

**City of Pontiac Police and Fire Retiree
Prefunded Group Health and Insurance Trust**

**Financial Report
with Supplemental Information
December 31, 2012**

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

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Independent Auditor's Report

To the Board of Directors
City of Pontiac Police and Fire Retiree
Prefunded Group Health and Insurance Trust

Report on the Financial Statements

We have audited the accompanying basic financial statements of the City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust (the "Trust"), a component unit of the City of Pontiac, Michigan (the "City") as of and for the year ended December 31, 2012, 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.

Auditor's Responsibility

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

To the Board of Directors
City of Pontiac Police and Fire Retiree
Prefunded Group Health and Insurance Trust

Opinions

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the trust net position of the City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust as of December 31, 2012 and the changes in the trust net position thereof for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplemental Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and the schedules of funding progress and employer contributions, as noted in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplemental 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 basic financial statements, and other knowledge we obtained during our audit of the basic 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.

Plante & Moran, PLLC

June 26, 2013

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Management's Discussion and Analysis

Using this Annual Report

This annual report consists of three parts: (1) management's discussion and analysis (this section), (2) the basic financial statements, and (3) required supplemental information. The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data.

Condensed Financial Information

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

	Fiscal Year Ended	
	December 31, 2012	December 31, 2011
Total assets	\$ 33,387,042	\$ 28,208,268
Total liabilities	864,839	938,272
Net trust position	\$ 32,522,203	\$ 27,269,996
Net investment gain (loss)	\$ 3,661,834	\$ (377,111)
Contributions - Employer	3,243,232	-
Contributions - Employee	359,331	35,875
Retiree health benefits paid	(1,972,119)	(3,129,737)
Benefits paid in excess of contributions	-	(3,093,862)
Contributions in excess of benefits paid	1,630,444	-
Ratio of contributions to benefits paid	182.7%	1.1%
General and administrative expenses	(51,468)	(43,690)
Net increase (decrease) in trust net position	5,252,207	(3,514,663)

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Management's Discussion and Analysis (Continued)

Plan Contributions

Employer contributions to the plan were \$0 and \$3,243,232 for 2011 and 2012, respectively. As discussed in Note 1, in March 2013, a settlement agreement was reached between the Trust and the plan sponsor whereby the City remitted payment for past due contributions in the amount of \$3,243,232. This amount, which had previously been omitted from the financial statements, has been recognized as of December 31, 2012.

Retiree Health Benefits and Employee Contributions

Retiree health benefits paid were \$3,129,737 and \$1,972,119 in 2011 and 2012, respectively. Employee contributions were \$35,875 and \$359,331 in 2011 and 2012, respectively. In April 2012, the City's emergency manager issued an executive order modifying the terms of health care insurance for all retirees eligible to currently receive benefits pursuant to the provisions of Public Act 152 of 2011 (PA 152). The executive order includes various plan changes, the most significant being that pre-age 65 retirees pay, by deduction from their pension checks, the amount above the "hard-cap" (as defined by PA 152), or 20 percent of the annual rates, whichever is higher, effective July 1, 2012.

Overall Fund Structure and Objectives

The City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust (the "Trust") exists to pay healthcare benefits to members retiring on or after August 22, 1996. The excess of contributions over benefits paid will allow for additional funding to increase investment income to a level where the Trust will generate adequate earnings to pay future benefits. The public capital markets represent the primary source of investments.

Asset Allocation

The Trust has established asset allocation policies, which are expected to deliver more than enough investment income over a very long period of time to satisfy the obligations to pay the benefits promised to the members of the Trust. The following is a summary of the asset allocation as of December 31, 2012:

Domestic equities	48.8%
Domestic fixed income	27.7%
International equities and fixed income	15.9%
Basket clause category securities	4.6%
Cash	3.0%

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Management's Discussion and Analysis (Continued)

