MUSCATINE

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FINANCE & RECORDS

TO: Honorable Mayor and City Council

DATE: December 5, 2012

Iowa law requires that all cities publish within six months of the close of each fiscal year a complete set of financial statements presented in conformity with generally accepted accounting principles (GAAP) and audited in accordance with generally accepted auditing standards by a firm of licensed certified public accountants. Pursuant to that requirement, we hereby issue the comprehensive annual financial report of the City of Muscatine for the fiscal year ended June 30, 2012.

Management assumes full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal control that it has established for this purpose. Because the cost of internal control should not exceed anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements.

McGladrey LLP, Certified Public Accountants, have issued an unqualified ("clean") opinion on the City of Muscatine's financial statements for the year ended June 30, 2012. The independent auditor's report is located at the front of the financial section of this report.

Management's discussion and analysis (MD&A) immediately follows the independent auditor's report and provides a narrative introduction, overview, and analysis of the basic financial statements. MD&A complement this letter of transmittal and should be read in conjunction with it.

The independent audit of the financial statements of the City was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the City's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are included in the compliance section of this report.

Profile of the Government

The City of Muscatine was incorporated in 1851 by a special act of the Iowa State Legislature and is located on the Mississippi River, which is the eastern boundary of the state of Iowa. The City is located 160 miles east of Des Moines, 200 miles west of Chicago, and is the county seat of Muscatine County. The City occupies a land area of approximately 17 square miles and serves a population of 22,886 people. The City is empowered to levy a tax on all property located within its boundaries.

The City operates under the mayor-council form of government and has a City Administrator. Policy-making and legislative authority are vested in a mayor and seven council members. The city council is responsible, among other things, for passing ordinances and resolutions, adopting the budget, appointing committees, and hiring both the City Administrator and the City Attorney. The City Administrator is responsible for carrying out the policies and ordinances of the city council, for overseeing the day-to-day operations of the government, and for appointing the heads of various departments. The council is elected on a non-partisan basis. Council members serve four-year staggered terms and the mayor is elected to serve a two-year term. Five of the council members are elected by district. The mayor and the two remaining council members are elected at large.

The City provides a full range of services including police and fire protection; roadway maintenance; water pollution control; solid waste management; recreational and cultural activities and facilities; and a general aviation airport.

The City Council is required to hold a public hearing on and adopt a budget for each fiscal year no later than March 15th of the preceding year. The annual budget serves as the foundation for the City's financial planning and control. The budget is prepared by function, fund and department. The legal level of control is at the function level. The budget may be amended by resolution of City Council following a required public hearing.

The City's government-wide financial statements include two discretely presented component units. These component units are those entities for which the City is considered to be financially accountable. These entities are the Muscatine County Solid Waste Management Agency (Agency) and Muscatine Power and Water (MP&W). The Agency is comprised of eight governmental entities in Muscatine County and based on the City of Muscatine population, the City accounts for 56% of the board's voting authority. The City Council also approves the Agency's budget, sets its rates and approves any debt issuance. MP&W is a municipal utility which provides water, electric, and communications services within the City of Muscatine and in other areas within Muscatine County. MP&W's governing board is appointed by the Mayor and approved by Council. MP&W provides a financial benefit to the City by providing electricity for City buildings and all street and traffic lighting free of charge to the City. These entities are reported in separate columns in the government-wide statements to emphasize that they are legally separate from the City.

Local Economy

The City of Muscatine has a history of business and industrial development equal to cities of much larger size. Muscatine is the corporate headquarters of HNI Corporation, makers of office furniture. Other major employers located in the Muscatine area include H.J. Heinz LP, food processing; Bridgestone-Bandag, makers of pre-cured tire tread rubber, Monsanto Company, herbicides and plastics; Raymond-Muscatine, front-end loaders, etc.; Muscatine Foods Corporation, corn distillates and feed; Stanley Consultants Inc., consulting engineers and architects; and Musco Sports Lighting LLC, sports lighting systems. The presence of many diverse companies has provided the Muscatine economy with economic stability and employment security for many years. Unemployment rates over the past ten calendar years ranged from 3.2% to 8.1% with the rate for 2011 at 6.4%. Prior to 2009, 2010, and 2011 when the rates were 8.1%, 7.6%, and 6.4%, respectively, the highest previous rate was 4.6% in 2008. The recent higher rates are attributed to the local effect from the national economy. Muscatine Power and Water, the City of Muscatine's municipal light, water, and communications utility, operates the largest municipal power plant in the State of Iowa. This plant provides for abundant supplies of low cost electricity.

