# UNDERSTANDING MICHIGAN CITIES, TOWNSHIPS AND VILLAGES

## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>1</td>
</tr>
<tr>
<td>Local Government Structure</td>
<td>2</td>
</tr>
<tr>
<td>Services Provided by Municipalities</td>
<td>5</td>
</tr>
<tr>
<td>Property Taxes</td>
<td>7</td>
</tr>
<tr>
<td>State-shared Revenue</td>
<td>11</td>
</tr>
<tr>
<td>Federal Grants</td>
<td>14</td>
</tr>
<tr>
<td>Debt Issuance</td>
<td>16</td>
</tr>
<tr>
<td>Water and Sewage Disposal Services</td>
<td>20</td>
</tr>
<tr>
<td>Employee Retirement Systems</td>
<td>23</td>
</tr>
<tr>
<td>Allowable Investment Vehicles</td>
<td>25</td>
</tr>
</tbody>
</table>

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UNDERSTANDING MICHIGAN CITIES, TOWNSHIPS & VILLAGES

PREFACE

The purpose of this manual is to help to familiarize the young (and the not so young) audit staff with the financial environment that Michigan cities, townships and villages work within. The primary purpose of this manual is not to give information on accounting issues and auditing issues; that information may be found in the existing literature (the Codification, State and Local Audit Guide, various federal single audit guidelines, and the periodic Plante & Moran technical update memos). Although this manual may at times deal with accounting and auditing issues, its primary purpose is to make us more aware of the environment in which municipalities operate, so that we can better understand "what kind of animal we are auditing," and how to apply the accounting and auditing theory to the specific facts and circumstances.

The municipal environment is in some ways very different than the commercial (or "private sector") environment, but in other ways it is remarkably similar. An understanding of the similarities and differences may help in understanding why some of the accounting treatment is different than commercial enterprises (then again, it may not help at all, since some of the recent governmental accounting pronouncements seem to be way out in left field!). The state statutes, legal opinions and court decisions that combine to set the rules within which the local municipality must operate is changing rapidly. Therefore, the municipal environment must be seen as a moving target. This manual will probably be at least partially outdated even as you read this. However, we will be sure to update this manual periodically for any significant changes in the municipal environment.
LOCAL GOVERNMENT STRUCTURE

**Townships**

The original structure of local governments in Michigan was created in the Northwest Territories Act of 1787, which set up a township structure for the whole Northwest Territory. The township form of government originated in the New England states where the early settlers built their homes in clusters, or towns, for protection from the cold weather and hot Indians. Some of the early practices of the New England towns, such as the Annual Town Meeting, still exist today. Townships in the Northwest Territories generally consisted of 36 square miles of land (usually 6 mile by 6 mile squares). Counties, which encompass a group of townships, were also created; originally the County Board of Commissioners was comprised of the Supervisor from each township (and was referred to as the "County Board of Supervisors"). The rules regarding operation of a township are derived from statutes enacted by the State of Michigan, the Michigan State Constitution, provisions of the Northwest Territories Act, and preexisting common law (rules such as structure of the legislative function vs. executive function, responsibilities of the three officials in the executive function, activities which the township is able to become involved in, etc.).

Unlike cities, townships are not able to form their own set of rules, via a charter or other type of by-laws. Townships are given responsibility for certain specific functions: the election process, property assessment and property tax collection process, land use zoning (planning), building safety inspection, and the constable function. In addition there are only a few additional functions which townships are permitted to carry on: police protection, fire protection, and water & sewer services for instance.

**Cities**

The Michigan Constitution allows citizens who desire services in addition to those of their local township to form a city. A city is formed through a positive vote of a majority of the electors within the proposed city boundaries. These boundaries do not necessarily coincide with the old township boundaries. When the city is formed, the area within its boundaries is no longer part of the township that preexisted it and the above Township responsibilities are accepted by the City; further, certain additional responsibilities are taken on by the City:

- Responsibility for the roads (through the major and local street funds which are funded by Act 51 monies).
Police (the county's sheriff's department is no longer responsible for patrolling within the city area as it is for a township).

In most cities, the following additional functions: fire protection, water, sewage disposal services, storm water drainage, library, parks and recreation.

**Annexation - Charter Townships**

The Michigan Constitution allows cities to change their boundaries and annex pieces of townships through a majority vote of the city, which gives the township few rights to deny this annexation. This may seem unfair to the township, but it is probably a result of the township being a "default" form of government, i.e. no positive action was required by the township citizens to form a government, this is just the form of government accepted from the Northwest Territories Act. In order to correct this perceived inequity, the State of Michigan enacted the Charter Township Act which permits townships to become a "Charter Township" through either a vote of the people or a vote of the existing township board. A city cannot annex land from a charter township without a vote of the citizens of the township. Townships that have not changed to a Charter Township are also referred to as "common law Townships."

**Villages**

There is also a provision for citizens who desire to have more services provided than their present township is providing but still want to retain the present township structure. They can form a village, which is a second layer of government that is created and co-exists with the Township to provide only the specific functions so designated by the electors. In other words, a village may be voted in to provide just certain services such as police protection, fire protection, water and sewer services. Villages typically do not encompass the entire township but only the portion of the township such as a downtown district that wishes to have and pay for these additional functions. Therefore, when you are in a village, you are also inside a township.

**Fiscal Years**

It is interesting to look at the fiscal years of the various local government units. Common law townships must have either March 31 or June 30 year ends. All charter townships have December 31 or March 31 year ends (prior to May 1988 a calendar year was dictated by the Charter Township Law). Cities are allowed to set any fiscal year, although the vast majority of cities have June 30 year ends.