Investment Results

The European Central Bank announced a program to save the Eurozone and the U.S. Federal Reserve introduced Quantitative Easing III; this intervention by the central banks provided stability to the capital markets and investors with confidence. Core inflation in the U.S. was below long-term targets at 1.7 percent and commodity prices tended to fall. Interest rates ended the year nearly unchanged from January 1. The fixed income market posted modest gains as spreads contracted; the Barclays U.S. Aggregated returned 4.2 percent for the year. The ECB's "Save the Euro" comments drove the equity markets higher over the summer, producing a significant portion of the year's gains. The Standard & Poor's 500 returned 16.1 percent, the Russell 2000 (a proxy for U.S. small cap stocks) rose 16.3 percent, and the MSCI EAFE Index (a proxy for international stocks) advanced 17.3 percent. The total fund gained 13.57 percent for the year ended December 31, 2012 (measured using the time weighted return on each component of the Total Fund).

The total Trust's return must always be considered in a longer-term context. The Trust's investment horizon is long term, corresponding to the long-term nature of the Trust's liabilities. Therefore, the board of trustees establishes an asset allocation policy to control risks and generate expected returns that will enable the Trust to pay the benefits promised to members and retirees. Accordingly, the board of trustees must make investment decisions that it believes will be the most beneficial to the Trust over many years, not just one or two years.

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Statement of Trust Net Position December 31, 2012

Assets

Cash and cash equivalents	\$ 87,400
Investments at fair value (Note 2):	
U.S. government obligations and agencies	1,060,608
Mortgage-backed securities	3,564,737
Collateralized mortgage obligations	571,291
Asset-backed securities	556,308
Corporate bonds	2,216,276
Foreign bonds and notes	326,039
Short-term investments	489,016
Foreign equity mutual fund	4,786,535
Equities	15,107,591
Private equities	1,378,009
Contributions receivable	3,243,232
Total assets	<u>33,387,042</u>

Liabilities

Due to City of Pontiac	778,141
Due to City of Pontiac Police and Fire Retirement System	86,698
Total liabilities	<u>864,839</u>

Trust Net Position \$ 32,522,203

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Statement of Changes in Trust Net Position Year Ended December 31, 2012

Additions

Investment income:

Interest and dividend income	\$ 690,859
Net increase in fair value of investments	3,050,071
Investment advisor fees	<u>(79,096)</u>

Net investment income 3,661,834

Contributions:

Employer contributions	3,243,232
Employee contributions	<u>359,331</u>

Total contributions 3,602,563

Miscellaneous income 11,397

Total additions 7,275,794

Deductions

Retirees' health benefits	1,972,119
Other expenses	<u>51,468</u>

Total deductions 2,023,587

Net Increase in Trust Net Position 5,252,207

Trust Net Position - January 1, 2012 27,269,996

Trust Net Position - December 31, 2012 \$ 32,522,203

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Notes to Financial Statements December 31, 2012

Note 1 - Summary of Significant Accounting Policies

The City of Pontiac (the "City") has established an irrevocable prefunded group health and insurance trust fund for health, optical, dental, and life insurance benefits for retirees who are members of the Police and Fire Retirement System of the City of Pontiac and who retired on or after August 22, 1996. All such benefits are paid out of the Trust. The City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust (the "Trust") was created as an Internal Revenue Code 501(c)(9) Trust (VEBA). The Police and Fire Retirement System (the "Retirement System") performs the Trust's accounting function.

Reporting Entity - The Trust is a component unit of the City of Pontiac, Michigan. The Trust does not hold securities of or make formal loans to the City.

Plan Sponsor Financial Condition - The City of Pontiac (the plan sponsor) is experiencing significant financial difficulty. The City is currently operating under Michigan Public Act 436 of 2012. The result is that the State has appointed an emergency manager to control the finances of the City. Uncertainty exists regarding the City's ability to continue to make contributions to the Pension and Healthcare Trust Plans. Contributions that were scheduled to be made to the plan for the years ended December 31, 2011 and 2010 in the amount of \$2,635,156 and \$2,104,382, respectively, were not remitted to the plan by the City in those years.

