

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

COMMUNICATIONS LETTER

For the Year Ended December 31, 2012

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, 2012, in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, we considered the City's internal control over financial reporting (internal control) as a basis for designing 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. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

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. Significant deficiencies are identified with 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 28, 2013, 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 28, 2013

CITY OF SILVER BAY
SIGNIFICANT DEFICIENCIES
December 31, 2012

LACK OF SEGREGATION OF ACCOUNTING DUTIES

During the year ended December 31, 2012, 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.
- Receipting Process
 - The Assistant Deputy Clerk creates and sends invoices, occasionally collects payments as they are received, prepares deposits and enters the receipts into the accounting system.
 - The Assistant Deputy Clerk enters the utility billing into the utility billing register, bills commercial and residential customers and mails the utility bills. The Assistant Deputy Clerk also occasionally receives payments, records the receipts and is also able to make adjustments to the utility billing register.
- Disbursement Process
 - The Assistant Deputy Clerk creates a batch list for City Council approval, enters information for payment on all bills, prints checks, mails checks and creates the paid claims list that is presented to the City Council.

PREPARATION OF FINANCIAL STATEMENTS

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, 2012

We have audited the financial statements of the City for the year ended December 31, 2012, and have issued our report dated February 28, 2013. 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. 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 has implemented Governmental Accounting Standards Board (GASB) Statement No. 63 during the year ended December 31, 2012. 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, 2012

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, 2012

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

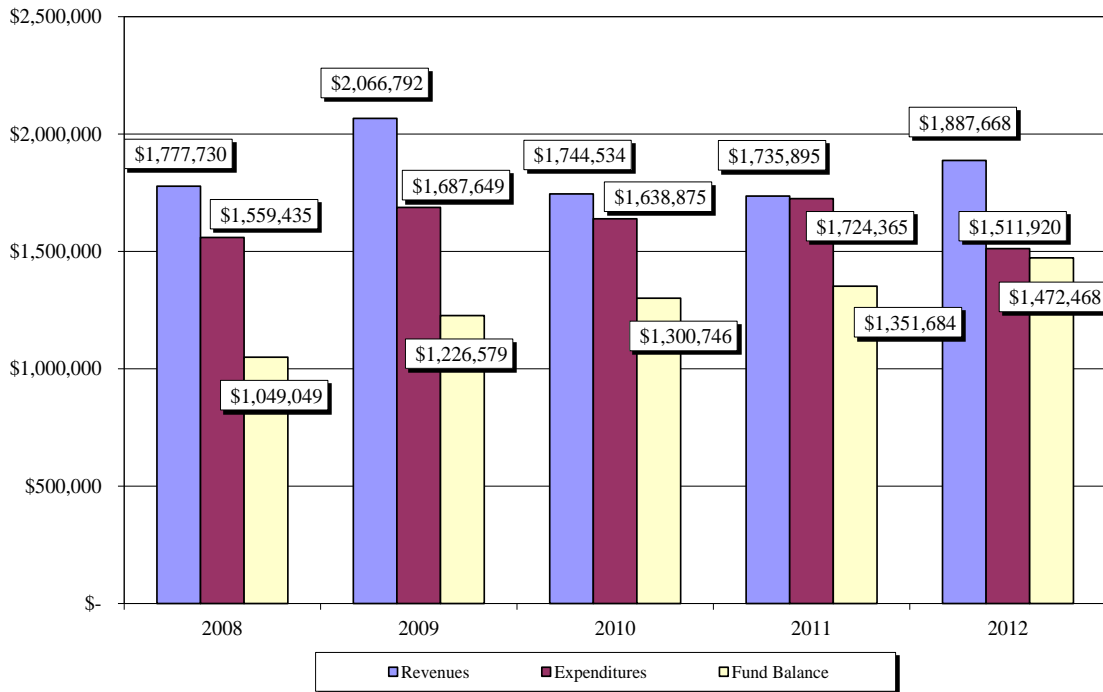
FINANCIAL ANALYSIS December 31, 2012

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 2012 totaled \$ 375,748. General Fund revenues funded \$ 268,076 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 \$ 120,784, or 8.9%, from \$ 1,351,684 in 2011 to \$ 1,472,468 in 2012. This fund balance represents just over eleven months of total General Fund operating expenditures. As the graph below indicates, revenues increased in 2012 after decreasing the previous two years. Fund balance has increased steadily over the last five years, to a high in 2012.

