Management Report

for

City of Prior Lake, Minnesota

December 31, 2013

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MMKR
CERTIFIED PUBLIC ACCOUNTANTS

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To the City Council and Management
City of Prior Lake, Minnesota

We have prepared this management report in conjunction with our audit of the City of Prior Lake, Minnesota's (the City) financial statements for the year ended December 31, 2013. 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
- Governmental Funds Overview
- Proprietary Funds Overview
- Government-Wide Financial Statements
- Legislative Updates
- 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
May 16, 2014

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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, each major fund, and the aggregate remaining fund information of the City as of and for the year ended December 31, 2013 and the related notes to the 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 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, 2013:

- We have issued an unmodified 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 required to be reported under *Government Auditing Standards*.
- We reported one finding based on our testing of the City's compliance with Minnesota laws and regulations.
    - Five out of twenty-five timesheets tested did not have a signed declaration stating the wages received were for actual time worked as required by Minnesota Statutes. These five timesheets noted were for payments to volunteer firefighters.

OTHER COMMENTS AND RECOMMENDATIONS

Segregation of Duties – Receipts

During our audit procedures, we noted that the same individual collects cash receipts, posts cash receipts, and prepares the bank deposit for cash receipts. There is no independent review of a system report of receipts for the day compared to the cash deposited for the day. While there are mitigating controls to minimize the risk to the City, it is our recommendation that the City review individual responsibilities for the custody and recording of cash receipts to further segregate duties. They should continue to encourage and utilize online bill pay in efforts to reduce the amount of the over-the-counter cash receipts. We would further recommend that the City utilize a system report of cash receipts collected for the day and have someone separate from the cash collection process reconcile that report to the bank deposit prepared for the day.

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, 2013, the City implemented Governmental Accounting Standards Board (GASB) Statement No. 65, "Items Previously Reported as Assets and Liabilities."

GASB Statement No. 65 identifies specific items previously presented as assets that will now be presented as either deferred outflows of resources or outflows (expenses/expenditures), and items previously reported as liabilities that will now be presented as deferred inflows of resources or inflows (revenues).

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:

- **Depreciation** – Management's estimates of depreciation expense are based on the estimated useful lives of the assets.

- **Compensated Absences** – Estimates for compensated absences payable are based on current sick and vacation leave balances.

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. We proposed one uncorrected audit adjustment to the financial statements for the City not reporting its liability for other post-employment benefits totaling $46,505. Management has determined that the effects of this item are immaterial, both individually and taken together, to the government-wide liabilities.

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 May 16, 2014.

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 MATTERS

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.

GOVERNMENTAL FUNDS OVERVIEW

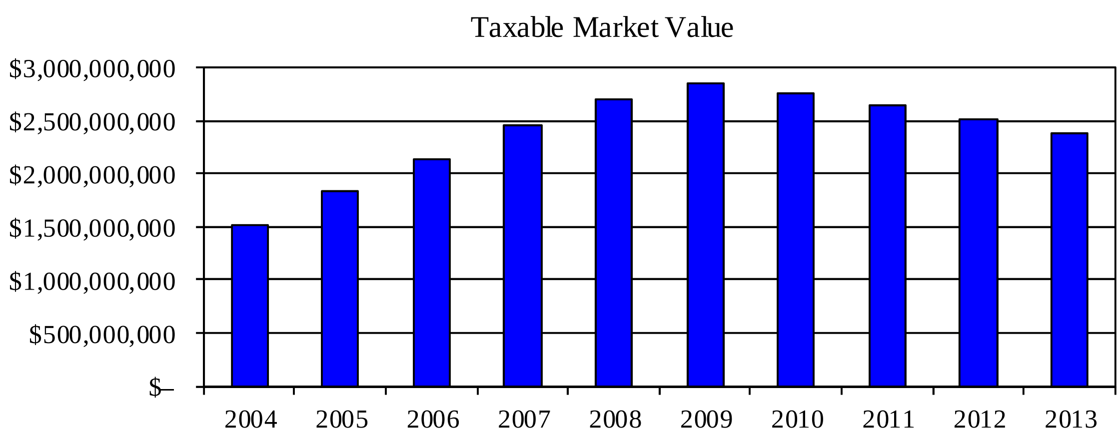
This section of the report provides you with an overview of the financial trends and activities of the City's governmental funds, which includes the General Fund, special revenue, debt service, and capital project funds. These funds are used to account for the basic services the City provides to all 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.

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, as economic conditions have resulted in reductions to other revenue sources such as state aids and fees generated from property development or redevelopment. Despite these conditions, property taxes levied by Minnesota cities increased a record low 0.9 percent state-wide for 2012, and 2.27 percent for 2013. Almost one-third of Minnesota cities kept their 2013 levy at the same level as the previous year, while another 13 percent reduced their levies for 2013.

Economic conditions have also had a profound effect on the tax base of Minnesota cities with state-wide taxable market values declining each of the last four levy years, including average decreases of 8.8 percent and 4.5 percent for taxes payable in 2012 and 2013, respectively. There is optimism that this trend is reversing, as the market value decline for the 2013 levy year was the smallest of the past four years. However, since the assessed valuation used for levying property taxes is based on values from the previous fiscal year (e.g. the market value for taxes payable in 2013 is based on estimated values as of January 1, 2012), taxable market value improvement has lagged behind recent upturns in the housing market and the economy in general.

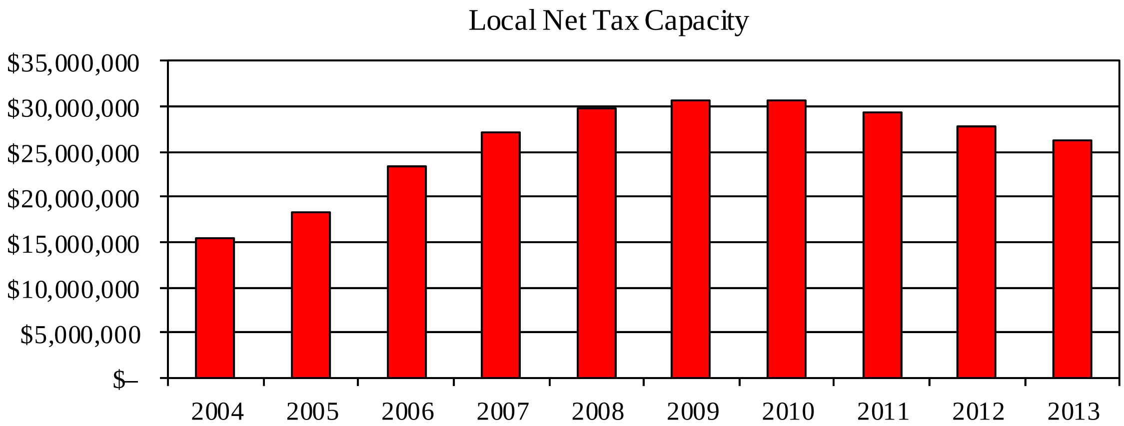
The City's taxable market value decreased 5.2 percent for taxes payable in 2012, which was less severe than the state-wide average, and 5.2 percent for taxes payable in 2013. The following graph shows the City's changes in taxable market value over the past 10 years:



The 2012 and 2013 data reflects the legislative change which eliminated the MVHC program and replaced it with a Market Value Exclusion program.

