CITY OF BAYPORT
BAYPORT, MINNESOTA

MANAGEMENT LETTER

YEAR ENDED
DECEMBER 31, 2009

ABDO
EICK &
MEYERS LLP
Certified Public Accountants & Consultants

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5201 Eden Avenue
Suite 370
Edina, MN 55436

April 19, 2010

Management, Honorable Mayor and Council
City of Bayport, Minnesota

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information the City of Bayport, Minnesota (the City), as of and for the year ended December 31, 2009 and have issued our report thereon dated April 19, 2010. 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

As stated in our engagement letter, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement and are fairly presented in accordance with accounting principles generally accepted in the United States of America. Because an audit is designed to provide reasonable, but not absolute, assurance and because we did not perform a detailed examination of all transactions, there is a risk that material errors, fraud or illegal acts may exist and not be detected by us.

Our responsibility is to plan and perform the 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 over financial reporting 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.

Significant Audit Findings

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all such deficiencies have been identified. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control over financial reporting 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. We consider the deficiencies described in the following pages as findings 2009-3, 2009-4 and 2009-5 to be material weaknesses in internal control over financial reporting.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the following pages as findings 2009-1 and 2009-2 to be significant deficiencies in internal control over financial reporting.

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2009-1: Limited Segregation of Duties (finding since 2007)

Condition: During our audit, we found that the City has a limited segregation of duties related to many aspects of its accounting systems.

Criteria: There are four general categories of duties: authorization, custody, record keeping and reconciliation. In an ideal system, different employees perform each of these four major functions. In other words, no one person has control of two or more of these responsibilities.

Cause: Specific situations include: cash receipts, cash disbursements, payroll and utility billing. The Finance Officer has responsibility over all areas of authorization, custody of assets, recording and reconciling activity. While there is some review of transactions by the Council and City Administrator, there is more than a remote likelihood that a misstatement of the City's financial statements that is more that inconsequential could go undetected.

Effect: The effectiveness of the internal control system relies on enforcement by management. The effect of deficiencies in segregation of duties and internal controls can result in undetected errors or misappropriation of assets of the City.

Recommendation: Under these circumstances the most effective controls lie in 1) managements knowledge of the City's financial operations and 2) striving to obtain as much segregation of duties as possible so that no one person has complete control of any type of financial transaction. We recommend the City evaluate its controls and make any changes considered necessary. 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 and other considerations. The following are some general ideas to help remedy this deficiency:

- Claims approval is an important control and should be at the front of the meeting to ensure that council reviews the claims closely.
- A thorough review of budget versus actual reporting and narrative at least quarterly.
- Monitor progress over the development of documented policies and procedures.
- The check sequence should be reported in each set of approved minutes. The council should review the order the checks approved to ensure that they move in sequence and any gaps in number are explained.
- Consider personnel policies that require someone else to fill finance duties for a period of time. A mandatory vacation period of one week for all finance staff and distribution of their duties for that week is often recommended

Management Response: There is no disagreement with the audit finding. The City reviews and makes improvements to its internal control structure on an ongoing basis and attempts to maximize the segregation of duties in all areas with the limits of the staff available. However, the City does not consider it cost beneficial at this time to increase the size of its staff in order to further segregate accounting functions.

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2009-2: Preparation of Financial Statements (finding since 2007)

Condition:	We were requested to draft the audited financial statements and related footnote disclosures as part of our regular audit services. Recent auditing standards require auditors to communicate this situation to the Council as an internal control deficiency. Ultimately, it is management's responsibility to provide for the preparation of your statements and footnotes, and the responsibility of the auditor to determine the fairness of presentation of those statements. From a practical standpoint we do both for you at the same time in connection with our audit. This is not unusual for us to do with organizations of your size. However, based on recent auditing standards, it is our responsibility to inform you that this deficiency could result in a material misstatement to the financial statements that could have been prevented or detected by your management. Essentially, the auditors cannot be part of your internal control process.
Criteria:	Internal controls should be in place to provide reasonable assurance over financial reporting.
Cause:	From a practical standpoint we do both for you at the same time in connection with our audit. This is not unusual for us to do with organization of your size.
Effect:	The effectiveness of the internal control system relies on enforcement by management. The effect of deficiencies in internal controls can result in undetected errors in financial reporting.
Recommendation:	It is your responsibility to make the ultimate decision to accept this degree of risk associated with this condition because of cost or other considerations. As in prior years, we have instructed management to review a draft of the auditor prepared financials in detail for their accuracy; we have answered any questions they might have, and have encouraged research of any accounting guidance in connection with the adequacy and appropriateness of classification of disclosure in your statements. We are satisfied that the appropriate steps have been taken to provide you with the completed financial statements. While the City is reviewing the financial statements we recommend a disclosure checklist is utilized to ensure all required disclosures are presented and the City should agree its financial software to the numbers reported in the financial statements.
Management Response:	For now, the City accepts the degree of risk associated with this deficiency and thoroughly reviews a draft of the financial statements.

