STATE OF MINNESOTA

Office of the State Auditor

Rebecca Otto
State Auditor

PETITION ENGAGEMENT

CITY OF WILLIAMS, MINNESOTA

JANUARY 1, 2008, THROUGH DECEMBER 31, 2010

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CITY OF WILLIAMS, MINNESOTA

January 1, 2008, through December 31, 2010

Petition Engagement

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Petitioners
Members of the City Council
City of Williams
Lake of the Woods County

INTRODUCTION

Eligible voters of the City of Williams petitioned the Office of the State Auditor (OSA) to examine the books, records, accounts, and affairs of the City in accordance with Minn. Stat. § 6.54 for the period January 1, 2008, through December 31, 2010. The statute allows the OSA, in the public interest, to confine the scope of the examination to less than that requested by the petition. Communications with petitioners assisted us in developing an understanding of the petitioners' areas of interest or concern. We established that some of the issues raised were not within the scope of this review.

The OSA has completed its examination into the concerns identified by the petitioners of the City of Williams. The objectives of the engagement were to address the concerns of, and to answer the questions raised by, the petitioners. Where applicable and appropriate, we make recommendations to the City in this report.

Municipal Liquor Store Losses

The petitioners expressed concerns over large losses sustained in the operation of the municipal liquor store. They noted that, in one of the more recent years, losses were almost $90,000. The petitioners questioned whether all receipts from sales at the municipal liquor store were getting deposited and posted to the general ledger; and they expressed concerns that the cost of goods sold appears to be high.

1. Municipal Liquor Store Receipting, Depositing, and Posting of Sales Revenue

The OSA requested various financial records from January 1, 2008, through December 31, 2010, from the City including, but not limited to, the following: cash register Z tapes; bank statements, including the municipal liquor store deposits; and the general ledger. A Z tape lists all sales made during a day/shift. The City had disposed of the cash register Z tapes for sales prior to March 30, 2009. The OSA conducted a detailed review of the receipting process, including the automated teller machine (ATM) in the municipal liquor store for the period beginning March 30, 2009, through December 31, 2010.

For most business days during the period reviewed, the Z tapes reconciled with the bank deposits and postings to the general ledger, considering minor differences noted on the daily reports that are common in retail operations. Certain transactions or practices were noted that resulted in unexplained differences in excess of $100 between the cash register Z tapes and the amounts deposited and posted to the general ledger, as well as weaknesses in internal control over the receipting and depositing process for the municipal liquor store as follows:

- Municipal liquor store employees used cash from the cash register to make various purchases for operations during the time period tested. There were 32 instances totaling $3,361 noted in 2009 and 20 instances totaling $644 noted in 2010. Some of these payments were supported with a copy of an invoice from the vendor, and some were supported only by a note written on the daily sheet. The expenses were for such things as food, music entertainment, karaoke, money for the jukebox, cleaning products, straw bales, party hats, and liquor. The largest expense paid out in this manner was an invoice dated October 22, 2009, from Northwest Beverages, Inc., for $1,343 for various beverages. The items purchased using cash from the cash register during 2009 were posted to their proper expenditure category in the liquor store general ledger. The items purchased using cash from the cash register during 2010 were netted off various sales revenues during that day's activity due to the limitations of the liquor store's new general ledger software.

- Three instances were noted during 2009 and one instance during 2010 of shortages in the daily deposit of $100 or more. The deposit for May 2, 2009, was short by $100; the June 13, 2009, deposit was short by $141; and the August 10 through 15, 2009, deposit was short by $199. The liquor store did deposit $100 on June 18, 2009, to make up for part of the June 13, 2009, shortage. The deposit for April 28, 2010, was short by $200. The cause of these shortages could not be determined.

- Five instances were noted during 2010 in which the daily deposits were long by $100 or more. The February 18, 2010, deposit was long by $200; the July 23, 2010, deposit was long by $100; the September 15, 2010, deposit was long by $600; the October 5, 2010, deposit was long by $100; and the November 17, 2010, deposit was long by $100. The cause of these overages could not be determined.

