

October 31, 2006

Honorable Mayor and City Councilmen:

The *Comprehensive Annual Financial Report* (CAFR) of the City of Midland for the year ended June 30, 2006 is hereby submitted. The report represents a comprehensive and detailed picture of our financial transactions during fiscal year 2005-06 and the financial condition of the various funds as of June 30, 2006. The City is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures. To the best of our knowledge and belief, the data as presented is accurate in all material respects and is reported in a manner that fairly sets forth the financial position and results of operations of the various funds of the City.

In 1999, the Governmental Accounting Standards Board (GASB) issued Statement No. 34, which significantly changed the contents and format of municipal financial statements. GASB Statement No. 34 was developed to promote comparability between various units of government and to demonstrate the operational, as well as the fiscal, accountability of each municipality. Prior to GASB No. 34, municipalities reported only on the fund basis. This demonstrated to the financial statement user that the municipality met its responsibility to the public and all legal requirements in the short term, usually a year or a budget cycle. With the adoption of GASB No. 34, a municipality must also include full accrual government-wide financial statements. The purpose of these statements is to demonstrate the operational accountability of the municipality, which refers to the government's responsibility to assure that it is currently meeting, and can continue to meet, operational objectives into the foreseeable future. The accompanying report is in compliance with the new format requirements of GASB No. 34.

The CAFR was prepared to meet the needs of a broad spectrum of financial statement readers and is divided into the following major sections:

Introductory Section: This section introduces the reader to the City of Midland and to this report. Included are this transmittal letter with continuing disclosure reporting enhancements, the City's organizational chart, and a list of principal officials.

Financial Section: The independent auditor's report, management's discussion and analysis letter, government-wide financial statements, combined fund financial statements (together with reconciliations between the government-wide governmental activities and the fund-based governmental funds), and notes to the financial statements are included here.

These are the City's basic financial statements and provide an overview for readers who require less detailed information than is contained in the balance of the report. In addition, required supplemental information and other supplemental information are provided for those readers who require more detailed information.

Statistical Section: Although this section contains substantial financial data, these schedules differ from financial statements in that they present some non-accounting data, cover more than the current year, and are designed to reflect social and economic data, financial trends, and the fiscal capabilities of the City.

Profile of the City

The City of Midland was incorporated in 1887. Located near the center of the eastern portion of Michigan's lower peninsula, approximately 120 miles northwest of Detroit, the City currently occupies a land area of 35.7 square miles and, according to the 2000 Census, serves a population of 41,685. The City is empowered to levy a property tax on both real and personal properties located within its boundaries. It is also empowered to extend its corporate limits by annexation, which occurs periodically in accordance with state statute and the terms of urban cooperation agreements between the City and its surrounding townships.

The City Charter calls for a council-manager form of government. The governing body consists of five council members who are elected on a non-partisan basis, one from each of the City's five wards and who in turn choose one of their number to serve as mayor. The City Manager and City Attorney are appointed independently by the City Council. The City Manager is responsible for carrying out the policies and ordinances of the City Council, for overseeing the day-to-day operations of the City, and for appointing heads of the various departments and all other City employees. The City Attorney oversees all legal matters of the City, including review of contracts and legal documents. An organization chart is included to better illustrate the City's governmental structure.

The City provides a full range of services including police and fire protection, community planning and zoning, building inspections, code enforcement, library, sanitation, water and wastewater treatment, construction and maintenance of highways, streets, and infrastructure, recreation programs, parks, public transportation, and cultural facilities.

Economic Condition and Outlook

The economic environment of the City has remained steady, despite the difficult economic conditions that the State of Michigan and neighboring communities face. Historically, the City has been recognized as a community that offers its residents many economic, cultural, recreational, and educational benefits. Today these benefits remain as promising as ever, thanks in large part to the growth the area continues to experience.

Much of past economic development has focused on the commercial and industrial sector's growth through The Dow Chemical Company and Dow Corning Corporation.

