

**City of Silver Bay
Lake County, Minnesota**

Communications Letter

December 31, 2019



**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 governmental activities, business-type activities, each major fund, and the aggregate remaining fund information of the City of Silver Bay, Minnesota, as of and for the year ended December 31, 2019, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions 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 have not been identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a material weakness and another deficiency that we consider to be a significant deficiency.

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 over financial reporting, 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. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

- *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
- *Probable.* The future event or events are likely to occur.

The material weakness identified is stated within this letter.

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 deficiency identified is 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 February 24, 2020, 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.

Bergan KDV, Ltd.

St. Cloud, Minnesota
February 24, 2020

City of Silver Bay
Material Weakness

Material Audit Adjustment

During the course of our engagement, we proposed a material audit adjustment to properly adjust contracts payable. The City had properly calculated the related liability amount but had not posted this adjustment to their accounting records at year end.

City of Silver Bay Significant Deficiency

Lack of Segregation of Accounting Duties

During the year ended December 31, 2019, 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.

City of Silver Bay Required Communication

We have audited the financial statements of the governmental activities, business-type activities, each major fund, and the aggregate remaining fund information of the City as of and for the year ended December 31, 2019. Professional standards require that we advise you of the following matters related to our audit.

Our Responsibility in Relation to the Financial Statement Audit

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

Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, as part of our audit, we considered the internal control of the City solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

We are also responsible for communicating significant matters related to the audit that are, in our professional judgement, relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures for the purpose of identifying other matters to communicate to you.

Generally accepted accounting principles provide for certain Required Supplementary Information (RSI) to supplement the basic financial statements. Our responsibility with respect to the RSI, which supplements the basic financial statements, is to apply certain limited procedures in accordance with generally accepted auditing standards. However, the RSI was not audited and, because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance, we do not express an opinion or provide any assurance on the RSI.

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 as a whole.

Our Responsibility in Relation to *Government Auditing Standards*

As communicated in our engagement letter, 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, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, the objective of our tests was not to provide an opinion on compliance with such provisions.

City of Silver Bay Required Communication

Planned Scope and Timing of the Audit

We conducted our audit consistent with the planned scope and timing we previously communicated to you.

Compliance with All Ethics Requirements Regarding Independence

The engagement team, others in our firm, as appropriate, our firm, and our network firms have complied with all relevant ethical requirements regarding independence.

Qualitative Aspects of Significant Accounting Practices

Significant Accounting Policies

Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in the notes to financial statements. There have been no initial selection of accounting policies and no changes to significant accounting policies or their application during 2019. No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

Significant Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgements. Those judgements are normally based on 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 markedly from management's current judgements. 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.

Net Pension Liability, Deferred Outflows of Resources Related to Pensions, and Deferred Inflows of Resources Related to Pensions – These balances are based on an allocation by the pension plans using estimates based on contributions.

We evaluated the key factors and assumptions used to develop the accounting estimates and determined that they are reasonable in relation to the financial statements taken as a whole.

Financial Statement Disclosures

Certain financial statement disclosures involve significant judgment and are particularly sensitive because of their significance to financial statement users. The financial statement disclosures are neutral, consistent, and clear.

City of Silver Bay Required Communication

Significant Difficulties Encountered during the Audit

We encountered no significant difficulties in dealing with management relating to the performance of the audit.

Uncorrected and Corrected Misstatements

For the purposes of this communication, professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that we believe are trivial, and communicate them to the appropriate level of management. Further, professional standards require us to also communicate the effects of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Management did not identify and we did not notify them of any uncorrected financial statement misstatements.

In addition, professional standards require us to communicate to you all material, corrected misstatements that were brought to the attention of management as a result of our audit procedures. The following material misstatement which was appropriately calculated by management, but just not posted to their accounting system, was detected as a result of audit procedures and was corrected by management.

- Recording contracts payable

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter, which could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of our audit.

Representations Requested from Management

We have requested certain written representations from management, which are included in the management representation letter.

Management's Consultations with Other Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters. Management has informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Other Significant Matters, Findings, or Issues

In the normal course of our professional association with the City, we generally discuss a variety of matters, including the application of accounting principles and auditing standards, operating conditions affecting the City, and operating plans and strategies that may affect the risks of material misstatement. None of the matters discussed resulted in a condition to our retention as the City's auditor.

**City of Silver Bay
Required Communication**

Other Information in Documents Containing Audited Financial Statements

We applied certain limited procedures to the RSI that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding 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 did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

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 the 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.

