

**CITY OF ANN ARBOR
RETIREE HEALTH CARE BENEFITS
PLAN AND TRUST**

FINANCIAL STATEMENTS

Fiscal Years Ended June 30, 2009 and 2008



Issued by: Retirement System, 532 S. Maple, Ann Arbor, Michigan 48103
(734) 794-6710

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

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INDEPENDENT AUDITOR'S REPORT

To the Members of the Audit Committee
City of Ann Arbor Retiree Health Care Benefits Plan and Trust
Ann Arbor, Michigan

We have audited the accompanying statement of plan net assets of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust as of June 30, 2009 and 2008, and the related statement of changes in plan net assets for the years then ended. These financial statements are the responsibility of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the City of Ann Arbor Retiree Health Care Benefits Plan and Trust and do not purport to, and do not present fairly the financial position of the City of Ann Arbor, Michigan, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust as of June 30, 2009 and 2008, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis and historical pension information, as identified in the table of contents, are not required parts of the financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and do not express an opinion on it.

ABRAHAM & GAFFNEY, P.C.
Certified Public Accountants

December 7, 2009

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2009 and 2008

The following is a discussion and analysis of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust's financial performance and position, providing an overview of the activities for the year ended June 30, 2009. This analysis should be read in conjunction with the *Independent Auditors Report* and with the accompanying financial statements.

The City of Ann Arbor Voluntary Employees Beneficiary Association (VEBA; the "Plan") is a single-employer defined benefit post employment healthcare plan established and administered by the City of Ann Arbor through the Board of Trustees of the Retiree Health Care Benefits Plan and Trust to provide health and life benefits for retirees and their beneficiaries.

Using this Annual Report

This annual report consists of two parts: (1) management's discussion and analysis (this section) and (2) the financial statements. The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data.

Condensed Financial Information

The table below compares key financial information in a condensed format between the current year and the prior year:

| | Fiscal Year Ended June 30, | |
|---|-------------------------------|---------------------------|
| | <u>2009</u> | <u>2008</u> |
| Total assets | \$ 54,088,677 | \$ 63,824,710 |
| Total liabilities | <u>29,985</u> | <u>32,267</u> |
| Net assets held in trust for healthcare benefits | 54,058,692 | 63,792,443 |
| Net investment (loss) | <11,433,172> | <4,851,925> |
| Contributions - employer | 1,699,505 | 4,622,604 |
| Retiree health benefits paid | <u>-</u> | <u>-</u> |
| Contributions in excess of benefits paid | 1,699,505 | 4,622,604 |
| General and administrative expenses | <u>84</u> | <u>72</u> |
| Net change in plan net assets | <u>\$ <9,733,751></u> | <u>\$ <229,393></u> |

Overall Fund Structure and Objectives

The City of Ann Arbor VEBA Trust exists to pay health care benefits to retired members. The Plan is currently accumulating assets to generate investment earnings and there are no benefits currently being paid. The excess of contributions over benefits paid will allow for additional funding to increase investment income to a level where the Plan will generate adequate earnings to pay future benefits. The public capital markets represent the primary source of investments.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2009 and 2008

Asset Allocation

It is the responsibility of the VEBA Board to determine the allocation of assets among distinct capital markets in accordance with allowable legal limits. Based on an asset allocation review conducted in 2009, which analyzed the expected returns of various asset classes, the Plan's actuarial assumption rate, and the risks associated with alternative asset mix strategies, the Board has established the following asset allocation:

| <u>Asset Class</u> | <u>Target</u> | <u>Range</u> |
|---------------------------|----------------------|---------------------|
| Domestic Equity | 47.5% | 42.5-52.5 |
| International Equity | 15% | 10-20 |
| Fixed Income | 27.5% | 22.5-32.5 |
| Real Estate | 10% | 0-10 |

The study has shown that this asset mix offers the optimal mix for meeting longer term goals. The asset classes stated above shall be further diversified (where possible) as to style and manager type to reduce risk further, while providing the opportunity for enhanced return.

Economic Factors, Investment Returns, and Other Important Matters

By most estimates the current recession has been the longest and most severe in the United States since the Great Depression. Current data indicated that the U.S. completed its eighteenth month of economic contraction in June with a decline of 3.1% in Gross Domestic Product from the peak in December 2007. At the end of the second quarter unemployment rate was 9.4% the highest since the early 80's. Most economists forecasted rates to peak near the end of the year above 10%. With the devaluation of the U.S. dollar in recent years, several foreign nations have suggested that they would like to reduce their currency risk by shifting from U.S. dollars. Investors continued to favor higher yielding securities, looking for inflation protection and unwinding the flight to quality that occurred during the fourth quarter of 2008.