- For 2010, the OSA noted two instances of missing cash register Z tapes. The daytime cash register Z tape for receipts of $141 was missing for June 23, 2010. The amount was written down on the liquor store's daily report, but the Z tape was not stapled to the daily report as were other cash register Z tapes. The daytime cash register Z tape for receipts of $179 was missing for September 10, 2010, but a note was written stating it was unavailable due to a cash register issue.

- When the liquor store deposited the receipts for December 3, 2010, staff forgot to deduct $331 in credit card sales from the daily sales before making the deposit into the bank. The OSA could not determine where the additional money came from that made it possible to deposit the entire day's sales.

- The sales activity for December 13 through 15, 2010, totaling $1,414 was not deposited into the bank account during 2010. There was an outstanding deposit in transit of $1,414 shown on the December 31, 2010, bank reconciliation. Of this amount, the bank records show a deposit was made on January 14, 2011, for $646; however the remaining $768 could not be identified in the bank statements.

- During the period of review, the municipal liquor store made an ATM available to its customers. The user would swipe their card at the ATM and select how much cash they wanted to receive. The machine would print out a slip that showed how much cash they withdrew from their account. The user would then present this slip to the bartender who would distribute that amount of cash to the customer from an ATM bag kept in a secure location. When the cash in the ATM bag needed to be replenished, cash was transferred from a cash register used for daily collections. The clerk would fill out a receipt that documented how much cash was being transferred to the ATM bag. When the liquor store staff made the deposit to the bank, the total of all the ATM transfer receipts in the cash register were deducted from the daily collections, along with any credit card sales, to arrive at the deposit amount. After a few days, the ATM provider made a deposit directly into the municipal liquor store's bank account to match the withdrawn amount. A record of the amount of cash in the ATM bag on any given day was not maintained. Without a beginning and ending ATM cash bag balance, the OSA could verify only whether transfers and deposits were reasonably close during a period of time. Due to unknown balances in the ATM cash bag and the timing differences between the transfers and the deposits, it was not possible to tie actual transfers to deposits; therefore, some differences were expected.

The difference between the amount of cash transferred to the ATM bag and the amount deposited into the bank account during the 2009 testing period was $10, with the deposits being the larger amount. The difference between the amount of cash transferred to the ATM bag and the amount deposited into the bank account during the 2010 testing period was $1,210, with the transfers to the ATM bag being the larger amount. The municipal liquor store stopped using this ATM process in January 2011.

2. Inventory and Cost of Goods Sold

The municipal liquor store uses a periodic inventory system rather than a perpetual inventory system. A periodic inventory system relies on the use of purchase accounts, net of any returns and discounts, and year-end physical inventory counts to determine the cost of goods sold for the year, resulting in large adjustments to reflect the actual year-end inventory and cost of goods sold amounts. To verify the reasonableness of the cost of goods sold, the OSA recalculated the cost of goods sold for 2008, 2009, and 2010 by taking purchases, net of returns and discounts, posted to the general ledger plus the beginning inventory and less the ending inventory as reflected in the annual financial statements. The cost of goods sold amounts recalculated by the OSA were reasonably close to the cost of goods sold reflected in the annual financial statements. The periodic inventory system does not provide sufficient detail to determine if reductions in inventory are due to sales or shortages resulting from spoilage, excessive pours, theft, or damage of inventory. Shortages in a periodic inventory system are hidden in the cost of goods sold. The OSA could not determine an amount, if any, of shortages included in the cost of goods sold.