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2009-3: Maintenance of Accounting System (finding since 2008)

Condition:	During our audit, it was evident that the City has not developed or practiced appropriate financial reconciliation processes and procedures. All balance sheet accounts should be reconciled on a monthly basis including cash, investments, utility receivable, payroll withholding accounts, and accounts payable. Some specifics follow: When reviewing payroll withholding accounts, we noted large balances in some accounts. Upon further review, we noted that the City had not been properly expensing the correct amount for healthcare expenses each pay period. The City should be reviewing the set up for the payroll software each time rate change goes into effect to ensure the proper amount is expensed each period.
Criteria:	Internal financial information is vital to effective operations of the City and the financial statements are the responsibility of management.
Cause:	Unknown.
Effect:	The financial information was not accurate throughout the year and many adjustments were required at year-end.
Recommendation:	We recommend the City establish monthly reconciliation procedures to ensure accurate financial reporting throughout the year.
Management Response:	The City will be creating a checklist and a procedure process to verify the monthly reconciliation of accounts.

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2009-4: Material Errors (finding since 2008)

Condition: During our audit, we noted a number of errors involved with transactions for payroll and sales tax.

We discovered multiple errors relating to payroll as follows:

- There are employees with incorrect Medicare and Social Security wages reported on their W-2's. During 2009, an employee retired and was paid out his sick and vacation balances; however, the City did not withhold taxes on this payment. Also, due to Medicare and Social Security wages being calculated incorrectly, the City has not been paying the correct amount of FICA taxes.

Nonresidential water use is applicable to sales tax as well as some general sales. When testing sales tax payable, we noted that quarterly sales tax is being calculated incorrectly. We believe that the City has not been paying enough sales tax each quarter.

Criteria: Internal financial information is vital to effective operations of the City. Accurate and reliable information is also necessary for outside parties as well. The City is required to submit reports and many times submit payment for payroll and sales taxes.

Cause: Unknown.

Effect: There are errors relating to utility billing and sales tax payable.

Recommendation: We recommend the City review and correct the errors noted and implement procedures to ensure accuracy in the future.

Management Response: Staff has been working with the auditor to correct the payroll errors and has elicited the assistance with the City's health insurance consultant to help ensure the W-2's are being reported accurately. The City has already made some corrections on certain individual employees who receive certain withholdings.

City staff has also has been working with Banyon, the City's utility fund accounting system, to identify the issues surrounding why there are errors in the reporting of the quarterly sales tax.

2009-5: Material Audit Adjustments (finding since 2007)

Condition:	During our audit, many audit adjustments were needed to correct coding, reclassifying transactions to the appropriate funds, and adjust accounts to the appropriate year-end balances. A prior period adjustment was made to record prior year activity in the correct fund and to record a capital asset.
Criteria:	The financial statements are the responsibility of the City's management.
Cause:	The City has not prepared a year end trial balance reflecting all necessary accounting entries.
Effect:	This indicates that it would be likely that a material misstatement may occur and not be detected by the City's system of internal control over financial reporting. The audit firm cannot serve as a compensating control over this deficiency.
Recommendation:	We recommend that management review each journal entry, obtain an understanding of why the entry was necessary and modify current procedures to ensure that future corrections are not needed.
Management Response:	Staff will continue to work with the auditor to modify the current procedures to ensure future corrections are not needed.

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Compliance

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of compliance with certain provisions of Minnesota statutes. However, the objective of our tests was not to provide an opinion on compliance with such provisions. We noted the following instance of noncompliance with Minnesota statutes as follows:

2009-6 Minnesota Legal Compliance Finding

Condition: During 2009, an employee's forfeited "flex plan" funds was used to pay for a retirement party. Also, private donations were received by the City for a park bench in honor of the former administrator and were never formally accepted by resolution.

Criteria: Based upon a letter received from the Attorney at the Office of the State Auditor dated March 30, 2010:

- The City had no authority to use forfeited medical "flex plan" funds to pay for a retirement party.
- The City had no authority to expend public funds for the retirement party held for the former City Administrator, and independent contractor.
- The City failed to adopt a resolution for donation received by the City.

Cause: Unknown

Effect: The City is out of compliance with Minnesota statute.

Recommendation: We recommend the City follow the Office of the State Auditor's recommendations to comply with Minnesota law and to adopt resolutions when accepting donations.

Management Response: The City of Bayport will adopt a policy on the use of tax payer funds for city events.

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Summary of Prior Year Findings

2008-6 Out of State Travel Policy

Condition:	During our audit, we noted that the City had not developed or approved an out of state travel policy.
Criteria:	Minnesota statute §471.661 requires that the City develop a policy that controls travel outside the state of Minnesota for elected officials of the City. The policy needs to be approved by a recorded vote, and should include: 1) when travel outside the state is appropriate; 2) applicable expense limits; and 3) procedures for approval of the travel. The policy must be made available for public inspection and should be reviewed annually.
Current Year Status:	The City Council approved a policy as outlined in Minnesota statute §471.661 at the April 6, 2009 meeting and the finding has been eliminated.

Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing.

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the financial statements. As discussed in Note 5 to the basic financial statements, the City adopted Governmental Accounting Standards board (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* for the year ended December 31, 2009. We noted no transactions entered into by the governmental unit during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

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 estimate affecting the financial statements was capital asset basis and depreciation.

Management's estimate of these accounting estimates is based on estimated or actual historical cost and the estimated useful lives of capital assets. We evaluated the key factors and assumptions used to develop these accounting estimates in determining that it is reasonable in relation to the financial statements taken as a whole.

The disclosures in the financial statements are neutral, consistent, and clear. Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users.

