

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

COMMUNICATIONS LETTER

Year Ended December 31, 2014

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, 2014, 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 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 9, 2015, 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 9, 2015

CITY OF SILVER BAY
SIGNIFICANT DEFICIENCIES
December 31, 2014

LACK OF SEGREGATION OF ACCOUNTING DUTIES

During the year ended December 31, 2014, 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.
- 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.
- 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, 2014

We have audited the financial statements of the City for the year ended December 31, 2014, and have issued our report dated March 9, 2015. 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 such 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 grants. 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 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, 2014. 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 financial statements in the proper period.

CITY OF SILVER BAY

REQUIRED COMMUNICATION December 31, 2014

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 significant 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, 2014

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, 2014

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 2014 totaled \$ 371,126. General Fund revenues funded \$ 292,126 in routine operating transfers to fund Library, Cemetery, Airport, Arena, Park and Recreation, Community Building and Public Work's Reserve Funds' operations. Fund balance in the General Fund increased \$ 186,094, or 11.7%, from \$ 1,594,217 in 2013 to \$ 1,780,311 in 2014. This fund balance represents just over 12 months of total General Fund operating expenditures. As the graph below indicates, revenues increased in 2014 for the third year in a row after decreasing from 2010 to 2011. Fund balance has increased steadily over the last five years, to a high in 2014.

General Fund Revenues, Expenditures and Fund Balance



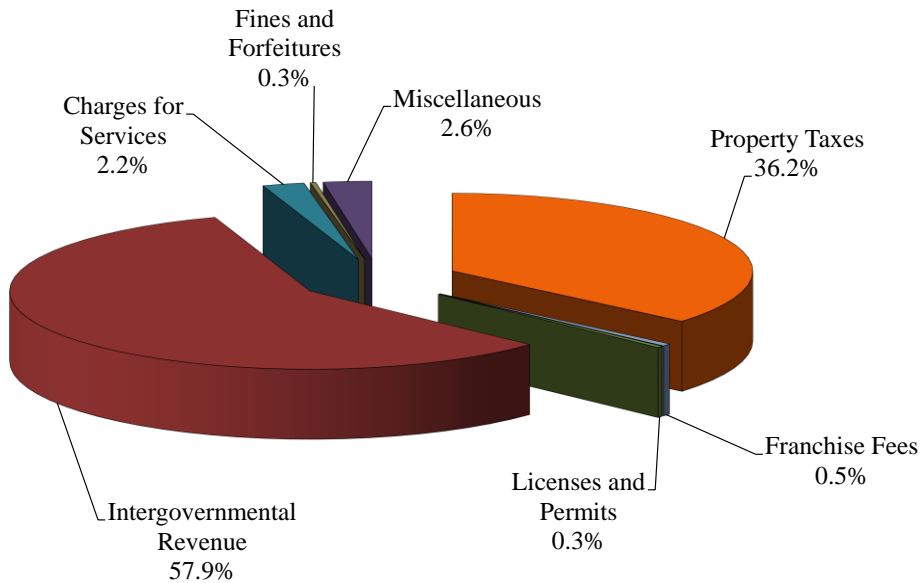
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2014

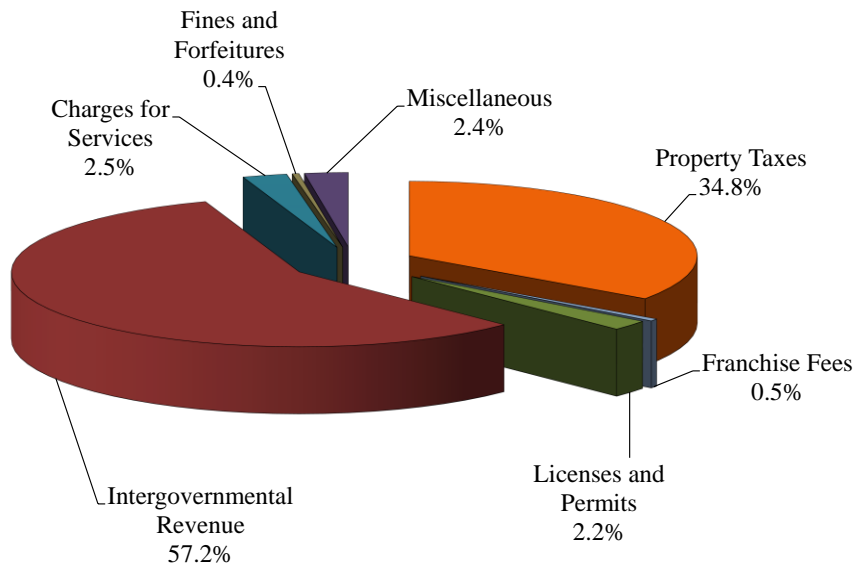
GENERAL FUND

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 94.1% and 92.0% of total revenue in 2014 and 2013, respectively.

General Fund 2014 Revenues by Source



General Fund 2013 Revenues by Source



CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2014**

GENERAL FUND

	Years Ended December 31,				
	2010	2011	2012	2013	2014
REVENUES					
Property Taxes	\$ 481,225	\$ 489,640	\$ 663,145	\$ 708,293	\$ 750,973
Franchise Fees	9,941	10,114	9,952	10,102	9,901
Licenses and Permits	22,921	10,109	15,411	44,728	6,920
Intergovernmental Revenue	1,142,362	1,117,779	1,083,161	1,166,623	1,200,661
Charges for Services	41,235	52,399	66,173	50,771	46,528
Fines and Forfeitures	8,026	8,057	6,060	7,607	6,265
Miscellaneous	38,824	47,797	43,766	49,705	53,997
Total Revenues	\$ 1,744,534	\$ 1,735,895	\$ 1,887,668	\$ 2,037,829	\$ 2,075,245

General Fund revenues increased \$ 37,416, or 1.8% from 2013. Property taxes increased \$ 42,680 from 2013 as a result of an increase in the General Fund portion of the levy in the amount of \$ 42,917. Intergovernmental revenue increased \$ 34,038 due to an increase in the state’s allotment for local government aid. Licenses and permits decreased \$ 37,808 due to a significant project done by North Shore Mining in 2013. In the five years presented, total revenues have increased significantly, increasing by \$ 330,711 or 19.0%. Revenues can change significantly year to year based on different grants received.

There were some significant changes between property tax revenue and intergovernmental revenue from 2011 to 2012. 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.