A comparison was made between the City of Williams liquor store and six other "On and Off Sale Only" municipal liquor stores that had a similar amount of operating revenues during 2008, 2009, and 2010 (see Appendix 1). The City of Williams municipal liquor store's cost of goods sold was lower than the average of the other six by $18,901 in 2008 and $15,435 in 2009, but was higher by $20,026 in 2010. The cost of goods sold as a percentage of operating revenue ranged from 52 percent in 2008 to 66 percent in 2010, while the percentages for the average of the six other stores ranged from 59 percent in 2008 to 60 percent in 2009 and 2010.

3. Operating Expenses

A comparison was made between the City of Williams liquor store and six other "On and Off Sale Only" municipal liquor stores that had a similar amount of operating revenues during 2008, 2009, and 2010 (see Appendix 1). The City of Williams liquor store's operating expenses were higher than the average of the other six in all three years, with the differences ranging from a low of $30,398 in 2009 to a high of $58,413 in 2010. The operating expenses for the City of Williams liquor store as a percent of operating revenues ranged from a low of 49 percent in 2009 to a high of 62 percent in 2010, while the percentages for the average of the six other stores ranged from 40 percent in 2008 to 43 percent in 2010. Scanning the operating expenses for the six other liquor stores, it appears most of the difference in operating costs relates to personnel services. A comparison of operating expenses as a percent of sales can help determine the efficiency of the operation. In operations with similar levels of sales, this percentage should be comparable.

4. **Product Pricing**

A comparison was made between the City of Williams liquor store and six other "On and Off Sale Only" municipal liquor stores that had a similar amount of operating revenues during 2008, 2009, and 2010 (see Appendix 1). The City of Williams liquor store's gross profit as a percentage of cost of sales ranged from 91 percent in 2008 to 51 percent in 2010, while the percentage for the average of the six other stores was 68 percent for each of the three years.

Since the cost of goods sold for the City of Williams liquor store was determined using a periodic inventory system, the OSA tested whether the gross profit as a percentage of the cost of goods sold ratio reflected the mark-up of the product. The mark-up for the 2010 off-sale activity of the liquor store was selected as the population to test. We obtained a copy of the liquor store's inventory count sheets for the end of December, which contained columns showing a description, quantity on hand, average cost per item, and total cost per item. The ending balance on these sheets was agreed to the inventory balance shown in the December 31, 2010, annual audit report. Seven invoices from various vendors were selected from October through December 2010, and the per unit prices on these invoices were agreed to the average cost per item on the inventory count sheets with only minor differences. Using the cash register tapes for December 27, 28, and 29, 2010, the per item cost for each item sold was documented on the inventory count sheets so that a dollar difference and a mark-up percentage could be calculated. There were 53 different items sold during these three days, and the average mark-up was 54.5 percent. Two items were being sold just below cost.

Recommendation

We recommend the City of Williams consider the following to improve the operation of its municipal liquor store:

- Establish a policy prohibiting the purchase of supplies or other services from the daily collections.

- Establish definitive change funds at the municipal liquor store. Any unapproved funds should be deposited and receipted into the City's financial records. This will help to ensure that the daily activity is being reconciled when preparing the deposits and not allow differences to be made up with funds on hand.

- Consider establishing a perpetual inventory system and conducting random counts to compare what is on hand with what the inventory system is showing.

- Identify ways to decrease operating costs.

- Establish a mark-up policy.

- Establish formal documented procedures for assessing risk and monitoring internal controls over the liquor store operations.

<u>Resources Restricted for the City's Waste Water Treatment Facility Project</u>

The petitioners expressed concerns that the City of Williams used resources restricted for the waste water treatment facility project to fund general operations of the City or operations of the liquor store.

In 2000, the City of Williams replaced its sewage treatment plant with a new plant designed to last at least 40 years. By 2009, the tank holding raw sewage was heavily corroded and had started to leak. The City's consulting engineer estimated the remaining life of the tank to be less than two years, and if the tank failed, approximately 50,000 gallons of raw sewage could spill each day. Working with the Minnesota Pollution Control Agency, Minnesota Public Facilities Authority, Minnesota Department of Employment and Economic Development, and the United States Department of Agriculture (USDA) Rural Development Office in Bemidji, plans including a financing package were put together for replacing the City's waste water treatment facility.