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 5.7 percent and 5.7 percent for taxes payable in 2012 and 2013, respectively.

The following graph shows the City's change in tax capacities over the past 10 years:



The 2012 and 2013 data reflects the legislative change which eliminated the MVHC program and replaced it with a Market Value Exclusion program.

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 Prior Lake**	
	2012	2013	2012	2013	**2012**	**2013**
Average tax rate						
City	46.3	48.8	43.4	46.1	**29.7**	**31.9**
County	46.8	48.5	45.0	47.1	**38.8**	**40.7**
School	27.3	28.5	28.5	30.3	**34.4**	**35.7**
Special taxing	6.8	7.2	8.7	9.4	**6.8**	**7.5**
Total	127.2	133.0	125.6	132.9	**109.7**	**115.8**

The City's portion of the total tax rate is below both the state-wide and metro area averages as presented in the table above. The school rate within the City exceeds the state-wide and the metro area averages. The average tax rate in total is below these averages.

As seen in the table above, the City's average tax rate in 2013 increased from fiscal 2012, mainly due to lower taxable market values.

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, 2013, presented both by fund balance classification and by fund:

Governmental Funds Change in Fund Balance

	Fund Balance as of December 31, 2013	Fund Balance as of December 31, 2012	Increase (Decrease)
Fund balances of governmental funds			
Total by classification			
Nonspendable	$ 71,082	$ –	$ 71,082
Restricted	6,012,005	6,193,184	(181,179)
Assigned	9,090,492	8,608,145	482,347
Unassigned	5,397,582	6,281,156	(883,574)
Total – governmental funds	$ 20,571,161	$ 21,082,485	$ (511,324)
Total by fund			
General	$ 6,431,258	$ 6,972,362	$ (541,104)
Debt Service	5,075,615	5,398,362	(322,747)
Construction Fund	1,759,511	975,938	783,573
Special revenue nonmajor funds	1,434,198	1,513,435	(79,237)
Capital projects nonmajor funds	5,870,579	6,222,388	(351,809)
Total – governmental funds	$ 20,571,161	$ 21,082,485	$ (511,324)

In total, the fund balances of the City's governmental funds decreased by $511,324 during the year ended December 31, 2013. Fund balances assigned for construction increased $783,573, mainly due to increased state grants and the timing of payments for the Welcome/CR12/Sunset road construction projects.

GOVERNMENTAL FUNDS REVENUE AND EXPENDITURES

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 the 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 Prior Lake**		
Year	December 31, 2012			**2011**	**2012**	**2013**
Population	2,500–10,000	10,000–20,000	20,000–100,000	**23,010**	**23,385**	**23,385**
Property taxes	$ 414	$ 382	$ 416	**$ 430**	**$ 406**	**$ 401**
Tax increments	32	44	46	**21**	**21**	**21**
Franchise and other taxes	29	36	30	**27**	**26**	**26**
Special assessments	60	54	62	**29**	**26**	**48**
Licenses and permits	24	24	35	**19**	**27**	**32**
Intergovernmental revenues	278	279	138	**61**	**160**	**172**
Charges for services	104	81	83	**68**	**115**	**114**
Other	66	58	50	**40**	**55**	**1**
Total revenue	$ 1,007	$ 958	$ 860	**$ 695**	**$ 836**	**$ 815**

In total, the City's governmental fund revenues for 2013 were $19,067,723, a decrease of $481,781 (2.5 percent) from the prior year. On a per capita basis, the City received $815 in governmental fund revenue for 2013, a decrease of $21 from the prior year. In general, the City has generated less governmental fund revenue per capita than the state-wide averages. Most of this relates to lower than average revenues in many of the development categories, including tax increment and special assessments.

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:

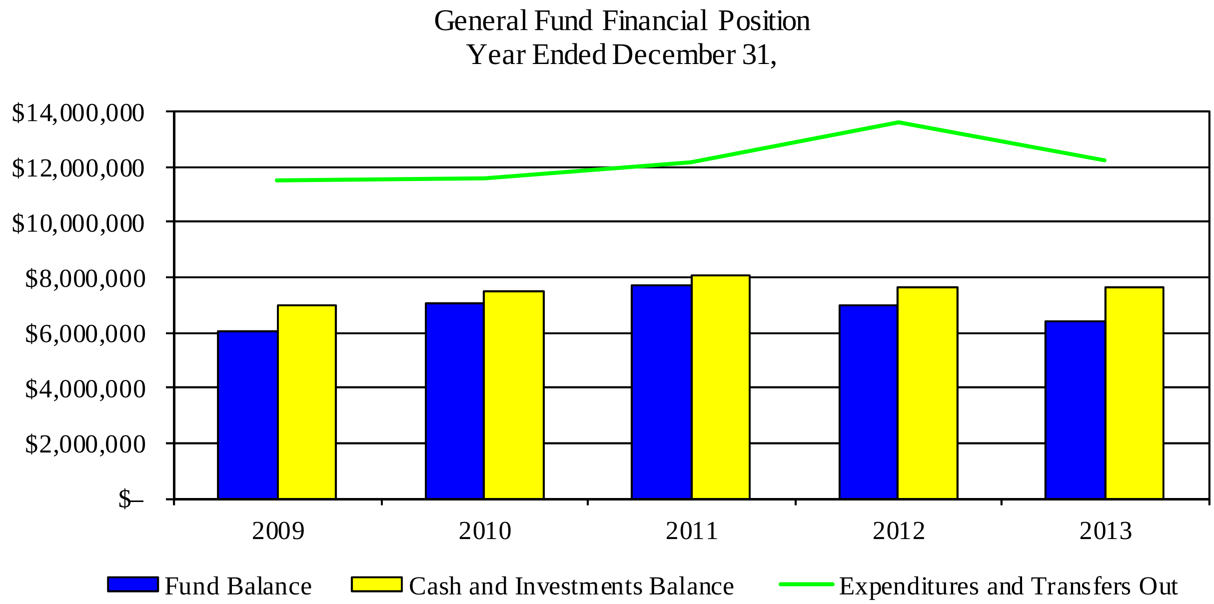
Governmental Funds Expenditures per Capita
With State-Wide Averages by Population Class

	State-Wide			**City of Prior Lake**		
Year	December 31, 2012			**2011**	**2012**	**2013**
Population	2,500–10,000	10,000–20,000	20,000–100,000	**23,010**	**23,385**	**23,385**
Current						
General government	$ 127	$ 101	$ 84	**$ 98**	**$ 105**	**$ 115**
Public safety	234	229	241	**187**	**187**	**199**
Streets and highways	114	105	92	**79**	**73**	**81**
Culture and recreation	82	95	86	**75**	**72**	**72**
All other	73	75	92	**4**	**8**	**8**
	$ 630	$ 605	$ 595	**$ 443**	**$ 445**	**$ 475**
Capital outlay and construction	$ 315	$ 313	$ 221	**$ 169**	**$ 356**	**$ 371**
Debt service						
Principal	$ 187	$ 135	$ 103	**$ 123**	**$ 142**	**$ 167**
Interest and fiscal charges	58	46	39	**72**	**63**	**56**
	$ 245	$ 181	$ 142	**$ 195**	**$ 205**	**$ 223**

Total expenditures in the City's governmental funds for 2013 were $24,988,749, an increase of $1,453,880 (6.2 percent) from the prior year. On a per capita basis, the City expended a total of $1,069 in 2013. Operating expenditures increased $30 per capita. Increases were spread across several functions in the current year, with the largest increase occurring in public safety costs. Capital outlay expenditures increased $15 per capita from the prior year due to increased street construction and equipment replacement expenditures. Debt service expenditures for 2013 were $18 per capita higher than the prior year, mainly due to an increase in bond maturities.