The story of how most common law townships came to have March 31 year ends is very interesting. Townships collect their taxes at December 1 of each year, which
means the tax bills are due by February 15 and become delinquent on February 28. It takes most townships three or four weeks to analyze their collections and give their list of delinquent tax bills to the county (the county is then responsible for reviewing and then collecting these tax bills). Many years ago townships would close their fiscal year on the day that the tax delinquencies were handed over to the county (the "tax settlement date"). If you look back at audited financial statements of townships that go back into the 1930's and 40's you will see fiscal year ends of March 24, March 28, etc. Apparently someone decided that we really ought to all be on a consistent 12 month fiscal year, and so March 31 was chosen.
SERVICES PROVIDED BY MUNICIPALITIES

Below is a list of the most common services provided by most municipalities:

1. Police protection.
2. Fire protection.
3. Building safety and inspection.
4. Elections
5. Street maintenance and construction (just cities and villages)
7. Water services
8. Sewage disposal services
9. Financing of the local District Court.
10. Financing vehicle for specific homeowners to use in constructing streets, sidewalks, water and sewer lines, etc. (i.e., special assessment districts).

Most municipalities perform some services in addition to those listed above. Some of these typical services would include: garbage collection, maintenance of a library, parks and recreation facilities, street lighting, theater, etc.

The key decision for most municipal policy makers (the City Council, the Township Board, or the Village Council) is choosing the level of the above services that should be provided, given the availability of the sources of financing such activities.

- The street maintenance and construction is financed by the local gas and weight tax (that’s the tax that you are paying at the gas station every time that you fill up and when you purchase license plates); quite often, however, this revenue (sometimes referred to as Act 51 revenue), is not nearly sufficient to finance the amount of street services required and the municipality is forced to find other sources of revenue to contribute to the streets.

- Water and sewer services are generally financed by the specific users of the water and sewer system.
Special assessment projects are generally financed by the individuals benefitted by the project (the individuals in the special assessment district).

The district court is financed primarily by the traffic fines and other fees collected by the court.

Parks and recreation, library and other such operations often charge a nominal fee to use the services, but it is rare that the fees are sufficient to cover the complete cost of the operations. To the extent that services are not completely financed by specific users of the services (police, fire, building safety, tax assessment, billing and collection, elections, etc.), the municipality must utilize its general financing sources to fund these programs; for these programs, the legislative body must match its available sources of financing with the level of services desired.

As explained in more detail in the following pages, the major sources of general financing are: property taxes, state-shared revenues, building licenses and permits, long-term financing (bonds, long-term leases, or other contractual obligations) and (sometimes) interest earnings. In addition, quite often federal and state grants are offered to local municipalities, which enable them to provide services that they would not normally otherwise provide (i.e., housing rehabilitation, and other projects that benefit the general health and welfare of the municipality).
PROPERTY TAXES

Property taxes are generally a municipality's most important source of revenue. In addition to normally being the largest single source of revenue (property taxes plus State-shared revenues generally make up two-thirds to three quarters of any city's general fund budget), it is also controllable by the community (within certain constitutional and statutory guidelines). State-shared revenues on the other hand, are outside the control of the local government.

Property tax revenue results from the following simple formula:

\[
\text{Taxable Value (TV)} \times \text{Millage Rate} = \text{Property Tax Revenue}
\]

However, there are numerous rules regarding the makeup of both the state equalized value and the millage rate which can make the property tax process appear to be very complicated. We will explore these details below.

**Taxable Valuation**

The process of calculating a community's TV begins with the assessor who places values on each piece of real property within the community and on certain business owned personal property within the community as of December 31, of each year. The assessor places two values on each property: The Assessed Value (AV) and the Taxable Value (TV). The Assessed Value is 50 percent of the property's true cash value. The Taxable Value is equal to the AV in the year a property is initially acquired; in subsequent years it is increased by the lesser of:

- five percent; or
- inflation

By March 1 of each year, the assessor must send a notice to each property owner whose assessed valuation has increased from the prior year. This gives each property owner a chance to challenge the assessor's increased valuation which they may do at the community's board of review (usually takes place during March or April of each year). The board of review may only adjust assessed valuations (it does not have the power to change a tax bill in any way other than changing the assessed valuation).

The County and State are responsible for reviewing the assessed valuation and, if necessary, adjusting it by a factor to arrive at the State equalized valuation. After the passage of Proposal A, however, this equalization process is no longer very meaningful (it no longer has the potential to result in a reduction in the millage rate levied).
Millage Rate

Authorized Operating Millage--Each community has a maximum authorized operating millage rate within which the legislative body may levy without voter approval. For cities, this maximum rate is set by its charter; however, if the charter is silent, then the state law provides a cap of 20 mills (before adjustment for the Headlee Amendment).

For common law townships, the operating millage is allocated to it by the County Allocation Board, (which generally has a combined maximum authorized rate of 15 or 18 mills less the 1993 school millage rate, which it then allocates between the County and the Townships). Most allocation boards allocate only one mill to the townships; therefore, for all practical purposes, the common law townships maximum authorized millage is generally 1 mill.

For charter townships, there is currently disagreement as to what is the maximum authorized operating millage. If the township became a charter township through a vote of the people, it seems fairly clear that the maximum millage is 5 mills. However, if the township became chartered through a vote of the township board, we have seen 4 different legal opinions in writing.

- The first opinion gives the same 5 mills to the township, i.e. it doesn’t matter that the people didn’t vote on it.

- The second opinion says that whatever the total millage was that was levied at the time the township board voted to go charter, now becomes the maximum authorized millage rate (the 1 mill operating levy plus any additional special voted millages would then become the maximum authorized operating millage).

- The third opinion says that you have to stick to the 1 mill given to you by the county equalization board.

- The last opinion says that you have no authorized millage since the county allocation board is no longer responsible to allocate the 1 mill to you.

Due to the current disagreement, it would normally be important to involve any given Charter Township’s legal counsel in the determination of maximum authorized millage.

