

CITY OF WATERLOO

REPORT ON INTERNAL CONTROL

(Including Memorandum on Accounting Procedures,
Internal Controls, and Other Matters)

As of and for the Year Ended December 31, 2011

To the City Council
City of Waterloo
Waterloo, Wisconsin

In planning and performing our audit of the financial statements of the City of Waterloo as of and for the year ended December 31, 2011 in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of its internal control. Accordingly, we do not express an opinion on the effectiveness of its internal control.

A separate Report on Internal Control was issued to the Utility Commission. The information contained in that report is not included with this report.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control 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 that we consider to be material weaknesses and a deficiency that we consider to be a significant deficiency.

A deficiency in internal control 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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiencies in the city's internal control to be material weaknesses:

- > Internal Control Over Financial Reporting
- > Internal Controls

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiency in the city's internal control to be a significant deficiency:

- > Information Technology System Internal Controls

This communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be, and should not be, used by anyone other than these specified parties.

Baker Tilly Virchow Krause, LLP

Madison, Wisconsin
July 13, 2012

CITY OF WATERLOO

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INTERNAL CONTROL OVER FINANCIAL REPORTING

In theory, a properly designed system of internal control staffed with enough people with sufficient training would provide your organization with the ability to not only process and record monthly transactions, but also to prepare a complete set of annual financial statements.

The definition of a material weakness in internal control includes consideration of the year end financial reporting process. To avoid the auditor reporting a material weakness in internal control, your system of controls would need to be able to accomplish the following:

1. Present the books and records to the auditor in such a condition that the auditor is not able to identify any material journal entries as a result of our audit procedures.
2. Be capable of preparing a complete set of year end financial statements in such a condition that the auditor is not able to identify any material changes as a result of the audit. This includes drafting the individual fund statements, making conversion entries, drafting the government-wide statements, and preparing footnote disclosures.

This level of internal control over financial reporting can be a difficult task for governments. Many governments operate with only enough staff to process monthly transactions and reports, and often rely on auditors to prepare certain year end audit entries and handle the year end financial reporting. As this is the case with the City of Waterloo, we are required to inform you that these are material weaknesses in your internal controls.

INTERNAL CONTROLS

As a result of our audit procedures, we are required to provide to you information about where your controls over transactions either do not exist, or could be improved. Below is a list of potential controls that should be in place to achieve a higher level of reliability that errors or irregularities in your processes would be discovered by your staff. Keep in mind that some of these controls may not be practical due to your staff size or other reasons. However, we are required to communicate these to you.

CONTROLS OVER ACCOUNTS PAYABLE/DISBURSEMENTS

1. Persons processing accounts payable should be separate from those ordering or receiving goods or services (segregation of duties).
2. There should be an appropriate system for review and approval of vendors.
3. There should be a review and approval in place of the fiscal year cutoff.
4. There is a process to review, record, and approve retainages and encumbrances at year end; however, there should be documentation in place which provides evidence of this.

INTERNAL CONTROLS (cont.)

CONTROLS OVER PAYROLL

1. Persons preparing the payroll should be independent of other personnel duties or restricted from access to the payroll account (segregation of duties).
2. Year-end accrued payroll should be recorded to ensure proper cutoff between fiscal years and this calculation should be reviewed and approved by an appropriate person.

CONTROLS OVER PROPERTY TAXES

1. Batch collections should be reconciled from the general ledger to the tax collection system by someone independent of the process.
2. There should be adequate review and approval of the journal entries to record taxes receivable and the tax settlements.
3. Bank reconciliations for the tax account should be performed timely by someone independent of the tax collection process.
4. Each property tax settlement should include a reconciliation of the general ledger to the tax collection system totals. This should be done by someone independent of the tax collection process.

CONTROLS OVER FINANCIAL REPORTING

1. Adjusting journal entries and supporting documentation should be reviewed and approved by an appropriate person who is not the original preparer.
2. Account reconciliations should be performed by someone independent of the processing of transactions in the account (segregation of duties).

We recommend that a designated person in the city review these potential controls and evaluate if any changes are practical to implement for your organization.