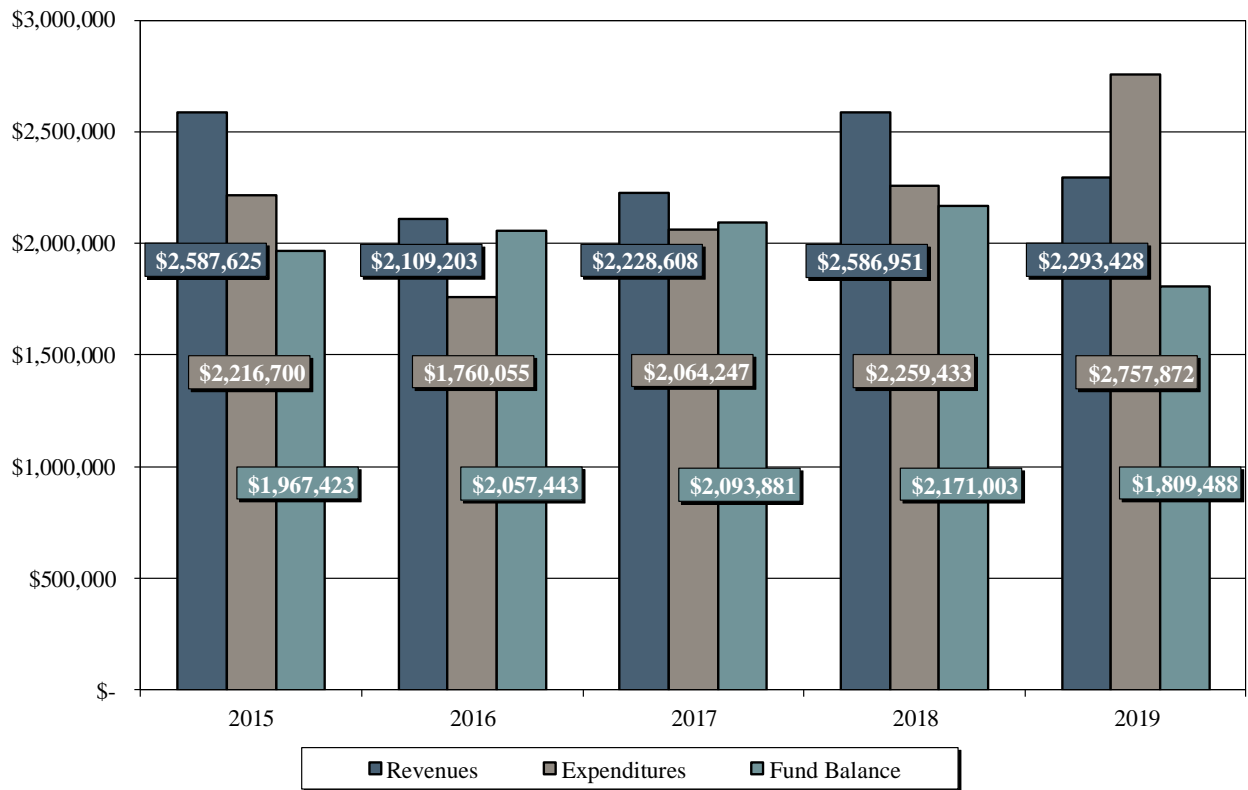
City of Silver Bay Financial Analysis

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

In 2019, General Fund expenditures exceeded revenues, before transfers and other financing sources, by \$464,444. General Fund revenues funded \$363,694 in routine operating transfers to fund Library, Cemetery, Arena, Park and Recreation, Community Building, Housing, Airport, Debt Service, and Public Works Reserve Funds' operations. Fund balance in the General Fund decreased \$361,515, or 16.7%, after long term debt and insurance proceeds totaling \$372,215 from \$2,171,003 in 2018 to \$1,809,488 in 2019. This fund balance represents just under eight months of total General Fund operating expenditures, based on 2019 operations. Fund balance increased steadily in the previous four years, however decreased in 2019 due to a planned increase in capital outlay related activity.

General Fund Revenues, Expenditures, and Fund Balance

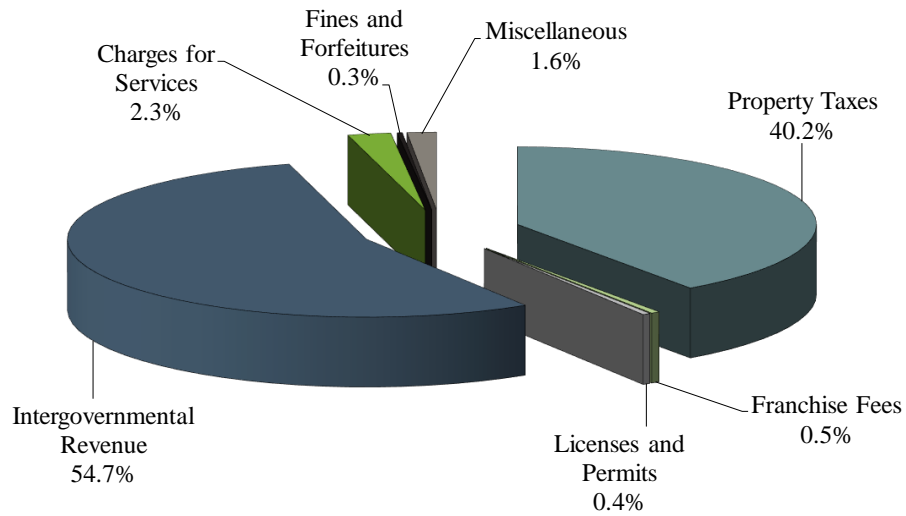


City of Silver Bay Financial Analysis

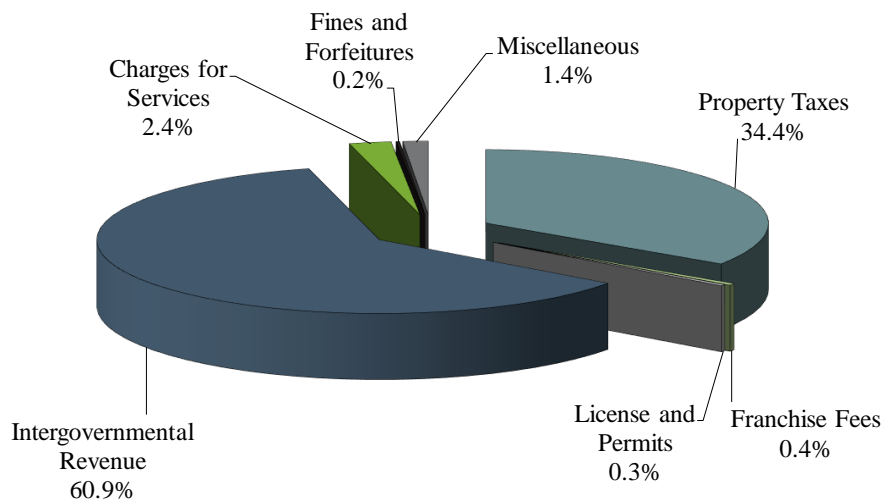
GENERAL FUND (CONTINUED)

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 revenue sources accounted for 95.3% and 94.9% of total revenue in 2018 and 2019, respectively. Revenue percentages were fairly consistent to the prior year. The intergovernmental revenue allocation decreased in 2019 as a result of a significant grant from the Lake County Water and Soil Conservation District received in 2018. The allocation increased proportionately for property taxes and most other sources as a result of that grant in the previous year.

General Fund 2019 Revenues by Source



General Fund 2018 Revenues by Source



**City of Silver Bay
Financial Analysis**

GENERAL FUND (CONTINUED)

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Revenues					
Property taxes	\$ 780,909	\$ 746,235	\$ 860,276	\$ 889,375	\$ 922,225
Franchise fees	10,033	9,540	10,502	9,923	10,797
Licenses and permits	9,029	8,553	7,613	7,423	9,623
Intergovernmental revenue	1,690,460	1,225,463	1,245,062	1,575,905	1,254,985
Charges for services	54,597	52,943	63,798	61,931	53,358
Fines and forfeitures	5,748	5,130	5,172	5,185	6,182
Miscellaneous	36,849	61,339	36,185	37,209	36,258
Total revenues	<u>\$ 2,587,625</u>	<u>\$ 2,109,203</u>	<u>\$ 2,228,608</u>	<u>\$ 2,586,951</u>	<u>\$ 2,293,428</u>

General Fund revenues decreased \$293,523, or 11.3% from 2018. Intergovernmental revenue decreased \$320,920 primarily due to a soil and water grant for the east branch of the Beaver River project that flowed through the City in 2018. In the five years presented, total revenues have decreased by \$294,197 or 11.4%. Revenues can change significantly year to year based on different grants received.

