ABDO
EICK &
MEYERS LLP
Certified Public Accountants & Consultants

February 22, 2007

Grandview Square
5201 Eden Avenue
Suite 370
Edina, MN 55436

Honorable Mayor and Council
City of Melrose
Melrose, Minnesota

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 of Melrose, Minnesota (the City) for the year ended December 31, 2006 and have issued our report thereon dated February 22, 2007. Professional standards require that we provide you with the following information related to our audit.

Our Responsibility Under Auditing Standards Generally Accepted in the United States of America and *Government Auditing Standards*

As stated in our engagement letter, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement and are fairly presented in accordance with accounting principles generally accepted in the United States of America. Because an audit is designed to provide reasonable, but not absolute assurance and because we did not perform a detailed examination of all transactions, there is a risk that material errors, fraud, or illegal acts may exist and not be detected by us.

In planning and performing our audit of the financial statements of the City, for the year ended December 31, 2006, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

As part of obtaining reasonable assurance about whether the general purpose financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts and grants. However, the objective of our tests was not to provide an opinion on compliance with such provisions. We noted no instances of non-compliance with Minnesota statutes.

Audit Adjustments

For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the City’s financial reporting process (that is, cause future financial statements to be materially misstated). We had no unadjusted audit differences.

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

Significant Accounting Policies

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the financial statements. We noted no transactions entered into by the City during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

Accounting Estimates

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.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting or auditing matter 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.

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.

Issues Discussed Prior to Retention of Independent Auditors

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.

Difficulties Encountered in Performing the Audit

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

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

Other Matters

Financial Position and Results of Operations

The following are items that came to our attention during the audit that we feel should be noted:

General Fund

The General fund is used to account for resources traditionally associated with government, which are not required legally or by sound principal management to be accounted for in another fund. The General fund balance increased $42,924 from 2005. The fund balance of $804,761 is 39 percent of the 2006 expenditures and transfers out. We recommend the fund balance be maintained at a level sufficient to fund operations until the major revenue sources are received in June. We feel a reserve of approximately 40 to 50 percent of planned expenditures and transfers out is adequate to meet working capital and small emergency needs.

The fund balance includes amounts reserved and designated as shown below:

	2002	2003	2004	2005	2006
Reserved for					
Due from other funds	$ 18,472	$ 69,840	$ 43,182	$ 65,646	$ -
Prepaid items	4,098	4,824	4,541	4,162	3,657
Unreserved					
Designated for insurance reserve	11,142	4,807	4,658	4,892	4,892
Designated for vacation and sick leave benefits	33,177	33,330	37,786	27,381	29,821
Designated for working capital	550,000	531,529	550,000	550,000	550,000
Undesignated	12,958	43,636	155,435	109,756	221,064
Total	$ 629,847	$ 687,966	$ 795,602	$ 761,837	$ 809,434
Total expenditures and transfers out	$ 2,134,642	$ 1,707,062	$ 1,657,881	$ 1,942,570	$ 2,066,289
Total fund balance as a percent of expenditures	29.51 %	40.30 %	47.99 %	39.22 %	39.17 %

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

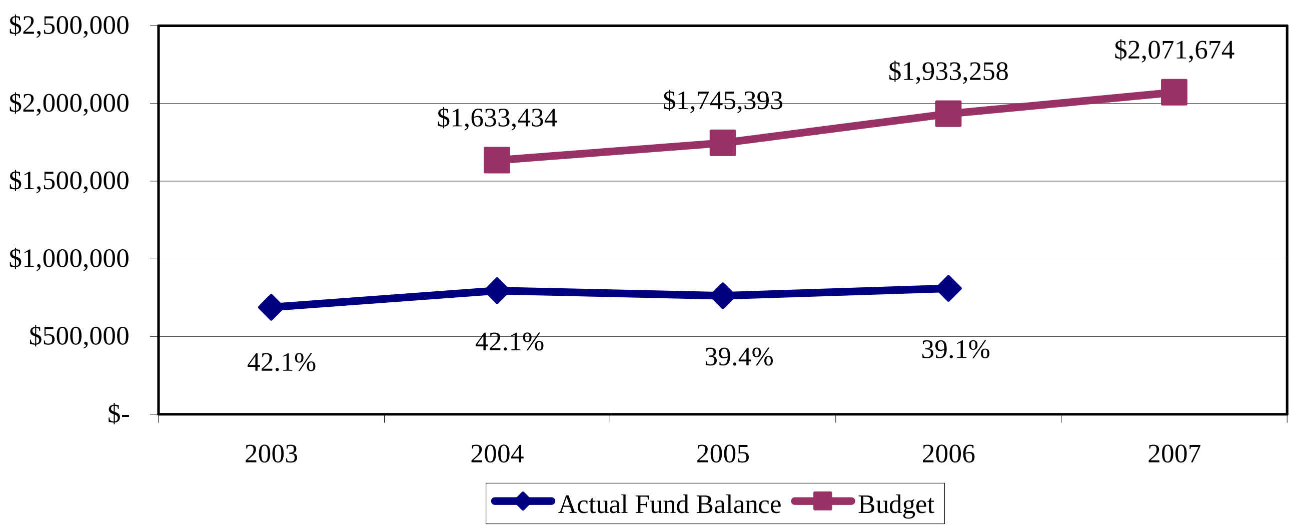
The Minnesota Office of the State Auditor has classified cities' unreserved fund balance levels relative to expenditures as follows:

Extremely low	Under 20%
Low	21 - 34
Acceptable	35 - 50
Moderately high	51 - 64
High	65 - 100
Very high	101 - 150
Extremely high	Above 150

The State Auditor does group all general and special revenue funds of the city when making this calculation where our calculation is based only on the General fund. Although there is no legislation regulating fund balance, it is a good policy to designate intended use of fund balance. This helps address citizen concerns as to the use of fund balance and tax levels. As shown above, the City does make formal designations of fund balance. The following table and graph further highlight the fund balance relative to planned expenditures.

Year	Unreserved Fund Balance December 31	Budget Year	General Fund Budget	Percent of Fund Balance to Budget
2003	$ 687,966	2004	$ 1,633,434	42.1 %
2004	795,601	2005	1,745,393	45.6
2005	761,837	2006	1,933,258	39.4
2006	809,434	2007	2,071,674	39.1

Fund Balance as a Percent of Next Year's Budget



952.835.9090 • Fax 952.835.3261
www.aemcpas.com

It becomes necessary for the City to maintain a reserve for the following reasons:

Purposes and Benefits of Maintaining a Fund Balance

- Expenditures are incurred somewhat evenly throughout the year. However, property tax and state aid revenues are not received until the second half of the year. An adequate fund balance will provide the cash flow required to finance the General fund expenditures.
- The City is vulnerable to legislative actions at the State and Federal level. The State eliminated HACA aid with the 2001 legislative session and imposed reductions of market value credit aid and local government aid for some cities. Levy limits have also been implemented for municipalities in past legislative sessions. An adequate fund balance will provide a temporary buffer against those aid adjustments and levy limits.
- Expenditures not anticipated at the time the annual budget was adopted may need immediate council action. These would include capital outlay replacement, lawsuits and other items. An adequate fund balance will provide the financing needed for such expenditures.
- A strong fund balance will assist the City in maintaining, improving or obtaining a bond rating.