The stock market is the principal investment forum utilized by the City's Retiree Health Care Benefit Plan & Trust. It is important to note that the Retiree Health Care Benefit Plan & Trust's purpose is to pay healthcare benefits to its members and it is through long-term investing that these promised benefits will be primarily funded. However, it is recognized that in the short term there will be market fluctuations that may result in negative returns for any given period. Such is the case for 2008/2009 which shows a -18.19% return for the year. Through its investment policy asset allocation, the Board positions the portfolio for the long-term investment objective to pay healthcare benefits to its members. In addition, to further maximize investment returns, management carefully monitors the performance of each of its investment managers and takes the necessary corrective action to ensure acceptable investment results.

The Plan is normally funded by contributions from the City of Ann Arbor. VEBA members are not required to contribute to the Plan. Current retiree medical and life benefits are budgeted and paid for out of various City of Ann Arbor departments.

Contacting the Plan Management

This financial report is intended to provide our citizens, taxpayers, and investors with a general overview of the Plan's finances and to show accountability for the money received. If you have questions about this report or need additional information, we welcome you to contact the City of Ann Arbor Retiree Health Care Benefits Plan and Trust Office at 532 S. Maple Rd., Ann Arbor, Michigan 48103, or (734) 794-6710.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

STATEMENTS OF PLAN NET ASSETS

June 30, 2009 and 2008

| | <u>2009</u> | <u>2008</u> |
|--|----------------------|----------------------|
| ASSETS | | |
| Cash | \$ 541,536 | \$ - |
| Investments, at fair value | 53,357,657 | 61,617,644 |
| Accrued interest and dividends | 161,492 | 217,158 |
| Due from other funds of the City of Ann Arbor | <u>27,992</u> | <u>1,989,908</u> |
| Total assets | 54,088,677 | 63,824,710 |
| LIABILITIES | | |
| Accounts payable | <u>29,985</u> | <u>32,267</u> |
| NET ASSETS | | |
| Held in trust for retiree health care benefits | <u>\$ 54,058,692</u> | <u>\$ 63,792,443</u> |

See accompanying notes to financial statements.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

STATEMENTS OF CHANGES IN PLAN NET ASSETS

Years Ended June 30, 2009 and 2008

| | 2009 | 2008 |
|---|---------------|---------------|
| ADDITIONS TO NET ASSETS | | |
| Investment income (loss) | | |
| Interest and dividends | \$ 2,010,118 | \$ 1,936,610 |
| Net appreciation (depreciation) in fair value of investments | (13,232,169) | (6,506,257) |
| Total investment (loss) | (11,222,051) | (4,569,647) |
| Less: investment expense | (211,121) | (282,278) |
| Net investment (loss) | (11,433,172) | (4,851,925) |
| Contributions | | |
| Employer | 1,699,505 | 4,622,604 |
| Total additions to net assets | (9,733,667) | (229,321) |
| DEDUCTIONS FROM NET ASSETS | | |
| Administrative expenses | 84 | 72 |
| CHANGE IN PLAN NET ASSETS | (9,733,751) | (229,393) |
| Net assets - beginning of year | 63,792,443 | 64,021,836 |
| Net assets - end of year | \$ 54,058,692 | \$ 63,792,443 |

See accompanying notes to financial statements.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

NOTE A: PLAN DESCRIPTION

The City of Ann Arbor Voluntary Employees Beneficiary Association (VEBA; the "Plan") is a single-employer defined benefit post employment healthcare plan established and administered by City of Ann Arbor through the Board of Trustees of the Retiree Health Care Benefit Plan & Trust to provide health and life benefits to eligible retirees and their beneficiaries. Chapter 21 1:707 assigns the authority to amend the benefit provisions of the Plan to the City of Ann Arbor.

The Plan is normally funded by actuarially determined contributions from the City of Ann Arbor, under a trust agreement established pursuant to Section 501(c)(9) of the Internal Revenue Code, which allows for the formation of a VEBA. This fund is included as a pension trust fund in the City's comprehensive annual financial report.