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Expenditures					
General government	\$ 513,041	\$ 490,658	\$ 482,555	\$ 494,133	\$ 518,842
Public safety	557,153	573,012	634,476	639,995	653,241
Public works	502,256	510,311	516,356	519,067	551,299
Culture and recreation	19,359	19,033	27,350	27,417	27,029
Capital outlay	624,891	167,041	403,510	578,821	1,007,461
Total expenditures	<u>\$ 2,216,700</u>	<u>\$ 1,760,055</u>	<u>\$ 2,064,247</u>	<u>\$ 2,259,433</u>	<u>\$ 2,757,872</u>

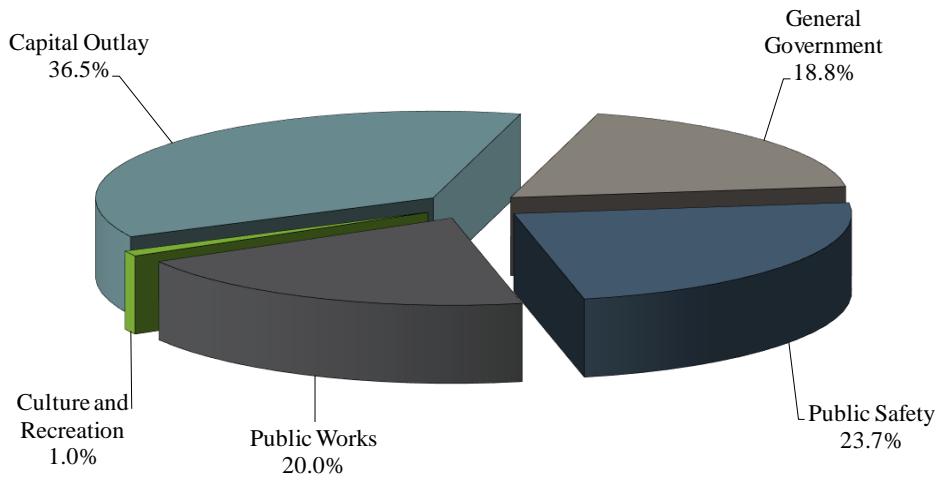
General Fund expenditures increased \$498,439, or 22.1% during 2019. Capital outlay changed significantly from 2018 to 2019, increasing by \$428,640. This increase is due to the city hall remodel as well as the public works street shop construction. All other functions were relatively consistent with the prior year.

City of Silver Bay Financial Analysis

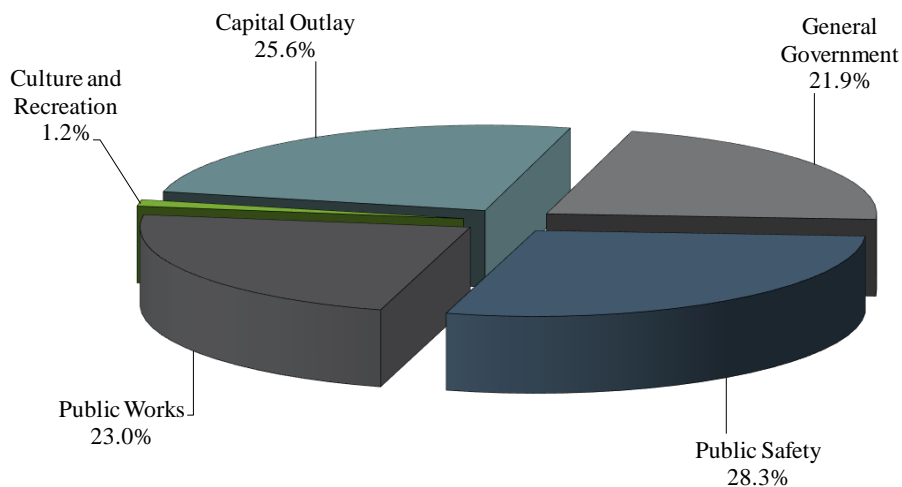
GENERAL FUND (CONTINUED)

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 2019, the capital outlay function increased in 2019 while expenditures in the other functions mostly decreased proportionately.