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 culture 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 and operating transfers out to reflect the change in the size of the General Fund operation over the same period.

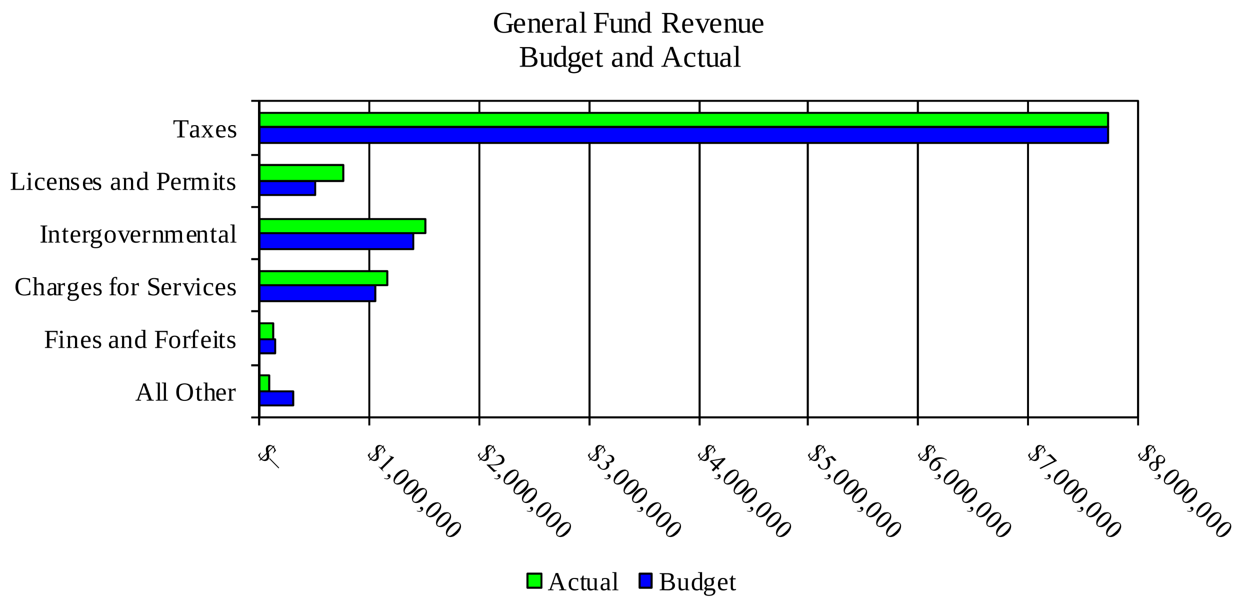


The City's General Fund cash and investments balance at December 31, 2013 was $7,635,527, a decrease of $1,732. Total fund balance at December 31, 2013 was $6,431,258, which is a decrease of $541,104 from the prior year.

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.

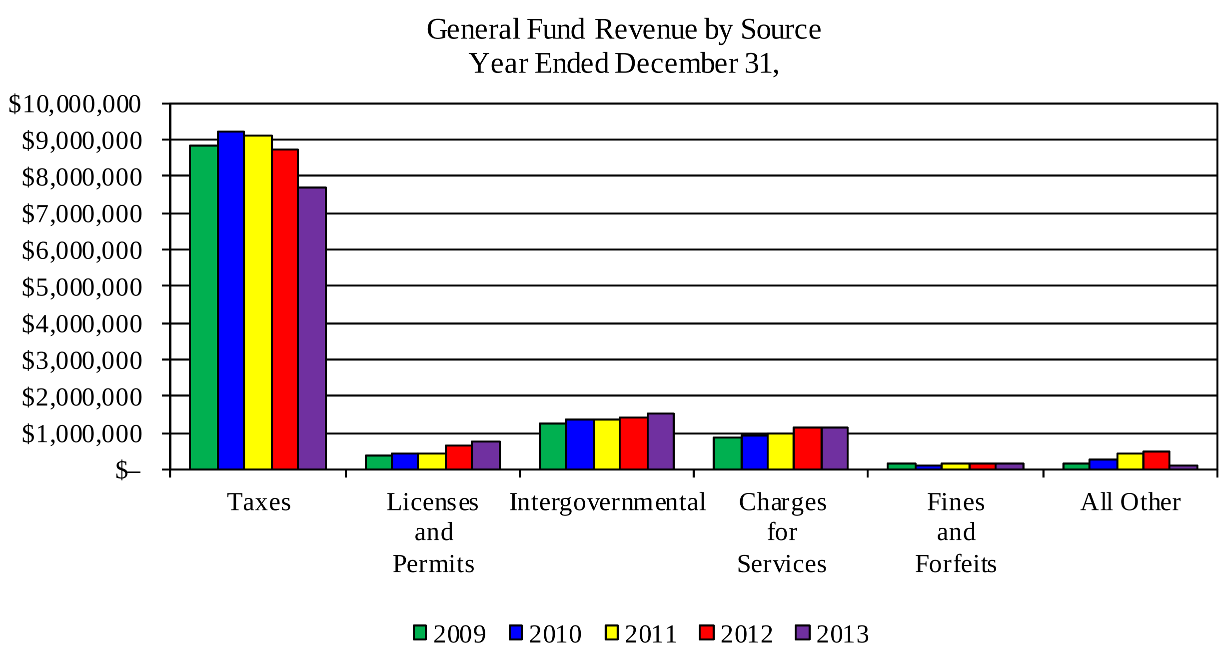
The City has formally adopted a fund balance policy regarding the minimum unrestricted fund balance for the General Fund. The policy establishes that the City will strive to maintain an unrestricted General Fund balance (which includes committed, assigned, and unassigned classifications) between 40 and 50 percent of the subsequent year's General Fund budgeted expenditures and transfers out. At December 31, 2013, the unrestricted fund balance of the General Fund was 50 percent of the subsequent year's budgeted expenditures and transfers out.

