

CITY OF ROCHESTER, MINNESOTA
INTRODUCTORY SECTION
DECEMBER 31, 2005

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ROCHESTER

Minnesota



FINANCE DEPARTMENT
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May 30, 2006

To the Honorable Mayor, Members of the Common Council, and the Citizens of the City of Rochester:

Minnesota statutes require all cities to issue an annual report on its financial position and activity prepared in accordance with generally accepted accounting principles (GAAP), and audited in accordance with generally accepted auditing standards by a firm of licensed certified public accountants or the Office of the State Auditor. Pursuant to that requirement, we hereby issue the comprehensive annual financial report of the City of Rochester for the fiscal year ended December 31, 2005.

This report consists of management's representations concerning the finances of the City of Rochester. Consequently, management assumes full responsibility for the completeness and reliability of all the information presented in this report. To provide a reasonable basis for making these representations, management of the City of Rochester has established a comprehensive internal control framework that is designed both to protect the City's assets from loss, theft, or misuse and to compile sufficient reliable information for the preparation of the City of Rochester's financial statements in conformity with GAAP. Because the cost of internal controls should not outweigh their benefits, the City of Rochester's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

The City of Rochester's financial statements have been audited by Smith, Schafer and Associates, Ltd., a firm of licensed certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of the City of Rochester for the fiscal year ended December 31, 2005, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditor concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the City of Rochester's financial statements for the fiscal year ended December 31, 2005, are fairly presented in conformity with GAAP. The independent auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the City of Rochester 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 available in the City of Rochester's separately issued Single Audit Report.

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GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The City of Rochester's MD&A can be found immediately following the report of the independent auditors.

PROFILE OF THE GOVERNMENT

The City of Rochester, incorporated on August 5, 1858, is located in the southeastern part of the State of Minnesota, which is considered to be one of the top growth areas in the state, and one of the top growth areas in the country. The City currently has a land area of nearly 50.90 square miles and serves a population of 97,191. The City of Rochester is empowered to levy a property tax on both real and personal properties located within its boundaries. It also is empowered by state statute to extend its corporate limits by annexation, which is done periodically when deemed appropriate by the governing council.

The City of Rochester is governed under a charter adopted August 22, 1904. Policy-making and legislative authority are vested in a governing council consisting of the mayor, the council president and six council members. The governing council is responsible, among other things, for passing ordinances, adopting the budget, appointing committees, and hiring both the City's administrator and attorney. The City's administrator is responsible for carrying out the policies and ordinances of the governing council, for overseeing the day-to-day operations of the City, and for appointing the heads of the various departments. The council is elected on a non-partisan basis. Council members, the president and mayor all serve four-year staggered terms, with four of these positions elected every two years. Six of the council members are elected by ward. The mayor and council president are elected at large.

The City of Rochester provides a full range of services including police and fire protection; construction and maintenance of streets and infrastructure; recreational facilities, library and cultural events; water, sewer, electric, public parking, mass transit and airport services.

The annual budget serves as the foundation for the City of Rochester's financial planning and control. All departments and agencies of the City of Rochester submit requests for appropriation to the city administrator in August of each year. The city administrator uses these requests as the starting point for developing a proposed budget. The city administrator then provides this proposed budget to the council for review prior to November 15th. Work sessions are then held with the council covering each department budget. The council is required to hold public hearings on the proposed budget and to adopt a final budget no later than December 31, the close of the City of Rochester's fiscal year. The appropriated budget is prepared by fund, function (e.g., public safety), and department (e.g., police). Department heads may make transfers of appropriations within a department. Transfers of appropriations between funds, however, require the special approval of the city council. Budget-to-actual comparisons are provided in this report for each individual governmental fund for which an appropriated annual budget has been adopted. For the general fund, this comparison is presented on page 28 as part of the basic financial statements for the governmental funds. For governmental funds, other than the general fund, with appropriated annual budgets, this comparison is presented in the governmental fund subsection of this report, which starts on page 80.

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FACTORS AFFECTING FINANCIAL CONDITION

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the City of Rochester operates.