Extra Voted and Other Millages--In addition to the operating millage, the community may have additional millage such as:

- Extra voted millage for special purposes
A debt millage for bonded indebtedness which originated prior to 1979

A judgement levy (which is a millage that is intended to pay off a legal obligation arising from a court judgement)

Sanitation levy

Act 345 Police and Fire Retirement levy, or

Economic Development and Promotion levy

The extra voted millage for special purposes is commonly used in townships which only have 1 mill (normally to provide police, fire and other services) or by a city that has reached its maximum authorized operating millage and feels it needs more.

The debt levy is also very common. Although the Headlee Amendment eliminated the community’s ability to levy a property tax millage to pay for debt without first going for a vote of the people, the community may still levy a millage to pay for debt incurred prior to 1978, merely through an action of its legislative body.

**Headlee Rollback**—The Headlee rollback factor is a result of the Headlee amendment of 1978, which included a provision that a community’s total taxable value (TV) (after adjusting for new property additions or losses) should not increase faster than the inflation rate. With the passage of Proposal A in 1994, this factor comes into play less often. The Headlee implementing legislation rolls back the maximum authorized millage rate for each municipality, to the extent that the total TV increases more than the rate of inflation. It does not apply to a debt millage (i.e. a millage that covers any pre-Headlee debt or post Headlee debt with voter approval) or any millage that has no maximum rate (such as an Act 345 millage). The Headlee millage reduction fraction compounds each year so that it builds on itself, but it can never increase from the prior year.

**Truth in Taxation**—Truth in Taxation is essentially superseded as of January 1, 1996. The law was not a property tax rollback law, but instead is a public notice/public hearing law. This law required that if the total operating taxes levied (after adjusting for additions and losses in SEV) was more than the prior year’s levy (without regard to the inflationary increase that Headlee allows), the local unit must publish a notice in the newspaper using a specified print size, etc. informing the public that they intend to raise taxes, and that a public hearing will be held to discuss the increase; secondly, a public hearing must be held at which the public has a chance to discuss the “increase in taxes.” Although the public has no vote in the public hearing, often times the requirements were enough to convince many localities to roll back their tax rates rather than proceed through the public notice and public hearing.
Current legislation (effective 1/1/96) states that the truth in tax provisions will not apply if:

- The budget hearing notice states that the millage rate will be discussed at the budget hearing; and
- The general appropriations act includes the number of mills to be levied

**Billing Procedures - Excess of Roll**

Just to complicate things, when the community prepares the property tax billings, it sometimes rounds the millage rate to the nearest two decimal places, and rounds each individual SEV to the nearest $100. The rounding convention is to always round up, never down. Thus, when you add up the amounts billed on each individual property tax bill, you get a number that is greater than the product of the community’s total unrounded SEV times the community’s unrounded millage rate. This excess is referred to as "excess of roll," and is retained by the community. In recent years, some assessors have begun to question the validity and/or legality of this excess of roll.
STATE-SHARED REVENUES

The State of Michigan is required by the state constitution to share ten percent of sales tax collections with cities and townships. This amount is distributed on a per capita basis and is known as the **constitutional sales tax distribution**.

The state also distributes additional amounts to cities, townships, villages and counties based on legislation begun in the early 1970’s. This is subject to the 1978 Headlee amendment that prohibits the state from reducing the portion of the total state budget returned to local units of government (which includes schools and colleges, by the way). This portion of state-shared revenue is subject to the annual state legislative budget process (battle), which causes it to be less reliable than the constitutional sales tax distribution. This distribution is known as the **statutory sales tax distribution**.

This distribution used to be based on relative tax effort (RTE), but beginning October 1, 1998 this is being phased out over ten years, and replaced with a new three-part formula (taxable value per capita, local unit type & population, and yield equalization factor).

RTE is computed as the local unit’s tax effort (total revenues derived from the property tax, city income tax, plus special assessment ad valorem tax divided by the total TV of the local unit - generally this computes out to the local unit’s total property tax rate) divided by the state-wide average tax effort rate (generally 13 to 15 mills in recent years). For purposes of the statutory sales tax distributions the local unit’s RTE is multiplied by the local unit’s population to come up with the distribution base under which these revenues are shared state wide.

There are a few additional state-shared revenues, including the single business tax inventory reimbursement. This is calculated as the local unit’s total property tax millage rate for the prior year, multiplied by the unit’s total SEV of inventory on December 31, 1975. The purpose of this distribution is to reimburse the local units for their revenue loss when the state repealed the local property tax on inventories (this happened at the same time that the SBT was instituted and it was determined that proceeds from the SBT would be used to reimburse local units for this revenue loss). In addition, there is the SBT index payment that is paid once a year (based on RTE and population) which is intended to make up for the effects of inflation on the inventory reimbursement.

We should also mention that there are a few additional possible types of state-shared revenue payments that are not commonly seen: the special census payment - a once a year payment for those communities who have demonstrated a greater than 15 percent increase in population from the last decennial census (the payment has to be approved annually by the State legislature and governor); the minimum guarantee; relative tax burden payment; and the census delay adjustment after the decennial census.
In order to help the local units in their budget and planning process, each March the State Department of Treasury projects the payment rates for eighteen months in advance for the sales tax distributions. For planning purposes it should be noted that the statutory sales tax distributions are also subject to legislative or executive order cuts; only the constitutional sales tax distribution is guaranteed (at ten percent of the gross collections).

Governmental units generally should be recording as a revenue and recognizing a receivable for any state-shared revenues that will be received within 30 or 60 days of year end, depending upon their revenue recognition criteria.

**Act 51 State Gas and Weight Tax**—All roads in Michigan fall into one of the following categories:

- Private roads
- Local roads
- Major roads
- County roads
- State trunklines
- Federal interstates

Private roads which legally are owned by individuals and are not the responsibility of any governing unit to maintain.