General Fund Revenues, Expenditures and Fund Balance



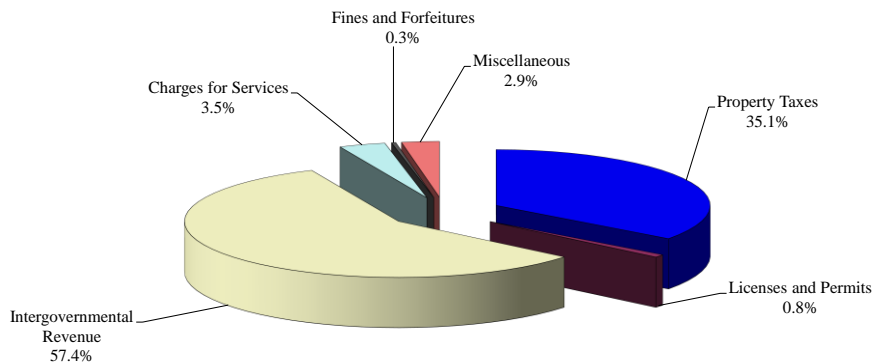
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2012

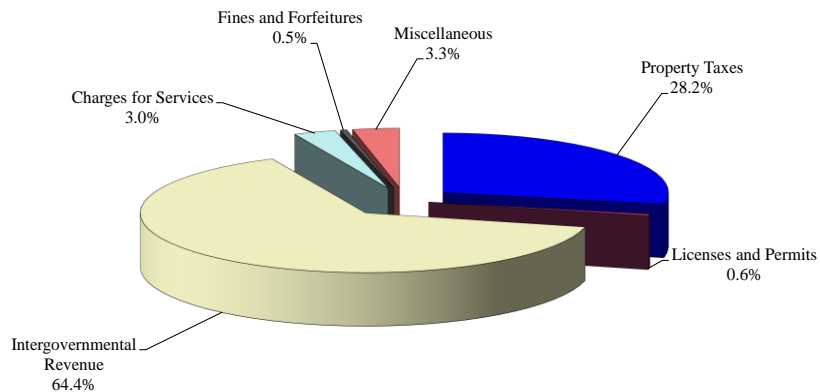
GENERAL FUND

As the graphs below indicate, the City relies upon intergovernmental revenue and tax levies as the majority of its total General Fund revenues. These two revenues accounted for 92.5% and 92.6% of total revenue in 2012 and 2011, respectively.

General Fund 2012 Revenues by Source



General Fund 2011 Revenues by Source



CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2012**

GENERAL FUND

	Year Ended December 31,				
	2008	2009	2010	2011	2012
REVENUES					
Property Taxes	\$ 384,465	\$ 450,321	\$ 481,225	\$ 489,640	\$ 663,145
Licenses and Permits	12,786	30,548	22,921	10,109	15,411
Intergovernmental Revenue	1,271,862	1,493,936	1,142,362	1,117,779	1,083,161
Charges for Services	43,953	37,413	41,235	52,399	66,173
Fines and Forfeitures	4,269	6,902	8,026	8,057	6,060
Miscellaneous	60,395	47,672	48,765	57,911	53,718
Total Revenues	\$ 1,777,730	\$ 2,066,792	\$ 1,744,534	\$ 1,735,895	\$ 1,887,668

General Fund revenues increased \$ 151,773, or 8.7% from 2011. This increase is primarily in property taxes. While the general fund levy increased \$ 79,305, the rest of the increase in property taxes is due to a change in the market value credit. 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. In 2011, the amount of the market value credit that offset property taxes was \$ 89,314 before the unallotment. The \$ 34,618 decrease in intergovernmental revenues is due to the elimination of the market value credit. In the five years presented, revenues have increased \$ 109,938, or 6.2%. Revenues can change significantly year to year based on different grants received.

