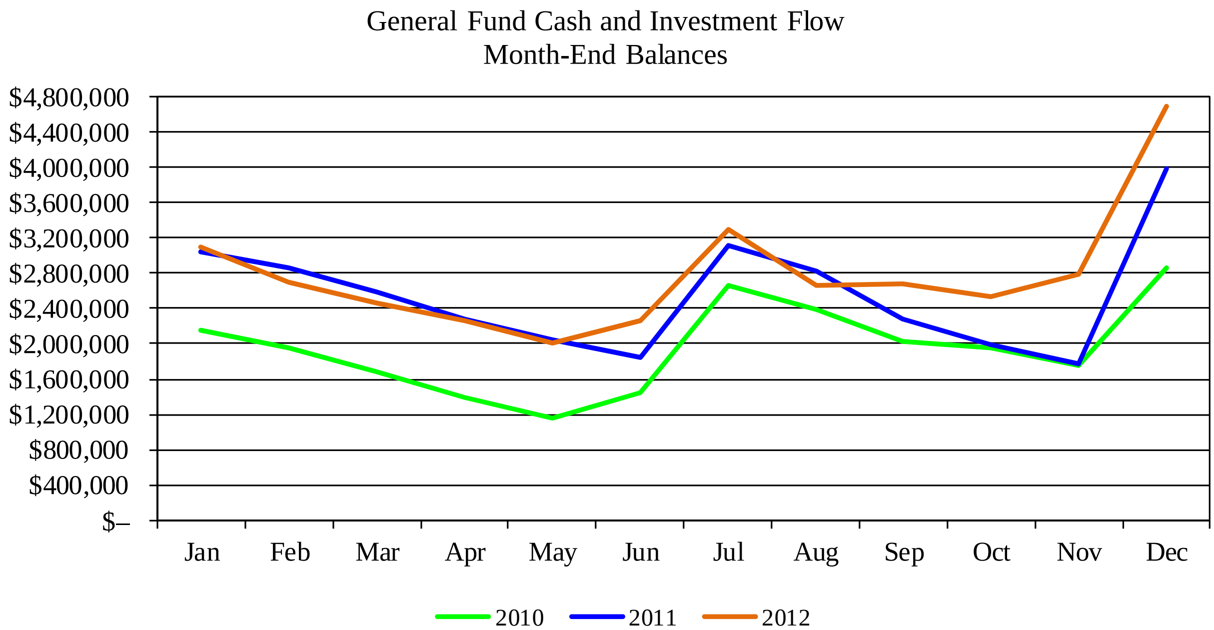
The City's General Fund financial position improved in 2012, ending the year with a fund balance of $3,963,763 and a cash balance, including interfund borrowing, of $4,696,521. In 2012, the City's fund balance increased $566,429.

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 fluctuations in state funding for cities in recent years.

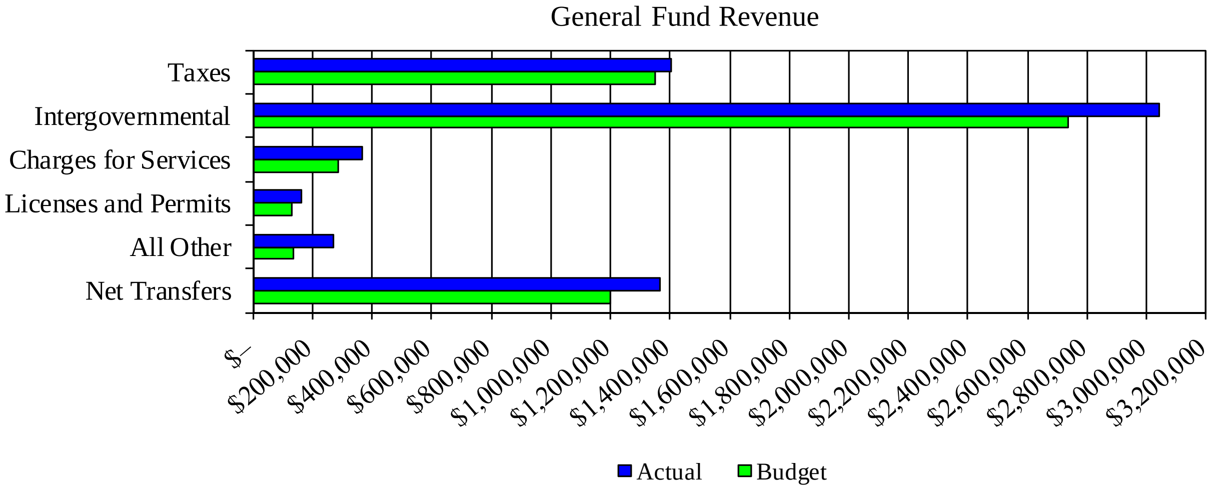
The City Council has formally adopted a fund balance policy regarding the fund balance for the General Fund. The policy establishes that the City will strive to maintain an unassigned fund balance in the General Fund in the range of 35 to 50 percent of the following year's budgeted expenditures. At December 31, 2012, the unassigned fund balance of the General Fund was 53.4 percent of the subsequent year's budgeted expenditures.

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 and state aids comprise almost 85 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 following graph illustrates the monthly cash flow of the General Fund in recent years. Adequate fund balances in the General Fund have provided for positive month-end balances for all three years presented.

