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April 25, 2014

Honorable Mayor and Members of the City Council
City of Tonka Bay, Minnesota

This letter is being prepared in conjunction with the audit of the financial statements and accounting records of the City of Tonka Bay (the City) for the year ended December 31, 2013. My report, dated April 25, 2014, expresses an unmodified report on the financial statements of the City as prepared and presented on the regulatory basis of accounting as prescribed by the State of Minnesota. The regulatory basis of accounting is a comprehensive basis of accounting other than generally accepted accounting principles.

As previously noted, the City has adopted the regulatory basis of accounting as prescribed by the State of Minnesota. Under this method, the *cash basis method of accounting* is used primarily to account for activities of the City's governmental funds, consisting of the General, Special Revenue and Capital Project Funds. However, under the regulatory basis of accounting, proprietary funds of the City are accounted for using the *accrual basis of accounting*, which is in accordance with generally accepted accounting principles.

The purpose of this letter is to communicate certain comments and observations noted during the audit of the financial statements. These comments are presented for your information and consideration. Comments and recommendations in this report are constructive in nature and should be read in this context; recommendations are intended to improve and/or strengthen internal control, financial management and administration.

As presented in the financial report, individual fund financial statements of the City are arranged into two broad categories of fund types – governmental and proprietary. Governmental funds account for the City's general government activities consisting primarily of general administration, public safety, public works, and parks and recreation. Proprietary fund types are those funds, which involve the City providing goods and services to the general public, which are financed primarily through user charges, such as utility operations.

Governmental Funds

The overall financial condition of the City's governmental funds continues to remain strong. Combined cash fund balances of the governmental funds at December 31, 2013 compared to 2012 are as follows:

	Balances		Net
	<u>2013</u>	<u>2012</u>	<u>Change</u>
Governmental Funds	<u>\$ 1,531,538</u>	<u>\$ 1,544,995</u>	<u>\$ (13,457)</u>

The primary explanation for the decrease in cash fund balances is the transfers of \$236,750 from the Utility Improvement Fund to the Water and Sewer funds to finance improvement projects in each of these funds exceeding the replenishment of these funds from transfers, representing depreciation charges, from these utility funds.

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Governmental Funds, continued

Cash fund balances of the individual fund types and changes in fund balance of the governmental funds for the year ended December 31, 2013 are summarized in the following chart.

	Fund Balance		Increase (Decrease)	2012 Change
	2013	2012		
General Fund	\$ 669,843	\$ 628,534	\$ 41,309	\$ 78,984
Special Revenue Funds	363,977	366,449	(2,472)	2,220
Capital Project Funds	497,718	550,012	(52,294)	175,085
	<u>\$ 1,531,538</u>	<u>\$ 1,544,995</u>	<u>\$ (13,457)</u>	<u>\$ 256,289</u>

As illustrated in the chart, the combined cash fund balances of the governmental funds totaled \$1,531,538 as of December 31, 2013, a slight decrease of \$13,457 or less than one percent from the previous year. Revenues and transfers of \$1,474,008 were offset by expenditures and transfers of \$1,487,465 resulting in the net decrease. Revenues in 2013 were \$52,401 lower than the previous year; revenue from licenses and permits, and charges for services account for the majority of the decrease. In addition, during the year transfers from other funds were less than the previous year by \$192,175. A special transfer of \$200,000 made in 2012 from the Sewer Fund to the Utility Improvement Fund accounts for this difference. Total expenditures of governmental funds decreased by \$58,837 or 4.7%. Capital outlay expenditures were \$65,632 less than the previous year which accounts for the reduction in expenditures. Transfers to other funds increased in 2013 due to the \$236,750 transferred to the Sewer and Water funds to finance improvement projects; prior year transfers for this purpose were \$162,185.

It should be noted that the City has budgeted for these improvement project expenditures and related transfers by accumulating sufficient resources from previous years to finance these projects.

Following are additional comments regarding each of the governmental fund types.

General Fund

The General Fund is the primary operating fund of the City and accounts for the costs of providing services to citizens of the City. General government activities consist primarily of general administration, public safety, public works, and parks and recreation. For the year, disbursements of the General Fund exceeded receipts by \$12,676 which was offset by transfers from other funds of \$53,985, resulting in a surplus of \$41,309 for the year. The surplus increased the fund balance to \$669,843 at December 31, 2013, an increase of 6.6%. Over the past four years the fund balance has increased approximately \$166,500 or 33%. Current Council members should be commended for continuing this trend.