	Year Ended December 31,				
	2008	2009	2010	2011	2012
EXPENDITURES					
General Government	\$ 406,709	\$ 396,565	\$ 415,398	\$ 439,134	\$ 434,300
Public Safety	559,129	564,161	571,227	587,363	529,727
Public Works	444,217	520,644	394,885	358,725	470,546
Culture and Recreation	31,085	29,293	18,549	19,216	27,086
Debt Service	26,261	56,009	36,228	21,423	21,422
Capital Outlay	92,034	120,977	202,588	298,504	28,839
Total Expenditures	\$ 1,559,435	\$ 1,687,649	\$ 1,638,875	\$ 1,724,365	\$ 1,511,920

General Fund expenditures decreased \$ 212,445, or 12.3% during 2012. Capital outlay changed the most significantly from 2011 to 2012, decreasing by \$ 269,665. This is the result of several large capital purchases during 2011, including two public works vehicles, a new police car and a boiler replacement at City Hall. Public safety expenditures decreased \$ 57,636 as a result of having one less person on the police force. Public works expenditures increased \$ 111,821 as a result of adding an additional person to the department, additional health insurance costs, as well as not charging a portion of the salaries to the EcoPark project to the Public Works Reserve Fund.

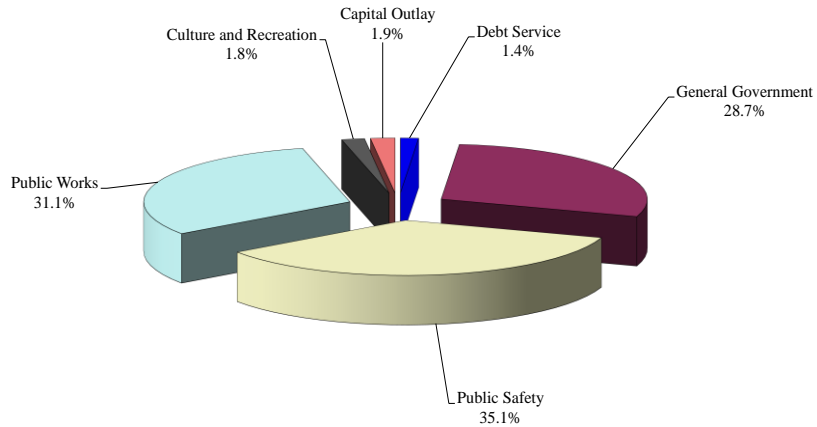
CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2012

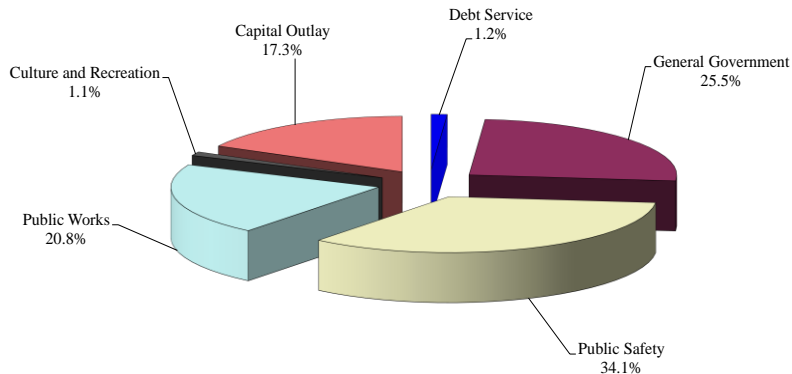
GENERAL FUND

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. There was more allocated to public works in 2011 as a result of the expense changes noted on the previous page. Due to the capital purchases of the City in 2011, that function decreased proportionately in 2012 to the rest of the functions.

