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April 30, 2015

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, 2014. My report, dated April 30, 2015, 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. This basis of accounting is a comprehensive basis of accounting other than accounting principles generally accepted. 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 accounting principles generally accepted.

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.

Financial Condition

The overall financial condition of the City continues to remain strong. Overall the fund balances of the City's governmental funds increased by \$174,729. The General Fund, the primary operating fund of the City, realized a surplus of \$54,071 for the year. Another significant increase was in the Capital Project Funds; combined fund balances of the Utility and Capital Improvement funds increased by over \$101,300. In the case of the both of these funds, transfers from the proprietary funds contributed to the surplus reported. These transfers resulted in a decrease in the net position of the proprietary funds of \$105,460 for the year ended December 31, 2014. Adjusting for these transfers, operations of the proprietary funds would have resulted in a surplus for the year.

Following are brief comments regarding operations of the governmental and proprietary funds.

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Governmental Funds

The overall financial condition of the City's governmental funds continues to be strong. Cash fund balances of the individual fund types and changes in fund balance of the governmental funds for the year ended December 31, 2014 are summarized in the following chart.

	Fund Balance		Increase (Decrease)	2013 Change
	2014	2013		
General Fund	\$ 723,914	\$ 669,843	\$ 54,071	\$ 41,309
Special Revenue Funds	374,924	363,977	10,947	(2,472)
Capital Project Funds	607,429	497,718	109,711	(52,294)
	<u>\$ 1,706,267</u>	<u>\$ 1,531,538</u>	<u>\$ 174,729</u>	<u>\$ (13,457)</u>

As illustrated in the chart, the combined cash fund balances of the governmental funds totaled \$1,706,267 as of December 31, 2014, an increase of \$174,729 or 11.40% from the previous year. Revenues and transfers of \$1,495,211 exceeded expenditures and transfers of \$1,320,482 resulting in the net increase for the year. Revenues in 2014 were \$40,768 higher than the previous year; revenue from franchise fees and insurance reimbursements accounting for the majority of the increase. In addition, during the year transfers from other funds were less than the previous year by \$19,565. Total expenditures of governmental funds increased by \$77,667 or 6.53%. Capital expenditures totaling \$87,034 were more than the previous year by \$75,665 which accounts for the increase in expenditures. A portion of this increase is attributed to a change in accounting for utility improvement projects; previously these projects were accounted for in the respective utility funds but beginning in 2014 these costs are reflected in the Utility Improvement Fund. Expenses of \$46,337 were incurred during the year related to utility improvement projects. Transfers to other funds decreased by \$244,650 due to this change in accounting policy.

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 and future improvement 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, receipts of the General Fund exceeded disbursements by \$1,586 and combined with transfers from other funds of \$52,485, resulted in a surplus of \$54,071 for the year. The surplus increased the fund balance to \$723,914 at December 31, 2014, an increase of 8.1%. Over the past five years the fund balance has increased approximately \$220,600 or 44%. Current Council members should be commended for continuing this trend.

Of the fund balance, \$700,384 or 96.75% 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 60.9% of budgeted expenditures for 2015 compared to ratios of 56.3%, 53.2% and 46.5% for the previous three years, respectively. This relationship is an indication of the financial strength of the General Fund.

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Governmental Funds, continued

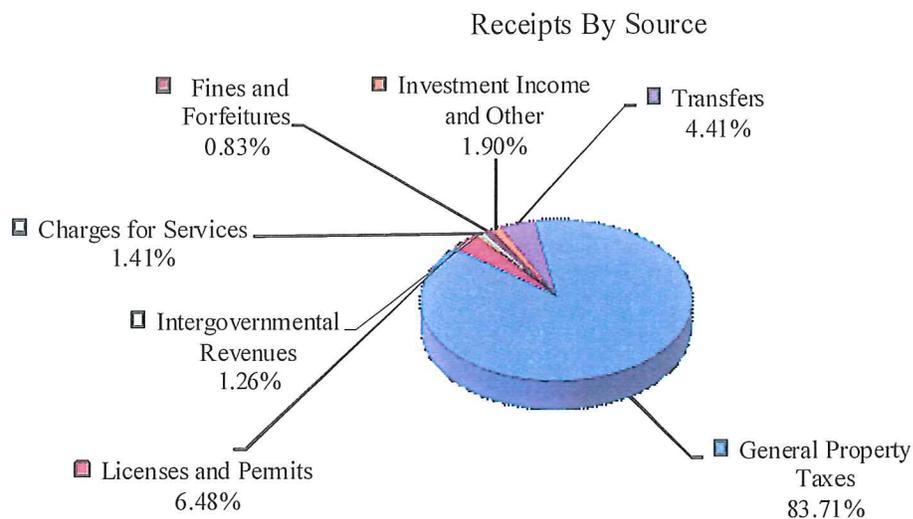
The State Auditor recommends cities maintain an unreserved fund balance in the General Fund of approximately 35% to 40% of operating expenditures. In the City's situation, my recommendation would be to maintain a fund balance reserve of approximately 50% due to the City's heavy reliance on property tax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

