

**CITY OF SILVER BAY
Lake County, Minnesota**

COMMUNICATIONS LETTER

Year Ended December 31, 2013

CITY OF SILVER BAY

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**REPORT ON MATTERS IDENTIFIED AS A RESULT OF
THE AUDIT OF THE FINANCIAL STATEMENTS**

Honorable Mayor, Members of the
City Council and Management
City of Silver Bay
Silver Bay, Minnesota

In planning and performing our audit of the financial statements of the City of Silver Bay, Minnesota, as of and for the year ended December 31, 2013, in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the City's financial statements will not be prevented or detected and corrected, on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. The significant deficiencies identified are stated within this letter.

The accompanying memorandum also includes financial analysis provided as a basis for discussion. The matters discussed herein were considered by us during our audit and they do not modify the opinion expressed in our Independent Auditor's Report dated March 4, 2014, on such statements.

This communication is intended solely for the information and use of management, Members of the City Council, others within the City and state oversight agencies and is not intended to be and should not be used by anyone other than these specified parties.

Kern, DeWenter, Viere, Ltd.

KERN, DEWENTER, VIERE, LTD.
St. Cloud, Minnesota
March 4, 2014

CITY OF SILVER BAY
SIGNIFICANT DEFICIENCIES
December 31, 2013

LACK OF SEGREGATION OF ACCOUNTING DUTIES

During the year ended December 31, 2013, the City had a lack of segregation of accounting duties due to a limited number of office employees. The lack of adequate segregation of accounting duties could adversely affect the City's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements.

Management and the City Council are aware of the lack of segregation of accounting duties and have taken certain steps to compensate for the condition, but due to the small staff needed to handle all of the accounting duties, the costs of obtaining desirable segregation of accounting duties can often exceed benefits which could be derived. However, management and the City Council must remain aware of this situation and should continually monitor the accounting system, including changes that occur.

The lack of segregation of accounting duties can be demonstrated in the following areas, which is not intended to be an all inclusive list:

- The Deputy Clerk has full General Ledger access, including the ability to write and post journal entries and is also responsible for review of the financial activities of the City, including preparation of the bank reconciliation.
- Receipting Process
 - The Assistant Deputy Clerk creates and sends invoices, occasionally collects payments as they are received, prepares deposits and enters the receipts into the accounting system.
 - The Assistant Deputy Clerk enters the utility billing into the utility billing register, bills commercial and residential customers and mails the utility bills. The Assistant Deputy Clerk also occasionally receives payments, records the receipts and is also able to make adjustments to the utility billing register.
- Disbursement Process
 - The Assistant Deputy Clerk creates a batch list for City Council approval, enters information for payment on all bills, prints checks, mails checks and creates the paid claims list that is presented to the City Council.

PREPARATION OF FINANCIAL STATEMENTS AND RELATED NOTE DISCLOSURES

As a function of the audit process, auditors are required to gain an understanding of the City's internal control, including the financial reporting process.

The City does not have an internal control system designed to provide for the preparation of the financial statements and related note disclosures in accordance with accounting principles generally accepted in the United States of America. As auditors, we were requested to draft the financial statements and accompanying Notes to the Financial Statements. This circumstance is not unusual in a city of your size.

This condition increases the risk that errors could occur which would not be prevented or detected and corrected in a timely manner. Even though all management decisions related to financial reporting are made by the City's management and approval of the financial statements and accompanying note disclosures lies with management, it is the responsibility of management and those charged with governance to make the decision whether to accept the degree of risk associated with this condition because of cost or other considerations.

CITY OF SILVER BAY

REQUIRED COMMUNICATION December 31, 2013

We have audited the financial statements of the City for the year ended December 31, 2013, and have issued our report dated March 4, 2014. Professional standards require that we provide you with the following information related to our audit.

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA AND *GOVERNMENT AUDITING STANDARDS*

As stated in our engagement letter, our responsibility, as described by professional standards, is to express an opinion about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit of the financial statements does not relieve you or management of your responsibilities.

As part of our audit, we considered the internal control of the City. Such considerations were solely for the purpose of determining our audit procedures and not to provide any assurance concerning internal control.

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the City's compliance with certain provisions of laws, regulations, contracts and grant agreements. However, the objective of our tests was not to provide an opinion on compliance with such provisions.

Our responsibility for the supplementary information accompanying the financial statements, as described by professional standards, is to evaluate the presentation of the supplementary information in relation to the financial statements as a whole and to report on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

PLANNED SCOPE AND TIMING OF THE AUDIT

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit involved judgment about the number of transactions to be examined and the areas to be tested.

Our audit included obtaining an understanding of the City and its environment, including internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing and extent of further audit procedures. Material misstatements may result from (1) errors, (2) fraudulent financial reporting, (3) misappropriation of assets or (4) violations of laws or governmental regulations that are attributable to the City or to acts by management or employees acting on behalf of the City.

QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year ended December 31, 2013. We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the proper period.

CITY OF SILVER BAY

REQUIRED COMMUNICATION December 31, 2013

QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

Depreciation – The City is currently depreciating its capital assets over their estimated useful lives, as determined by management, using the straight-line method.

Expense Allocation – The City is currently allocating certain costs among the programs and supporting services benefited. The costs are allocated based on management's estimates.