General Fund 2012 Expenditures by Function



General Fund 2011 Expenditures by Function



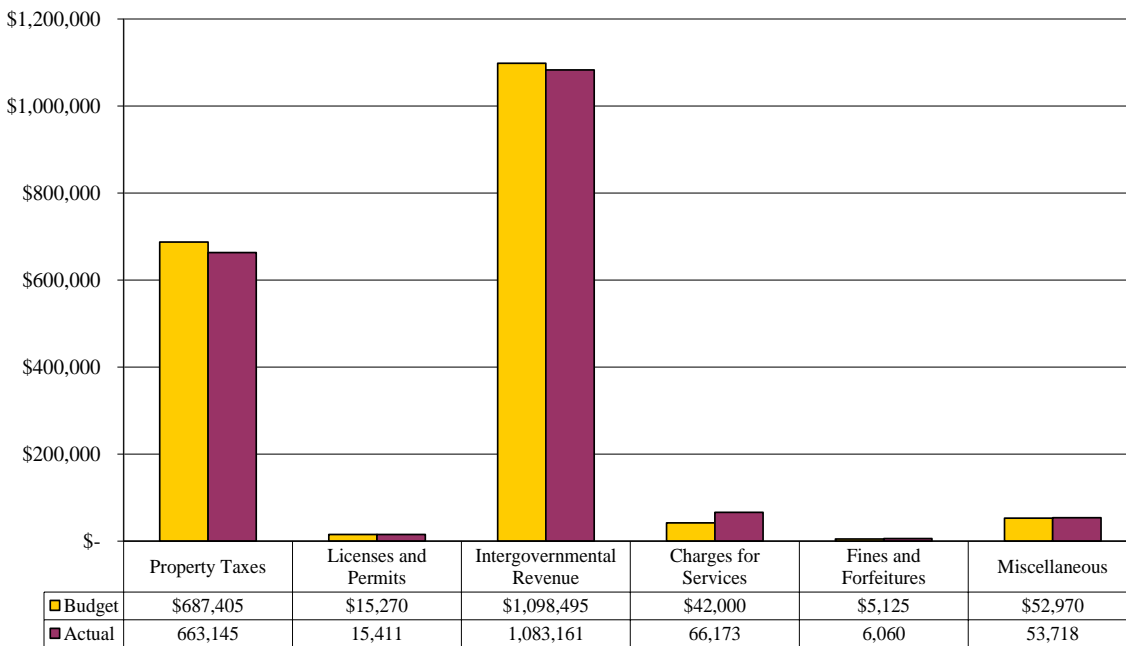
CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2012**

GENERAL FUND

The graph below and on the following page outline the budget and actual comparison for General Fund revenues and expenditures. Overall, revenue was \$ 13,597 under budget. Property taxes were under budget \$ 24,260 as a result of delinquent taxes coming in under expected amounts. Charges for services were over budget \$ 24,173 due to receiving more in revenue from the fire contracts as a result of capital purchases that were reimbursed during the year. Intergovernmental revenues were under budget \$ 15,334 due to timing of FEMA aid. The rest of the revenue categories only had minimal budget variances.