Local economy. The third largest City in Minnesota, Rochester is located 78 miles southeast of Minneapolis and St. Paul. Rochester's strong economy is built around world-renowned health care, cutting-edge technology, agriculture and agribusiness. As home to the Mayo Clinic and IBM Rochester, the City has developed into an economic growth center and the cultural hub of southeastern Minnesota. Its many recreational and cultural activities draw people from southeastern Minnesota and northern Iowa. Add these benefits to a low crime rate and an exceptional school system and it is easy to see why Rochester continues to rank as one of the top places to live. In May of 2005, Forbes Magazine placed Rochester at number 2 of the 10 best small cities to start a business.

Other recent indicators of Rochester's economic vitality include:

- **Jobs.** Rochester posted a 12 month increase of 1,691 jobs through March of 2006. This is after an increase of 1,214 jobs in the prior 12 months and continues a 15-year growth pattern. Education and Health services accounted for the bulk (800+) of that increase. Total employment stood at 103,565 at the end of the first quarter of 2006.
- **Unemployment.** Rochester's unemployment rate decreased to 4.2 percent by the end of March 2006, down from 4.4 percent one year ago. It remains below the state and U.S. averages of 4.8 percent. The average unemployment rate for Rochester over the past 12 months was 3.5%.
- **Home Sales.** Home sales for the first quarter of 2006 reached just shy of \$68 million and represented a 1.3 percent increase from the same period last year.
- **Building Activity.** First quarter 2006 commercial and residential building permits totaled over \$64 million, but did represent a decrease of 7.4 percent from the same quarter in 2005. Still, this was 8.7 percent higher than the same period in 2004.

Long-term financial planning. The Rochester council is directing City staff on numerous projects that will affect the growth of the City. A partial list includes:

- Waste Water Treatment Plant Expansion. Construction is underway on this \$64 expansion of our wastewater treatment plant. The project is necessary to meet the ever-growing capacity demands. Council issued bonds and approved of a new "plant investment fee" charged to new development to support the additional debt service requirements. Construction should be completed by the end of 2006.
- Water Quality Project. The \$22 million in sales tax monies allocated toward extending sanitary sewer and water lines to parcels adjacent to the City that had failing septic systems is in its final stages of completion this spring. In addition to protecting the community's drinking water aquifers, the project is providing both additional tax base through annexation of these developed properties as well as the

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Long-term financial planning (continued).

development of many in-fill areas that were previously not able to be developed without this infrastructure.

- Cascade Lake Development. The City has purchased some properties, provided for the relocation of power lines, obtained easements and accepted development plans for the gravel mining and eventual development of what will become the largest lake in the area. Plans are proceeding for adjacent public parkland and a public bike trail surrounding the lake. This project has already become a significant attraction for new residential development, and will eventually be a wonderful asset for all the citizens of Rochester to enjoy.
- Downtown Development. The new Downtown Alliance and the City's development department are working on a number of exciting projects to rejuvenate this area including the Downtown Plaza Project, and a new 9-story Bioscience Building to be built by the City's EDA.
- Expansion of Sewer Collection and Water Service Systems. With the treatment plant expansion nearing completion, construction of new sewer mains from the plant to new development territory is underway. This, along with the upgrade of a major lift station will open up significant new areas for the City to expand.

Cash management policies and practices. Cash temporarily idle during the year was invested in short-term government money market accounts, commercial paper, obligations of the U.S. Treasury and its agencies, and municipal bonds. The maturities of the investments range from 30 days to 20 years with an average maturity of 1.7 years. Investment income includes appreciation or depreciation in the fair value of investments. Increases or decreases 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 government intends to hold to maturity.

Risk management. The City maintains a self-insurance program for employee group health coverage and workers' compensation and a high deductible policy on property and casualty coverage. The group health program is limited to losses of \$225,000 per claim with a variable annual aggregate, and the 2005 workers' compensation exposure is limited to \$760,000 per occurrence, both through the use of stop-loss policies. The City's general and auto liability policies retain a \$200,000 aggregate deductible exposure with a \$1,000,000 statutory limit of coverage. The City recognizes a liability on individual claims when a claim is probable and the amount can be reasonably estimated. In addition the City recognizes an estimated liability on claims that have been incurred but not reported. The workers' compensation premium charged to the departmental budgets for 2005 was a factor of 0.30 of the Workers' Compensation Reinsurance Association adjusted pure premium exposure base rate.

