

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

MANAGEMENT LETTER

For the Year Ended December 31, 2011

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

Honorable Mayor and Members
of the City Council
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, 2011, in accordance with U.S. generally accepted auditing standards and *Government Auditing Standards*, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures 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 would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all deficiencies, significant deficiencies or material weaknesses have been identified. Material weaknesses and significant deficiencies identified, if any, are stated within this letter.

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 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.

A significant deficiency is a deficiency, or 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 accompanying memorandum includes financial analysis and recommendations for improvement of accounting procedures and internal control measures that came to our attention as a result of our audit of the financial statements of the City for the year ended December 31, 2011. 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 27, 2012, on such statements.



This communication is intended solely for the information and use of management, the City Council, federal and state oversight awarding agencies and pass-through entities 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
February 27, 2012

CITY OF SILVER BAY
SIGNIFICANT DEFICIENCIES
December 31, 2011

LACK OF SEGREGATION OF ACCOUNTING DUTIES

During the year ended December 31, 2011, the City had a lack of segregation of accounting duties due to a limited number of office employees.

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.
- Receiving 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.
- Payroll
 - The Deputy Clerk processes payroll, prints checks and signs with Certex signer.
- 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

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 being audited. 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.

Even though all management decisions related to financial reporting are made by the City's management and approval of the financial statements 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, 2011

We have audited the basic financial statements of the City for the year ended December 31, 2011, and have issued our report dated February 27, 2012. Professional standards require that we provide you with the following information related to our audit.

OUR RESPONSIBILITY UNDER U.S. GENERALLY ACCEPTED AUDITING STANDARDS 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 U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of your responsibilities. Our responsibility is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement. 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 such internal control. We are responsible for communicating significant matters related to the audit that are, in our professional judgment, relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures specifically to identify such matters.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its 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, providing an opinion on compliance with those provisions was not an objective of our audit.

PLANNED SCOPE AND TIMING OF THE AUDIT

We performed the audit according to the planned scope and timing previously communicated to you.

QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

Management is responsible for the selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the financial statements. The City implemented a new fund balance policy during the year ended December 31, 2011 to accommodate Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. We noted no transactions entered into during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

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 as listed on the following page.

CITY OF SILVER BAY
REQUIRED COMMUNICATION
December 31, 2011

QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

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.

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

The disclosures in the financial statements 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 known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management has determined their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this letter, professional standards define a disagreement with management as 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 which were provided to us in the management representation letter.

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. We are not aware of any consultations by the City’s management with other accountants during the course of our audit.

CITY OF SILVER BAY
REQUIRED COMMUNICATION
December 31, 2011

OTHER 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 INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

We have not reviewed, and it is our understanding, that no other published documents exist that contain audited financial statement information, for which we are currently auditing. As stated in our engagement letter, if you publish or reproduce the financial statements or make reference to our Firm name in relation to such documents, you agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