A summary of the 2006 operations are as follows:

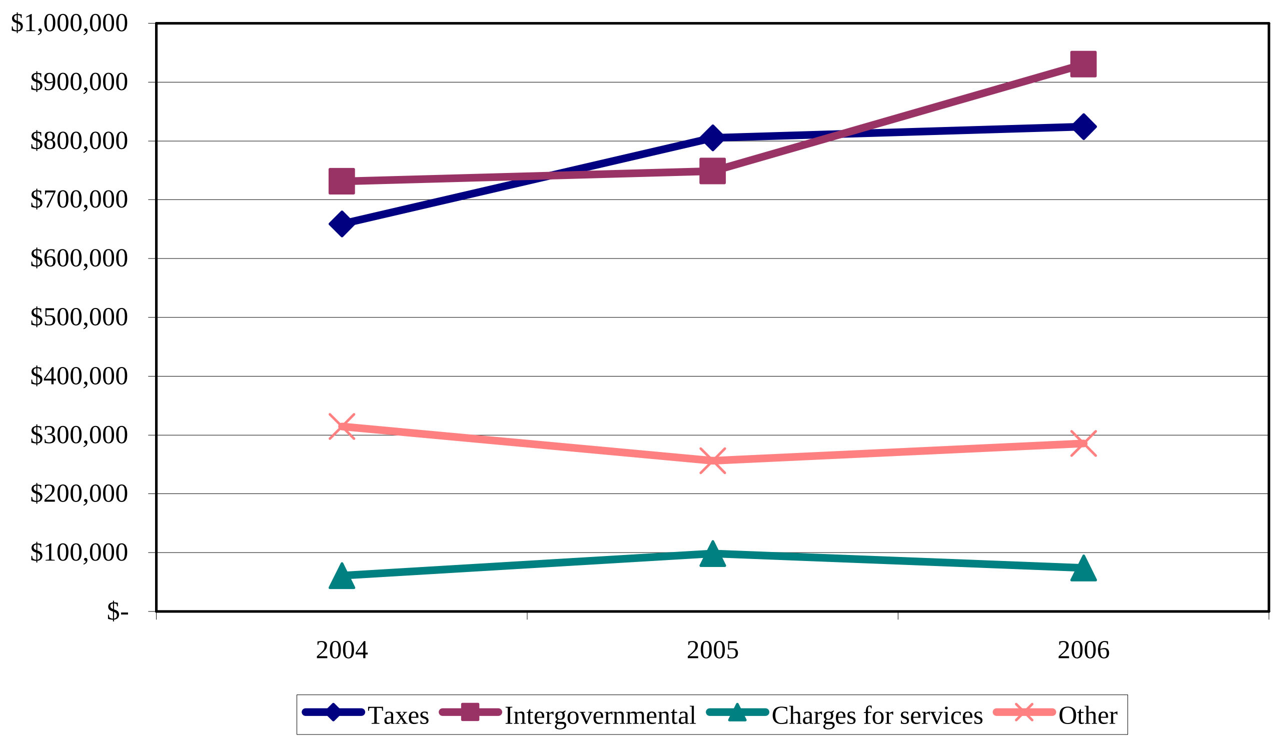
	Final Budget Amounts	Actual Amounts	Variance with Final Budget - Positive (Negative)
Revenues	$ 1,798,921	$ 1,965,695	$ 166,774
Expenditures	1,701,753	1,607,388	94,365
Excess of revenues over expenditures	97,168	358,307	261,139
Other financing sources (uses)			
Transfers in	134,337	148,191	13,854
Transfers out	(231,505)	(458,901)	(227,396)
Total other financing sources (uses)	(97,168)	(310,710)	(213,542)
Net change in fund balances	-	47,597	47,597
Fund balances, January 1	761,837	761,837	-
Fund balances, December 31	$ 761,837	$ 809,434	$ 47,597

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

A summary and comparison of 2006, 2005 and 20054 General fund revenues and transfers in is as follows:

Revenue Source	2004	2005	2006	Percent of Total
Taxes	$ 658,686	$ 805,204	$ 824,108	39.0 %
Licenses and permits	46,673	43,176	46,325	2.2
Intergovernmental	731,336	748,650	930,144	44.0
Charges for services	60,810	98,463	74,093	3.5
Fines and forfeitures	24,270	14,730	18,669	0.9
Special assessments	-	45	-	-
Interest on investments	12,447	20,226	43,284	2.1
Miscellaneous	103,489	46,762	29,072	1.4
Transfers in	127,806	131,549	148,191	7.0
Total revenues and transfers	$ 1,765,517	$ 1,908,805	$ 2,113,886	100.0 %

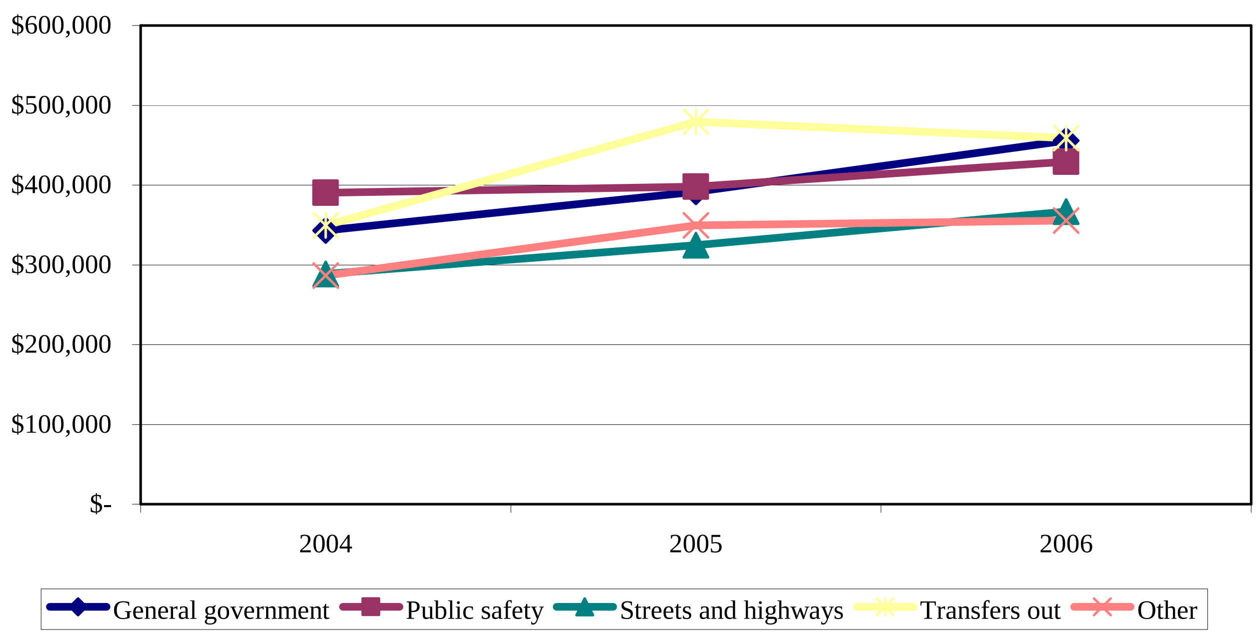
The sources of 2006, 2005 and 2004 revenues are presented graphically as follows:



A summary and comparison of 2006, 2005 and 20054 General fund expenditures and transfers out is as follows:

Program	2004	2005	2006	Percent of Total
Current				
General government	$ 343,065	$ 391,538	$ 455,876	22.1 %
Public safety	390,326	397,880	429,248	20.8
Streets and highways	288,603	324,574	366,705	17.8
Sanitation	3,647	3,228	3,984	0.2
Economic development	62,662	66,926	71,124	3.4
Total current	1,088,303	1,184,146	1,326,937	64.2
Capital outlay	11,838	62,932	64,657	3.1
Debt service	208,386	216,251	215,794	10.4
Transfers out	349,354	479,241	458,901	22.2
Total expenditures and transfers	$ 1,657,881	$ 1,942,570	$ 2,066,289	100.0 %

The 2006, 2005 and 2004 expenditures are presented graphically as follows:



Nonmajor Special Revenue Funds

The nonmajor special revenue funds account for revenue sources that are legally restricted to expenditures for specified purposes (not including major capital projects). The funds in this account group include:

Fund	Fund Balances (Deficits) December 31, 2006	Fund Balances (Deficits) December 31, 2005	Increase (Decrease)
Nonmajor			
Business Improvement Loans	$ 10,421	$ 10,133	$ 288
Melrose Area Development authority (MADA)	(62,589)	(175,757)	113,168
Parks and Recreation	(481,002)	(539,119)	58,117
MADA Revolving Loan	421,369	394,859	26,510
Soccer League	422	422	-
Senior Activity Center	2,552	2,735	(183)
PIA Asset Building	723	854	(131)
Tri Cap Bus	7,086	-	7,086
Fire Department	80,810	114,044	(33,234)
Tax Increment Projects	-	-	-
Total	$ (20,208)	$ (191,829)	$ 171,621

Business Improvement Loans

This fund was added in 1997 to provide loan sources for local businesses. Financing came from contributions and transfers from the Melrose Area Development Authority and the Electric fund.

Melrose Area Development Authority (MADA)

The focus of the fund will be business development. The deficit is being financed by other funds and was a result of planned capital outlay in excess of reserves.

Parks and Recreation

Transfers from the General fund along with contribution commitments from civic organizations provide the funding for the activities of the Parks and Recreation fund. The deficit will be eliminated over time with these transfers and contributions.

