

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

**MANAGEMENT LETTER**

**For the Fiscal Year Ended December 31, 2010**

**CITY OF SILVER BAY  
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*Expert advice. When you need it.<sup>SM</sup>*

**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, 2010, 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, 2010. 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 22, 2011, 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  
March 22, 2011

**CITY OF SILVER BAY**  
**SIGNIFICANT DEFICIENCIES**  
**December 31, 2010**

**LACK OF SEGREGATION OF ACCOUNTING DUTIES**

During the year ended December 31, 2010, 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.
- 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**

### **DEFICIENCY December 31, 2010**

#### **PRIOR PERIOD ADJUSTMENT**

A prior period adjustment was proposed to correct prior financial statements. This adjustment corrected an understatement of fund balance and net assets in the Economic Development Fund and governmental activities, respectively. This understatement was the result of a nonroutine transaction in 2009 when the City contributed \$ 25,000 to the Minnesota Community Capital Fund. It was determined in 2010 that the City still has rights to this money and it is being held in the City's name.

## CITY OF SILVER BAY

### RECOMMENDATION FOR MANAGEMENT December 31, 2010

#### **CONSIDER THE IMPLICATIONS OF GOVERNMENTAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 54, *FUND BALANCE REPORTING AND GOVERNMENTAL FUND TYPE DEFINITIONS***

Governmental Accounting Standards Board (GASB) Statement No. 54 was enacted to enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. The initial distinction that is made in reporting fund balance information is identifying amounts that are considered nonspendable, such as fund balance associated with inventories or prepaid expenses. This Statement also provides for additional classification as restricted, committed, assigned and unassigned based on the relative strength of the constraints that control how specific amounts can be spent.

The restricted fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers or through enabling legislation. The committed fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the assigned fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds other than the general fund, assigned fund balance represents the remaining amount that is not restricted or committed, unless that is a negative balance. Unassigned fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. In other funds, the unassigned classification should be used only to report a deficit balance resulting from overspending for specific purposes for which amounts have been restricted, committed or assigned.

Governments are allowed to have stabilization amounts which are formally set aside for use in emergency situations or when revenue shortages or budgetary imbalances arise. These funds must be restricted or committed for a specific purpose, and cannot occur routinely.

Governments are required to have a fund balance policy which addresses a reasonable minimum level of unrestricted fund balance to be maintained, how the unrestricted fund balance can be used or spent down and how that fund balance will be replenished if it falls below the minimum level.

Elimination of the reserved component of fund balance in favor of a restricted classification will enhance the consistency between information reported in the government-wide statements and information in the government fund financial statements and avoid confusion about the relationship between the reserved fund balance and restricted net assets. The Statement is also designed to enhance the usefulness of fund balance information by clarifying the definitions of governmental fund types. For example, special revenue funds are created only to report a revenue source that is restricted or committed to a specified purpose and that revenue source should constitute a substantial portion of the resources reported in the fund. In addition, the definition of the capital project fund type has been clarified to focus on the broader, more consistent understanding of capital outlays and capital activities in today's environment.

This Statement is effective for the year ending December 31, 2011. Fund balance reclassifications made to conform to the provisions of this Statement should be applied retroactively by restating fund balance for all prior periods presented.

## **CITY OF SILVER BAY**

### **REQUIRED COMMUNICATION December 31, 2010**

We have audited the basic financial statements of the City for the year ended December 31, 2010, and have issued our report dated March 22, 2011. 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. No new accounting policies were adopted and the application of existing policies was not changed during 2010. 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, 2010**

**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 did not identify and we did not notify them of any uncorrected financial statement misstatements. 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, 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, 2010**

