

Management Report  
for  
City of Prior Lake, Minnesota  
December 31, 2014

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PRINCIPALS

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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, 2014. 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
- Enterprise 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 15, 2015

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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, 2014 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, 2014:

- 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 no findings based on our testing of the City's compliance with Minnesota laws and regulations.

### **FOLLOW-UP ON PRIOR YEAR FINDINGS AND RECOMMENDATIONS**

As a part of our audit of the City's financial statements for the year ended December 31, 2014, 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 the prior year, we noted that the City had five timesheets out of twenty-five that 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. During this year's audit testing, all timesheets we tested had the proper signed declaration.
- In the prior year, we proposed that the City implement proper segregation of duties within the cash receipt process that would involve an independent review of a system report of receipts for the day compared to the cash deposited for the day. We recommended that the City adjust individual responsibilities to further segregate duties to have someone separate from the cash collection process reconcile that report to the bank deposit prepared for the day. During this year's audit testing, appropriate segregation of duties in the cash receipt process had been implemented.

## **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. No new accounting policies were adopted and the application of existing policies was not changed during the fiscal year ended December 31, 2014.

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.
- **Net Other Post-Employment Benefit (OPEB) Liabilities** – Actuarial estimates of the net OPEB obligation is based on eligible participants, estimated future health insurance premiums, and estimated retirement dates.

We evaluated the key factors and assumptions used by management to develop these estimates in determining that they are reasonable in relation to the basic financial statements taken as a whole.

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

## **CORRECTED AND UNCORRECTED MISSTATEMENTS**

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

## **DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT**

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

## **DISAGREEMENTS WITH MANAGEMENT**

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

## **MANAGEMENT REPRESENTATIONS**

We have requested certain representations from management that are included in the management representation letter dated May 15, 2015.

## **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**

We applied certain limited procedures to Management's Discussion and Analysis and the Schedules of Funding Progress for the Volunteer Fire Department Firefighter's Relief and Pension Association and the City of Prior Lake Other Post-Employment Benefits Plan, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

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

We were not engaged to report on the introductory and other information sections accompany the financial statements but are not RSI. We did not audit or perform other procedures on this other information and we do not express an opinion or provide any assurance on it.

## GOVERNMENTAL FUNDS OVERVIEW

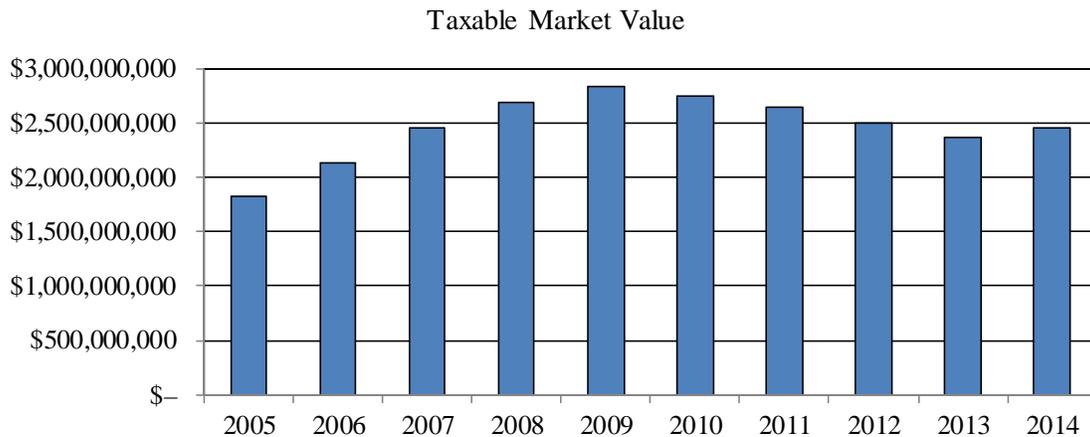
This section of the report provides you with an overview of the financial trends and activities of the City's governmental funds, which includes the General, special revenue, debt service, and capital project funds. These funds are used to account for the basic services the City provides to all of its 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. For the 2013 fiscal year, local property tax levies provided 41.1 percent of the total governmental fund revenues for cities over 2,500 in population, and 35.5 percent for cities under 2,500 in population. Property tax levies certified by Minnesota cities for 2014 increased about 1.6 percent over 2013, compared to an increase of 2.3 percent the prior year. This moderate increase was due in part to a one-year levy limit for 2014 imposed on cities over 2,500 in population.

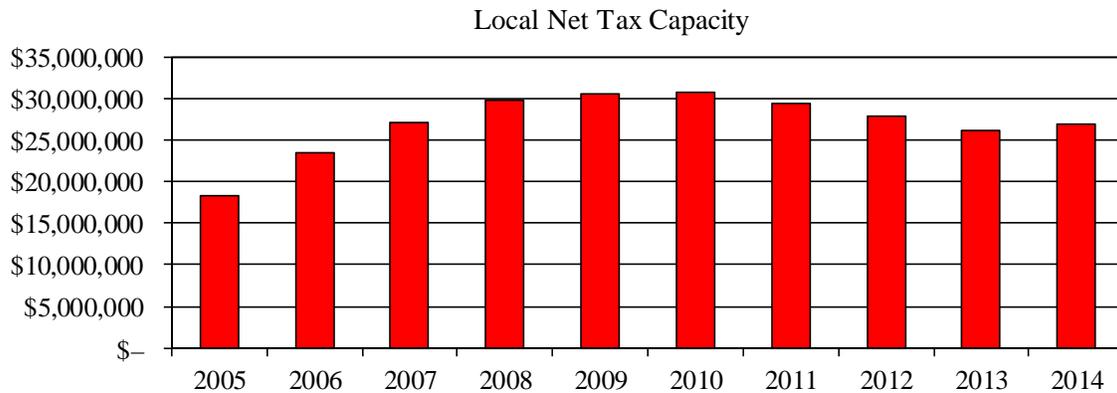
The total market value of Minnesota cities increased about 1.1 percent for the 2014 levy year, ending a four-year trend of declining market values that began in 2010 and peaked with a state-wide decline of about 8.8 percent for levy year 2012. Market values showed modest increases in all property categories for 2014, with the largest gains in agricultural and non-homestead residential properties. Because 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 2014 is based on estimated values as of January 1, 2013), 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 2013 and increased 3.2 percent for taxes payable in 2014. The following graph shows the City's changes in taxable market value over the past 10 years:



Tax capacity is considered the actual base available for taxation. It is calculated by applying the state's property classification system to each property's market value. Each property classification, such as commercial or residential, has a different calculation and uses different rates. Consequently, a city's total tax capacity will change at a different rate than its total market value, as tax capacity is affected by the proportion of the City's tax base that is in each property classification from year-to-year, as well as legislative changes to tax rates. The City's tax capacity decreased 5.7 percent and increased 2.9 percent for taxes payable in 2013 and 2014, respectively.