General Fund 2019 Expenditures by Function



General Fund 2018 Expenditures by Function

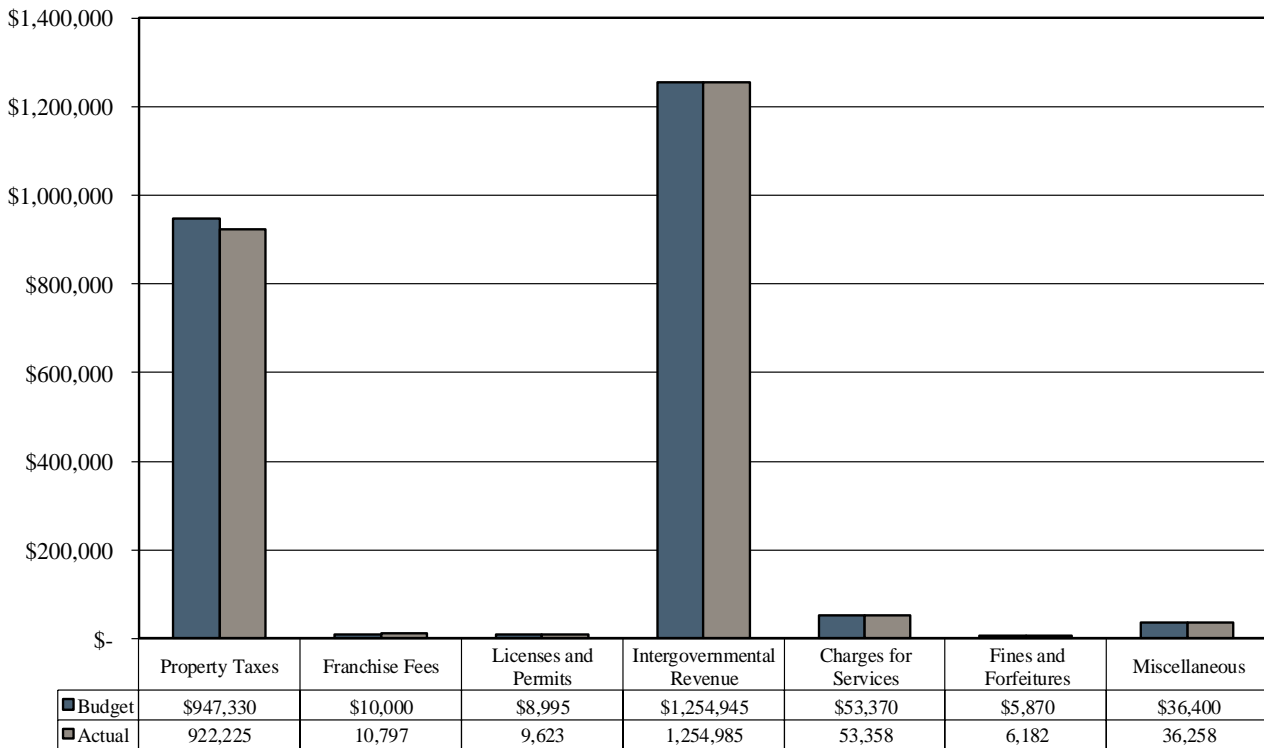


**City of Silver Bay
Financial Analysis**

GENERAL FUND (CONTINUED)

The graphs below and on the following page outline the budget and actual comparison for General Fund revenues and expenditures. Overall, revenue was \$23,482 under budget. Property taxes were under budget \$25,105 as a result of delinquent tax receipts coming in under expected amounts. The remaining revenue categories only had minimal budget variances.

**2019 General Fund Revenues
Budget and Actual**

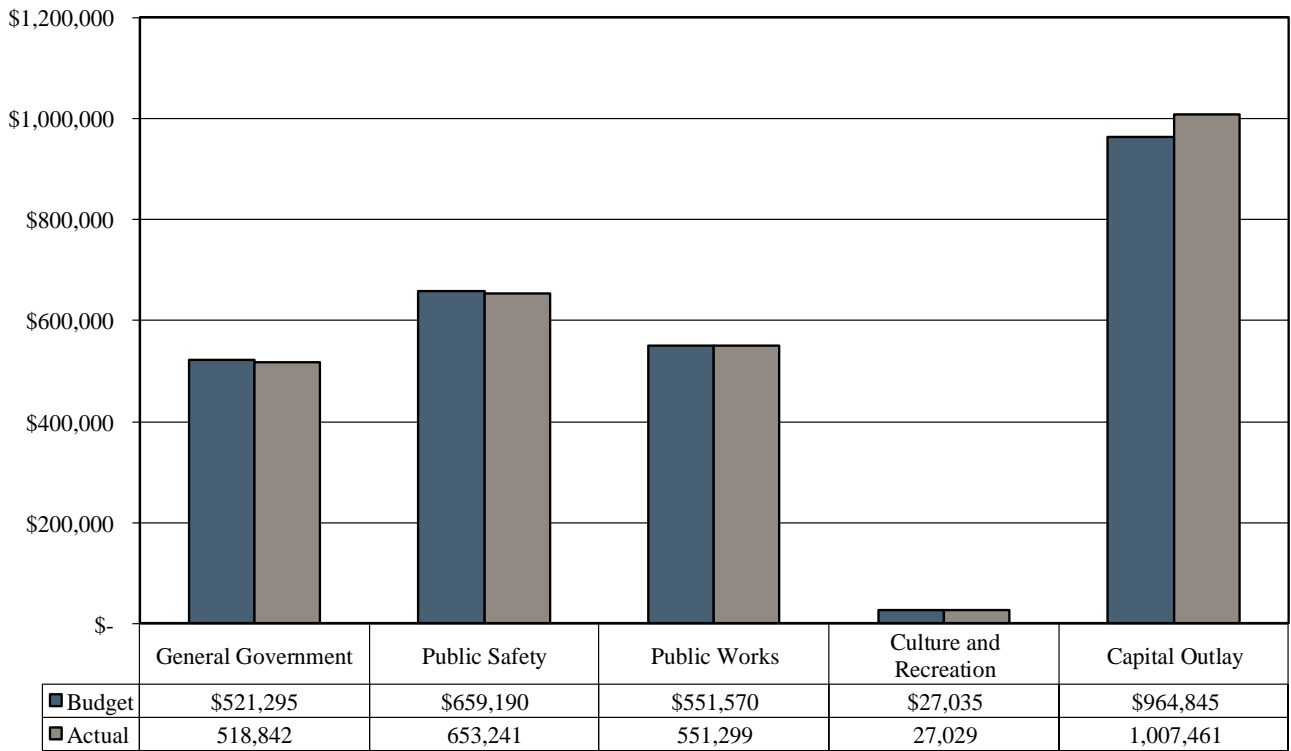


**City of Silver Bay
Financial Analysis**

GENERAL FUND (CONTINUED)

Overall, expenditures were \$33,937 over budget in 2019. All functions had minor variances from the budget except for capital outlay expenditures which were \$42,616 over budget due to incurring more capital costs than expected.