MADA Revolving Loan

This fund was established with a low interest loan from US Bank. The proceeds were used for local business loans. At year end, $339,766 is outstanding on those loans.

Tax Increment Financing Districts

These funds were created in 1997 to account for the City's pay-as-you-go districts. They are also used to account for the amounts due to the General fund and the 1992 Abandoned Railroad Property Project Fund for costs paid in past years.

Debt Service Funds

Debt service funds account for the servicing of general long-term debt not being financed by proprietary funds. The funds in this group include:

Debt Description	Cash Balance	Total Assets	Bounds Outstanding	Year of Maturity
Improvement Bonds of 2002	$ 87,756	$ 243,109	$ 605,000	12/01/17
Equipment Certificates of 2003	12,496	12,496	75,000	12/01/07
Improvement Bonds of 2004	100,257	274,545	985,000	02/01/20
Improvement Bonds of 2005A	173,226	711,143	2,545,000	02/01/21
Total G.O. Bonds	$ 373,735	$ 1,241,293	$ 4,210,000	

Capital Projects Funds

The capital projects funds account for the acquisition of capital assets or construction of major capital projects not being financed by proprietary funds. The funds in this group include:

Fund	Fund Balances (Deficits) December 31, 2006	2005	Increase (Decrease)
Major			
Capital improvements	$ 2,084,594	$ 2,226,407	$ (141,813)
Total major	2,084,594	2,226,407	(141,813)
Nonmajor			
2005 Capital Improvements	63,293	322,601	(259,308)
2004 I-94 Industrial Park Improvements	125,519	167,812	(42,293)
1992 Abandoned Railroad Property Project	771	503	268
2003 Equipment	76,714	119,383	(42,669)
2006 Kraft Drive Extension	206,321	637,692	(431,371)
2006 Tri Quality Improvement	41,261	(4,190)	45,451
2006 EBM Improvement	(14,402)	(4,220)	(10,182)
2007 Fire and Ambulance Station	542	-	542
Total nonmajor	500,019	1,239,581	(739,562)
Total	$ 2,584,613	$ 3,465,988	$ (881,375)

In 1990, several of the designated funds within the General fund were transferred to establish the Capital Improvement fund. Other revenue sources, which were available, have been transferred to this fund. This fund gives the City the ability to finance its capital improvement projects internally rather than issuing bonds and incurring the related issuance costs. The City has also planned well for its use through a thorough fund balance designation policy

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

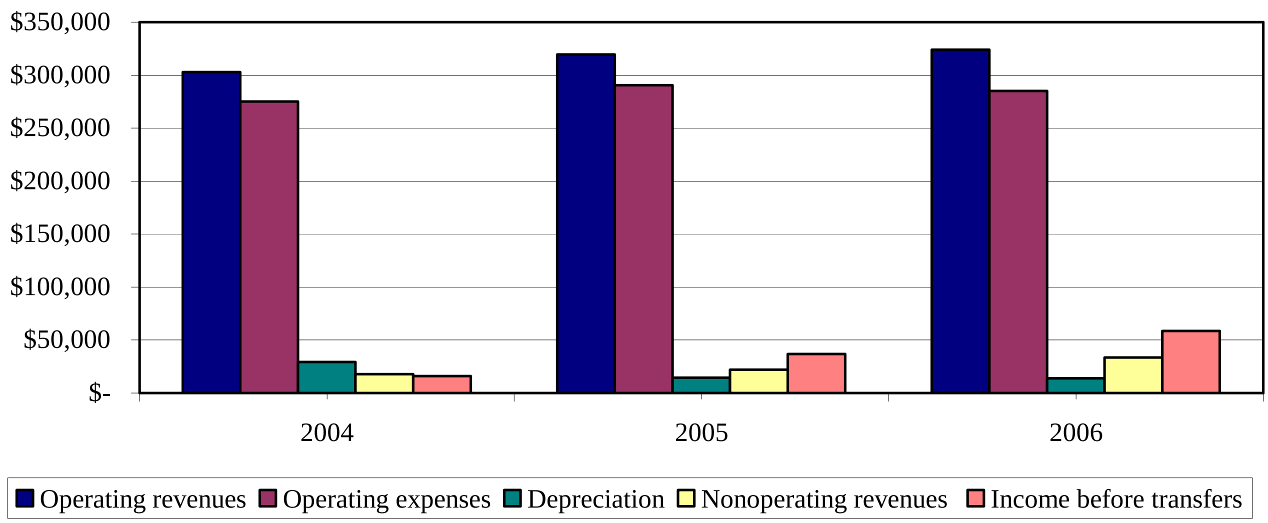
Proprietary Funds

The operations of the Ambulance fund for the past three years are summarized as follows:

Ambulance Fund Operations

	2004		2005		2006	
	Amount	Percent of Revenue	Amount	Percent of Revenue	Amount	Percent of Revenue
Operating revenues	$ 302,810	100.0 %	$ 319,632	100.0 %	$ 324,116	100.0 %
Operating expenses	(275,248)	(90.9)	(290,380)	(90.8)	(285,181)	(88.0)
Depreciation	(29,238)	(9.7)	(14,552)	(4.6)	(13,814)	(4.3)
Operating income (loss)	(1,676)	(0.6)	14,700	4.6	25,121	7.8
Nonoperating revenues	17,790	5.9	22,025	6.9	33,547	10.4
Change in net assets	$ 16,114	5.3 %	$ 36,725	11.5 %	$ 58,668	18.1 %
Cash and investments	$ 430,149		$ 521,669		$ 586,801	

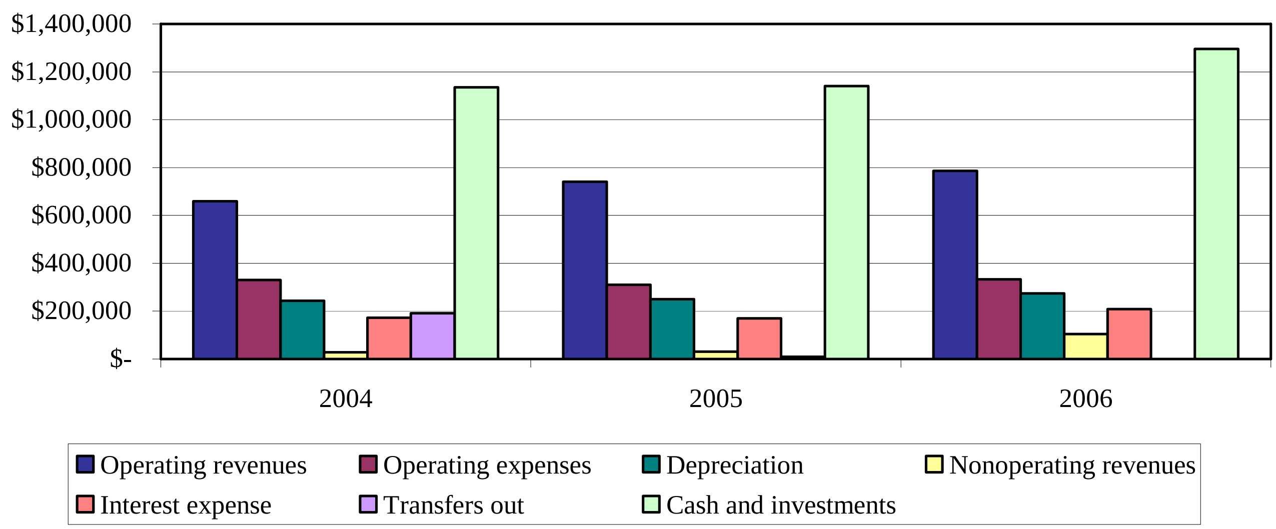
The cash balance is at a level sufficient to provide for working capital and other needs.