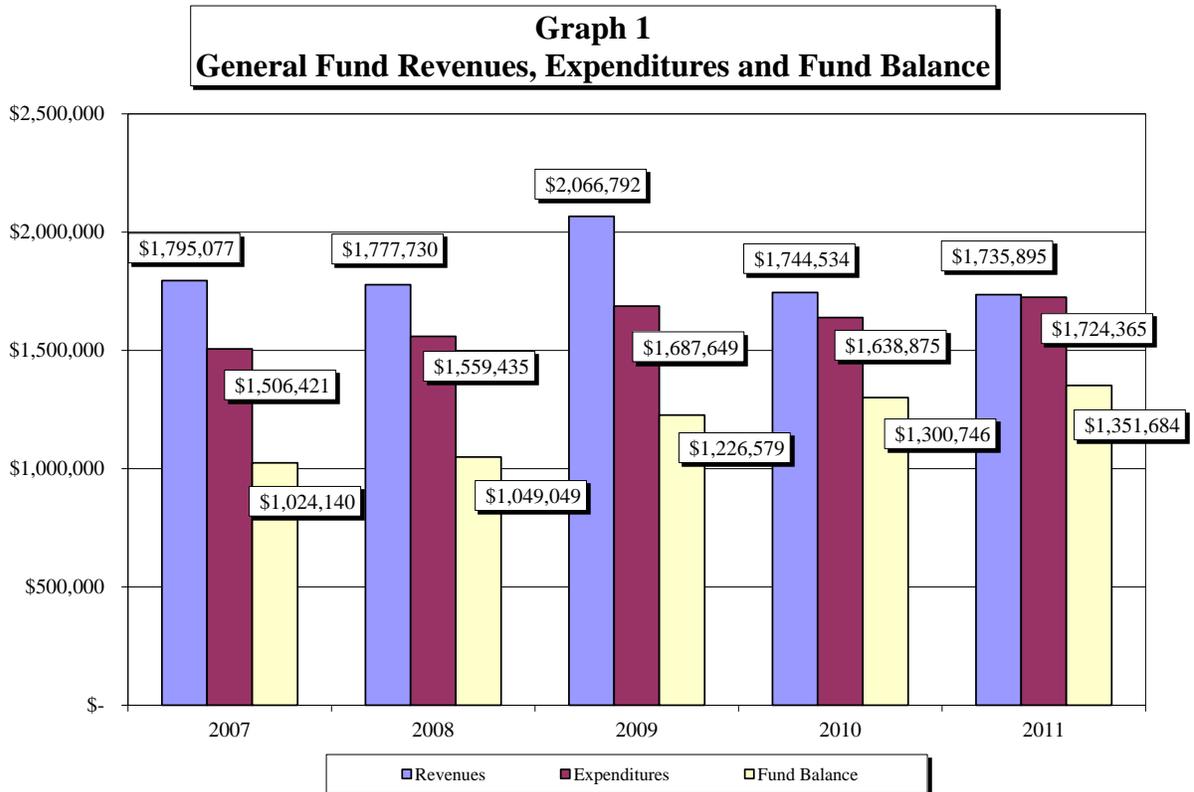
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2011

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 2011 totaled \$ 11,530. General Fund revenues funded \$ 232,825 in routine operating transfers to fund Library, Cemetery, Airport, Arena, Park and Recreation and Community Building Funds' operations. Fund balance in the General Fund increased \$ 50,938, or 3.9%, from \$ 1,300,746 in 2010 to \$ 1,351,684 in 2011. This fund balance represents just over nine months of total General Fund operating expenditures. As Graph 1 illustrates, revenues decreased for the third time in the five years presented while expenditures increased in 2011. Fund balance has increased steadily over the last five years, to a high in 2011.



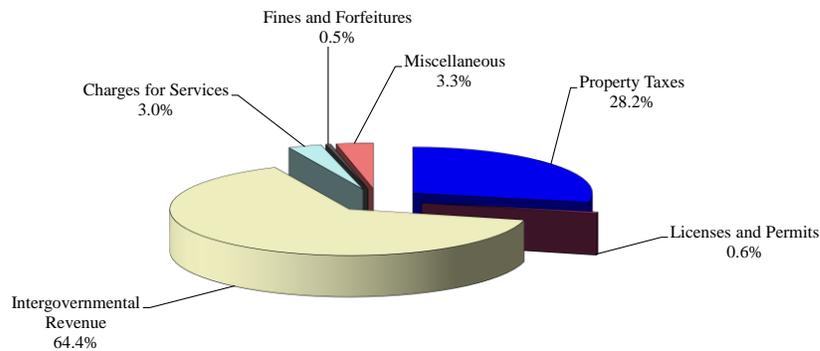
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FINANCIAL ANALYSIS December 31, 2011

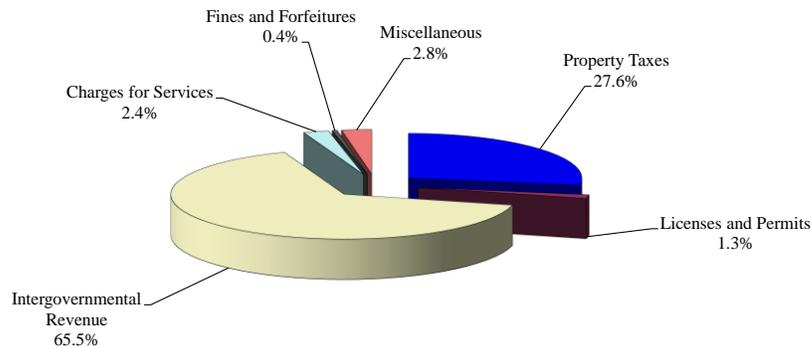
GENERAL FUND

As Graphs 2 and 3 indicate, the City relies upon intergovernmental revenue and tax levies as the majority of its total General Fund revenues. These two revenues accounted for 92.6% and 93.1% of total revenue in 2011 and 2010, respectively.

