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April 22, 2013

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

This letter has been 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, 2012. My report, dated April 22, 2013, 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 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.

Financial Summary

The overall financial position of the City, prepared on the regulatory basis of accounting, continues to be strong. However, significant changes occurred within the two broad fund categories.

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 services to the general public, which are financed primarily through user charges, such as utility operations.

Combined fund balance of governmental funds and net assets of proprietary funds at December 31, 2012 and 2011 are:

	Balances		Net
	2012	2011	Change
Governmental Funds	\$ 1,544,995	\$ 1,288,706	\$ 256,289
Proprietary Funds	2,520,177	2,605,663	(85,486)
	<u>\$ 4,065,172</u>	<u>\$ 3,894,369</u>	<u>\$ 170,803</u>

As summarized above, the overall financial position of the City improved compared to the prior year. One of the items impacting the change between fund categories is the special \$200,000 transfer made during the year from the Sewer Fund (a proprietary fund) to the Utility Improvement Fund (a governmental fund). Adjusting for the transfer would reduce the change in governmental funds to \$56,289, which resulted primarily from favorable operations of the General Fund for the year. Similarly, the adjustment would have resulted in a surplus from operations of the proprietary fund.

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Financial Summary, continued

Governmental Funds

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 to account for activities of the City's governmental funds, consisting of the General, Special Revenue and Capital Project Funds.

Fund balances of the individual fund types and changes in fund balance of the governmental funds for the year ended December 31, 2012 are summarized in the following chart.

	Fund Balance		Increase (Decrease)	2011 Change
	2012	2011		
General Fund	\$ 628,534	\$ 549,550	\$ 78,984	\$ 17,268
Special Revenue Funds	366,449	364,229	2,220	7,215
Capital Project Funds	550,012	374,927	175,085	(121,216)
	<u>\$ 1,544,995</u>	<u>\$ 1,288,706</u>	<u>\$ 256,289</u>	<u>\$ (96,733)</u>

As illustrated in the chart, the combined fund balances of the governmental funds totaled \$1,544,995 as of December 31, 2012, an increase of \$256,289 or approximately 19.9% from the previous year. Revenues and transfers of \$1,718,504 were offset by expenditures and transfers of \$1,462,295 resulting in the net increase. Revenues in 2012 were \$59,561 higher than the previous year, most notably licenses and permits. In addition, during the year transfers of \$370,176 were made from the proprietary funds to the governmental funds. Total expenditures decreased slightly for the year. Included in expenditures were major equipment acquisitions of \$77,001 and included among transfers to other funds was \$162,185 for utility improvement projects. The City had budgeted for these expenditures and transfers by accumulating and/or setting aside sufficient resources over the prior years to fund these acquisitions.

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 \$28,041 and combined with transfers from other funds resulted in a surplus of \$78,984 for the year. The surplus increased the fund balance to \$628,534 at December 31, 2012, which represents an increase of 14.4%. Of the fund balance, \$605,004 or 96.25% is unassigned and available to finance current year operations until tax revenues are received. The remaining portion of the fund balance is nonspendable (prepaid items) and assigned as a reserve for accumulated employee compensated absences. This unassigned fund balance represents 53.2% of budgeted expenditures for 2013 compared to a ratio of 46.5% in 2012. This relationship is an indication of the financial strength of the General Fund.

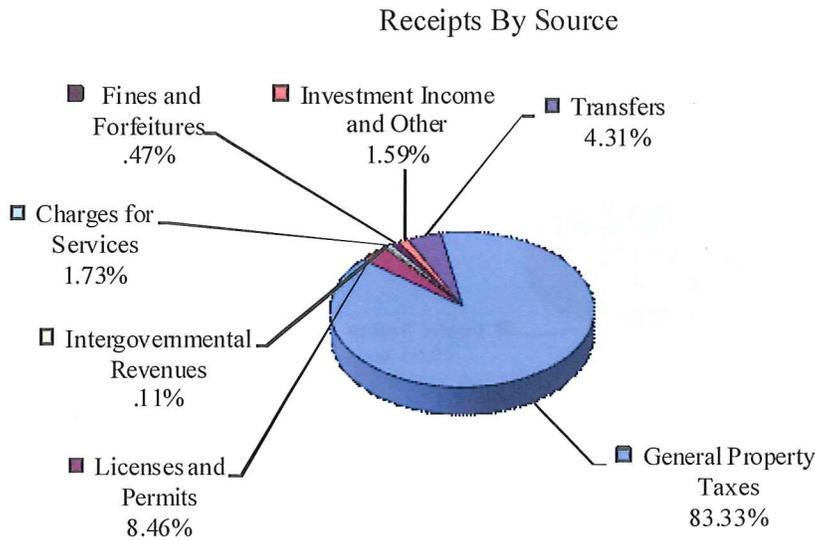
As previously stated, the unassigned fund balance of the General Fund was \$605,004 at December 31, 2012. This fund balance provides a reserve for financing of current year operations until tax revenues are received. It is estimated that the General Fund exhausts most of its cash balance by the time tax revenues are received. For instance, tax revenues received in December totaled approximately \$480,000; the majority of this amount is required to sustain operations in the current year until the first tax revenues are received. As a result, the remaining portion of the 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.