The financial statement disclosures are neutral, consistent and clear.

DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT

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

CORRECTED AND UNCORRECTED MISSTATEMENTS

Professional standards require us to accumulate all misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. We identified the following uncorrected misstatement of the financial statements. Management has determined its effect is immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

- Adjustment to record Marina fuel inventory.

In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the financial statements taken as a whole.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this letter, a disagreement with management is a financial accounting, reporting or auditing matter, whether or not resolved to our satisfaction that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

MANAGEMENT REPRESENTATIONS

We requested certain representations from management that are included in the management representation letter.

CITY OF SILVER BAY

REQUIRED COMMUNICATION

December 31, 2013

MANAGEMENT CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a “second opinion” on certain situations. If a consultation involves application of an accounting principle to the City’s financial statements or a determination of the type of auditor’s opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

OTHER AUDIT FINDINGS OR ISSUES

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City’s auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

OTHER MATTERS

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content and methods of preparing the information to determine that the information complies with accounting principles generally accepted in United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

CITY OF SILVER BAY

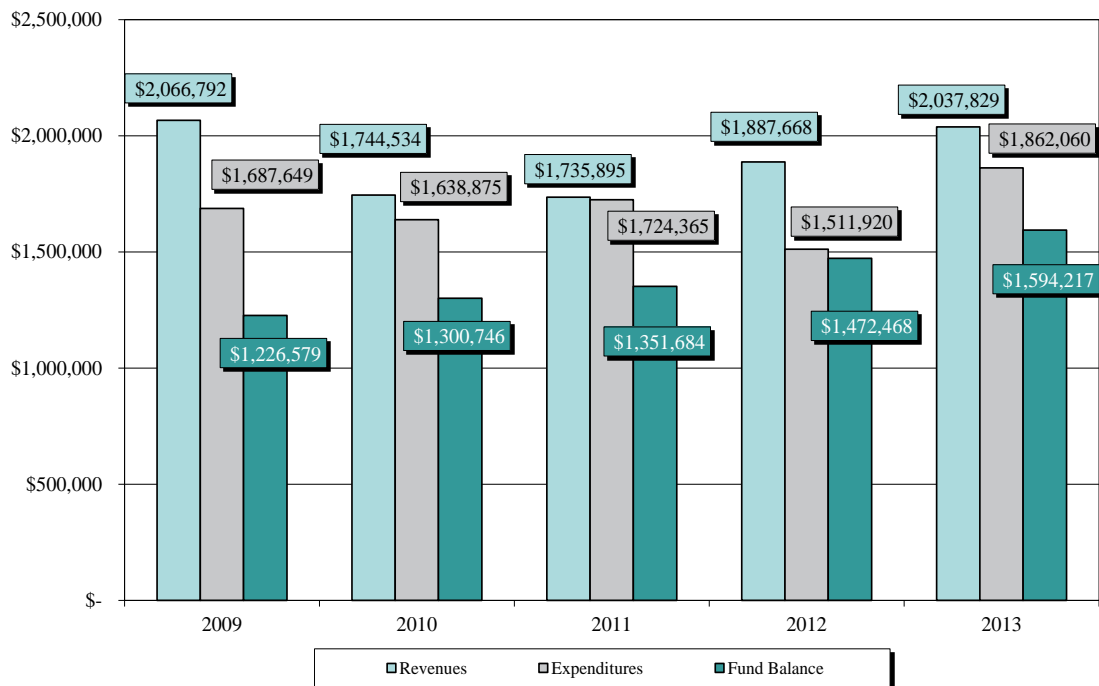
FINANCIAL ANALYSIS December 31, 2013

The following pages provide graphic representation of select data pertaining to the financial position and operations of the City for the past five years. Our analysis of each graph is presented to provide a basis for discussion of past performance and how implementing certain changes may enhance future performance. We suggest you view each graph and document if our analysis is consistent with yours. A subsequent discussion of this information should be useful for planning purposes.

GENERAL FUND

Revenues over expenditures, before transfers and other financing sources, in the General Fund for 2013 totaled \$ 175,769. General Fund revenues funded \$ 278,944 in routine operating transfers to fund Library, Cemetery, Arena, Park and Recreation, Community Building and Public Work's Reserve Funds' operations. Fund balance in the General Fund increased \$ 121,749, or 8.3%, from \$ 1,472,468 in 2012 to \$ 1,594,217 in 2013. This fund balance represents just over ten months of total General Fund operating expenditures. As the graph below indicates, revenues increased in 2013 for the second year in a row after decreasing the two years prior to 2012. Fund balance has increased steadily over the last five years, to a high in 2013.