Health coverage premiums were increased 24.5 percent in 2004 and 35 percent for 2005 as we struggled to respond to some high claims and continued increases in general health care that exceed inflation rates. Dental premiums were not increased in 2004 and were increased a modest 4% in 2005. Despite these large increases, premiums still remain about average in the market for comparable

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Risk management (continued) .

coverage. Additional information on the City's risk management activity can be found in Note 4:A of the notes to the financial statements.

Pension. Substantially all employees of the City of Rochester are covered by a statewide defined benefit pension plan administered by the Public Employees Retirement Association of Minnesota (PERA). Employees participated in one of the following plans during 2005:

Public Employees Retirement Fund (PERF), a cost-sharing multiple-employer plan
Public Employees Police and Fire Fund (PEPFF), a cost-sharing multiple-employer plan

PERF members belong to either the Coordinated Plan or the Basic Plan. Coordinated members are covered by Social Security and Basic members are not. All new members must participate in the Coordinated Plan. All police officers, fire fighters and peace officers qualifying for membership by statute are covered by the PEPFF. Additional information on the City's pension benefits can be found in Note 4:E. of the notes to the financial statements.

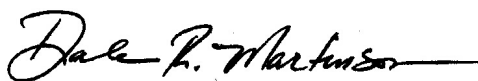
AWARDS AND ACKNOWLEDGEMENTS

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Rochester, Minnesota for its comprehensive annual financial report for the fiscal year ended December 31, 2004. This was the thirty-seventh consecutive year that the City has received this prestigious award. In order to be awarded a Certificate of Achievement, the government must publish an easily readable and efficiently organized comprehensive annual financial report. This report satisfied both generally accepted accounting principles and applicable legal requirements.

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

The preparation of this report could not be accomplished without the professional , efficient services of many dedicated people. We first express our appreciation to all members of the Finance department who assisted and contributed in preparing the report. We also thank the staff of Smith, Schafer and Associates, Ltd. for their assistance and review of the document. And finally, we acknowledge the Mayor and the members of the Common Council for their interest and support in planning and conducting the financial operations of the City in a responsible and progressive manner.