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



The following table presents the average tax rates applied to city residents for each of the last two levy years, along with comparative state-wide and metro area rates.

Rates expressed as a percentage of net tax capacity						
	All Cities State-Wide		Seven-County Metro Area		City of Prior Lake	
	2013	2014	2013	2014	2013	2014
<b>Average tax rate</b>						
City	48.8	48.8	46.1	46.0	<b>31.9</b>	<b>30.7</b>
County	48.5	47.6	47.1	46.6	<b>40.7</b>	<b>39.7</b>
School	28.5	28.9	30.3	30.9	<b>35.7</b>	<b>36.2</b>
Special taxing	<u>7.2</u>	<u>7.3</u>	<u>9.4</u>	<u>9.5</u>	<u><b>7.5</b></u>	<u><b>7.4</b></u>
Total	<u><u>133.0</u></u>	<u><u>132.6</u></u>	<u><u>132.9</u></u>	<u><u>133.0</u></u>	<u><u><b>115.8</b></u></u>	<u><u><b>114.0</b></u></u>

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 2014 decreased from fiscal 2013, mainly due to higher taxable market values.

## 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 the 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.

<b>Governmental Funds Revenue per Capita</b>							
With State-Wide Averages by Population Class							
Year	State-Wide			City of Prior Lake			
	December 31, 2013			2012	2013	2014	
Population	2,500-10,000	10,000-20,000	20,000-100,000	23,385	24,223	24,223	
Property taxes	\$ 422	\$ 388	\$ 423	\$ 406	\$ 388	\$ 390	
Tax increments	30	42	40	21	20	19	
Franchise and other taxes	31	39	34	26	24	25	
Special assessments	63	58	72	26	47	25	
Licenses and permits	27	26	38	27	32	24	
Intergovernmental revenues	253	268	148	160	166	84	
Charges for services	109	84	91	115	110	114	
Other	56	33	30	55	1	50	
<b>Total revenue</b>	<b>\$ 991</b>	<b>\$ 938</b>	<b>\$ 876</b>	<b>\$ 836</b>	<b>\$ 788</b>	<b>\$ 731</b>	

In total, the City's governmental fund revenues for 2014 were \$17,735,118, a decrease of \$1,332,605 (7.0 percent) from the prior year. On a per capita basis, the City received \$731 in governmental fund revenue for 2014, a decrease of \$57 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:

<b>Governmental Funds Expenditures per Capita</b>							
With State-Wide Averages by Population Class							
Year	State-Wide			City of Prior Lake			
	December 31, 2013			2012	2013	2014	
Population	2,500–10,000	10,000–20,000	20,000–100,000	23,385	24,223	24,223	
<b>Current</b>							
General government	\$ 129	\$ 100	\$ 83	\$ 105	\$ 111	\$ 116	
Public safety	244	235	239	187	191	195	
Streets and highways	123	121	91	73	79	77	
Culture and recreation	83	99	85	72	69	73	
All other	66	73	91	8	8	5	
	<u>\$ 645</u>	<u>\$ 628</u>	<u>\$ 589</u>	<u>\$ 445</u>	<u>\$ 458</u>	<u>\$ 466</u>	
Capital outlay and construction	<u>\$ 303</u>	<u>\$ 288</u>	<u>\$ 219</u>	<u>\$ 356</u>	<u>\$ 359</u>	<u>\$ 262</u>	
<b>Debt service</b>							
Principal	\$ 164	\$ 133	\$ 102	\$ 142	\$ 161	\$ 131	
Interest and fiscal charges	55	43	39	63	54	52	
	<u>\$ 219</u>	<u>\$ 176</u>	<u>\$ 141</u>	<u>\$ 205</u>	<u>\$ 215</u>	<u>\$ 183</u>	

Total expenditures in the City's governmental funds for 2014 were \$22,083,510, a decrease of \$2,905,239 (11.6 percent) from the prior year. On a per capita basis, the City expended a total of \$911 in 2014. Capital outlay expenditures which decreased \$97 per capita from the prior year due to significant street construction and equipment replacement expenditures in 2013. Debt service expenditures for 2014 were \$32 per capita lower than the prior year, mainly due to a decrease in bond maturities.

## GOVERNMENTAL FUND BALANCES

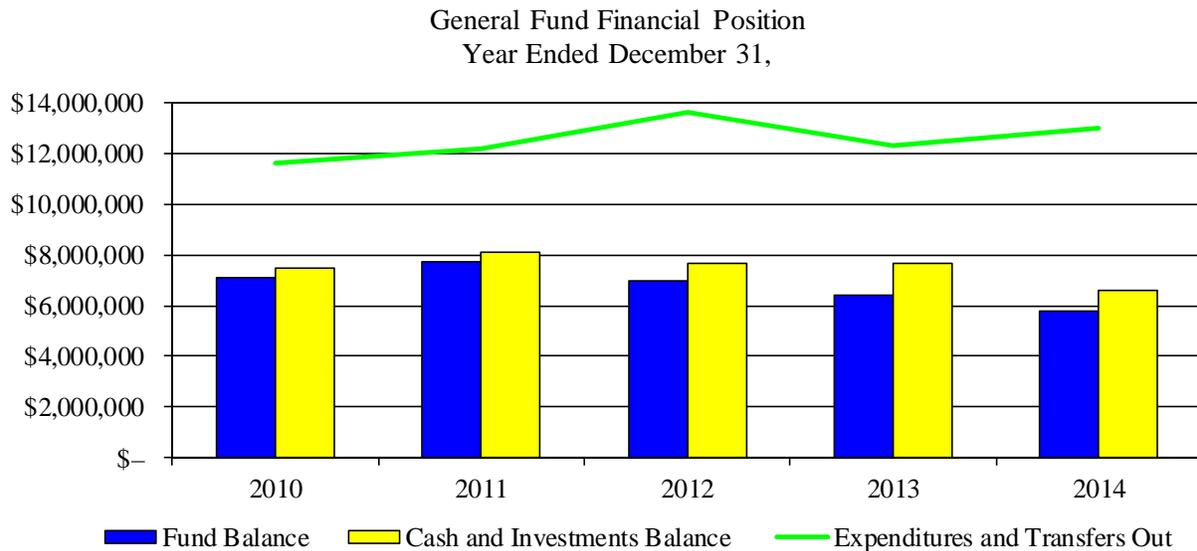
The following table summarizes the changes in the fund balances of the City's governmental funds during the year ended December 31, 2014, presented both by fund balance classification and by fund:

	Fund Balance		Increase (Decrease)
	as of December 31,		
	2014	2013	
<b>Governmental Funds Change in Fund Balance</b>			
Fund balances of governmental funds			
Total by classification			
Nonspendable	\$ 710	\$ 71,082	\$ (70,372)
Restricted	5,188,054	6,012,005	(823,951)
Assigned	8,803,981	9,090,492	(286,511)
Unassigned	<u>5,775,889</u>	<u>5,397,582</u>	<u>378,307</u>
Total – governmental funds	<u>\$ 19,768,634</u>	<u>\$ 20,571,161</u>	<u>\$ (802,527)</u>
Total by fund			
General	\$ 5,776,647	\$ 6,431,258	\$ (654,611)
DAG Special Revenue	681,406	724,922	(43,516)
Debt Service	1,543,772	5,075,615	(3,531,843)
Construction Fund	1,346,445	1,759,511	(413,066)
Special revenue nonmajor funds	1,088,160	709,276	378,884
Capital projects nonmajor funds	<u>9,332,204</u>	<u>5,870,579</u>	<u>3,461,625</u>
Total – governmental funds	<u>\$ 19,768,634</u>	<u>\$ 20,571,161</u>	<u>\$ (802,527)</u>

In total, the fund balances of the City's governmental funds decreased by \$802,527 during the year ended December 31, 2014. Debt Service Fund balance decreased due to the use of refunded bond escrow accounts to refund outstanding debt. Capital Project Fund balances increased from the issuance of energy loans toward the end of 2014.

## 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.

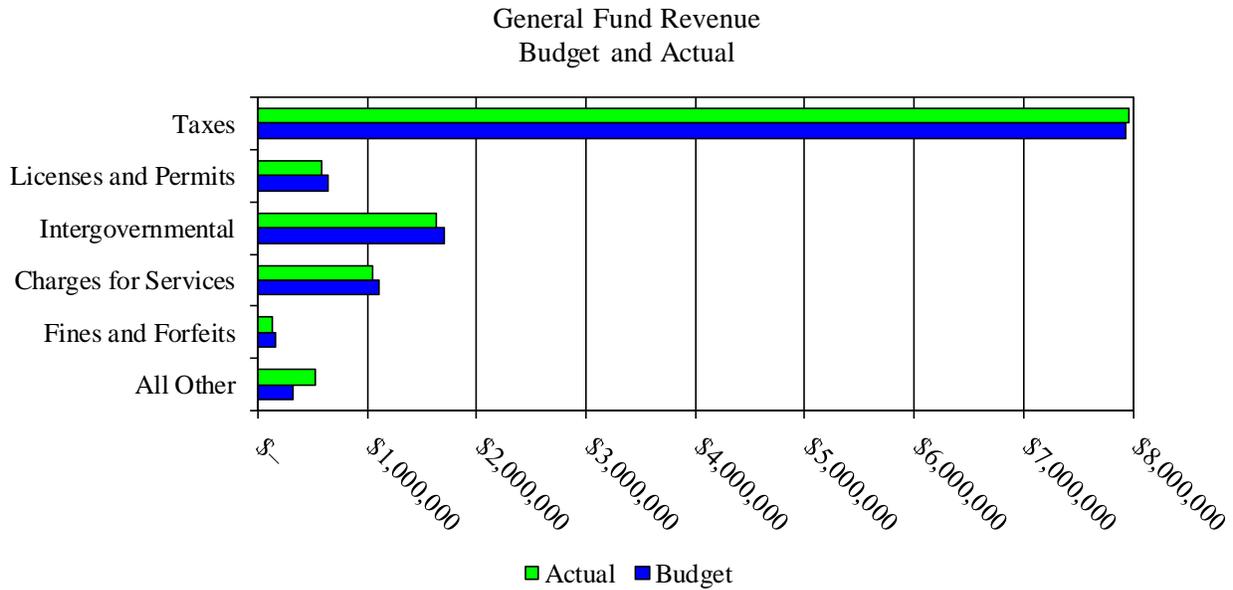


The City's General Fund cash and investments balance at December 31, 2014 was \$6,622,398, a decrease of \$1,013,129. Total fund balance at December 31, 2014 was \$5,776,647, which is a decrease of \$654,611 from the prior year.

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.

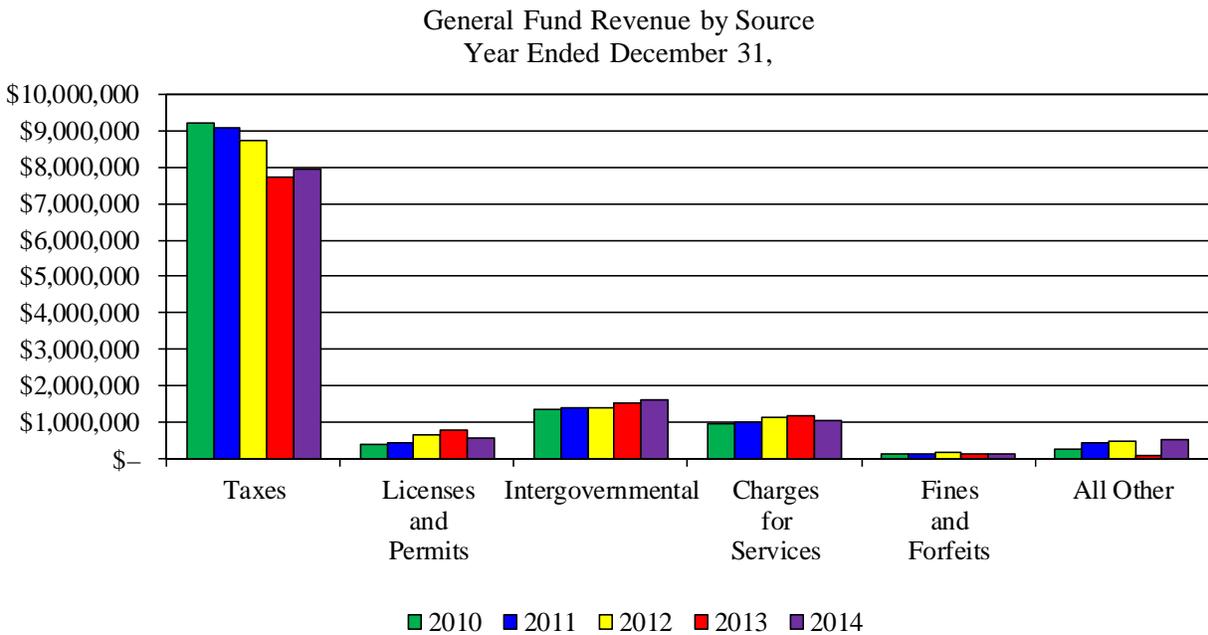
The City has formally adopted a fund balance policy regarding the minimum unrestricted fund balance for the General Fund. The policy establishes that the City will strive to maintain an unrestricted General Fund balance (which includes committed, assigned, and unassigned classifications) between 40 and 50 percent of the subsequent year's General Fund budgeted expenditures and transfers out. At December 31, 2014, the unrestricted fund balance of the General Fund was 46 percent of the subsequent year's budgeted expenditures and transfers out.