The operations of the Water fund for the past three years are summarized as follows:

Water Fund Operations

	2004		2005		2006	
	Amount	Percent of Revenue	Amount	Percent of Revenue	Amount	Percent of Revenue
Operating revenues	$ 659,160	100.0 %	$ 740,744	100.0 %	$ 786,861	100.0 %
Operating expenses	(330,934)	(50.2)	(310,180)	(41.9)	(332,559)	(42.3)
Depreciation	(242,855)	(36.8)	(250,087)	(33.8)	(274,657)	(34.9)
Operating income	85,371	13.0	180,477	24.4	179,645	22.8
Nonoperating revenues	27,737	4.2	31,097	4.2	104,142	13.2
Interest expense	(172,729)	(26.2)	(169,966)	(22.9)	(208,691)	(26.5)
Income before transfers	(59,621)	(9.0)	41,608	5.6	75,096	9.5
Contributed assets	-	-	101,349	13.7	236,992	30.1
Transfers out	(190,607)	(28.9)	(9,266)	(1.3)	-	-
Change in net assets	$ (250,228)	(38.0) %	$ 133,691	18.1 %	$ 312,088	39.7 %
Cash and investments	$ 1,135,886		$ 1,140,805		$ 1,295,552	
Loans and bonds payable	$ 4,167,700		$ 5,291,700		$ 5,080,700	

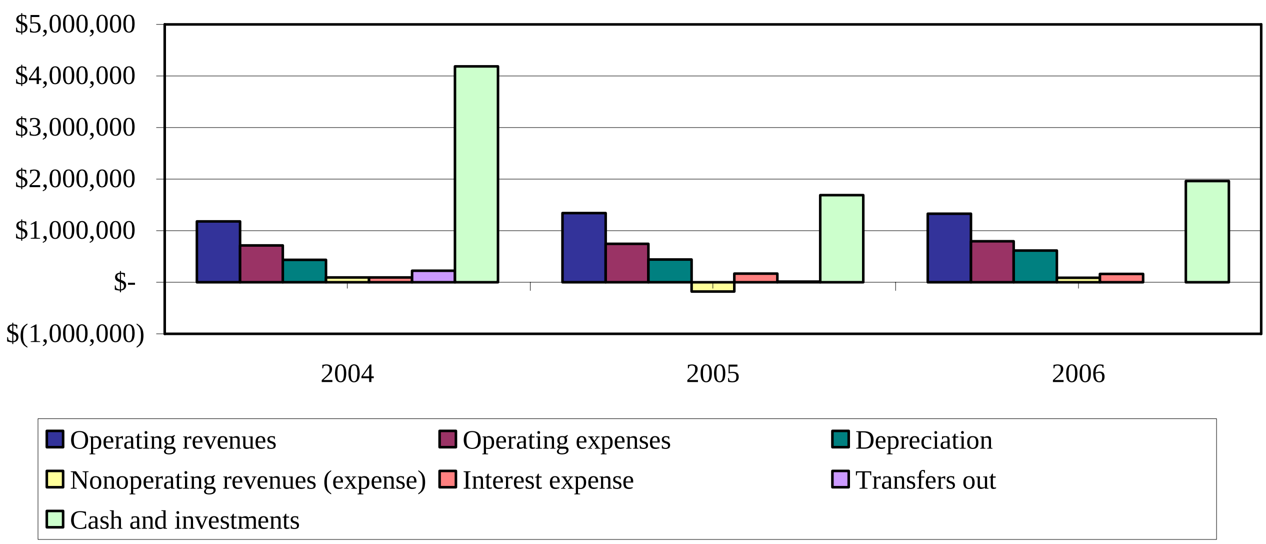


The operating income has been adequate to support cash flow needs in the past and is expected to remain sufficient but it is always important to review cash flow each year to determine if rates are adequate to cover operations and debt service.

The operations of the Wastewater fund for the past three years are summarized as follows:

Wastewater Fund Operations

	2004 Amount	2004 Percent of Revenue	2005 Amount	2005 Percent of Revenue	2006 Amount	2006 Percent of Revenue
Operating revenues	$ 1,181,425	100.0 %	$ 1,339,806	100.0 %	$ 1,331,739	100.0 %
Operating expenses	(712,414)	(60.3)	(743,030)	(55.5)	(797,531)	(59.9)
Depreciation	(437,752)	(37.1)	(443,074)	(33.1)	(616,328)	(46.3)
Operating income	31,259	2.6	153,702	11.5	(82,120)	(6.2)
Nonoperating revenues (expense)	91,475	7.7	(181,506)	(13.5)	85,915	6.5
Interest expense	(95,727)	(8.1)	(169,272)	(12.6)	(162,623)	(12.2)
Income before transfers	27,007	2.3	(197,076)	(14.7)	(158,828)	(11.9)
Contributed assets	-	-	127,371	9.5	965,997	72.5
Transfers out	(224,094)	(19.0)	(15,117)	(1.1)	-	-
Change in net assets	$ (197,087)	(16.7) %	$ (84,822)	(6.3) %	$ 807,169	60.6 %
Cash and investments	$ 4,183,303		$ 1,690,099		$ 1,962,490	
Loans and bonds payable	$ 3,845,000		$ 3,700,000		$ 3,550,000	

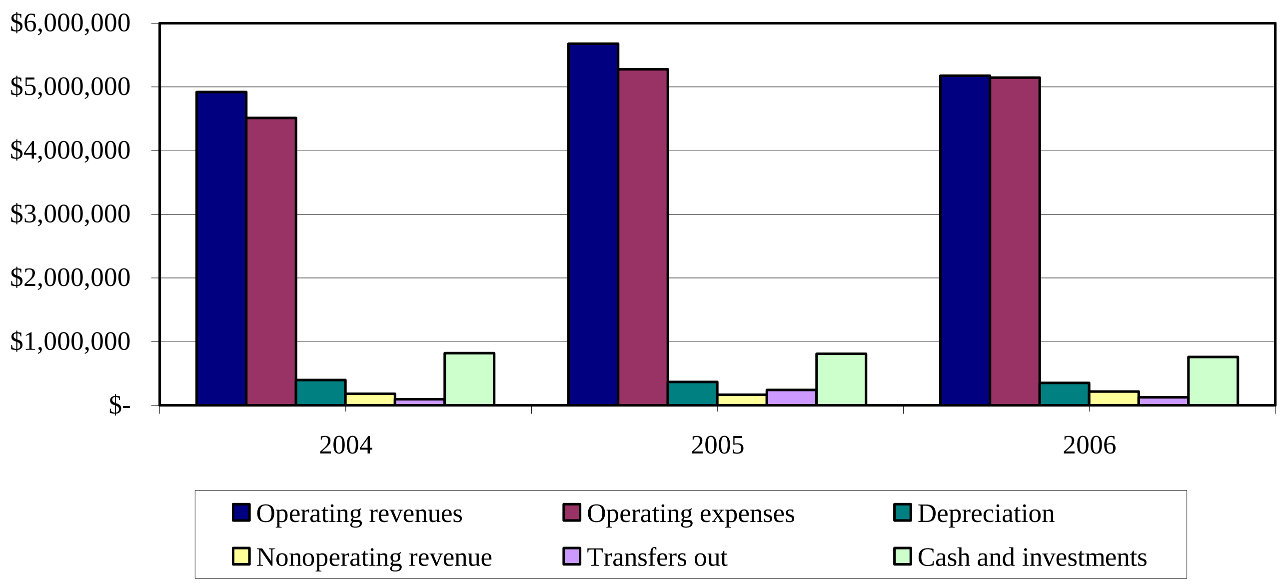


The cash balance remains strong in relation to operations but like the Water fund, it will be important to maintain cash flow to cover future debt service.

