

STATE OF MINNESOTA

Office of the State Auditor



Patricia Anderson
State Auditor

MANAGEMENT AND COMPLIANCE REPORT OF THE

CITY OF DULUTH
DULUTH, MINNESOTA

YEAR ENDED DECEMBER 31, 2005

Description of the Office of the State Auditor

The Office of the State Auditor serves as a watchdog for Minnesota taxpayers by helping to ensure financial integrity, accountability, and cost-effectiveness in local governments throughout the state.

Through financial, compliance, and special audits, the State Auditor oversees and ensures that local government funds are used for the purposes intended by law and that local governments hold themselves to the highest standards of financial accountability.

The State Auditor performs approximately 250 financial and compliance audits per year and has oversight responsibilities for over 4,300 local units of government throughout the state. The office currently maintains five divisions:

Audit Practice - conducts financial and legal compliance audits for local governments;

Government Information - collects and analyzes financial information for cities, towns, counties, and special districts;

Legal/Special Investigations - provides legal analysis and counsel to the Office and responds to outside inquiries about Minnesota local government law; as well as investigates allegations of misfeasance, malfeasance, and nonfeasance in local government;

Pension - monitors investment, financial, and actuarial reporting for over 700 public pension funds; and

Tax Increment Financing, Investment and Finance - promotes compliance and accountability in local governments' use of tax increment financing through financial and compliance audits.

The State Auditor serves on the State Executive Council, State Board of Investment, Land Exchange Board, Public Employee's Retirement Association Board, Minnesota Housing Finance Agency, and the Rural Finance Authority Board.

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**CITY OF DULUTH
DULUTH, MINNESOTA**

Year Ended December 31, 2005



Management and Compliance Report

**Audit Practice Division
Office of the State Auditor
State of Minnesota**

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**CITY OF DULUTH
DULUTH, MINNESOTA**

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**CITY OF DULUTH
DULUTH, MINNESOTA**

Schedule 1

**SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED DECEMBER 31, 2005**

I. SUMMARY OF AUDITOR'S RESULTS

- A. Our report expresses an unqualified opinion on the basic financial statements of the City of Duluth.
- B. Reportable conditions in internal control were disclosed by the audit of financial statements of the City of Duluth and are reported in the "Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*." None were material weaknesses.
- C. No instances of noncompliance material to the financial statements of the City of Duluth were disclosed during the audit.
- D. No matters involving internal control over compliance relating to the audit of the major federal award programs were reported in the "Report on Compliance with Requirements Applicable to Each Major Program and Internal Control Over Compliance in Accordance with OMB Circular A-133."
- E. The Auditor's Report on Compliance for the major federal award programs for the City of Duluth expresses an unqualified opinion.
- F. A finding relative to a major federal award program for the City of Duluth was reported as required by Section 510(a) of OMB Circular A-133.
- G. The major programs are:
- | | |
|---------------------------------------|--------------|
| Home Investment in Affordable Housing | CFDA #14.239 |
| Section 108 Loan Guarantees | CFDA #14.248 |
| Homeland Security Grant Program | CFDA #97.067 |
- H. The threshold for distinguishing between Types A and B programs was \$431,982.
- I. The City of Duluth was determined to be a low-risk auditee.

II. FINDINGS RELATED TO FINANCIAL STATEMENTS AUDITED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

INTERNAL CONTROL

PREVIOUSLY REPORTED ITEMS NOT RESOLVED

96-5 Departmental Internal Control

The limited number of office personnel within various City departments prevents a proper segregation of the revenue accounting functions necessary to ensure adequate internal accounting control. The revenue accounting functions consist of collecting and receipting fines, permits, licenses, utility billings, and miscellaneous revenues.

Such a situation is not unusual in small departmental operations or where cash collection is decentralized. However, the City's management should constantly be aware that the concentration of duties and responsibilities in a limited number of individuals is not desirable from an accounting point of view.

We recommend that the City's management be aware of the lack of segregation of the accounting functions within City departments and, if possible, implement oversight procedures to ensure that the internal control policies and procedures are being implemented by staff. The City should consider centralizing the cash collection functions under the City Treasurer in order to strengthen the internal control over cash receipting.

Client's Response:

The City is aware that, in some departments, staffing levels may prevent an ideal segregation of duties. Mitigating controls are implemented when feasible. The City is investigating implementing a new accounting system module that may allow us to integrate departmental cash collections together with the City Treasurer's Office.