Of the fund balance, \$647,300 or 96.63% is unassigned and available to finance current year operations until tax revenues are received. The remaining portion of the fund balance is non-spendable (prepaid items) and assigned as a reserve for accrued salaries and accumulated employee compensated absences. This unassigned fund balance represents 56.3% of budgeted expenditures for 2014 compared to ratios of 53.2% and 46.5% for 2012 and 2011, respectively. This relationship is an indication of the financial strength of the General Fund.

The State Auditor recommends cities maintain an unreserved fund balance in the General Fund of approximately 35% to 40% of operating expenditures. In the City's situation, my recommendation would be to maintain a fund balance reserve of approximately 50% due to the City's heavy reliance on property tax revenues as the primary source of revenue of the General Fund.

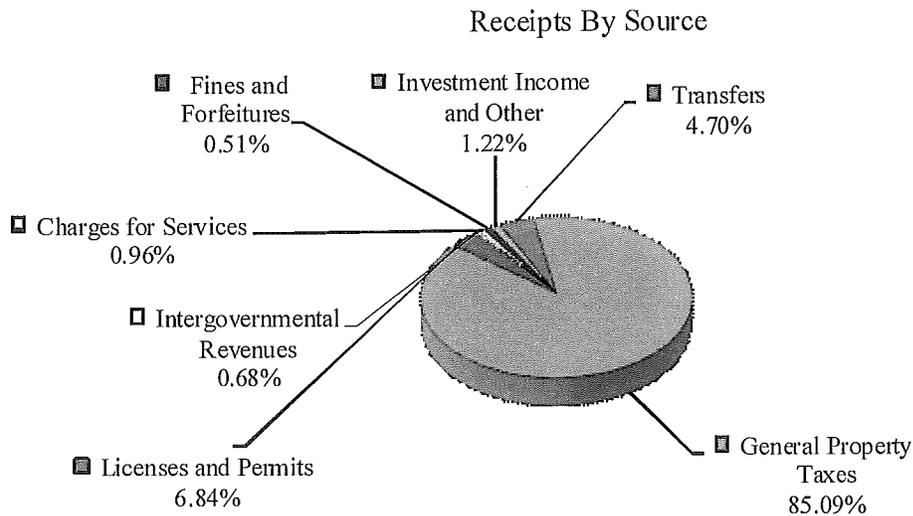
Governmental Funds, continued

As previously stated, the unassigned fund balance of the General Fund was \$647,300 at December 31, 2013. This cash fund balance provides a reserve for financing current year operations until tax revenues are received. It is estimated that the General Fund exhausts most of its cash fund balance by the time tax revenues are received. For instance, tax revenues received in December totaled approximately \$497,000; the majority of this amount is required to sustain operations in the current year until the tax revenues are received in the following July. As a result, the remaining portion of the cash fund balance is designated for working capital purposes. This reserve also serves as a safeguard against future potential revenue shortages or unexpected expenditures, which may occur during the current year.

Council could consider transferring the excess amount over the 50% threshold, or some other similar threshold, to another fund to provide financing or funding of other City projects. These funds can always be transferred back to the General Fund if the need arises. At December 31, 2013 this excess would be approximately \$72,750.

For the year ended December 31, 2013 receipts and transfers totaled \$1,147,893. This total exceeded budget estimates by \$10,726, resulting in a positive variance of slightly less than 1%. The largest factor contributing to this surplus was revenues from permits; for the year permit revenues totaled \$65,710 compared to a budget estimate of \$47,400. However, this revenue source was significantly less than 2012 revenues of \$85,851.

Following is a graph of receipts and transfers by source for the year:

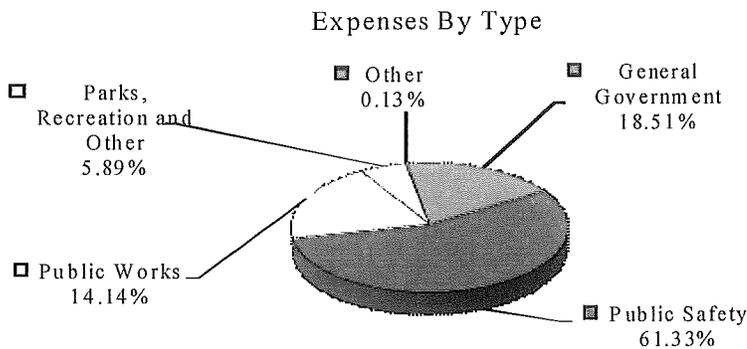


As illustrated by the graph, property taxes are the largest source of receipts of the General Fund; this percentage increased by approximately 2% from the previous year. Revenues from licenses and permits are the second largest source of revenue for the General Fund in 2013, totaling \$78,569 for the year. Transfers from the Liquor and Antenna Funds were \$53,985 compared to \$50,943 in the previous year. With interest rates remaining at historical low levels it is unlikely that the City will be able to transfer significant amounts from the Liquor Fund in future years and still maintain minimum fund balance requirements of the Liquor Fund. Similarly, transfers from the Antenna Fund correlate to the amount of revenues received from lease agreements. If any of these leases are canceled, it may be difficult to transfer the budgeted amounts in future years. Being so heavily reliant on property taxes, it may be very difficult to maintain City services without increasing property taxes in future years.

