City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

Financial Statements

June 30, 2017

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Independent Auditors' Report

To the Board of Directors
City of Ann Arbor Retiree Health Care Benefits Plan and Trust

We have audited the accompanying statements of fiduciary net position of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust, a voluntary employees beneficiary association (VEBA) (hereinafter referred to as the "Plan" or "VEBA") as of June 30, 2017 and the related statements of changes in fiduciary net position for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Independent Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on auditor judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the VEBA's net position restricted for healthcare benefits at June 30, 2017 and changes therein for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

As discussed in Note 1, the financial statements present only the City of Ann Arbor Retiree Health Care Benefits Plan and Trust and do not purport to, and do not, present fairly the financial position of the City of Ann Arbor as of June 30, 2017, and the changes in its financial position for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the schedules of changes in net OPEB liability and related ratios, employer contributions, and investment returns, as listed in the table of contents, be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Yeo & Yeo, P.C.

Ann Arbor, Michigan
December 6, 2017

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust
Statement of Fiduciary Net Position
June 30, 2017

Assets		
Investments, at fair value		
Equities	$	87,103,067
Fixed income		48,070,527
Other		20,022,675
Total investments		155,196,269
Equity in City of Ann Arbor pooled cash and investments		2,172,821
Accrued interest and dividends		252,980
Total assets		157,622,070
Liabilities		
Accrued liabilities		102,124
Due to broker for securities purchased		180,840
Total liabilities		282,964
Net position restricted for benefits	$	157,339,106

See Accompanying Notes to the Financial Statements

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust
Statement of Changes in Fiduciary Net Position
For the Year Ended June 30, 2017

Additions	
Investment income	
From investing activities	
Net appreciation in fair value of investments	$ 14,504,896
Interest and dividends	2,816,875
Total investment income	17,321,771
Investment management fees	(260,886)
Net investment income from investing activities	17,060,885
From securities lending activities	
Gross earnings	20,360
Borrower rebates paid	(4,431)
Securities lending fees	(4,745)
Net investment income from securities lending activities	11,184
Total net investment income	17,072,069
Employer contributions	16,819,824
Total additions	33,891,893
Deductions	
Participant benefits	13,206,887
Administrative expenses	129,561
Total deductions	13,336,448
Change in net position	20,555,445
Net position - beginning of year	136,783,661
Net position - end of year	$ 157,339,106

See Accompanying Notes to the Financial Statements

Note 1 - Plan Description and Contribution Information

Plan description

The City of Ann Arbor Retiree Health Care Benefits Plan and Trust, a voluntary employees beneficiary association (VEBA) (hereinafter referred to as the “Plan” or “VEBA”) is a single-employer defined benefit postemployment healthcare plan established and administered by the City of Ann Arbor (the “City”) through a board of trustees to provide health and life benefits to eligible retirees and their beneficiaries.

The City of Ann Arbor Employees’ Retirement System Board of Trustees consists of nine members, three are elected (representing fire, police and general City employees), five are appointed by the City Council of the City of Ann Arbor and one is Chief Financial Officer of the City of Ann Arbor, who serves as ex-officio member.

Plan membership – At June 30, 2017, the plan membership consisted of the following:

	2017
Retirees and surviving spouses currently covered	1,043
Spouses of retirees currently covered	546
Vested active participants	696
Total Membership	2,285

Benefits provided – The Plan provides certain healthcare and life insurance benefits for eligible retired employees and their dependents in accordance with the Ann Arbor City Code Chapter 21. Substantially all the City’s employees may become eligible for these benefits if they retire directly from City employment. These and similar benefits for active employees are provided by various insurance companies. Health insurance benefits are provided through an administrative service contract under which the City reimburses the administrator for claims paid plus an administration fee. Plan benefit provisions are established and may be amended by the City, subject to the City’s various collective bargaining agreements.

Contributions – The Plan is funded by actuarially determined contributions from the City, under a trust agreement established pursuant to Section 501(c)(9) of the Internal Revenue Code, which allows for the formation of such a plan. The VEBA is included as a pension and other employee benefits trust fund in the City’s comprehensive annual financial report. For the year ended June 30, 2017, the City’s average contribution rate was 31.39 percent of covered-employee payroll. Plan members are not required to contribute to the plan.

The contribution requirements of plan members and the City are established and may be amended by the City Council. The required contribution is based on projected pay-as-you-go financing requirements, with an additional amount to prefund benefits as determined annually by the actuary. For fiscal year ended June 30, 2017, the City contributed approximately $16,820,000 to the plan, including $13,360,000 for current premiums and an additional $3,460,000 to prefund benefits.