VEBA members are not required to contribute to the Plan. Employer contributions for the year ended June 30, 2009 were \$1,699,505. Administrative costs of the Plan are financed through investment earnings. Current retiree medical and life benefits are budgeted and paid for out of the various City of Ann Arbor departments.

Membership of the plan consisted of the following at June 30, 2009 and 2008, according to actuarial valuations as of those two dates:

| | <u>June 30, 2009</u> | <u>June 30, 2008</u> |
|--|----------------------|----------------------|
| General | 547 | 501 |
| Police | 148 | 151 |
| Fire | 91 | 89 |
| Total Active Members | 786 | 801 |
| Retirees and Beneficiaries receiving benefits not currently funded by the plan | 834 | 820 |
| Terminated plan members not entitled to benefits | 126 | 117 |
| | 1,746 | 1,738 |
| Number of participating employers | 1 | 1 |

NOTE B: SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting: The VEBA statements are prepared using the accrual basis of accounting.

Method Used to Value Investments: Plan investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on national exchanges are valued at the last reported sales price. Investments that do not have an established market are reported at estimated fair values.

Administration: Administrative costs are financed through the Plan's investment earnings.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

NOTE C: DEPOSITS AND INVESTMENTS

Deposits

The Plan does not maintain any checking or other demand/time deposit accounts. Amounts reported as cash in the statement of plan net assets are composed entirely of short-term investments in money market accounts. These amounts are not Federally insured by the FDIC.

Investments

The Michigan Public Employees Retirement Systems' Investment Act, Public Act 314 of 1965, as amended, authorizes the Plan to invest in stocks, government and corporate securities, mortgages, real estate, and various other investment instruments, subject to certain limitations. The Plan's Board has the responsibility and authority to oversee the investment portfolio. Various professional investment managers are contracted to assist in managing the Plan's assets. All investment decisions are subject to Michigan law and the investment policy established by the Board.

The Plan's investments are held by independent investment management companies. Following is a summary of the Plan investments as of June 30, 2009:

| | <u>Fair Value</u> | <u>Cost</u> |
|---|--------------------------|--------------------------|
| Investments at fair value, as determined by quoted market prices: | | |
| Common stocks | \$ 31,447,796 | \$ 37,115,248 |
| US government obligations | 15,962,321 | 15,618,867 |
| Real Estate - Fund | 1,643,774 | 2,734,530 |
| Short-Term investments | <u>4,303,766</u> | <u>4,454,461</u> |
| Total investments | <u>\$ 53,357,657</u> | <u>\$ 59,923,106</u> |

Following is a summary of the Plan investments as of June 30, 2008:

| | <u>Fair Value</u> | <u>Cost</u> |
|---|--------------------------|--------------------------|
| Investments at fair value, as Determined by quoted market prices: | | |
| Common stocks | \$ 37,099,913 | \$ 37,059,776 |
| Corporate bonds | 20,997,390 | 21,005,515 |
| Real Estate - Fund | 2,893,078 | 3,251,104 |
| Short-Term investments | <u>627,263</u> | <u>627,263</u> |
| Total investments | <u>\$ 61,617,644</u> | <u>\$ 61,943,658</u> |

Interest Rate Risk

For investments, the risk that changes in interest rates will adversely affect the fair value of the investment is known as interest rate risk. The Plan's investment policy provides for securities with terms to maturity of up to 30 years. None of the investments held by the Plan as of June 30, 2009 are subject to interest rate risk.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

NOTE C: DEPOSITS AND INVESTMENTS - CONTINUED

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Plan's investment policy provides that corporate bonds rated lower than BBB by Standard & Poor's should be limited to 10% of the investment portfolio. The corporate bonds are in an index fund, and are not rated. The Plan has no investments that are rated as to risk category at June 30, 2009.

Custodial Credit Risk

For investments, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Plan will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Plan's investment policy requires that investment securities be held in trust by a third-party institution in the Plan's name. As such, although uninsured and unregistered, the Plan's investments are not exposed to custodial credit risk since the securities are held by the counterparty's trust department in the Plan's name. Short-term investments in money market funds are not subject to custodial credit risk.

Concentration of Credit Risk

The Plan's Board has established ranges for investment asset allocation as follows:

| <u>Asset Class</u> | <u>% Range</u> |
|--------------------|----------------|
| Equities | 58-68 |
| Fixed Income | 23-33 |
| Real Estate | 0-10 |

Also, at the time of purchase, no more than 5% of the equity securities of a single issuer may be owned, and no security should be more than 5% of the total portfolio at market value.