Public roads are maintained at the following levels:

- Major and local roads are maintained by cities, villages and by county road commissions on behalf of the townships within their county
- County roads are maintained by the County Road Commission
- State trunklines are maintained by the Michigan Department of Transportation
- Interstates are maintained by the federal government and do not come under the purview of the state’s Act 51. (You have probably noticed that there is also a federal gas tax paid at the pump which is used for this purpose.)

Act 51 of 1951 of the State of Michigan imposes the gas tax that we all pay at the gas pumps and the license fees that we pay on our cars (now based on value rather than on weight of the vehicle). These fees and taxes are used to fund road maintenance and construction. The state allocates this revenue to its own Department of Transportation, county road commissions, cities, and villages based on a complex formula that includes miles of streets, population, etc.
The state distributes the Act 51 revenues to the cities and villages monthly. The distribution is made in two separate checks, one for local roads, and one for major roads. It is important that these two amounts be accounted for separately. One of the legal requirements of the Act is to have two separate bank accounts for these two purposes, but that is not followed by many communities--a separate accounting is generally sufficient. Some of the other major requirements of Act 51 are as follows:

- Separate major street and local street funds.

- Funds can be redirected from the major street fund to the local street fund up to 25 percent of total revenue, if approved by the city council. If approved by the state, an additional 15 percent can be redirected. (There is no limit on the amount of local street funds which may be redirected to the major street fund).

- Construction of new local roadways must be matched dollar for dollar with locally generated revenues. (This local match can include other federal and state grants, special assessments, etc.).

- Administrative costs charged to these funds must be no more than ten percent of total Act 51 revenue.

- An annual highway report must be filed with the state each October, detailing all road related expenditures during the year. It is permissible to account for some road expenditures in other funds (for instance, when a grant fund is paying for road construction, it is acceptable to account for it in that fund rather than in the major or local street fund); however, all such expenditures must be included on the annual highway report.

- Funds cannot be used to purchase equipment or any other capital outlay other than road construction. Equipment must be purchased by the city with other funds (typically in either the general fund or in an internal service fund); rent can then be charged to the major and local street fund for actual use. These rental rates cannot exceed the rates published annually by the state of Michigan in its "Schedule C" report, unless the city can specifically prove that its costs are higher.
FEDERAL GRANTS

Grant Revenue--The number of federal grants available to local communities seems to be decreasing yearly. In the past some of the major programs were:

- Local Public Works Program (LPW)
- Anti-recession Fiscal Assistance (ARFA)
- Comprehensive Employment Training Act (CETA)
- Federal Revenue Sharing (FRS)

With the demise of these programs, the Community Development Block Grant Program (CDBG) is the only remaining program that is widely available to most communities. The CDBG Program is administered by the United States Department of Housing and Urban Development. At this point in time HUD only gives CDBG funds directly to certain communities, generally those with over 50,000 population. However, for all other communities, HUD also gives funds to the state and urban counties (Wayne, Kent, Oakland, Macomb and Genesee counties) and encourages them to pass CDBG funds through to the local communities on a sub-grantee basis. The state of Michigan administers CDBG both through its Department of Commerce and the Michigan State Housing Development Authority (MSHDA).

The CDBG program is very restrictive. The grants are awarded once a year, after the community completes a very rigorous application process. The funds will be used primarily to benefit low and moderate income individuals. Other approved uses include removing blight, benefiting senior citizens, and improvements of an emergency nature. In addition, there is a restriction on the amount of federal funds allowed to be on hand. To meet this requirement, most communities spend the money first, and then ask to be reimbursed later. In fact, for some CDBG pass-through programs, the granting agencies require the local community to show proof of payment before they will reimburse the community.

Program Income--Most non-federal cash received by the municipality that is received as a result of federal grant activity is considered to be "program income." The most common example of this would be a loan repayment resulting from a federal grant that was used to make a below-market loan (such as a CDBG housing rehabilitation loan); the repayment of the loan is program income. The significance of program income is that the municipality must either return the funds to the federal government (whichever agency gave it the original grant that resulted in the program income), or use the money for additional expenditures that meet the exact same compliance requirements and restrictions as the original federal grant. Program income is generally required to be used before any further drawdowns on the original grant. There are two alternative accounting treatments for program income:
The first is to record any program income as deferred revenue, and then when
the funds are subsequently spent (following the terms and conditions of the
original federal grant), recognize additional federal grant revenue and grant
expenditure.

However, a practical approach is to record program income as current revenue
and later reduce the reimbursement requested from the federal government.

Revenue Recognition for Grants

Grant revenue recognition prior to GASB 33 (effective 6/15/00):
For an expenditure driven grant, the grant revenue, including program income, is
recognized at the time that an allowable expenditure is incurred. Deferred revenue is
recorded when grant funds and program income are received before an allowable
expenditure is incurred; and a receivable is recorded when an allowable expenditure is
incurred before federal funds or program income is received, without regard to the
"availability" rule. As a result, revenues exactly equal expenditures at any given time
(total grant expenditures less program income would equal grant revenues). When a
revenue and expenditure are recognized for allowable economic or housing loans it is
customary to set up a loan receivable and offset this with deferred revenue to maintain
control of the outstanding loans.

Grant revenue recognition after adoption of GASB 33 will be the same as for any other
revenue. This means that governmental funds may only recognize the revenue if it is
measurable and available (collected within 30 to 60 days of year end)
DEBT ISSUANCE

Types of Financing Vehicles

When municipalities need funds to finance projects or working cash needs, they may issue long-term bonds, short-term notes, or they may finance items through a vendor using an installment purchase contract. In addition, the municipality may obtain a bank loan, if approved by the State of Michigan. Long-term bonds may be issued directly by the municipality, or through a financing conduit such as a building authority or the county (via an Act 342 or Act 185 contract).