**Graph 2
General Fund 2011 Revenues by Source**



**Graph 3
General Fund 2010 Revenues by Source**



CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2011

GENERAL FUND

	Year Ended December 31,				
	2007	2008	2009	2010	2011
REVENUES					
Property Taxes	\$ 337,664	\$ 384,465	\$ 450,321	\$ 481,225	\$ 489,640
Licenses and Permits	13,521	12,786	30,548	22,921	10,109
Intergovernmental Revenue	1,322,115	1,271,862	1,493,936	1,142,362	1,117,779
Charges for Services	45,735	43,953	37,413	41,235	52,399
Fines and Forfeitures	3,295	4,269	6,902	8,026	8,057
Miscellaneous	72,747	60,395	47,672	48,765	57,911
Total Revenues	\$ 1,795,077	\$ 1,777,730	\$ 2,066,792	\$ 1,744,534	\$ 1,735,895

General Fund revenues remained consistent with 2010, decreasing only 0.5% during 2011. The decrease in revenues was primarily a result of a decrease in intergovernmental revenues. Intergovernmental revenues decreased \$ 24,583, or 2.2%, which is the result of the fire department receiving a federal grant in 2010 for capital purchases. In the five years presented, revenues have decreased \$ 59,182, or 3.3%.

	Year Ended December 31,				
	2007	2008	2009	2010	2011
EXPENDITURES					
General Government	\$ 499,176	\$ 406,709	\$ 396,565	\$ 415,398	\$ 439,134
Public Safety	502,449	559,129	564,161	571,227	587,363
Public Works	412,026	444,217	520,644	394,885	358,725
Culture and Recreation	17,921	31,085	29,293	18,549	19,216
Debt Service	26,260	26,261	56,009	36,228	21,423
Capital Outlay	48,589	92,034	120,977	202,588	298,504
Total Expenditures	\$ 1,506,421	\$ 1,559,435	\$ 1,687,649	\$ 1,638,875	\$ 1,724,365

General Fund expenditures increased 5.2% during 2011. Capital outlay changed the most significantly from 2010 to 2011, increasing by \$ 95,916. This is the result of several large capital purchases during the year, including two public works vehicles, a new police car and a boiler replacement at City Hall. Public works expenditures decreased \$ 36,160 as a result of some employees' salaries being charged to the Public Works Reserve Fund for work done on the EcoPark Project. Additionally, the City needed to purchase less salt during 2011. These decreases were offset by payments to employees for a change in the personnel policy regarding retirement and health insurance payments. General government expenditures increased \$ 23,736, primarily as a result of paying employees for the change in health insurance payments.

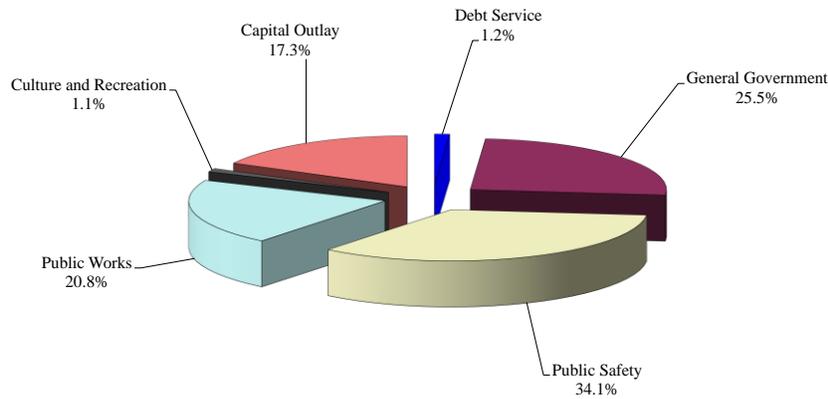
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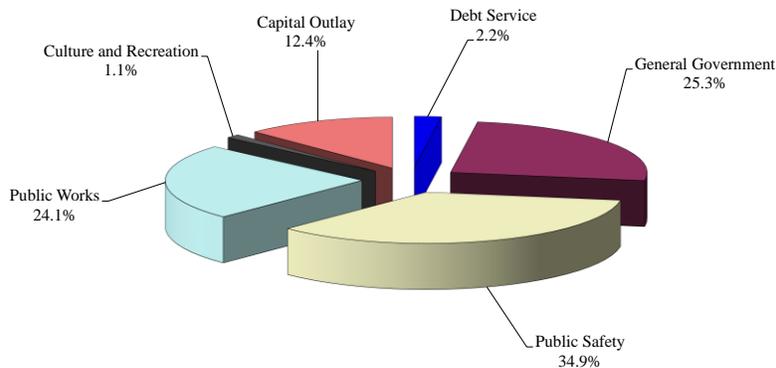
GENERAL FUND

Graphs 4 and 5 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. There was less allocated to public works in 2011 as a result of the salary and salt expense changes noted on the previous page. Due to the capital purchases of the City in 2011, that function increased proportionately to the rest of the functions.