Difficulties Encountered in Performing the Audit

We encountered no significant 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 corrected all such misstatements. We proposed 11 journal entries that we consider to be audit entries or corrections of management decisions. They related to the following situations:

- A material audit entry was necessary to record accruals for grant monies received in 2010 that were reimbursing the City for 2009 expenditures.
- Management recorded an inappropriate accounts payable transaction, which resulted in an immaterial audit adjustment to remove the accrual.
- During the year, when insurance premiums were expensed, they were not allocated between workers compensation and general liability expenses. An immaterial audit entry was required to allocate insurance expenses to the appropriate expense account.
- A number of audit entries, including a material entry, were required to reverse accruals, record accruals and to reclassify tax and assessment activity.
- An immaterial audit entry was required to adjust payroll withholding accounts to their appropriate year-end balance.
- Interfund transfers are required to be reported as a separate line-item within the financial statements. An immaterial audit entry was required to reclassify transfers out of accounts that included other activity; as well as to record a budgeted transfer that was not originally recorded by management.
- During the year, management was coding City activity into an Agency fund. A material audit entry was required to reclassify City activity from the Agency fund into a capital project fund.
- A material audit entry was required for a prior period adjustment, which reclassified prior year activity and recorded a capital asset for the Perro Creek Outlet project.
- The City has an outstanding construction contract for the improvements being made at Barker's Alps Park. An immaterial audit entry was required to record retainage payable, which the City withholds payment to the contractor until the project is completed as specified.
- An immaterial audit entry was required to reverse business licenses received in 2008 that were for 2009 licenses.
- An immaterial audit entry was required to reclassify canine expenditures into their appropriate accounts.

We also assisted in preparing a number of year-end accounting entries. These were necessary to adjust the City's records at year end to correct ending balances. The City should establish more detailed processes and procedures to reduce the total number of entries in each category. The City will receive better more timely information if the preparation of year-end entries is completed internally.

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 have requested certain representations from management that are included in the management representation letter dated April 19, 2010.

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 governmental unit'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. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or 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.

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Financial Position and Results of Operations

Our principal observations and recommendations are summarized below. These recommendations resulted from our observations made in connection with our audit of the City's financial statements for the year ended December 31, 2009.

General Fund

The General fund is used to account for resources traditionally associated with government, which are not required legally or by sound principal management to be accounted for in another fund. The General fund balance decreased $255,019 from 2008. The fund balance of $2,625,201 is 126 percent of the 2010 budgeted expenditures. We recommend the fund balance be maintained at a level sufficient to fund operations until the major revenue sources are received in June. We feel a reserve of approximately 50 percent of planned expenditures and transfers out is adequate to meet working capital and small emergency needs.

The Office of the State Auditor (the OSA) has issued a *Statement of Position* relating to fund balance stating "a local government should identify fund balance separately between reserved and unreserved fund balance. The local government may assign and report some or all of the fund balance as designated and undesignated." The OSA also recommends local governments adopt a formal policy on the level of unreserved fund balance that should be maintained in the general and special revenue funds. This helps address citizen concerns as to the use of fund balance and tax levels.

The purposes and benefits of a strong fund balance are as follows:

- Expenditures are incurred somewhat evenly throughout the year. However, property tax and state aid revenues are not received until the second half of the year. An adequate fund balance will provide the cash flow required to finance the governmental fund expenditures.

- The City is vulnerable to legislative actions at the State and Federal level. The State imposed reductions of market value credit aid and local government aid for some cities for 2009 and 2010. The Governor has recently presented increased reductions of 2010 funding as well as reductions of 2011 funding. Levy limits have also been implemented for municipalities in past legislative sessions. An adequate fund balance will provide a temporary buffer against those aid adjustments and levy limits.

- Expenditures not anticipated at the time the annual budget was adopted may need immediate Council action. These would include capital outlay, replacement, lawsuits and other items. An adequate fund balance will provide the financing needed for such expenditures.

- A strong fund balance will assist the City in maintaining, improving or obtaining its bond rating. The result will be better interest rates in future bond sales.

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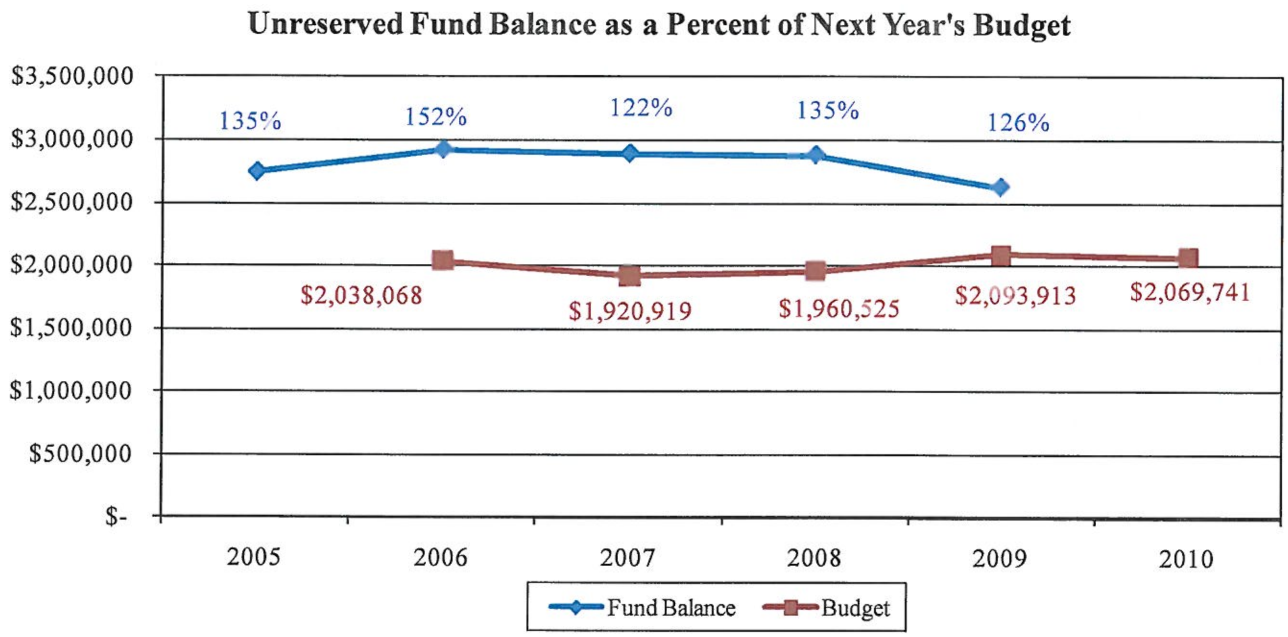
A table summarizing the General fund balance in relation to budget follows:

Year	Total Fund Balance December 31	Unreserved - Designated Fund Balance December 31	Budget Year	General Fund Budget	Percent of Unreserved Fund Balance to Budget
2005	$ 2,741,495	$ 2,741,495	2006	$ 2,038,068	135 %
2006	2,921,605	2,921,605	2007	1,920,919	152
2007	2,891,548	2,389,848	2008	1,960,525	122
2008	2,880,220	2,825,196	2009	2,093,913	135
2009	2,625,201	2,604,170	2010	2,069,741	126



We have compiled peer group average fund balance information from approximately 120 fourth class cities. The peer group average is derived from information available on the website of the Office of the State Auditor. In 2008, the average General fund balance as a percentage of expenditures was 55 percent. Based on comparison to the peer group, the City's current percentage is much higher than average.

A summary of the 2009 operations is as follows:

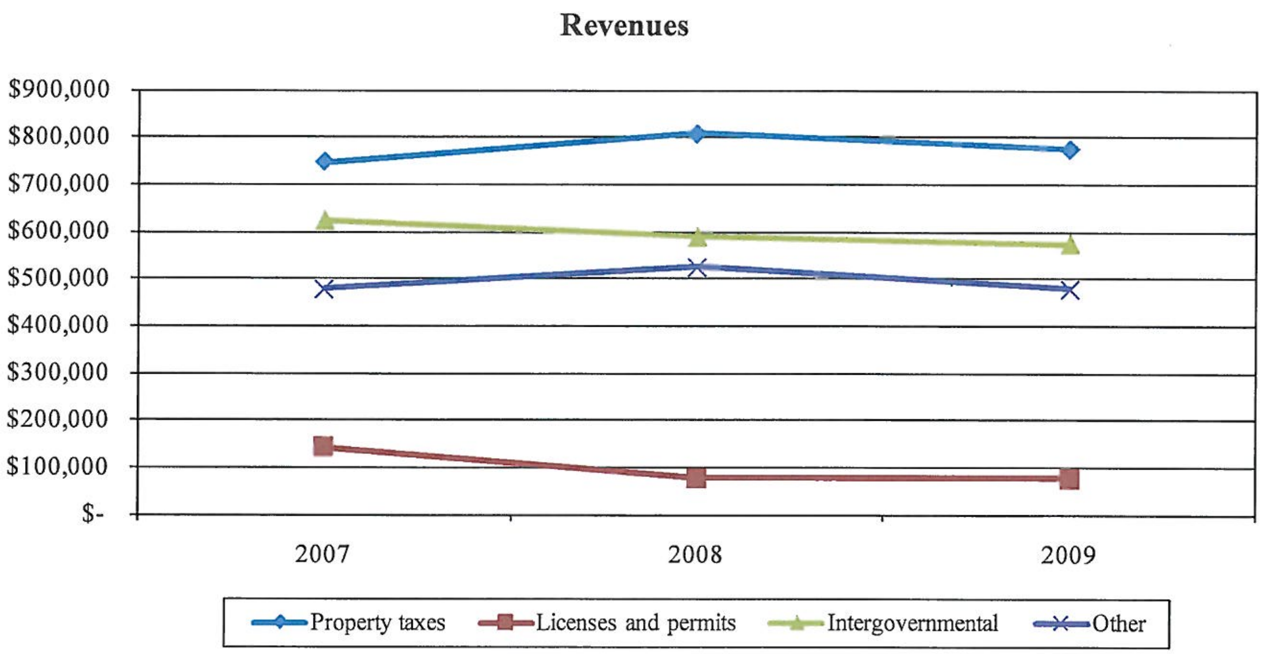
	Final Budget Amounts	Actual Amounts	Variance with Final Budget - Positive (Negative)
Revenues	$ 2,135,378	$ 1,903,985	$ (231,393)
Expenditures	1,901,404	1,973,083	(71,679)
Excess (deficiency) of revenues over (under) expenditures	233,974	(69,098)	(303,072)
Other financing sources (uses)			
Transfers in	-	5,938	5,938
Sale of capital assets	500	650	150
Transfers out	(192,509)	(192,509)	-
Total other financing sources (uses)	(192,009)	(185,921)	6,088
Net change in fund balance	41,965	(255,019)	(296,984)
Fund balance, January 1	2,880,220	2,880,220	-
Fund balance, December 31	$ 2,922,185	$ 2,625,201	$ (296,984)

- The negative revenue variance was spread across the City's major sources of revenue. The largest variances were caused by interest on investments and intergovernmental revenues, which were under budget $80,090 and $70,660 respectively.
- The negative expenditure variance was caused by public safety and public works, which were over budget by $50,339 and $43,383 respectively. These negative variances were offset with a positive variance within capital outlay.
- The General fund transferred $192,509 for funding of capital purchases.