**2012 General Fund Revenues
Budget and Actual**



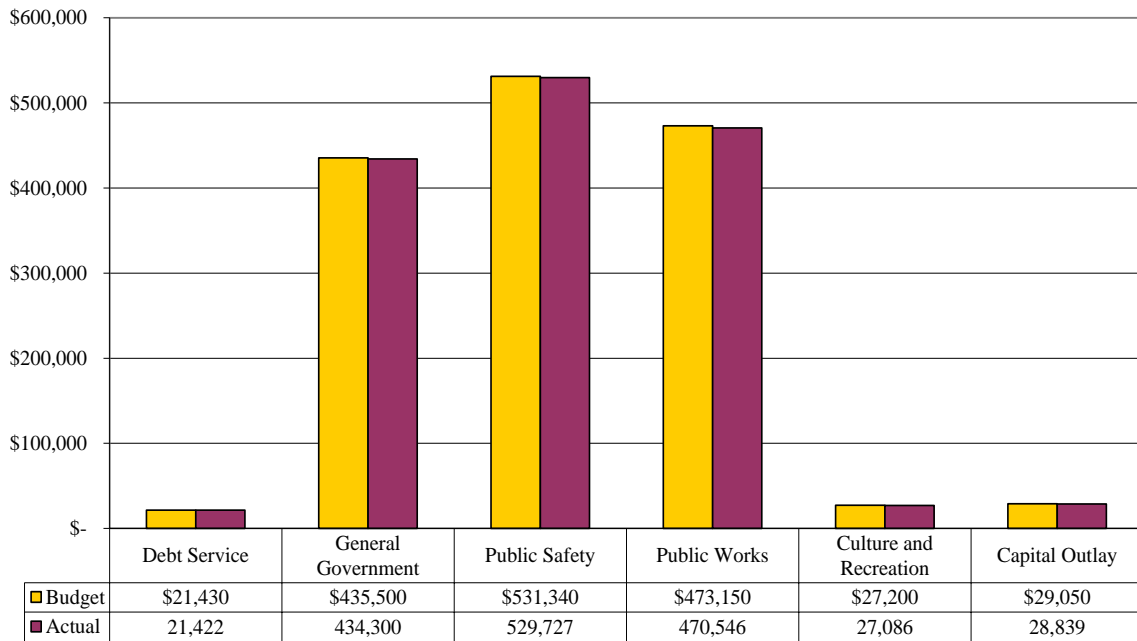
CITY OF SILVER BAY

**FINANCIAL ANALYSIS
December 31, 2012**

GENERAL FUND

Overall, expenditures were \$ 5,750, or 0.4%, under budget in 2012. All functions had minor variances from the budget.

**2012 General Fund Expenditures
Budget and Actual**

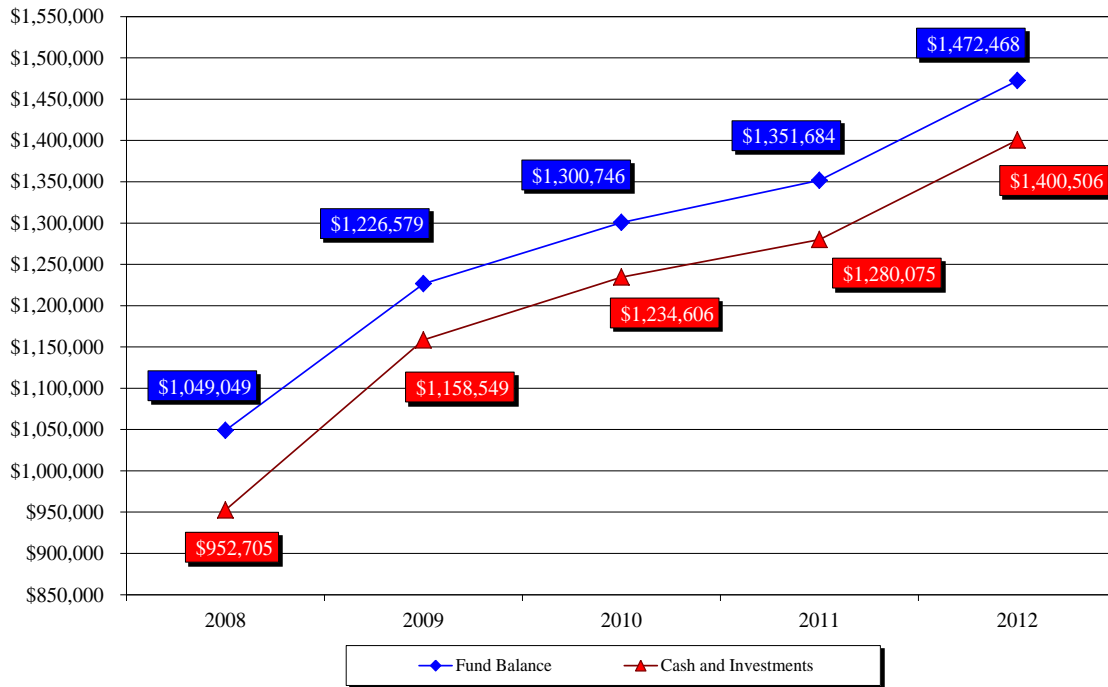


CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2012

GENERAL FUND

As illustrated below, the fund balance and cash balance in the General Fund increased in 2012. Cash increased during 2012 by approximately 9.4%, while fund balance increased 8.9%. 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.