General Fund Revenues, Expenditures and Fund Balance



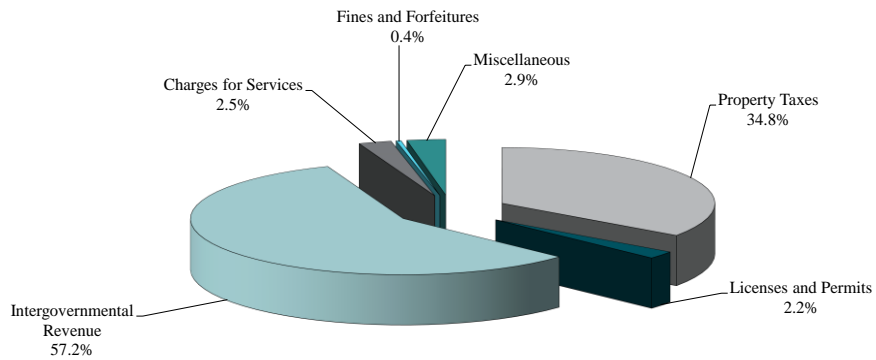
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2013

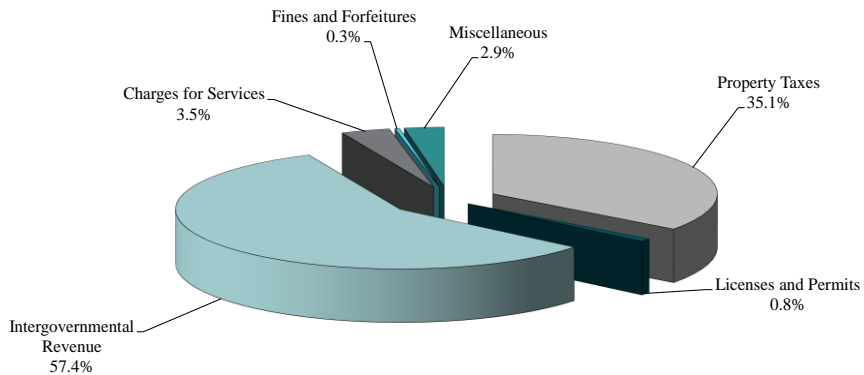
GENERAL FUND

As the graphs below indicate, the City relies upon intergovernmental revenue and tax levies as the majority of its total General Fund revenues. These two revenues accounted for 92.0% and 92.5% of total revenue in 2013 and 2012, respectively.

General Fund 2013 Revenues by Source



General Fund 2012 Revenues by Source



CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2013

GENERAL FUND

	Year Ended December 31,				
	2009	2010	2011	2012	2013
REVENUES					
Property Taxes	\$ 450,321	\$ 481,225	\$ 489,640	\$ 663,145	\$ 708,293
Licenses and Permits	30,548	22,921	10,109	15,411	44,728
Intergovernmental Revenue	1,493,936	1,142,362	1,117,779	1,083,161	1,166,623
Charges for Services	37,413	41,235	52,399	66,173	50,771
Fines and Forfeitures	6,902	8,026	8,057	6,060	7,607
Miscellaneous	47,672	48,765	57,911	53,718	59,807
Total Revenues	\$ 2,066,792	\$ 1,744,534	\$ 1,735,895	\$ 1,887,668	\$ 2,037,829

General Fund revenues increased \$ 150,161, or 8.0% from 2012. This increase is primarily in intergovernmental revenues, property taxes and licenses and permits. Intergovernmental revenues increased due to the City receiving more taconite aid in 2013, which represented \$ 71,719 of the \$ 83,462 increase in intergovernmental revenue. The amount of property taxes levied for the General Fund increased \$ 37,430 from the prior year. Prior to 2012, the state subsidized a portion of property taxes and paid that portion in the form of a market value credit. In an effort to balance the state's budget, the market value credit subsidization was discontinued beginning with the 2012 levy, resulting in the entire levy being the responsibility of local tax payers causing the property tax revenue to be significantly higher and intergovernmental revenue lower than previous years. Licenses and permits revenue increased \$ 29,317 due to the North Shore Mining permit. The City received reimbursement from Minnesota Power for engineering costs related to this project. In the five years presented, total revenues have stayed relatively consistent, decreasing \$ 28,963 or 1.4%. Revenues can change significantly year to year based on different grants received.

	Year Ended December 31,				
	2009	2010	2011	2012	2013
EXPENDITURES					
General Government	\$ 396,565	\$ 415,398	\$ 439,134	\$ 434,300	\$ 485,463
Public Safety	564,161	571,227	587,363	529,727	533,772
Public Works	520,644	394,885	358,725	470,546	506,284
Culture and Recreation	29,293	18,549	19,216	27,086	17,799
Debt Service	56,009	36,228	21,423	21,422	21,423
Capital Outlay	120,977	202,588	298,504	28,839	297,319
Total Expenditures	\$ 1,687,649	\$ 1,638,875	\$ 1,724,365	\$ 1,511,920	\$ 1,862,060

General Fund expenditures increased \$ 350,140, or 23.2% during 2013. Capital outlay changed most significantly from 2012 to 2013, increasing by \$ 268,480. This is the result of replacing the damaged bridge at the golf course, replacing the roofs of several City buildings as a result of hail damage, purchasing equipment for the golf course and purchasing a new excavator. General government expenditures increased \$ 51,163 primarily due to contractor costs for the North Shore Mining and Minnesota Power project and an increase in the allocation of general liability insurance to the General Fund in 2013 based on the League of Minnesota Cities formula. Public works expenditures increased \$ 35,738 as a result of additional snow plowing costs in 2013 and repairs done on City buildings for hail damage. Expenditures in public safety, culture and recreation and debt service stayed consistent with the prior year.