**Graph 4
General Fund 2011 Expenditures by Function**



**Graph 5
General Fund 2010 Expenditures by Function**



CITY OF SILVER BAY

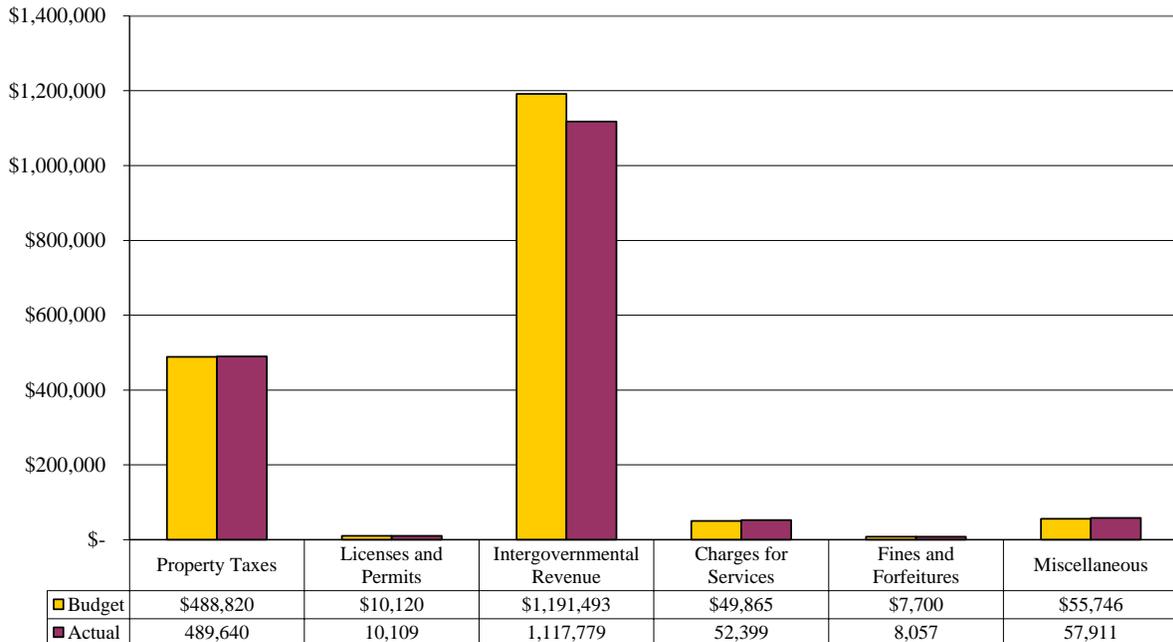
**FINANCIAL ANALYSIS
December 31, 2011**

GENERAL FUND

Graphs 6 and 7 outline the budget and actual comparison for General Fund revenues and expenditures.

Overall, revenue was \$ 67,849 under budget. Actual intergovernmental revenue was lower than budget by \$ 73,714. Intergovernmental revenues were under budget due to the unallotment of the state’s Market Value Credit. The budget was not revised to reflect the unallotment. The rest of the revenue categories only had minimal budget variances.