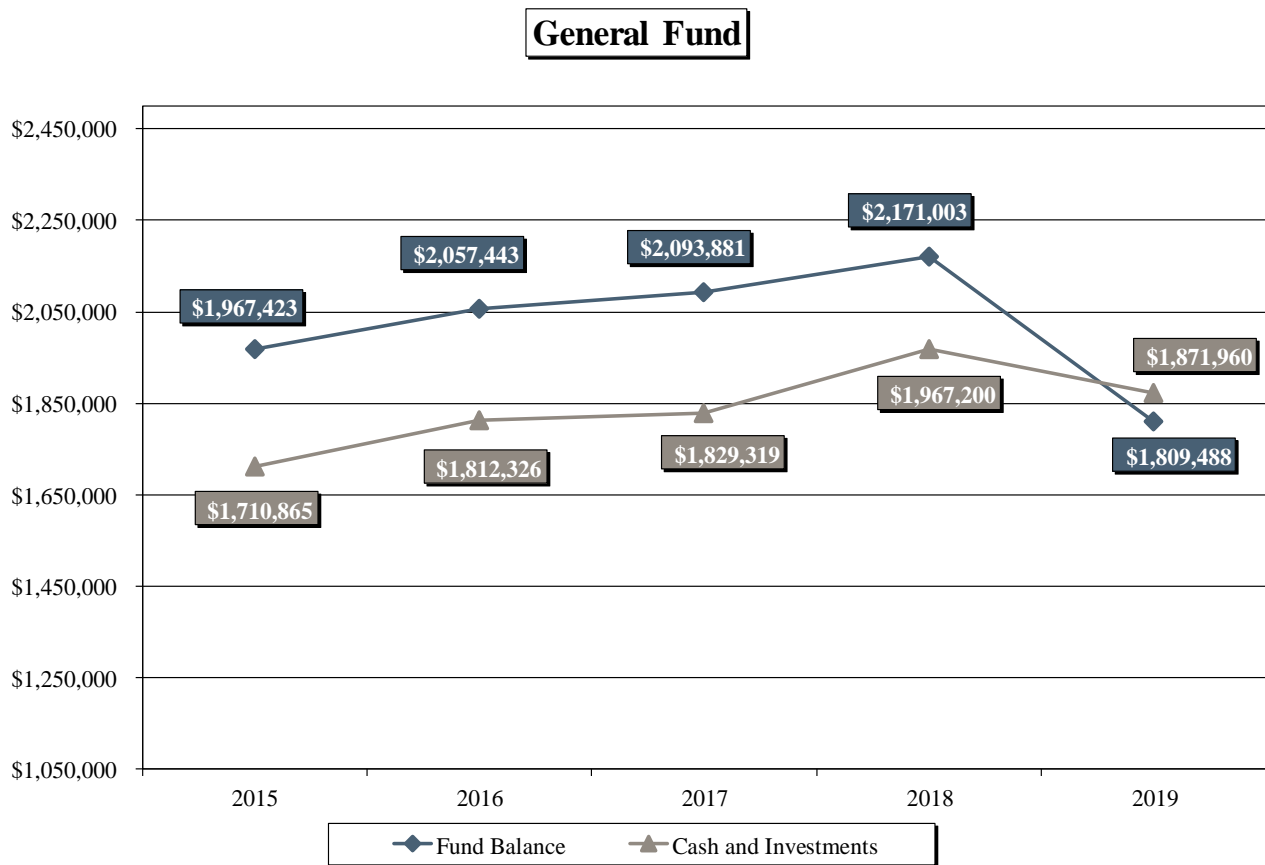
**2019 General Fund Expenditures
Budget and Actual**



City of Silver Bay Financial Analysis

GENERAL FUND (CONTINUED)

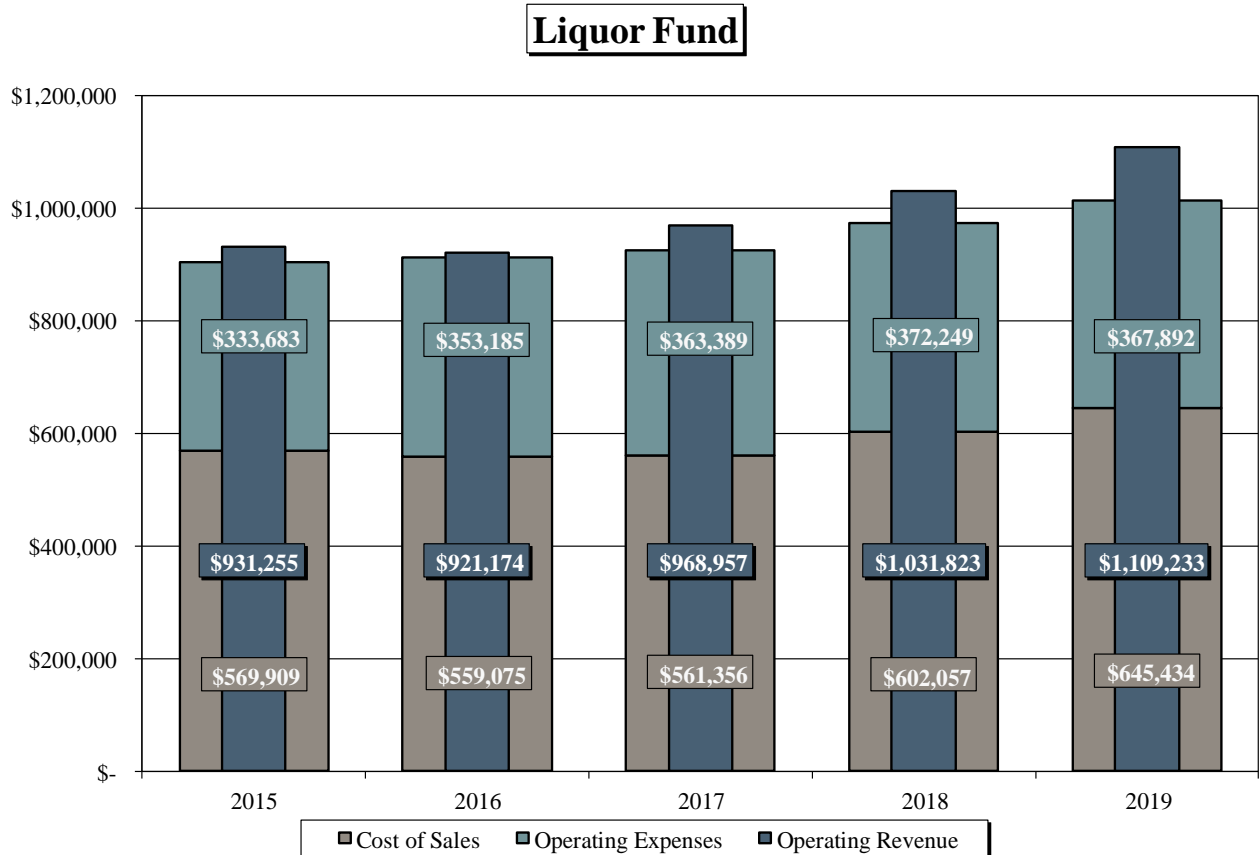
As illustrated below, the fund balance and cash balance in the General Fund decreased in 2019. Cash decreased during 2019 by approximately 4.8%, while fund balance decreased 16.7%. We commend the City and its administration for its focus and dedication in maintaining its General Fund balance at levels that can adequately fund operations and provide sufficient reserves to fund small projects without incurring bond issuance costs.