Additionally, the State of Michigan Public Employee Retirement System Investment Act limits domestic equity participation to no more than 70% of the total fund market value and international investments to 20% of total fund market value. The investments are listed above and no individual investment exceeds these concentration parameters.

NOTE D: CONTINGENT LIABILITIES

Effective October 19, 1998, the City and the VEBA Board of Trustees entered into a funding agreement for the allocation of Retirement System annual excess earnings (if any) for the payment of current City retiree health benefit costs thereby allowing the City to allocate the equivalent budgetary amount to prefund the City's VEBA. This agreement and all transfers were executed in compliance with Michigan Public Act 28 (PA 28). It has come to the City's attention that Michigan Act 28 (PA 28) may not fully comply with Section 420 of the Internal Revenue Code with respect to the transfers to the VEBA. The City has committed to compliance with both State and Federal law (as applicable) and will address any required compliance matters through the Internal Revenue Service Voluntary Correction Program. The City expects that any compliance matters which may need to be addressed will not adversely affect the tax qualified status of the Plan.

REQUIRED SUPPLEMENTARY INFORMATION

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

SCHEDULE OF FUNDING PROGRESS
(Dollar amounts in thousands)

| Actuarial Valuation Date | Value of Assets (a) | Liability (AAL) Entry Age (b) | AAL (UAAL) (b-a) | Funded Ratio (a/b) | Covered Payroll (c) | Percentage of Covered Payroll [(b-a)/c] |
|--------------------------------|---------------------------|-------------------------------------|------------------------|--------------------------|---------------------------|--|
| 6/30/2008 | \$ 68,312 | \$ 225,998 | \$ 157,686 | 30.2% | \$ 51,287 | 307.5% |
| 6/30/2007 | 60,090 | 215,949 | 155,859 | 27.8% | 50,678 | 307.5% |
| 6/30/2006 | 55,250 | 197,199 | 141,949 | 28.0% | 49,627 | 286.0% |
| 6/30/2005 | 45,256 | 166,824 | 121,568 | 27.1% | 47,225 | 257.4% |
| 6/30/2004 | 39,163 | 131,703 | 92,540 | 29.7% | 47,109 | 196.4% |

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

SCHEDULE OF EMPLOYER CONTRIBUTIONS

Employer Contributions

| <u>Year Ended June 30,</u> | <u>Annual Required Contribution</u> | <u>Current Premiums Paid by City</u> | <u>Pre-funding Contributions To VEBA Trust</u> | <u>Percentage Contributed</u> |
|--------------------------------|---|--|--|-----------------------------------|
| 2009 | \$13,908,444 | \$7,890,737 | \$1,699,505 | 68.60% |
| 2008 | 12,360,028 | 7,737,424 | 4,622,604 | 100.00% |
| 2007 | 10,370,568 | 7,616,064 | - | 73.40% |
| 2006 | 8,099,607 | 7,292,343 | 7,065,913 | 87.20% |
| 2005 | 8,607,188 | 6,522,226 | 4,099,025 | 47.60% |

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTE TO THE SCHEDULE OF FUNDING PROGRESS
AND SCHEDULE OF EMPLOYER CONTRIBUTIONS

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Actuarial determined amounts are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedules of funding progress, presented as required supplementary information following the notes to the financial statements, present multiyear trend information about whether the actuarial values of plan assets are increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

The accompanying schedule of employer contributions presents trend information about the amounts contributed to the plan by the employer in comparison to the ARC, an amount that is actuarially determined in accordance with the parameters of GASB Statement 43. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost for each year and amortized any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets consistent with the long-term perspective of the calculations. Additional information as of the latest actuarial valuation follows:

Actuarial Valuation:

| | |
|-------------------------------|---------------------------------|
| Frequency | Annual |
| Latest valuation date | 6/30/09 |
| Actuarial cost method | Entry Age |
| Amortization method | Level percent of payroll - open |
| Remaining amortization period | 30 years |
| Asset valuation method | 5-year smoothed - market value |

Actuarial assumptions:

| | |
|-----------------------------|-------------------------------|
| Investment rate of return * | 7.0% |
| Healthcare cost trend rate | 9.0% initial 3.5% ultimate |
| Projected salary increases | 3.5% |
| *Includes inflation at: | 3.5% |