	Years Ended December 31,				
	2010	2011	2012	2013	2014
EXPENDITURES					
General Government	\$ 415,398	\$ 439,134	\$ 434,300	\$ 485,463	\$ 489,705
Public Safety	571,227	587,363	529,727	533,772	562,821
Public Works	394,885	358,725	470,546	506,284	514,993
Culture and Recreation	18,549	19,216	27,086	17,799	41,454
Debt Service	36,228	21,423	21,422	21,423	3,240
Capital Outlay	202,588	298,504	28,839	297,319	91,906
Total Expenditures	\$ 1,638,875	\$ 1,724,365	\$ 1,511,920	\$ 1,862,060	\$ 1,704,119

General Fund expenditures decreased \$ 157,941, or 8.5% during 2014. Capital outlay changed most significantly from 2013 to 2014, decreasing by \$ 205,413. This is the result of increased capital needs during 2013 as a result of storm damage, such as replacing the damaged bridge at the golf course and replacing the roofs of several City buildings as a result of hail damage as well as purchasing equipment for the golf course and purchasing a new excavator. Public safety expenditures increased \$ 29,049 due to severance payments for officers who left the City during 2014. Culture and recreation expenditures increased \$ 23,655 due to more salary and benefit expenditures related to time spent on culture and recreation projects, including the golf course bridge. Debt service expenditures decreased with the City no longer having the obligation for the golf cart lease expense. Expenditures in general government and

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FINANCIAL ANALYSIS
December 31, 2014

public works stayed consistent with the prior year.

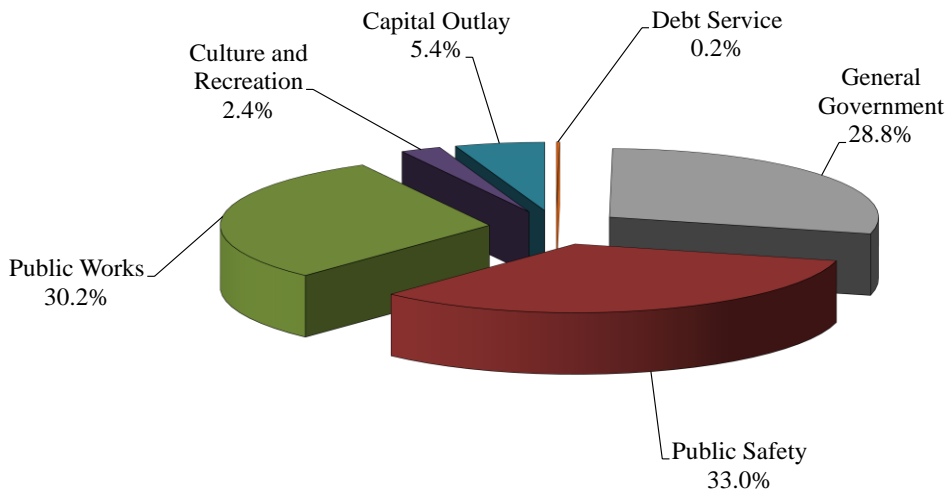
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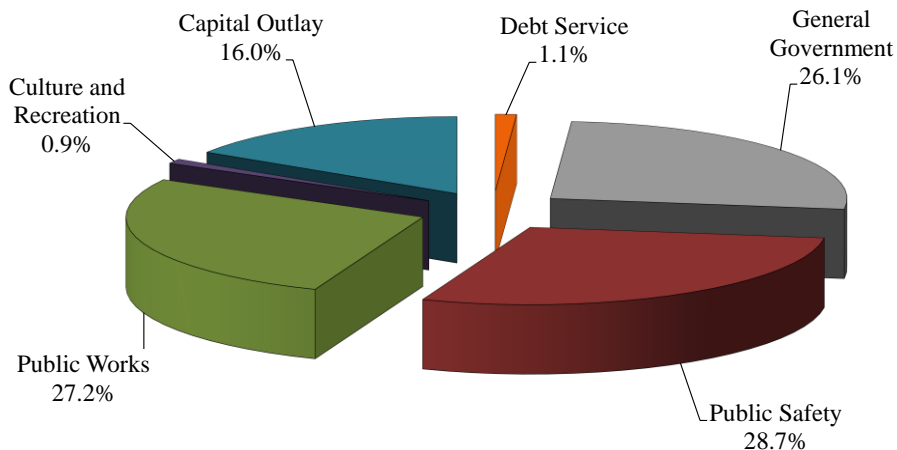
GENERAL FUND

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 decreased while expenditures in the other functions increased proportionately in 2014.

General Fund 2014 Expenditures by Function



General Fund 2013 Expenditures by Function



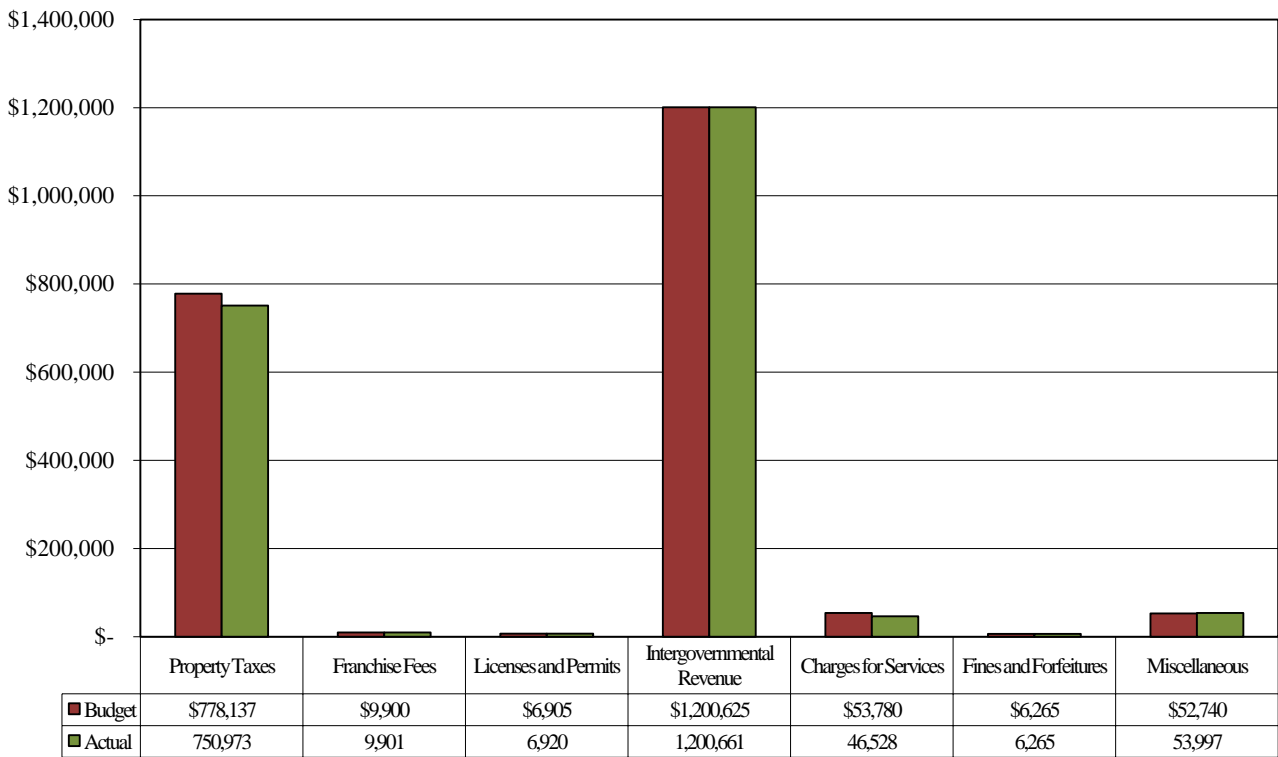
CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2014**