**Graph 6
2011 General Fund Revenues
Budget and Actual**



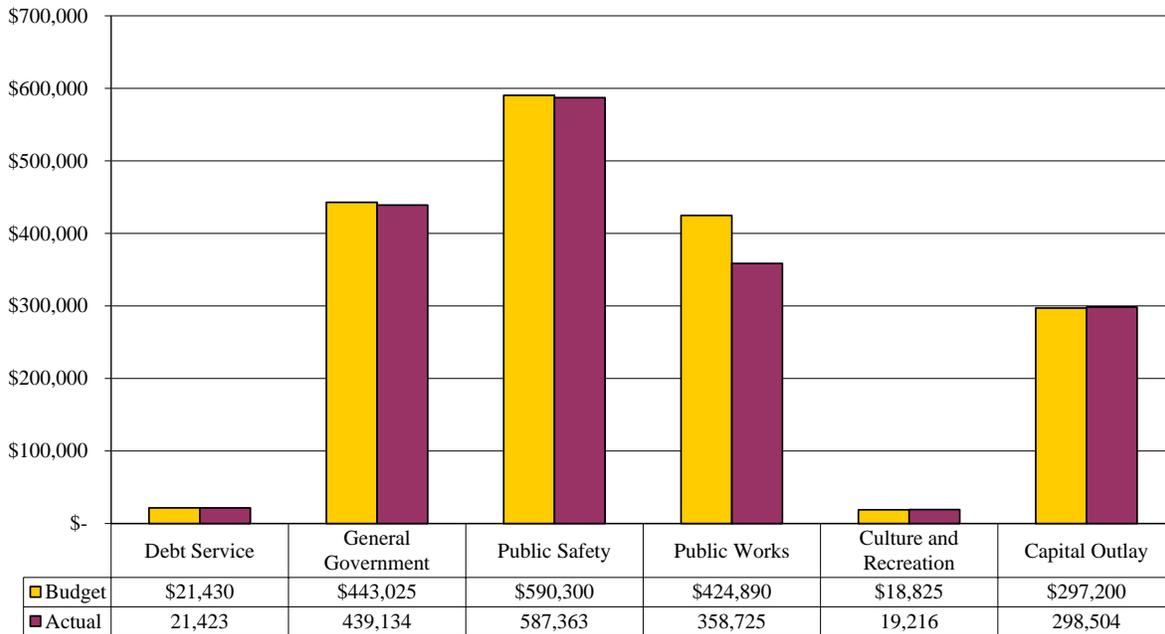
CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2011**

GENERAL FUND

Overall, expenditures were \$ 71,305, or 4.0%, under budget in 2011. The majority of the difference is in public works, which was \$ 66,165 under budget due to the salary expenditures of employees being coded to the public works reserve for work done at the EcoPark. All other functions had minor variances from the budget.

**Graph 7
2011 General Fund Expenditures
Budget and Actual**

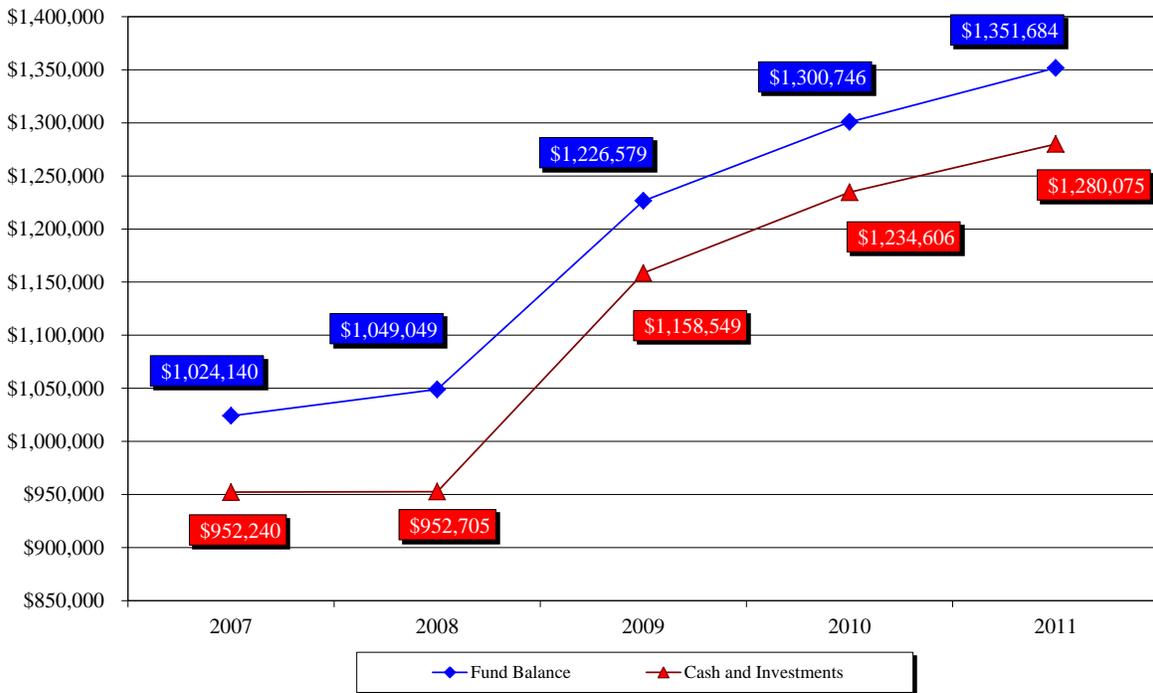


CITY OF SILVER BAY
FINANCIAL ANALYSIS
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GENERAL FUND

As illustrated on Graph 8, the fund balance and cash balance in the General Fund increased in 2011. Cash increased during 2011 by approximately 3.7%, while fund balance increased 3.9%. 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.