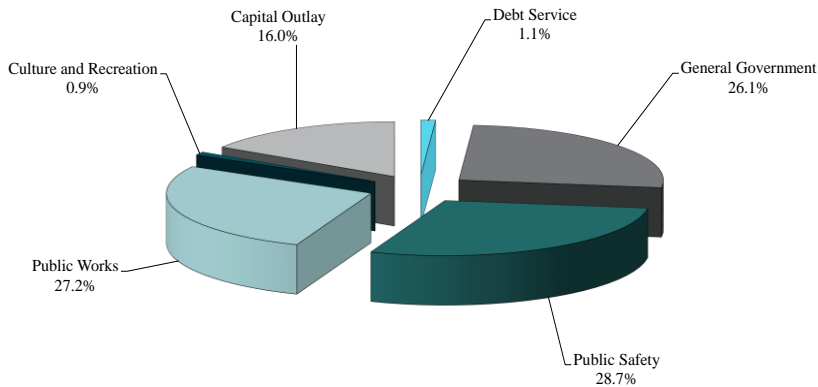
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2013

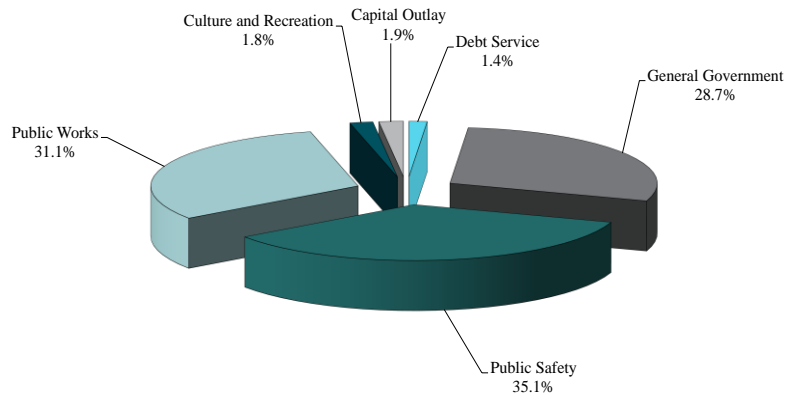
GENERAL FUND

The graphs below illustrate the breakdown of expenditures by function for the last two years. As with other cities of similar size, public safety, public works and general government expenditures make up the largest components of General Fund expenditures. Due to the capital purchases of the City in 2013, that function increased while expenditures in the other functions decreased proportionately from 2012.

General Fund 2013 Expenditures by Function



General Fund 2012 Expenditures by Function



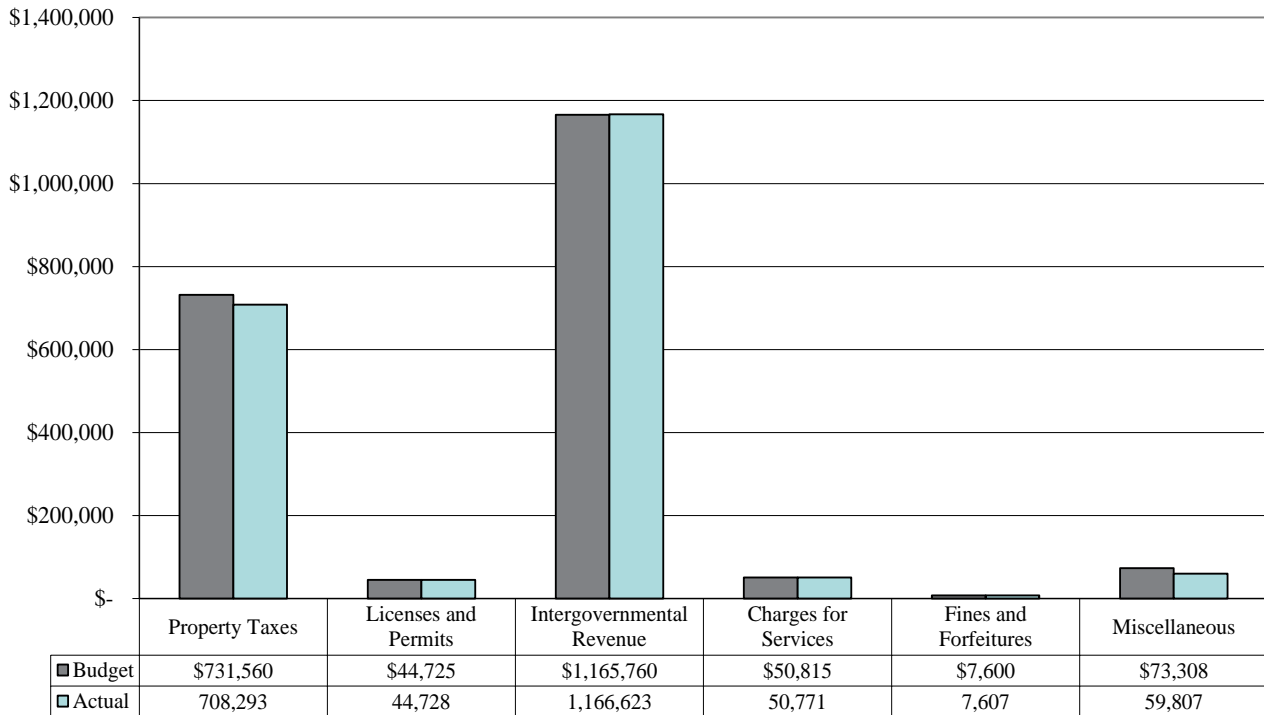
CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2013**

GENERAL FUND

The graphs below and on the following page outline the budget and actual comparison for General Fund revenues and expenditures. Overall, revenue was \$ 35,939 under budget. Property taxes were under budget \$ 23,267 as a result of delinquent taxes coming in under expected amounts. Miscellaneous revenues were under budget \$ 13,501 due to the City not receiving as much insurance refunds as anticipated. The rest of the revenue categories only had minimal budget variances.