General Fund



CITY OF SILVER BAY

FINANCIAL ANALYSIS

December 31, 2012

LIQUOR FUND

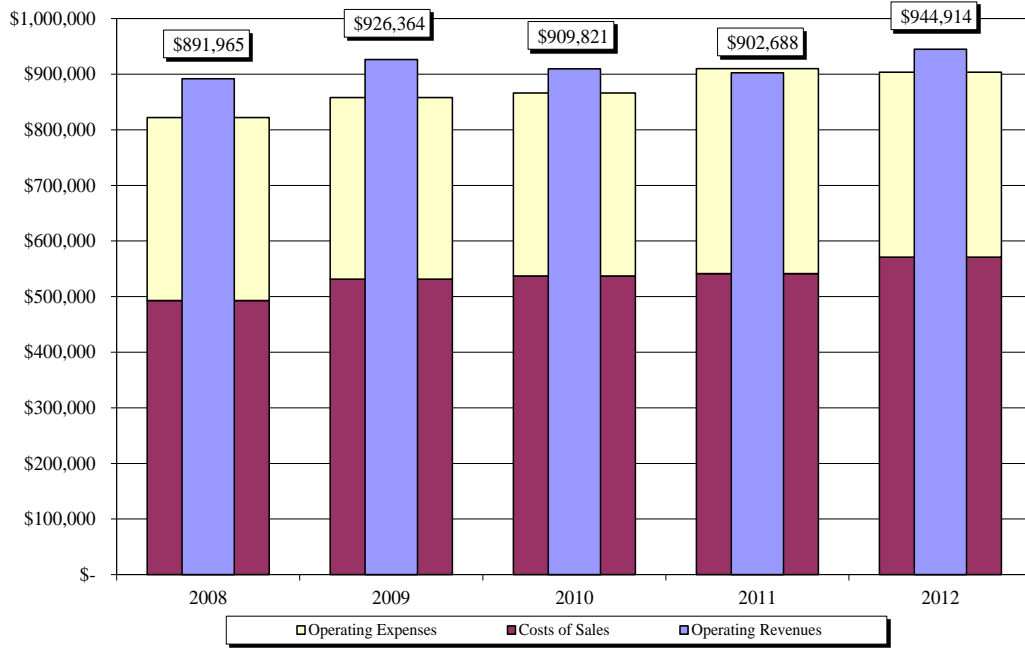
Liquor Fund operating trends are illustrated on the graphs on the following page. Sales increased by 4.5%, from \$ 893,898 in 2011 to \$ 934,085 in 2012. This increase is due to the ATV parade in town, as well as record Bay Days attendance in 2012. Gross profit percentage decreased from 39.4% in 2011 to 38.9% in 2012. This percentage has decreased 5.3% since 2008. Operating income was \$ 41,349 in 2012, an increase from the 2011 loss total of \$ 7,309. This was primarily a result of a change in retirement payments and compensated absence accruals during 2011. The City Council has chosen to suspend transfers from the Liquor Fund to other City operations until the Municipal Liquor Store Revenue Bonds have been paid in full.

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

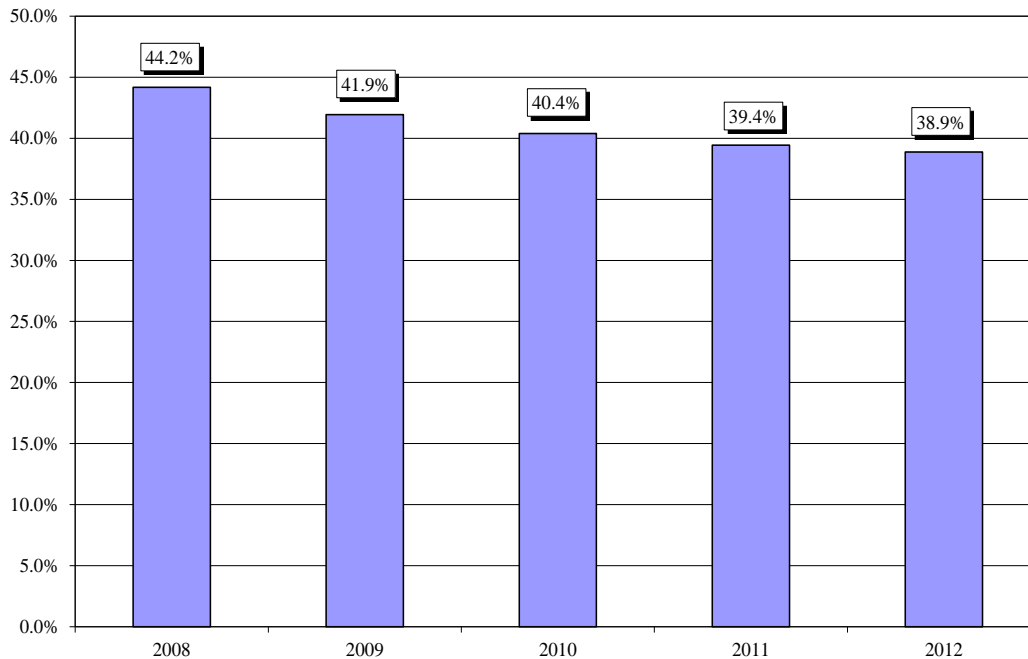
CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2012