The operations of the Electric fund for the past three years are summarized as follows:

Electric Fund Operations

	2004		2005		2006	
	Amount	Percent of Revenues	Amount	Percent of Revenues	Amount	Percent of Revenues
Operating revenues	$ 4,920,582	100.0 %	$ 5,680,141	100.0 %	$ 5,174,467	100.0 %
Operating expenses	(4,514,848)	(91.8)	(5,274,058)	(92.9)	(5,145,889)	(99.4)
Depreciation	(395,605)	(8.0)	(368,950)	(6.5)	(353,713)	(6.8)
Operating income (loss)	10,129	0.2	37,133	0.7	(325,135)	(6.3)
Nonoperating revenue	294,503	6.0	164,429	2.9	219,503	4.2
Loss on disposal of fixed assets	(114,132)	(2.3)	-	-	(1,850)	(0.0)
Income before transfers	190,500	3.9	201,562	3.6	(107,482)	(2.1)
Transfers out	(97,920)	(2.0)	(241,721)	(4.3)	(126,856)	(2.5)
Change in net assets	$ 92,580	1.9 %	$ (40,159)	(0.7) %	$ (234,338)	(4.5) %
Cash and investments	$ 817,554		$ 811,462		$ 757,144	



City Obligation to the Firefighter's Relief Association

The Council approves the Association's per year of service benefit level. The benefit level is currently $1,200 per year of active service. As the Council approves the retirement benefit level, the City is ultimately liable to provide these pension funds if the assets of the Association are not sufficient. In the annual report, the Association's liabilities exceeded their assets as follows:

	Required Supplementary Information				
Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability	Assets in Excess of (Unfunded) Accrued Liability	Funded Rate	Benefit per Year of Service
12/30/06	$ 302,257	$ 302,296	(39)	100.0 %	$ 1,200
12/31/05	293,087	317,757	(24,670)	92.2	1,200
12/31/04	290,245	330,705	(40,460)	87.8	1,200
12/31/05	254,981	276,350	(21,369)	92.3	1,000
12/31/04	249,123	281,490	(32,367)	88.5	1,000
12/31/03	267,500	304,940	(37,440)	87.7	900

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

Other Matters

Ratio Analysis

The following captures a few ratios from the City's financial statements that give some additional information for trend and peer group analysis. The peer group average consists of the average of Abdo, Eick & Meyers' client base of approximately 90 cities. The majority of these ratios facilitate the use of economic resources focus and accrual basis of accounting at the government-wide level. A combination of liquidity (ability to pay its most immediate obligations), solvency (ability to pay its long-term obligations), funding (comparison of financial amounts and economic indicators to measure changes in financial capacity over time) and common-size (comparison of financial data with other cities regardless of size) ratios are shown below.

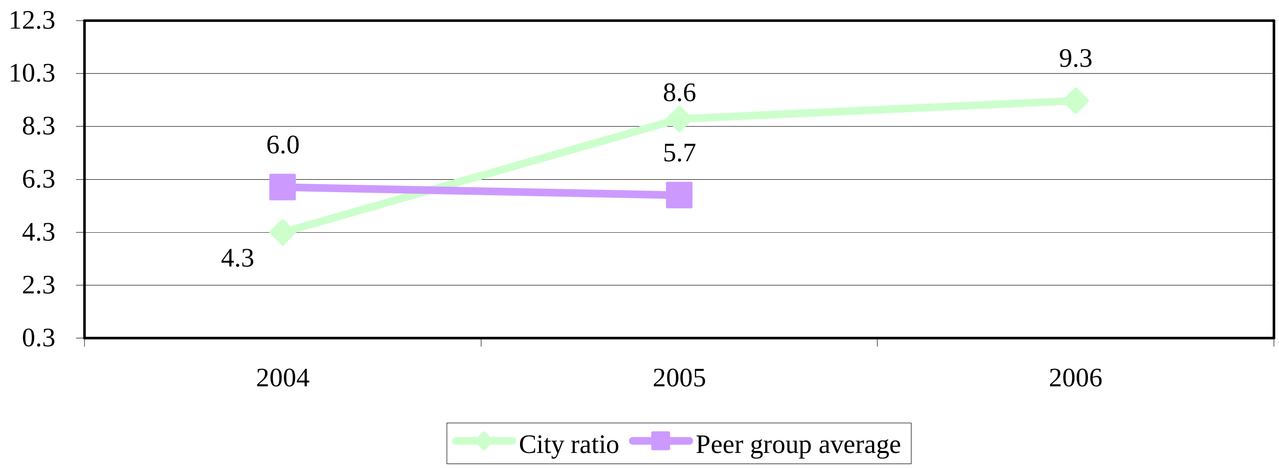
Ratio	Calculation	Source	2004	2005	2006
Current	Current assets/current liabilities	Government-wide	4.3	8.6	9.3
			6.0	5.7	N/A
Debt to assets	Total liabilities/total assets	Government-wide	25%	28%	27%
			34%	34%	N/A
Debt service coverage	Net cash provided by operations/ enterprise fund debt payments	Enterprise funds	37%	54%	61%
			130%	155%	N/A
Debt per capita	Bonded debt/population	Government-wide	$ 3,105	$ 4,153	$ 3,964
			$ 2,159	$ 2,272	N/A
Taxes per capita	Tax revenues/population	Government-wide	$ 271	$ 281	$ 178
			$ 341	$ 365	N/A
Expenditures per capita	Governmental fund expenditures/ population	Governmental funds	$ 503	$ 603	$ 1,117
			$ 982	$ 1,157	N/A
Capital assets % left to depreciate - Governmental	Net capital assets/ gross capital assets	Government-wide	84%	82%	80%
			68%	67%	N/A
Capital assets % left to depreciate - Business-type	Net capital assets/ gross capital assets	Government-wide	67%	66%	64%
			66%	67%	N/A
Charges to total operating revenues - Governmental	Governmental charges for services/ governmental operating revenue	Government-wide	22%	17%	11%
			23%	23%	N/A
Unrestricted net assets to operating expenses	Unrestricted net assets/ operating expenses	Government-wide	89%	104%	91%
			103%	93%	N/A

Represents the City of Melrose
Peer Group ratio

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

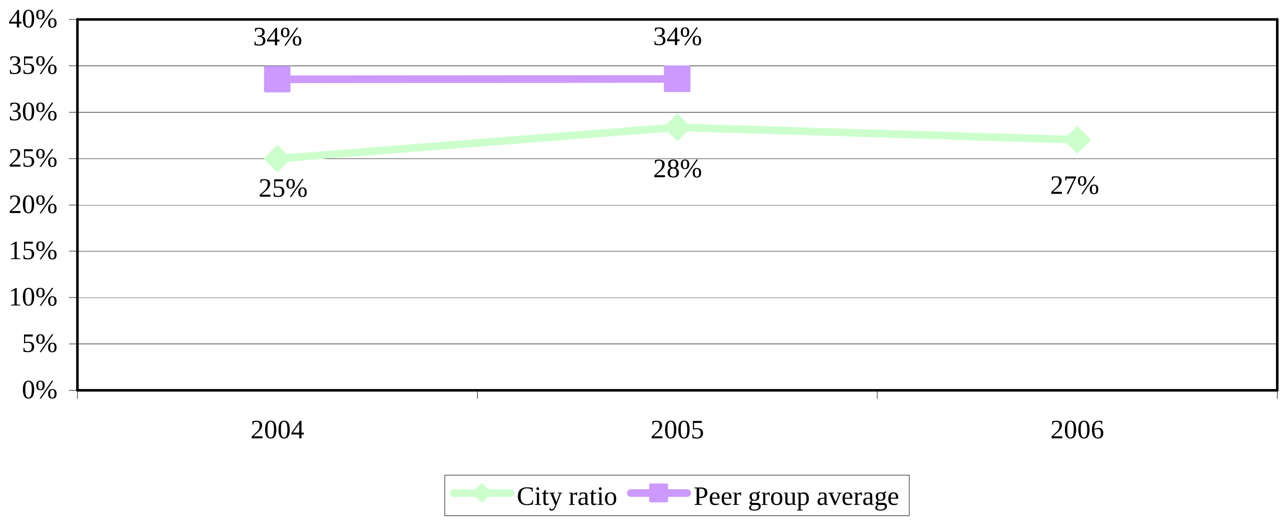
Current Ratio (Liquidity Ratio)

The current ratio is a comparison of a city's current assets to its current liabilities. The current ratio is an indication of a city's ability to meet short-term debt obligations. Acceptable current ratios vary from industry to industry, but a current ratio between 1 and 2 is considered standard. If a city's current assets are in this range, then it is generally considered to have good short-term financial strength. If current liabilities exceed current assets (the current ratio is below 1), then the city may have problems meeting its short-term obligations. If the current ratio is too high, then the city may not be efficiently utilizing its current assets.