**2013 General Fund Revenues
Budget and Actual**

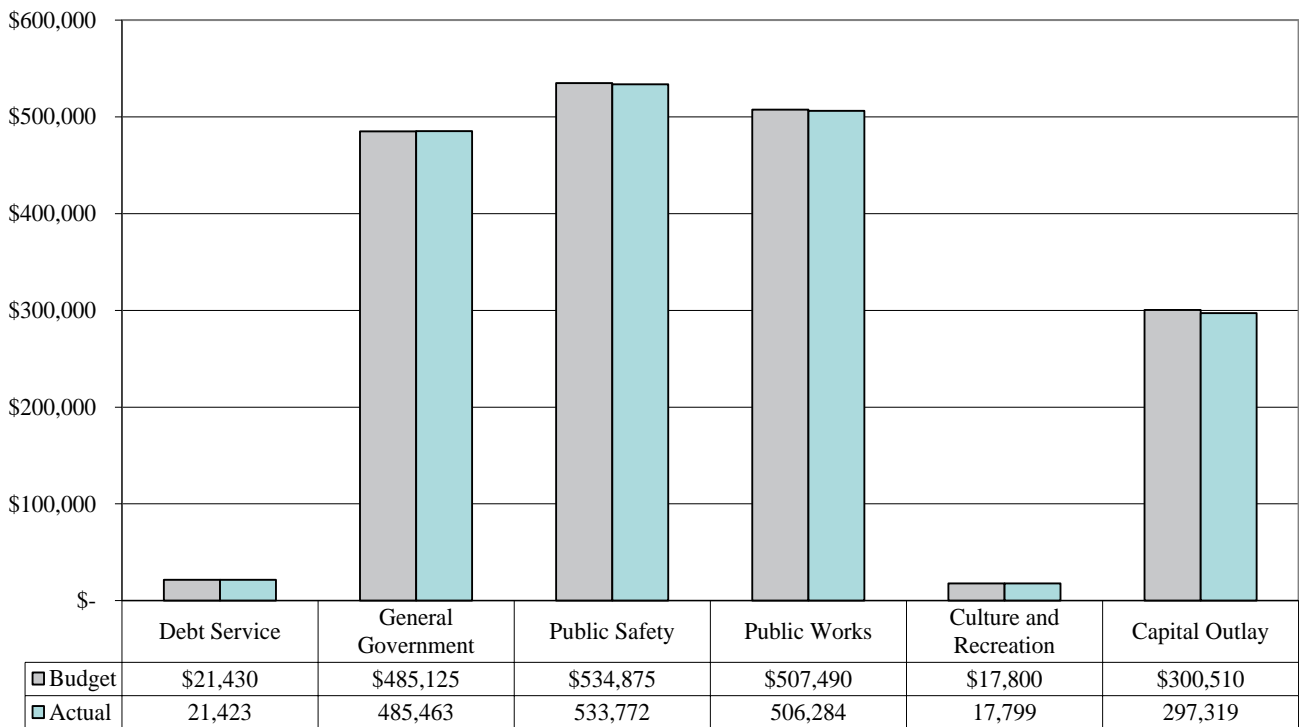


CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2013

GENERAL FUND

Overall, expenditures were \$ 5,170, or 0.3%, under budget in 2013. All functions had minor variances from the budget.