INFORMATION TECHNOLOGY SYSTEM INTERNAL CONTROLS

1. The city lacks various controls surrounding its information technology related to the accounting functions. These include: user access controls, password controls, monitoring of IT access, and policy documentation related system changes. Proper system back-up should be evaluated and maintained.
2. The city's present software system lacks certain security features that, if operated improperly, would not allow for the identification of changes made to financial data after the original entry of such data. This is a control weakness that exists in many database software packages, including Microsoft Office Access, which is the basis for your software. Many of the system users may not possess the technical knowledge to operate the system in a manner that would impair the system's control integrity. However, it is possible that some users may possess the knowledge to circumvent the system's controls. Therefore, we believe that it is reasonably possible that a material error could occur resulting in a misstatement of the city's financial statements, and your controls would not prevent or detect the error. Accordingly, we are required to communicate this fact to you.

INFORMATIONAL DISCLOSURES

GASB STATEMENT NO. 54: FUND BALANCE REPORTING

Last year, we informed you that the Governmental Accounting Standards Board (GASB) had issued Statement No. 54, which changes governmental financial reporting. These changes affected your financial statements for the year ended December 31, 2011, primarily the governmental fund's balance sheet presentation. No changes are necessary for proprietary fund types or government-wide statements. The major change is to the terminology used for fund balance reporting. The terms reserved, unreserved, designated, and undesignated are being replaced with the following categories: nonspendable, restricted, committed, assigned, and unassigned. The new categories are designed to promote more consistent financial reporting throughout the nation.

The city has implemented the necessary changes, and you will see the new information on both the 2011 fund financial statements and in the footnote disclosures. Please contact us if you have any questions on the new presentation.

GASB STATEMENT NO. 61: THE FINANCIAL REPORTING ENTITY: OMNIBUS

The Governmental Accounting Standards Board (GASB) has issued Statement No.61, which changes governmental financial reporting for component units. These changes will affect your financial statements for the year ended December 31, 2013, primarily the government-wide financial statements, and possibly the fund financial statements.

This Statement modifies certain requirements for inclusion of component units in the financial reporting entity. For organizations that previously were required to be included as component units by meeting the fiscal dependency criterion, a financial benefit or burden relationship also would need to be present between the primary government and that organization for it to be included in the reporting entity as a component unit. Further, for organizations that do not meet the financial accountability criteria for inclusion as component units but that, nevertheless, should be included because the primary government's management determines that it would be misleading to exclude them, this Statement clarifies the manner in which that determination should be made and the types of relationships that generally should be considered in making the determination.

This Statement also amends the criteria for reporting component units as if they were part of the primary government (that is, blending) in certain circumstances. For component units that currently are blended based on the "substantively the same governing body" criterion, it additionally requires that (1) the primary government and the component unit have a financial benefit or burden relationship or (2) management (below the level of the elected officials) of the primary government have operational responsibility (as defined) for the activities of the component unit. New criteria also are added to require blending of component units whose total debt outstanding is expected to be repaid entirely or almost entirely with resources of the primary government. The blending provisions are amended to clarify that funds of a blended component unit have the same financial reporting requirements as a fund of the primary government. Lastly, additional reporting guidance is provided for blending a component unit if the primary government is a business-type activity that uses a single column presentation for financial reporting.

This Statement also clarifies the reporting of equity interests in legally separate organizations. It requires a primary government to report its equity interest in a component unit as an asset.

You will need to determine how these new requirements will affect your financial statements.

INFORMATIONAL DISCLOSURES (cont.)

GASB STATEMENT NO. 63: FINANCIAL REPORTING OF DEFERRED OUTFLOWS OF RESOURCES, DEFERRED INFLOWS OF RESOURCES, AND NET POSITION

The Governmental Accounting Standards Board (GASB) has issued Statement No. 63, which changes governmental financial reporting for certain assets and liabilities. These changes will affect your financial statements for the year ended December 31, 2012, primarily the government-wide financial statements, and possibly the fund financial statements.

This Statement provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. Concepts Statement No. 4, *Elements of Financial Statements*, introduced and defined those elements as a consumption of net assets by the government that is applicable to a future reporting period, and an acquisition of net assets by the government that is applicable to a future reporting period, respectively. Previous financial reporting standards do not include guidance for reporting those financial statement elements, which are distinct from assets and liabilities.