A more detailed comparison of general fund revenues for the past three years is as follows:

Source	2007	2008	2009	Percent of Total	Per Capita
Property taxes	$ 747,767	$ 808,012	$ 774,542	40.7 %	$ 234
Licenses and permits	143,163	77,025	76,463	4.0	23
Intergovernmental	623,253	587,910	574,323	30.2	174
Charges for services	253,732	312,128	287,418	15.1	87
Fines and forfeits	32,991	34,741	21,337	1.1	6
Special assessments	3,609	3,974	4,177	0.2	1
Interest on investments	149,546	118,876	69,910	3.7	21
Miscellaneous	38,634	55,037	95,815	5.0	29
Total revenues	$ 1,992,695	$ 1,997,703	$ 1,903,985	100.0 %	$ 575

The sources of revenue summarized above are presented graphically as follows:

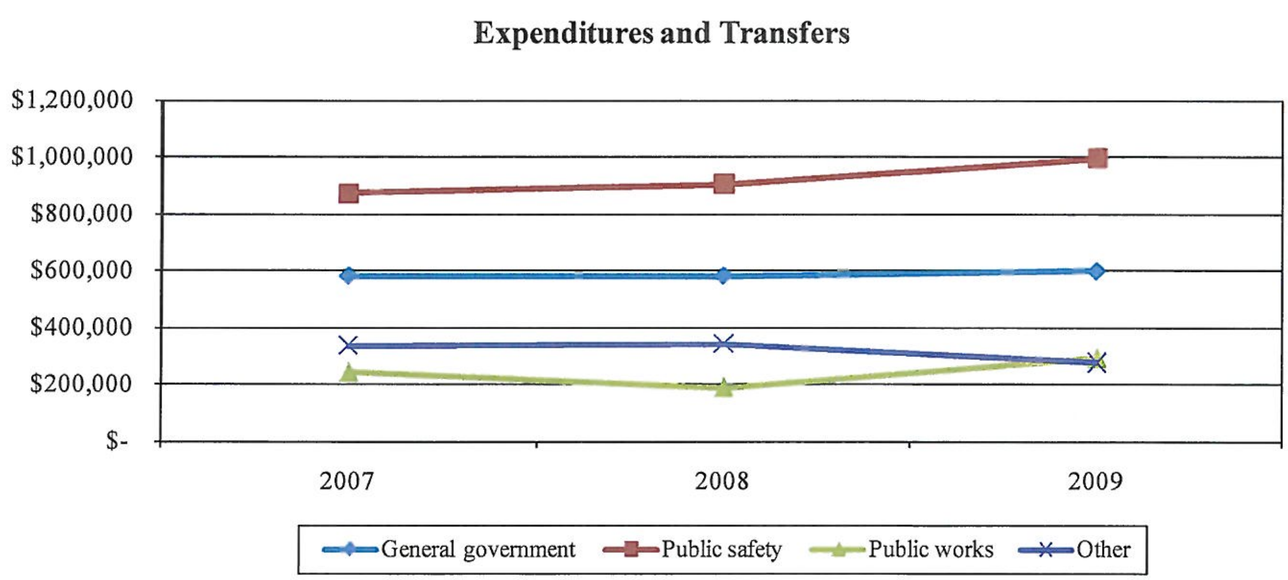


A more detailed comparison of general fund expenditures and transfers is as follows:

Program	2007	2008	2009	Percent of Total	Per Capita	Peer Group Per Capita
General government	$ 580,350	$ 580,688	$ 598,290	27.7 %	$ 181	$ 141
Public safety	870,623	904,361	995,986	46.0	301	205
Public works	241,178	187,740	292,980	13.5	89	115
Culture and recreation	85,288	93,597	82,940	3.8	25	52
Miscellaneous	2,538	5,211	2,887	0.1	1	14
Capital outlay	31,918	68,252	-	-	-	49
Transfers out	214,880	175,500	192,509	8.9	58	-
Total expenditures and transfers	$ 2,026,775	$ 2,015,349	$ 2,165,592	100.0 %	$ 654	$ 576

The above chart compares the amount the City spends per capita, in comparison to a peer group. We have compiled peer group average fund balance information from approximately 120 fourth class cities. The peer group average is derived from information available on the website of the Office of the State Auditor.

The expenditures and transfers summarized above are presented graphically as follows:



Special Revenue Funds

Special revenue funds include funds used to account for revenue derived from specific revenue sources that are restricted to expenditures for specified purposes. The fund balances (deficits) of each fund in this group are as follows:

Fund	Fund Balances (Deficits) December 31, 2009	Fund Balances (Deficits) December 31, 2008	Increase (Decrease)
Major			
Park Improvement	$ (689,954)	$ (28,120)	$ (661,834)
Nonmajor			
Fire Equipment Replacement	349,356	289,688	59,668
Drug Forfeiture	18,922	18,179	743
Public Works Equipment Replacement	857,414	669,964	187,450
Recreation Capital Equipment Maintenance	64,167	59,120	5,047
Tax Stabilization	1,009,298	983,876	25,422
K-9 Unit	986	10,275	(9,289)
Library	291,377	273,444	17,933
Total	$ 1,901,566	$ 2,276,426	$ (374,860)

The Park Improvement fund incurred a significant decrease during the year, which was due to capital improvements being made at Barker's Alps Park. The City needs to define a financing plan to fund the deficit fund balance.