The following chart reflects the City's General Fund revenue sources for 2014 compared to budget:



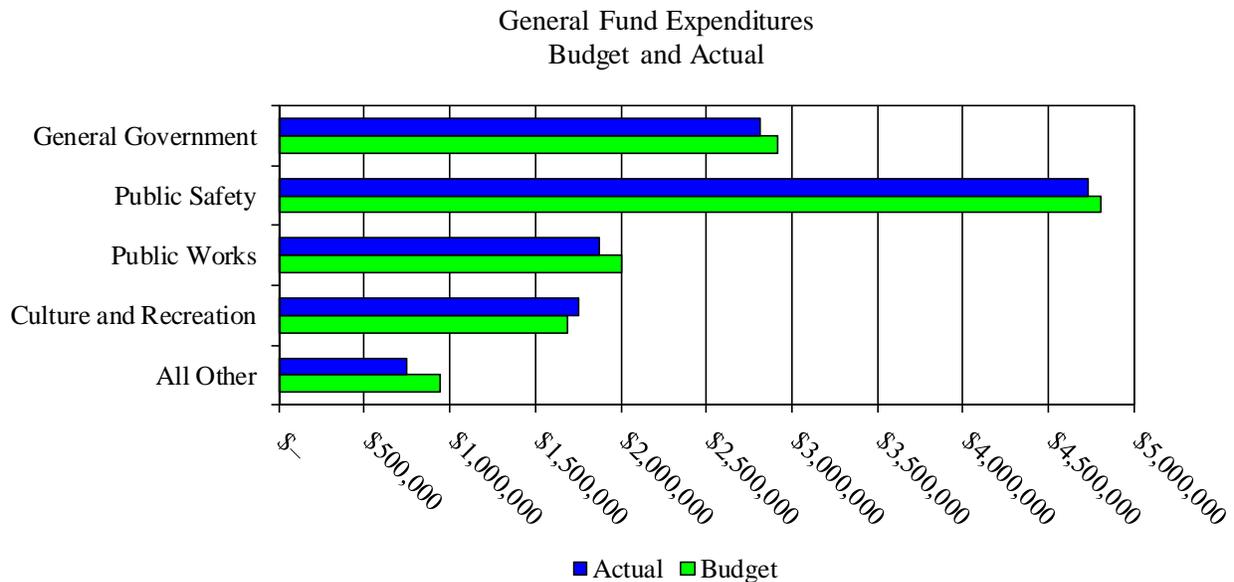
General Fund revenue for 2014 was \$11,870,725, which was \$13,878 (0.1 percent) more than budget. All other revenue was \$211,825 more than budget, mainly due to positive market value adjustments on the City's investment portfolio.

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.



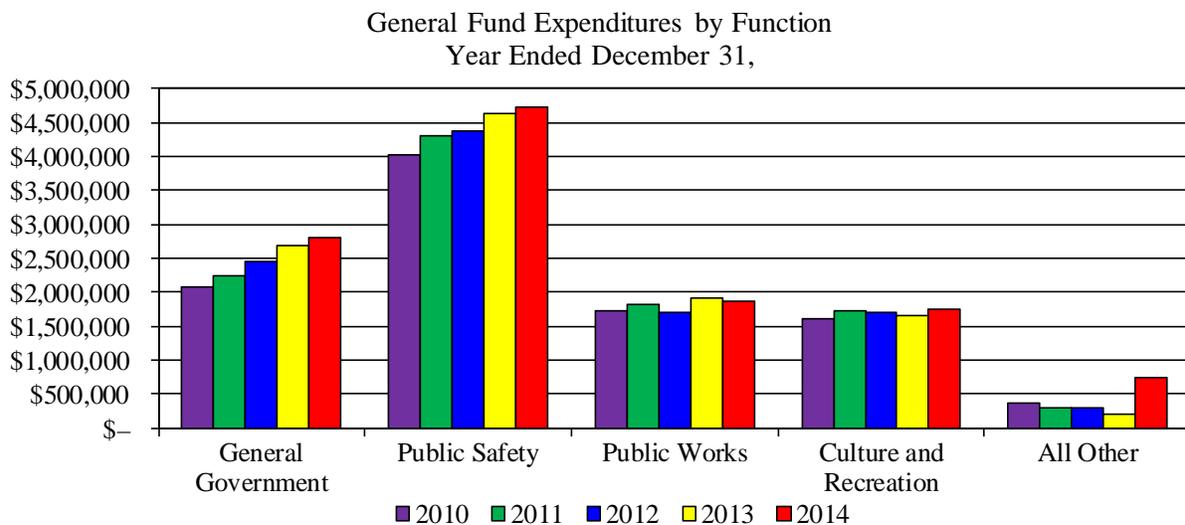
Total General Fund revenue for 2014 was \$479,995 (4.2 percent) higher than last year. Tax revenue increased by \$243,500, or 3.2 percent. All other revenue was higher than last year as well by \$439,305, or 477.4 percent, mainly due to the positive market value adjustments on the City's investment portfolio as noted above.

The following graphs illustrate the components of General Fund spending for 2014 compared to budget:



Total General Fund expenditures for 2014 were \$11,915,443, which was \$437,824 (3.5 percent) under budget. Public Works expenditures were \$128,051 under budget, due mostly to anticipated projects that did not occur in 2014. All other expenditures were \$200,323 under budget, mainly due to capital outlay that was conservatively budgeted for, but some projects didn't occur.

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



Total General Fund expenditures for 2014 were \$841,979 (7.6 percent) higher than the previous year. General government and all other expenditures increased by \$135,859 and \$545,023, respectively. General management increases were mainly for technology and personal. All other increases were mainly for capital outlay for technology, parks, and economic development.

## ENTERPRISE FUNDS OVERVIEW

The City maintains a number of enterprise funds to account for services the City provides that are financed primarily through fees charged to those utilizing the service. This section of the report provides you with an overview of the financial trends and activities of the City's enterprise funds, which includes 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, 2014, presented by both classification and by fund:

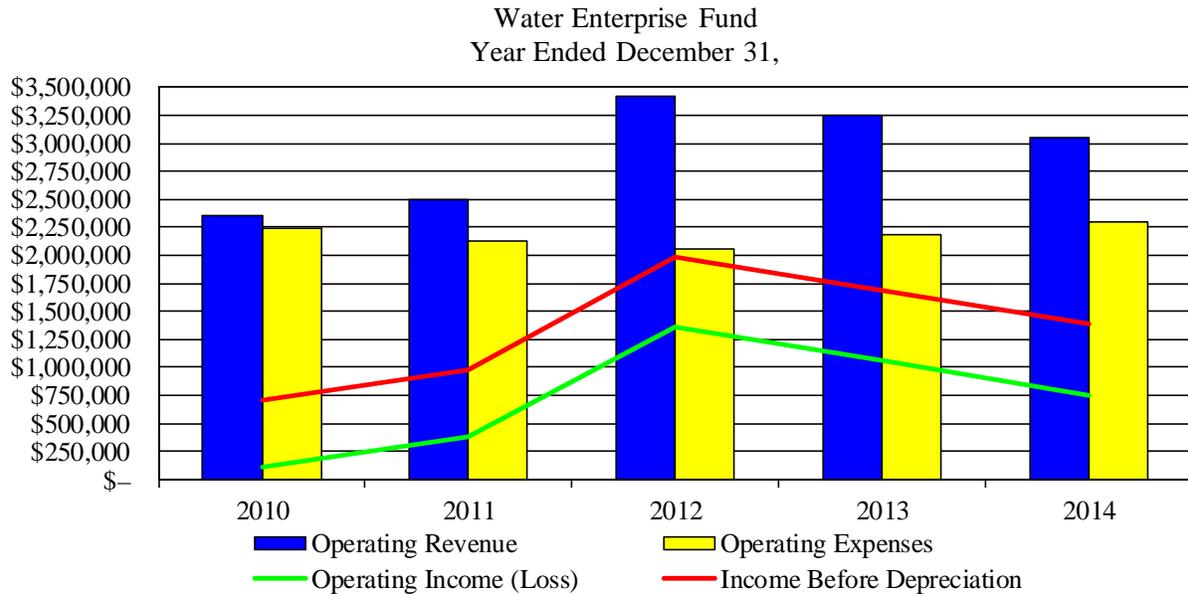
<b>Enterprise Funds Change in Financial Position</b>			
	Net Position as of December 31,		Increase (Decrease)
	<u>2014</u>	<u>2013</u>	
Net position of enterprise funds			
Total by classification			
Net investment in capital assets	\$ 46,627,184	\$ 45,640,328	\$ 986,856
Unrestricted	<u>6,415,575</u>	<u>7,569,891</u>	<u>(1,154,316)</u>
Total – enterprise funds	<u>\$ 53,042,759</u>	<u>\$ 53,210,219</u>	<u>\$ (167,460)</u>
Total by fund			
Water	\$ 31,192,000	\$ 30,748,974	\$ 443,026
Sewer	20,348,812	19,869,373	479,439
Water Quality	1,501,947	970,672	531,275
Transit	<u>–</u>	<u>1,621,200</u>	<u>(1,621,200)</u>
Total – enterprise funds	<u>\$ 53,042,759</u>	<u>\$ 53,210,219</u>	<u>\$ (167,460)</u>

### 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, 2014, this fund had assets totaling \$537,883 while liabilities totaled \$929,153, leaving a deficit net position balance of (\$391,270). 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 five years of comparative operating results for the City's Water Fund:



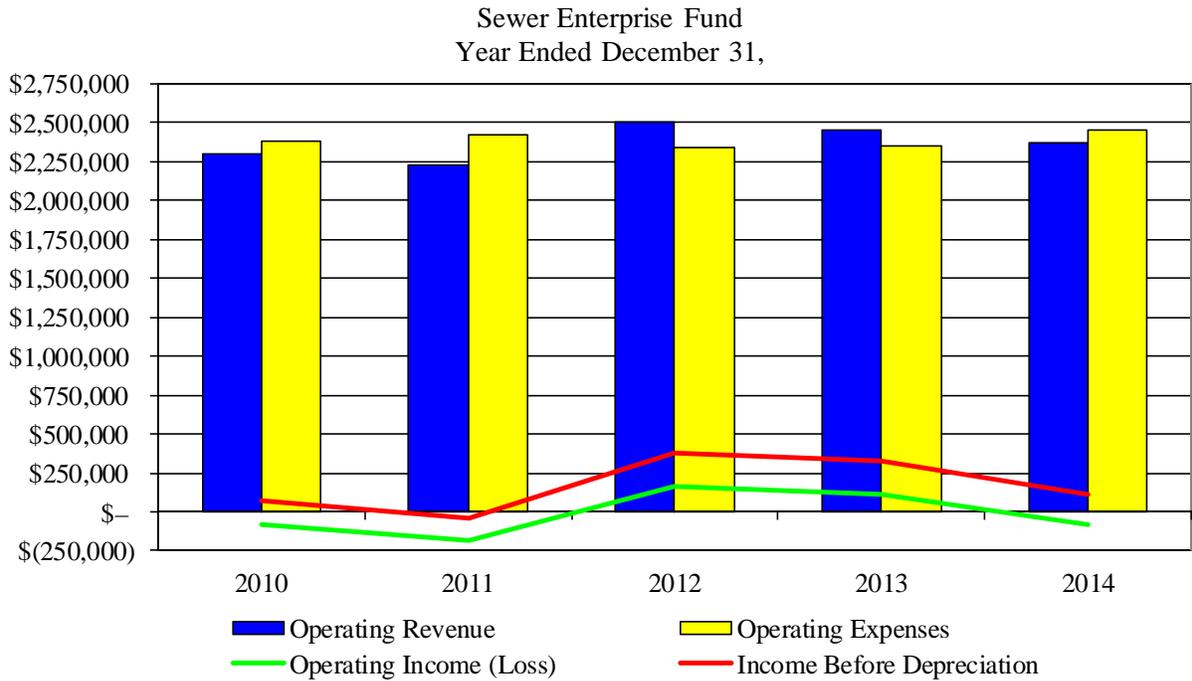
The Water Fund ended 2013 with net position of \$31,192,000, an increase of \$443,026 from the prior year. Of this, \$27,885,997 represents the investment in capital assets, leaving \$3,306,003 in unrestricted net position. The Water Fund had transfers out totaling \$1,306,350 in fiscal 2014 to support other funds, pay debt service, and provide for construction projects.

Operating revenue in the Water Fund was \$3,051,682, a decrease of 6.0 percent from the prior year. This decrease was due to a combination of increased rates and a decrease in water usage in fiscal 2014 due to major flooding in the area during the spring.

Water Fund operating expenses for 2014 were \$2,297,197, an increase of \$108,652 (5.0 percent) from the previous year. The largest factor contributing to the change was an increase in utilities of \$151,299.