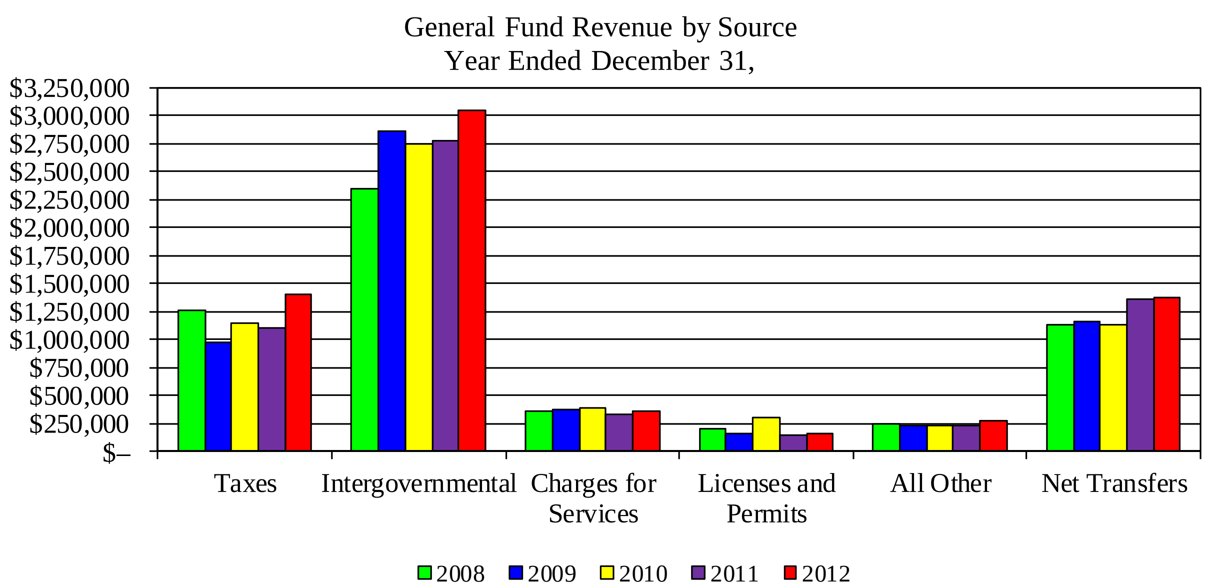


The following graph reflects the City's General Fund revenues and net transfers, budget and actual, for 2012:



Total General Fund revenues and net transfers in 2012 were $6,614,915, which was $779,401 (13.3 percent) more than the final budget. The majority of this variance is in intergovernmental, in which the City received approximately $300,000 to upgrade the emergency radio system, which was not included in the adopted budget. Transfers in from other funds were also higher than budgeted by about $169,000.

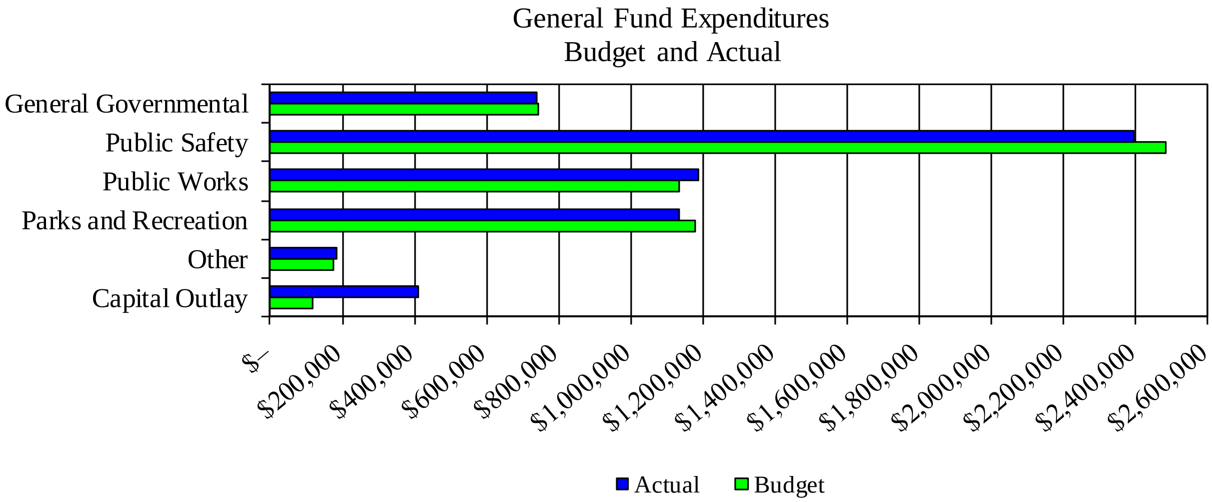
The following graph presents the City's General Fund revenue sources for the last five years:



Revenues and net transfers for the year ended December 31, 2012 increased by $664,359. Revenue increases were mainly from intergovernmental revenues and taxes, which increased by $265,596 and $305,519, respectively. The increase in intergovernmental revenue is related to the emergency radio system grant received, which is described above. Further, the increase in the taxes is related to the MVHC state aid reduction totaling about $180,000 in fiscal 2011. The City also increased the amount of the total levy allocated to the General Fund by about $70,000.

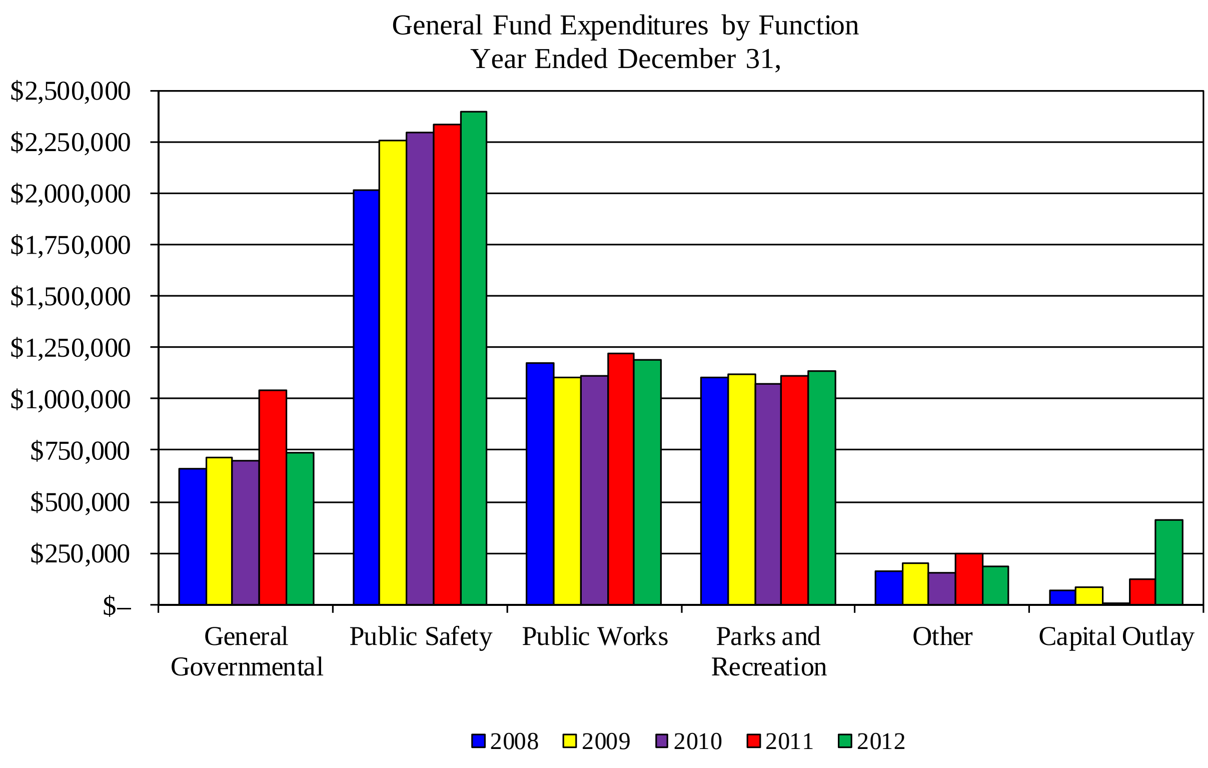
Due to the large amount of tax exempt property in the City, the City has historically relied heavily on intergovernmental revenue (mainly state aid) and transfers from its enterprise funds to help support General Fund operations.