One recommendation would be for the Council to set an unreserved fund balance policy for the General Fund of 50% of current year budgeted amounts. Council could then 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 such a situation arises. At December 31, 2014 this excess would be approximately \$125,000.

As previously stated, the unassigned fund balance of the General Fund was \$700,384 at December 31, 2014. 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 \$496,000; 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.

For the year ended December 31, 2014 receipts and transfers totaled \$1,189,869. This total exceeded budget estimates by \$40,784, resulting in a positive variance of 3.6%. The largest factors contributing to this surplus was revenues from franchise fees (new in 2014) and insurance reimbursements.

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



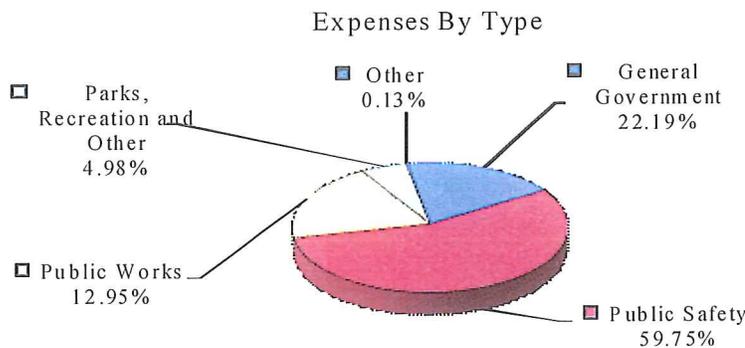
As illustrated by the graph, property taxes are the largest source of receipts of the General Fund; this percentage decreased by approximately 1.3% from the previous year. Revenues from licenses and permits are the second largest source of revenue for the General Fund in 2014, totaling \$77,066 for the year. Transfers from the Liquor and Antenna Funds were \$52,485 compared to \$53,985 in the previous year. Being so heavily reliant on property taxes, may make it very difficult to maintain City services without increasing property taxes in future years.

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Governmental Funds, continued

Disbursements for the year totaled \$1,135,798; this total was \$13,287 less than the budgeted amounts, resulting in a positive variance of 1.2%. Positive variances were experienced in each of the City's major functions within the General Fund, except for general government where capital outlay expenditures exceeded budget estimates. The largest expenditure category for the City is public safety, accounting for 59.75% 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 44% of the total expenditures of the General Fund. Disbursements in 2014 increased by \$30,602 or approximately 2.8% compared to 2013 expenditures.

Following is a graph of expenses by type:



Special Revenue Funds

During the year these funds had no disbursements; however, transfers of \$52,485 were made from the Special Revenue Funds (Liquor and Antenna) to the General Fund.

The fund balance of the Liquor Fund was \$302,829 at December 31, 2014 and is available for projects at the discretion of the City Council.

The Antenna Fund recognized lease revenues of \$54,960 for the year, which exceeded the amount transferred to the General Fund by \$6,975. The fund balance of the Antenna Fund was \$64,875 at December 31, 2014 and is assigned as an additional reserve for the General Fund. Deferred revenue of \$19,961 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.

The PEG Fund, new in 2014, received \$3,386 of franchise fees 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 capital improvement projections into its planning process to provide for the financing of utility improvements and equipment acquisitions.

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Governmental Funds, continued

As a result, much of the activity during the past several 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.