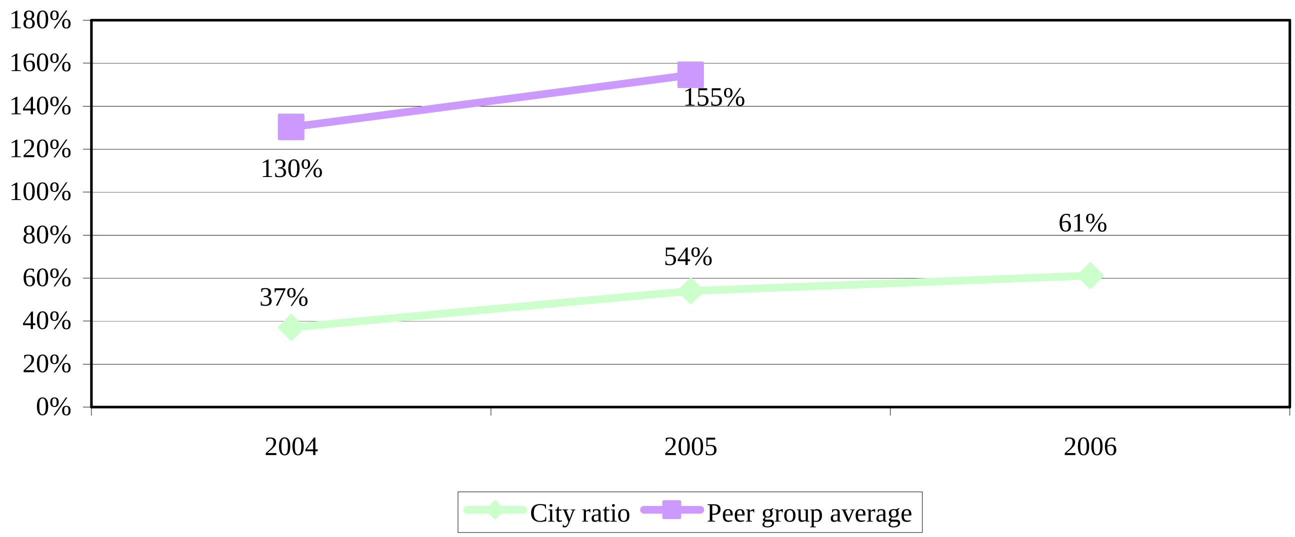
Debt-to-Assets Leverage Ratio (Solvency Ratio)

The debt-to-assets leverage ratio is a comparison of a city's total liabilities to its total assets or the percentage of total assets that are provided by creditors. It indicates the degree to which the City's assets are financed through borrowings and other long-term obligations (i.e. a ratio of 50 percent would indicate half of the assets are financing with outstanding debt).



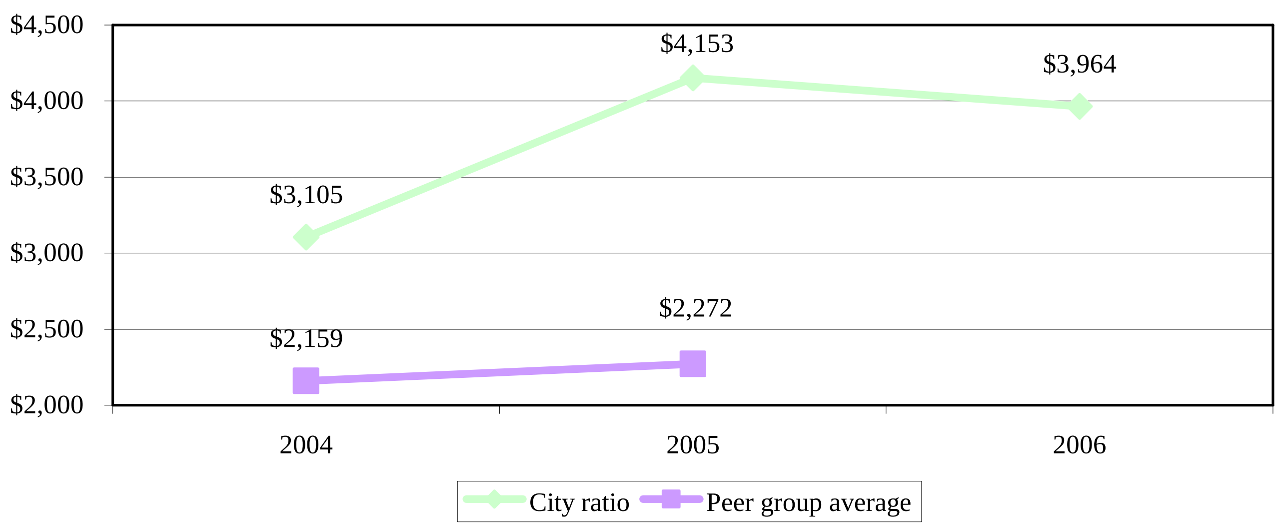
Debt Service Coverage Ratio (Solvency Ratio)

The debt coverage ratio is a comparison of cash generated by operations to total debt service payments (principal and interest) of enterprise funds. This ratio indicates if there are sufficient cash flows from operations to meet debt service obligations. Except in cases where other nonoperating revenues (i.e. taxes, assessments, transfers from other funds, etc.) are used to fund debt service payments, an acceptable ratio would be above 100 percent.



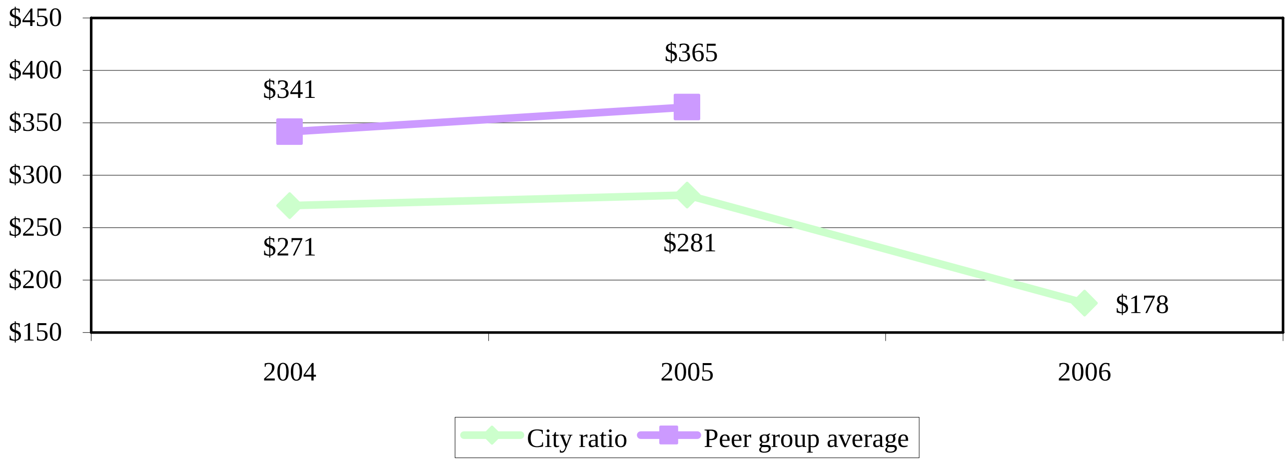
Bonded Debt per Capita (Funding Ratio)

This dollar amount is arrived at by dividing the total bonded debt by the population of the city and represents the amount of bonded debt obligation for each citizen of the city at the end of the year. The higher the amount, the more resources are needed in the future to retire these obligations through taxes, assessments or user fees.



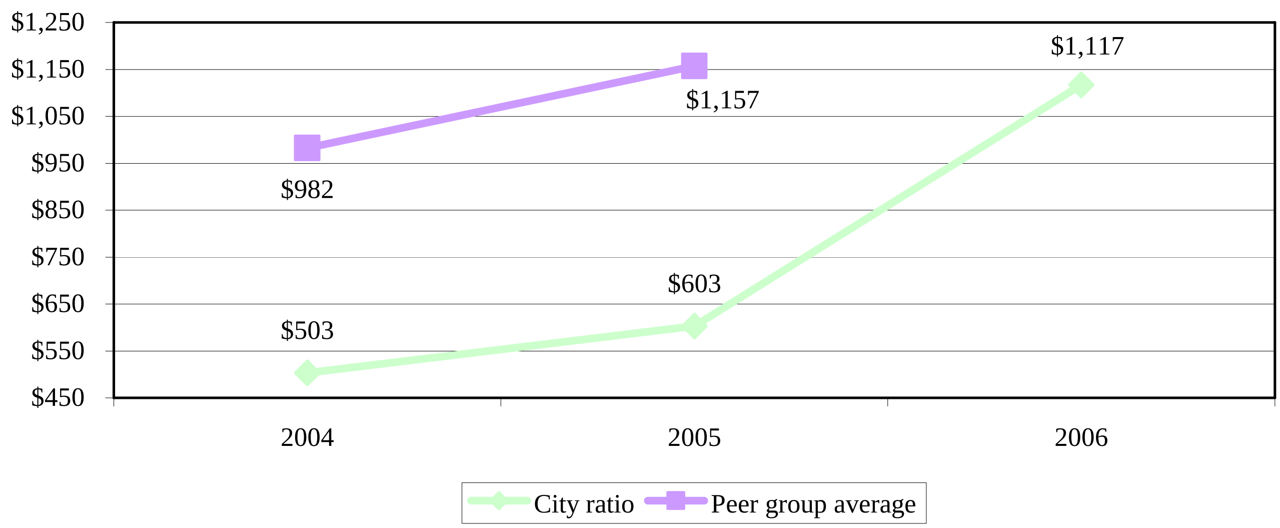
Taxes per Capita (Funding Ratio)

This dollar amount is arrived at by dividing the total tax revenues by the population of the city and represents the amount of taxes for each citizen of the city for the year. The higher this amount is, the more reliant the city is on taxes to fund its operations.