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 \$ 33,107 under budget. Property taxes were under budget \$ 27,164 as a result of delinquent tax receipts coming in under expected amounts. The rest of the revenue categories only had minimal budget variances.

**2014 General Fund Revenues
Budget and Actual**



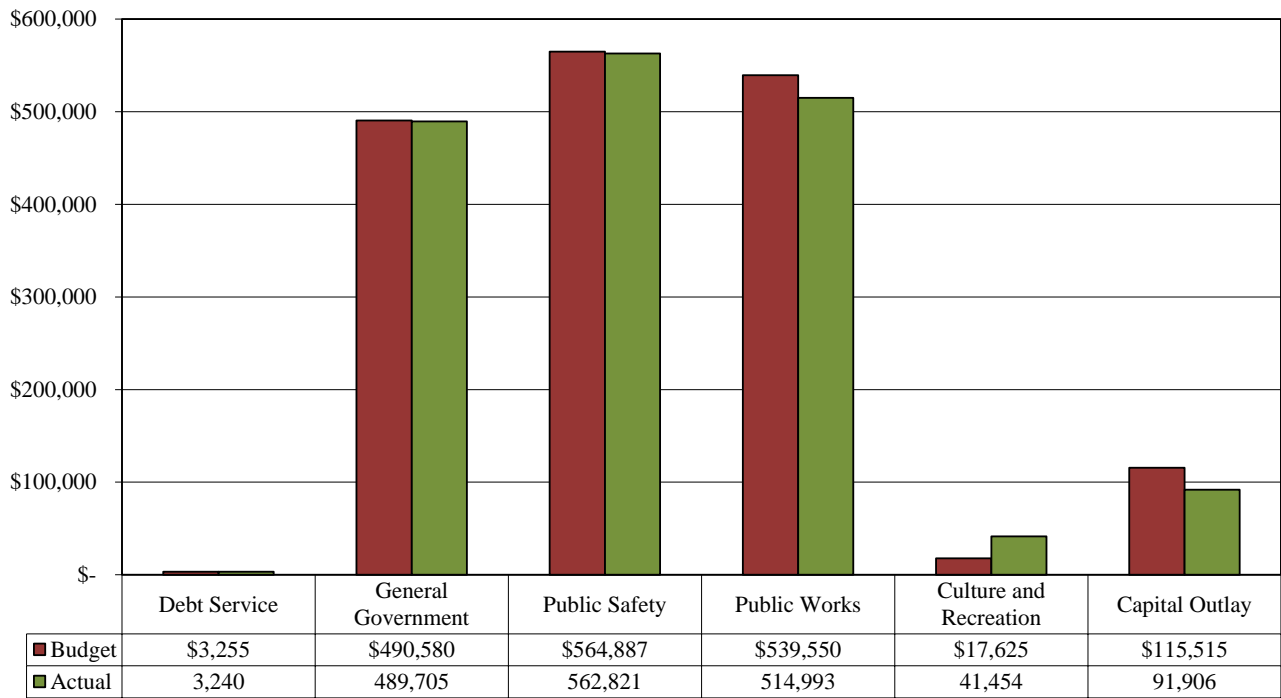
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**FINANCIAL ANALYSIS
December 31, 2014**

GENERAL FUND

Overall, expenditures were \$ 27,293, or 1.6%, under budget in 2014. Public works was under budget \$ 24,557 and culture and recreation was over budget \$ 23,829 as a result of charging more public works employee’s time to culture and recreation as a result of their time spent on golf course projects. Capital outlay was under budget \$ 23,609 due to budgeting for the golf work as capital but it was expensed through salaries. All other functions had minor variances from the budget.