**SEWER ENTERPRISE FUND**

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

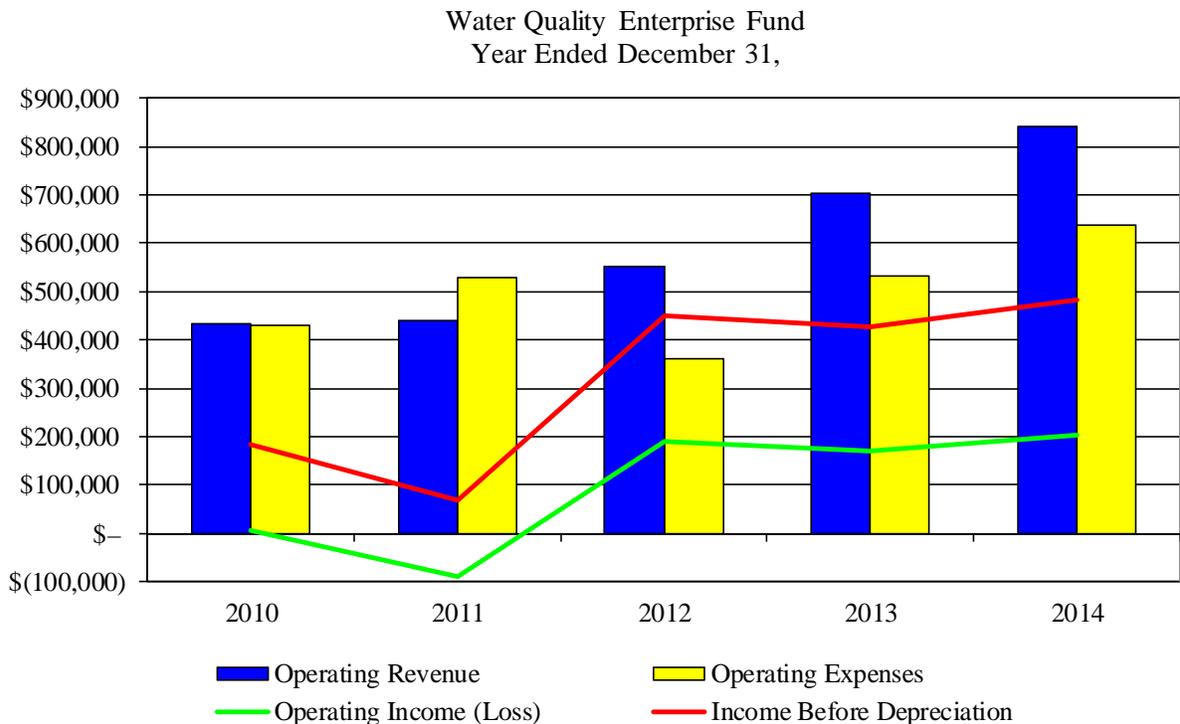


The Sewer Fund ended 2014 with net position of \$20,348,812, an increase of \$479,439 from the prior year. Of this, \$17,837,354 represents the City’s investment in capital assets, leaving \$2,511,458 in unrestricted net position. The Sewer Fund had transfers out totaling \$502,086 in fiscal 2014 to support other funds, pay debt service, and provide for construction projects.

Operating revenue in the Sewer Fund was \$2,369,423, a decrease of \$84,009, or 3.4 percent, from the prior year, mainly related to decreased usage. Sewer Fund operating expenses for 2014 were \$2,447,618, an increase of \$102,451, or 4.4 percent, from the previous year due to an increase in personal services needs.

## WATER QUALITY ENTERPRISE FUND

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



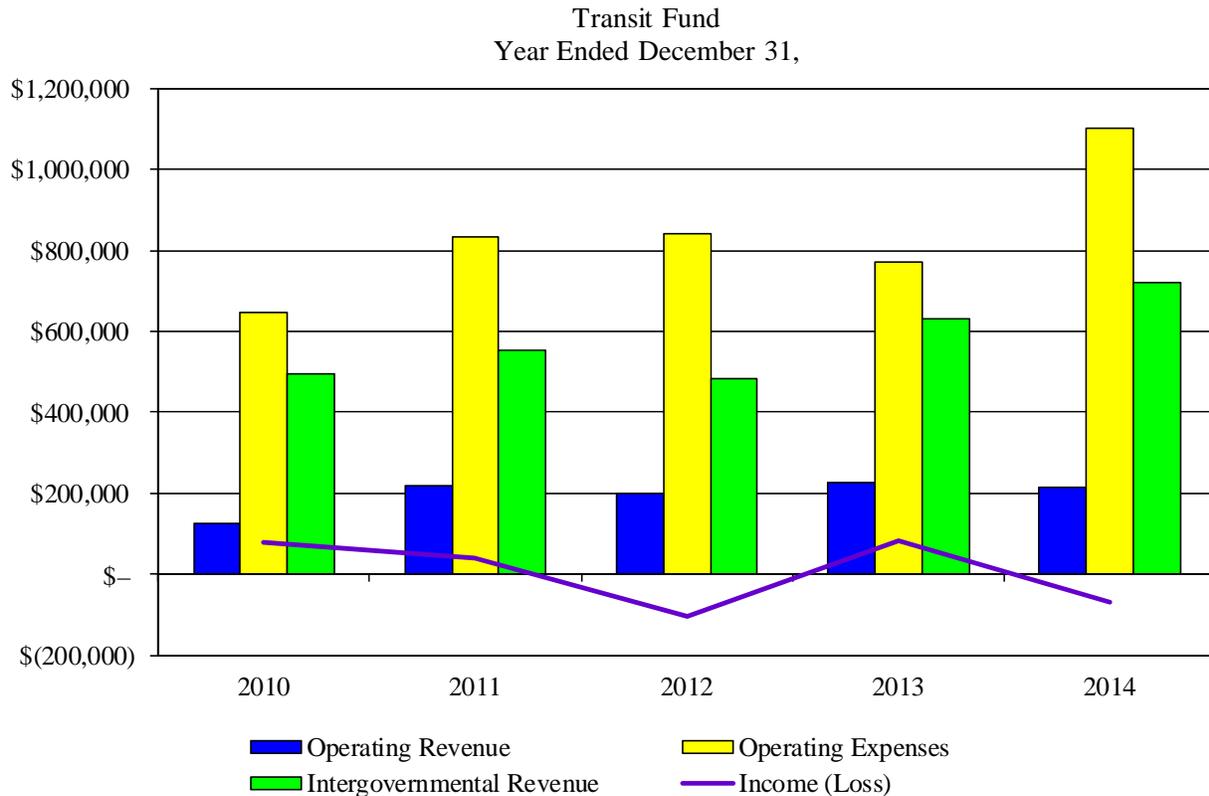
The Water Quality Fund ended 2014 with net position of \$1,501,947, an increase of \$531,275 from the prior year. Of this, \$903,833 represents the investment in capital assets, leaving \$598,114 in unrestricted net position.

Operating revenue in the Water Quality Fund was \$843,292, an increase of \$140,763, or 20.0 percent, from the prior year due to an increase in the rates in fiscal 2014. Water Quality Fund operating expenses for 2014 were \$638,570, an increase of \$106,062, or 19.9 percent, from the previous year, due mostly to increased repairs and maintenance needs.

State and federal grant income, which is not included in the table above, totaled \$162,041 in fiscal 2014. After including this revenue, the Water Quality Fund reflected income before contributions and transfers of \$387,865.

## TRANSIT FUND

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



Operating revenue in the Transit Fund was \$215,138, a decrease of \$10,060, or 4.5 percent, from the prior year. Transit Fund operating expenses for 2014 were \$1,099,899, an increase of \$327,192 from the previous year.