96-8 Tourism Tax Collections

The City Treasurer's Office audits, collects, and accounts for food and beverage and hotel and motel taxes. An independent party outside the City Treasurer's Office does not review the individual tax accounts. The tax collection function should be separate from the auditing and accounting functions.

We recommend the Finance Director review the internal control over the collection of tourism taxes.

Client's Response:

Duties and responsibilities for the tourism tax collection function are segregated among City Treasurer's Office staff. Segregating tourism tax auditing and accounting functions outside the City Treasurer's Office is not feasible at current staffing levels. Software is currently in use that provides automated audit notification for errors or non filing.

III. FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARD PROGRAMS

COMPLIANCE

ITEM ARISING THIS YEAR

05-1 Section 108 Loan Guarantees - Cash Management (CFDA #14.248)

The contract between the City and the United States Department of Housing and Urban Development (HUD) states that the City must deposit the Section 108 cash into a "separate, identifiable account with a financial institution whose deposits are federally insured." The City created a separate Section 108 fund in its general ledger to account for the funds, but did not deposit the actual cash into a separate bank account. The cash was included within the City's pooled cash and investments.

The contract between the City and HUD also calls for the establishment, within three business days, of a "Guaranteed Loan Funds Investment Account" in cases where the unspent Section 108 funds are greater than Federal Deposit Insurance. The investment account is to be fully invested in federal governmental obligations. There were instances in 2005 when the City held Section 108 funds in excess of Federal Deposit Insurance for a period of greater than three business days. The City did not establish the investment account as specified in the agreement with HUD.

We recommend the City Treasurer establish the accounts as required by HUD.

Corrective Action Plan:

Contact Person:

*Larry Jeneson, City Treasurer
(218) 730-5350*

Corrective Action Plan:

The investment account required by HUD regulations has been established.

Estimated Completion Date:

Complete

IV. OTHER FINDINGS AND RECOMMENDATIONS

A. MINNESOTA LEGAL COMPLIANCE

ITEM ARISING THIS YEAR

05-2 Collateral Pledged to Secure Deposits

The City is required by Minn. Stat. § 118A.03 to secure deposits in each bank at 110 percent of the uninsured amount of deposit. At one bank, deposits exceeded collateral by \$74,637 at December 31, 2005. City deposits are at risk should a bank default when the deposits are not backed by sufficient collateral.

We recommend that the City Treasurer obtain the necessary collateral to secure the City's deposits.

Client's Response:

The collateral shortfall was the result of a large loan payoff transaction processed by a local financial institution acting as the City's agent. The local financial institution failed to notify the City of this transaction. The City took action to remove the excess funds when the transaction became known.

B. MANAGEMENT PRACTICES

PREVIOUSLY REPORTED ITEMS NOT RESOLVED

96-10 Policies and Procedures Manual

The City should update the accounting policies and procedures manual to cover current financial operations. Existing policies and procedures should be updated and new policies and procedures written for current accounting systems.

A manual helps to prevent the deterioration of key elements in the City's internal controls. A manual can often help to avoid circumvention of City policy. It provides assistance in training new personnel and provides a source of reference for current personnel.

We recommend the Finance Director update the accounting policies and procedures manual covering the current financial operations.

Client's Response:

The City Auditor's Office will work, as time permits, on updating accounting-related items within the City's Policies and Procedures Manual.

01-6 Premium Hours

Our review of the premium hours report for the year ended December 31, 2005, indicates that City employees accrued a total of 122,914 overtime and compensatory time hours worth approximately \$3,145,000. This is an increase of 16,025 hours from the prior year. Sixty-eight employees earned in excess of 400 premium hours, of which one employee was compensated for 1,085 premium hours worth \$38,844.

Following is a breakdown by department of the 68 employees:

Public Works and Utilities	
Utility Operations Department	31 employees
Maintenance Operations Department	3 employees
Aerial Lift Bridge Department	3 employees
Fire Department	21 employees
Police Department	8 employees
Zoo	2 employees

The City limits the number of full-time employees for each department during the budget process. Department managers may be using premium hours in order to stay within these authorized limits. In addition, the City has limited the hiring of new staff. The City relies on the employees' supervisors to determine that hours compensated were necessary and were actually worked.