**2014 General Fund Expenditures
Budget and Actual**

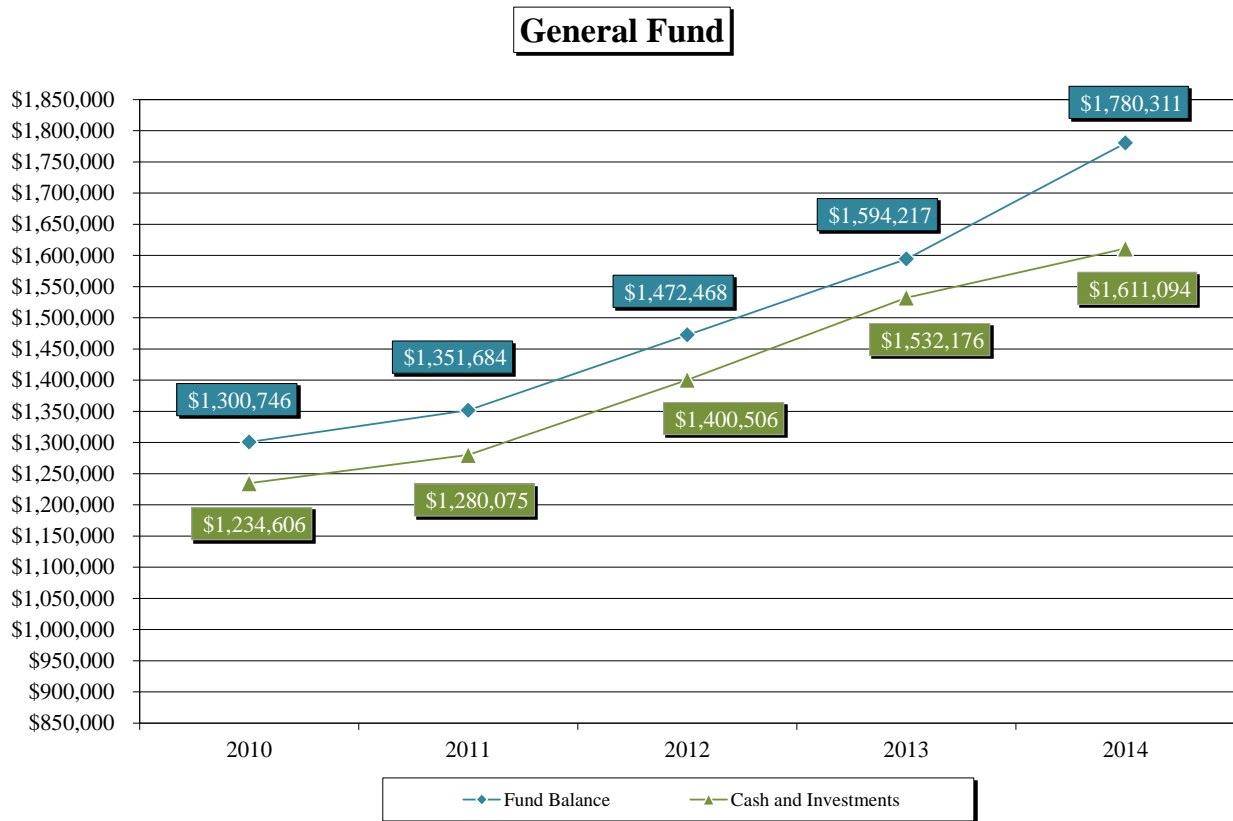


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FINANCIAL ANALYSIS December 31, 2014

GENERAL FUND

As illustrated below, the fund balance and cash balance in the General Fund increased in 2014. Cash increased during 2014 by approximately 5.2%, while fund balance increased 11.7%. 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.



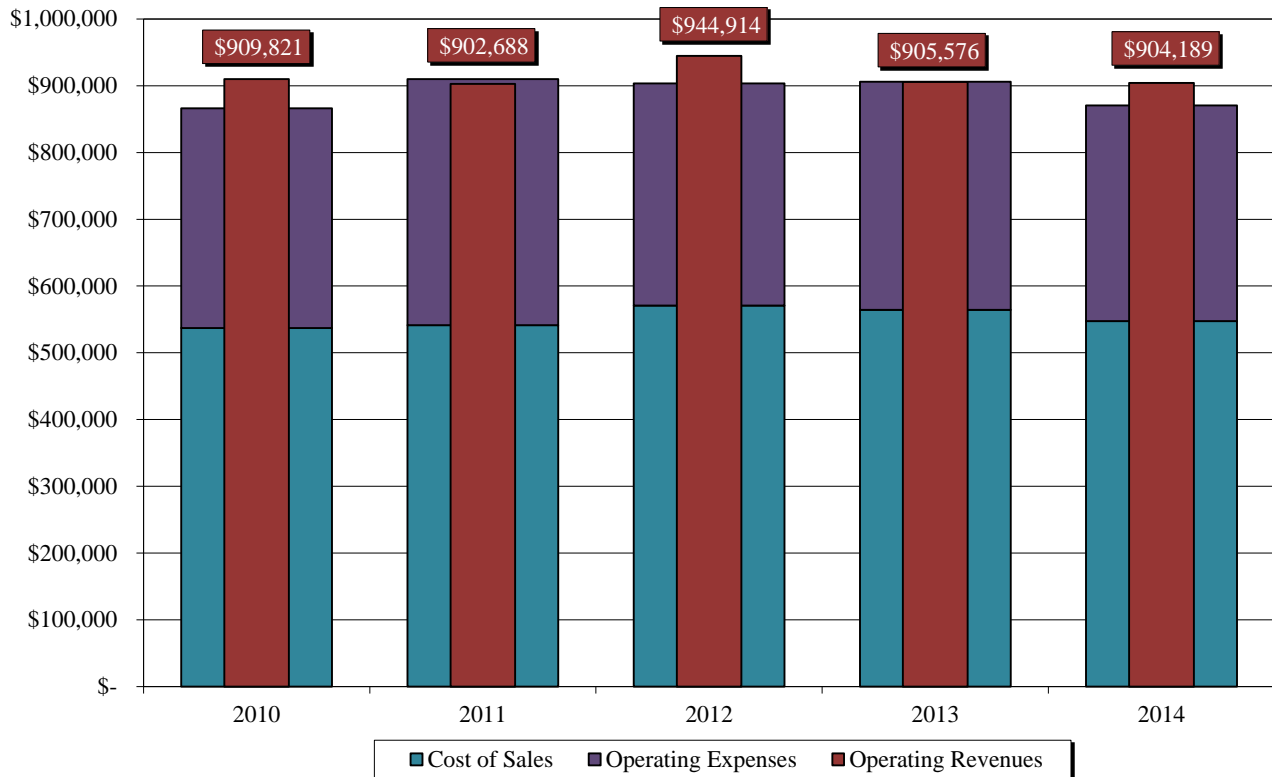
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LIQUOR FUND

Liquor Fund operating trends are illustrated on the graphs below and on the following page. Sales decreased by 1.1%, from \$ 898,700 in 2013 to \$ 889,061 in 2014. Off-sale decreased \$ 27,894 due to changes in policies at North Shore Mining which no longer allowed alcohol on their property, while on-sale increased \$ 18,555 due to an increased customer base in the last quarter of the year.

Liquor Fund



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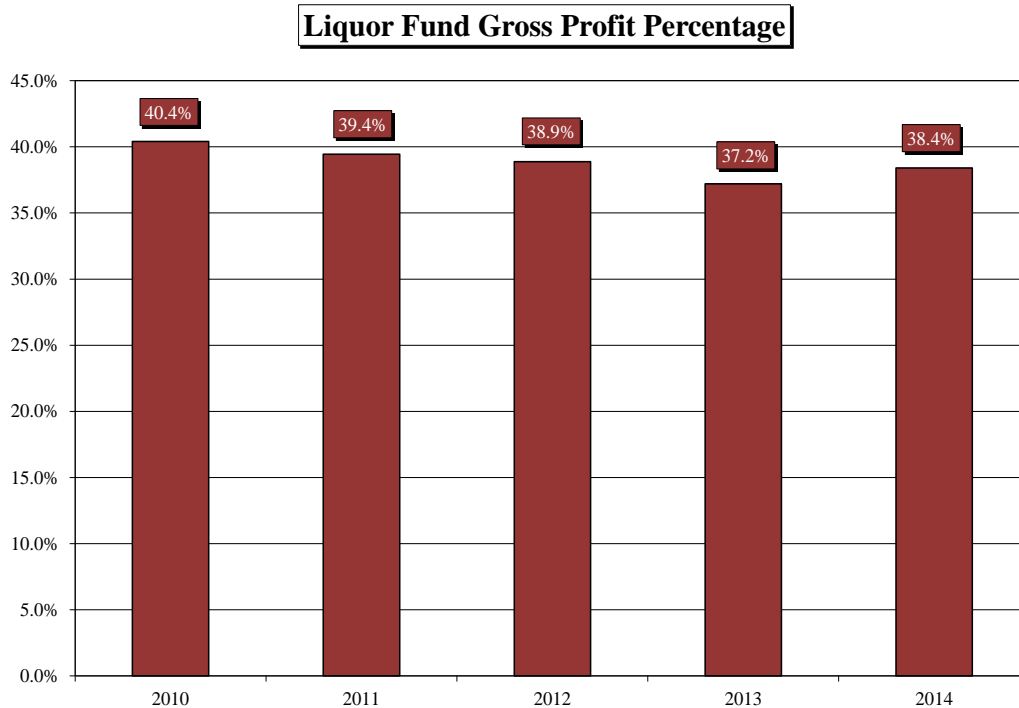
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LIQUOR FUND