The following chart reflects the City's General Fund revenue sources for 2013 compared to budget:



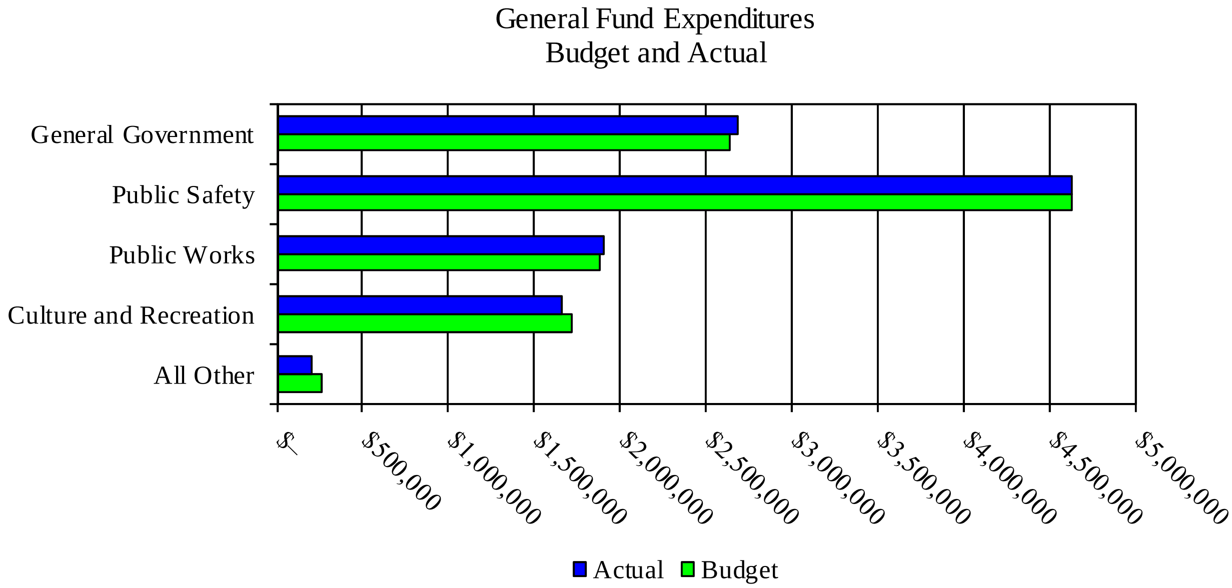
General Fund revenue for 2013 was $11,390,730, which was $231,102 (2.1 percent) more than budget. Licenses and permits and charges for services were $254,814 and $110,442, respectively, over budget mainly due to the City having more permits issued than projected. All other was $219,975 less than budget, mainly due to negative market value adjustments on the City's investment portfolio.

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



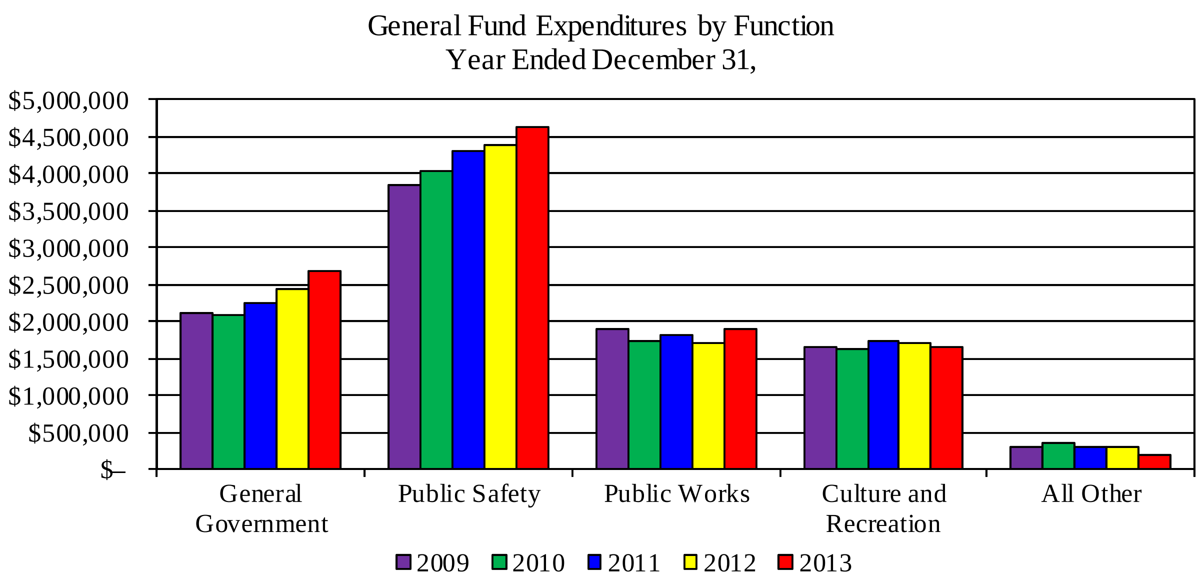
Total General Fund revenue for 2013 was $1,145,846 (9.1 percent) lower than last year. Tax revenue decreased by $1,018,442, or 11.7 percent. This decline is the result of more of the total tax levy of the City being allocated to the debt service funds when compared to prior years.

The following graphs illustrate the components of General Fund spending for 2013 compared to budget:



Total General Fund expenditures for 2013 were $11,073,464, which was $52,973 (0.5 percent) under budget. General government expenditures were $39,319 over budget, due mostly to budget overages in building and plant. Culture and recreation experienced budget savings of $60,925 mainly in natural resources.

The following graph presents the City's General Fund expenditures by function for the last five years:



Total General Fund expenditures for 2013 were $551,271 (5.2 percent) higher than the previous year. General government and public safety expenditures increased by $232,627 and $250,394, respectively.

PROPRIETARY 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 the Water, Sewer, Water Quality, and Transit 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, 2013, presented by both classification and by fund:

Enterprise Funds Change in Financial Position

	Net Position as of December 31, 2013	Net Position as of December 31, 2012	Increase (Decrease)
Net position of enterprise funds			
Total by classification			
Net investment in capital assets	$ 45,640,328	$ 45,764,121	$ (123,793)
Unrestricted	7,569,891	7,332,348	237,543
Total – enterprise funds	$ 53,210,219	$ 53,096,469	$ 113,750
Total by fund			
Water	$ 30,748,974	$ 30,776,518	$ (27,544)
Sewer	19,869,373	19,954,061	(84,688)
Water Quality	970,672	787,256	183,416
Transit	1,621,200	1,578,634	42,566
Total – enterprise funds	$ 53,210,219	$ 53,096,469	$ 113,750