During 2011, the Trust filed a lawsuit against the plan sponsor to compel payment on past due contributions. In March 2013, a settlement agreement was reached between the Trust and the plan sponsor and the City remitted a payment for past due contributions in the amount of \$3,243,232. This amount, which had been previously omitted from the Trust financial statements, has been recognized in both revenue and receivables as of December 31, 2012. Contributions for 2012 are currently the subject of a separate lawsuit. As these contributions may not be forthcoming, the contributions have not been reflected in the Trust's 2012 financial statements.

Basis of Accounting - The City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust's financial statements are prepared using the accrual basis of accounting. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Insurance costs are recognized when due and payable in accordance with the terms of the Trust.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

**Notes to Financial Statements
December 31, 2012**

Note 1 - Summary of Significant Accounting Policies (Continued)

Investments - Investments are reported at fair value. Money market funds and mutual fund investments are valued at net asset value. Dividend income is recorded on the ex-dividend date. Income from other investments is recorded as earned on an accrual basis. In accordance with the policy of stating investments at fair value, net unrealized appreciation or depreciation for the year is reflected in the statement of changes in trust net assets. Investments that do not have an established market value are reported at estimated fair value as determined by the Trust's management. These estimates are determined using financial statements issued by the private equity companies in which such investments are held, adjusted by management as deemed appropriate based on known circumstances. Approximately 5 percent of the Trust's assets are not publicly traded and therefore do not have a readily determinable market value. Because these alternative investments are not readily marketable, their estimated value is subject to uncertainty and therefore may differ significantly from the values that would have been used had a ready market for these securities existed.

Federal Income Taxes - The Trust is exempt from income tax under Section 501(a).

Note 2 - Investments

Michigan Compiled Laws Section 129.91 (Public Act 20 of 1943, as amended) authorizes local governmental units to make deposits and invest in the accounts of federally insured banks, credit unions, and savings and loan associations that have offices in Michigan. The law also allows investments outside the state of Michigan when fully insured. The local unit is allowed to invest in bonds, securities, and other direct obligations of the United States or any agency or instrumentality of the United States; repurchase agreements; bankers' acceptances of United States banks; commercial paper rated within the two highest classifications, which matures not more than 270 days after the date of purchase; obligations of the State of Michigan or its political subdivisions, which are rated as investment grade; and mutual funds composed of investment vehicles that are legal for direct investment by local units of government in Michigan.

A retiree healthcare fund is also authorized by Michigan Public Act 314 of 1965 (the "Act"), as amended, to invest in certain reverse repurchase agreements, stocks, diversified investment companies, annuity investment contracts, real estate leased to public entities, mortgages, debt or equity of certain small businesses, certain state and local government obligations, and certain other specified investment vehicles.

The Trust has designated one bank for the deposit of its funds. The investment policy adopted by the board in accordance with Public Act 196 of 1997 has authorized investment in mutual or commingled funds, but not the remainder of state statutory authority as listed above. The Trust's deposits and investment policies are in accordance with statutory authority.

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Notes to Financial Statements December 31, 2012

Note 2 - Investments (Continued)

The Trust's cash and investments are subject to several types of risk, which are examined in more detail below:

Interest Rate Risk - Interest rate risk is the risk that the value of investments will decrease as a result of a rise in interest rates. The Trust's investment policy does not restrict investment maturities.

At year end, the average maturities of the Trust's investments are as follows:

Investment	Fair Value	Weighted Average Maturity (Years)
Corporate:		
Asset-backed securities	\$ 556,308	6.81 years
Corporate bonds	2,216,276	5.83 years
Collateralized mortgage obligations	490,932	30.11 years
Foreign bonds	326,039	7.29 years
U.S. government:		
Agency	74,465	6.78 years
Collateralized mortgage obligations	80,359	8.82 years
Mortgage-backed securities	3,564,737	28.29 years
Treasuries, notes, and bonds	986,143	1.33 years

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Notes to Financial Statements December 31, 2012

Note 2 - Investments (Continued)