Gross profit percentage increased from 37.2% in 2013 to 38.4% in 2014. The Liquor Fund had an operating income of \$ 33,686 in 2014, an increase from the operating loss in 2013 of \$ 373. This was primarily due to the retirement of a long time employee whose position was filled by part time help for part of the year saving the city in salaries and benefits for the position.

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.



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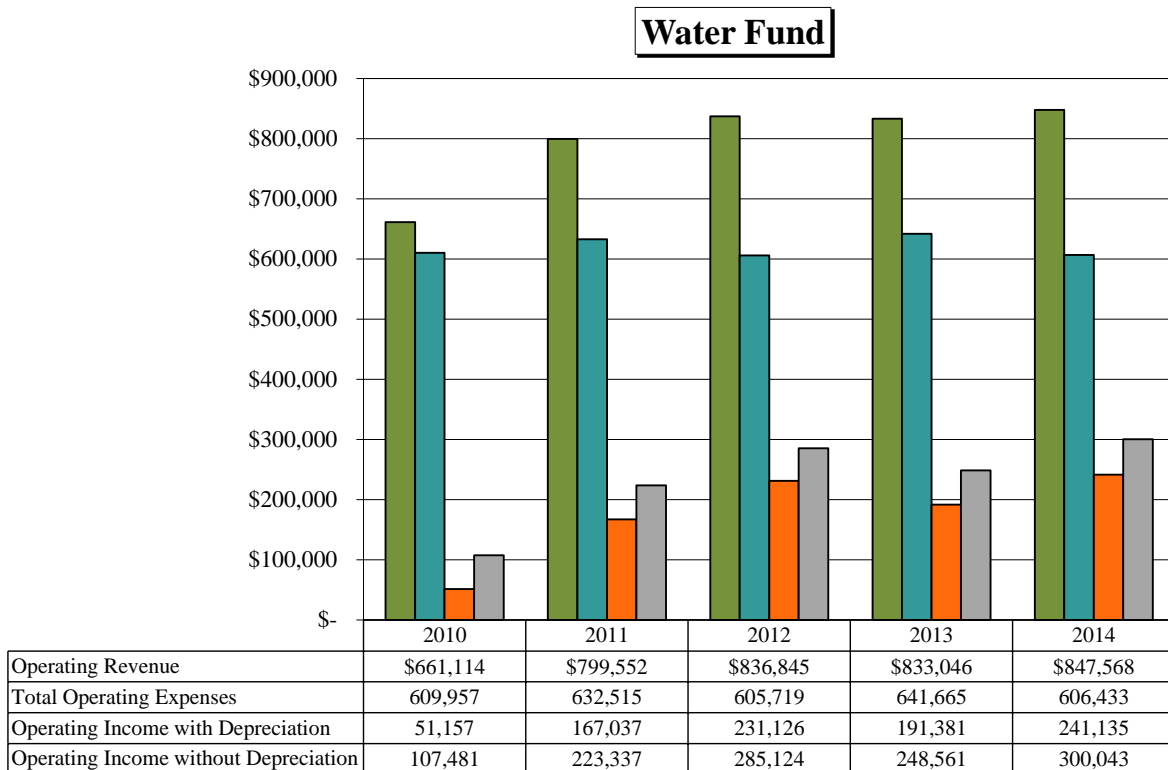
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WATER AND SEWER FUNDS

Water and sewer rates increased in late 1995, 1999, 2005 and 2007-2014 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. For the fourth time in the five years presented, the Sewer Fund had an operating profit, generating \$ 165,648 in 2014.

The operating trends of the Water and Sewer Funds are illustrated below and on the following page. Operating expenses of the Water Fund decreased 5.5% in 2014 as a result of a decrease in repairs and maintenance, including valves and blacktopping related to water main breaks in 2013 as well as reduced cost related to the Honeywell service contract. Operating revenues in 2014 increased slightly from 2013 revenues, increasing only \$ 14,522 or 1.7% as a result of an increase of 2% in the water rate.

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.