Financial Summary, 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 case, I would recommend a fund balance reserve of 50% due to the City's heavy reliance on property tax revenues as its primary source of revenues for the General Fund. As indicated by these percentages, the City of Tonka Bay satisfies this recommendation and should be commended for maintaining this unreserved balance

For the year ended December 31, 2012 receipts and transfers totaled \$1,182,555. This total exceeded budget estimates by \$48,425, resulting in a positive variance of 4.3%. The largest factor contributing to this surplus was revenues from permits; for the year permit revenues totaled \$85,851 compared to a budget estimate of \$41,000, the total for 2011 was \$31,960. In addition, increased revenues from insurance dividends contributed to this positive variance.

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 5% from the previous year. One reason for the change in percentages was that in 2012 the City reallocated a portion of its certified levy (approximately \$61,500) to the Capital Improvement Fund. The current year's tax collection percentage was 98.1% compared to 2011's percentage of 98.4%.

Revenues from licenses and permits replaced transfers as the second largest source of revenue for the General Fund in 2012, totaling \$99,990 for the year. Transfers from the Liquor and Antenna Funds were \$50,943 for the 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.

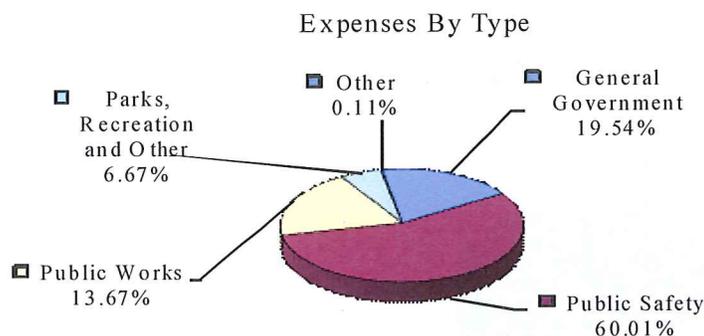
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Financial Summary, continued

Disbursements for the year totaled \$1,103,571; this total was \$30,559 less than the budget 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, except for a slight negative variance in parks and recreation. The largest expenditure category for the City is public safety, accounting for 60.01% of the total General Fund expenditures. 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 46% of the total expenditures of the General Fund.

Disbursements in 2012 decreased by \$65,036 or 5.5% compared to 2011. The decrease can be attributed to a portion of the public works disbursements for street maintenance (\$80,000) being transferred to the Capital Improvement Fund.

Following is a graph of expenses by type:



Special Revenue Funds

During the year these funds had no disbursements; however, transfers of \$50,943 were made from the Special Revenue Funds (Liquor and Antenna) to the General Fund.

As previously noted, the transfer from the Liquor Fund was limited to maintain the minimum fund balance requirement set by previous Council action. The fund balance of the Liquor Fund was \$309,258 at December 31, 2012 and is available for projects at the discretion of the City Council.

The Antenna Fund recognized lease revenues of \$50,205 for the year, which exceeded the amount transferred to the General Fund of \$47,985. The fund balance of the Antenna Fund was \$53,357 at December 31, 2012 and is assigned as an additional reserve for the General Fund. Deferred revenue of \$19,826 is recorded pertaining to existing lease agreements; these amounts will be recognized as revenue in future years.

The Southshore Center Fund had no activity during the year.