**2013 General Fund Expenditures
 Budget and Actual**

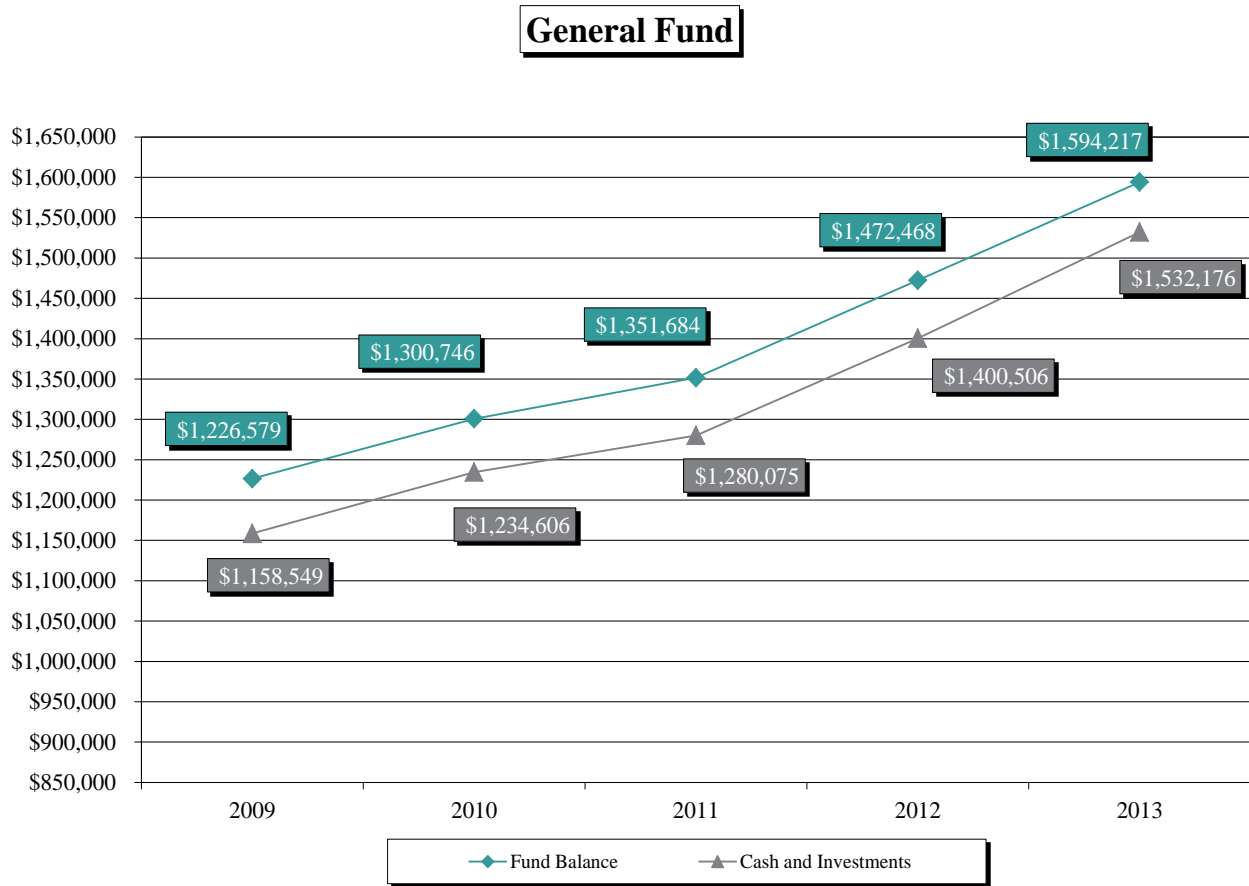


CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2013

GENERAL FUND

As illustrated below, the fund balance and cash balance in the General Fund increased in 2013. Cash increased during 2013 by approximately 9.4%, while fund balance increased 8.3%. We commend the City and its administration for its focus and dedication in maintaining its General Fund balance at levels that can adequately fund operations and provide sufficient reserves to fund small projects without incurring bond issuance costs.



CITY OF SILVER BAY

FINANCIAL ANALYSIS

December 31, 2013

LIQUOR FUND

Liquor Fund operating trends are illustrated on the graphs on the following page. Sales decreased by 3.8%, from \$ 934,085 in 2012 to \$ 898,700 in 2013. This decrease is due mostly to a decrease in on sale revenue which decreased \$ 46,863. This decrease is due to a variety of reasons, such as a record Bay Days crowd in 2012, an ATV parade in 2012 and North Shore Mining Company changing its policy preventing boat employees from purchasing alcohol at their port. This decrease in on sale was offset partially by an increase in off sale, which increased \$ 11,478 from 2012.

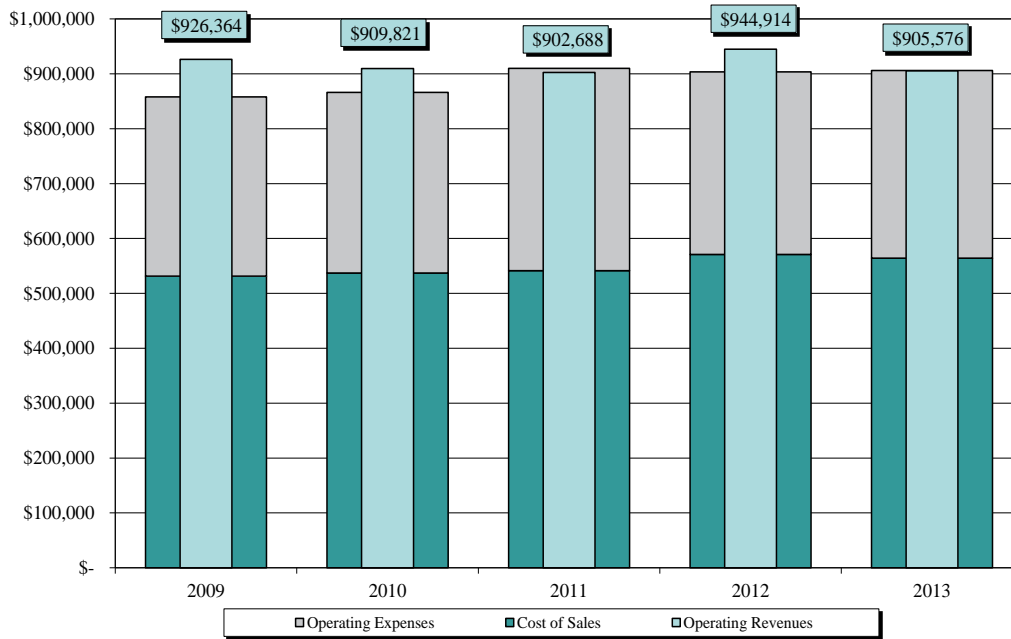
Gross profit percentage decreased from 38.9% in 2012 to 37.2% in 2013. This percentage has decreased 4.7% since 2009. The Liquor Fund had an operating loss of \$ 373 in 2013, a decrease from the operating income in 2012 of \$ 41,349. This was primarily due to the decrease in operating revenue in 2013. The City Council has chosen to suspend transfers from the Liquor Fund to other City operations until the Municipal Liquor Store Revenue Bonds have been paid in full.