We recommend the City Administration and City Council carefully review the necessity of the premium hours compensated and consider the cost of premium hours versus additional staffing.

Client's Response:

The City continues to monitor the use of premium hours in all City Departments. Premium hours are often the result of having to fill shifts to meet minimum staffing requirements. In addition, a hiring freeze has contributed to an increase in premium hours. The Administration believes the use of premium hours in some areas is less expensive than hiring additional employees, especially after considering the liability incurred for other post-employment benefits.

01-7

Special Assessment Debt Service Fund

The Special Assessment Debt Service Fund had a negative cash balance of \$1,044,412 after the February 1, 2005, principal and interest payments and remained negative through much of the year. The negative balance is caused by abatements, certification withdrawals, and bond costs not being funded by the City.

An analysis of future collections based on the December 31, 2005, outstanding assessment balance and projects yet to be assessed estimated a shortfall of approximately \$2,300,000 when compared to future debt service requirements. The analysis indicated that parcel owners prepay a substantial amount of assessments. The prepayment of assessments lowers the interest earnings on future assessment collections. Prepayment does allow the City to invest the collections and earn interest that offsets the loss of future assessment interest earnings. However, the interest earnings are not allocated specifically to the Special Assessment Debt Service Fund. Interest earnings are allocated among City funds based on each fund's cash balance. Because the Special Assessment Debt Service Fund had a negative cash balance for the majority of 2005, it was only allocated \$212 in interest earnings.

We recommend the City Administration estimate the unfunded amount each year and develop a plan to fund these amounts.

Client's Response:

The City Auditor's Office will review the funding mechanisms for the Special Assessment Debt Service Fund and evaluate the need for increased funding.

03-2

Uncollectible Receivables Policy

The City does not have a formal policy addressing the proper procedures and authorization needed to write off uncollectible miscellaneous and billed receivables from the City's accounting records. Uncollectible accounts should be written off only in accordance with applicable legal and policy requirements and be approved by a responsible official who is not associated with the detailed receivable and cash functions.

We recommend a policy be adopted outlining the proper procedures to follow and authorization needed to write off uncollectible accounts.

Client's Response:

The vast majority of account receivable adjustments occur in our utility billing system which does have a formal written procedure for the write-off of bad debts. All other miscellaneous billing adjustments are approved informally by management. A formal miscellaneous billing policy will be developed, as time permits, when the City's Policies and Procedures Manual is updated.

ITEMS ARISING THIS YEAR

05-3

Untimely Grant Reimbursement Requests

The Homeland Security Grant agreement between the City and the Minnesota Department of Public Safety specified the time frame to be used for grant reimbursement requests. The City was delinquent in making its grant reimbursement requests. The City was reimbursed for its expenditures; however, the City lost out on interest earnings by not requesting reimbursement in a timely manner. The largest purchase under the grant was for a mobile command center. The check for the command center, approximately \$409,000, was issued on May 31, 2005. The City did not request reimbursement for the expenditure until 2006.

Timely grant reimbursement requests will improve the City's cash flow and interest earnings. It will also protect the City from issues that could arise from noncompliance with grant agreements.

We recommend that the City Auditor review the procedures for grant reimbursement requests and implement any necessary measures to comply with grant requirements.

Client's Response:

Grant reimbursement requests were delayed due to staffing constraints. The impact of recent staff retirements, additional job responsibilities and a hiring freeze has had an impact on the timely preparation of grant reimbursement requests. All amounts due under the grant have been received by the City.

05-4 Engineering Overhead Charges

The City's General Fund charges other City funds for engineering services and recovers costs through special assessments. Overhead charged for City engineering services has not been updated since 1996. The engineer's hourly salary rate is increased by the overhead rate to determine the total hourly rate charged out to the other City funds.

We recommend the City Auditor annually review and update the overhead charge.

Client's Response:

The City will review the engineering overhead charge calculation for reasonableness. The current overhead charge adds approximately 60% to actual engineering costs to reflect the cost of employee fringe benefits including payroll taxes.

05-5 Zoological Society Fundraisers

The Zoological Society retained the Zoo gate receipts during the days the Society conducted its 2005 fundraisers. Currently, the Zoo's management agreement between the City and the Society does not state that the Society can keep the gate receipts. There is no authority for the Society to keep the gate receipts.