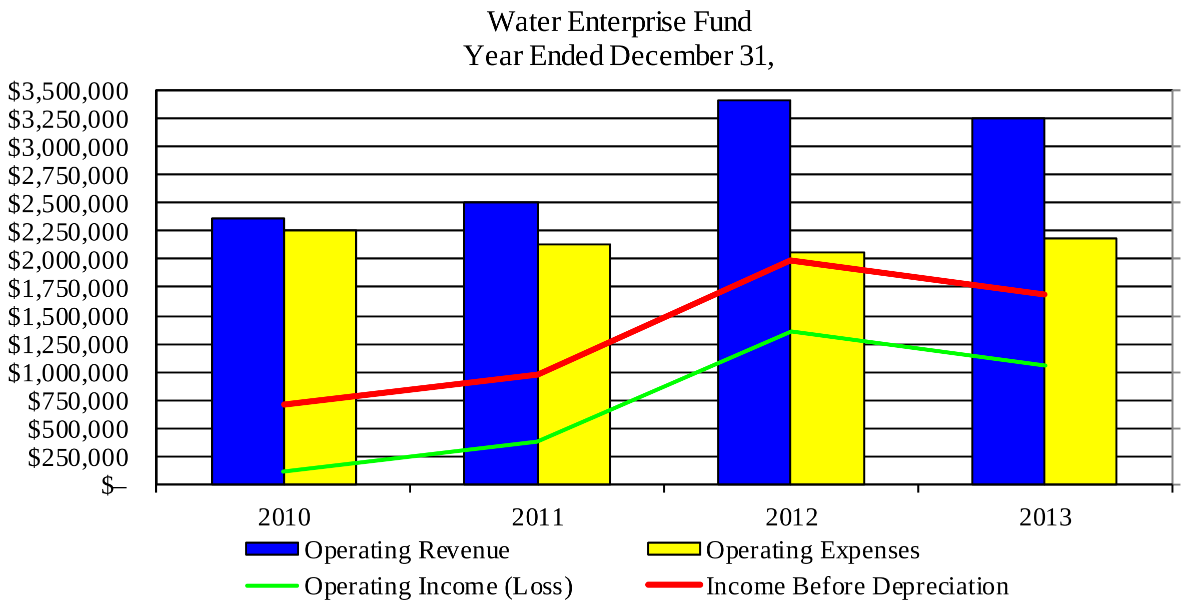
In total, the net position of the City's enterprise funds increased by $113,750 during the year ended December 31, 2013, mostly due to the positive financial results in the Water Quality Fund.

INTERNAL SERVICE FUND

During the year ended December 31, 2011, the City established a Compensated Absences Internal Service Fund to finance the compensated absence obligations of the governmental funds of the City. At December 31, 2013, this fund had assets totaling $561,744 while liabilities totaled $941,453, leaving a deficit net position balance of ($379,709). We recommend that the City continue to include the financing of these obligations as part of its long range financial plans.

WATER ENTERPRISE FUND

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



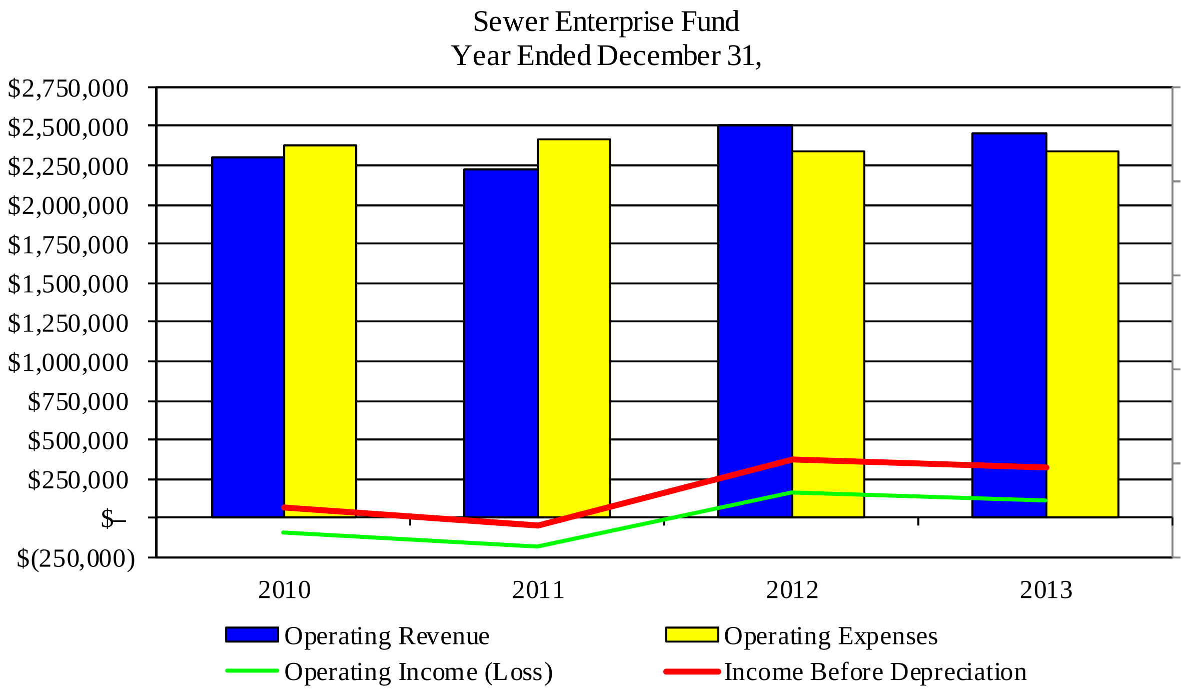
The Water Fund ended 2013 with net position of $30,748,974, a decrease of $27,544 from the prior year. Of this, $27,682,498 represents the investment in capital assets, leaving $3,066,476 in unrestricted net position. The Water Fund had transfers out totaling $1,556,856 in fiscal 2013 to support other funds, pay debt service, and provide for construction projects.

Operating revenue in the Water Fund was $3,246,774, a decrease of 5.0 percent from the prior year. This decrease was due to a combination of increased rates (8.0 percent) and a decrease in water usage in fiscal 2013 of approximately 14.0 percent.

Water Fund operating expenses for 2013 were $2,188,545, an increase of $137,682 (6.7 percent) from the previous year. The largest factor contributing to the change was an increase in repairs and maintenance of $139,691.