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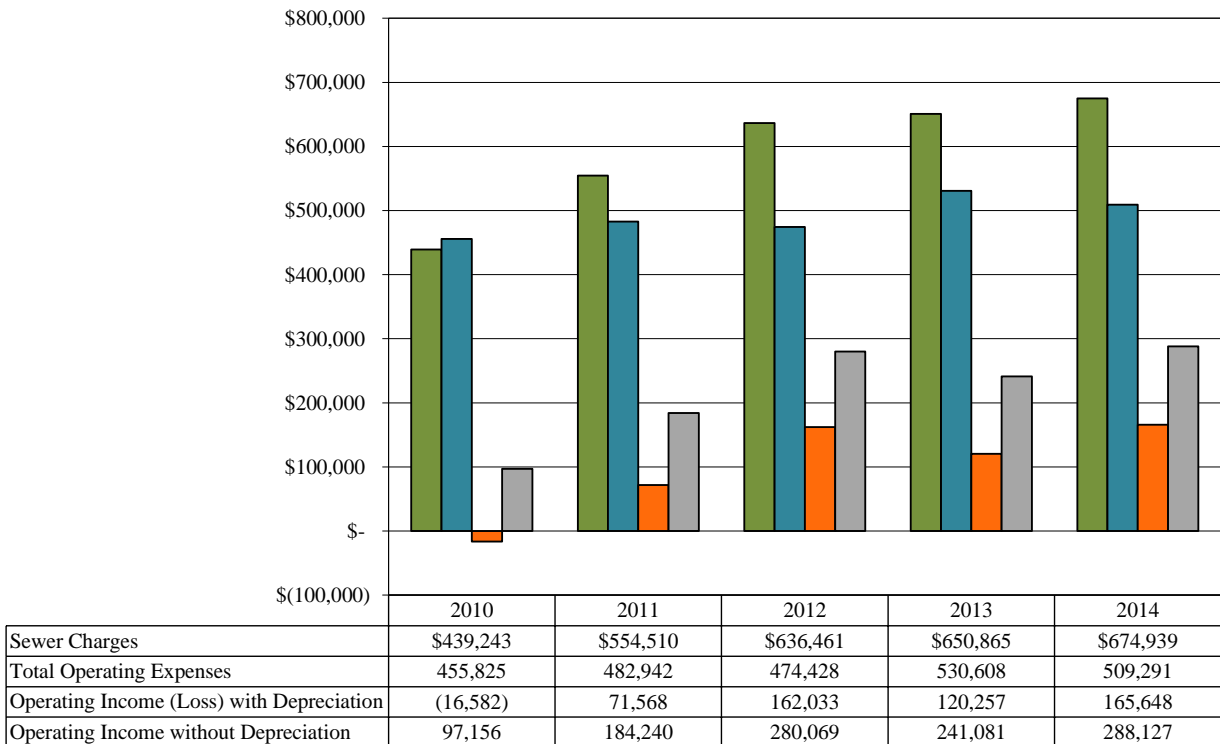
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WATER AND SEWER FUNDS

As a result of the 4.0% increase in the rate in 2014, Sewer Fund operating revenues increased 3.7% in 2014. Operating expenses decreased \$ 21,317 from \$ 530,608 in 2013 to \$ 509,291 in 2014, for a decrease of 4.0%. This decrease was due to two different sewer pump replacements, higher heating costs due to a colder winter and natural gas conversion expenses in 2013.

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.

Sewer Fund

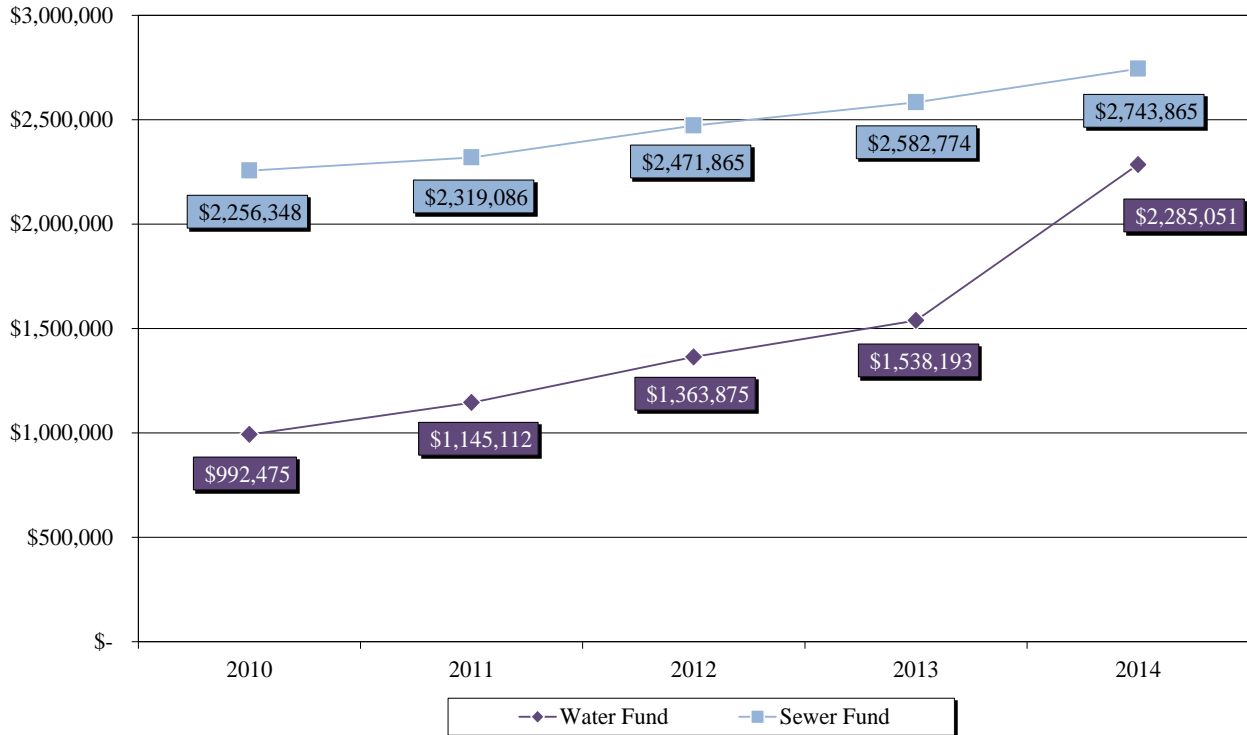


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FINANCIAL ANALYSIS December 31, 2014

WATER AND SEWER FUNDS

**Net Position Balances
Water Fund and Sewer Fund**



CITY OF SILVER BAY

EMERGING ISSUES

December 31, 2014

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 updates include:

- **Internal Control Integrated Framework** – COSO has issued an updated integrated framework for internal control. The update is expected to make the integrated internal control framework easier to use and apply. In addition, the update takes into account globalization of businesses today and its interdependence on technology. The updated framework superseded the original framework beginning January 1, 2015.
- **Accounting Standard Update – Accounting for Pensions** – GASB has issued new statements relating to accounting and disclosures for pension. The new statements require governments providing defined benefit pensions to recognize their long-term obligation for pension benefits as a liability. In addition, the statement includes new requirements for required supplementary information and more extensive footnote disclosures.
- **Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards** – The Office of Management and Budget (OMB) issued grant reform rules on December 23, 2013. This reform streamlines the language from eight existing OMB Circulars (listed below) into one consolidated set of guidance, in the code of Federal regulations, known as the “Super Circular”.

The following are extensive summaries of each of the current updates. 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.

COSO PROJECT – INTERNAL CONTROL INTEGRATED FRAMEWORK

In 1992, the Committee on Sponsoring Organizations of the Treadway Commission (COSO) developed an internal control framework that has been adopted and used by entities worldwide. In 2013, COSO finalized and released an updated integrated internal control framework. The update is expected to make the integrated framework easier to use and apply. In addition, the update takes into account, the business environment of today and the reliance on and interdependence of technology within business systems.

The internal control update is not changing the core definition of internal control, the three categories of objectives or the five components of internal control.