The following illustrations provide the components of the City's General Fund spending for 2012 compared to budget:



Total General Fund expenditures for 2012 were $6,048,566, which was $212,972 (3.7 percent) greater than the budget. Capital outlay costs were over budget by $290,253, mainly due to the purchases and work completed on the emergency radio system, for which the City received federal grant revenues.

The following graph presents the components of the City's General Fund spending for the past 5 years:



In 2012, total General Fund expenditures decreased $24,254, or 0.4 percent. The decrease was mainly the result of two items. General government expenditures decreased by $297,395, primarily due to the costs associated with the demolition of the old hospital and nursing home facility in the prior year. Capital outlays increased by $286,888, which is the result of the purchases and work completed on the emergency radio system previously described.

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.

The enterprise funds comprise a considerable portion of the City's activities. These funds help to defray overhead and administrative costs and provide additional support to general government operations by way of annual transfers. We understand the City is proactive in reviewing these activities on an ongoing basis and we want to reiterate the importance of continually monitoring these operations. Over the years we have emphasized to our city clients the importance of these utility operations being self-sustaining, preventing additional burdens on general governmental funds. This would include the accumulation of net position for future capital improvements and to provide a cushion in the event of a negative trend in operations.

ENTERPRISE FUNDS FINANCIAL POSITION

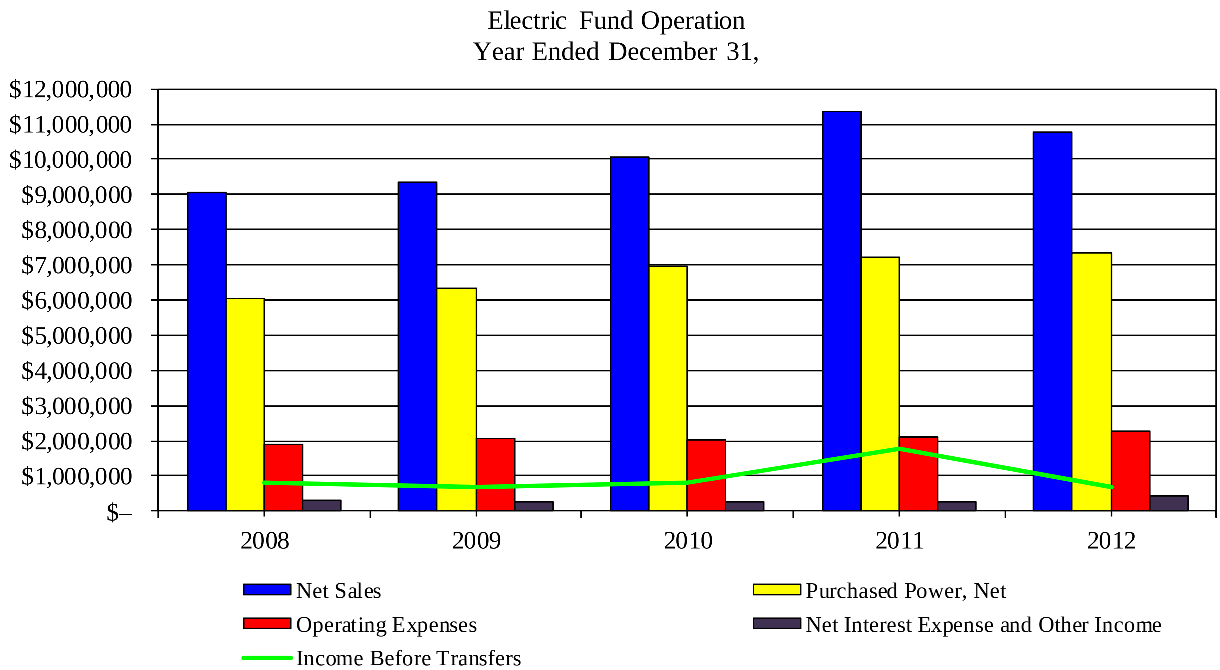
The following table summarizes the changes in the financial position of the City's enterprise funds during the year ended December 31, 2012, presented both by classification and by fund:

Enterprise Funds Change in Financial Position

	Net Position as of December 31, 2012	Net Position as of December 31, 2011	Increase (Decrease)
Net position of enterprise funds			
Total by classification			
Net investment in capital assets	$ 43,624,677	$ 43,936,523	$ (311,846)
Restricted for debt service	1,168,228	1,168,228	–
Restricted for capital replacement	508,074	464,507	43,567
Unrestricted	5,580,598	6,460,750	(880,152)
Total enterprise funds	$ 50,881,577	$ 52,030,008	$ (1,148,431)
Total by fund			
Electric	$ 16,483,793	$ 16,744,234	$ (260,441)
Water	10,106,176	10,923,858	(817,682)
Environmental Services	245,953	288,686	(42,733)
Wastewater	16,427,584	16,193,219	234,365
Heartland Transit	28,561	62,345	(33,784)
Storm Water	5,064,742	5,135,575	(70,833)
Telecommunications Conduit	257,579	276,561	(18,982)
Long-Term Care Facility	(765,539)	(740,763)	(24,776)
Medical Office Building	3,032,728	3,146,293	(113,565)
Total enterprise funds	$ 50,881,577	$ 52,030,008	$ (1,148,431)