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Financial Summary, continued

Capital Project Funds

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

	Fund Balance		Increase (Decrease)
	2012	2011	
Utility Improvement	\$ 585,833	\$ 427,484	\$ 158,349
Capital Improvement	18,002	17,271	731
Road Improvement	(58,183)	(74,188)	16,005
Park Improvement	1,632	1,632	-
Seawall Improvement	2,728	2,728	-
	<u>\$ 550,012</u>	<u>\$ 374,927</u>	<u>\$ 175,085</u>

The increase in the Utility Improvement Fund is the result of transfers from the Water and Sewer Funds to maintain a reserve necessary to finance future improvements to the existing utility system. Transfers to the Utility Improvement Fund from the Water and Sewer Funds represent the amount of depreciation charged against operations in these funds. In addition, a special \$200,000 transfer from the Sewer Fund was made during the year. During the year, \$162,185 was transferred from this fund to these utility funds to finance current utility improvement projects.

Expenditures in the Capital Improvement Fund totaled \$141,270 for the year. As previously noted, costs of street maintenance projects were transferred to this fund in 2012 and accounted for \$64,269 of the total expenditures. The remaining balance of expenditures was for capital outlay acquisitions. The primary source of revenues was from property taxes, in addition to transfers from other funds. The fund balance of this fund was \$18,002 at December 31, 2012 is available to finance capital outlay requirements in the current year.

The Road Improvement Fund involves the Woodpecker Ridge Road improvement project. The fund balance (deficit) is from construction costs incurred related to this project. This deficit will be reduced annually as collection of assessments levied against benefited property owners are received; these proceeds will be used to repay the advances from other funds utilized to pay construction costs. The outstanding balance of the advances at December 31, 2012 was \$58,183, 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 determine the applicable user rates.

Financial Summary, continued

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	\$ 303,186	\$ 365,923	\$ 99,785	\$ 62,394	\$ 20,668	\$ 79,730
Operating Expenses	278,020	342,984	86,632	80,996	11,163	18,302
Operating Income (Loss)	25,166	22,939	13,153	(18,602)	9,505	61,428
Other Revenues	3,995	1,810	88	72	2,509	442
Income (Loss)	29,161	24,749	13,241	(18,530)	12,014	61,870
Transfers In (Out)	9,608	(168,025)				(49,574)
Net Income (Loss)	<u>\$ 38,769</u>	<u>\$ (143,276)</u>	<u>\$ 13,241</u>	<u>\$ (18,530)</u>	<u>\$ 12,014</u>	<u>\$ 12,296</u>
Net Assets at December 31, 2012	<u>\$1,215,499</u>	<u>\$ 82,184</u>	<u>\$ 90,788</u>	<u>\$ 30,925</u>	<u>\$ 118,156</u>	<u>\$ 243,005</u>
Net Income (Loss) - 2011	<u>\$ 83,987</u>	<u>\$ 23,911</u>	<u>\$ 7,007</u>	<u>\$ (10,916)</u>	<u>\$ 14,077</u>	<u>\$ 19,633</u>

In summary, the financial position of the City's proprietary funds remains strong. It should be noted that a significant portion of the net assets 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 assets of these funds, 83% and 53% is invested in capital assets, respectively. One positive note is that there is no outstanding debt associated with any of the City's proprietary funds. As a result, the net assets of each of the proprietary funds is unrestricted.

As illustrated in the chart above, the Water Fund had income from operations (before transfers) of \$29,161 for the year compared to a loss of \$26,682 in the previous year. The Sewer Fund reported net income of \$24,749 compared to income of \$32,372 in the previous year. Operating revenues of the Water Fund increased considerably whereas the Sewer Fund remained similar to the previous year. Operating expenses of the Water Fund decreased slightly and expenses of the Sewer Fund increased slightly. The largest operating expense of the Sewer Fund is treatment charges, which increased by \$17,000 in 2012. Included in operating expenses of the Water and Sewer Funds is depreciation charges of \$66,577 and \$43,025, respectively.

During the year these utility funds expended \$52,726 and \$98,700, respectively, for system improvements and equipment acquisitions. These capital expenditures were funded primarily by transfers from the Utility Improvement Fund. Continuing with the practice commenced in prior years, these two funds transferred the amount of depreciation charges to the Utility Improvement Fund to provide necessary funds to finance future system improvements.

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 Recycling Fund sustained a minor loss for the year similar to the prior year. Net assets of these funds at December 31, 2012 are sufficient to maintain operations in 2013. Net assets from 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 \$61,870 in 2012 compared to \$37,986 in 2011. The increase in net income is attributed to a reduction in operating expenses due to the dredging costs being postponed in 2012. Transfers of \$49,574 were to the Capital Improvement Fund.

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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