Most of the funding for the transit services came from other governmental units and their revenue is reported in the nonoperating revenue category. State and federal grant income totaled \$721,038 in fiscal 2014.

During the year ended December 31, 2014, the City transferred the responsibility for operating a transit operation to the Minnesota Valley Transit Authority (MVTA). As part of transferring this responsibility, the City is required by Minnesota Statutes to transfer the remaining assets, liabilities, and net position to the MVTA as well. The transfer of the assets, liabilities, and net position to the MVTA is reported as a special item in the Statement of Activities and the Statement of Revenues, Expenses, and Changes in Net Position on the date the MVTA becomes obligated for the operation transferred.

The special item – transfer of operation reported in the City's financial report totaled \$1,371,480.

## 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 capital assets, restricted, and unrestricted.

The following table presents the components of the City's net position as of December 31, 2014 and 2013, for governmental activities and business-type activities:

	As of December 31,		Increase (Decrease)
	2014	2013	
Net position			
Governmental activities			
Net investment in capital assets	\$ 87,398,664	\$ 81,787,853	\$ 5,610,811
Restricted	4,950,822	6,069,035	(1,118,213)
Unrestricted	<u>14,190,355</u>	<u>14,320,281</u>	<u>(129,926)</u>
Total governmental activities	106,539,841	102,177,169	4,362,672
Business-type activities			
Net investment in capital assets	46,627,184	45,640,328	986,856
Unrestricted	<u>6,415,575</u>	<u>7,569,891</u>	<u>(1,154,316)</u>
Total business-type activities	<u>53,042,759</u>	<u>53,210,219</u>	<u>(167,460)</u>
Total net position	<u>\$ 159,582,600</u>	<u>\$ 155,387,388</u>	<u>\$ 4,195,212</u>

The City's total net position at December 31, 2014 was \$4,195,212 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 capital outlay activity during fiscal 2014.

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, 2014 and 2013:

	2014		2013
	Expenses	Program Revenues	Net Change
Net (expense) revenue			
Governmental activities			
General government	\$ 3,557,910	\$ 740,969	\$ (2,816,941)
Public safety	5,230,546	2,209,341	(3,021,205)
Public works	4,227,440	5,614,905	1,387,465
Culture and recreation	2,229,987	444,198	(1,785,789)
Economic development	535,955	175,480	(360,475)
Interest on long-term debt	1,185,474	–	(1,185,474)
Business-type activities			
Water	2,297,197	3,371,419	1,074,222
Sewer	2,447,618	2,625,926	178,308
Water quality	638,570	1,005,333	366,763
Transit	1,099,899	936,176	(163,723)
Total net (expense) revenue	<u>\$ 23,450,596</u>	<u>\$ 17,123,747</u>	(6,326,849)
General revenues			
Taxes			10,518,306
Unrestricted grants and contributions			52,555
Investment earnings (losses)			1,112,257
Other revenues			210,423
Special item – transfer of operations			(1,371,480)
Total general revenues			<u>10,522,061</u>
Change in net position			<u>\$ 4,195,212</u>
			<u>\$ 7,229,062</u>

One of the goals of this statement is to provide a side-by-side comparison to illustrate the difference in the way the City's governmental and business-type operations are financed. The 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

The 2014 legislative session began with a projected budget excess for the remainder of the biennium of \$1.09 billion, later revised upward to a projected excess of \$1.23 billion in the February 2014 economic forecast. The Legislature utilized a portion of the projected excess to bolster the state's financial condition; repaying \$246 million "borrowed" from K-12 education through previous financing shifts, and using \$150 million to replenish the state "Rainy Day Fund" budget reserve. The Legislature also approved increases to future funding for local government aid, and expanded the sales tax exemption approved for cities in 2013 to include joint powers entities and other instrumentalities of local government.

The following is a summary of recent legislation affecting Minnesota cities in 2014 and into the future:

**Local Government Aid (LGA)** – The 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 simplified the LGA calculation, and reduced the volatility of the LGA distribution by limiting the amount it may decline in a given year. Under the new formula, the minimum LGA 2014 distribution for each city was an amount equal to their 2013 LGA. Beginning in 2015, any reduction to a city's calculated 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 was \$507.6 million for fiscal 2014, \$516.9 million for 2015, and \$519.4 million for fiscal 2016 and thereafter.

**Sales Tax Exemption** – Cities are exempted from paying sales tax on qualifying purchases, effective for purchases made on or after January 1, 2014. Purchases of goods or services by an exempt local government for a publically provided liquor store, gas or electric utility, golf course, marina, campground, café, laundromat, solid waste hauling or recycling operation, or landfill will remain taxable. The definition of "cities" for this statute include both home-rule and statutory cities.

The 2014 Legislature extended the definition of tax exempt local government to include all special district; city, county, or township instrumentalities; economic development authorities; housing and redevelopment authorities; and all joint power boards or organizations. However, this expanded exemption list is not effective until January 1, 2016.

**Proposed Property Tax Levy Certification Date** – The deadline for cities to certify their proposed annual tax levies was extended from September 15 to September 30.

**Agricultural Homestead Market Value Credit** – The rate of agricultural homestead market value was increased to a maximum of \$490 at a market value of \$270,000 and over.

**Capital Investment Act Requirements** – The Legislature approved capital improvement projects totaling about \$1.1 billion under two separate capital investment (bonding) acts. Both require that, to the extent practicable, a public entity receiving an appropriation of public money for a project under these acts must assure those facilities are built with American-made steel.

**Authority to Inspect Public Buildings and State-Licensed Facilities** – A formal delegation process was established that must be used by the state Department of Labor and Industry (DLI) when delegating the authority to inspect public buildings and state-licensed facilities to local building officials. The new provisions did not alter the circumstances under which the DLI is required to delegate this authority in most circumstances, only the process to be followed. However, for certain smaller construction projects designated as "reserved projects," the DLI is now required to delegate inspection authority to any municipality with a designated building official without going through the formal delegation process.

**Open Meeting Law** – A change was made to the Open Meeting Law to clarify that the use of social media by members of a public body does not violate the Open Meeting Law if the use is limited to exchanges open to the public. The new statute specifically excludes email but does not otherwise define the term social media.

**Deputy Registrar Residency** – The statutory requirement that an individual appointed as deputy registrar for a statutory or home-rule charter city be a resident of the county in which the city is located was repealed.

**Local Campaign Finance** – Changes were made to increase the campaign contribution limits for local elections. For candidates in a territory with a population of 100,000 or less, the contribution limits were raised to \$600 in an election year and \$250 in a non-election year. For candidates in a territory with a population over 100,000, the limits were raised to \$1,000 in an election year and \$250 in a non-election year. In addition, all campaign finance reports required to be filed with a local government must now be published on the local government's website, if the local government maintains a website.