On August 26, 2010, the City of Williams issued $600,000 General Obligation Grant Anticipation Bonds to provide temporary financing for the City's waste water treatment facility project, including engineering costs and land acquisition.[1] Of the $579,495 net proceeds, $565,228 were to be deposited to a construction fund for project costs, and $14,267 were to be deposited to a debt service account available to pay the interest due August 1, 2011, through February 1, 2013.[2] Other funding obtained for the project included $2,800,000 from a Wastewater Infrastructure Fund Program grant through the Minnesota Public Facilities Authority, $600,000 from a Small Cities Development Program grant through the Minnesota Department of Employment and Economic Development, and $600,000 from a USDA Rural Development Grant. The City intends to use grant funds from the Wastewater Infrastructure Funding Program to pay the debt service on the $600,000 General Obligation Anticipation Bonds.[3] In addition, as part of the permanent funding, the City refunded existing debt with the

[1]Source: Closing memorandum for City of Williams, Minnesota $600,000 General Obligation Grant Anticipation Bonds, Series 2010.
[2]Source: The calculation and distribution of net proceeds page of the closing memorandum for City of Williams, Minnesota $600,000 General Obligation Grant Anticipation Bonds, Series 2010.
[3]Source: The details of proposed debt document for City of Williams, Minnesota $600,000 General Obligation Grant Anticipation Bonds, Series 2010.

USDA Rural Development Office through the issuance of $285,000 General Obligation Sewer Revenue Refunding Bonds in 2011. These refunding bonds were issued for the payment of $245,830 principal and interest due on the prior bonds on the call date.[4] Any monies remaining after the payment of issuance costs and the $245,830 principal and interest were to be transferred to the construction account.

Copies of invoices for costs associated with the project are submitted to the USDA Rural Development Office in Bemidji. The USDA Rural Development Office, in collaboration with the other agencies involved, reviews all the invoices to determine which expenses are allowable under each funding source. A pay request spreadsheet is prepared detailing the service date, invoice number, vendor, amount requested, ineligible amounts, and the funding by source for the eligible amounts. To ensure the grant funding is available for potential failure of the corroded tank prior to completion of the new waste water treatment facility, certain expenses, including engineering expenses related to reduced inflow and infiltration, are temporarily shown as ineligible. These expenses will be reviewed for eligibility at the end of the project if funding is available.

Beginning January 1, 2010, a new Sewer Pond Project Fund was established to account for receipts and disbursements related to the new waste water treatment facility project. For presentation in the annual financial statements, this fund is merged with the Sewer Fund and presented as a single Sewer Enterprise Fund.

1. <u>Sewer Pond Project Fund Activity - 2010</u>

The 2010 Sewer Pond Project Fund reflects the receipt of $579,495 net proceeds from the $600,000 General Obligation Grant Anticipation Bonds issued and interest earnings of $132 totaling $579,627. Disbursements totaling $454,429 include principal and interest payments of $21,130 for existing debt with the USDA Rural Development Office. These principal and interest payments should have been paid from net revenues from the operations of the Sewer Fund rather than from the $600,000 General Obligation Grant Anticipation Bonds proceeds in the Sewer Pond Project Fund. We reconciled $408,333 of disbursements for engineering costs to pay request spreadsheet number 1 as expenses either approved or related to reduced inflow and infiltration which will be reviewed for eligibility at the end of the project. For the remaining $24,966 in disbursements posted to the fund, the City will meet with a representative from USDA Rural Development Office to determine allowability of the costs for the project through the funding sources available.