Examples of deferred outflows may include:

- > Loss on refunding of debt
- > Certain advances to grantees
- > Purchase of future revenues

Examples of deferred inflows may include:

- > Advances received for certain grants
- > Gain on refunding of debt
- > Sales of future revenues
- > Certain revenues received under FASB 71

The result of these changes means that your balance sheet may need to have 2 additional categories, one below assets and another below liabilities. In addition, some titles as “statement of net assets” will change to “statement of net position”. There are also increased footnote disclosure requirements.

You will need to determine how these new requirements will affect your financial statements.

ECONOMIC CONDITIONS AND YOUR COMMUNITY

Economic conditions for the nation as a whole have declined in recent years. There has been widespread impact on federal, state, and local governments. To position your community for fiscal stability, you should continue to regularly evaluate many of the topics we’ve outlined in our letters from prior years, including:

- > Collateralized bank balances
- > Long term borrowing and refinancing plans in a tightening credit market
- > Cash flow impacts of an increase in delinquencies
- > Equalized value changes
- > Tax base impacts of slowed development
- > State budget issues

Suggested steps in proactively planning for these challenges include:

- > Preparing annual budgets that are realistic and accurate
- > Monitoring compliance with the annual budget based on financial records that are accurate and understandable
- > Making amendments to the budget when necessary and determining sources of revenues to cover additional appropriations

INFORMATIONAL DISCLOSURES (cont.)

ECONOMIC CONDITIONS AND YOUR COMMUNITY (cont.)

- > Developing a fund balance policy to ensure that your community has enough reserves on hand for emergency appropriations
- > Forecasting cash flows as a result of changing economic conditions and developing a plan to address significant issues
- > Forecasting capital needs and anticipated financing available
- > Monitoring your community's debt capacity compared to the limit established by the state
- > Exploring ways to confine costs, such as consolidation of services with other local governments or outsourcing
- > Developing investment policies that address collateralization of deposits and investments

Your community's long-term success is important. As a governing body, your involvement and understanding of your community's financial activities will help you make informed decisions regarding the future of your community. Please feel free to contact us if you have questions – we are happy to discuss these topics in further detail.

ASSISTANCE WITH FINANCIAL OPERATIONS

Local governments are always searching for ways to do a better job providing services and utilizing resources. Two organizations provide tools and information to help you meet those objectives.

The Government Finance Officers Association (GFOA) based in Chicago, Illinois has a large number of best practices, advisories, and public policy statements available free of charge. The best practices and advisories are organized by category:

- > Accounting, Auditing and Financial Reporting
- > Budgeting and Fiscal Policy
- > Debt Management
- > Economic Development and Capital Planning
- > Retirement and Benefits Administration
- > Treasury and Investment Management

Included in these topics are approximately 180 individual documents which present a best practice or advice. Recently, the GFOA released the following 6 new or updated documents:

- > Presentation of the Departmental Section in the Operating Budget
- > Establishing and Administering an OPEB Trust
- > The Public Finance Officer's Role in Sustainability
- > Expenses Charged by Underwriters in Negotiated Sales
- > Managing Build America and Other Direct Subsidy Bonds
- > Using Mutual Funds for Cash Management Purposes

In addition, the GFOA has a practice manual entitled "Best Practices in Public Budgeting".

All of these are available for your review at www.gfoa.org.

The Governmental Accounting Standards Board (GASB) also has publications available to assist governments. The latest guide is called "What You Should Know About Your Local Government's Finances – A Guide to Financial Statements". There are also guides specific to school districts and others. There is a small charge for these guides at www.gasb.org.

We encourage you to consider using these resources as appropriate to improve your financial operations.

CURRENT YEAR POINTS

BUDGET REQUIREMENTS

Wisconsin state statutes regarding municipal budgeting specify the information that should be incorporated into the city's class 1 notice regarding the budget public hearing and the budget document adopted by the city.

The city's budget notice should include the following items:

- A. Summary budget for the proposed budget, the budget in effect and the percentage changed between the budget of the current year and the proposed budget. A summary budget would include:
 - 1. All expenditures by major expenditure category for general fund.
 - 2. All revenues by major revenue source for general fund.
 - 3. Any financing source and use not included in 1. and 2. above.
 - 4. All beginning and year-end fund balances for all funds.
 - 5. Total revenues and expenditures for each fund.
 - 6. Summary totals of revenues and expenditures (all funds).
 - 7. Local property taxes for each fund and the total for all funds.
 - 8. List of budget increases and decreases due to new or discontinued activities.
- B. The place where the budget, in detail, is available for public inspection.
- C. The time and place for holding the public hearing.