Long-Term Bonds - Almost all municipalities use a paying agent when issuing bonds. Under this system, the community makes its semi-annual payment to the paying agent rather than directly to each bondholder (typically interest is paid twice a year and principal once a year). The paying agent then is responsible for paying each individual bondholder.

Tax Anticipation Notes--Tax anticipation notes are short term notes which state law only allows if you can show a cash flow deficit within that short term operating period. The property tax revenues of the municipality are pledged as collateral on these notes. These notes would generally be shown as liabilities of the receiving fund, rather than of the long term debt group of accounts.

Installment Purchase Agreements - Sometimes referred to as capital leases or vendor financing leases, these are just vehicles that allow the vendor to finance the acquisition of a capital asset. The advantages of these contracts are their simplicity, requiring no state approval, and low costs of issuance (as compared to a bond issue that requires an attorney to assist with the maze of rules to follow and has a sometimes substantial cost of issuance attached to it).

Building Authority Bonds--This is a financing vehicle that communities can use to finance construction of new facilities. A new authority is created (the building authority) that issues the bonds and builds the facility (such as a new town hall) and then leases the facility to the municipality. In most recent instances the amount of the lease payment exactly equals the amount of the debt service on the building authority bonds. Even though the building authority is technically a separate authority from the city or township, we generally consider this to be part of the city entity for financial statement purposes, so the building authority bonds are reported in a municipality's general purpose financial statements. A building authority bond may be either a G.O. bond or a revenue bond (see discussion below).

County Contractual Obligations--Another common financing source for water and sewer lines is Act 342 and Act 185 construction bonds. Under the provision of this Act the county actually issues the bonds under its name and uses the proceeds to manage the construction project. The local municipality then signs a contractual
agreement with the county whereby it will "lease" the lines from the county for an amount that normally equals the county's debt service on the bonds (be careful, the rental payments do not always match the debt service exactly) and then at the end of the bond issue the ownership of the lines revert to the local municipality. These leases are typically capitalized by recording the lines as assets of the local municipality and recording the contractual obligation as long term debt.

Act 175 Bonds - These bonds are issued by cities or villages to finance construction of roads. Debt payments on these bonds are funded from gas and weight tax revenues received under Act 51 (by the Major and Local Street Funds). The amount that can be borrowed under this Act is limited to that resulting in debt service of no more than 45 percent of the Act 51 revenues of the fiscal year prior to the borrowing.

Level of Commitment

The level of the municipality's commitment may be one of the following:

- A general obligation
- Limited to specific revenues (i.e. a "revenue bond")
- Secondary liability, after the primary bond payor (such as in a special assessment bond)
- No commitment, as in most IDRB (Industrial Development Revenue Bond) and EDC (Economic Development Corporation) issues

General Obligation Debt--G.O. debt is any debt (bond issue or other contractual obligations such as a financing lease, etc.) in which the local municipality pledges its full faith and credit. Before the Headlee amendment in 1978 a municipality could issue a general obligation bond and this would commit the community as a whole insofar as the community could then raise its property tax to pay for the debt service on such bonds without a vote of the people. Since the Headlee Amendment said that communities could not commit the full faith and credit without a vote of the people, "limited tax G.O." bond issues now commit the full faith and credit of the community "as limited by the laws under the State of Michigan." What this means is that the community cannot raise its property taxes above their charter limit without a vote of the people to pay for the debt service on any bond issued after December 23, 1978.

Revenue Bond--This is a bond that pledges all revenues from a specific project to be used to pay the debt service on these bonds. In other words, if the revenues from this specific project are not sufficient to pay the debt service requirement then the community as a whole is not obligated to do so. This bond is riskier of course for the bond holder, so there is generally a higher interest rate attached to this. You would see this type of bond mainly with construction of water and sewer lines.
One special type of revenue bond is the Act 175 Motor Vehicle Highway Fund bond issue. These bonds are issued by cities and villages to construct roads; the Act 51 gas and weight tax revenues are pledged to support the bond repayment. However, no community may pledge for debt service requirements in excess of 45 percent of the revenues received during the fiscal year next preceding any borrowings under Act 51.

Special Assessment Bonds--Special assessment bonds are generally a vehicle used to finance infrastructure improvements for an area of the city or township which is going to be paid for by the residents of the area. In some instances the city or township participates in paying for this, but in its simplest form a special assessment district is formed which pledges to pay off the bonds. Generally the cost of the project is estimated before it is begun, the bonds are issued for that amount and a special assessment levy is set up for the same amount. Typically the levy is payable over the same number of years as the bond, and the interest rate is within one percent of the rate on the bond issue.

IDRB and EDC Bonds - Under certain limited circumstances, municipalities are allowed to issue debt on behalf of a commercial enterprise to be used for the private purpose of the enterprise, and for which the debt will be serviced by the enterprise, with no commitment on the part of the municipality to guarantee payment on the bonds. This type of debt may be issued directly by a municipality under the Industrial Development Revenue Bond (IDRB) Act of 1963, or may be issued by an Economic Development Corporation (EDC). This type of debt is generally excluded from the community’s balance sheet, since it is not the community’s obligation to pay the debt (even though the bond document has the name of the municipality on it).