Graph 8
General Fund



CITY OF SILVER BAY

FINANCIAL ANALYSIS

December 31, 2011

LIQUOR FUND

Liquor Fund operating trends are illustrated on the graphs on the following page. Sales remained stable, decreasing only 0.8% from \$ 901,146 in 2010 to \$ 893,898 in 2011. Gross profit percentage decreased from 40.4% in 2010 to 39.4% in 2011. Loss before operating transfers was \$ 7,309 in 2011, a decrease from the 2010 income total of \$ 43,625. This was primarily a result of increased operating expenses for a change in the health insurance and retirement payments and compensated absence accruals. The Liquor Fund did not transfer profits to fund various City operations as they have in the past because, after taking into account the principal payment of \$ 45,882 made in 2011 on the Liquor Store Bond, the Fund did not meet its requirements for profit transfers.

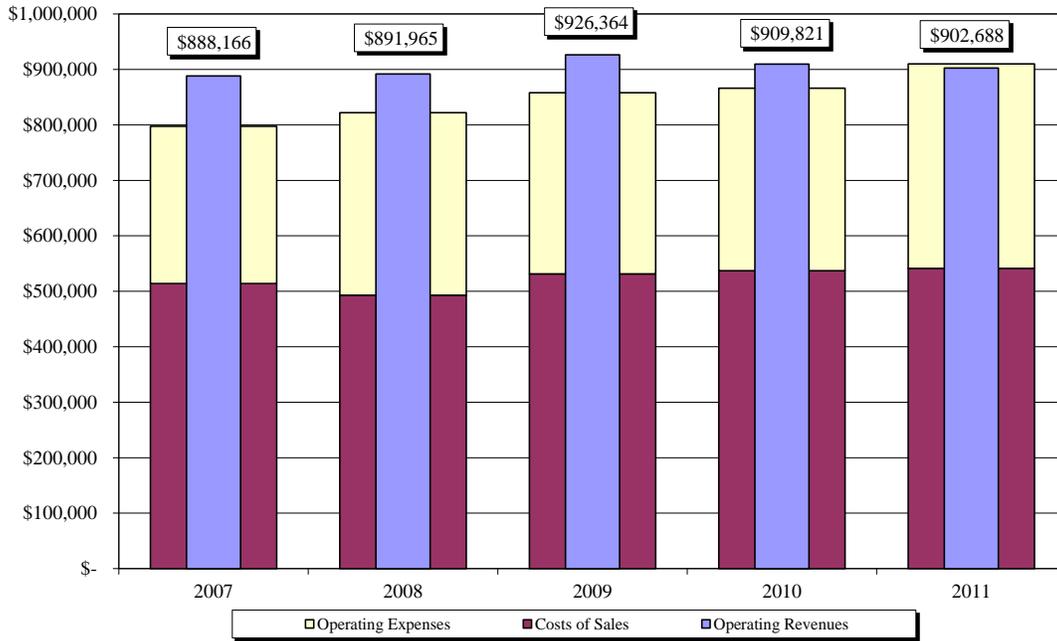
We recommend the City continue to review markups on all products to maintain a gross profit percentage at approximately 40% to 42%. The liquor operations should consider increased strategic marketing through new products and promotion and display of higher margin products in order to increase sales and 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