Credit Risk - State law limits investments in commercial paper to the top two ratings issued by nationally recognized statistical rating organizations. The Trust has no investment policy that would further limit its investment choices. As of year end, the credit quality ratings of debt securities are as follows:

Investment	Fair Value	Rating	Rating Organization
Corporate:			
Asset-backed securities	\$ 209,360	AAA	S&P
Asset-backed securities	109,827	AA	S&P
Asset-backed securities	140,032	A	S&P
Asset-backed securities	22,513	BBB	S&P
Asset-backed securities	74,576	Not Rated	N/A
Corporate bonds	752,367	A	S&P
Corporate bonds	1,359,646	BBB	S&P
Corporate bonds	104,263	BB	S&P
Collateralized mortgage obligations	102,953	AA	S&P
Collateralized mortgage obligations	82,631	A	S&P
Collateralized mortgage obligations	120,419	BBB	S&P
Collateralized mortgage obligations	184,930	Not Rated	N/A
Foreign bonds	66,323	AA	S&P
Foreign bonds	149,022	A	S&P
Foreign bonds	110,695	BBB	S&P
U.S. government:			
Agency	74,465	A	S&P
Collateralized mortgage obligations	80,359	Not Rated	N/A
Mortgage-backed securities	3,564,737	Not Rated	N/A
Treasuries, notes, and bonds	986,143	Not Rated	N/A

Foreign Currency Risk - Foreign currency risk is the risk that an investment denominated in the currency of a foreign country could reduce its U.S. dollar value as a result of changes in foreign currency exchange rates. The following securities contained within the international stock fund are subject to foreign currency risk:

	Fair Market Value
European euro	\$ 2,285,950
Japanese yen	559,532
British pound	856,036
Latin american peso	229,552
Other	526,056

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Notes to Financial Statements December 31, 2012

Note 3 - Trust Contribution Information

The Trust is primarily funded by employer contributions. The trustees voted to implement funding at the actuarial recommended rate beginning July 1, 2006. Effective July 1, 2010, employees in one of the three bargaining units covered by this Trust are required to contribute 1.0 percent of covered wages; however, the other two bargaining units along with the covered nonunion members continue to have no employee contribution requirements. Employer contributions to the Trust for the City's fiscal year ended June 30, 2012 were determined as part of the March 1, 2012 actuarial valuation, which recommended an employer contribution of \$4,031,162. However, scheduled contributions were not paid to the Trust by the City. See Note 1 for the status of outstanding contributions due to the Trust in light of the City's financial condition.

Note 4 - Trustees

Two trustees of the City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust as of December 31, 2012 were elected by the membership, two sit by virtue of their position, and one is appointed by the other trustees.

Note 5 - Membership Data

At March 1, 2012, the date of the most recent actuarial valuation, membership data consisted of the following:

Retirees and beneficiaries currently receiving benefits	231
Terminated employees entitled to benefits, but not yet receiving them	161
Current employees*:	
Fully vested	-
Nonvested	-

* As of March 1, 2012 there were no active employees.

During 2011, a partial termination of the Pension Plan for Police and Fire Employees was deemed to have occurred. This resulted from the termination of various active employee positions at the City under executive orders issued by the emergency manager. The impact of membership composition is reflected above, with the impact of the funded status of the healthcare trust being demonstrated in Note 6 below.

In addition, effective March 1, 2012, the remaining fire employees ceased to be employees of the City. As such, the plan is effectively closed for active or new participants.

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Notes to Financial Statements December 31, 2012

Note 6 - Postemployment Benefits

Plan Description - The City provides retiree healthcare benefits to eligible employees and their spouses through the City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust. This is a single-employer benefit plan administered by the City of Pontiac Police and Fire Retirement System.

The plan's financial statements are also included in the City of Pontiac's financial report and can be obtained by writing to 47450 Woodward Ave., Pontiac, MI 48342.