**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.

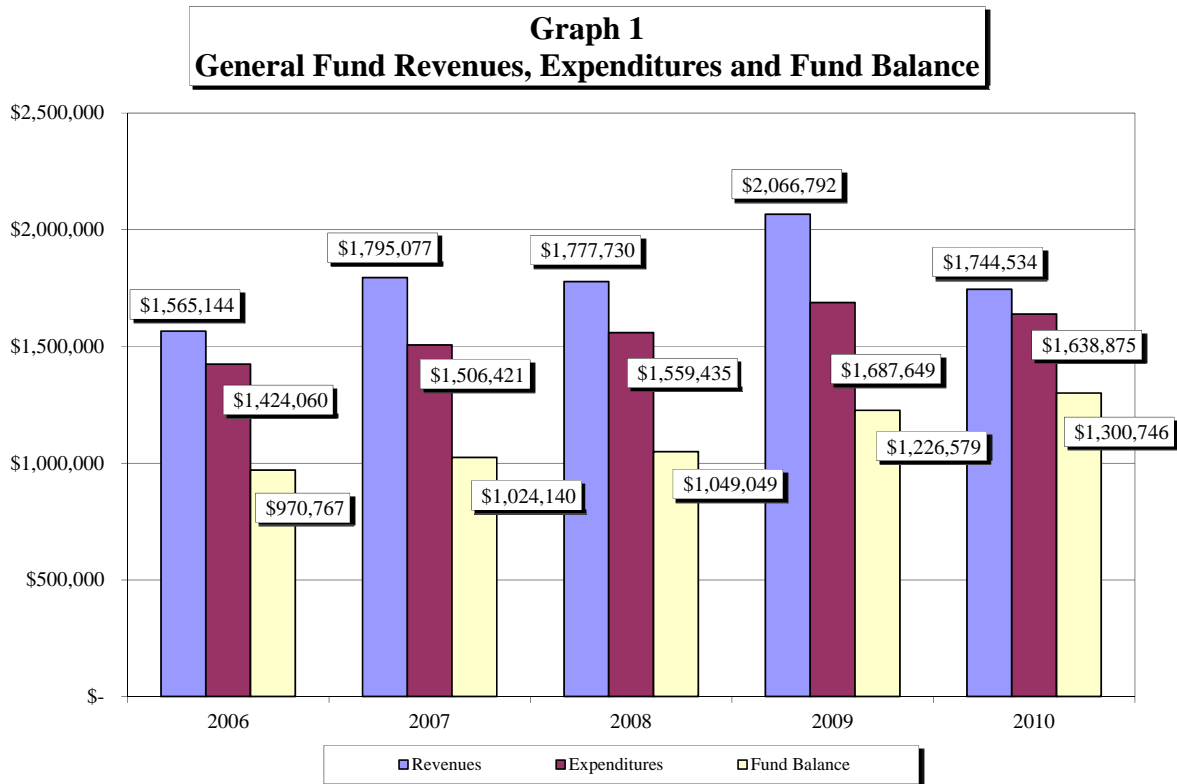
# CITY OF SILVER BAY

## FINANCIAL ANALYSIS December 31, 2010

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 2010 totaled \$ 105,659. General Fund revenues funded \$ 203,120 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 \$ 74,167, or 6.1%, from \$ 1,226,579 in 2009 to \$ 1,300,746 in 2010. This fund balance represents just over nine months of total General Fund operating expenditures. As Graph 1 illustrates, revenues decreased for the second time in the five years presented and expenditures decreased for the first time in the last five years. Fund balance has also increased steadily over the last five years, with the largest increase from 2008 to 2009.



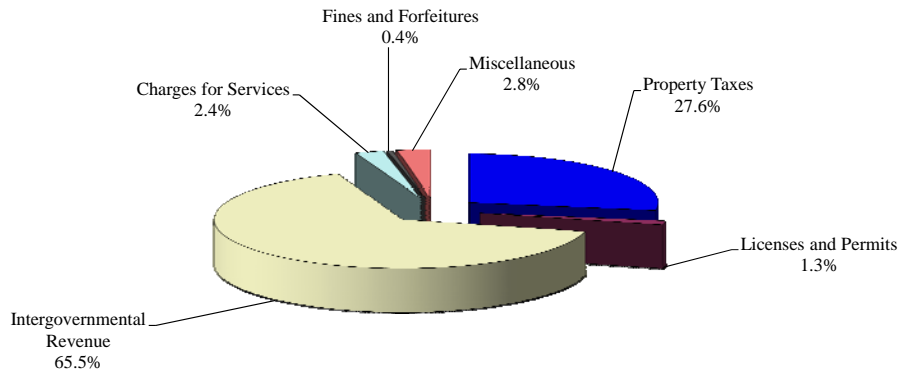
# CITY OF SILVER BAY

## FINANCIAL ANALYSIS December 31, 2010

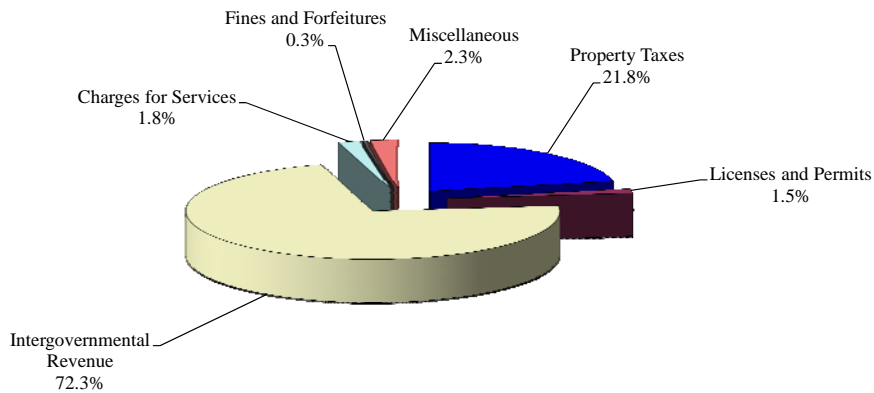
### GENERAL FUND

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 93.1% and 94.1% of total revenue in 2010 and 2009, respectively.