ELECTRIC FUND

The following graph presents five years of comparative data for the City's Electric Fund:

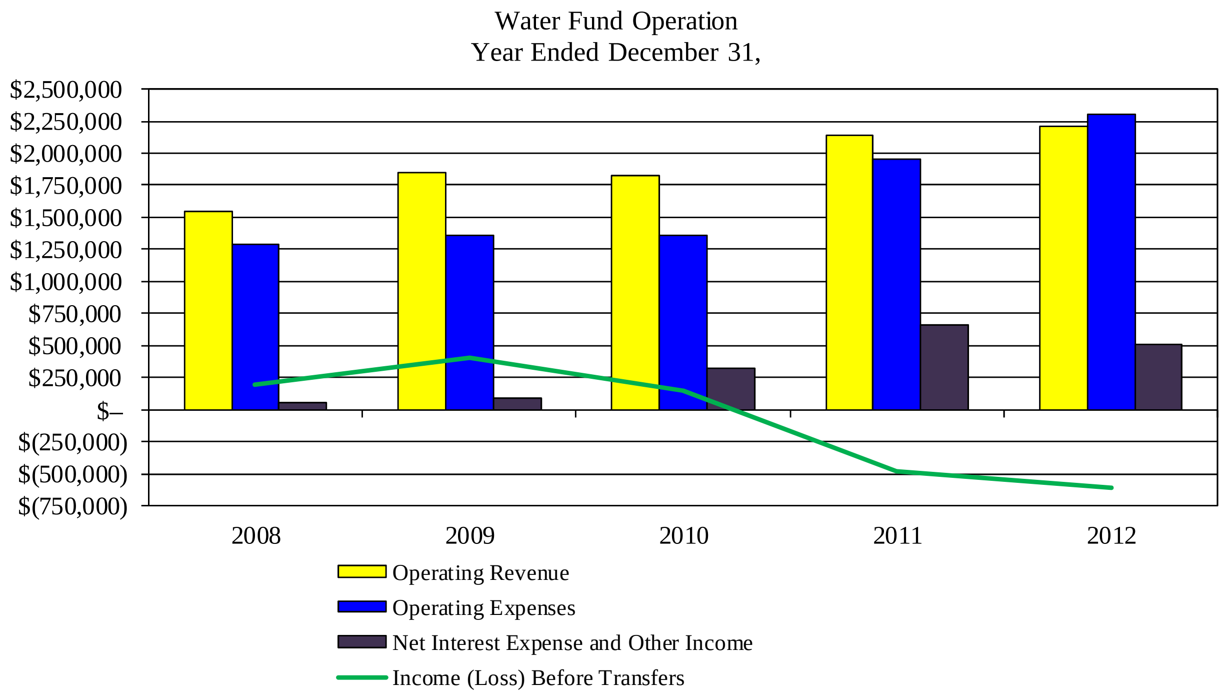


At December 31, 2012, the Electric Fund had a total net position of $16,483,793, of which $1,061,428 was restricted for debt service; $12,435,359 was the net investment in capital assets; and $2,987,006 was unrestricted. The Electric Fund ended the year with working capital of $2,389,286.

The Electric Fund operating revenue was $10,751,186 for 2012, a decrease of about $613,343 (5.4 percent). Charges for services declined about $380,000. This decline was mainly due to the City issuing credits to customers during fiscal 2012 for adjustments that were needed for a meter the City found to have incorrect settings and thus the City was billing invalid usage amounts to specific customers. Other revenue declined around $236,000 as the City received insurance proceeds totaling about $390,000 in fiscal 2011. Purchased power increased $136,396, or 1.9 percent. Operating expenses (excluding purchased power) increased by $178,316 (8.4 percent) in 2012 mainly due to increases in supplies and materials.

WATER FUND

The following graph presents selected data for the City's Water Fund for the past five years:



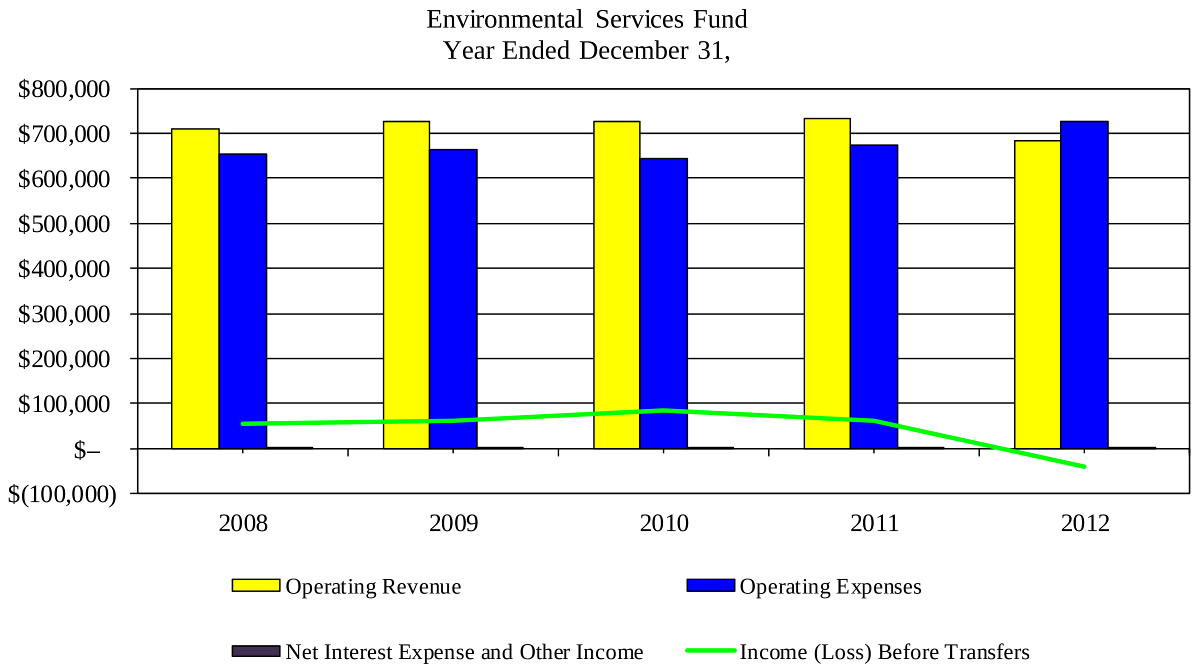
At December 31, 2012, the Water Fund had a total net position of $10,106,176, of which $8,899,087 was the net investment in capital assets and $1,207,089 was unrestricted. The Water Fund ended the year with working capital of $651,395.