COSO defines internal control as a process, affected by an entity’s board of directors, management and other personnel. This process is designed to provide reasonable assurance regarding the achievement of the three objectives, as follows: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations.

1. Internal control is a process. It is a means to an end, not an end in itself.
2. Internal control is not merely documented by policy manuals and forms. Rather, it is put in by people at every level of an organization.
3. Internal control can provide only reasonable assurance, not absolute assurance, to an entity’s management and board.
4. Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

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EMERGING ISSUES

December 31, 2014

COSO PROJECT – INTERNAL CONTROL INTEGRATED FRAMEWORK (CONTINUED)

The five components of internal control, which are unchanged, are as follows:

1. Control Environment – integrity, ethics, management style, etc.
2. Risk Assessment – identification and analysis of relevant risks
3. Control Activities – policies, procedures and activities, including segregation of duties
4. Information and Communication – ensure information effectively flows up, down and across the organization, both internally and externally
5. Monitoring Activities – assessment of the systems performance over time

The updated framework has changed to address the changes in business and operating environments, such as globalization of markets and operations, greater complexities in businesses, reliance on evolving technologies and expectations relating to preventing and detecting fraud. In addition, principles of effective internal controls have been added to each of the components of internal control as follows:

Control Environment:

1. Demonstrates a commitment to integrity and ethical values.
2. The board of directors is independent from management and exercises oversight responsibility of the performance of internal controls.
3. Management establishes structure, reporting lines, authority and responsibility.
4. Demonstrates a commitment to attract, develop and retain competent individuals.
5. Enforces accountability for individual's internal control responsibilities.

Risk Assessment:

1. Specifies suitable objectives with sufficient clarity.
2. Identifies and analyzes risk as a basis for how risks should be managed.
3. Assesses the potential for fraud risk.
4. Identifies and analyzes significant changes that could impact the system of internal controls.

Control Activities:

1. Selects and develops control activities that contribute to the mitigation of risks.
2. Selects and develops general controls over technology.
3. Deploys control activities through policies that establish what is expected and procedures that put policies into place.

Information and Communication:

1. Uses relevant information to support the functioning of other components of internal control.
2. Communicates information internally, including objectives and responsibilities necessary to support the internal controls.
3. Communicates with external parties regarding matters affecting internal control.

Monitoring Activities:

1. Conducts ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
2. Evaluates and communicates deficiencies to those parties responsible for corrective actions.

The updated framework also has additional examples relevant to operation, compliance and reporting objectives added.

While COSO integrated internal control framework is very extensive, this is only a short summary of some of the changes of the updated framework. The updated framework superseded the original framework beginning January 1, 2015.

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EMERGING ISSUES

December 31, 2014

ACCOUNTING STANDARD UPDATE – ACCOUNTING FOR PENSIONS

GASB Statement No. 68 replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* and Statement No. 50, *Pension Disclosures*, as they relate to governments that provide pensions through pension plans administered as trusts or similar arrangements that meet certain criteria. Statement No. 68 requires governments providing defined benefit pensions to recognize their long-term obligation for pension benefits as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits. GASB Statement No. 71 – *Pension Transition for Contributions Made Subsequent to the Measurement Date* – is an amendment of GASB No. 68.

- GASB 68 will require presentation of the local government’s proportionate share of the pension plan’s Net Pension Liability to be reported on the government-wide statement of net position and the proprietary fund statements of net position – based on last year’s employer contributions
- The Net Pension Liability is measured as the total pension liability less the amount of the pension plan’s fiduciary net position – PERA and TRA currently estimating this around \$6 - 7 billion each
- Governmental Funds will present pension expenditures equal to the total of 1) amounts paid by employer to the pension plan and 2) the change between the beginning and ending balances of amounts normally expected to be liquidated with expendable available financial resources (i.e. No Change)
- PERA and TRA have been proactive in steps toward implementation and the outlook for reporting to members appears good, based on current plans – the hope is that most of the implementation will be a “plug-in” of PERA and TRA generated data
- PERA and TRA both have a June 30 fiscal year-end – this is the measurement date you will utilize for your presentation in your June 30 financial statements twelve months subsequent to that date
- Other Deferred Inflows/Outflows will include: differences between expected and actual economic experience and investment earnings, changes in assumptions and changes in employer proportion and difference between contributions and proportionate share of pension expense
- Required Supplementary Information will be two separate schedules – Schedule of Changes in Net Pension Liability and Related Ratios & Schedule of Contributions – 10-year presentation for each with notes
- GASB 71 clarifies that in the year of implementation you must determine the deferred outflows associated with pension contributions made subsequent to the measurement date – even if it is not practical to determine the other deferred inflows and outflows

PERA and TRA Plan:

- Perform annual actuarial valuations to determine funded status and liabilities
- Require plan actuary to calculate collective amount of items requiring deferred treatment
- Engage external auditor or audit actuarial census data and schedule of employer’s proportionate share
- Communicate results to the local governments
- Provide RSI and suggested footnotes

CITY OF SILVER BAY

EMERGING ISSUES

December 31, 2014

ACCOUNTING STANDARD UPDATE – ACCOUNTING FOR PENSIONS (CONTINUED)

Local Impacts:

- Your city's proportionate share of the plan's net pension liability will be recognized as a liability on your city's accrual financial statements. As of December 31, 2014, PERA has estimated the liability for your city to be \$ 1,014,660, based on the total unfunded liability as of their June 30, 2014 year end.
- Expenditures will continue to be tracked in the fund statements for your statutory contributions, but a reconciling item will be needed to adjust these contributions with your government-wide expenses which will be represented by the change in the net pension liability
- As a result, your financial statements/financial position will be immediately impacted by funding shortfalls at the pension plan
- Additional RSI presenting 10 years of information regarding net pension liability, required & actual contributions and related ratios
- Adds more extensive note disclosures, including sensitivity analysis of investment return assumption
- Requires employer to track annual balances of deferred outflows of resources and inflows of resources.
- Must describe signification assumptions and other inputs used to measure total pension liability.

UNIFORM ADMINISTRATIVE REQUIREMENTS, COST PRINCIPLES AND AUDIT REQUIREMENTS FOR FEDERAL AWARDS

The Office of Management and Budget (OMB) issued grant reform rules on December 23, 2013. This uniform grant guidance streamlines Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards.

Effective Dates

Federal agencies must implement the requirements to be effective by December 26, 2014. Non-federal entities will need to implement the new Administrative Requirements and Cost Principles for all new Federal Awards made after December 26, 2014. Audit Requirements are effective for fiscal years beginning on or after December 26, 2014.