**Graph 2  
General Fund 2010 Revenues by Source**



**Graph 3  
General Fund 2009 Revenues by Source**



## CITY OF SILVER BAY

### FINANCIAL ANALYSIS December 31, 2010

#### GENERAL FUND

	Year Ended December 31,				
	2006	2007	2008	2009	2010
REVENUES:					
Property Taxes	\$ 216,159	\$ 337,664	\$ 384,465	\$ 450,321	\$ 481,225
Licenses and Permits	10,157	13,521	12,786	30,548	22,921
Intergovernmental Revenue	1,206,869	1,322,115	1,271,862	1,493,936	1,142,362
Charges for Services	41,203	45,735	43,953	37,413	41,235
Fines and Forfeitures	4,219	3,295	4,269	6,902	8,026
Miscellaneous	86,537	72,747	60,395	47,672	48,765
	<u>\$ 1,565,144</u>	<u>\$ 1,795,077</u>	<u>\$ 1,777,730</u>	<u>\$ 2,066,792</u>	<u>\$ 1,744,534</u>

General Fund revenues decreased 15.6% during 2010. The decrease in revenues was primarily a result of a decrease in intergovernmental revenues, offset by an increase in property tax revenue. Intergovernmental revenues decreased \$ 351,574, or 23.5%, which is attributed to two factors: First, the City's Local Government Aid (LGA) and Market Value Credit initial entitlements were reduced by the state in the amount of \$ 109,615 and \$ 55,440, respectively, resulting in a decrease of \$ 111,344 in total in these aids from 2009. In addition, the City received a number of state and federal grants in 2009 to cover the damage caused by an ice storm that occurred in March 2009. Property taxes increased \$ 30,904, or 6.9%, as a result of an increase in levy for the General Fund.

	Year Ended December 31,				
	2006	2007	2008	2009	2010
EXPENDITURES:					
General Government	\$ 417,728	\$ 499,176	\$ 406,709	\$ 396,565	\$ 415,398
Public Safety	474,844	502,449	559,129	564,161	571,227
Public Works	367,897	412,026	444,217	520,644	394,885
Culture and Recreation	16,984	17,921	31,085	29,293	18,549
Debt Service	-	26,260	26,261	56,009	36,228
Capital Outlay	146,607	48,589	92,034	120,977	202,588
	<u>\$ 1,424,060</u>	<u>\$ 1,506,421</u>	<u>\$ 1,559,435</u>	<u>\$ 1,687,649</u>	<u>\$ 1,638,875</u>

General Fund expenditures decreased 2.9% during 2010. This decrease was a result of changes among several of the expenditure functions. General government expenditures increased \$ 18,833 as a result of wage increases and an increase in health insurance premium costs. Public works expenditures decreased \$ 125,759, or 24.2%, due to costs in 2009 for tree replacement as the result of an ice storm in March 2009, with no such costs being incurred in 2010. The decrease in public works expenditures was partially offset by an increase in capital outlay of \$ 81,611, or 67.5%, primarily as a result of the purchase of a public works Caterpillar loader and 12 golf carts for the golf course. Debt service expenditures decreased \$ 19,781 as a result of the sidewalk plow/snow blower lease being paid off in 2009.