Constitutional Debt Limitation

Cities, villages, and charter townships are limited in the amount of general obligation debt they may incur to ten percent of the municipality’s state-equalized valuation. In computing the limitation, certain kinds of indebtedness are excluded for the various entities. In general, the ten percent debt limitation for cities and villages does not include revenue bonds, motor vehicle highway fund bonds, special assessment bonds, mortgage bonds, (which are secured only by a mortgage on the property or franchise of a public utility), bonds issued to refund money advanced as paid on special assessments for water main extensions and bonds issued or contracted as assessment obligations incurred to comply with an order of the water resources commission or a court of competent jurisdiction. For charter townships, the ten percent debt limitation does not include special assessment bonds that are limited tax obligations, and revenue bonds. Common law townships do not have an overall debt limitation similar to cities, villages, and charter townships. In addition, State law (P.A. 99 of 1933) limits the total installment purchase contracts outstanding to 1.25 percent of SEV.
Arbitrage

"Arbitrage" is the concept of earning a profit by purchasing a security and subsequently selling it at a higher price. More specific to the municipal environment, arbitrage is earned when a bond (or other type of obligation) is sold, with interest payable at a set interest rate, and the proceeds are reinvested in investments earning higher yields.

While this is not illegal, under the IRS regulations this could result in a loss of the tax exempt status to the bondholders. For bonds issued after August 31, 1986, the Tax Reform Act of 1986 both: a) tightened up the definition of arbitrage; and b) provided that the municipality could rebate the arbitrage earnings to the federal government, thereby retaining the tax exempt status of the bonds. If any of the following exemptions apply, the arbitrage rules do not need to be applied:

- If total obligations issued during a calendar year are under $5 million, all obligations issued that year will be exempt from the requirements.
- If the gross proceeds are invested in tax exempt bonds or in U.S. Treasury SLG’s, the investment earnings are not subject to the arbitrage requirements.
- In certain circumstances, investment earnings of bona fide debt service funds are exempt from the requirements.
- Any issues whose proceeds were spent within 6 months are exempt.
- Any issues spent within 18 months, if the following schedule is met: 15% in 6 months, 60% in 12 months, and 100% in 18 months.
- Construction-related issues that meet the "two-year exception", which has a payout schedule as follows: 10% in 6 months, 45% in 12 months, 75% in 18 months, 95% in 24 months, and 100% in 36 months (the last 5% is to represent only the construction retainage).

WATER AND SEWAGE DISPOSAL SERVICES

One of the more important services provided by most cities and urban townships is the provision of treated water and sanitary sewage disposal. Unlike most of the other services provided by municipalities, the users of this service can normally be specifically identified, and therefore directly charged a fee to cover the cost of providing the services. From an economic transaction perspective, this is very similar to the types of activity we would see in a typical commercial enterprise. As a result, this activity is generally accounted for in a separate "enterprise fund type." (Normally water and sewer services are combined in a single fund, although it is common to show them as two distinct funds if the customer base is significantly different.)
Capital Assets--Water and sewage disposal services are extremely capital-intensive. Providing water services requires finding a clean source of water, pumping the water out, treating it chemically, and pumping it through the community through underground lines which must be maintained and repaired as leaks occur. (Most communities in Southeast Michigan rely on the City of Detroit to pump the water from its source, and chemically treat it. The City then wholesales it to the individual communities.)

To provide sewage disposal services the community must again build underground lines which must have periodic lift stations (unlike water that is under pressure, sewage disposal generally uses gravity to move the sewage, so the lines must always decrease in elevation as it moves through the community, therefore necessitating lift stations periodically to increase the elevation), and a sewage treatment plant to treat the sewage to acceptable standards and discharge it into a water source. Over the past ten years the Clean Water Act has been amended to tighten the required levels of sewage treatment, and the Environmental Protection Agency has forced most sewage treatment plants to upgrade the treatment facilities. Again in Southeast Michigan many communities have historically relied on the City of Detroit to operate the sewage treatment plant, and the local communities act as wholesalers. The biggest expense of the majority of communities is putting in the water lines and sewer lines. This typically is an enormous expense, and is normally bonded over a period of 20-40 years.

Many communities have taken advantage of Act 342 of 1939 and Act 185 of 1957, both of which allows the county to act as an agent in this construction process. Basically it works like this:

The county issues the bonds which will be financing the project, and uses the proceeds to build the water and sewer lines. (The county typically manages the project also.) The community then signs a contract with the county whereby it leases the lines from the county for a rental payment which is normally exactly equal to the bond obligation that the county has issued. Title to the lines is retained by the county until the bonds are paid off, at which time legal title reverts to the local community. Although legally the title is in the name of the county, economic rights reside with the local community. The cost of the lines constructed by the county is recorded as a capital asset of the local community’s water and sewer fund, and any cash and investments still on hand at the county related to the project is recorded as a restricted asset of the water and sewer fund. (Use of this excess cash on hand is restricted.) Any transaction involving this cash held by the county is recorded as a transaction of the water and sewer fund (i.e., interest earnings, capital construction, any federal grants received, and any bond payments made on behalf of the municipality).
In addition, once the initial water and sewer lines have been constructed, many communities require new building developments to construct their own water and sewer lines, and donate it to the municipality. In such circumstances these lines would be recorded as capital assets of the water and sewer fund, and contributed capital would be recognized. (Contributed capital is an equity account of the water and sewer fund.) Furthermore, to help pay for the lines put in by the municipality, it is very common to assess a significant fee to customers when they first tap in to the system, to help defray the cost of building the system. (These fees have various names, some of which are: privilege fees, tap-in fees, connection fees.) These fees (which may be paid in cash or paid in over a ten-to-twenty year period) are also recorded as contributed capital. Another common method of paying for the water and sewer lines (after they have been originally funded with bonds or contracts with the county) is to assess a property tax millage to pay for part or all of the debt service requirements on the related debt obligation. This property tax millage is generally recorded as a non-operating revenue rather than as contributed capital.

**Operations**--The operations of a water and sewer system are really quite similar to the operations of a typical commercial enterprise. However, the number of factors that affect the profit are generally quite low, and therefore analyzing the operations is usually much more straightforward than in a typical commercial enterprise.