The City's Water Pollution Control Plant has undergone renovation over the years and currently has the capacity to triple the volume of wastewater it treats with only marginal increases in operating expenditures. The City operates a general aviation airport and has excellent railroad service provided by the Canadian Pacific Railroad.

All of these elements provide an excellent atmosphere for continued economic stability and growth.

Long-term Financial Planning

On May 10, 1994, the citizens of Muscatine first voted to implement a 1% local option sales tax for the purpose of funding storm and sanitary sewer renovation and extension projects. The tax was imposed effective July 1, 1994, for a five-year period. Voters approved continuation of the local option sales tax for two subsequent 5-year periods through June 30, 2009. This tax was used primarily for storm and sanitary storm sewer projects with the exception of 10% that was allocated to the Pearl of the Mississippi project from May 1, 2003 through June 30, 2009. The 1% local option sales tax generated over $2.6 million in the most recent year.

In 2008 the City held an election for the continuation of this tax. The ballot question approved by voters extended this tax for an additional ten years (though June 30, 2019) with up to 20% of the proceeds to be used for the City's Pavement Management Program with the remaining 80% to be used for storm and sanitary sewer improvement projects. Future sewer projects have been identified including those required by an Order for Compliance on Consent issued by the United States Environmental Protection Agency (E.P.A.). Provisions of the Order require the City to complete separation of the combined sewers in the Hershey Avenue area by December 31, 2011, and separation for the remaining combined portions of the sewer system including the West Hill area by December 31, 2024. The City recently received approval from the E.P.A for extension of this completion deadline for the multi-phase, multi-year West Hill area sewer separation to December 31, 2028. The Hershey Avenue Sewer Separation project was completed in 2011/2012 and the contract for the first phase of the West Hill Sewer Separation project was awarded in May of 2012. The election to continue the local option tax again received strong support by voters.

The City began a comprehensive Pavement Management Program in 2007. Allocations totaling over $5 million funded the initial upgrade of streets throughout the City. These improvements were substantially completed by June 30, 2010. The initial costs of this program were funded with general obligation bond proceeds. Annual allocations to maintain all streets at this higher level began in 2010/2011 with funding from the 20% allocation of local option sales tax. This 20% allocation was $531,100 in 2011/2012. In addition to street improvements funded from local option sales taxes, engineering design is currently underway for major improvements to both Cedar Street and Colorado Street. Those projects will be funded from federal grants and general obligation bond proceeds.

The City continues to complete improvements at the municipal airport as part of the long range plan for this facility. In 2011/2012 construction of the hangar access road and improvements to the municipal hangar and T-hangars were completed. Construction was also underway on the runway lighting improvement project. Projects for the upcoming year include completion of the airport runway lighting project, airfield maintenance, and the airport hangar access security and T-hangar drainage project.

Since 2003/2004 the City has made operational changes to address funding reductions to the City's General fund as a result of reductions in funding from the State of Iowa which began in

2003/2004 and continued in 2004/2005. The state eliminated approximately $360,000 in annual funding to the City of Muscatine beginning in 2003/2004 and an additional $70,000 annually was eliminated in 2004/2005. In response to these reductions, the City made a number of significant budget changes which included personnel reductions, funding transfers and consolidation of services. Full-time equivalent employees of the City are fifteen (15) less than what was included in the original 2003/2004 budget. Nine (9) of these positions were eliminated when the City of Muscatine and Muscatine County combined their emergency dispatch services effective in September, 2004. Both entities have and will continue to benefit both financially and operationally by combining their dispatch services.