The balance remaining from the bond proceeds and interest earnings in the Sewer Pond Project Fund at December 31, 2010, should have been $146,328. However, the total cash and pooled investments for the entire City reflected in Exhibit 1 of the 2010 financial statements were $84,297. The Sewer and the Municipal Liquor Store Enterprise

[4]Source: The extract of minutes of the meeting of the City Council that relate to the $285,000 General Obligation Sewer Revenue Refunding Bonds.

Funds had cash deficits of $91,404[5] and $92,358, respectively, at December 31, 2010. Therefore, for 2010, the City did use cash from the sale of the $600,000 General Obligation Grant Anticipation Bonds in the Sewer Pond Project Fund and cash from other funds to cash flow the operations of the Sewer and the Municipal Liquor Store Enterprise Funds.

2. **Sewer Pond Project Fund Activity - 2011**

We extended our review into 2011 to determine if funds restricted for the water treatment facility project continued to be used to cash flow other operations. The 2011 Sewer Pond Project Fund receipted $285,000 for the G.O. Sewer Revenue Refunding Bonds issued, $308,845 from the Wastewater Infrastructure Fund Program, $4,200 from the Small Cities Development Program, and $869 in interest and other receipts, for total receipts of $598,914.

Disbursements totaling $422,320 include principal and interest of $21,417 that again should have been paid from net revenues from the operations of the Sewer Fund as should $5,400 for Operator B Services relating to the operation of the old facility. We reconciled $114,828 of disbursements for engineering, legal, and advertising costs to pay request spreadsheet numbers 1 and 2 as expenses either approved or related to reduced inflow and infiltration which will be reviewed for eligibility at the end of the project. Disbursements also included $4,200 in consulting costs for the Small Cities Development Program, $5,267 in interest expenses associated with the $600,000 General Obligation Grant Anticipation Bonds, and $252,563 in refunding and other debt expenses associated with the $285,000 G.O. Sewer Revenue Refunding Bonds. Again, for the remaining $18,645 in disbursements posted to the fund, the City will meet with a representative from USDA Rural Development Office to determine allowability of the costs through the funding sources available.

Given a beginning balance of $146,328 in the Sewer Pond Project Fund, plus receipts of $598,914, less current project-related disbursements of $395,503, the balance at December 31, 2011, should have been $349,739. Total cash and pooled investments for the entire City reflected in Exhibit 1 of the 2011 financial statements were $200,966. The Sewer and the Municipal Liquor Store Enterprise Funds had cash deficits of $143,554[6] and $157,865, respectively, at December 31, 2011. Similar to 2010, the City used cash restricted for the water treatment facility project from the Sewer Pond Project Fund and other funds to cash flow the operations of the Sewer and the Municipal Liquor Store Enterprise Funds.

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[5] The net cash and pooled investments for 2010 shown in the financial statements of the Sewer Enterprise Fund are $54,924, which includes the Sewer Pond Project Fund balance of $146,328 and the Sewer Fund deficit balance of $91,404.

[6] The net cash and pooled investments for 2011 shown in the financial statements of the Sewer Enterprise Fund are $206,185, which includes the Sewer Pond Project Fund balance of $349,739 and the Sewer Fund deficit balance of $143,554.

Recommendation

We recommend that, in the future, bond proceeds be handled consistent with the bond covenants. This will require that bond proceeds be placed in the project construction fund and debt service fund if provided in the bond covenant and not used to cash flow the operations of other funds. We further recommend the City of Williams establish a system to monitor the cash balance of each of its funds and provide the budgetary guidance and resources necessary to ensure all funds maintain positive cash balances.

* * *

CONCLUSION

We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on specified elements, accounts, or items relating to the petitioners' concerns as identified in this report. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters may have come to our attention that we would have reported to you.

This report has been prepared for the information of the petitioners of the City of Williams, the Mayor and City Council, and the management of the City, but is a matter of public record, and its distribution is not limited.