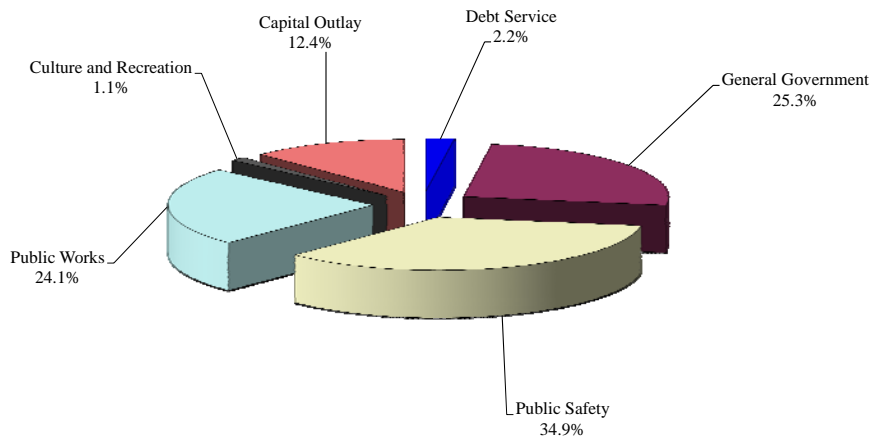
# CITY OF SILVER BAY

## FINANCIAL ANALYSIS December 31, 2010

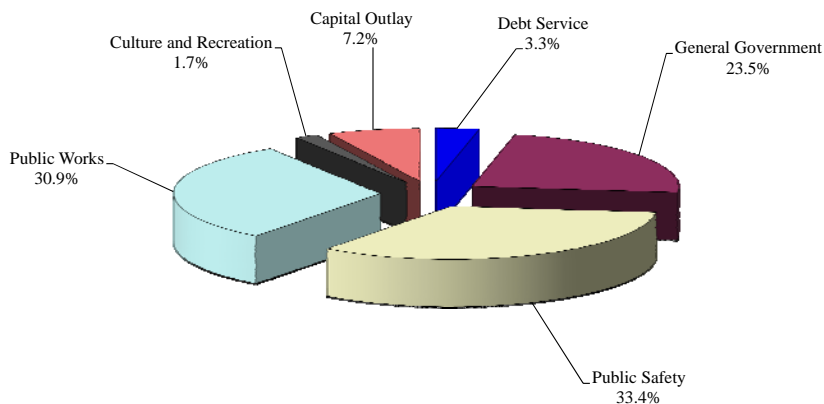
### GENERAL FUND

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 2010 as a result of the one-time expenditures in 2009 for the ice storm clean up. As a result, the amount allocated to most other functions increased slightly.

**Graph 4  
General Fund 2010 Expenditures by Function**



**Graph 5  
General Fund 2009 Expenditures by Function**



**CITY OF SILVER BAY**

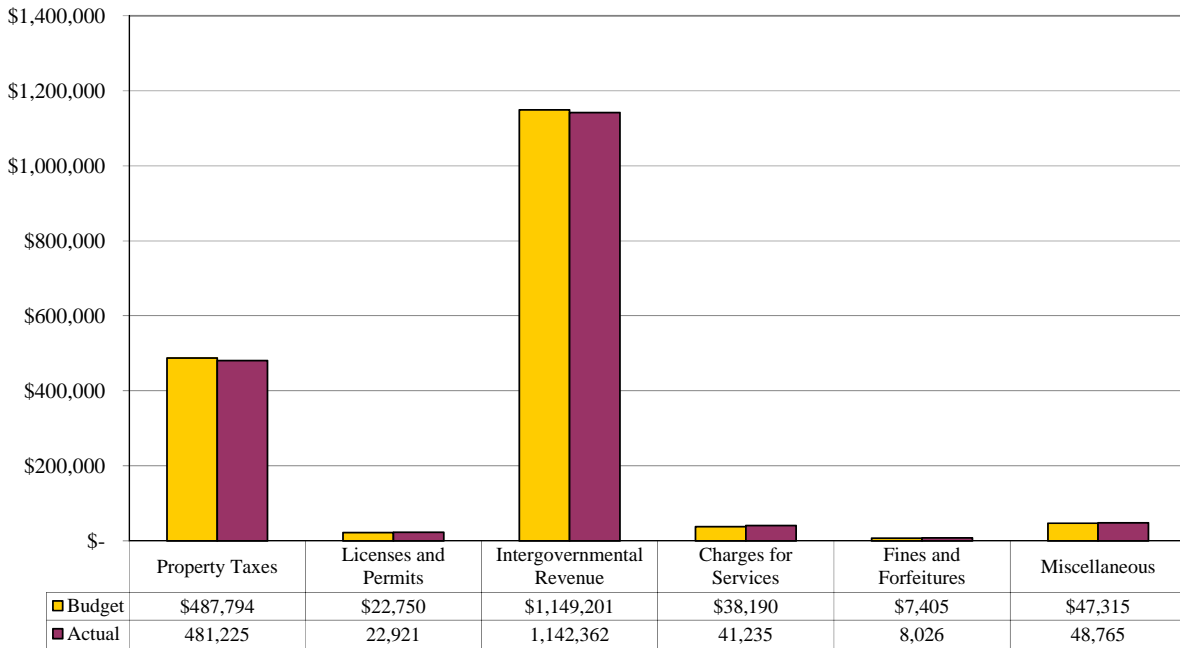
**FINANCIAL ANALYSIS  
December 31, 2010**

**GENERAL FUND**

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

Overall, revenue was \$ 8,121 under budget. Actual intergovernmental revenue was lower than budget by \$ 6,839 and actual property tax revenue was lower than budget by \$ 6,569, while charges for service revenue was over budget by \$ 3,045. The rest of the revenues were accurately budgeted for as the next largest variance is \$ 1,450 over budget in miscellaneous revenues.