The budget document is required to include these items:

- A. List all existing indebtedness.
- B. Actual revenues and expenditures of the preceding year.
- C. Actual revenues and expenditures for not less than the first six months of the current year and estimated revenues and expenditures for the balance of the year.
- D. All anticipated revenue from all sources and all proposed appropriations for the ensuing year (proposed budget).
- E. All anticipated unexpended or unappropriated balances and surpluses for each fund.

Recommendation

We recommend that the city review state statutes pertaining to municipal budgets. When preparing the city budget, you should include the items mentioned above.

CURRENT YEAR POINTS (cont.)

DEFICIT CAPITAL PROJECTS FUND BALANCE

As of December 31, 2011, the city's general capital projects fund had a deficit fund balance of \$443,588. This fund started the year with a deficit fund balance of \$229,729 or an increase of \$213,859 during 2011.

A portion of this deficit (approximately \$275,000) will be eliminated when the city receives grant funding related to purchasing properties in the flood plain, demolishing the buildings and related services. The city submitted a reimbursement request for this amount on February 3, 2012.

However, even after this grant reimbursement, the city's general capital project fund will continue to have a significant deficit balance with no plans in the 2012 budget to reduce this deficit. The city did levy taxes of \$114,134 in this fund; however, our understanding is that the 2012 tax revenue will be used to finance 2012 projects and not to reduce the deficit.

To finance this deficit as of December 31, 2011 the following funds have "loaned" money to the general capital projects fund:

1. General Fund - \$276,577. It is anticipated that this will be paid off with the grants funds to be received by the capital projects fund in 2012.
2. General Fund - \$163,339. This is currently reflected as an advance between the general fund and general capital projects as there is no 2012 revenue anticipated to reimburse the general fund. The general fund is showing this as non-spendable fund balance which has a negative impact on its unassigned fund balance.
3. TIF No. 1 - \$41,000. This amount was advanced from TIF No. 1 to the general capital projects fund. These monies will need to be repaid when funds are available.

We recommend that the city develop a plan to reduce the deficit in the general capital projects fund in order to repay the general fund and TIF No. 1. The plan might include an increase in tax levy support, which is difficult given the tax levy limitations, research other revenue sources (grant funding, etc.), reduce 2012 expenditures or postpone or eliminate future capital projects.

PRIOR YEAR POINTS

UNCOLLATERALIZED DEPOSITS

Governmental Accounting Standards Board (GASB) Statement No. 40 requires disclosures about deposits and investments. One of the main purposes of GASB Statement No. 40 is to indicate to users of financial statements the custodial risks involved with an entity's deposits and investments. These disclosures are included in the notes to your financial statements.

With regard to deposits at banks, the FDIC coverage was changed during 2011. Here are the new rules. There are now three categories of coverage:

- 1) Time (CDs) and savings deposits (defined as "NOW accounts and money market deposit accounts but not interest bearing demand deposit accounts")
- 2) Interest bearing demand deposit accounts (defined as "deposits payable on demand and for which the depository institution does not reserve the right to require advanced notice of withdrawal")
- 3) Non-interest bearing demand deposit accounts

The FDIC coverage for these categories is as follows:

- 1) \$250,000
- 2) \$250,000
- 3) Unlimited

These rules are supposed to be good through 12-31-12. You will need to consider whether the new rules affect your investment policies or practices in any way.

Status (12/31/11)

As of December 31, 2011, the city had \$936,415 of uncollateralized deposits with its banks. We recommend that the city evaluate this to determine if further action is necessary. We also recommend the city review their collateral agreements with the banks to ensure the safety of its assets.

DECENTRALIZED ACTIVITIES

As part of our annual audit process, we focus our efforts on the primary accounting systems, internal controls, and procedures used by the city. This is in keeping with our goal to provide an audit opinion which states that the financial statements of the city are correct in all material respects.