A key issue in the development of the 2010/2011 budget was the consideration of and ultimate adoption of a Utility Franchise Fee on Alliant Energy, the provider of natural gas to the community. The ordinance change adopting this fee provides that the fee may be up to 5% on natural gas sales by Alliant in the community. The initial rate was set at 2% which was effective July 1, 2010. Implementation of this fee allowed for a reduction in the City's property tax rate for 2010/2011 and future years. The establishment of this fee allowed the City to diversify its funding sources used for the provision of General Fund services and reduce the City's property tax rate. With this franchise fee in place for up to 5% of gas sales, this also allows flexibility in future years for the City Council to modify this rate if needed to continue to provide expected levels of City services to residents. This rate can be modified by giving a 90-day notice to Alliant Energy. For the 2012/2013 year City Council chose to reduce the Utility Franchise Fee rate to 1% which is projected to generate $112,500. This reduction was possible since there have been strong revenues in other areas of the General Fund budget, specifically Automatic Traffic Enforcement (ATE) fines, fees for Fire department inspections and permits, and increased hotel/motel taxes.

The City made a number of structural and operational changes in 2010/2011 in an effort to place the General Fund in a better financial position for 2011/2012 and future budget years. These included (1) a reduction of one full-time position in the Park Maintenance budget; seasonal staff was increased to partially offset this reduction for a net savings of $49,300, (2) elimination of one full-time custodian position with contract cleaning services partially offsetting the cost savings for a net savings of $7,400, (3) funding economic development administrative costs and the Chamber economic development allocation with Tax Increment Financing (TIF) funds (a total of $137,500 in 2011/2012), (4) not filling the budgeted ¾ time Automatic Traffic Enforcement (Red Light Camera) Technician in the Police department net of the cost of creating an additional sergeant position for this function ($30,000 savings), and (5) transferring the dredge operation to the Water Pollution Control fund ($42,000 General Fund savings). These items total $266,200 which provided a positive impact on the General Fund for 2011/2012 and will continue to have a positive impact on the General Fund in future years.

Additional changes implemented in 2011/2012 focused on department efficiencies and cost savings including (1) using sponsorships for the Parks seasonal brochure and Golf score cards saving $4,700 annually; (2) the new eleven foot mower in the Parks department and trackhoe for grave digging at the Cemetery both saved man hours that were redirected to other functions in those divisions; (3) additional Park sites were "adopted" under the "Adopt a Park" program with this program expanding from four sites in 2010 to eleven in 2011; (4) redesigning the Library circulation system process eliminating a 35-hour/week position and creating a new 30-hour/week "Holds" person at a lower pay rate for a savings of $17,800; (5) using staggered work times in the Police investigations division which reduced overtime and call-ins saving an estimated $3,500 in overtime costs annually; (6) activities in the Engineering (engineering design for smaller projects), Community Development (Comprehensive Plan update), and Art Center (printing) were done in-house rather than under contracts resulting in varying amounts of cost savings; (7) using

inmate labor to clear the Airport fence line of unwanted growth saved an estimated $22,000; and (8) the use of automatic traffic enforcement cameras has allowed the Police department to re-direct their time to other areas of law enforcement.

Departments will continue to look for efficiencies and cost savings in their operations in 2012/2013 and future years. The City's goal for the upcoming year of establishing a formal "Lean" program will assist departments in identifying and implementing efficiencies and cost savings applicable to their department operations. With limited financial resources expected to be available in future years and a growing demand for municipal services, the City must continue to take significant steps to enhance revenue streams as well as reduce expenditures where appropriate to meet these challenges.

Relevant Financial Policies

The City's budget policies provide that the City's unreserved General Fund balance be at least 10% of budgeted General Fund expenditures. The City implemented Governmental Accounting Standards Board (GASB) Statement No. 54 in 2010/2011. This Statement provided for the following new classifications of governmental fund balances: nonspendable, restricted, committed, assigned, and unassigned. The unassigned portion of the General Fund balance is similar to the previous classification of unreserved balance referenced in the City's financial policies. The unassigned General Fund balance at June 30, 2011 was $2,141,534 which was 14.3% of General Fund expenditures. The unassigned General Fund balance increased to $3,319,319 at June 30, 2012 which is 21.2% of General Fund expenditures. This was an increase of $1,177,785 compared to the prior year unassigned balance. The City has been striving to increase the General Fund balance in recent years over the minimum required by the City's financial policies. The General Fund balance increase is attributed to several categories of revenues exceeding their budget estimates and most General Fund departments operating under their budget allocations. The major revenue sources which exceeded their budget estimates included building permits and related fees ($56,787 over the budgeted amount), parks and recreation fees ($69,575 over the budget estimate with most of this increase from the Aquatic Center due to the very hot and dry summer), automatic traffic enforcement fines ($133,887 over the estimate), and court fines ($48,187 over the estimate).