City of Silver Bay Financial Analysis

LIQUOR FUND

Liquor Fund operating trends are illustrated on the graphs below and on the following page. Sales increased by 7.1%, from \$1,014,897 in 2018 to \$1,087,208 in 2019. Sales increased as a result of an increase in off sale business. Cost of sales had a corresponding increase of 7.2%, from \$602,057 in 2018 to \$645,434 in 2019.

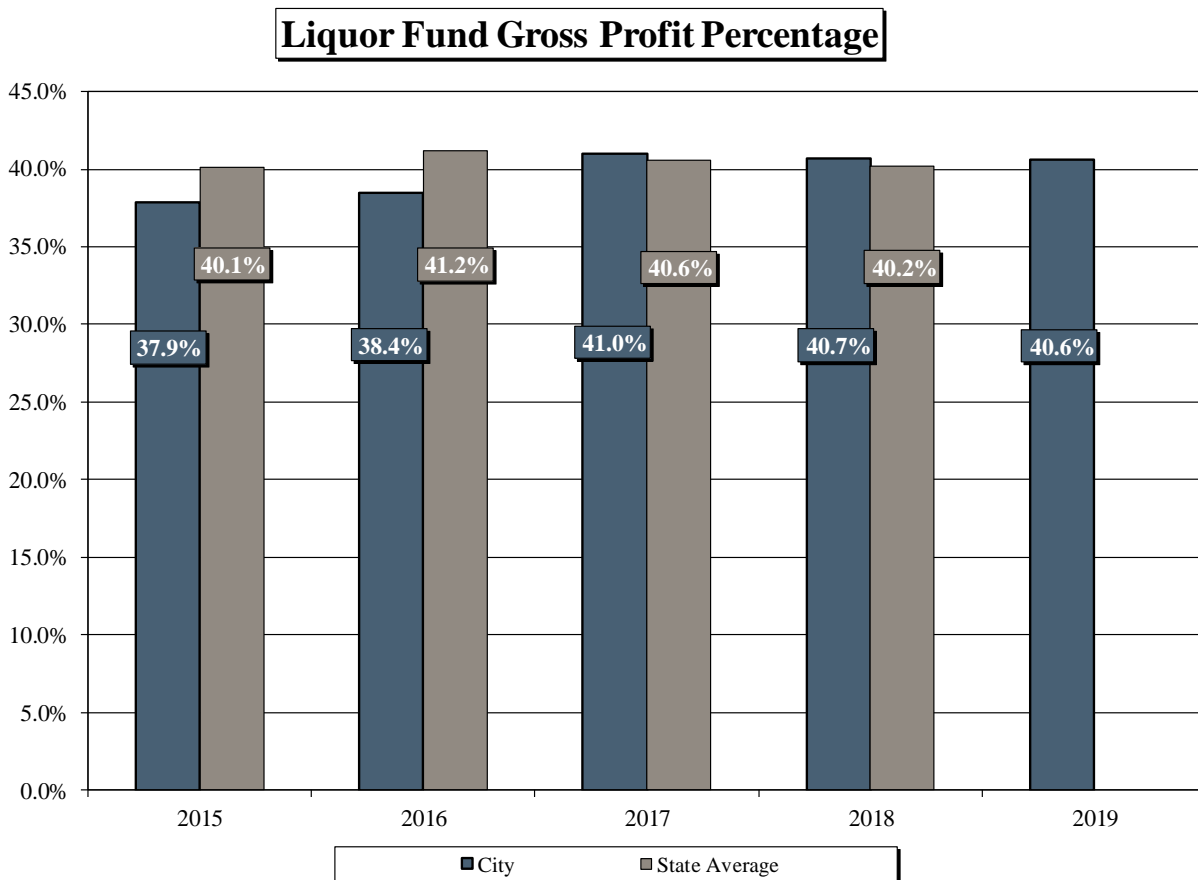


City of Silver Bay Financial Analysis

LIQUOR FUND (CONTINUED)

Gross profit percentage decreased from 40.7% in 2018 to 40.6% in 2019. The Liquor Fund had operating income of \$95,907 in 2019, an increase from the operating income in 2018 of \$57,517. This was primarily due to increased sales.

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.