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

	Fund Balance		Increase (Decrease)
	2014	2013	
Utility Improvement	\$ 552,997	\$ 479,079	\$ 73,918
Capital Improvement	91,511	64,058	27,453
Road Improvement	(41,439)	(49,779)	8,340
Park Improvement	1,632	1,632	-
Seawall Improvement	2,728	2,728	-
	<u>\$ 607,429</u>	<u>\$ 497,718</u>	<u>\$ 109,711</u>

The increase in the Utility Improvement Fund is the result of transfers from the Water and Sewer Funds to finance improvements to the existing utility system. During the year, \$106,894 was transferred to this fund from these utility funds to finance current and future 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. It should be noted that one significant cost related to an improvement project was not paid in 2014.

The increase in the fund balance of the Capital Improvement Fund is the result of revenues and transfers exceeding expenditures by 427,453 for the year. Revenues and transfers for the year were \$110,231, consisting of property taxes and transfers from other funds. The fund balance of \$91,511 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, 2014 was \$41,439, which matches the fund balance deficit. Based on cash flow estimates this fund may need a transfer in future years to fully retire the outstanding balance of the advances due to prepayments of special assessments received.

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.

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Proprietary Funds, continued

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, 88.7% and 52.0% 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.

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

	Water Fund	Sewer Fund	Garbage Fund	Recycling Fund	Storm Water Fund	Dock Fund
Operating Revenues	\$ 231,965	\$ 370,578	\$ 111,918	\$ 69,587	\$ 20,678	\$ 88,540
Operating Expenses	298,366	328,678	89,567	90,202	49,493	27,207
Operating Income (Loss)	(66,401)	41,900	22,351	(20,615)	(28,815)	61,333
Other Revenues	1,390	3,111	155	-	36,224	801
Income (Loss)	(65,011)	45,011	22,506	(20,615)	7,409	62,134
Transfers Out	(66,894)	(40,000)				(50,000)
 Net Income (Loss)	 <u>\$ (131,905)</u>	 <u>\$ 5,011</u>	 <u>\$ 22,506</u>	 <u>\$ (20,615)</u>	 <u>\$ 7,409</u>	 <u>\$ 12,134</u>
 Net Position at December 31, 2014	 <u>\$1,010,603</u>	 <u>\$1,082,548</u>	 <u>\$ 134,004</u>	 <u>\$ (11,971)</u>	 <u>\$ 131,548</u>	 <u>\$ 267,455</u>
 Net Income (Loss) - 2013	 <u>\$ (89,608)</u>	 <u>\$ 255,733</u>	 <u>\$ 20,710</u>	 <u>\$ (22,281)</u>	 <u>\$ 5,983</u>	 <u>\$ 12,316</u>

As illustrated in the chart above, the Water Fund incurred a loss from operations (before transfers) of \$65,011 for the year compared to a loss of \$56,266 in the previous year. One of the main reasons for the decline in operations is that operating revenues of the Water Fund decreased by approximately \$38,000. The Sewer Fund reported net income of \$45,011 compared to income of \$105,934 in the previous year. The primary reason for this decrease is that in 2013 grant proceeds of \$48,518 utilized for a sewer improvement project were recognized as revenue. Operating revenues and expenses of the Sewer Fund remained similar to the previous year. Included in operating expenses of the Water and Sewer Funds are depreciation charges of \$69,390 and \$60,473, respectively. In addition, amounts are transferred to the Utility Improvement Fund to provide resources to finance future improvement projects; amounts transferred in 2014 totaled \$106,894.

Operations of the Garbage Fund were consistent with prior year's operations and reflected net income from operations. The Recycling Fund sustained a loss from operations of \$20,615. Losses in each of the past four years have resulted in a deficit net position of \$11,971 at December 31, 2014 for this fund. If losses in this fund continue the fund will require other revenues, such as transfers, to supplement its operations. Expenses of the Storm Water Fund increased significantly in 2014 due to clean up expenses incurred. These expenses were offset by reimbursements resulting in a net income from operations similar to the prior year.

Net position balances of these funds, with the exception of the Recycling Fund, are being maintained to provide a measure of security against increasing operating costs of future operations.

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Proprietary Funds, continued

Net income (before transfers) of the Dock Fund was \$62,134 in 2014 compared to \$60,582 in 2013. Operating revenues and expenses were similar for both years. Transfers of \$50,000 and \$48,266 were made to the Capital Improvement Fund in 2014 and 2013, 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.



Stuart J. Bonniwell
Certified Public Accountant