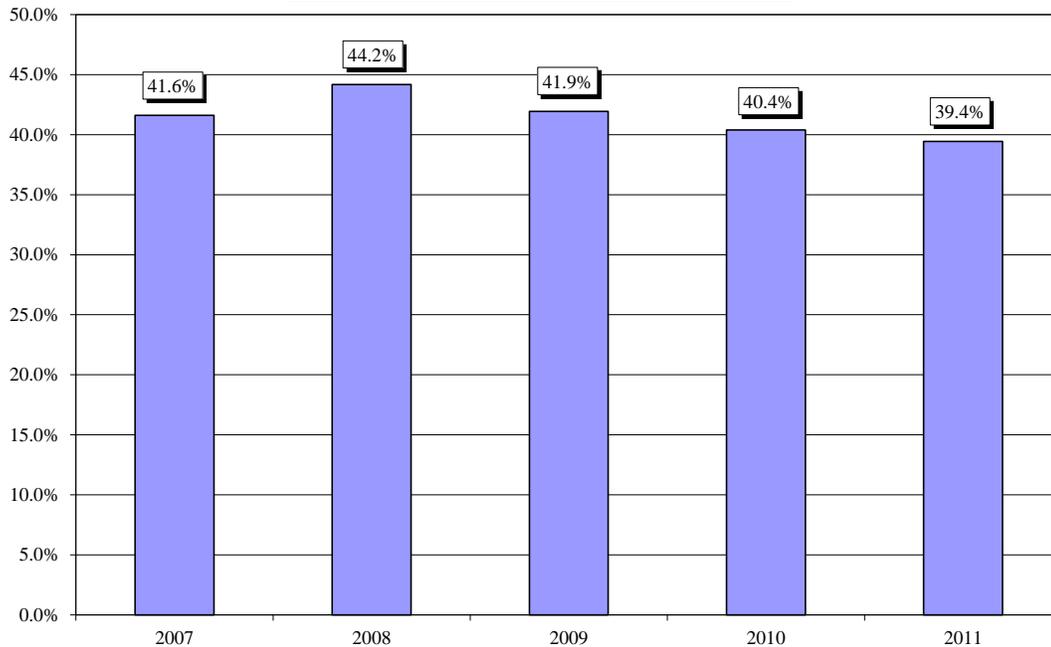
FINANCIAL ANALYSIS December 31, 2011

LIQUOR FUND

**Graph 9
Liquor Fund**



**Graph 10
Liquor Fund Gross Profit Percentage**



CITY OF SILVER BAY

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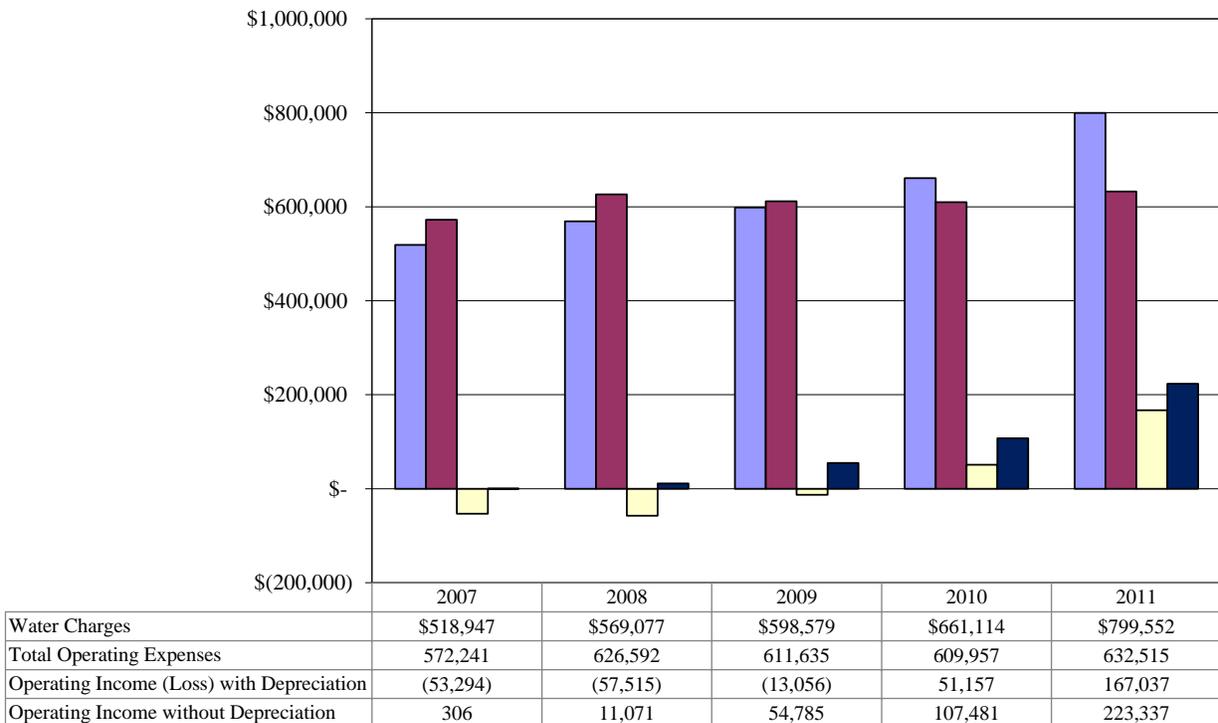
WATER AND SEWER FUNDS