While both companies are still the major influences, with enough undeveloped land within their fences to expand further, there has also been an increased effort spent on attracting and accommodating other firms. This emphasis upon diversifying the economic base reflects a broader development strategy, which is expected to continue into the future.

Tax base and/or employment in the City is also provided by a cogeneration power plant facility, small-to-medium manufacturing companies, retail and service establishments, a regional health care organization, state and local educational institutions, financial institutions, and local government. The City's June 2006 unemployment rate of 4.2 percent compares favorably to the state's average rate of 6.5 percent and the national average of 4.8 percent.

The largest single revenue source is property taxes. The City's tax base has shown steady growth historically, averaging 2 percent over the past five years. In recent years that growth rate has slowed, actually decreasing by 6/10 of 1 percent for the 2005-06 fiscal year. The City's tax base is approximately 35 percent residential and 65 percent commercial, industrial, and utility. The commercial, industrial, and utility sector is comprised of administrative, research, and production facilities of two large chemical companies, a cogeneration power plant, and a variety of other industries and businesses. The three largest industrial/utility taxpayers make up nearly 50 percent of the City's tax base. The City Charter allows a property tax rate of up to 18 mills, which is then reduced by the Headlee Amendment to 17.87 mills. During the 2005-06 fiscal year, the City levied only 9.17 of its authorized mills. Under applicable state statutes, the City is also authorized to levy up to one additional mill for libraries and up to 3 additional mills for solid waste management.

In 1997, the City's three largest taxpayers filed property assessment appeals, involving approximately 25 percent of the City's total tax base. While two of the three appeals were settled, one in October 2004 and another in November 2006, the largest of the three appeals remains unsettled. Note 17 of the Notes to Financial Statements provides more historical and current information on the City's tax appeals.

Major Initiatives

Fiber Optic Network: The City is part owner of a fiber optic network which connects all City facilities with other area agencies, including the county, local intermediate school district, and other nonprofit agencies.

Civic Arena: In the fall of 2005, the City opened a newly constructed, 107,000 square foot civic arena. The new facility includes two NHL-size rinks, one Olympic-size rink, 12 locker rooms, and seats 1,000 people. The City issued \$6.5 million in bonds and collected \$4.5 million in pledges from area foundations and ice enthusiasts to fund the construction of the facility.

Downtown Streetscape Project: During the year, the City completed a \$1.2 million streetscape project providing new patterned sidewalks, planters, light poles, and other sidewalk amenities to several blocks within the Downtown District. The project was funded by the Downtown Development Authority as part of their long-range capital plan for the Downtown area.

Geographic Information System: During this fiscal year, the City initiated a three-year phased implementation plan to create an integrated, enterprise-wide Geographic Information Systems (GIS) program. GIS will allow its users to request information, such as the location of floodplains, the location of specific water and wastewater lines, or all commercial zoned properties in the city to be displayed in an easy-to-read graphical format on a computer.

Financial Information

Internal Controls: Management of the City is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City are protected from loss, theft, or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal structure is designed to provide reasonable, but not absolute, assurance that these objectives are met.

The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived; and (2) the valuation of costs and benefits requires estimates and judgments by management.

Budget Controls: The annual budget serves as the foundation for the City's financial planning and control. In April of each year, the City Manager presents a proposed budget to the City Council for review. The Council holds public hearings and a final budget must be prepared and adopted no later than the fourth Monday in May. The Council approves appropriations on the functional basis, which is the legal level of control. Expenditures in excess of departmental appropriations are a violation of state law. Amounts not spent by the end of the fiscal year lapse, and require City Council approval to re-appropriate into the next year.

Cash Management Policies and Practices: Cash temporarily idle during the year was invested, as authorized by the City's formal investment policy and Michigan Public Act 20 of 1943, as amended, in certificates of deposit, obligations of the U.S. Treasury, commercial paper, repurchase agreements, and certain investment pools. Maturities of the investments range from 30 days to 18 months, with an average maturity of approximately 90 days. The pension trust fund portfolio also includes common stocks, international stocks, corporate bonds, collateralized mortgage obligations and asset-backed securities. The City's average yield on investments was 4.3 percent, and 9 percent for the pension trust fund. Investment income includes appreciation in the fair value of investments. Changes in fair value during the current year, however, do not necessarily represent trends that will continue; nor is it always possible to realize such amounts, especially in the case of temporary changes in the fair value of investments that the City intends to hold to maturity.