**Graph 6  
2010 General Fund Revenues  
Budget and Actual**



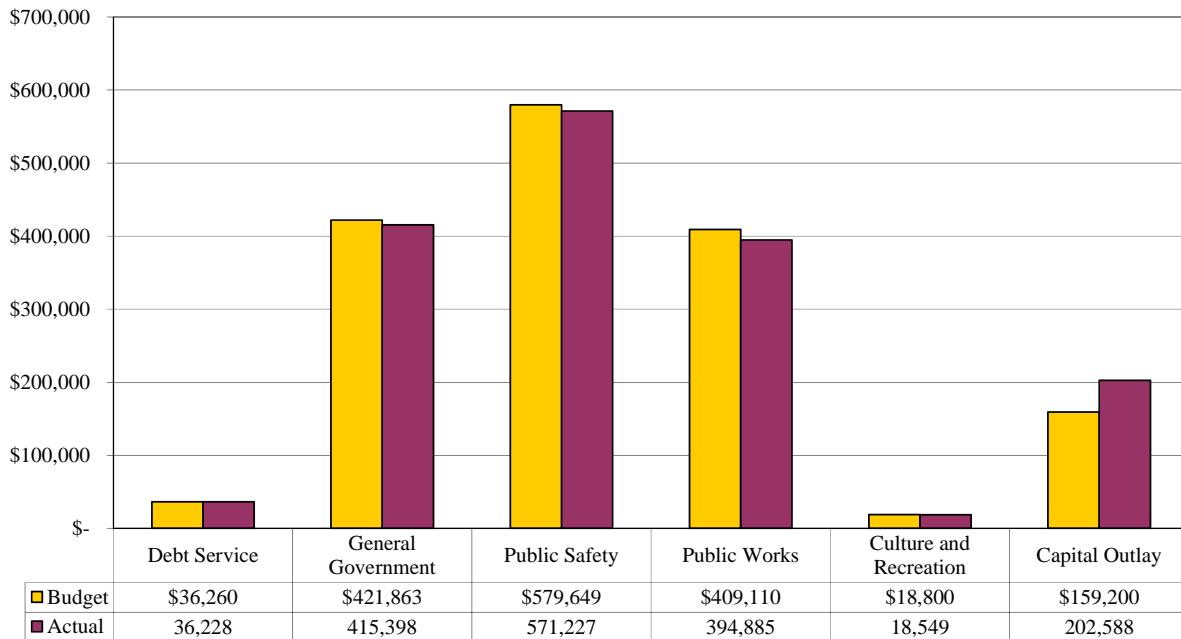
**CITY OF SILVER BAY**

**FINANCIAL ANALYSIS  
December 31, 2010**

**GENERAL FUND**

Overall, expenditures were \$ 13,993, or 0.9%, over budget in 2010. The majority of the difference is in capital outlay, which was \$ 43,388 over budget due to the new golf carts that were purchased through a capital lease for the golf course.