Investment policy – The Plans policy in regard to the allocation of invested assets is established and may be amended by the Retirement System Board of Trustees. The Policy pursues an investment strategy that protects the financial health of the Plan and reduces risk through the prudent diversification of the portfolio across a broad selection of distinct asset classes. The Plans assets will be invested in the broad investment categories and asset classes to achieve the allocation targets below. Recognizing that asset returns may vary, causing fluctuations in the relative dollar value levels of assets within classes, the Plan may not maintain strict adherence to the targets in the short-term, but may allow the values to fluctuate within these ranges. Over the long-term, the Plan will strive to adhere to the targets as financially practicable and move toward target allocations in a prudent manner consistent with its fiduciary duty.

The long-term expected rate of return on OPEB plan investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best-estimate of arithmetic real rates of return for each major class included in the target asset allocation as of June 30, 2017 are summarized below along with the Boards adopted asset allocation policy:

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Equities		
Domestic equity	33.0%	5.7%
Developed Foreign Equity	12.0%	6.3%
Emerging Markets Equity	7.0%	9.6%
Private equity	3.0%	9.3%
Fixed Income		
Investment Grade Bonds	12.0%	2.5%
TIPS	7.0%	3.0%
High Yield Bonds	6.0%	5.0%
Bank Loans	4.0%	5.1%
Emerging Markets Debt	3.0%	5.4%
Other Investments		
Real estate	10.0%	5.7%
Natural Resources	3.0%	4.8%
Cash	0.0%	1.5%

Rate of return – For the year ended June 30, 2017, the annual money-weighted rate of return on investments, net of investment expense, was 11.78%. The money-weighted rate of return expresses investment performance, net of investment expenses, adjusted for the changing amounts actually invested.

Net OPEB liability – the components of the net OPEB liability as of June 30, 2017 were as follows:

Total OPEB liability	$ 254,029,000
Plan fiduciary net position	157,339,000
Net OPEB liability	$ 96,690,000

Plan fiduciary net position as a percentage of the total OPEB liability is 61.94%.

Actuarial assumptions – The total OPEB liability was determined by an actuarial valuation as of June 30, 2017, using the following actuarial assumptions, applied to all periods included in the measurement.

Inflation	3.00%
Salary increases	3.5%, average, including inflation
Investment rate of return	7%, net of OPEB plan investment expense, Including inflation
Healthcare cost trend rates	Medical Pre-65: 8.25% for 2017, decreasing .25 % per year to an ultimate rate of 4.5%; Medical Post-65: 6.25% for 2017, decreasing .25 % per year to an ultimate rate of 4.5% for 2031.

Mortality rates were based on the RP-2000 Combined Table projected to 2007 set forward 2 years for males and set back 3 years for females.

The actuarial assumptions used in the June 30, 2017 valuation were based on the results of an actuarial experience study from May 2013.

Discount rate – The discount rate used to measure the total OPEB liability was 7.0%. The projection of cash flows used to determine the discount rate assumed that City contributions will be made at rates equal to the actuarially determined contribution rates. Based on those assumptions, the OPEB plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on OPEB plan investments was applied to all periods of projected benefit payments to determine the total OPEB liability.

Sensitivity of the net OPEB liability to changes in the discount rate – The following presents the net OPEB liability of the City, as well as what the City's net OPEB liability would be if it were calculated using a discount rate that is 1% lower (6.0%) or 1% higher (8.0%) than the current discount rate.

	1% Decrease	Discount rate	1% Increase
	6.00%	7.00%	8.00%
Net OPEB liability	$131,239,000	$96,690,000	$69,153,000

Sensitivity of the net OPEB liability to changes in the healthcare cost trend rates – The following presents the net OPEB liability of the City, as well as what the City's net OPEB liability would be if were calculated using healthcare cost trend rates that are 1% lower (7.25%) or 1% higher (9.25%) than the current healthcare cost trend rates:

	1% Decrease	Healthcare cost trend rates	1% Increase
Net OPEB liability	$67,256,000	$96,690,000	$132,636,000

Note 2 - Summary of Significant Accounting Policies

Basis of Accounting

The Plan's financial statements are prepared using the accrual basis of accounting. Employer contributions are recognized in the period that the contributions are due and when the employer has made a formal commitment to provide the contributions. Benefits are recognized when due and payable in accordance with the trust agreement.

Valuation of Investments
The Plan's investments are stated at fair value which is determined as follows: (a) short-term investments are reported at cost, which approximates fair value; (b) securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates; (c) investments for which market quotations are not readily available are valued at their fair values as determined by the custodian under the direction of the VEBA's governing body, with the assistance of a valuation service; and (d) cash deposits are reported at carrying amounts which reasonably approximates fair value.