/s/Rebecca Otto	*/s/Greg Hierlinger*
REBECCA OTTO STATE AUDITOR	GREG HIERLINGER, CPA DEPUTY STATE AUDITOR

February 20, 2013

City of Williams
Municipal Liquor Store Comparison - On and Off Sale Only
2008 through 2010

	Williams	Average of Other Stores	Hanska
2008			
Population	197		404
Operating revenue	$ 337,440	$ 329,628	$ 325,885
Cost of sales	(177,127)	(196,028)	(178,412)
Gross profit	$ 160,313	$ 133,600	$ 147,473
Operating expense	(169,332)	(132,194)	(131,237)
Operating income	$ (9,019)	$ 1,405	$ 16,236
Cost of sales to operating revenue ratio	52%	59%	55%
Operating expense to operating revenue ratio	50%	40%	40%
Gross profit to cost of sales ratio	91%	68%	83%
2009			
Population	186		396
Operating revenue	$ 340,111	$ 334,311	$ 314,317
Cost of sales	(183,560)	(198,995)	(180,355)
Gross profit	$ 156,551	$ 135,316	$ 133,962
Operating expense	(168,323)	(137,925)	(118,886)
Operating income	$ (11,772)	$ (2,608)	$ 15,076
Cost of sales to operating revenue ratio	54%	60%	57%
Operating expense to operating revenue ratio	49%	41%	38%
Gross profit to cost of sales ratio	85%	68%	74%
2010			
Population	191		402
Operating revenue	$ 317,758	$ 319,731	$ 307,907
Cost of sales	(210,709)	(190,683)	(186,864)
Gross profit	$ 107,049	$ 129,047	$ 121,043
Operating expense	(196,012)	(137,599)	(125,402)
Operating income	$ (88,963)	$ (8,552)	$ (4,359)
Cost of sales to operating revenue ratio	66%	60%	61%
Operating expense to operating revenue ratio	62%	43%	41%
Gross profit to cost of sales ratio	51%	68%	65%

Source: The data above came from the *Analysis of Minnesota Liquor Store Operations* reports by year found on http://www.auditor.state.mn.us, with the exception of the City of Williams 2008 and 2009 data, which came from its annual audit reports.

Appendix 1

	Verndale	Mazeppa	Herman	Ogema	Holdingford
	549	778	416	125	772
	$ 302,904	$ 346,702	$ 310,641	$ 354,223	$ 337,411
	(200,861)	(229,753)	(181,732)	(203,337)	(182,074)
	$ 102,043	$ 116,949	$ 128,909	$ 150,886	$ 155,337
	(160,923)	(124,805)	(123,217)	(101,407)	(151,577)
	$ (58,880)	$ (7,856)	$ 5,692	$ 49,479	$ 3,760
	66%	66%	59%	57%	54%
	53%	36%	40%	29%	45%
	51%	51%	71%	74%	85%
	540	772	406	125	779
	$ 340,735	$ 320,908	$ 320,141	$ 359,981	$ 349,782
	(236,380)	(210,479)	(170,840)	(203,026)	(192,888)
	$ 104,355	$ 110,429	$ 149,301	$ 156,955	$ 156,894
	(173,243)	(117,716)	(144,428)	(107,760)	(165,514)
	$ (68,888)	$ (7,287)	$ 4,873	$ 49,195	$ (8,620)
	69%	66%	53%	56%	55%
	51%	37%	45%	30%	47%
	44%	52%	87%	77%	81%
	602	842	437	184	708
	$ 312,076	$ 319,174	$ 324,134	$ 325,770	$ 329,322
	(200,194)	(209,655)	(170,861)	(191,529)	(184,996)
	$ 111,882	$ 109,519	$ 153,273	$ 134,241	$ 144,326
	(163,460)	(116,133)	(156,876)	(111,409)	(152,314)
	$ (51,578)	$ (6,614)	$ (3,603)	$ 22,832	$ (7,988)
	64%	66%	53%	59%	56%
	52%	36%	48%	34%	46%
	56%	52%	90%	70%	78%