SEWER ENTERPRISE FUND

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

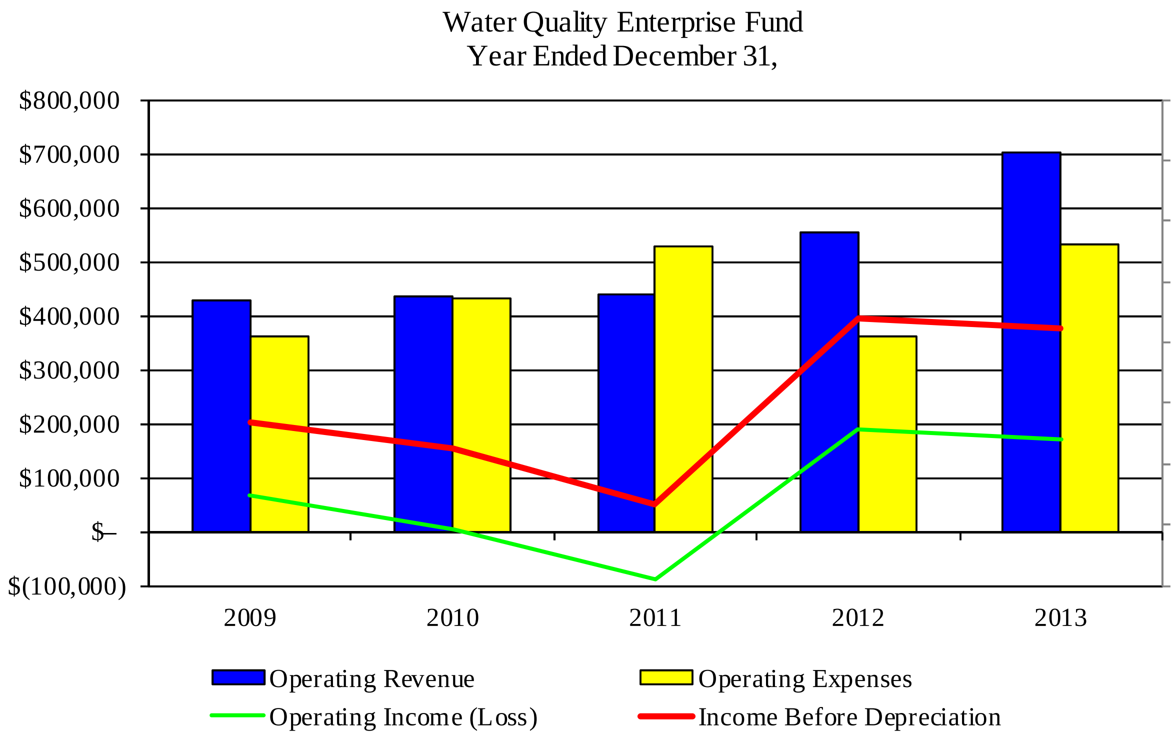


The Sewer Fund ended 2013 with net position of $19,869,373, a decrease of $84,688 from the prior year. Of this, $17,264,731 represents the City's investment in capital assets, leaving $2,604,642 in unrestricted net position. The Sewer Fund had transfers out totaling $355,268 in fiscal 2013 to support other funds, pay debt service, and provide for construction projects.

Operating revenue in the Sewer Fund was $2,453,432, a decrease of $48,977, or 2.0 percent, from the prior year, mainly related to decreased usage (5.9 percent). Sewer Fund operating expenses for 2013 were $2,345,167, an increase of $2,252, or 0.1 percent, from the previous year due to a slight increase in repairs and maintenance needs.

WATER QUALITY ENTERPRISE FUND

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



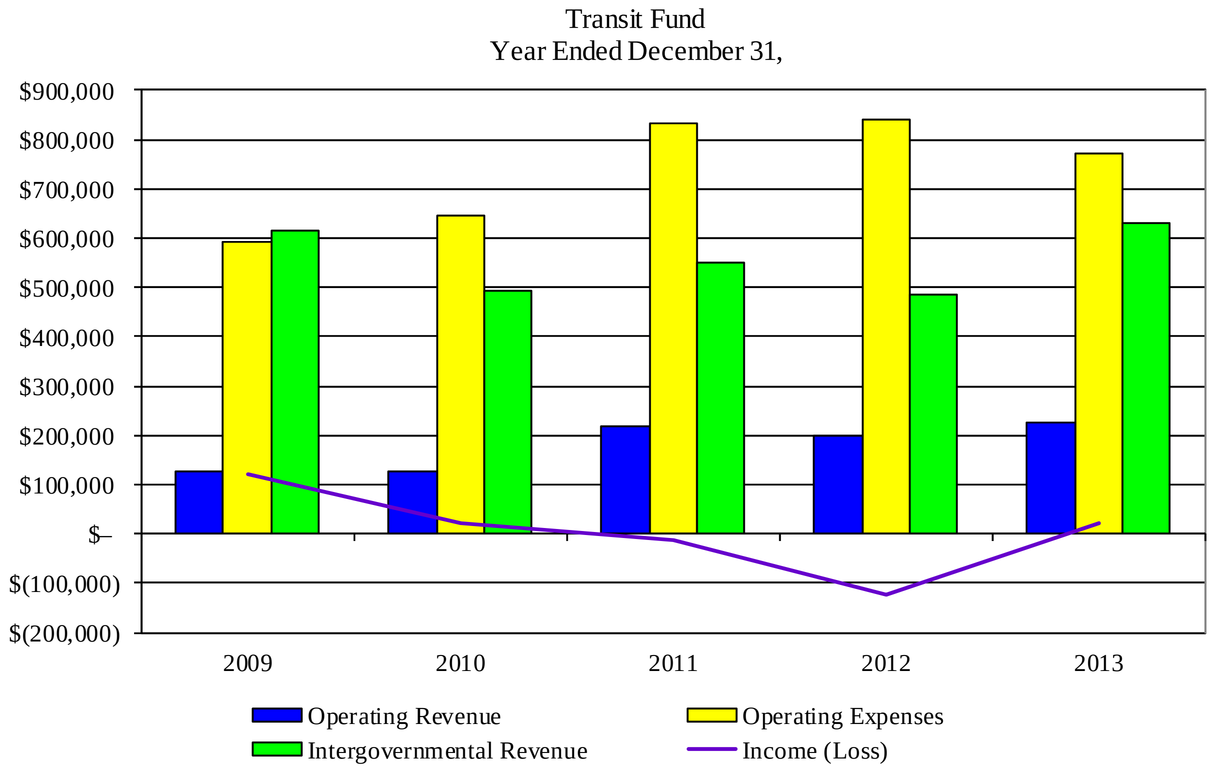
The Water Quality Fund ended 2013 with net position of $970,672, an increase of $183,416 from the prior year. Of this, $693,099 represents the investment in capital assets, leaving $277,573 in unrestricted net position.

Operating revenue in the Water Quality Fund was $702,529, an increase of $150,265, or 27.2 percent, from the prior year due to an increase in the rates in fiscal 2013. Water Quality Fund operating expenses for 2013 were $532,508, an increase of $170,049, or 47.0 percent, from the previous year, due mostly to more repairs and maintenance services and an increase in personal services expenditures.

State and federal grant income, which is not included in the table above, totaled $75,487 in fiscal 2013. After including this revenue, the Water Quality Fund reflected income before contributions and transfers of $236,553.

TRANSIT FUND

The following graph presents operating revenues over the last five years for the City's Transit Fund:



The Transit Fund ended 2013 with net position of $1,621,200, an increase of $42,566 from the prior year. The entire amount represents unrestricted net position.

Operating revenue in the Transit Fund was $225,198, an increase of $26,393, or 13.3 percent, from the prior year. Transit Fund operating expenses for 2013 were $772,707, a decrease of $68,333 from the previous year.

Most of the funding for the transit services comes from other governmental units and their revenue is reported in the nonoperating revenue category. State and federal grant income totaled $630,198 in fiscal 2013. After including this revenue, the Transit Fund reflected an increase in net position of $42,566 in fiscal 2013.

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 City's net position as of December 31, 2013 and 2012 for governmental activities and business-type activities:

	As of December 31,		Increase
	2013	2012	(Decrease)
Net position			
Governmental activities			
Net investment in capital assets	$ 81,787,853	$ 75,168,765	$ 6,619,088
Restricted	6,069,035	5,087,442	981,593
Unrestricted	14,320,281	14,805,650	(485,369)
Total governmental activities	102,177,169	95,061,857	7,115,312
Business-type activities			
Net investment in capital assets	45,640,328	45,764,121	(123,793)
Unrestricted	7,569,891	7,332,348	237,543
Total business-type activities	53,210,219	53,096,469	113,750
Total net position	$ 155,387,388	$ 148,158,326	$ 7,229,062

The City's total net position at December 31, 2013 was $7,229,062 higher than the total net position reported at the previous year-end. The increase in the net investment in capital assets balance was mostly due to an increase in street reconstruction projects in fiscal 2013.