**Graph 7  
2010 General Fund Expenditures  
Budget and Actual**

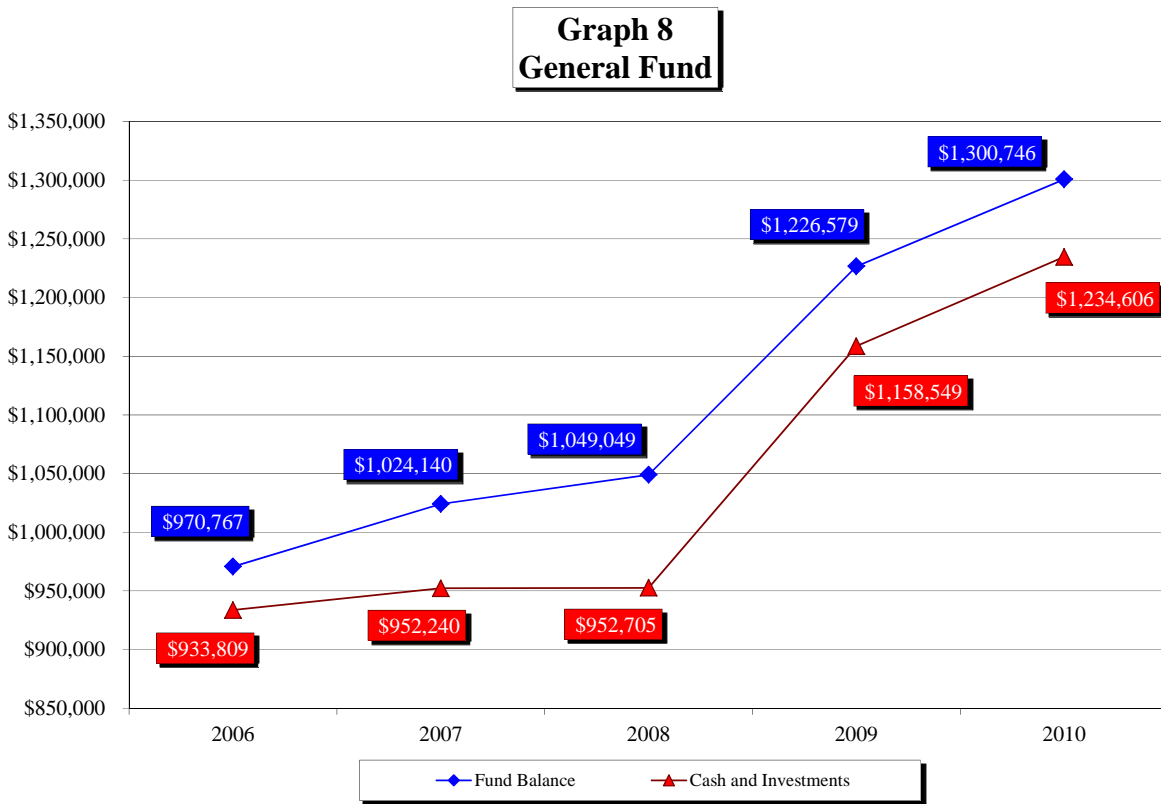




**CITY OF SILVER BAY**  
**FINANCIAL ANALYSIS**  
**December 31, 2010**

**GENERAL FUND**

As illustrated on Graph 8, the fund balance and cash balance in the General Fund increased in 2010. Cash increased during 2010 by approximately 6.6%, while fund balance increased 6.1%. We commend the City and its administration for its focus and dedication in maintaining its General Fund balance at levels that can adequately fund operations and provide sufficient reserves to fund small projects without incurring bond issuance costs.



**CITY OF SILVER BAY**  
**FINANCIAL ANALYSIS**  
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**LIQUOR FUND**

Liquor Fund operating trends are illustrated on the graphs on the following page. Sales remained stable, decreasing only 1.5% from \$ 915,267 in 2009 to \$ 901,146 in 2010. Gross profit percentage decreased from 41.9% in 2009 to 40.4% in 2010. Income before operating transfers was \$ 31,341 in 2010, a decrease from the 2009 total of \$ 57,519. This was primarily a result of decreased investment income along with a decrease in gross profit. 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 \$ 44,012 made in 2010 on the Liquor Store Bond, the Fund did not meet its requirements for profit transfers.

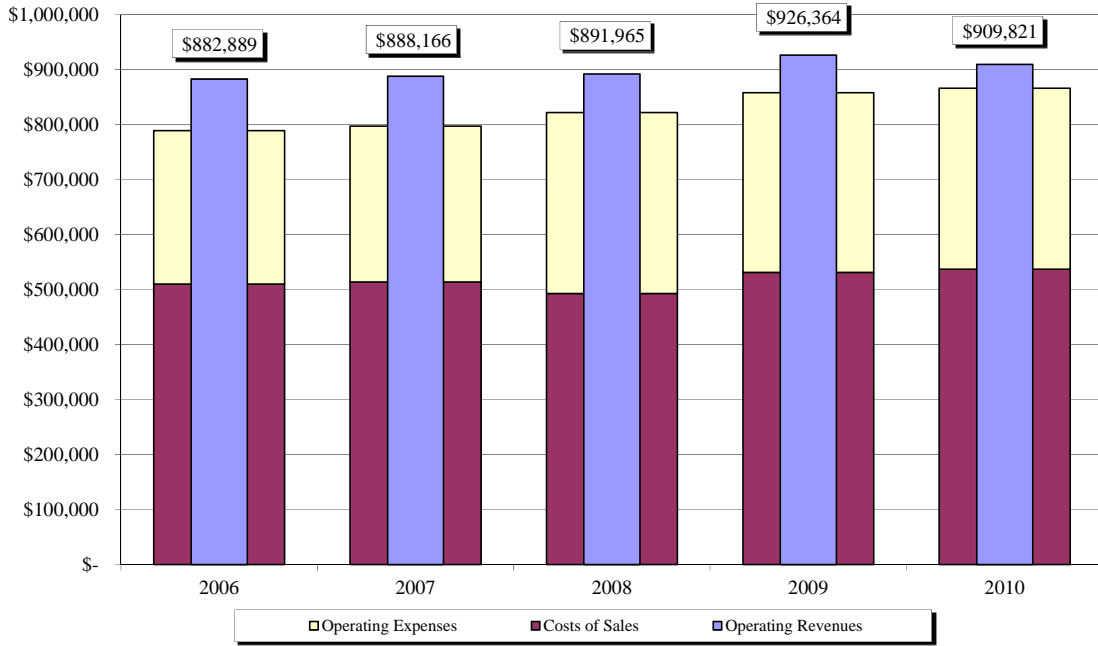
We recommend the City continue to review markups on all products to maintain a gross profit percentage at approximately 40% to 42%. The liquor operations should consider increased strategic marketing through new products and promotion and display of higher margin products in order to increase sales and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