**City of Silver Bay
Financial Analysis**

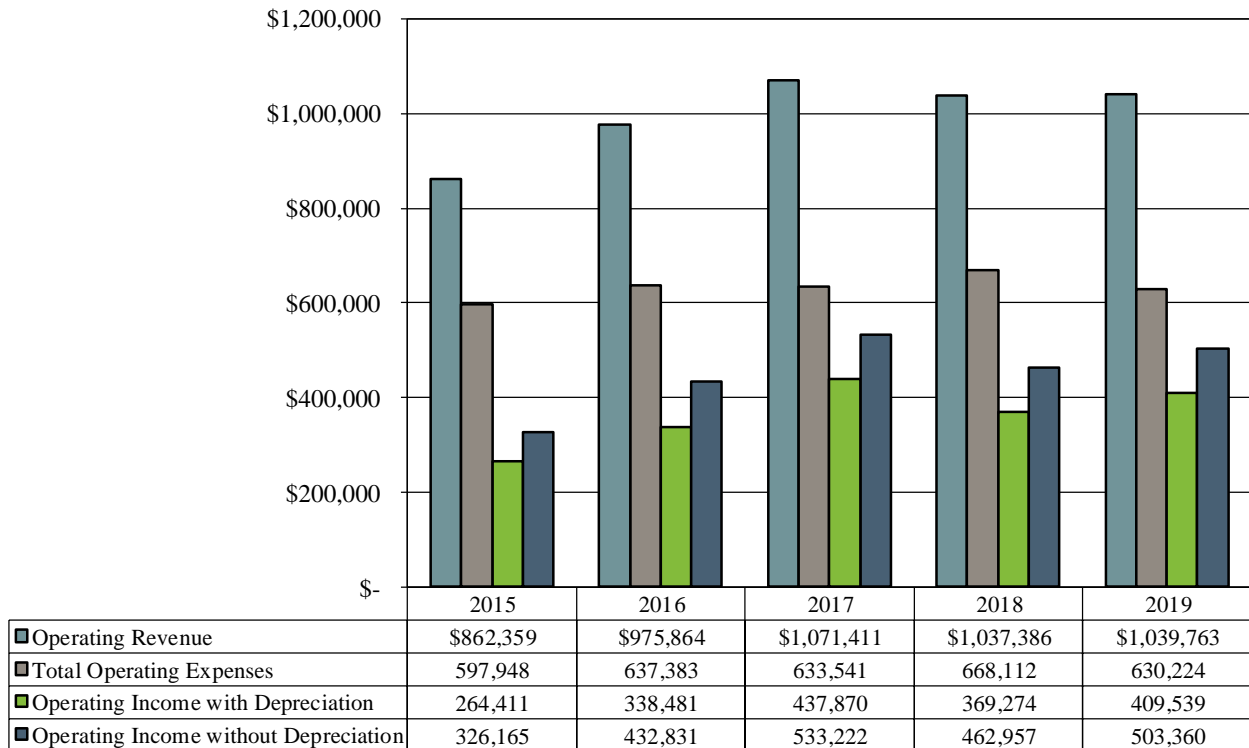
WATER AND SEWER FUNDS

Water and sewer rates increased in late 1995, 1999, 2005, and annually from 2007 to 2016, to fund the repayment of the water and wastewater treatment facilities and water system improvements financed through the PFA loan program. For all five years presented, sufficient revenues were generated in the Water Fund to cover the costs associated with the facilities, generating \$409,539 of operating profit in 2019. For all years presented, the Sewer Fund also had an operating profit, generating \$360,093 in 2019.

The operating trends of the Water and Sewer Funds are illustrated below and on the following pages. Operating expenses of the Water Fund decreased 5.7% in 2019 and operating revenue increased \$2,377 or 0.2% as a result of consistent usage and fewer supplies and maintenance expenses in 2019.

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. The City has been able to realize an operating gain with the inclusion of depreciation expense charged to the Fund in all five years presented. The City should look to continue this trend in future years.

Water Fund

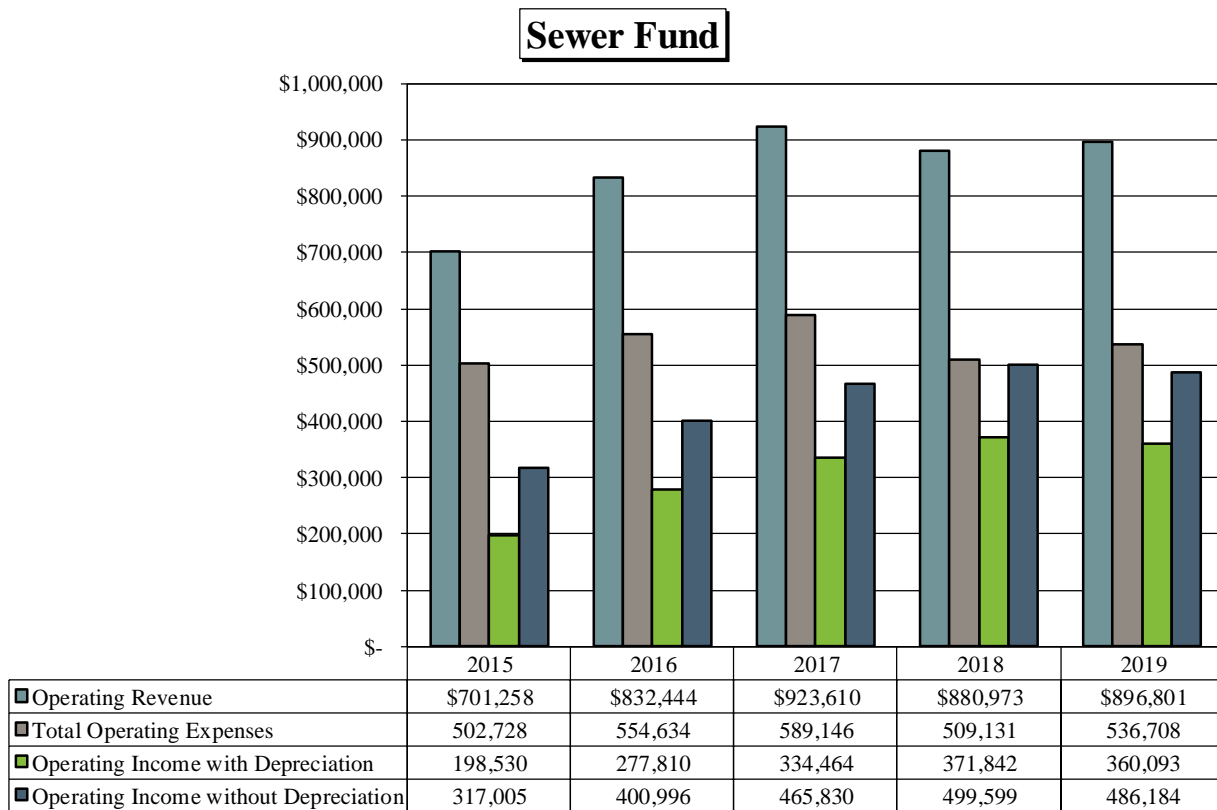


**City of Silver Bay
Financial Analysis**

WATER AND SEWER FUNDS (CONTINUED)