Objective of OMB Grant Reform

This reform streamlines the language from eight existing OMB Circulars into one consolidated set of guidance, in the code of Federal regulations, known as the "Super Circular". The objective of the grant reform is to reduce administrative burden for non-federal entities receiving Federal Awards while reducing the risk of waste, fraud and abuse by:

1. Eliminating duplicative and conflicting guidance
2. Focusing on performance over compliance for accountability
3. Encouraging efficient use of information technology and shared services
4. Providing for consistent and transparent treatment of costs
5. Limiting allowable costs to make the best use of federal resources
6. Setting standard processes using data definitions
7. Encouraging non-federal entities to have family friendly policies
8. Strengthening oversight
9. Targeting audit requirements on risk of waste, fraud and abuse

CITY OF SILVER BAY

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UNIFORM ADMINISTRATIVE REQUIREMENTS, COST PRINCIPLES AND AUDIT REQUIREMENTS FOR FEDERAL AWARDS (CONTINUED)

This grant reform complements targeted efforts by OMB and a number of Federal agencies to reform overall approaches to grant-making by implementing innovative, outcome-focused grant making decisions and processes in collaboration with their non-federal partners.

Administrative Requirements – Subpart A-D of Federal Register

Following are some of the notable items in the updated Administrative Requirements.

- Must is defined as required
- Should is defined as best practice or recommended approach
- The term “vendor” is no longer used and was replaced with the term “contractor” (Section 200.23)
- Personally Identifiable Information (PII) and Protected Personally Identifiable Information (PPII) are defined (Sections 200.79 and 200.82)
- Fixed amount awards focused on meeting performance milestones (Section 200.201)
- Emphasis on performance goals and performance reporting (Section 200.301)
- Defined that computers are considered supplies, not equipment (Section 200.940)
- Flexibility in electronic documentation retention, with associated internal controls (Section 200.335)

Internal Controls (Section 200.303)

Internal controls should comply with:

- “Standards for Internal Control in the Federal Government” issued by the Comptroller General of the United States and the “Internal Control Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)
- Federal statutes, regulations and terms and conditions of the Federal award

Internal controls must:

- Evaluate and monitor compliance
- Take prompt action for noncompliance
- Take reasonable measures to safeguard PPII and other sensitive information

Procurement Standards (Sections 200.317 through 200.326)

Guidelines provide five different procurement methods

- Micro-purchases
- Small purchases
- Sealed bids
- Competitive proposals
- Noncompetitive proposals

Entities must have a documented procurement policy, written standards of conduct covering organizational conflicts of interest and must maintain oversight to ensure that contractors perform in accordance with the terms, conditions and specifications of their contracts or purchase orders.

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UNIFORM ADMINISTRATIVE REQUIREMENTS, COST PRINCIPLES AND AUDIT REQUIREMENTS FOR FEDERAL AWARDS (CONTINUED)

Subrecipient Monitoring (Sections 200.330 through 200.332 and 200.521)

The pass-through entity must clearly identify the agreements as a subaward and must provide up to 13 different award identification pieces of information within the contract. There are also other required disclosures described for all requirements imposed by the pass-through entity on the subrecipient, indirect cost rate, allowing access to records, etc. An evaluation of each subrecipients risk of noncompliance is also required.

Cost Principles – Subpart E of Federal Register

Following are some of the notable items in the updated Cost Principles.

Indirect/Direct Costs (Sections 200.413-200.414)

- Salaries of administrative or clerical staff could be directly charged to a federal program if they meet certain conditions.
- Any non-federal entity that has never negotiated an indirect cost rate may elect to charge a de minimis rate of 10% of modified total direct costs which may be used indefinitely
- Federally negotiated indirect cost rates must be accepted by all federal awarding agencies (usually).
- Any non-federal entity that has a federally negotiated indirect cost rate may apply for a one-time extension of a current negotiated indirect cost rates for a period of up to four years.

Time and Effort Reporting (Section 200.430)

Charges to Federal Awards must be based on records that accurately reflect the work performed.

- Records are to be supported by a system of internal controls which provides reasonable assurance that the charges are accurate, allowable and properly allocated
- There is flexibility in process used to meet those standards
- Personnel activity reports not specifically required
- Maintained budget estimates may be used for interim accounting purposes, provided that, the non-federal entity's system of internal controls includes processes to review after-the-fact interim charges made to a Federal Award based on budget estimates to ensure adjustments are made so final amounts to Federal Awards are proper.

Audit Requirements – Subpart F of Federal Register

Following are some of the notable items in the updated Audit Requirements.

- Single Audit threshold raised from \$ 500,000 in Federal Awards per year to \$ 750,000 in Federal awards per year
- Major program determination changes include:
 - Type A/B program threshold is a sliding scale with a minimum of \$ 750,000
 - Percentage of coverage rule changes to 40% (50% currently) for non-low risk auditees and 20% (25% currently) for low risk auditees
- Updated criteria for a low-risk auditee
 - Going concern is incorporated
 - Cognizant/oversight agency can no longer waive exception
- Reporting for questioned costs threshold raised from \$ 10,000 to \$ 25,000

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UNIFORM ADMINISTRATIVE REQUIREMENTS, COST PRINCIPLES AND AUDIT REQUIREMENTS FOR FEDERAL AWARDS (CONTINUED)

Other Items of Interest

- List of items requiring prior written approval (*Section 200.407*)
- Advertising and public relations clarified, include program outreach (*Section 200.421*)
- Conference spending clarified (*Section 200.432*)
- Employee “morale” costs eliminated (*Section 200.437*)

Example of Strategy to Implement OMB Grant Reform Changes

1. Understand grant reform changes
2. Assign an internal expert who will be responsible for leading effort (time, resources and availability)
3. Establish a team and include those in program, financial and budget sides of federal grant management
4. Develop a plan and concentrate on areas of most significance first
5. Obtain approval from management and those charged with governance as it relates to policy changes
6. Attain/Provide training on new requirements and new entity specific policies and procedures
7. Monitor plan and focus on areas of most significant change

Additional Resources on OMB Grant Reform

- OMB Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards
 - (<https://www.federalregister.gov/articles/2013/12/26/2013-30465/uniform-administrative-requirements-cost-principles-and-audit-requirements-for-federal-awards>)
- COFAR FAQs
 - (<https://cfo.gov/wp-content/uploads/2013/01/2-C.F.R.-200-FAQs-2-12-2014.pdf>)
 - (<https://cfo.gov/wp-content/uploads/2014/08/2014-08-29-Frequently-Asked-Questions.pdf>)
- OMB Policy Statements
 - (http://www.whitehouse.gov/OMB/grants_docs)