The Water Fund operating revenue was $2,204,700 for 2012, an increase of about $69,761 (3.3 percent) which was a result of an increase in the water usage and water rates. Operating expenses increased by $348,529, or 17.8 percent, which was related to an increase in the depreciation expense due to the new water treatment facility that was opened in the prior year.

Although this fund is in a positive financial position, we suggest that the City continue to review the water rates on an annual basis. This is especially important considering the decline in the operating results over the past three years. Water rates are generally designed to cover operating costs and provide an accumulation of resources for significant repairs and replacements, and an operating cushion for potential negative years in financial operations.

ENVIRONMENTAL SERVICES FUND

The following graph presents selected data for the City's Environmental Services Fund for the past five years:

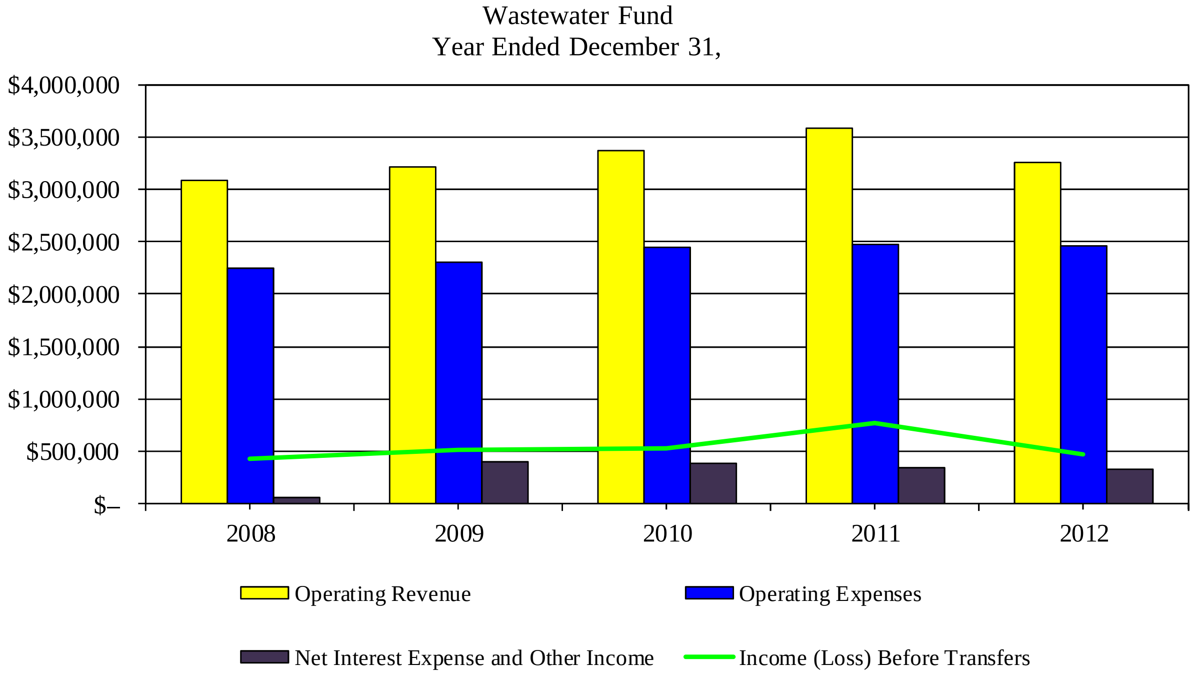


At December 31, 2012, the Environmental Services Fund had a total net position of $245,953, of which $39,881 was the net investment in capital assets and $206,072 was unrestricted. The Environmental Services Fund ended the year with working capital of $256,593.

The Environmental Services Fund operating revenue was $683,726 for 2012, a decrease of $51,064 (7.0 percent). Operating expenses increased about $50,848 (7.5 percent) compared to the prior year.

WASTEWATER FUND

The following graph presents selected data for the City's Wastewater Fund for the past five years:

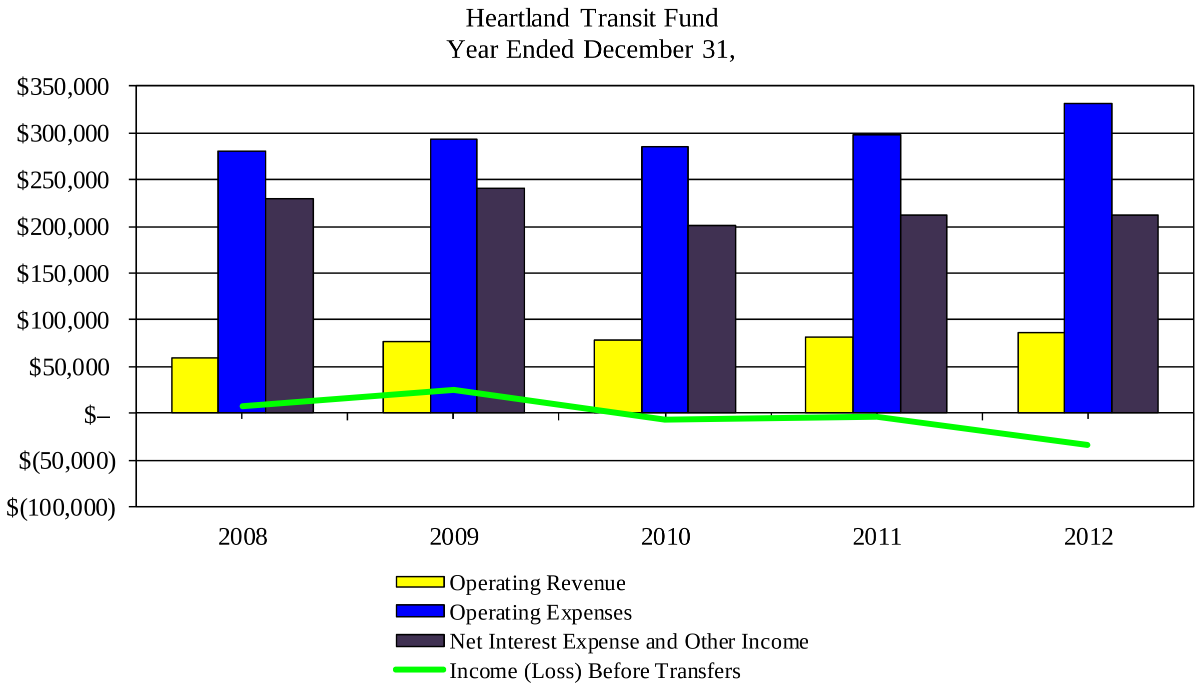


At December 31, 2012, the Wastewater Fund had a total net position of $16,427,584, of which $15,447,412 was the net investment in capital assets; $508,074 was restricted; and $472,098 was unrestricted. The Wastewater Fund ended the year with a deficit working capital balance of ($203,983).

The Wastewater Fund operating revenue was $3,253,915 for 2012, a decrease of about $329,812 (9.2 percent), mainly due to a decrease in the total gallons billed. Operating expenses decreased $12,475, or 0.5 percent.

HEARTLAND TRANSIT FUND

The following graph presents selected data for the City's Heartland Transit Fund for the past five years:

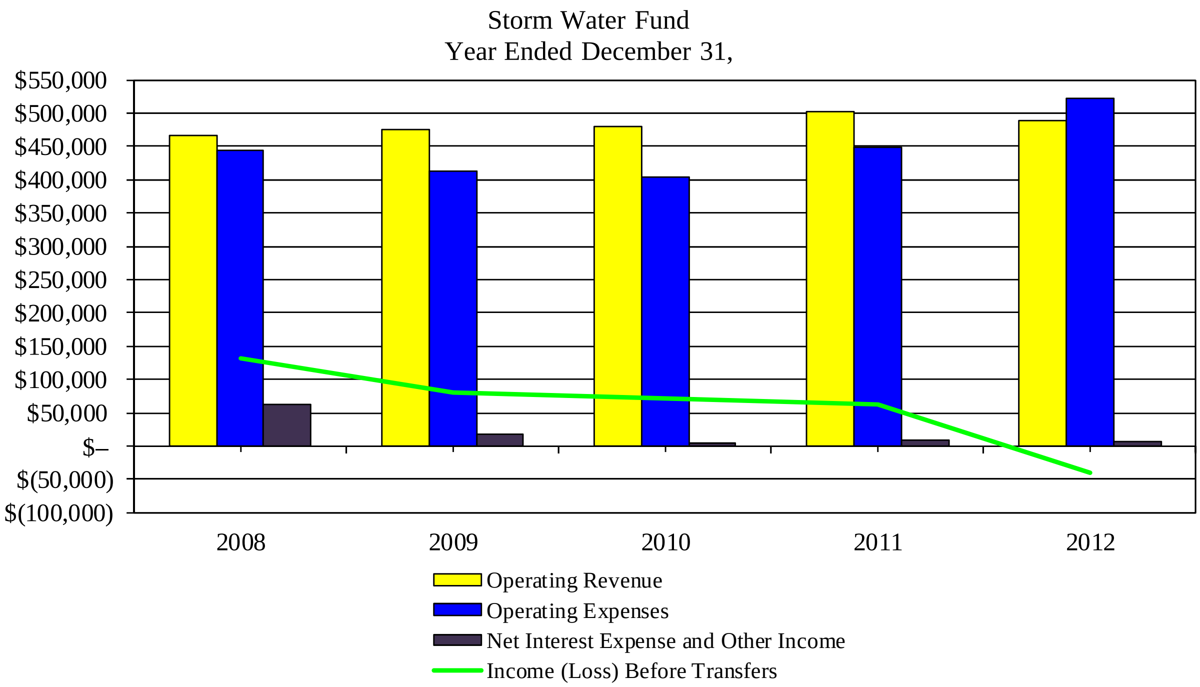


At December 31, 2012, the Heartland Transit Fund had a total net position of $28,561, of which $31,770 was the net investment in capital assets and a deficit balance of ($3,209) was unrestricted. The Heartland Transit Fund ended the year with a working capital balance of $7,651.

The Heartland Transit Fund operating revenue was $85,972 for 2012, an increase of $4,975. Operating expenses increased by $34,626, or 11.6 percent, from the prior year mainly for supplies and materials.

STORM WATER FUND

The following graph presents selected data for the City's Storm Water Fund for the past five years:

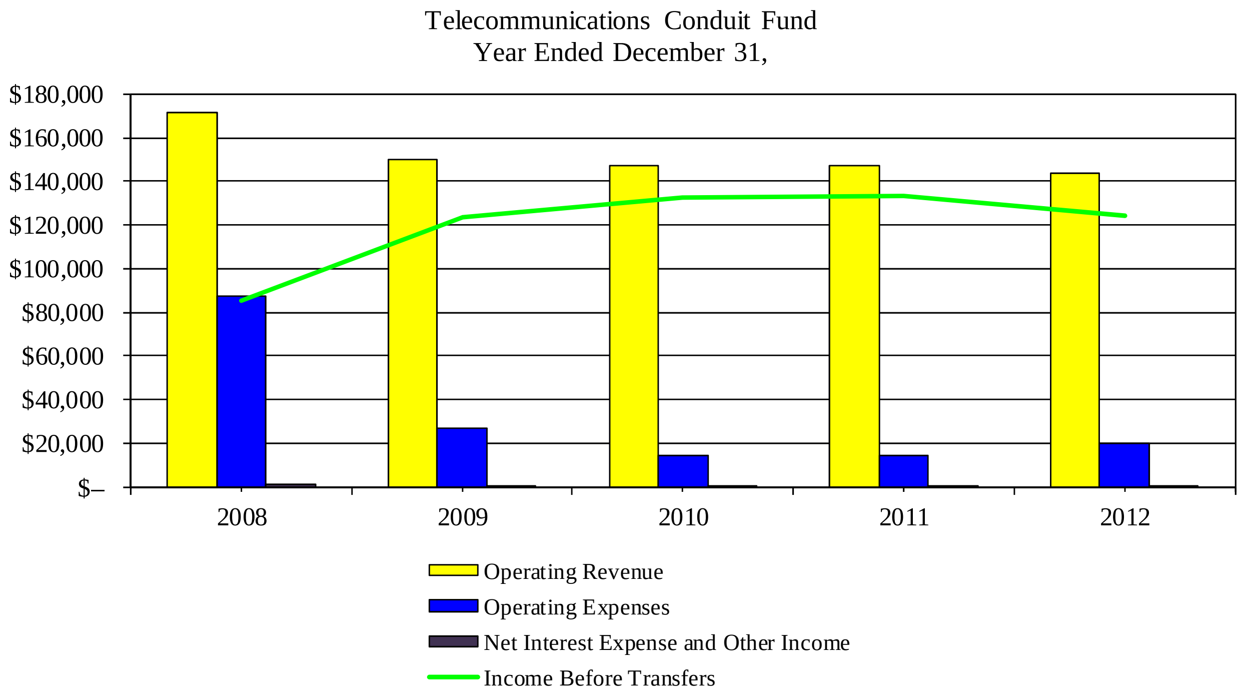


At December 31, 2012, the Storm Water Fund had a total net position of $5,064,742, of which $4,533,187 was the net investment in capital assets and $531,555 is considered unrestricted. The Storm Water Fund ended the year with working capital of $456,677.

The Storm Water Fund operating revenue was $488,622 for 2012, a decrease of $13,671, or 2.7 percent. Operating expenses increased $73,891 in 2012, or 16.5 percent, due mainly to an increase in personal services of about $47,000.

TELECOMMUNICATIONS CONDUIT FUND

The following graph presents selected data for the City's Telecommunications Conduit Fund for the past five years:

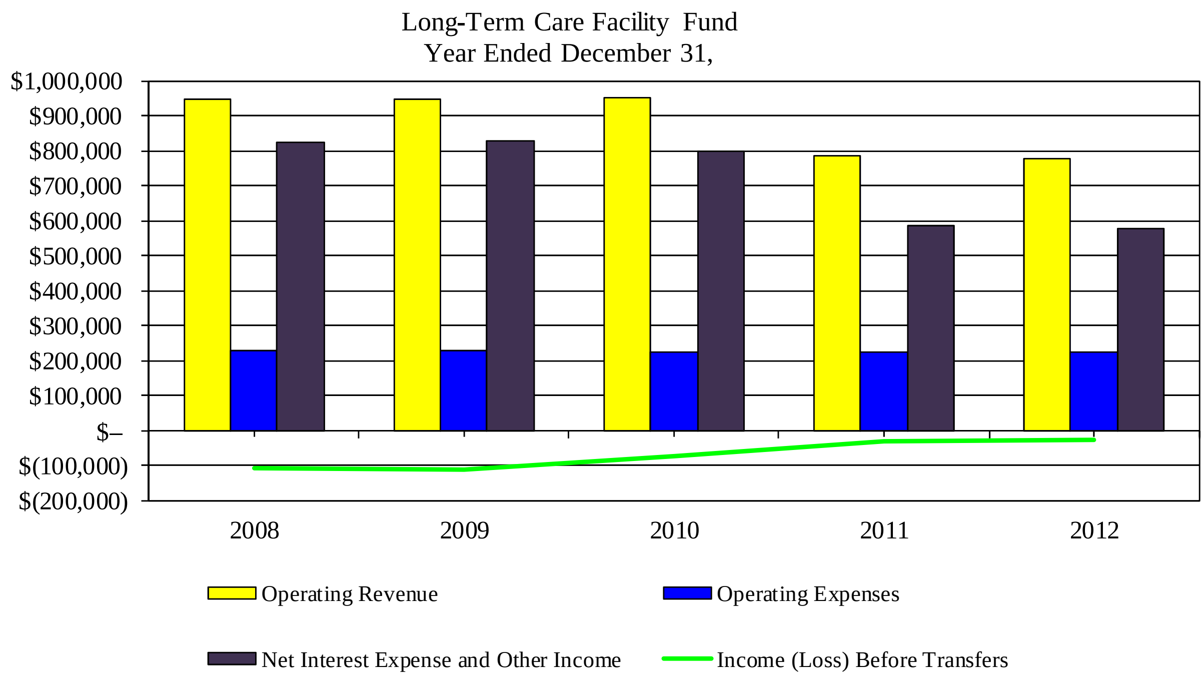


At December 31, 2012, the Telecommunications Conduit Fund had a total net position of $257,579, of which $254,085 was the net invested in capital assets and $3,494 was considered unrestricted. The Telecommunications Conduit Fund ended the year with deficit working capital of $3,494.

The Telecommunications Conduit Fund operating revenue was $143,736 for 2012, a decrease of $3,446. Operating expenses increased by $5,406 in the current year.