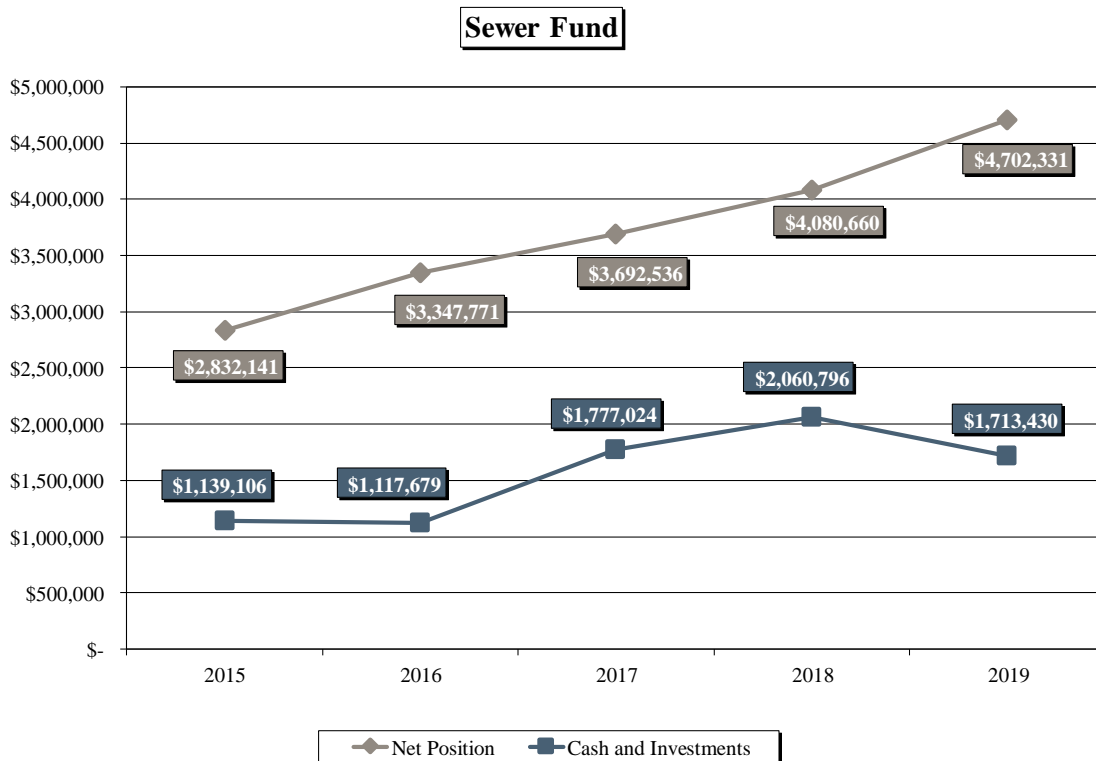
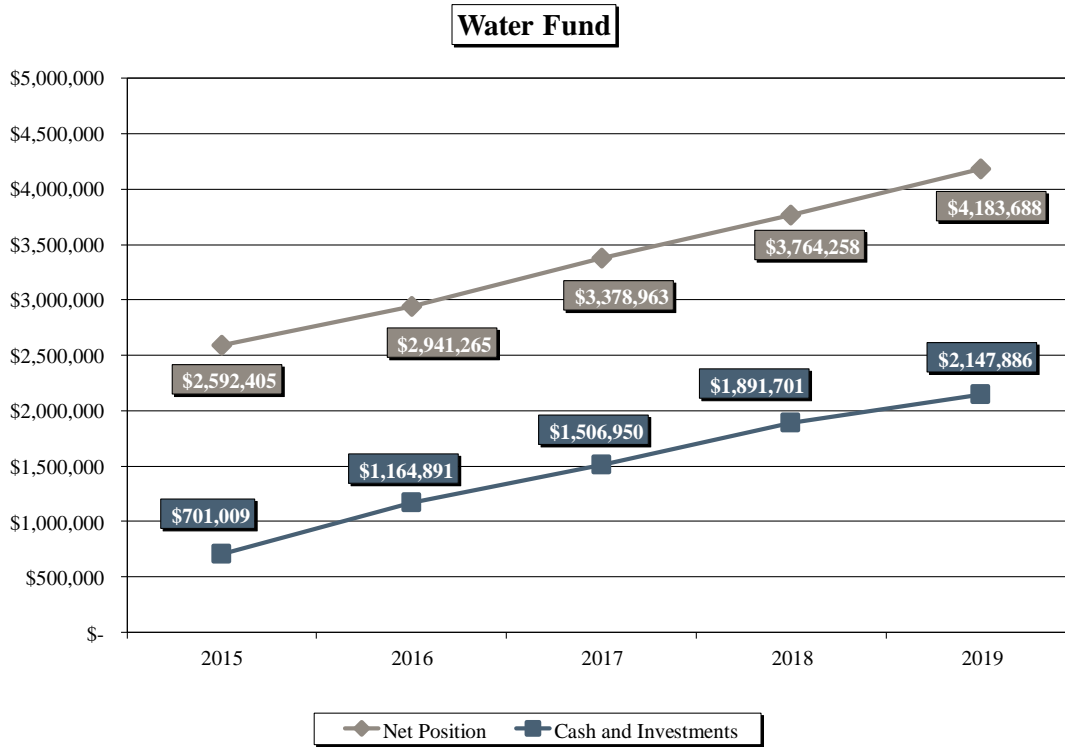
Sewer Fund operating revenue increased 1.8%, or \$15,828, in 2019 due to increased usage at commercial companies. Operating expenses increased \$27,577, or 5.4%, due to increased salaries and wages related to more hours being worked in 2019.

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

WATER AND SEWER FUNDS (CONTINUED)



City of Silver Bay Emerging Issue

Executive Summary

The following is an executive summary of financial and business related updates to assist you in staying current on emerging issues in accounting and finance. This summary will give you a preview of the new standards that have been recently issued and what is on the horizon for the near future. The most recent and significant update includes:

- **Accounting Standard Update – GASB Statement No. 87 – Leases** – GASB has issued GASB Statement No. 87 relating to accounting and financial reporting for leases. This new statement establishes a single model for lease accounting based on the principle that leases are financing of the right to use an underlying asset.

The following is an extensive summary of the current update. As your continued business partner, we are committed to keeping you informed of new and emerging issues. We are happy to discuss these issues with you further and their applicability to your City.

ACCOUNTING STANDARD UPDATE – GASB STATEMENT NO. 87 – LEASES

The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities.

A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any contract that meets this definition should be accounted for under the leases guidance, unless specifically excluded in this Statement.

A short-term lease is defined as a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised. Lessees and lessors should recognize short-term lease payments as outflows of resources or inflows of resources, respectively, based on the payment provisions of the lease contract.

City of Silver Bay
Emerging Issue

ACCOUNTING STANDARD UPDATE – GASB STATEMENT NO. 87 – LEASES
(CONTINUED)

A lessee should recognize a lease liability and a lease asset at the commencement of the lease term, unless the lease is a short-term lease or it transfers ownership of the underlying asset. The lease liability should be measured at the present value of payments expected to be made during the lease term (less any lease incentives). The lease asset should be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term and certain direct costs. A lessee should reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability. The lessee should amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. The notes to financial statements should include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.

A lessor should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term, with certain exceptions for leases of assets held as investments, certain regulated leases, short-term leases, and leases that transfer ownership of the underlying asset. A lessor should not derecognize the asset underlying the lease. The lease receivable should be measured at the present value of lease payments expected to be received during the lease term. The deferred inflow of resources should be measured at the value of the lease receivable plus any payments received at or before the commencement of the lease term that relate to future periods. A lessor should recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred inflows of resources in a systematic and rational manner over the term of the lease. The notes to financial statements should include a description of leasing arrangements and the total amount of inflows of resources recognized from leases.

GASB Statement No. 87 is effective for reporting periods beginning after December 15, 2019. Earlier application is encouraged.

Information provided above was obtained from www.gasb.org.