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

Adoption of New Accounting Standards
Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* addresses the other postemployment benefit plans (OPEB), defined benefit and defined contribution, administered through trusts. This Statement will improve the financial reporting primarily through enhanced note disclosures and schedules of required supplementary information that will be presented by OPEB plans that are administered through trusts. This information will enhance the transparency by providing information about measures of net OPEB liabilities and explanations of how and why those liabilities changed from year to year. Statement No. 74 is effective for the fiscal year ending June 30, 2017.

Note 3 - Deposits, Investments, and Securities Lending

The Plan does not maintain any checking or other demand/time deposit accounts. Amounts reported as cash in the statement of plan net position are composed entirely of amounts held by the City of Ann Arbor as part of its cash pool. As a result, the insured and uninsured amounts related to these accounts cannot be determined.

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

The Plan’s investments are held by an independent trust company. Following is a summary of the Plan’s investments as of June 30, 2017:

	Domestic	Foreign	Total	On Loan
Equities				
Common stock	$ 18,897,468	$ 2	$ 18,897,470	$ 1,795,404
Common stock funds	42,995,079	25,210,518	68,205,597	-
Total equities	61,892,547	25,210,520	87,103,067	1,795,404
Fixed income				
Corporate bond funds	31,359,286	3,598,797	34,958,083	-
Bank loan participation	5,367,003	-	5,367,003	-
Index linked government bonds	6,563,257	-	6,563,257	-
Private credit	1,182,184	-	1,182,184	-
Total fixed income	44,471,730	3,598,797	48,070,527	-
Other investments				
Real estate	14,614,091	-	14,614,091	-
Short-term investment fund	5,408,584	-	5,408,584	-
Total other investments	20,022,675	-	20,022,675	-
Total investments	$ 126,386,952	$ 28,809,317	$ 155,196,269	$ 1,795,404

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Investments in any particular asset class may or may not be consistent with the objectives of the Plan. The investment policy statement specifically indicates permissible asset classes, including high yield fixed income and alternatives, in appropriate target percentages.

The Plan's fixed income securities consisted of the following at June 30:

	2017
Corporate bond funds	$ 34,958,083
Bank loan participation	5,367,003
Index linked government bonds	6,563,257
Private credit	1,182,184
	$ 48,070,527

The Plan’s investments in corporate bond funds, bank loan participation and index linked government bonds (each of which are essentially funds) are not rated.

Concentration of Credit Risk
Concentration of credit risk is the risk of loss attributed to the magnitude of the Plan's investment in a single issuer. The Plan's investment policy requires that no more than 5% of the total fund be invested in any one company or governmental agency.

Interest Rate Risk
Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Plan's investment policy requires a maximum term to maturity of 30 years for any single fixed income security. The Plan's investment policy does not address weighted average portfolio maturities.

Inasmuch as all of the debt or fixed income securities as of June 30, 2017, is essentially held in funds by the portfolio managers, maturity information is not available.

Securities Lending
A contract approved by the Plan's Board of Trustees, permits the VEBA to lend its securities to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The Plan's custodial trust company manages the securities lending program and receives securities, cash or irrevocable bank letters of credit as collateral. The collateral securities cannot be pledged or sold by the Plan unless the borrower defaults. Collateral is initially pledged at 102 percent of the market value of the securities lent, and may not fall below 100 percent during the term of the loan. There are no restrictions on the amount of securities that can be loaned.

At year end, the Plan has no credit risk exposure to borrowers because the amounts the Plan owes the borrowers exceeds the amounts the borrowers owe the Plan. The contract with the Plan's custodian requires it to indemnify the Plan if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay the Plan for income distributions by the securities' issuers while the securities are on loan.

At June 30, 2017, the total collateral received from borrowers had a fair value of $1,834,452, all of which was cash.

Fair Value Measurements
The System categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs – other than quoted prices – included within Level 1 that are observable for the asset or liability, either directly or indirectly. Finally, Level 3 inputs are unobservable and are based on estimates and assumptions. These levels are determined by the System's investment manager. These are determined at the fund level based on a review of the investment's class, structure, and what kind of securities are held in funds. The investment manager will request the information from the fund manager if necessary.