Respectfull y submitted,



Dale R. Martinson
Director of Finance



Stevan E. Kvenvold
City Administrator

Certificate of Achievement for Excellence in Financial Reporting

Presented to

City of Rochester,
Minnesota

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
December 31, 2004

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



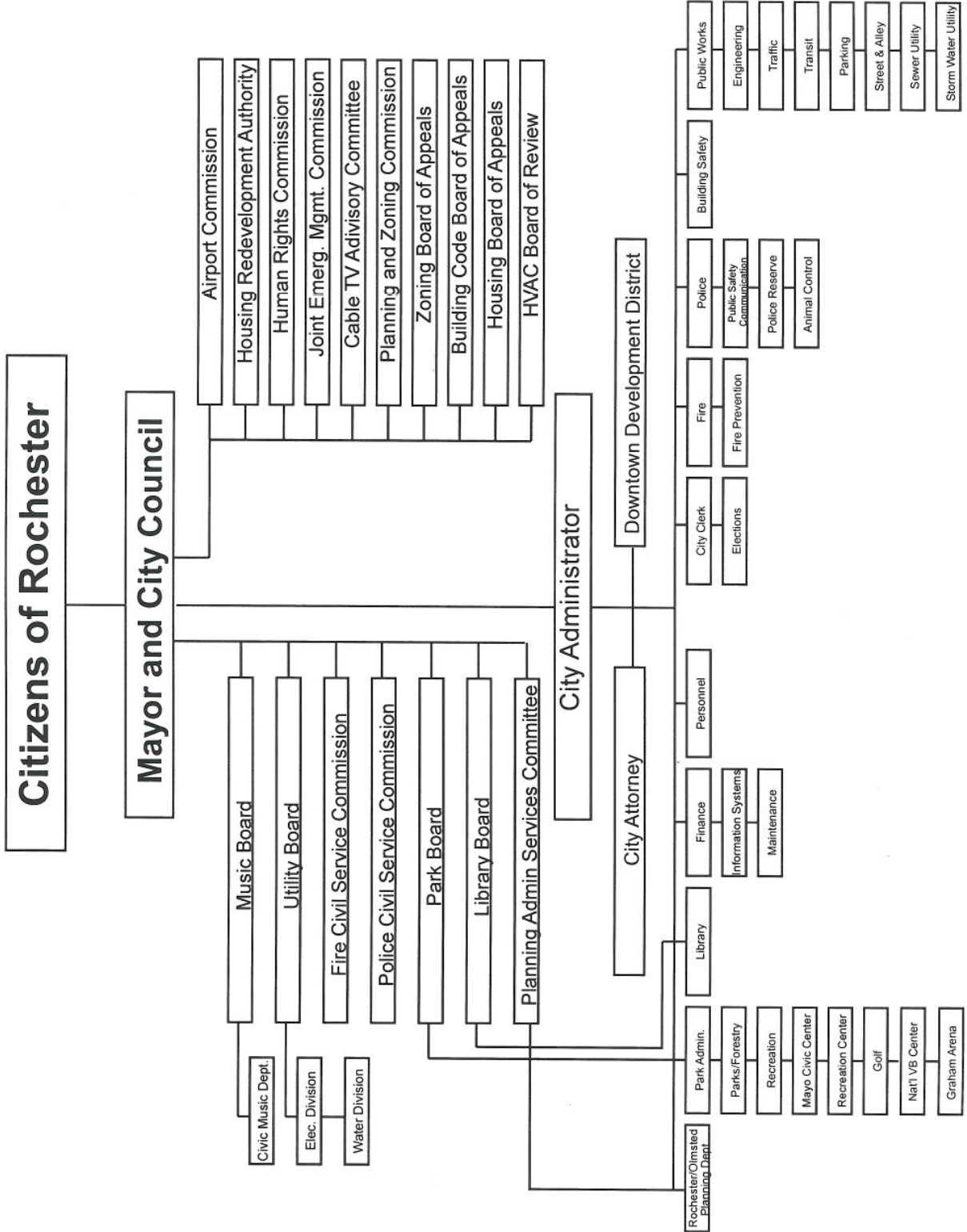
Carla E. Perry

President

Jeffrey R. Emmer

Executive Director

**CITY OF ROCHESTER, MINNESOTA
ORGANIZATIONAL CHART**



**CITY OF ROCHESTER, MINNESOTA
LIST OF ELECTED AND APPOINTED OFFICIALS**

MAYOR - COUNCIL

	Initial Term <u>Commenced</u>	Current Term Expires <u>December 31</u>
Mayor, Ardell F. Brede	2003	2006
Council President, Dennis L. Hanson	1999	2008
Councilmember First Ward, Amy Blenker	2005	2006
Councilmember Second Ward, Marcia Marcoux	1996	2008
Councilmember Third Ward, Bruce Snyder	2006	2006
Councilmember Fourth Ward, Patt Carr	2005	2008
Councilmember Fifth Ward, Bob Nowicki	2003	2006
Councilmember Sixth Ward, Sandra Means	2003	2008

CITY ADMINISTRATOR

Stevan E. Kvenvold

DIRECTOR OF FINANCE – TREASURER

Dale R. Martinson

OTHER CITY OFFICIALS

City Attorney, Terry L. Adkins
City Clerk, Judy Kay Scherr
Director of Public Works, Richard W. Freese
Director of Building Safety, Ronald D. Boose
Chief of Police, Roger L. Peterson
Fire Chief, David A. Kapler
Director of Human Resources, Linda F. Gilsrud
Director Library Services, Audrey Betcher
Superintendent of Parks and Recreation, Roy Sutherland
General Manager - Music, Steven J. Schmidt
General Manager - Public Utilities, Larry J. Koshire
Superintendent of Water Reclamation Plant, Lyle J. Zimmerman