We recommend the City continue to review markups on all products to maintain a gross profit percentage at approximately 40% to 42%. The liquor operations should consider increased strategic marketing through new products and promotion and display of higher margin products in order to increase sales and improve operating results. With this policy, the City should return to having the necessary funds to provide for park and recreation and public works reserve projects as they have in the past.

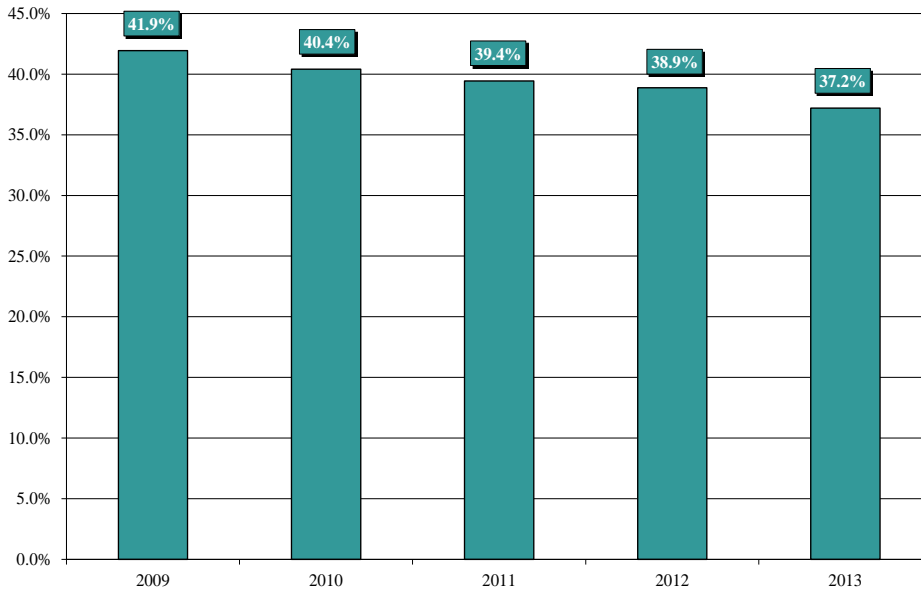
CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2013

LIQUOR FUND

Liquor Fund



Liquor Fund Gross Profit Percentage



CITY OF SILVER BAY

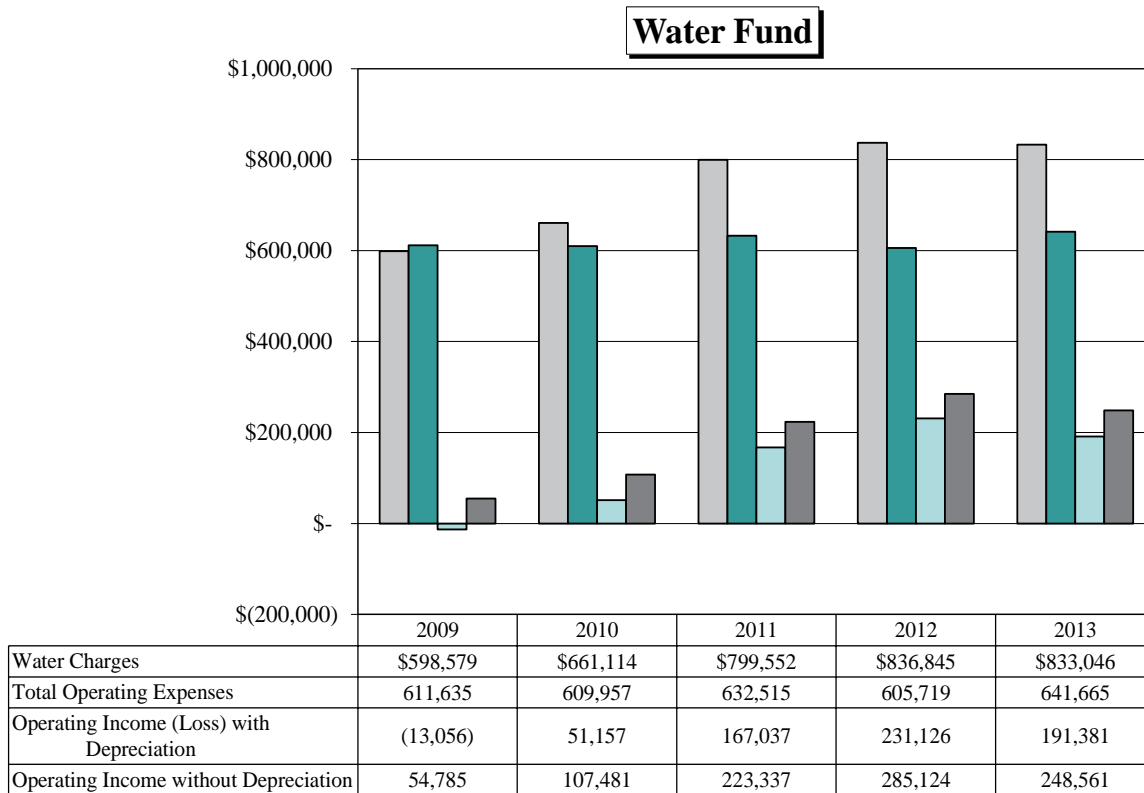
**FINANCIAL ANALYSIS
December 31, 2013**