Expenditures per Capita (Funding Ratio)

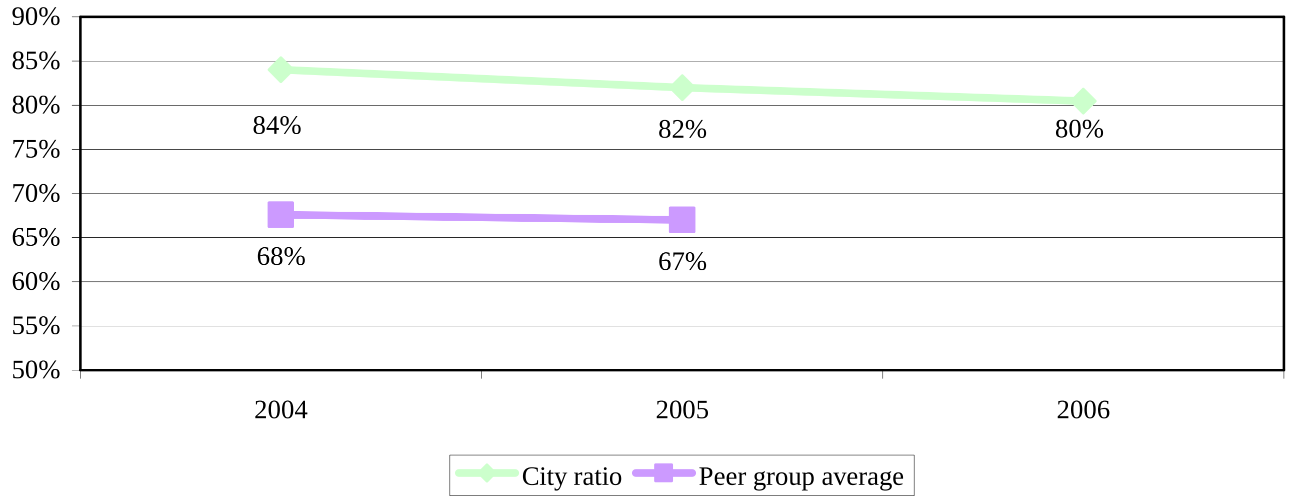
This dollar amount is arrived at by dividing the total governmental expenditures by the population of the City and represents the amount of governmental expenditure for each citizen of the City during the year. Because of major capital projects from year to year, this number may fluctuate accordingly.



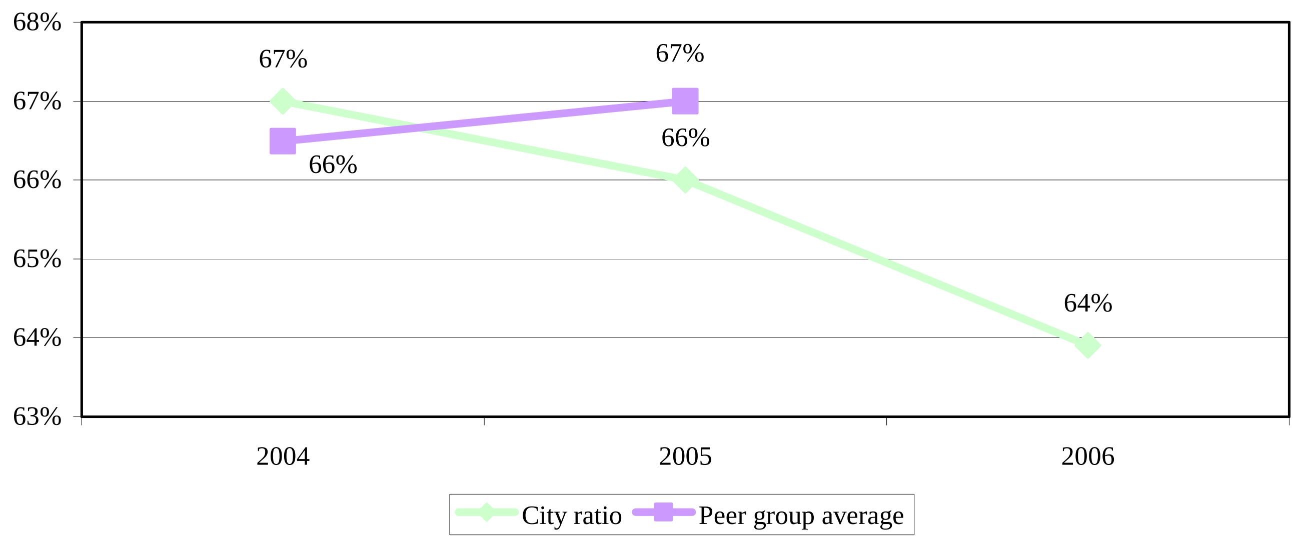
Capital Assets Percentage (Common-size Ratio)

This percentage represents the percent of governmental or business-type capital assets that are left to be depreciated. The lower this percentage, the older the city's capital assets are and may need major repairs or replacements in the near future. A higher percentage may indicate newer assets being constructed or purchased and may coincide with higher debt ratios or bonded debt per capita.