In some cases, the primary system of accounting procedures and controls of the city are supported by smaller systems which are decentralized, and reside within a department or location. In many cases, those systems are as simple as handling cash collections and remitting those collections to the city treasurer. (For example, this would be the case in a typical municipal swimming pool.) In other cases, the department may send invoices or statements of amounts due, and track collections of those amounts in a standalone accounts receivable system. (For example, this would be the case in a typical municipal court.)

Generally, the more centralized a function is, the easier it is to design and implement accounting controls that provide some level of checks and balances. That is because you are able to divide certain tasks over the people available to achieve some segregation of duties. For those tasks that are decentralized, it is usually very difficult to provide for proper segregation of duties. Therefore, with one person being involved in most or all aspects of a transaction, you lose the ability to rely on the controls to achieve the safeguarding of assets and reliability of financial records.

PRIOR YEAR POINTS (cont.)

DECENTRALIZED ACTIVITIES (cont.)

As auditors, we are required to communicate with you on a variety of topics. Since there is now more emphasis on internal controls and management's responsibilities, we believe it is appropriate to make sure that you are informed about the lack of segregation of duties that may occur at departments or locations that handle cash or do miscellaneous billing. Examples in your city that fit this situation may include the following:

Library fines
Police issued tickets

As auditors, we are required to focus on the financial statements at a highly summarized level and our audit procedures support our opinion on those financial statements. Departments or locations that handle relatively smaller amounts of money are not the primary focus of our audit. Yet, because of the lack of segregation of duties, the opportunity for loss is higher there than in centralized functions that have more controls.

Because management is responsible for designing and implementing controls and procedures to detect and prevent fraud, we believe that is important for us to communicate this information to you. We have no knowledge of any fraud that has occurred or is suspected to have occurred within the departments mentioned above. However, your role as the governing body is to assess your risk areas and determine that the appropriate level of controls and procedures are in place. As always, the costs of controls and staffing must be weighed against the perceived benefits of safeguarding your assets.

We recommend that the procedures for decentralized cash collection be reviewed and internal controls strengthened. This could be done by reassigning tasks to establish new system controls, or moving the accounting function to centralized city staff.

Status (12/31/11)

This point still pertains.

CAPITALIZATION POLICY

The city currently does not have a written capitalization policy. We recommend that the city formalize a policy to be used as a guideline when preparing the capital asset reports.

Status (12/31/11)

This point still pertains.

TIF AUDITS

The city presently has one Tax Incremental Financing (TIF) District which is reported as a capital projects fund in the financial statements.

In addition to the annual financial statement audit coverage, the district is also required by state statutes to have a separate audit throughout its lifetime of up to 27 years. This is known as a TIF compliance audit and is required at the following times:

1. After 30% of the project expenditures are made.
2. After the end of the expenditure period.
3. After the termination of the district.

PRIOR YEAR POINTS (cont.)

TIF AUDITS (cont.)

Each of the audits described contains three separate areas of coverage:

1. Financial audit of the district from date of creation through applicable date.
2. Compliance of the district with the approved project plan.
3. Compliance of the district with state statutes.

Status (12/31/11)

A 30% compliance audit of the TIF No. 1 expenditures has been completed.

TWO WAY COMMUNICATION REGARDING YOUR AUDIT

As part of our audit of your financial statements, we are providing communications to you throughout the audit process. Auditing requirements provide for two-way communication and are important in assisting the auditor and you with more information relevant to the audit.

As this past audit is concluded, we use what we have learned to begin the planning process for next year's audit. It is important that you understand the following points about the scope and timing of our next audit:

- a. We address the significant risks of material misstatement, whether due to fraud or error, through our detailed audit procedures.
- b. We will obtain an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. We will obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. We will use such knowledge to:
 - > Identify types of potential misstatements.
 - > Consider factors that affect the risks of material misstatement.
 - > Design tests of controls, when applicable, and substantive procedures.

We will not express an opinion on the effectiveness of internal control over financial reporting or compliance with laws, regulations, and provisions of contracts or grant programs. For audits done in accordance with *Government Auditing Standards*, our report will contain the following restriction: "This report is intended solely for the information and use of those charged with governance, management, others within the city, federal and state awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties."

- c. The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles while other matters are not important. In performing the audit, we are concerned with matters that, either individually or in the aggregate, could be material to the financial statements. Our responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected.