WATER AND SEWER FUNDS

Water and sewer rates increased in late 1995, 1999, 2005 and 2007-2013 to fund the repayment of the water and wastewater treatment facilities and water system improvements financed through the PFA loan program. For the fourth time in the last five years presented, sufficient revenues were generated in the Water Fund to cover the costs associated with the facilities, as demonstrated by 2010 through 2013 operating incomes in the Water Fund. For the third time in the five years presented, the Sewer Fund had an operating profit, generating \$ 121,738 in 2013.

The operating trends of the Water and Sewer Funds are illustrated below and on the following page. Operating expenses of the Water Fund increased 5.9% in 2013 as a result of an increase in repairs and maintenance, including valves and blacktopping related to water main breaks. Operating revenues in 2013 stayed consistent with 2012 revenues, decreasing only \$ 3,799 or 0.5%.

We recommend the City continue to monitor operating costs and user fees in this Fund to ensure rates are sufficient to provide revenues to cover operating costs and fund future capital improvements of the water system. Since 2010, the City has been able to realize an operating gain with the inclusion of depreciation expense charged to the Fund. The City should look to continue this trend in future years.



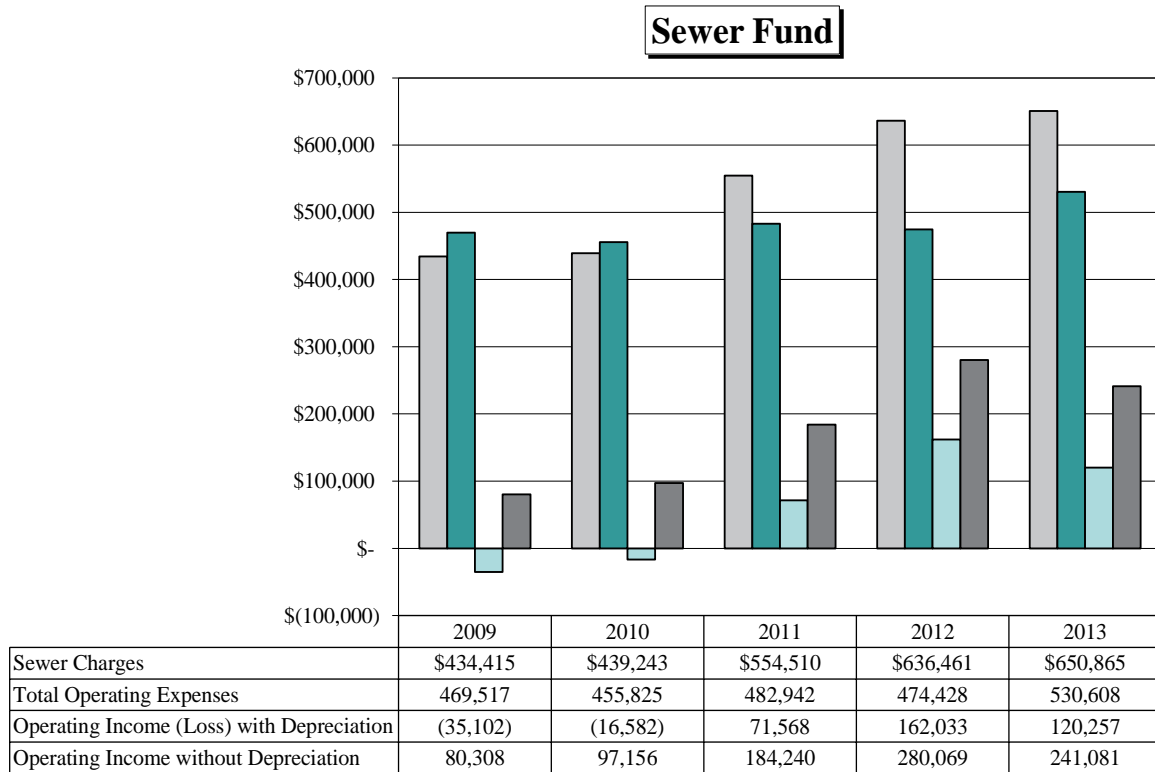
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2013

WATER AND SEWER FUNDS

As a result of the increase in the rate in 2013, Sewer Fund operating revenues increased 2.3% in 2013. Operating expenses increased \$ 56,180 from \$ 474,428 in 2012 to \$ 530,608 in 2013, for an increase of 11.8%. This increase was due to two different sewer pump replacements in 2013, higher heating costs due to a colder winter and natural gas conversion expenses.

We recommend the City continue to monitor operating costs and user fees in this Fund to ensure rates are sufficient to provide revenues to cover operating costs including depreciation and fund future improvements.



CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2013

WATER AND SEWER FUNDS

Net Position Balances
Water Fund and Sewer Fund