We recommend that the City Treasurer ensure that the Zoo Director deposit future gate receipts into the City account unless the management agreement is amended to allow the Society to keep the gate receipts.

Client's Response:

The management agreement with the Zoological Society will be reviewed and revised as deemed necessary. Pending management agreement revision, it is the City's policy that all zoo gate receipts be deposited intact into the City's zoo bank account.

05-6

Fuel Contract

Several issues were noted during our review of the City's fuel bids and contracts.

- The contract to provide the City with fuel expired on December 31, 2004. The new fuel contracts were bid out twice; the new contract became effective September 1, 2005.
- A City resolution was passed allowing the old vendor to continue providing fuel until new contracts could be completed. This resolution set the fuel price at the Duluth daily rack average price plus five cents per gallon for service station fuel and six cents per gallon for delivered fuel. Based on our testing, the City was charged, and paid, eight cents per gallon over the rack price for both service station and delivered fuel.
- The City awarded the new delivered fuel contract to the old vendor and the service station fuel contract to a new vendor. The new vendor indicated on its bid that there would not be a freight charge; however, based on the invoices we examined, a freight charge was added. The bid price plus the added freight charge made the total price higher than the price bid by the other vendor.
- The City has no procedures in place to monitor the Duluth daily rack average price in order to determine if it is being properly charged for the fuel purchased. Also, the City has not monitored prices to determine if it is actually benefiting from having a fuel contract by paying less than if the City just paid the pump price.
- The Attorney General opinion 707b, dated March 14, 1988, suggests that the City may not need to bid out its fuel purchases unless it chooses to.

We recommend that the City Purchasing Agent perform a review to determine if fuel bidding is the best method for purchasing the City's fuel. As long as the City continues to purchase fuel under contract, it must implement procedures to ensure that the amounts specified in the contracts agree with the actual amounts charged to the City.

Client's Response:

The City was not made aware that additional delivery cost was to be added to the bid price until after the bid had been awarded. Because of the discrepancies noted, the City will not be honoring the five-year fuel contract. The fuel contract is being re-bid this fall.

05-7

Contracts

The City enters into a large number of contracts each year; however, the City does not have formal contract policies and procedures in place. Contract policies provide guidelines for consistency and efficiency in the contracting process as well as requirements for monitoring terms specified in the contracts. Contract policies address when written contracts are needed and the form or content of contracts. A signed contract indicates a mutual agreement of the terms between the parties involved and can serve as an important tool in resolving contract disputes.

The following are examples of issues that may have been avoided had formal contract policies and procedures been in place:

- The City solicited bids for the lease of motor graders for use by the City for snow removal. The bid asked for a price per grader for the 2005-2006 snow season and for a price for multiple year use. Resolution 05-0425 awarded the contract for the 2005-2006 winter season but also indicated the contract as the first year of a potential five-year contract. The City made payments for the 2005-2006 snow season without a signed contract and at the bid price for a five-year lease.
- The City is not adequately monitoring the requirements of the Visit Duluth, aka Duluth Visitor and Convention Bureau, contract. The City enters into an annual contract with Visit Duluth for the purpose of providing Visit Duluth with funding for promotion of the City. The contract contains a line item budget specifying how Visit Duluth will spend the funding. The

Schedule 1
(Continued)

contract states that Visit Duluth can vary from the budget, but expenditures in excess of 125 percent of a budgeted line item need the prior written consent of the City's Chief Administrative Officer. Visit Duluth submits paid invoices to the City for reimbursement, but the City does not track expenditures made by Visit Duluth against the budget contained in the contract. Visit Duluth provides actual expenditures for the prior year when entering into the contract for the next year, but these figures are after-the-fact and do not serve as a control on the current year contract.

- The City has a written agreement with the Lake Superior Center, a private nonprofit organization, to provide a \$250,000 revolving loan to the Center. The loan is required to be paid back to the City by October 1 each year. The Center paid back the loan as required then immediately requested the loan again. The City Council passed a resolution in 2005 providing an additional \$150,000 loan to be repaid in 2005. The Center did not pay the \$150,000 loan back in 2005, resulting in the Center owing the City \$400,000 at December 31, 2005.