For instance, revenues would be expected to remain fairly constant each year, with adjustments only for the following:

- Increased rates (which is completely controllable by the municipality)
- New customers (which is not controllable, but is usually fairly predictable, and usually results in an increase in revenues rather than a decrease); and
- Average use per customer (which changes according to weather conditions and economic conditions, but does not usually result in wide swings).
If the municipality is purchasing the water and sewage disposal services from the City of Detroit and the County, then cost of sales will also be relatively constant, with fluctuations as a result of:

- The number of units purchased (which should change in direct proportion to units of water sold); and

- The water loss percentage (“water loss: is the difference between water purchased and water sold to customers, as a result of both leakage in the underground lines and water use that is not metered--water loss is usually around 6-8 percent for very new water lines, and 13-15 percent for older water lines.)

The financial statement information is also used very differently by a water and sewer fund than a typical commercial enterprise. The typical commercial enterprise is primarily concerned with the true cost of each product line and the profitability thereof in order to determine which product lines should be pushed, and which product lines should be dropped. The typical municipality is not trying to make the decision whether or not to continue providing water and sewer disposal services. Typically the question being asked is whether the rate structure is appropriate to provide sufficient working capital to meet anticipated obligations. Given this focus, it is generally more appropriate for a municipality to focus on working capital (or cash) and the current year change in working capital (or cash) in order to provide information about the rate structure, rather than net income and retained earnings. The working capital measurement in an enterprise fund is very analogous to the fund balance measurement that we typically focus on in a governmental fund. It is very common for a municipality to have a retained earnings deficit on the balance sheet, but a significant positive working capital position, or cash position. This is caused normally by water and sewer lines that may be donated, or paid for by privilege fees that result in significant contributed capital. However, the depreciation of the related assets is charged against current income, and therefore retained earnings. (In certain instances it is allowed to charge this depreciation against the contributed capital.)
EMPLOYEE RETIREMENT SYSTEMS

Most municipalities provide a retirement plan of one sort or another for its employees. In the most simple cases, this would be a defined contribution plan in which the amount of the contribution is fixed (for example, a percentage of gross pay). In such plans, the contribution is generally paid to a third party (usually an insurance underwriter or a bank trust department), which then invests the money and keeps a separate accounting for each employee. When that employee retires, whatever money is in the account would be paid to him or her, under the terms of the pension plan (lump sum, ten year payout, etc.)

Defined Benefit Plans--More common in unionized situations, however, is the Defined Benefit Plan. Instead of defining the amount of money that would be contributed for each employee each year, the Defined Benefit Plan defines the amount that the employee would be compensated upon retirement. This is normally stated as a percentage of the final three to five years average annual compensation. Because the municipality does not know today how much money will be paid out on retirement (we don’t know what each individual employee will be earning in the future), and there is no way of knowing when the pension payments are to begin, or to end (again we don’t know exactly when the employee will retire and what their life span will be after retirement), it is impossible to know for sure how much money will be needed to pay these benefits. In addition, most all plans want to set the money aside today to pay for these future benefits. Since we don’t know what will happen to the market interest rate, we also don’t know how much money to set aside today in order to have sufficient funds in the future to pay the benefits.

Because of the complexities involved, an actuary is nearly always retained to compute the amount of the recommended current contribution. The actuary prepares an annual report which tries to give a feel for the municipality’s progress in funding the retirement system, and shows the calculation of the subsequent year’s recommended contribution. In measuring the system’s progress towards funding the pension obligation, the actuary compares the current value of cash and investments set aside in the pension system to an estimated liability that the actuary calculates, which is intended to represent the amount of money that should be set aside today, which will have sufficient earnings accumulated by the time the current employees retire, to pay those employees their expected average final compensation, given the terms of the benefit package as it stands today. The vast majority of retirement systems have less cash and investments set aside today than the amount of this computed liability. This situation is generally called “unfunded.” The unfunded liability is usually compared over a number of years, both in absolute dollar terms and as a percentage of the pension benefit obligation; the trend of this number is a strong indicator of the strength of the retirement system (hopefully going down).

Quite often the municipality retains control of the cash and investments in the retirement system, rather than handing administration of the retirement system over to
a third party. In such situations, the assets are usually recorded in the municipality's financial statements, as a pension trust fund.
ALLOWABLE INVESTMENT VEHICLES

Surplus funds of non-pension funds are allowed to invest in the following types of investment vehicles by Public Act 20 of 1943 (as amended through December, 1997):

- Savings/checking accounts
- Certificates of deposit
- Bonds or other U.S. obligations
- Commercial paper
- Bankers acceptances
- Repurchase agreements
- Mutual funds consisting of these above vehicles
- Bank investment pools consisting of these above vehicles
- Investments under an interlocal agreement investment pool (such as MBIA-CLASS or MIGIT)
- Local unit investment pools (Kent county is the only unit having one of these)

Savings/Checking Accounts - Savings and checking accounts are allowable investment vehicles for a municipality only if deposited in a bank (if a member of FDIC), savings and loan (if a member of FSLIC) or credit union (if a member of the NCUA) that has a branch located in the State of Michigan.

Certificates of Deposit - Certificates of deposit are allowable investment vehicles for a municipality only if deposited in a bank (if a member of FDIC), savings and loan (if a member of FSLIC) or credit union (if a member of the NCUA) that has a branch located in the State of Michigan. Certificates of deposit are short-term instruments sold by commercial banks. Certificates of deposit are negotiable certificates that evidence a time deposit of funds with a bank at a specified rate of interest for a specific period of time.