At the end of the current fiscal year, the City is able to present positive balances in all three categories of net position, both for the government as a whole, as well as for its separate governmental and business-type activities. The same situation held true for the prior 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 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, 2013 and 2012:

	2013			2012
	Expenses	Program Revenues	Net Change	Net Change
Net (expense) revenue				
Governmental activities				
General government	$ 3,188,370	$ 1,083,063	$ (2,105,307)	$ (2,114,175)
Public safety	5,059,458	2,051,628	(3,007,830)	(2,910,091)
Public works	3,921,783	6,405,747	2,483,964	(611,605)
Culture and recreation	2,188,148	424,622	(1,763,526)	(1,302,632)
Economic development	669,303	2,366,228	1,696,925	1,057,610
Interest on long-term debt	1,829,979	–	(1,829,979)	(2,101,559)
Business-type activities				
Water	2,188,545	3,382,648	1,194,103	1,368,449
Sewer	2,345,167	2,627,254	282,087	156,752
Water quality	532,508	803,653	271,145	260,042
Transit	772,707	855,396	82,689	(157,219)
Total net (expense) revenue	$ 22,695,968	$ 20,000,239	(2,695,729)	(6,354,428)
General revenues				
Taxes			10,419,600	10,520,436
Unrestricted grants and contributions			16,106	18,066
Investment earnings (losses)			(620,634)	697,847
Other revenues			109,719	348,454
Total general revenues			9,924,791	11,584,803
Change in net position			$ 7,229,062	$ 5,230,375

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.

LEGISLATIVE UPDATES

Despite an improving economy, the 2013 Legislature faced the familiar prospect of having to address a significant projected deficit in order to adopt a balanced budget for the next biennium. The November 2012 financial forecast projected a deficit of $1.1 billion in the state General Fund for the 2014–2015 biennium, which was revised down to a $627 million deficit in the February 2013 forecast. Even with this challenge, there was an expectation that with one political party holding the Governor's office and majorities in both the House and Senate, this biennial budget agreement would be reached more quickly and easily than the previous one, which featured numerous vetoes, a special session, and the longest shutdown of non-essential state government services in Minnesota history. While in the end there was no special session or government shutdown, the 2013 session still stretched until the final day allowable under the state constitution, with the last bill passed at midnight.

The following is a summary of recent legislative activity affecting the finances of Minnesota cities in 2013 and into the future:

Local Government Aid (LGA) – The state-wide LGA appropriation for fiscal 2013 was set to increase about 2.8 percent to $426.4 million. However, the 2012 Legislature froze 2013 LGA payments at 2012 levels for cities with a population of 5,000 or more. For cities with populations below 5,000, 2013 LGA was the greater of their 2012 aid or the amount they would have received for 2013 under existing law.

The 2013 Legislature completely overhauled the LGA formula for fiscal year 2014 and thereafter, creating a three-tiered formula that includes separate "need factor" calculations for cities with populations under 2,500, between 2,500 and 10,000, or over 10,000. The new formula simplifies the LGA calculation, and is designed to reduce the volatility of the LGA distribution by limiting the amount it may decline in a given year. Under the new formula, each city's LGA distribution for 2014 will be no less than their 2013 LGA. Beginning in 2015, any reduction to a city's LGA distribution will be limited to the lesser of $10 per capita, or 5 percent of their previous year net tax levy. For cities that gain under the new formula, the increases will be distributed proportionate to their unmet need, as determined by the new "need factor" calculations. The state-wide LGA appropriation is $507.6 million for fiscal 2014, $509.1 million for 2015, and $511.6 million for fiscal 2016 and thereafter.

Levy Limits – A levy limit for city property tax levies payable in 2014 was established for all cities with populations exceeding 2,500. The levy limit base is the certified levy (excluding special levies) plus the certified LGA for taxes payable in fiscal 2012 or 2013, whichever is greater, increased by 3 percent. The levy limit is equal to the base, less the city's certified LGA for fiscal 2014. Levies for special purposes such as debt service, abatements, or voter-approved purposes, are not subject to this limitation.

Market Value Definitions – A number of levy, tax, spending, debt, and similar limits that had previously been computed based on "market value" or "taxable market value" must now be computed based on "estimated market value." This change was enacted to eliminate the effects of the homestead market value exclusion established in 2011.

Levy Authority for Watershed Management Plan – Cites are granted the authority to levy taxes to provide funding for the implementation of a comprehensive watershed management plan.

Tax Status of Leased Tax-Exempt Property – Tax-exempt property owned by a political subdivision and held under a lease for a term of at least one year, or under a contract for the purchase thereof, is considered to be the property of the person holding it for all purposes of taxation. This change makes the tax treatment of leased property owned by local governments consistent with leased property owned by the federal government.

Tax Increment Financing (TIF) – A number of changes and clarifications were made to rules governing the use of TIF, including:

- The prohibition on using tax increments for improvements or equipment primarily of a decorative or aesthetic nature, or with costs twice as high due to the selection of materials or designs compared to more commonly used improvements or equipment, is eliminated.
- The four-year rule originally applying to TIF Districts certified between January 1, 2005 and April 20, 2009 is extended through December 31, 2016.
- Development authorities may elect to reduce the original net tax capacity of qualifying TIF districts for the effects of the homestead market value exclusion that replaced the homestead tax credit program.
- Taxes paid by captured tax capacity of TIF districts that are attributable to the new general education levy authorized by the 2013 Legislature, will be paid to the school district that imposes the levy.

Park Dedication Fees – A clarification was made to define the basis on which a city calculates a park dedication fee charged to a developer in lieu of dedicating land for park usage. The fee must be calculated on the fair market value of the land as annually determined by the city based on tax valuation or other relevant data. The new law also provides a method for resolving valuation disputes through negotiation or the use of independent appraisals of land in the same land use category.

Host Community Economic Development Grants – A new program was created that will provide grants for the acquisition and improvement of publicly owned capital assets for metro-area cities that host waste disposal facilities. No local matching funds are required.

Change to Small Cities Development Block Grants – The Minnesota Department of Employment and Economic Development is now allowed to provide a forgivable loan through the Small Cities Development Block Grant Program directly to a private enterprise. The city in which the private enterprise is located is no longer required to submit an application, only a resolution of support.

Wastewater and Stormwater Funding – Several changes were made to wastewater and stormwater grant and loan programs administered by the Public Facilities Authority. The changes include expanded eligibility for some programs, and increased grant or loan ceilings for others.

Sales Tax Exemption – Cities are exempted from paying sales tax on qualifying purchases, effective for purchases made on or after January 1, 2014. This exemption does not include purchases of goods or services to be used as inputs to goods or services cities provide to the public that are generally provided by a private business, such as liquor stores, golf courses, marinas, or fitness centers.

Cities with a population over 500 will be required to include a property tax savings report along with its proposed 2013 payable 2014 property tax levy certification, with the amount of sales or use taxes paid or estimated to have been paid in fiscal 2012. Cities must also discuss the savings resulting from the sales tax exemption at their fall truth-in-taxation public hearings.