We recommend the City Attorney's Office, City Purchasing Department, and City Auditor's Office work together to develop a formal contract policy. The policy should address when written contracts are required, the form and content of the terms of the agreement, and responsibilities for monitoring contract requirements. The City Purchasing Department and the City Auditor's Office should ensure that, when required, signed contracts are in place before disbursements are made. We recommend the City Auditor's Office monitor the expenditures made by Visit Duluth during the contract year for compliance with its contract. We recommend all contract noncompliance be reported to the Mayor and City Council.

Client's Response:

The City will review its contracting procedures. The motor grader lease agreement was delayed due in part to lease agreement language disagreements with the leasing company. Additional information will be requested from Visit Duluth that documents line item budget compliance for future contract payments. Lake Superior Center has been billed for interest due on the \$150,000 loan.

05-8

Direct Deposit

Minn. Stat. § 471.426 gives the City the authority to require direct deposit for all its employees who are being paid by its payroll system. Currently, City employees are paid by direct deposit and checks. Requiring employees to be paid through direct deposit would increase internal control over payroll. It would eliminate having to pay employees through two different means. Any control issues related to employees switching from actual checks to direct deposit or vice versa would be eliminated. Less time would need to be spent reconciling the payroll account because employees would no longer have outstanding checks.

We recommend that the City require all employees to be paid by direct deposit.

Client's Response:

The City will investigate the feasibility of mandating direct deposit for payroll payments. Our ability to mandate direct deposit is impacted by payroll payments to seasonal part-time employees and workforce development grant participants.

PREVIOUSLY REPORT ITEM RESOLVED

Capital Equipment Budget (03-3)

The City Council did not formally approve a capital equipment budget.

Resolution

The City adopted resolution 05-0834, which established the "Capital Improvement Budget and Five Year Plan 2006-2010."

B. OTHER ITEMS FOR CONSIDERATION

Postemployment Health Care Benefits

The City provides postemployment health care benefits to retirees in accordance with the various union contracts. Expenses for health care benefits are recognized as reported claims when paid and include a provision for estimated claims incurred but not yet reported to the City. The City does not report, nor do generally accepted accounting principles currently require the reporting of, a liability when the benefit is earned.

During 2005, retirees' health care claims of \$6,179,823 were paid. This is a 1,076 percent increase from the 1989 claims of \$574,578 and a \$688,191 increase (13 percent) from the 2004 claims. We believe the City's expenses will continue to increase dramatically because of increasing numbers of retirees receiving this benefit, longer life spans, ever increasing medical costs, and possible decreasing Medicare coverage. An actuary calculated the City's unfunded post-retirement benefit obligation for health care benefits as of December 31, 2004, to be \$279,934,736.

We recommend the City continue seeking methods of controlling and funding this rising unfunded employee benefit.

Client's Response:

The City is currently negotiating changes in health care benefits with its bargaining units which will lower the cost of future post employment health care benefits. The City will continue to seek ways to further control OPEB costs and investigate funding options in conjunction with implementation of Governmental Accounting Standards Board Statement No. 43 and Statement No. 45.

Other Postemployment Benefits (OPEB)

The Governmental Accounting Standards Board (GASB) recently issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which establishes financial reporting for OPEB plans, and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which governs employer accounting and financial reporting for OPEB. These standards, like what GASB Statements 25 and 27 did for government employee pension benefits and plans, provide the accounting and reporting standards for the various other postemployment benefits many local governments offer to their employees. OPEB can include many different benefits offered to retirees such as health, dental, life, and long-term care insurance coverage. Also, if retirees are included in an insurance plan and pay a rate similar to that paid for younger active employees, this implicit rate subsidy is considered OPEB. In fact, local governments may be required to continue coverage pursuant to Minn. Stat. § 471.61, subd. 2b. This benefit is common when accumulated sick leave is used to pay for retiree medical insurance. Under the new statements, accounting for OPEB is now similar to the accounting used by governments for pension plans.

Schedule 1
(Continued)

Some of the issues that the City will need to address in order to comply with the statements are:

- determine if the employees are provided OPEB;
- if OPEB are being provided, the City will have to determine whether it will advance fund the benefits or pay for them on a pay-as-you-go basis;
- if OPEB are being provided, and the City determines that the establishment of a trust is desirable in order to fund the OPEB, the City will have to wait until legislation is enacted authorizing the creation of an OPEB trust and establishing an applicable investment standard; and
- in order to determine annual costs and liabilities that need to be recognized, the City will have to decide whether to hire an actuary.