For the 2012/2013 budget, taxable property values increased by 2.8% which will provide $173,971 more in tax funding from the general fund tax levy which has been at the maximum rate of $8.10 per $1,000 of valuation in all recent years. There was growth in residential property valuations of 5.4%. Commercial property valuations, however, increased by only .5% and industrial property valuations decreased for 2012/2013 by .9% due to revaluation of these properties by the County Assessor.

As noted in the previous section, beginning in 2010/2011 the City implemented a 2% utility franchise fee on the provider of natural gas services in the community. This fee will decrease to 1% for 2012/2013. The availability of this new revenue source will assist in continuing to fund the City's core General Fund services to the community. This fee is budgeted to generate $112,500 in the upcoming 2012/2013 fiscal year. As noted above, this fee may be increased up to 5% by City Council action with a 90-day notice to the utility.

The City continues to claim less than the full amount of incremental taxes available from the Downtown and Southend Tax Increment Financing (TIF) areas. As growth in valuations in these areas has exceeded original projections, balances have been accumulating in these funds in advance of the debt schedules in effect. Not claiming the full amount allows a portion of the

increased values in each area to go back onto regular taxable valuations of all taxing entities affected. Approximately $532,000 of incremental taxes were not claimed by the City for 2011/2012 and this amount is estimated at $519,000 for 2012/2013. This results in increased regular taxable values and increased taxes generated by the $8.10 General Fund levy.

The effects of the changes implemented by City Council in 2010/2011 and 2011/2012 as well as those implemented in previous years in reducing the General Fund workforce, combining services with Muscatine County, and claiming less than the full amount of incremental taxes will continue to be realized in future years. These changes as well as the implementation of the utility franchise fee beginning in 2010/2011 have placed the City in a more favorable position to address funding requirements for the provision of General Fund services in future years.

Major Initiatives

The City continues to strive to make significant capital improvements to the City's infrastructure and facilities. Major budget initiatives for 2012/2013 include (1) completion of engineering design and starting construction for major improvements to Cedar Street, and Colorado Street; (2) construction on the first phase of the multi-year, multi-phase West Hill separation project with the first phase scheduled to be completed late in 2013; (3) final engineering design for the second phase of the West Hill Sewer Separation project; (4) completion of the Mad Creek Sewer Extension project in conjunction with the voluntary annexation of 400 acres of property including a mobile home park in the northeast section of the city; and (5) replacement of the fairway irrigation system at the golf course.

Awards and Acknowledgements Updated

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Muscatine for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2011. This was the 18th consecutive year that the City has received this prestigious award. In order to be awarded a Certificate of Achievement, the City published an easily readable and efficiently organized CAFR. This report satisfied both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current CAFR continues to meet the Certificate of Achievement program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

In addition, the City has also received the GFOA's Distinguished Budget Presentation Award for its annual budget document for fiscal year 2012/2013. In order to qualify for the Distinguished Budget Presentation Award, the City's budget document was judged to be proficient in several categories, including as a policy document, a financial plan, an operations guide, and a communications device. The award for the 2012/2013 budget was the 28th consecutive year that the City of Muscatine has received the GFOA's Award for Distinguished Budget Presentation. The GFOA's Distinguished Budget Presentation Award is good for a period of one year. The City of Muscatine plans to submit its budget document for the 2013/2014 fiscal year to the GFOA to again be considered for this award.

In regard to the preparation of this report and the accounting activity throughout the year in the Finance Department, we would like to express our appreciation to all members of this department for their assistance and contributions for this endeavor. Also appreciated is the continued interest and support by the members of the City Council in planning and conducting the financial operations of the city in a responsible and prudent manner in these times of limited resources and ever-increasing demands. Lastly, we would extend our appreciation to McGladrey LLP, Certified Public Accountants, for their assistance and suggestions in regard to the preparation of the Comprehensive Annual Financial Report.

Respectfully submitted,

Gregg Mandsager
City Administrator

Nancy A. Lueck
Finance Director