**Data Practices** – Several changes were made to address unauthorized access of private data by public employees, requiring local governments to: establish security measures to help ensure private data is only accessible to public employees whose work assignment reasonably requires access to the data, and that the data is only being accessed by those individuals for the purposes of their work assignment; follow the data breach reporting requirements that were previously only applicable to state agencies; and perform annual security assessments of personal information maintained by the entity. The statute also states that accessing private data without authorization is a misdemeanor, and willful violation by a public employee constitutes just cause for suspension without pay or dismissal.

**Part-Time Peace Officers** – A change in the statutes now prohibits law enforcement agencies from hiring new part-time peace officers, existing part-time peace officers from transferring to new agencies, and the Peace Officer Standards and Training Board from licensing new part-time peace officers. Part-time peace officers that are currently employed may continue to serve indefinitely with their current employer, but must turn in their license upon leaving their current place of employment or otherwise becoming unemployed.

**Responsible Contractor Requirement** – Contractors who bid on public contracts in excess of \$50,000 are now required to certify that they are a “responsible bidder” in order to be awarded a contract as the lowest responsible bidder or best value alternative. A responsible contractor must be in compliance with various state and federal requirements for income tax, workers’ compensation, unemployment insurance, minimum wage, and safety. City solicitations for bid must include: the definition of “responsible contractor,” which may include criteria in addition to the statutory requirements established by the city, or reference to the statutory definition; a statement that a contractor failing to meet the criteria or verify compliance is ineligible to be awarded or perform work on the contract; a statement that submitting a false verification renders the contractor ineligible and can result in termination of the contract; and a statement requiring the contractor to provide copies of verification forms for all subcontractors upon request. Cities are not obligated to verify any of the information in the contractor verification; and have no liability if reasonably relying on the certification when awarding the contract, or declining to award the contract based on a reasonable determination that a contractor failed to verify compliance.

**Disaster Assistance Contingency Fund** – A new state account was created to provide emergency cash flow for local governments located in counties declared federal disaster areas. The fund may be used to meet non-federal fund matching requirements to speed the availability of federal funds.

**Pensions** – A number of changes to the Public Employees Retirement Association (PERA) General Plan were adopted, including:

- The minimum salary threshold for inclusion into the PERA General Plan was changed from \$425 in any one month to \$5,100 on any year for non-school employees or \$3,800 in any year for school employees.
- Employers are required to provide written notice to any employee excluded from membership in the PERA General Plan within two weeks of the determination on a form prescribed by the PERA executive director.
- PERA contribution rates for both employees and employers were increased by 0.25 percent of salary effective January 1, 2015.

## ACCOUNTING AND AUDITING UPDATES

### **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 No. 50, as they relate to pensions that are provided through pension plans administered as trusts or equivalent arrangements that meet certain criteria. The requirements of GASB Statement Nos. 27 and No. 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 expenses/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 non-employer 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. 72 – FAIR VALUE MEASURE AND APPLICATION**

GASB Statement No. 72 addresses accounting and financial reporting issues related to fair value measurements. The requirements of this statement are intended to enhance comparability among government financial statements by requiring certain assets and liabilities be reported at fair value, using a consistent definition of fair value and accepted valuation techniques. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2015, with earlier application encouraged.

GASB Statement No. 72 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are generally assumed to take place in the government's principal or most advantageous market, taking into account the highest and best use for a nonfinancial asset, and assuming market participants would act in their economic best interest. The statement requires a government to use measurement techniques that are appropriate under the circumstances and for which sufficient data are available to measure fair value; consistent with a market, (replacement) cost, or income approach. It also establishes a hierarchy of inputs to be used in valuation techniques.

The statement establishes or clarifies the applicability of fair value measurement for certain assets and liabilities. Fair value is generally required for investments, defined as securities or other assets held primarily for the purpose of generating income, or which have a present service capacity based solely on their ability to generate cash. The statement requires measurement at acquisition value for donated capital assets, donated works of art, historical treasures, and capital assets received through a service concession arrangement. The statement also outlines the required financial statement disclosures about fair value measurements, valuation techniques, and the hierarchy of inputs used for valuation.

#### **CHANGES TO REQUIREMENTS FOR FEDERAL GRANTS**

In December 2013, the 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 from \$500,000 to \$750,000; changes to the thresholds and process used for determining major programs; reductions in the percentages of expenditures required to be covered by a Single Audit from 50 percent to 40 percent for high-risk auditees and from 25 percent to 20 percent for low-risk auditees; revised criteria for determining low-risk auditees; and an increase in the threshold for reporting questioned costs from \$10,000 to \$25,000. Auditees are required to implement the administrative requirements of the new “Super Circular” by December 26, 2014. The revised audit requirements will be effective for fiscal year 2015 city audits, with an optional one-year grace period for implementing the new procurement standards included in this guidance.

## **COSO INTERNAL CONTROL FRAMEWORK**

The clarified auditing standards applicable to governmental audits incorporate a definition of internal control that is based on the internal control integrated framework developed and issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In May 2013, COSO issued an updated framework which supersedes the original after December 15, 2014. The new COSO framework retains the basic definition of internal control and its five components established in its original framework, along with the fundamental requirements to consider these five components and to use judgment when assessing and evaluating the effectiveness of a system of internal controls. The new COSO framework enhances and clarifies a number of concepts from the original framework to make it easier to use and apply. One of the more significant enhancements was the establishment of 17 principles, associated with the 5 components of internal control, intended to assist users in understanding the requirements of effective internal control and designing effective systems of internal control.

The 5 components of internal control and 17 underlying principles are as follows:

### **Control Environment –**

1. Organization demonstrates a commitment to integrity and ethical values.
2. Governing body is independent from management and exercises oversight control.
3. Management establishes structure, reporting lines, authority, and responsibilities.
4. Organization demonstrates a commitment to the competence of individuals involved with internal control.
5. Organization holds individuals accountable for internal control responsibilities.

### **Risk Assessment –**

6. Organization specifies clear objectives for the identification and assessment of risks.
7. Organization identifies and analyzes risk.
8. Organization assesses the potential for fraud risks.
9. Organization identifies and assesses significant changes that could impact internal control.

### **Control Activities –**

10. Organization selects and develops control activities to mitigate risks.
11. Organization selects and develops general IT controls.
12. Organization establishes and implements control policies and procedures.

### **Information and Communication –**

13. Organization uses relevant, quality information to support internal control.
14. Organization communicates internal control information internally.
15. Organization communicates internal control information externally.

### **Monitoring –**

16. Organization conducts ongoing and/or separate internal control evaluations.
17. Organization evaluates and communicates deficiencies to responsible parties for corrective action.

COSO defines an effective system of internal control as one that reduces to an acceptable level the risk of failing to achieve an organizational objective in the areas of operations, compliance, or reporting. According to the new framework, an organization can achieve effective internal control by applying all of the principles listed above. To achieve this, each of these five components and the relevant principles must be present and functioning, and the five components must operate in an integrated manner. Local governments should be reviewing their internal control systems to assure these principles have been incorporated and implemented.