GASB Statements 43 and 45 are effective for the years ended December 31, 2006 and 2007, respectively for the City.



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PATRICIA ANDERSON
STATE AUDITOR

**REPORT ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED
ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS***

Mayor and City Council
City of Duluth

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Duluth as of and for the year ended December 31, 2005, and have issued our report thereon dated May 17, 2006. These financial statements include the Spirit Mountain Recreation Area Authority activities for the year ended April 30, 2005. We did not audit the financial statements of the Steam District #2 Enterprise Fund, which statements represent 6.0 percent of the assets and 7.5 percent of the program revenues of the business-type activities. Those financial statements were audited by other auditors. Separate management and compliance letters have been issued for the Duluth Airport Authority, Duluth Entertainment and Convention Center Authority, Steam District #2 Enterprise Fund, Duluth Transit Authority, and Spirit Mountain Recreation Area Authority. The letters for the Duluth Airport Authority and the Duluth Transit Authority included the reports required for a single audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The financial statements of the Steam District #2 Enterprise Fund were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the City of Duluth's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control

over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the City's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as items 96-5 and 96-8.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe neither of the reportable conditions indicated above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City of Duluth's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Minnesota Legal Compliance

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the provisions of the *Minnesota Legal Compliance Audit Guide for Local Government*, promulgated by the State Auditor pursuant to Minn. Stat. § 6.65. Accordingly, the audit included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The *Minnesota Legal Compliance Audit Guide for Local Government* contains seven categories of compliance to be tested: contracting and bidding, deposits and investments, conflicts of interest, public indebtedness, claims and disbursements, miscellaneous provisions, and tax increment financing. Our study included all of the listed categories.

The results of our tests indicate that, for the items tested, the City of Duluth complied with the material terms and conditions of applicable legal provisions, except as described in the Schedule of Findings and Questioned Costs as item 05-2.

This report is intended solely for the information and use of the City's management, the Mayor, the City Council, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than those specified parties.

/s/Pat Anderson

PATRICIA ANDERSON
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

End of Fieldwork: May 17, 2006

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PATRICIA ANDERSON
STATE AUDITOR

**REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO
EACH MAJOR PROGRAM AND INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

Mayor and City Council
City of Duluth

Compliance

We have audited the compliance of the City of Duluth with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended December 31, 2005. The City's major federal programs are identified in the Summary of Auditor's Results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the City's management. Our responsibility is to express an opinion on the City's compliance based on our audit.

The City of Duluth's basic financial statements include the operations of the Duluth Airport Authority and the Duluth Transit Authority component units, which expended \$12,689,702 and \$1,907,353, respectively, in federal awards during the year ended December 31, 2005, which are not included in the Schedule of Expenditures of Federal Awards. Our audit, described below, did not include the operations of the Duluth Airport Authority and the Duluth Transit Authority because they had separate single audits in accordance with OMB Circular A-133.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements

referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the City of Duluth's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the City's compliance with those requirements.

In our opinion, the City of Duluth complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended December 31, 2005. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements that is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying Schedule of Findings and Questioned Costs as item 05-1.

Internal Control Over Compliance

The management of the City of Duluth is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the City's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Duluth as of and for the year ended December 31, 2005, and have issued our report thereon dated May 17, 2006. We did not audit the financial statements of the Steam District #2 Enterprise Fund. Our audit was performed for the purpose of forming opinions on the financial statements that collectively comprise the City of Duluth's basic financial statements. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by OMB Circular A-133 and

is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the City's management, the Mayor, the City Council, and federal awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than those specified parties.

/s/Pat Anderson

PATRICIA ANDERSON
STATE AUDITOR

/s/Greg Hierlinger

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR

End of Fieldwork: May 17, 2006

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**CITY OF DULUTH
DULUTH, MINNESOTA**

Schedule 2

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
YEAR ENDING DECEMBER 31, 2005**