Water and sewer rates increased in late 1995, 1999, 2005 and 2007-2011 to fund the repayment of the water and wastewater treatment facilities and water system improvements financed through the PFA loan program. For the second 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 and 2011 operating incomes of \$ 51,157 and \$ 167,037, respectively, in the Water Fund. For the second time in the five years presented, the Sewer Fund had an operating profit, generating \$ 71,568 in 2011.

The operating trends of the Water and Sewer Funds are illustrated in Graphs 11 and 12. Operating expenses of the Water Fund increased 3.7% in 2011. Operating revenues increased 20.9% in 2011 primarily due to a change in the rate structure in 2011.

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. With the water rate increase in 2010, the City was able to realize an operating gain with the inclusion of depreciation expense charged to the Fund. The City should look to follow this trend in future years.

**Graph 11
Water Fund**



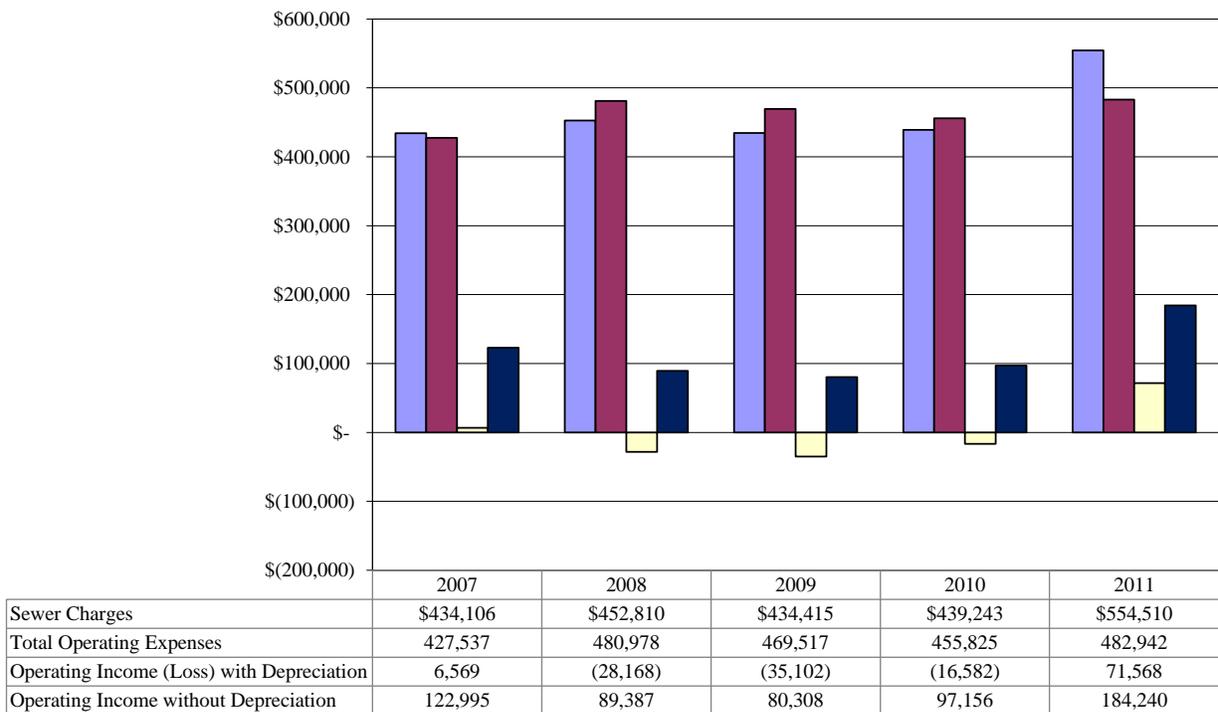
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FINANCIAL ANALYSIS
December 31, 2011

WATER AND SEWER FUNDS

As a result of the change in the rate structure, Sewer Fund operating revenues increased 26.2% in 2011. Operating expenses increased 5.9% due primarily to changes in salaries and benefits.

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.

Graph 12
Sewer Fund



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WATER AND SEWER FUNDS

Graph 13
Net Asset Balances
Water Fund and Sewer Fund