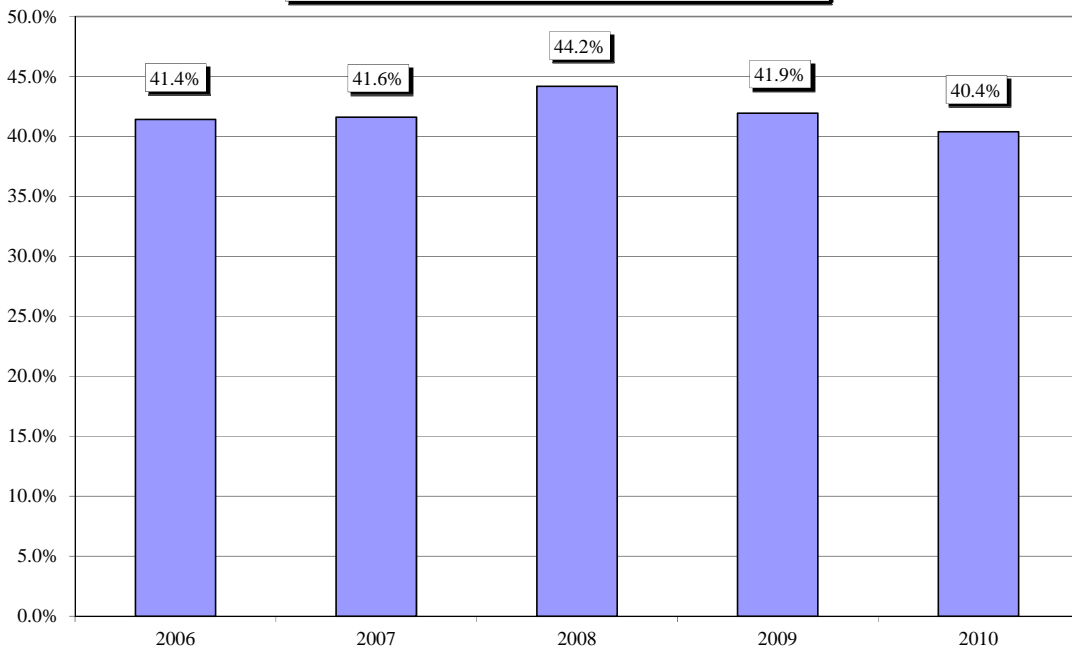
**FINANCIAL ANALYSIS  
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**LIQUOR FUND**