Organized Solid Waste Collection – The process for imposing the city-organized collection of solid waste was streamlined and better defined. The previous 180-day process for cities to adopt organized collection of solid waste was eliminated. The process now begins with a 60-day period in which cities may negotiate with collectors currently operating in the city, thereby giving them the first opportunity to develop a proposal for organized collection. If the 60-day negotiation period ends without an agreement, a city may continue the process by passing a resolution to form a committee to study the methods of organizing collection and make recommendations. A city must provide public notice and hold at least one public hearing before deciding to implement organized collection.

Pensions – An omnibus pension bill was passed that made a number of changes to both state-wide pension plans and single employer relief associations, including:

- Changes to the Public Employees Retirement Association (PERA) General Plan:
    - The "average salary" for determining surviving spouse and dependent benefits was redefined.
    - A number of clarifications were made to what constitutes "salary" for plan purposes.
    - Changes were made to the level of annual post-retirement adjustments, which will vary based on the funding level of the plan.
- Changes to the PERA Police and Fire Plan:
    - Increases employee contribution rate from 9.6 percent of salary to 10.2 percent for fiscal 2014, and 10.8 percent for fiscal 2015 and thereafter.
    - Increases employer contribution rate from 14.4 percent of salary to 15.3 percent for fiscal 2014, and 16.2 percent for fiscal 2015 and thereafter.
    - A 20-year proportional vesting period was established for new hires beginning in 2014, under which the member becomes 50 percent vested after 10 years, and vests an additional 5 percent annually until fully vested at 20 years.
    - The retirement annuity formula calculation was changed to incorporate the effect of the new 20-year vesting period, and a new cap of 33 years on allowable service time included in the annuity calculation.
    - The early retirement reduction factor was increased from the current 2.4 percent per year to 5 percent, phased in over a 5-year period beginning July 1, 2014.
    - Changes were made to the level of annual post-retirement adjustments, which will vary based on the funding level of the plan.
- Changes to single employer relief associations:
    - The threshold of assets at which police relief associations and salaried or volunteer fire relief associations must prepare financial statements and have them audited by an independent auditor was raised from $200,000 to $500,000.
    - Volunteer firefighter relief associations are now required to pay a supplemental survivor benefit whenever it pays a survivor benefit, regardless of whether it is authorized in the association bylaws.
    - Any change to the interest rate paid during the deferral period of lump-sum service pensions must be approved by the governing body of the city or independent firefighting corporation to which the association is related.

In addition, a new supplemental state aid was created to provide funding for pension plans. An annual allotment of $15.5 million will be distributed among the PERA Police and Fire Plan ($9 million), municipal volunteer firefighter associations ($5.5 million allocated based on proportionate share of fire state aid), and the Minnesota State Retirement System State Patrol Plan ($1 million).

Expansion of Debt Authority – Several changes were made to expand the allowable uses of certain types of debt, including:

- Home rule charter city or statutory city capital notes are allowed to be used for the purchase of application development services and training related to the use of computer hardware and software.
- Capital improvement program (CIP) bonds are allowed to be used for expenditures incurred before the adoption of the CIP, if the expenditures are included in the plan.
- Street reconstruction bonds are allowed to be used for bituminous overlay projects, which previously had not been included in the definition of reconstruction.

Authorized Investments – The list of authorized investments for cities was expanded to include: revenue obligations issued by local governments without levy authority that are rated AA or better; short-term (13 month maturity or less) obligation issued by a school district that is either rated in the highest credit rating category or covered by the State of Minnesota Credit Enhancement Program; and short-term (18 month maturity or less) guaranteed investment contracts when the issuer's or guarantor's short-term debt is rated in the highest rating category, even if their long-term debt is rated below the top two rating categories.

Elections – The Legislature passed an omnibus elections policy bill that made a number of changes and clarifications to election requirements, including:

- Establishing "no excuse" absentee balloting;
- Increasing the time for counting absentee ballots from 4 days prior to the election to 7;
- Reducing the number of people a voter may vouch for in a polling place from 15 to 8;
- Eliminating the requirement to have at least one telecommunications device for deaf voter registration in every city of the first, second, or third class;
- Requiring that the municipal clerk designated to administer absentee ballots also be responsible for the administration of a "ballot board";
- Reducing the number of election judges required in a precinct for elections other than a general election from 4 to 3, for precincts with more than 500 voters; and allowing the minimum number of three election judges for all elections including general elections for precincts with less than 500 registered voters;
- Modifying the vote differentials requiring publically funded recounts to 0.25 percent in elections where more than 50,000 votes are cast, and 0.5 percent for elections in which between 400 and 50,000 votes are cast;
- Amending the time period in which cities are prohibited from holding a special election from the first 40 days following a general election to the first 56 days;
- Increasing the number of days' notice a city clerk must provide to a county auditor before holding a municipal election from 67 to 74 days; and
- Establishing a pilot program and task force for the use of electronic rosters of voters.

Alternative Bid Publication for Projects Funded by Special Assessments – A technical change was made to eliminate duplicative publication requirements for projects funded with special assessments. The definition of "recognized industry trade journal" was broadened to include websites or electronic publications, thereby eliminating circumstances that were forcing cities utilizing an alternative electronic publication method to also publish written notice for certain projects.

Met Council Allocated Costs – A change was made to allow cities that are allocated costs by the Met Council to request the cost be deferred, or to be paid over time on a payment schedule with interest as agreed to by the Met Council.

Liquor Licensing – An omnibus liquor bill was passed that made several changes to liquor licensing and distribution. Among the changes are: authorizing cities with municipal liquor operations to issue brewer taproom licenses that allow consumption on the premises or adjacent to malt liquor breweries; authorizing cities to issue brewers a license for off-sale of malt liquor packaged by the brewer; providing for the sale of malt-liquor educator licenses that will allow malt liquor tastings and education to be conducted similar to wine tastings; and allowing micro-distilleries to provide product samples on site.

Tax-Exempt Holding Period for Development Property – The tax exempt holding period for city-owned land held for development is increased from 9 to 15 years for property acquired between January 1, 2000 and December 31, 2010, or for property located in a city outside of the metro area with a population under 20,000.

Citizen Contact Information Classified as Private Data – Citizen contact information submitted to cities in order to receive certain notifications or to subscribe to the city's electronic publications, such as phone numbers or email addresses, is now classified as private data. The names of people on such lists remain public information.

Criminal History and Background Checks – Cities are authorized to perform criminal history checks on applicants for: city employment, volunteer positions, or a license that does not otherwise subject the applicant to a criminal history check. Such criminal history checks may not be substituted for statutorily mandated background checks.

Background checks are now required for all fire department applicants, and are allowed for current fire department employees. The fire chief is also required to perform criminal history record checks of applicants.

ACCOUNTING AND AUDITING UPDATES

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 the Teachers' Retirement Association (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.

CHANGES TO REQUIREMENTS FOR FEDERAL GRANTS

In December 2013, the U.S. Office of Management and Budget (OMB) issued "Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Audits," which supersedes all or parts of eight OMB circulars; consolidating federal cost principles, administrative principles, and audit requirements in one document. The "Super Circular" 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 thresholds and process used 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, and an increase in the threshold for reporting questioned costs. The draft version of this guidance also included proposed reductions in the number of compliance requirements to be tested in a Single Audit, but final guidance on those changes will not be available until an updated compliance supplement is issued in 2014.