Risk Management: At the beginning of this fiscal year, the City entered into a public entity risk pool with other Michigan units of government by joining the Michigan Municipal League Liability and Property Pool for its general liability and property coverage.

For employee injury claims, the City also participates in a public entity risk pool with other Michigan units of government, the Michigan Municipal Workers' Compensation Pool.

Police and Fire Pension - Defined Benefit Plan: The City sponsors a single-employer, defined-benefit pension plan for its police and fire employees. The City fully funds each year's annual required contribution to the pension plan as determined by an independent actuary. The most recent actuarial valuation, as of December 31, 2005, reports this plan to be 92.4 percent funded. The remaining unfunded amount is being systematically amortized over 20 years as part of the annual required contribution calculation by the actuary.

MERS - Defined Benefit Plan: The City also provides pension benefits that cover substantially all employees hired before July 1, 2005, other than police and fire employees. These benefits are provided through a state-wide plan managed by the Municipal Employees' Retirement System of Michigan (MERS). The City fully funds each year's annual required contribution to the pension plan as determined by an independent actuary. The most recent actuarial valuation, as of December 31, 2005, reports this plan to be 76 percent funded. Effective July 1, 2005, this plan was closed to new employees.

MERS - Defined Contribution Plan: This plan was adopted for non-police and fire employees, hired on July 1, 2005 or later. This plan requires the City to contribute to the plan an amount equal to 5 percent of each participant's gross earnings.

ICMA - Deferred Compensation Plan: The City participates in a deferred compensation plan administered by International City/County Management Association (ICMA) for all eligible employees hired on July 1, 2005 or later, except police and fire employees. The City will match 100 percent of a participant's contribution, up to a maximum of 7 percent of the participant's gross earnings.

Postemployment Health Benefits: The City provides postemployment health care benefits for police and fire employees, and certain other employees and their dependents. Except for police and fire employees, this benefit program was closed to new employees hired after June 30, 2005. As of the end of the current fiscal year, there were 309 retired employees receiving these benefits, which are financed on both a "pay-as-you-go" and "prefunding" basis. GAAP does not yet require the City to report a liability in the financial statements in connection with an employer's obligation to provide these benefits.

MERS - Health Savings Account: This plan is for substantially all employees hired on July 1, 2005 or later, except police and fire employees. The City contributes an amount equal to 2 percent of the participant's wages into a health savings account administered by MERS.

Additional information on the City's pension arrangements and postemployment benefits can be found in Notes 11 and 12 in the notes to the financial statements.

Independent Audit

The City Charter and State statutes require an annual audit of all accounts of the City by certified public accountants. The accounting firm of Plante & Moran, PLLC was selected by the City Council. The City received an unqualified opinion from Plante & Moran, PLLC, which is the best opinion that an organization can receive on its financial statements. Additionally, during the current year, an audit was performed in accordance with the requirements of the Single Audit Act Amendments of 1996. Information and auditor's findings related to the single audit are published as a separate report.

Certificate of Achievement

The Government Finance Officers Association (GFOA) of the United States and Canada awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Midland for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2005. This was the 17th consecutive year that the City has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, which satisfies both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current Comprehensive Annual Financial Report 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.

Acknowledgements

The preparation of this report was made possible by the dedicated service of the entire staff of the Finance Department. Each member of the Department has our sincere appreciation for the contributions made in the preparation of this report.

In closing, the preparation of this document and the accomplishments reported therein would not have been possible without the leadership and support of the Midland City Council.

Respectfully submitted,

Jon J. Lynch
City Manager

David A. Keenan
Director of Fiscal Services