Governmental Funds, continued

Disbursements for the year totaled \$1,106,584; this total was \$30,583 less than the budgeted amounts, resulting in a positive variance of 2.7%. Positive variances were experienced in each of the City's major functions within the General Fund. The largest expenditure category for the City is public safety, accounting for 61.33% of the total expenditures of the General Fund. The majority of these expenditures are associated with public safety services provided by other organizations of which the City is a member of through joint powers agreements. As a result, the City directly controls only approximately 43% of the total expenditures of the General Fund. Disbursements in 2013 increased by \$3,013 or less than 1% compared to 2012.

Following is a graph of expenses by type:



Special Revenue Funds

During the year these funds had no disbursements; however, transfers of \$60,385 were made from the Special Revenue Funds (Liquor and Antenna) to the General Fund and the Capital Improvement Fund.

The fund balance of the Liquor Fund was \$302,243 at December 31, 2013 and is available for projects at the discretion of the City Council.

The Antenna Fund recognized lease revenues of \$52,528 for the year, which exceeded the amount transferred to the General Fund of \$47,985. The fund balance of the Antenna Fund was \$57,900 at December 31, 2013 and is assigned as an additional reserve for the General Fund. Deferred revenue of \$19,892 is recorded pertaining to lease payments received in advance; these amounts will be recognized as revenue in future years.

The Southshore Center Fund had no activity during the year.

Capital Project Funds

Capital Project Funds are used to account for the financial resources to be utilized for the acquisition or construction of major capital facilities or the acquisition of equipment. In recent years the City has developed and incorporated projections into its planning process to provide for the financing of utility improvements and equipment acquisitions. As a result, much of the activity during the past two years has involved the Utility and Capital Improvement Funds. The Utility Improvement Fund is maintained to finance future improvements to the existing utility system. The Capital Improvement Fund provides the funding required for the acquisition of equipment.

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Capital Project Funds, continued

Cash fund balances and changes in individual Capital Project Funds are summarized in the following table:

	Fund Balance		Increase
	2013	2012	(Decrease)
Utility Improvement	\$ 479,079	\$ 585,833	\$ (106,754)
Capital Improvement	64,058	18,002	46,056
Road Improvement	(49,779)	(58,183)	8,404
Park Improvement	1,632	1,632	-
Seawall Improvement	2,728	2,728	-
	<u>\$ 497,718</u>	<u>\$ 550,012</u>	<u>\$ (52,294)</u>

The decrease in the Utility Improvement Fund is the result of transfers to the Water and Sewer Funds to finance improvements to the existing utility system. During the year, \$236,750 was transferred from this fund to these utility funds to finance current utility improvement projects. The primary source of revenue for this fund is from transfers from the Water and Sewer Funds, which represent the amount of depreciation charged against operations in these funds. In this manner the City is accumulating funds from the operations of these utilities to fund future improvements as the original systems age and need maintenance or replacement.

The increase in the Capital Improvement Fund is the result of expenditures totaling \$80,166 for the year compared to \$141,270 in 2012. Revenues for the year were \$126,222, consisting of property taxes and transfers from other funds. The fund balance of \$46,056 is available to finance capital requirements in future years.

The Road Improvement Fund involved the Woodpecker Ridge Road improvement project. This deficit will be reduced annually as collection of assessments levied against benefited property owners are received; these proceeds are being used to repay the advances from other funds utilized to pay construction costs. The outstanding balance of the advances at December 31, 2013 was \$49,779, which matches the fund balance deficit.

The Park Improvement Fund and the Seawall Improvement Fund had no activity during the year.

Proprietary Funds

Unlike accounting for governmental funds, the accrual basis of accounting is prescribed by the regulatory basis of accounting for proprietary fund types as compared to the cash basis.

Operations of proprietary funds are intended to be self-sustaining. Expenses (including depreciation) of providing goods or services to the public on a continuing basis are financed or recovered through user charges and fees. The accrual basis of accounting is utilized to account for all costs and expenses (including depreciation) of providing services to aid in determining the applicable user rates.