**Graph 9  
Liquor Fund**



**Graph 10  
Liquor Fund Gross Profit Percentage**



## CITY OF SILVER BAY

### FINANCIAL ANALYSIS December 31, 2010

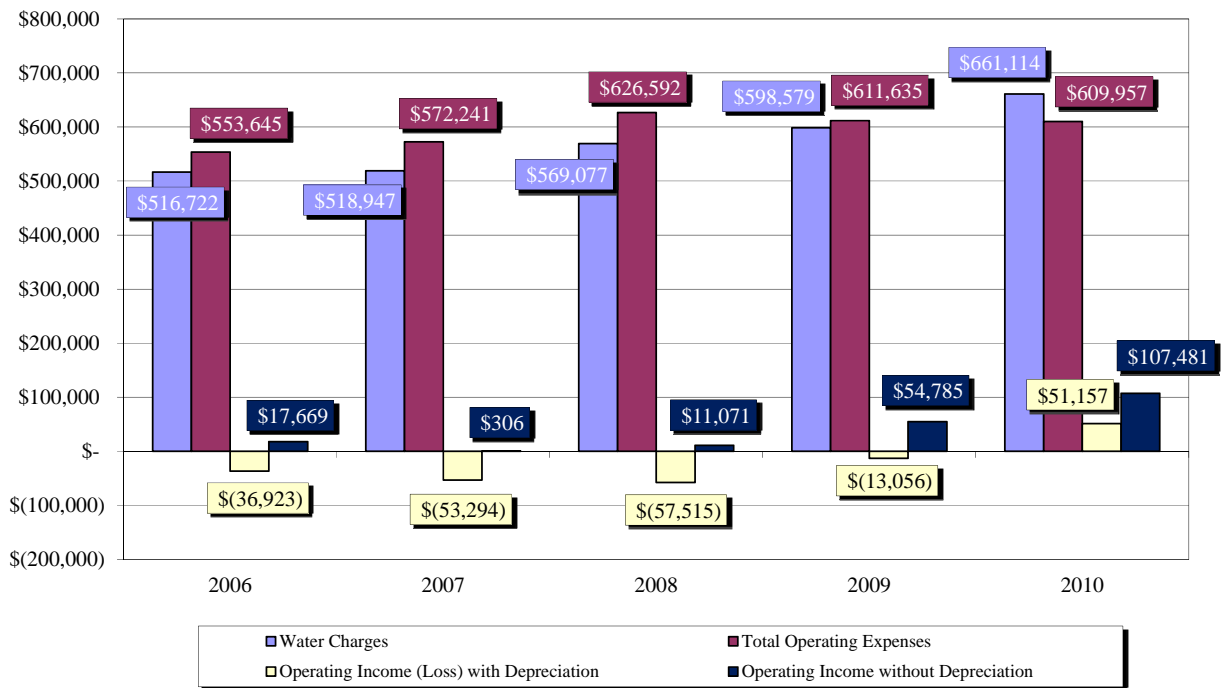
#### WATER AND SEWER FUNDS

Water and sewer rates increased in late 1995, 1999, 2005 and 2007-2010 to fund the repayment of the water and wastewater treatment facilities and water system improvements financed through the PFA loan program. For the first 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 operating income of \$ 51,157 in the Water Fund. The Sewer Fund had an operating profit during one of the previous five years; however, it operated at a loss of \$ 16,582 in 2010, an improvement from the 2009 operating loss of \$ 35,102.

The operating trends of the Water and Sewer Funds are illustrated in graphs 11 and 12. Operating expenses of the Water Fund decreased 0.3% in 2010. Operating revenues increased 10.4% in 2010 primarily due to an increase in rates and increased usage during the year.

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**



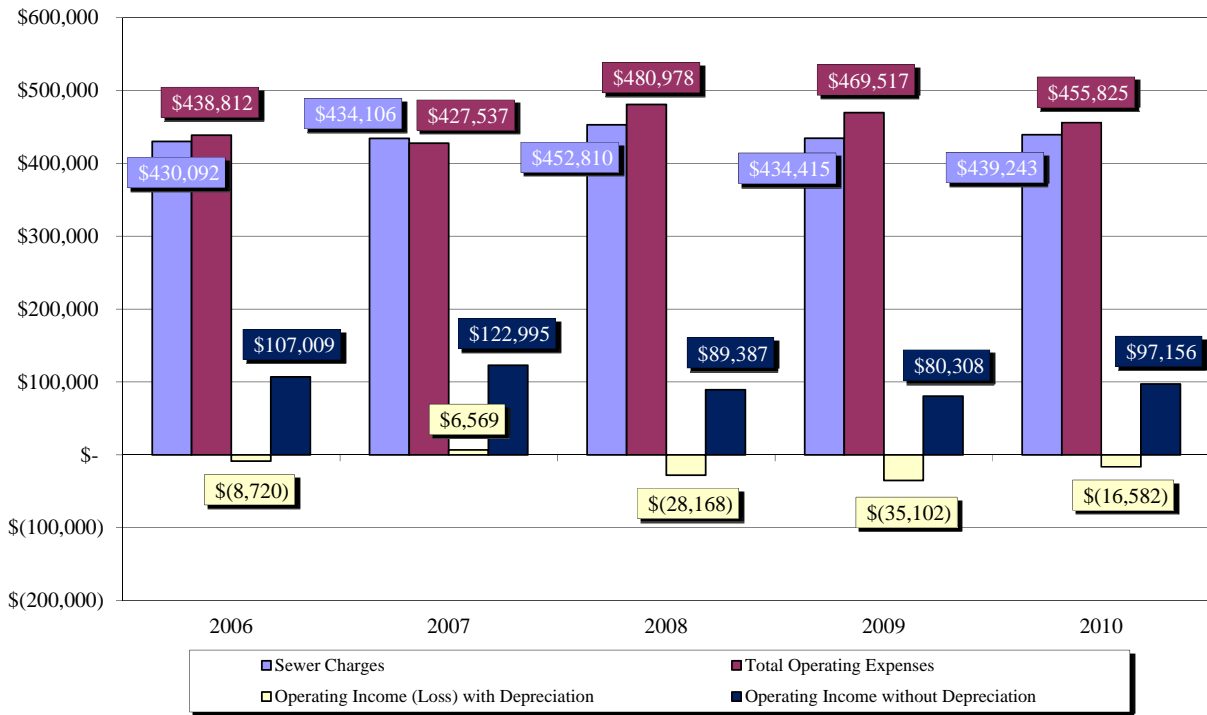
**CITY OF SILVER BAY**  
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**WATER AND SEWER FUNDS**

As a result of the increase in rates, Sewer Fund operating revenues increased 1.1% in 2010. Operating expenses decreased 2.9% due to various small decreases, mostly in contracted services and materials and supplies.

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**



**CITY OF SILVER BAY**  
**FINANCIAL ANALYSIS**  
**December 31, 2010**

**WATER AND SEWER FUNDS**

**Graph 13**  
**Net Asset Balances**  
**Water Fund and Sewer Fund**