The Public Works Equipment Replacement fund increased over $187 thousand during the year. This increase was due to transfers from the General fund to finance future capital improvements.

Debt Service Funds

Debt service funds are a type of governmental fund to account for the accumulation of resources for the payment of interest and principal on debt (other than enterprise fund debt).

Debt service funds may have one or a combination of the following revenue sources pledged to retire debt as follows:

- Property taxes - Primarily for general City benefit projects such as parks and municipal buildings. Property taxes may also be used to fund special assessment bonds which are not fully assessed.

- Tax increments - Pledged exclusively for tax increment/economic development districts.

- Capitalized interest portion of bond proceeds - After the sale of bonds, the project may not produce revenue (tax increments or special assessments) for a period of one to two years. Bonds are issued with this timing difference considered in the form of capitalized interest.

- Special assessments - Charges to benefited properties for various improvements.

In addition to the above pledged assets, other funding sources may be received by Debt Service funds as follows:

- Residual project proceeds from the related capital projects fund
- Investment earnings
- State or federal grants
- Transfers from other funds

The following is a summary of the assets accumulated in each debt service fund and the related long-term debt at year end.

	December 31, 2009			Final
Debt Description	Total Cash	Total Assets	Bonds Outstanding	Maturity Date
G.O. Tax Increment Bonds:				
Tax Increment Refunding, Series 2001	$ 380,573	$ 408,044	$ 895,000	11/30/2016

Capital Projects Funds

These funds accumulate resources to finance major capital acquisition and construction projects. A recap of each fund and fund balances follows:

Fund	Fund Balances (Deficits) December 31, 2009	Fund Balances (Deficits) December 31, 2008	Increase (Decrease)
Major			
Street Reconstruction	$ 3,044,473	$ 2,941,789	$ 102,684
Water & Sewer Improvements	849,611	758,449	91,162
Perro Creek Outlet	(2,316)	-	(2,316)
Nonmajor			
Tax Increment District 1	269,308	264,184	5,124
Tax Increment District 2-1	9,981	20,036	(10,055)
Prison Sewer Project	-	890	(890)
Developer Reimbursed Projects	131,466	132,041	(575)
Cemetery Capital Improvements	52,458	51,137	1,321
Police Equipment	56,316	66,479	(10,163)
Office Automation	62,546	51,137	11,409
Municipal Buildings Maintenance	167,505	153,412	14,093
Total	$ 4,641,348	$ 4,439,554	$ 201,794

As projects are completed the City should transfer the remaining resources to the original funding source or to a fund the Council approves.

Restricted Investments Fund

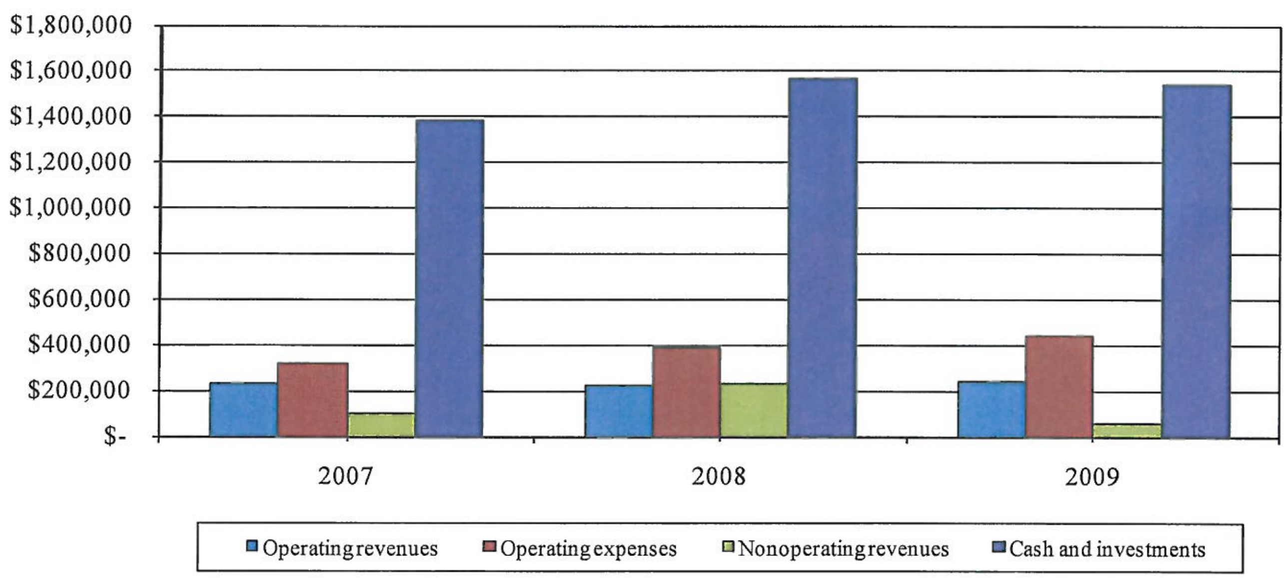
This fund has an ending fund balance of $593,336 with an unreserved balance of $68,336 available for the City to transfer out to other funds. The remaining $525,000 is reserved and should remain in the fund.