LIQUOR FUND

Liquor Fund



Liquor Fund Gross Profit Percentage



CITY OF SILVER BAY

FINANCIAL ANALYSIS December 31, 2012

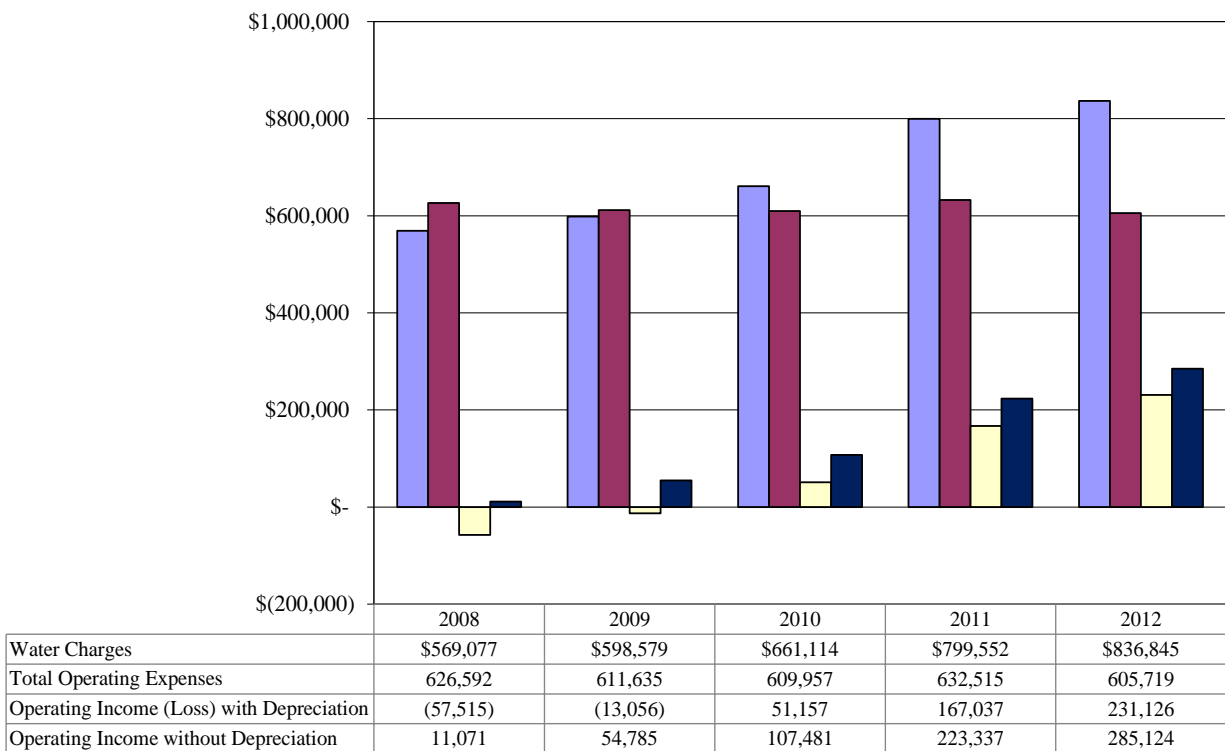
WATER AND SEWER FUNDS

Water and sewer rates increased in late 1995, 1999, 2005 and 2007-2012 to fund the repayment of the water and wastewater treatment facilities and water system improvements financed through the PFA loan program. For the third time in the last five years presented, sufficient revenues were generated in the Water Fund to cover the costs associated with the facilities, as demonstrated by 2010 through 2012 operating incomes in the Water Fund. For the second time in the five years presented, the Sewer Fund had an operating profit, generating \$ 162,033 in 2012.