The System had the following recurring fair value measurements as of June 30, 2017:

	Level 1	Level 2	Level 3	Total
Equities				
Common stock	$ 6,925,540	$ 11,971,930	$ -	$ 18,897,470
Common stock funds	5,028,617	63,039,112	137,868	68,205,597
Total equities	11,954,157	75,011,042	137,868	87,103,067
Fixed income				
Corporate bond funds	3,598,797	31,359,286	-	34,958,083
Bank loan participation	-	-	5,367,003	5,367,003
Index linked government bonds	6,563,257	-	-	6,563,257
Private credit	-	-	1,182,184	1,182,184
Total fixed income	10,162,054	31,359,286	6,549,187	48,070,527
Other investments				
Real estate	5,573,152	-	9,040,939	14,614,091
Short-term investment fund	5,408,584	-	-	5,408,584
Total other investments	10,981,736	-	9,040,939	20,022,675
Total investments	$ 33,097,947	$ 106,370,328	$ 15,727,994	$ 155,196,269

Note 4 - Funded Status and Funding Progress

The funded status of the Plan as of June 30, 2017, the date of the most recent actuarial valuation, was as follows:

Actuarial accrued liability (AAL)	$ 254,029,000
Actuarial value of assets	$ 157,924,000
Unfunded AAL (UAAL)	$ 96,105,000
Funded ratio	62.2%
Covered payroll	$ 53,583,000
UAAL as % of covered payroll	179.4%

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Actuarially determined amounts are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multi-year trend information about whether the actuarial values of trust assets are increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

The accompanying schedule of employer contributions presents trend information about the amounts contributed to the Plan by the employer in comparison to the ARC (annual required contribution), an amount that is actuarially determined in accordance with the parameters of GASB Statement 74. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost for each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

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

Additional information as of the latest actuarial valuation includes:

Valuation date	June 30, 2017
Actuarial cost method	Entry Age
Amortization method	Level percentage of projected pay (amortization of the unfunded AAL)
Remaining amortization period	30 years
Asset valuation method	5-year smoothed market
Actuarial assumptions:	
Investment rate of return	7.0%
Projected salary increase	3.5%
Healthcare cost trend rate	8.25% initial, 4.5% ultimate
Inflation rate	3.5%
Post-retirement benefits increases	None

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust
Required Supplementary Information
Other Post Employment Benefits
Schedule of Changes in Net OPEB Liability and Related Ratios
June 30, 2017

Fiscal year ended June 30,	2017
Total OPEB Liability	
Service cost	$ 3,071,000
Interest	17,058,000
Benefit payments	(13,207,000)
Net change in total OPEB liability	6,922,000
Total OPEB liability - beginning	247,107,000
Total OPEB liability - ending (a)	$ 254,029,000
Plan Fiduciary Net Position	
Employer contributions	$ 16,820,000
Net investment income (loss)	17,225,000
Benefit payments and refunds	(13,207,000)
Administrative expense	(130,000)
Other	(153,000)
Net change in plan fiduciary net position	20,555,000
Plan fiduciary net position - beginning	136,784,000
Plan fiduciary net position - ending (b)	157,339,000
Net OPEB liability (a-b)	$ 96,690,000
Plan fiduciary net position as a percentage of total OPEB liability	61.94%
Covered employee payroll	$ 53,583,000
Net OPEB liability as a percentage of covered employee payroll	180.45%

*GASB Statement No. 74 was implemented for the fiscal year ended June 30, 2017 and does not require retroactive implementation. Data will be added as information is available until 10 years of such data is available.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust
Required Supplementary Information
Schedule of Employer Contributions
June 30, 2017

Actuarial Valuation Date	Annual Determined Contribution	Actual Contribution	Contribution Deficiency (Excess)	Covered Payroll	Actual Contribution as a % of Covered Payroll
6/30/2017	$ 11,168,000	$ 16,819,824	$ (5,651,824)	$ 53,583,000	31.39%

The information presented above was determined as part of the actuarial valuations at the date indicated above. Additional information as of June 30, 2017, the latest actuarial valuation, follows:

Methods and assumptions used to determine contribution rates:

Actuarial cost method	Entry Age
Amortization method	Level percentage of projected pay (amortization of the unfunded AAL)
Remaining amortization period	30 years
Asset valuation method	5-year smoothed market
Actuarial assumptions:	
Investment rate of return	7.0%
Projected salary increase	3.5%
Healthcare cost trend rate	8.25% initial, 4.5% ultimate
Inflation rate	3.5%
Post-retirement benefits increases	None
Inflation	3.00%
Salary increases	3.5%, average, including inflation
Investment rate of return	7%, net of OPEB plan investment expense, Including inflation
Healthcare cost trend rates	Medical Pre-65: 8.25% for 2017, decreasing .25 % per year to an ultimate rate of 4.5%; Medical Post-65: 6.25% for 2017, decreasing .25 % per year to an ultimate rate of 4.5% for 2031.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust
Required Supplementary Information
Other Post Employment Benefits
Schedule of Investment Returns

Fiscal Year Ended June 30,	Annual Return % *
2017	11.78%

* Annual money-weighted rate of return, net of investment expenses

GASB Statement No. 74 was implemented for the fiscal year ended June 30, 2017 and does not require retroactive implementation. Data will be added as information is available until 10 years of such data is available.