Governmental Activities



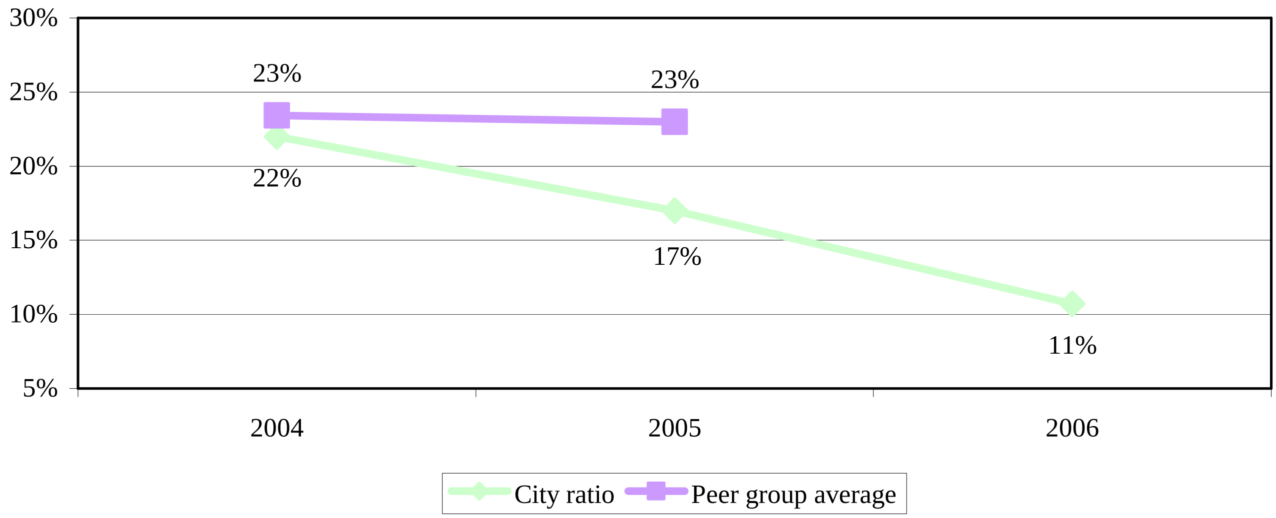
Business-type Activities



952.835.9090 • Fax 952.835.3261
www.aemcpas.com

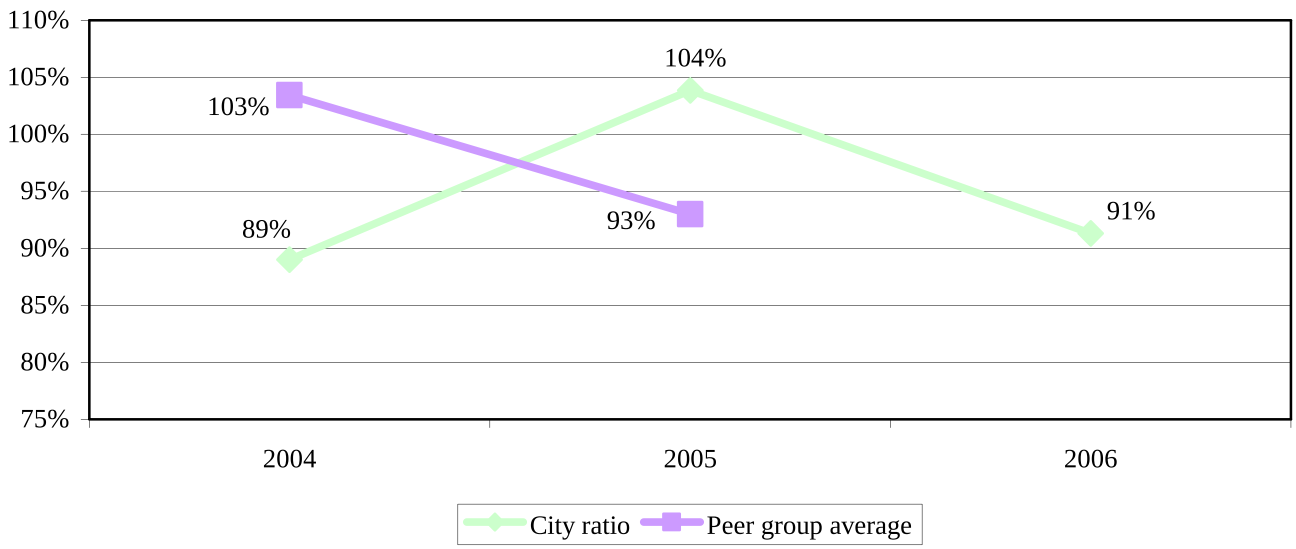
Charges for Service to Total Operating Revenues (Common-size Ratio)

This percentage is arrived at by dividing charges for service by total operating revenues from governmental operations. This percentage indicates the percent of governmental operating revenues that are funded by user charges versus other revenues. It measures the amount of control a city has in funding its governmental operating costs.



Unrestricted Net Assets to Total Expenses (Common-size Ratio)

This percentage is arrived at by dividing total expenses by the unrestricted net assets of the city. It indicates percent of unrestricted funds available at year end to pay for a current year expenses. Approximately every 8 percent represents a month of funds available to cover expenses, so a percentage of 25 percent would indicate funds available to cover 3 months of expenses.



Future Accounting Standard Changes

The following Governmental Accounting Standards Board (GASB) Statements have been issued and may have an impact on future City financial statements:

GASB Statement No. 43 - *Financial Reporting for Post employment Benefit Plans Other than Pension Plans*

This statement is effective one year prior to the effective date of Statement No. 45 for the employer or largest participating employer in the benefit plan for multiple-employer plans. According to Statement No. 43, "The objective of this statement is to establish uniform standards of financial reporting by State and local governmental entities for other post employment benefit plans (OPEB plans). The term other post employment benefits (OPEB) refers to post employment benefits other than pension benefits and includes (a) post employment healthcare benefits and (b) other types of post employment benefits (for example, life insurance) if provided separately from a pension plan. The term plans, in this context, refers to trust or other funds through which assets are accumulated to finance OPEB, and benefits are paid as they come due. This Statement provides standards for measurement, recognition, and display of the assets, liabilities, and, where applicable, net assets and changes in net assets of such funds and for related disclosures. The requirements of this statement apply whether an OPEB plan is reported as a trust or agency fund or a fiduciary component unit of a participating employer or plan sponsor, or the plan is separately reported by a public employee retirement system (PERS) or other entity that administers the plan."

GASB Statement No. 45 - *Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions*

This statement is effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999:

- Governments that were phase 1 governments for the purpose of implementation of Statement No. 34 - those with annual revenues of $100 million or more - are required to implement this Statement in financial statements for periods beginning after December 15, 2006.

- Governments that were phase 2 governments for the purpose of implementation of Statement No. 34 - those with total annual revenues of $10 million or more but less than $100 million - are required to implement this Statement in financial statements for periods beginning after December 15, 2007.

- Governments that were phase 3 governments for the purpose of implementation of Statement No. 34 - those with total annual revenues of less than $10 million - are required to implement this Statement in financial statements for periods beginning after December 15, 2008.

Statement No. 45 gives the following summary, "In addition to pensions, many state and local governmental employers provide other post employment benefits (OPEB) as part of the total compensation offered to attract and retain the services of qualified employees. OPEB includes post employment healthcare, as well as other forms of post employment benefits (for example, life insurance) when provided separately from a pension plan. This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers."

GASB Statement No. 47 - *Accounting for Termination Benefits*

In general, Statement No. 47 is effective for financial statements for periods beginning after June 15, 2005. However, for termination benefits that affect defined benefit post employment benefits other than pensions, governments should implement Statement No. 47 simultaneously with Statement No. 45, *Accounting and Financial Reporting by Employers for Post employment Benefits Other Than Pensions.* The Statement provides accounting and reporting guidance for state and local governments that offer benefits such as early retirement incentives or severance to employees that are involuntarily terminated. The Statement requires that similar forms of termination benefits be accounted for in the same manner and is intended to enhance both the consistency of reporting for termination benefits and the comparability of financial statements.

New Auditing Standards Related to Risk Assessment (SAS 104 - 111)

There are significant changes in the auditing profession that undoubtedly will impact how we perform your annual financial statement audit.

Four years ago, in the wake of the Enron scandal and other business failures, Congress enacted the Sarbanes-Oxley Act. This legislation had a profound effect on both company management and the audit profession; however, the law was applicable only to publicly traded companies and so most of our firm's clients were unaffected.

Earlier this year, the standards-setting body that governs auditors of non-public entities passed a sweeping set of new standards that rewrite many of the fundamental principles of a financial statement audit. Though less in scope than the rules for public companies, these new standards parallel many of the key themes of Sarbanes-Oxley, including new requirements that

- Auditors gain a more thorough understanding of their clients' internal control
- Auditors obtain more detailed information about their clients' operations, their business objectives and strategies, and the risks to achieving these objectives,
- Client management clearly accept responsibility for preparing all financial information and the financial statements.

The main objective of the new auditing standards is to strengthen and maintain the integrity of the independent financial statement audit. We support this objective. We also believe that the new standards will benefit all stakeholders in the financial reporting process - those who prepare financial information, those of us who provide assurance on the reliability of that information, and those who use the information to make decisions about your government.

Because these standards demand a higher level of performance, there will be changes to the way we perform audits. The new standards require us to perform more extensive procedures than we have in the past. In many cases these new procedures will result in higher audit fees.

The good news is that the new rules do not go into effect until next year, that is, the 2007 audit. Between now and then, our firm will be investing significant resources to re-design our audit process and train our engagement teams so they are able to perform their audits as effectively and efficiently as possible.

Over the coming months, as we develop our new audit approach, we will have more details about how that approach will affect our audit clients. Going forward, your engagement partner will be working with you directly to communicate these changes and pave the way for a smooth implementation of the new, higher standards.

952.835.9090 • Fax 952.835.3261
www.aemcpas.com

* * * * *

This report is intended solely for the information and use of management, Council and the Minnesota Office of the Minnesota Office of the State Auditor and is not intended to be and should not be used by anyone other than these specified parties.

Our audit would not necessarily disclose all weaknesses in the system because it was based on selected tests of the accounting records and related data. The comments and recommendations in the report are purely constructive in nature, and should be read in this context.

If you have any questions or wish to discuss any of the items contained in this letter, please feel free to contact us at your convenience. We wish to thank you for the continued opportunity to be of service and for the courtesy and cooperation extended to us by your staff.

Abdo Eick & Meyers, LLP

February 22, 2007
Minneapolis, Minnesota

ABDO, EICK & MEYERS, LLP
Certified Public Accountants

952.835.9090 • Fax 952.835.3261
www.aemcpas.com