Bonds or Other U.S. Obligations - This category includes any U.S. agency obligations. The most common types of bonds or other U.S. obligations include treasury bonds, treasury notes and treasury bills. Treasury bonds are usually issued in denominations of $1,000 to $1,000,000 with a maturity of ten years or more. Interest is usually payable every six months. Treasury notes are usually issued in denominations of $1,000 to $1,000,000 with a maturity ranging from one to ten years from the date of issue. Interest is usually payable every six months. Treasury bills are short-term issues with a maximum maturity of one year. Treasury bills are issued through a competitive bidding process at discount from par. Treasury bills do not pay interest - the return on the investment is the discount which accrues by the maturity date. Treasury bills are usually issued in denominations of $10,000 to $1,000,000. Other obligations would include G.N.M.A. obligations (Government National Mortgage Association obligations), and FNMA obligations (Federal National Mortgage Association). The following is a list of investments that might appear to be U.S.
government investments, but the Department of Treasury believes is not legal because they are not issued directly by the federal government or one of its agencies:

- CATS (Certificates of Accrual on Treasury Securities)
- COUGRs (Certificates on Government Receipts)
- ETRs (Easy Growth Treasury Receipts)
- TBRs (Treasury Bond Receipts)
- TIGRs (Treasury Investment Growth Receipts)
- TRs (Treasury Receipts)
- ZCTOs (Zero Coupon Treasury Obligations)
- REF Corp=es
- GTCs
- Supremes
- CMO Pools (as opposed to CMO Mutual Funds)

Commercial Paper - Commercial paper is unsecured short-term promissory notes issued in bearer form by large, well known businesses. Commercial paper must have a maturity of less than 270 days and be rated within the two highest rated categories by at least two rating services; no more than 50% of any fund may be invested in commercial paper (although there is no guidance to what constitutes a "fund"). Commercial paper is usually issued at the prevailing discounts rate and therefore the return on the investment is the discount that accrues by the maturity date.

Bankers Acceptances - Bankers acceptances, also called time drafts, are highly liquid short-term bills of exchange used to finance international and domestic trade. They represent a promise by the bank to pay the face amount of a note at maturity date, which usually ranges from one to 270 days.

Repurchase Agreements - Repurchase agreements, also called "Repo's," are highly flexible, short-term money market instruments. The municipality enters into a contract with the dealer in which the municipality "purchases" a U.S. government security (although generally does not receive the security), and the dealer agrees to "repurchase" the security at an agreed upon price and at a stated time. Therefore, the return on investment is the difference between what the municipality purchased the security at and what it ultimately receives for it upon maturity (repurchasing by dealer).

Mutual Funds/Investment Pool - The governing body of often enters into a contract with a financial institution (bank, savings and loan or credit union) to place surplus funds in an investment pool. The financial institution is responsible for managing, investing and reinvesting these surplus funds in investments within the scope allowed for Michigan municipalities. These arrangements have become very popular in recent years because they generally have the same liquidity as savings accounts (deposits and withdrawals can be made daily), yet earn a competitive market rate of interest.
Surplus Monies of Pension Funds - Pension funds have a very broad range of investment vehicles available to them. Act 314 of 1965 (as amended by Act 485 of 1996) allows the following investments:

- **Stocks**
  - Limited to 65% of a system’s assets, valued at market
  - Must be registered on a national exchange, or on NASDAQ
  - The amount of stock purchased in any one corporation is limited to the lower of 5% of the system’s assets or 5% of the corporation’s stock outstanding

- **Mutual Funds**
  - Investments in mutual funds are generally considered to be investments in the underlying assets (i.e., if 45% of the mutual fund’s assets were in stocks, then these would count towards the 65% test above). The management company offering the mutual fund must have been in business 5 years and have $500 million of assets under management.

- **Life Insurance Company general or special account**

- **Other investments**
  - Obligations of any solvent U. S. entity which are not in default as to principal or interest
  - Lease obligations secured by a security interest in real estate
  - U.S. Government or U.S. Agency obligations
  - State or local government obligations rated in the top four major grades as determined by two national ratings services, and not to exceed 5% of the system’s assets
  - Commercial accounts, certificates of deposit, bankers acceptances, or depository receipts issued by a bank, trust company, savings and loan association or credit union
  - Commercial paper with a maturity of less than 270 days and which is rated in the two highest categories by not less than two national rating services
  - Repurchase agreements and reverse repurchase agreements
  - Variable interest rates on the above vehicles is acceptable
  - Dollar denominated obligations issued in the U. S. by foreign banks, corps. or govts., if rated in the top 4 categories by 2 ratings services.

- **Leased real property (real estate or mortgages on real property to be leased to the U.S. Government, a state, or instrumentality of the U.S.)**

- **Direct investments in property (real or personal)**
  - Limited to 5% of the system’s assets
- Certain real estate loans

- Small business or venture capital firms
  - Includes debt, warrant, or equity interest; in a
  - Small business, small business investment company, or venture capital firm
  - The pension system must have assets over $250 million
  - Limited to 2% of the system's assets
  - A system with over $250 million may also operate a small business investment firm or venture capital firm to invest in qualified small businesses (limited to 5% of assets, rather than 2%)

- Surplus Funds Pooled Accounts
  - Systems may make deposits with the treasurer of the jurisdiction sponsoring the system or with the state treasurer for investment in accordance with laws governing the investment of surplus funds by the treasurer

- Bank or Trust Company Collective Investment Funds
  - Banks or trust companies retained to invest system assets may invest in any collective investment fund or common trust fund

- Investments Not Otherwise Qualified Under the Act
  - A percentage of the assets of certain systems may be used for investments not otherwise qualified under the law. The percentages allowed are as follows:
    - 5% for systems with up to $250 million in assets
    - 10% for systems with assets in excess of $250 million
    - 15% for the state treasurer

- Securities Lending
  - Bonds, stocks, or other securities may be loaned if fully secured by collateral of cash or U.S. Government or U.S. Agency securities
  - Foreign securities