LONG-TERM CARE FACILITY FUND

The following graph presents selected data for the City's Long-Term Care Facility Fund for the past five years:

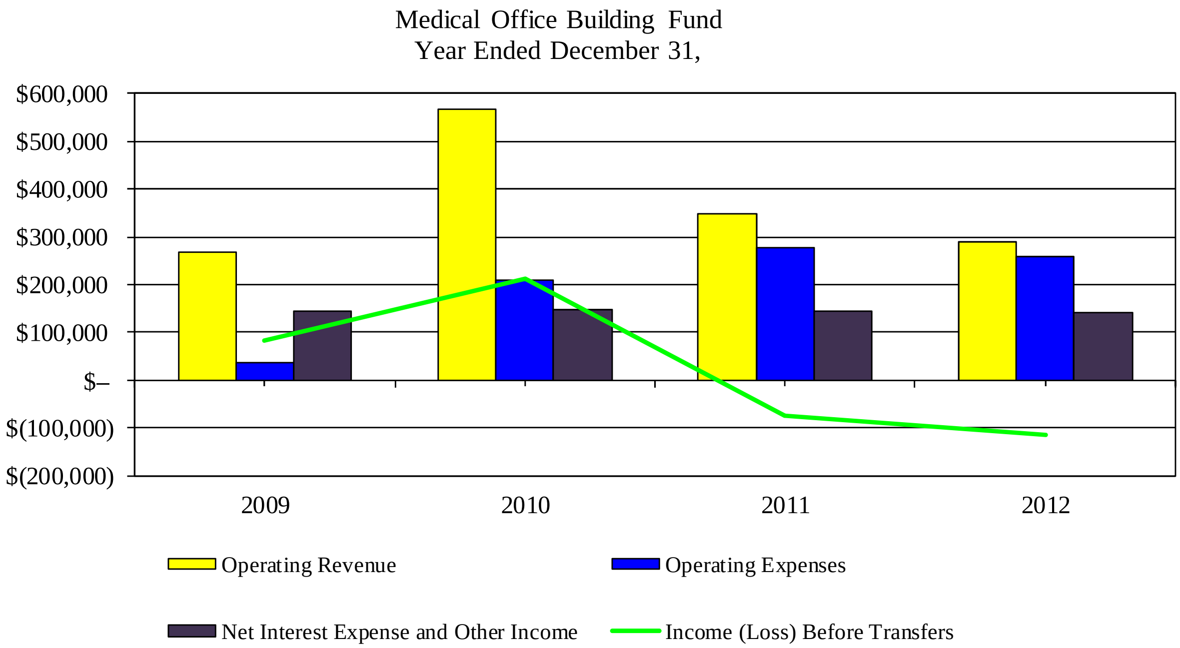


At December 31, 2012, the Long-Term Care Facility Fund had a total net position deficit of ($764,539), of which a deficit of ($870,241) was the net investment in capital assets; $106,800 was restricted for debt service; and a deficit of ($2,098) was considered unrestricted.

The Long-Term Care Facility Fund is used to collect lease revenue and pay debt service on the long-term care facility.

MEDICAL OFFICE BUILDING FUND

The following table presents selected data for the City's Medical Office Building Fund for the past four years:



At December 31, 2012, the Medical Office Building Fund had a total net position of $3,032,728, of which $2,854,137 was the net investment in capital assets and $178,591 was unrestricted.

The Medical Office Building Fund is used to account for the construction of the new medical office building which opened in 2009. This fund is also used to collect lease revenue and pay debt service on this same facility.

In fiscal 2010, this fund received one-time revenue for construction improvements.

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 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 in capital assets, restricted, and unrestricted.

The following table presents the components of City's net position as of December 31, 2012 and 2011, for governmental activities and business-type activities:

	As of December 31, 2012	As of December 31, 2011	Increase (Decrease)
Net position			
Governmental activities			
Net investment in capital assets	$ 21,903,302	$ 20,130,564	$ 1,772,738
Restricted	6,040,936	6,293,170	(252,234)
Unrestricted	4,398,647	3,809,040	589,607
Total governmental activities	32,342,885	30,232,774	2,110,111
Business-type activities			
Net investment in capital assets	43,624,677	43,936,523	(311,846)
Restricted	1,676,302	1,632,735	43,567
Unrestricted	5,580,598	6,460,750	(880,152)
Total business-type activities	50,881,577	52,030,008	(1,148,431)
Total net position	$ 83,224,462	$ 82,262,782	$ 961,680

Most of the decrease in total net assets was due to transfers totaling $1,550,858 from the business-type activities to the governmental activities in fiscal 2012.

Much of the City's net position is restricted by virtue of external restrictions (statutory reserves) or by the nature of the fund it is in. Further, a significant portion of net position has been identified as invested in capital assets, net of related debt, which leaves the balance to unrestricted.

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 positions. 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 the net position of the City for the years ended December 31, 2012 and 2011:

	2012			2011
	Expenses	Program Revenues	Net Difference	Net Difference
Net (expense) revenue				
Governmental activities				
General government	$ 1,202,469	$ 672,255	$ (530,214)	$ (5,239,627)
Public safety	2,540,582	546,899	(1,993,683)	(1,948,493)
Public works	2,074,011	1,527,240	(546,771)	32,204
Parks and recreation	1,765,456	177,313	(1,588,143)	(1,569,155)
Economic development	623,734	146,027	(477,707)	(359,193)
Interest on long-term debt	297,361	–	(297,361)	(330,985)
Business-type activities				
Electric	10,124,291	10,752,594	628,303	1,675,288
Water	2,833,841	2,215,351	(618,490)	(503,145)
Environmental services	725,109	684,052	(41,057)	60,855
Wastewater	2,789,797	3,254,963	465,166	766,802
Transit	332,038	298,254	(33,784)	(4,133)
Storm sewer	533,382	488,665	(44,717)	57,609
Telecommunications conduit	19,670	143,736	124,066	132,918
Long-term care facility	801,667	776,165	(25,502)	(28,494)
Medical office building	403,295	288,242	(115,053)	(75,277)
	$ 27,066,703	$ 21,971,756	(5,094,947)	(7,332,826)
General revenues				
Taxes			2,954,063	2,544,562
Unrestricted grants and contributions			2,923,347	2,658,545
Investment earnings			105,559	145,262
Other revenues			73,163	169,587
Gain on sale of assets			495	15,000
Total general revenues			6,056,627	5,532,956
Change in net position			$ 961,680	$ (1,799,870)

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 table clearly illustrates the dependence of the City's governmental operations on general revenues, such as property taxes and unrestricted grants. It also shows that, for the most part, the City's business-type activities are generating sufficient program revenues (service charges and program-specific grants) to cover expenses. This is critical given the current downward pressures on the general revenue sources.

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.