In summary, the financial position of each of the City's proprietary funds remains strong, with the exception of the Recycling Fund. It should be noted that a significant portion of the net position of the Water and Sewer Funds are invested in capital assets of each fund, which are not available to pay operating expenses. Of the net position of these funds, 85% and 58% is invested in capital assets, respectively. One positive note is that the City has no outstanding debt associated with any of its proprietary funds. As a result, the remaining net position of each of the proprietary funds is unrestricted.

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Proprietary Funds

The following chart summarizes the operations of the various proprietary funds maintained by the City.

	<u>Water Fund</u>	<u>Sewer Fund</u>	<u>Garbage Fund</u>	<u>Recycling Fund</u>	<u>Storm Water Fund</u>	<u>Dock Fund</u>
Operating Revenues	\$ 270,043	\$ 367,664	\$ 104,723	\$ 65,397	\$ 20,738	\$ 79,470
Operating Expenses	<u>330,881</u>	<u>314,012</u>	<u>84,226</u>	<u>87,678</u>	<u>17,420</u>	<u>19,951</u>
Operating Income (Loss)	(60,838)	53,652	20,497	(22,281)	3,318	59,519
Other Revenues	<u>4,572</u>	<u>52,282</u>	<u>213</u>	<u>-</u>	<u>2,665</u>	<u>1,063</u>
Income (Loss)	(56,266)	105,934	20,710	(22,281)	5,983	60,582
Transfers In (Out)	<u>(33,342)</u>	<u>149,799</u>				<u>(48,266)</u>
Net Income (Loss)	<u>\$ (89,608)</u>	<u>\$ 255,733</u>	<u>\$ 20,710</u>	<u>\$ (22,281)</u>	<u>\$ 5,983</u>	<u>\$ 12,316</u>
Net Position at December 31, 2013	<u>\$1,125,891</u>	<u>\$1,077,537</u>	<u>\$ 111,498</u>	<u>\$ 8,644</u>	<u>\$ 124,139</u>	<u>\$ 255,321</u>
Net Income (Loss) - 2012	<u>\$ 38,769</u>	<u>\$ (143,276)</u>	<u>\$ 13,241</u>	<u>\$ (18,530)</u>	<u>\$ 12,014</u>	<u>\$ 12,296</u>

As illustrated in the chart above, the Water Fund incurred a loss from operations (before transfers) of \$56,266 for the year compared to income of \$29,161 in the previous year. One of the main reasons for this decline in operations is the significant amount of expenses incurred in 2013 pertaining to water main breaks and subsequent repairs. In addition, operating revenues of the Water Fund decreased by approximately \$33,000. The Sewer Fund reported net income of \$105,934 compared to income of \$24,749 in the previous year. Two reasons for this increase in net income are: 1) a decrease in treatment charges of \$40,000 compared to 2012, and 2) grant proceeds of \$48,518 utilized for a sewer improvement project recognized as revenue. Operating revenues of the Sewer Fund remained similar to the previous year. Included in operating expenses of the Water and Sewer Funds are depreciation charges of \$67,592 and \$52,701, respectively. These amounts are subsequently transferred to the Utility Improvement Fund to provide resources to finance future improvement projects. During the year the Sewer Fund expended \$241,485 for various improvement projects, which were funded from transfers from the Utility Improvement Fund.

Operations of the Garbage and Storm Water funds were consistent with prior year's operations, as each of these funds reflected net income from operations. The net position of each of these funds at December 31, 2013 is sufficient to maintain operations in 2014. Operations of the Recycling Fund have sustained increasing losses for each of the past three years. As a result, the net position balance of this fund has declined to be only \$8,644 at December 31, 2013. If losses in this fund continue the fund will require other revenues, such as transfers, to supplement its operations. Net position balances of these funds are being maintained to provide a measure of security against increasing operating costs of future operations.

Net income (before transfers) of the Dock Fund was \$60,582 in 2013 compared to \$61,870 in 2012. Operating revenues and expenses were similar for both years. Transfers of \$48,266 and \$49,574 were made to the Capital Improvement Fund in 2013 and 2012, respectively.

Operating budgets are prepared for each of the proprietary funds. Typically after adjusting for improvement projects capitalized and related transfers, operations of these funds compare favorably with budget estimates.

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This report is intended solely for the use of the City Council and management of City of Tonka Bay and is not intended to be and should not be used by anyone other than these specified parties. If the Council wishes, I would be pleased to meet and discuss any of the observations, comments, or other matters pertaining to the audit with the City Council or management at your convenience.

I wish to express my appreciation for the courtesies and cooperation extended by City personnel during the audit and the opportunity to be of service to City of Tonka Bay. I look forward to continuing working with you in the future.

A handwritten signature in cursive script that reads "Stuart J. Bonniwell". The signature is written in black ink and is positioned above the printed name and title.

Stuart J. Bonniwell
Certified Public Accountant