Enterprise Funds

The Water Utility and Sewer Utility make up this fund type. A comparison of the Water Utility Fund follows:

	2007		2008		2009	
	Total	Percent	Total	Percent	Total	Percent
Operating revenues	$ 232,204	100.0 %	$ 226,983	100.0 %	$ 241,420	100.0 %
Operating expenses	320,885	138.2	390,680	172.1	440,877	182.6
Income (loss) from operations	(88,681)	(38.2)	(163,697)	(72.1)	(199,457)	(82.6)
Nonoperating revenues	98,990	42.6	228,421	100.6	57,072	23.6
Net transfers	(2,919)	(1.3)	(5,000)	(2.2)	(6,475)	(2.7)
Capital contributions	3,831,917	1,650.2	7,808	3.4	-	-
Change in net assets	$ 3,839,307	1,653.3 %	$ 67,532	29.7 %	$ (148,860)	(61.7) %
Cash and investments	$ 1,382,213		$ 1,566,329		$ 1,543,075	

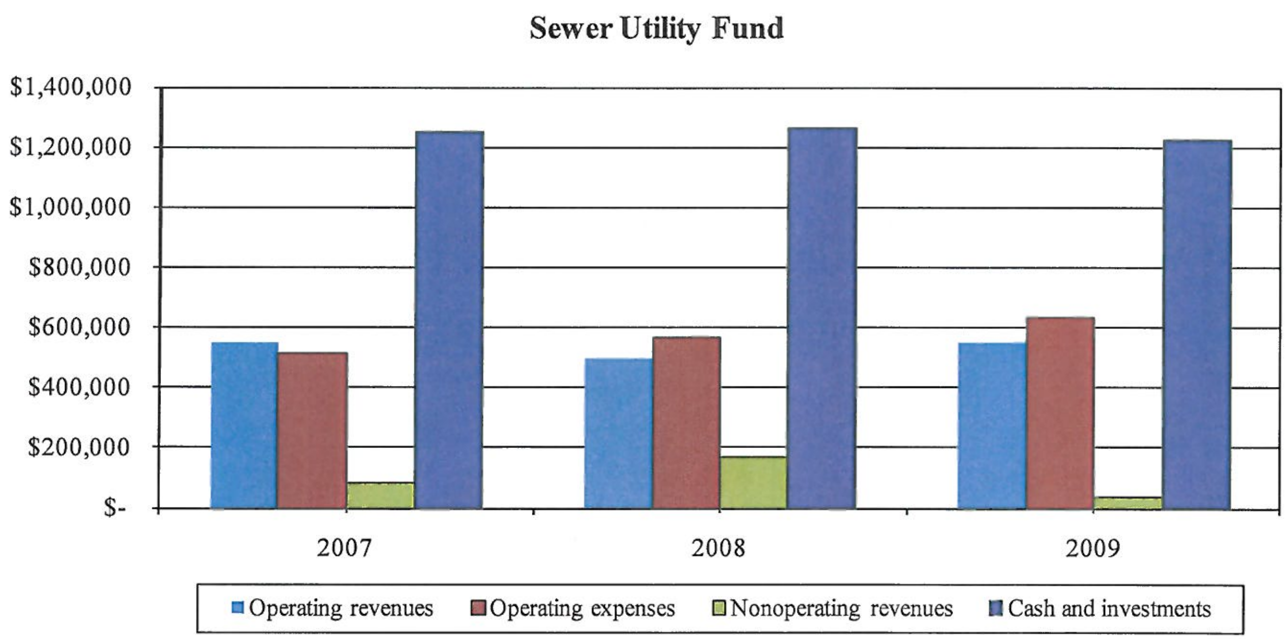
Water Utility Fund



The Water fund has continued to provide negative operating margins for the fourth consecutive year; as a result, the operating margin has approached a loss of $200,000. The City needs to consider evaluating their rate structure to ensure that operations are self supporting.

A comparison for the Sewer Utility fund follows:

	2007		2008		2009	
	Total	Percent	Total	Percent	Total	Percent
Operating revenues	$ 550,732	100.0 %	$ 495,379	100.0 %	$ 548,121	100.0 %
Operating expenses	516,675	93.8	566,881	114.4	631,978	115.3
Income (loss) from operations	34,057	6.2	(71,502)	(14.4)	(83,857)	(15.3)
Nonoperating revenues	82,054	14.9	171,924	34.7	35,949	6.6
Net transfers	(112,925)	(20.5)	(115,000)	(23.2)	(116,475)	(21.2)
Capital contributions	692,411	125.7	7,808	1.6	-	-
Change in net assets	$ 695,597	126.3 %	$ (6,770)	(1.3) %	$ (164,383)	(29.9) %
Cash and investments	$ 1,250,475		$ 1,265,668		$ 1,226,408	



The Sewer fund incurred an operating loss for the second consecutive year. The City should consider conducting a rate study and cash flow projection to ensure the stability of operating activities in the future.

Ratio Analysis

The following captures a few ratios from the City's financial statements that give some additional information for trend and peer group analysis. The peer group average is derived from information available on the website of the Office of the State Auditor for Cities of the 4th class (under 10,000). The majority of these ratios facilitate the use of economic resources focus and accrual basis of accounting at the government-wide level. A combination of liquidity (ability to pay its most immediate obligations), solvency (ability to pay its long-term obligations), funding (comparison of financial amounts and economic indicators to measure changes in financial capacity over time) and common-size (comparison of financial data with other cities) ratios are shown below.