TWO WAY COMMUNICATION REGARDING YOUR AUDIT (cont.)

We are very interested in your views regarding certain matters. Those matters are listed here:

- a. We typically will communicate with your top level of management unless you tell us otherwise.
- b. We understand that the city council has the responsibility to oversee the strategic direction of your organization, as well as the overall accountability of the entity. Management has the responsibility for achieving the objectives of the entity.
- c. We need to know your views about your organization's objectives and strategies, and the related business risks that may result in material misstatements.
- d. Which matters do you consider warrant particular attention during the audit, and are there any areas where you request additional procedures to be undertaken?
- e. Have you had any significant communications with regulators?
- f. Are there other matters that you believe are relevant to the audit of the financial statements?

Also, is there anything that we need to know about the attitudes, awareness, and actions of the city concerning:

- a. The city's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control?
- b. The detection or the possibility of fraud?

We also need to know if you have taken actions in response to developments in financial reporting, laws, accounting standards, governance practices, or other related matters, or in response to previous communications with us.

With regard to the timing of our audit, here is some general information. If necessary, we may do preliminary audit work during the months of October-December, and sometimes early January. Our final fieldwork is scheduled during the spring to best coincide with your readiness and report deadlines. After fieldwork, we wrap up our audit procedures at our office and may issue drafts of our report for your review. Final copies of our report and other communications are issued after approval by your staff. This is typically 6-12 weeks after final fieldwork, but may vary depending on a number of factors.

Keep in mind that while this communication may assist us with planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

We realize that you may have questions on what this all means, or wish to provide other feedback. We welcome the opportunity to hear from you.

REQUIRED COMMUNICATIONS

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA

The objective of a financial statement audit is the expression of an opinion on the financial statements. We conducted the audit in accordance with auditing standards generally accepted in the United States of America. These standards require that we plan and perform our audit to obtain reasonable, rather than absolute, assurance about whether the financial statements prepared by management with your oversight are free of material misstatement, whether caused by error or fraud. Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit does not relieve management or those charged with governance of their responsibilities.

As part of the audit we obtained an understanding of the entity and its environment, including internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing and extent of further audit procedures. The audit was not designed to provide assurance on internal control or to identify deficiencies in internal control.

OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

Our responsibility does not extend beyond the audited financial statements identified in this report. We do not have any obligation to and have not performed any procedures to corroborate other information contained in client prepared documents, such as official statements related to debt issues.

PLANNED SCOPE AND TIMING OF THE AUDIT

We performed the audit according to the planned scope and timing previously communicated to you in our letter about planning matters dated August 17, 2011.

QUALITATIVE ASPECTS OF THE ENTITY'S SIGNIFICANT ACCOUNTING PRACTICES

Accounting Policies

Management is responsible for the selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City of Waterloo are described in Note I to the financial statements. As described in Note I to the financial statements, the City of Waterloo changed accounting policies related to fund equity by adopting Statement of Governmental Accounting Standards (GASB) Statement No. 54 – *Fund Balance Reporting in Governmental Fund Type Definitions* in 2011. We noted no transactions entered into by the City of Waterloo during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

REQUIRED COMMUNICATIONS (cont.)

QUALITATIVE ASPECTS OF THE ENTITY'S SIGNIFICANT ACCOUNTING PRACTICES (cont.)***Accounting Estimates***

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:

Management's estimate of the allowance for ambulance receivables is based on payment history for this type of receivable. The estimate appears reasonable.

Financial Statement Disclosures

The disclosures in the financial statements are neutral, consistent, and clear.

DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT

We encountered no significant difficulties in dealing with management in performing our audit.

AUDIT ADJUSTMENTS

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.

The following is a summary of material financial statement misstatements (audit adjustments):

	<u>Amount</u>
Adjustments to due from other governments	\$ 570,712
Adjustments to deferred revenue	378,098
Adjustments to grant revenue	185,073

In addition, we prepared GASB No. 34 conversion entries which are summarized in the "Reconciliation of the Balance Sheet of Governmental Funds to the Statement of Net Assets" and the "Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities" in the financial statements.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter 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.

REQUIRED COMMUNICATIONS (cont.)

CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS

In some cases, management may decide to consult with other accountants about auditing and accounting matters. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditors' 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.

MANAGEMENT REPRESENTATIONS

We have requested certain representations from management that are included in the management representation letter. This letter is attached.

INDEPENDENCE

We are not aware of any relationships between Baker Tilly Virchow Krause, LLP and the City of Waterloo that, in our professional judgment, may reasonably be thought to bear on our independence.

Relating to our audit of the financial statements of for the year ended December 31, 2011, Baker Tilly Virchow Krause, LLP hereby confirms in accordance with the Code of Professional Conduct issued by the American Institute of Certified Public Accountants, that we are, in our professional judgment, independent with respect to the City of Waterloo and provided no services to the City of Waterloo other than the audit of the current year's financial statements and nonaudit services which in our judgment do not impair our independence.

- > Financial statement preparation
- > Adjusting journal entries
- > Compiled TIF financial statements
- > Compiled regulatory reports
- > Civic Systems software

None of these nonaudit services constitute an audit under generally accepted auditing standards, including *Government Auditing Standards*.

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 of Waterloo's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

CLOSING

This letter, by its nature, focuses on improvements and does not comment on the many strong areas of the city's systems and procedures. The comments and suggestions in this report are not intended to reflect in any way on the integrity or ability of the personnel of the city. They are made solely in the interest of establishing sound internal control practices and improving the city's financial operations.

This information is intended solely for the use of the governing body and management and is not intended to be, and should not be, used by anyone other than the specified parties.

CLOSING (cont.)

We will review the status of these comments during our next audit engagement. We would be pleased to discuss these comments and suggestions with you in further detail.

We would like to thank you for allowing us to serve the city. We are very interested in the long-term success of the City of Waterloo and our comments are intended to draw your attention to issues which need to be addressed for the city to meet its goals and responsibilities.



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Website: www.waterloowi.us

July 13, 2012

Baker Tilly Virchow Krause, LLP
Ten Terrace Court
P.O. Box 7398
Madison, WI 53707-7398

Dear Auditors:

We are providing this letter in connection with your audit of the financial statements of the City of Waterloo as of December 31, 2011 and for the year then ended for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of the City of Waterloo and the respective changes in financial position and cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation of the previously mentioned financial statements in conformity with accounting principles generally accepted in the United States of America. We are also responsible for adopting sound accounting policies, establishing and maintaining internal control, and preventing and detecting fraud.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America. We have engaged you to advise us in fulfilling that responsibility. The financial statements include all properly classified funds of the oversight unit and all component units required by accounting principles generally accepted in the United States of America to be included in the financial reporting entity.
2. We have made available to you all –
 - a. Financial records and related data (and all audit or relevant monitoring reports, if any, received from funding sources.)
 - b. Minutes of the meetings of the city council or summaries of actions of recent meetings for which minutes have not yet been prepared.

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3. There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. All known audit and bookkeeping adjustments have been included in our financial statements, and we are in agreement with those adjustments.
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving:
 - a. Management,
 - b. Employees who have significant roles in internal control, or
 - c. Others where the fraud could have a material effect on the financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, or others.
9. We have a process to track the status of audit findings and recommendations.
10. We have identified to you any previous financial audits, attestation engagements, and other studies related to the audit objectives and whether related recommendations have been implemented.
11. We have provided our views on reported findings, conclusions, and recommendations, as well as our planned corrective actions, for our report
12. The City of Waterloo has no plans or intentions that may materially affect the carrying value or classification of assets, liabilities, or fund equity.

13. The following, if any, have been properly recorded or disclosed in the financial statements:
 - a. Related party transactions, including revenues, expenditures/expenses, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
 - b. Guarantees, whether written or oral, under which the municipality is contingently liable.
 - c. All accounting estimates that could be material to the financial statements including the key factors and significant assumptions underlying those estimates and measurements. We believe the estimates and measurements are reasonable in the circumstances, consistently applied, and adequately disclosed.
14. We are responsible for compliance with federal, state, and local laws, regulations, and provisions of contracts and grant agreements applicable to us, including tax or debt limits and debt contracts; and we have identified and disclosed to you all federal, state, and local laws, regulations and provisions of contracts and grant agreements that we believe have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives, including legal and contractual provisions for reporting specific activities in separate funds.
15. There are no –
 - a. Violations or possible violations of budget ordinances, provisions of contracts and grant agreements, federal, state, and local laws or regulations including those pertaining to adopting and amending budgets, tax or debt limits, and any related debt covenants whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency, or for reporting on noncompliance.
 - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with generally accepted accounting principles.
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by generally accepted accounting principles.
 - d. Nonspendable, restricted, committed, or assigned fund balances that were not properly authorized and approved.
 - e. Rates being charged to customers other than the rates as authorized by the applicable authoritative body.
 - f. Violations of restrictions placed on revenues as a result of bond resolution covenants such as revenue distribution or debt service funding.