Funding Policy - The City is required by ordinance to contribute on a percentage of covered payroll which the trustees have deemed to be based on actuarial recommended amounts. During the City's fiscal year ended June 30, 2012, the City did not make any contributions into the Trust, which is reported in the City's financial statements as a pension and other employee benefit trust fund. The City has not yet made the minimum contribution to the Trust of \$4,031,162 for the plan period ended December 31, 2012. However, contributions were made subsequent to year end pursuant to the terms of a settlement agreement between the Trust and plan sponsor for prior plan years. Those contributions are recorded as a receivable and revenue as of December 31, 2012.

The funding progress of the plan as of March 1, 2012 (the most recent valuation date, based on the 5 percent alternate investment return assumption, and as revised for the impact of PA 152) is as follows:

Actuarial value of assets	\$ 29,667,807
Actuarial accrued liability (AAL)	137,140,392
Unfunded AAL (UAAL)	107,472,585
Funded ratio	22 %
Annual covered payroll	-
Ratio of UAAL to covered payroll	N/A

Actuarial Methods and Assumptions - 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.

Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The required schedule of funding progress immediately following the notes to the financial statements presents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

**Notes to Financial Statements
December 31, 2012**

Note 6 - Postemployment Benefits (Continued)

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the 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.

In the March 1, 2012 actuarial valuation, the entry age actuarial cost method was used. The actuarial assumptions included a 7.5 percent investment rate of return as well as an alternate 5 percent investment rate of return compounded annually (net of administrative expenses). The financial statements reflect the use of the alternate 5 percent investment rate of return. The valuation also included a 10 percent medical care inflation rate assumption related to healthcare cost increases in the first year, decreasing in increments of 0.5 percent over the next 12 years to the ultimate 4 percent assumption. The actuarial value of assets is set to equal the smoothed market value as of December 31, 2011. The UAAL is being amortized as a level dollar of projected payroll on closed basis. The remaining amortization period at March 1, 2012 was 30 years.

Required Supplemental Information

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Required Supplemental Information Schedule of Analysis of Funding Progress

Actuarial Valuation Date*	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (Percent) (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll
12/31/06	\$ 25,534,993	\$ 79,788,465	\$ 54,253,472	32.0	\$ 12,831,719	422.8
12/31/07	30,185,216	73,171,572	42,986,356	41.3	11,066,828	388.4
12/31/08	31,405,001	113,221,193	81,816,192	27.7	9,749,807	839.2
12/31/09	32,313,276	125,406,797	93,093,521	25.8	7,405,796	1,257.0
12/31/10	34,821,105	115,446,247	80,625,142	30.2	6,667,866	1,209.2
3/1/12	29,667,807	137,140,392	107,472,585	21.6	-	-

* Beginning with the 12/31/08 valuation and thereafter, actuarial valuation information was derived from the actuary's 5 percent alternate return assumption.

Outstanding contributions related to 2010 and 2011 that were not remitted by the plan sponsor were removed from the asset value in the 3/1/12 valuation.

City of Pontiac Police and Fire Retiree Prefunded Group Health and Insurance Trust

Required Supplemental Information Schedule of Employer Contributions

<u>Fiscal Year Ended</u>	<u>Annual Required Contribution</u>	<u>Amount Contributed *</u>
6/30/09	\$ 5,594,865	2,678,324
6/30/10	4,553,185	3,158,681
6/30/11	3,915,371	-
6/30/12	4,031,162	3,243,332**

* GASB Statement No. 45 was adopted by the City for the City's fiscal year ended June 30, 2009. As such, the amount contributed corresponds to the City's fiscal year end (pursuant to GASB Statement No. 45) as opposed to the plan's calendar year end.

** Amount shown as contributions during the year ended June 30, 2012 relate to 2011, but were not received during that year. Contributions for 2012 are currently in litigation.

Amortization method	Level dollar, closed
Amortization period	30 years
Asset valuation method	Smoothed market
Actuarial assumptions:	
Alternate Investment rate of return*	5.0 %
*Includes inflation at	4.0 %
Medical inflation rate, graded down in 0.5% increments over 12 years	10% - 4%