Ratio	Calculation	Source	2006	2007	2008	2009
Debt to assets	Total liabilities/total assets	Government-wide	8%	4%	4%	3%
			35%	36%	34%	N/A
Debt per capita	Bonded debt/population	Government-wide	$ 364	$ 331	$ 304	$ 270
			$ 2,505	$ 2,673	$ 2,677	N/A
Taxes per capita	Tax revenues/population	Government-wide	$ 299	$ 311	$ 325	$ 333
			$ 346	$ 382	$ 401	N/A
Current expenditures per capita	Governmental fund current expenditures / population	Governmental funds	$ 659	$ 811	$ 702	$ 695
			N/A	$ 553	$ 663	N/A
Capital expenditures per capita	Governmental fund capital outlay / population	Governmental funds	$ 1,153	$ 326	$ 67	$ 528
			N/A	$ 409	$ 323	N/A
Capital assets % left to depreciate - Governmental	Net capital assets/ gross capital assets	Government-wide	71%	79%	78%	78%
			70%	70%	70%	N/A
Capital assets % left to depreciate - Business-type	Net capital assets/ gross capital assets	Government-wide	76%	88%	86%	84%
			68%	68%	67%	N/A

Represents the City of Bayport
Represents the Peer Group Average

Debt-to-Assets Leverage Ratio (Solvency Ratio)

The debt-to-assets leverage ratio is a comparison of a city's total liabilities to its total assets or the percentage of total assets that are provided by creditors. It indicates the degree to which the City's assets are financed through borrowings and other long-term obligations (i.e. a ratio of 50 percent would indicate half of the assets are financing with outstanding debt).

Bonded Debt per Capita (Funding Ratio)

This dollar amount is arrived at by dividing the total bonded debt by the population of the city and represents the amount of bonded debt obligation for each citizen of the City at the end of the year. The higher the amount, the more resources are needed in the future to retire these obligations through taxes, assessments or user fees.

Taxes per Capita (Funding Ratio)

This dollar amount is arrived at by dividing the total tax revenues by the population of the city and represents the amount of taxes for each citizen of the city for the year. The higher this amount is, the more reliant the city is on taxes to fund its operations.

Current Expenditures per Capita (Funding Ratio)

This dollar amount is arrived at by dividing the total current governmental expenditures by the population of the City and represents the amount of governmental expenditure for each citizen of the City during the year. Since this is generally based on ongoing expenditures, we would expect consistent annual per capita results.

Capital Expenditures per Capita (Funding Ratio)

This dollar amount is arrived at by dividing the total governmental capital outlay expenditures by the population of the City and represents the amount of capital expenditure for each citizen of the City during the year. Since projects are not always recurring, the per capita amount will fluctuate from year to year.

Capital Assets Percentage (Common-size Ratio)

This percentage represents the percent of governmental or business-type capital assets that are left to be depreciated. The lower this percentage, the older the city's capital assets are and may need major repairs or replacements in the near future. A higher percentage may indicate newer assets being constructed or purchased and may coincide with higher debt ratios or bonded debt per capita.

Other Items

Tax Increment Financing Payable

The City had a $30,000 payable to the County from a tax increment settlement previous to 2007. The City made no effort to remit this payment to the County during the year. When the County remitted the January 2010 tax settlement, they reduced the payment by $15,000, which has brought the amount due to $15,000 as of December 31, 2009. We recommend the City pay or have the County deduct the remaining balance from the tax settlements during 2010.

Invoice Approval

During our audit procedures, we discovered that a number of invoices were paid without having any management approval. The City's current policies and procedures require that department heads approve invoices and provide the appropriate expense coding. We recommend that the City review its current policies and procedures with the department heads to ensure that the approval process is completed for all invoices. Invoice approval is an important control in preventing fraud and material misstatements.

Future Accounting Standard Changes

The following Governmental Accounting Standards Board (GASB) Statements have been issued and may have an impact on future City financial statements:

GASB Statement No. 54 - *Fund Balance*

This statement was issued in March of 2009 and is effective for periods beginning after June 15, 2010. This new standard is intended to improve the usefulness of information provided to financial report users about fund balance by providing clearer, more structured fund balance classifications, and clarifying the definitions of existing governmental fund types.

GASB No. 54 distinguishes fund balance between amounts that are considered non-spendable, such as fund balance associated with inventories, and other amounts that are classified based on the relative strength of the constraints that control the purposes for which specific amounts can be spent. The following classifications and definitions will be used:

- *Restricted* - amounts constrained by external parties, constitutional provision, or enabling legislation
- *Committed* - amounts constrained by a government using its highest level of decision-making authority
- *Assigned* - amounts a government intends to use for a particular purpose
- *Unassigned* - amounts that are not constrained at all will be reported in the general fund.

In addition to the classifications of fund balance, the standard clarified the definitions of individual governmental fund types, for example, special revenue funds, debt service funds, and capital project funds.

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This report is intended solely for the information and use of management, Council and the Minnesota Office of the State Auditor and is not intended to be and should not be used by anyone other than these specified parties.

Our audit would not necessarily disclose all weaknesses in the system because it was based on selected tests of the accounting records and related data. The comments and recommendations in the report are purely constructive in nature, and should be read in this context.

If you have any questions or wish to discuss any of the items contained in this letter, please feel free to contact us at your convenience. We wish to thank you for the opportunity to be of service and for the courtesy and cooperation extended to us by your staff.

Abdo Eick & Meyers, LLP

April 19, 2010
Minneapolis, Minnesota

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