16. The City of Waterloo has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
17. The City of Waterloo has complied with all aspects of contractual agreements that would have a material effect on the financial statement in the event of noncompliance.
18. We have followed all applicable laws and regulations in adopting, approving, and amending budgets.
19. The financial statements include its component unit. There are no joint ventures with an equity interest or other joint ventures or other related organizations that should be reported.
20. The financial statements properly classify all funds and activities.
21. All funds that meet the quantitative criteria in GASB Statement No. 34 and No. 37 for presentation as major are identified and presented as such and all other funds that are presented as major are particularly important to financial statement users.
22. Components of net assets (invested in capital assets, net of related debt; restricted; and unrestricted) and equity amounts are properly classified and, if applicable, approved.
23. Provisions for uncollectible receivables have been properly identified and recorded.
24. Expenses have been appropriately classified in or allocated to functions and programs in the statement of activities, and allocations have been made on a reasonable basis.
25. Revenues are appropriately classified in the statement of activities within program revenues, general revenues.
26. Interfund, internal, and intra-entity activity and balances have been appropriately classified and reported.
27. Deposits and investment securities are properly classified as to risk, and investments are properly valued.
28. The city has no derivative financial instruments such as contracts that could be assigned to someone else or net settled, interest rate swaps, collars or caps at year end.
29. Capital assets, including infrastructure assets, are properly capitalized, reported, and, if applicable, depreciated.

30. We have appropriately disclosed the city's policy regarding whether to first apply restricted or unrestricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available and have determined that net assets were properly recognized under the policy. We have also disclosed our policy regarding how restricted and unrestricted fund balance is used when an expenditure is incurred for which both restricted and unrestricted fund balance is available, including the spending hierarchy for committed, assigned, and unassigned amounts.
31. We acknowledge our responsibility for the required supplementary information (RSI). The RSI is measured and presented within prescribed guidelines and the methods of measurement and presentation have not changed from those used in the prior period. We have disclosed to you any significant assumptions and interpretations underlying the measurement and presentation of the RSI.
32. We acknowledge our responsibility for presenting the management's discussion and analysis and budgetary comparison information in accordance with accounting principles generally accepted in the United States of America, and we believe the management's discussion and analysis and budgetary comparison information, including its form and content, is fairly presented in accordance with accounting principles generally accepted in the United States of America. The methods of measurement and presentation of the management's discussion and analysis and budgetary comparison information have not changed from those used in the prior period, and we have disclosed to you any significant assumptions or interpretations underlying the measurement and presentation of the supplementary information.
33. In regards to the nonattest services performed by you listed below, we have 1) made all management decisions and performed all management functions; 2) designated an individual with suitable skill, knowledge, or experience to oversee the services; 3) evaluated the adequacy and results of the services performed, and 4) accepted responsibility for the results of the services.
 - a. Financial statement preparation
 - b. Adjusting journal entries
 - c. Compiled TIF financial statements
 - d. Civic Systems software
 - e. Trial balance formatting from general ledger data


Baker Tilly Virchow Krause, LLP

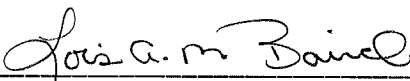
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We have evaluated and classified any subsequent events as recognized or unrecognized through the date of this letter. To the best of our knowledge and belief, no events, including instances of noncompliance, have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

Sincerely,

CITY OF WATERLOO

Signed: 
Morton J. Hansen, City Clerk/Treasurer

Signed: 
Lois A.M. Baird, Deputy Clerk/Treasurer

Signed: 
Jeni Quimby, Council President