Federal Grantor Pass-Through Agency Grant Program Title	Federal CFDA Number	Expenditures	Passed Through to Subrecipients
U.S. Department of Agriculture			
Passed Through Great Lakes Commission			
Soil and Water Conservation	10.902	\$ <u>9,150</u>	\$ -
U.S. Department of Commerce			
Passed Through Minnesota Department of Natural Resources			
Coastal Zone Management Administration Awards	11.419	\$ <u>127,206</u>	\$ -
U.S. Department of Housing and Urban Development			
Direct			
Community Development Block Grant	14.218	\$ 3,111,507	\$ 2,493,333
Emergency Shelter	14.231	110,773	102,470
Home Investment Partnerships Program	14.239	817,085	745,646
Section 108 Loan Guarantees	14.248	<u>7,349,182</u>	-
Total U.S. Department of Housing and Urban Development		\$ <u>11,388,547</u>	\$ <u>3,341,449</u>
U.S. Department of Justice			
Direct			
Grants to Encourage Arrest Policies and Enforcement of Protection Orders Program	16.590	\$ 239,383	\$ -
Local Law Enforcement Block Grant	16.592	28,360	-
Bulletproof Vest Partnership Program	16.607	22,614	-
Passed Through Minnesota Department of Public Safety			
Edward Byrne Memorial Formula Grant Program	16.579	81,737	-
Enforcing Underage Drinking Laws Program	16.727	<u>6,000</u>	-
Total U.S. Department of Justice		\$ <u>378,094</u>	\$ -
U.S. Department of Labor			
Passed Through Senior Service America, Inc.			
Senior Community Service Employment Program	17.235	\$ 105,753	\$ -
Passed Through Minnesota Department of Employment and Economic Development			
Employment Service/Wagner-Peysar Funded Activities	17.207	1,235	-
Senior Community Service Employment Program	17.235	245,107	-
Workforce Investment Act - Adult Program	17.258	185,143	-
Workforce Investment Act - Youth Activities	17.259	190,983	-
Dislocated Worker	17.260	<u>75,523</u>	-
Total U.S. Department of Labor		\$ <u>803,744</u>	\$ -

**CITY OF DULUTH
DULUTH, MINNESOTA**

Schedule 2
(Continued)

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
YEAR ENDING DECEMBER 31, 2005**

Federal Grantor Pass-Through Agency Grant Program Title	Federal CFDA Number	Expenditures	Passed Through to Subrecipients
U.S. Department of Transportation			
Passed Through Minnesota Department of Transportation Highway Planning and Construction	20.205	\$ 42,359	\$ -
Passed Through Minnesota Department of Natural Resources Recreational Trails Program	20.219	15,545	-
Passed Through Minnesota Department of Public Safety State and Community Highway Safety Alcohol Traffic Safety and Drunken Driving Prevention Incentive Grants	20.600 20.601	14,061 <u>5,502</u>	- <u>-</u>
Total U.S. Department of Transportation		<u>\$ 77,467</u>	<u>\$ -</u>
U.S. Environmental Protection Agency			
Direct			
Great Lakes Program	66.469	\$ 1,389	\$ -
Brownfield Assessment and Cleanup Cooperative Agreements	66.818	1,587	-
Environmental Education Grants	66.951	8,250	-
Passed Through Minnesota Department of Employment and Economic Development Capitalization Grant for Clean Water State Revolving Funds	66.458	<u>471,541</u>	<u>-</u>
Total U.S. Environmental Protection Agency		<u>\$ 482,767</u>	<u>\$ -</u>
U.S. Department of Health and Human Services			
Passed Through Arrowhead Regional Development Commission Senior Nutrition Program	93.045	<u>\$ 217,676</u>	<u>\$ -</u>
U.S. Department of Homeland Security			
Direct			
Assistance to Firefighters Grant	97.044	\$ 45,475	\$ -
Passed Through Minnesota Department of Public Safety Homeland Security Grant Program	97.067	<u>869,279</u>	<u>-</u>
Total U.S. Department of Homeland Security		<u>\$ 914,754</u>	<u>\$ -</u>
Total Federal Awards		<u>\$ 14,399,405</u>	<u>\$ 3,341,449</u>

Notes to the Schedule of Expenditures of Federal Awards

1. The Schedule of Expenditures of Federal Awards presents the activity of federal award programs expended by the City of Duluth and does not include activities of its component units. The City's reporting entity is defined in Note 1 to the basic financial statements.
2. The expenditures on this schedule are on the basis of accounting used by the individual funds of the City. Governmental funds use the modified accrual basis, and proprietary funds use the accrual basis.
3. Pass-through grant numbers were not assigned by the pass-through agencies.