The operating trends of the Water and Sewer Funds are illustrated below and on the following page. Operating expenses of the Water Fund decreased 4.2% in 2012, as a result of a decrease in repairs and maintenance. Operating revenues increased 4.7% in 2012, primarily due to a change in the rate structure in 2012.

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.

Water Fund



CITY OF SILVER BAY

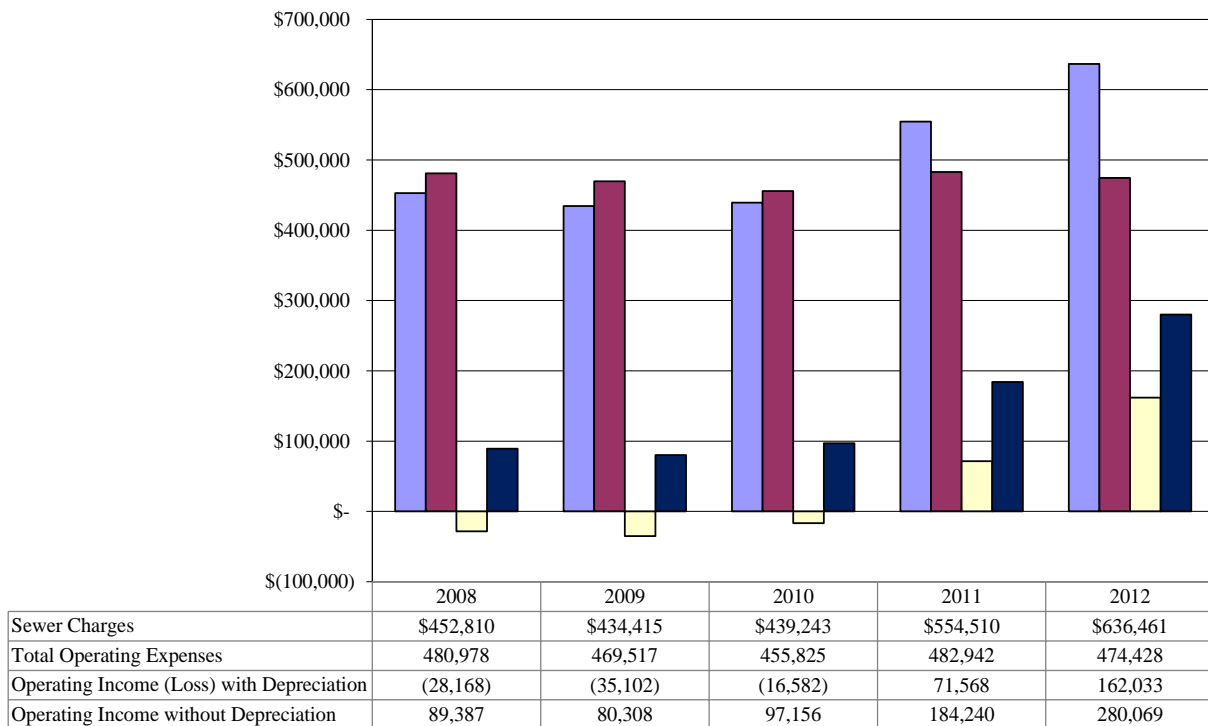
FINANCIAL ANALYSIS December 31, 2012

WATER AND SEWER FUNDS

As a result of the change in the rate structure during 2012, Sewer Fund operating revenues increased 14.8% in 2012. Operating expenses stayed consistent with the prior year, decreasing 1.8%, or \$ 8,514.

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



CITY OF SILVER BAY
FINANCIAL ANALYSIS
December 31, 2012

WATER AND SEWER FUNDS

Net Position Balances
Water Fund and Sewer Fund

