

**CITY OF MADISON**

REPORT ON INTERNAL CONTROL

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

December 31, 2005



To the Honorable Mayor and Common Council  
City of Madison

In planning and performing our audit of the basic financial statements of the City of Madison for the year ended December 31, 2005, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control.

However, during our audit we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The following comments are related to procedural matters which can be implemented by City staff. As always, you should consider the costs of making improvements to the expected benefits. This letter does not affect our report dated May 5, 2006, on the financial statements of the City of Madison.

We will review the status of these comments during our next audit engagement. We have already discussed many of these comments and suggestions with various City personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

This report is intended solely for the information and use of City management and others within the administration and is not intended to be, and should not be, used by anyone other than the specified parties.

*Virchow Krause + Company LLP*

Madison, Wisconsin  
May 5, 2006

# CITY OF MADISON

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## INFORMATIONAL POINTS

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### *NEW AUDITING STANDARD – STATEMENT ON AUDITING STANDARDS (SAS) NO. 103*

As part of our audit of your financial statements for the year ended December 31, 2006, we will be required to follow a significant new auditing standard, or rule.

The new standard establishes standards and provides guidance to an auditor on audit documentation. Audit documentation is an essential element of audit quality. Although audit documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate audit documentation contributes to the quality of an audit.

Among other things, the SAS:

- Requires the auditor to prepare audit documentation in connection with each engagement in sufficient detail to provide an experienced auditor with no previous connection to the audit a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.
- Provides enhanced guidance on matters that should be documented, including guidance on documentation that should be retained.
- States that oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the audit reached, but may be used by the auditor to clarify or explain information contained in the audit documentation.
- Requires the auditor to document audit evidence that is identified as being contradictory or inconsistent with the final conclusions, and how the auditor addressed the contradiction or inconsistency.
- Requires that the auditor assemble the audit documentation to form the final audit engagement file within 60 days following the report release date. After this date, the SAS requires the auditor not to delete or discard existing audit documentation, and to appropriately document any subsequent additions.

How does this impact your organization? As auditors, we still have the same responsibility as we did in the past. Now we are required to document our efforts in new ways. For example, the new rule requires that we date our audit opinion when we are ready to release the final reports. In the past, we were required to date the opinion as of the last day we did fieldwork at your office. This change is significant because we are also required to do many of our audit procedures through the date of our opinion. The new rule will require us to perform a number of inquiries and do procedures for several weeks to several months past the old date. This, of course, will require more time to do the audit, and may cause some timing problems with issuing the final audited documents. We will be working with your staff to minimize any concerns.

The new standard is supposed to benefit you and the public with financial statements that have less risk of unidentified significant events occurring after year end, but not being disclosed in the statements. In addition, there are eight new standards being developed which will likely be issued in 2006. These new standards will make a significant change in how auditors do a variety of procedures and are expected to add 5 to 10% to the amount of time an audit will take. These new standards are expected to be effective for your year ending December 31, 2007.

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## **INFORMATIONAL POINTS (cont.)**

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### ***NEW AUDITING STANDARD – PROPOSED GUIDANCE ON INTERNAL CONTROLS***

As part of our audit of your financial statements for the year ended December 31, 2006, we will be required to follow a significant new auditing standard, or rule.

The new standard provides guidance to an auditor on communicating internal control matters to the governing body.

Among other things, the new auditing standard:

- Defines the term “material weakness” more broadly than before.
- Describes situations in which the auditor would most likely determine that a “material weakness” exists. It is likely that many more governments will now have material weaknesses than in the past.
- Changes the current terminology of “reportable condition” to “significant deficiency”.

How does this affect your government? The new rule will review many factors to determine if a material weakness exists within your government. There are two new factors in particular which may cause a material weakness in many governments for the first time.

- The auditor finds material journal entries not detected by the client, or
- The auditor prepares the annual financial statements and footnotes for the client.

Under the present reporting rules, these two factors are not usually reported as material weaknesses. The new rules are going to change that.

What are the impacts of a material weakness to your government?

- Federal and state granting agencies may require additional programs to be audited, which changes the scope of the audit.
- The public’s perception of your government may change.

What should you do?

To avoid the condition of material journal entries, you would need to present the books and records in such a condition that the audit finds no material changes. If you have questions on how to achieve that goal, our audit team is available to meet with you.

To avoid the condition regarding auditor prepared statements, you would need to demonstrate the skills to prepare the entire financial statement document internally. Whether or not your personnel have that ability is a matter of judgment, which needs to be discussed with the auditor in charge of your engagement.

Conversely, you could continue with business as usual, except that the internal control report may be changed as described above. Please discuss this issue with your audit team for further information.

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**INFORMATIONAL POINTS (cont.)**

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***WISCONSIN IMPACT FEE STATUTE CHANGES******Wisconsin Act 203***

Recently 2005 Wisconsin Act 203 (Act) was passed amending the current impact fee statute to require impact fees be spent within seven years of collection. This amendment replaces the political subdivision's ability to determine a reasonable time period of any length, most often anywhere from five to twenty years. The time limit may be extended for three years if a resolution is adopted specifying extenuating circumstances or hardship in meeting the seven year time limit. If you believe the three year extension is warranted, we recommend your attorney review the basis for extending the ordinance time period to ensure it is in compliance with the extension requirements.

This Act was effective April 11, 2006 and while the language on applicability is ambiguous, we understand the intent was to be retroactive. Therefore, we recommend you review any current impact fee ordinances you have to determine if changes are needed.

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**PRIOR YEAR'S POINTS**

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***GASB No. 40: NEW INVESTMENT DISCLOSURE REQUIREMENTS***

The Governmental Accounting Standards Board (GASB) has adopted new rules which modified the required financial statement disclosures for deposits and investments.

In the past, the city was required to disclose in the notes to the financial statements summarized information on its bank deposits and other investments. Those disclosures focused on custodial credit risk, which is the risk that the custodian of the city's money, either the banks or brokerage firms, would fail to return this money. A table of three risk categories was used to present these risks.

The new requirement, known as GASB No. 40, changes the disclosure of custodial credit risk to an exception reporting method. The only deposits or investments disclosed are those that are uninsured, unregistered, and uncollateralized or collateralized or held but not in the government's name.

In addition, GASB No. 40 requires disclosure of other types of investment risks including concentrations of risk, credit risk (related to the securities ratings), and the risk that market values will fluctuate with changes in interest rates. These disclosures have been made in the footnotes to the financial statements as applicable.

Finally, the new rules require disclosure of your investment policy as it relates to the items described above, or a statement that no such policy exists. We recommend management draft and the commission approve an investment policy that addresses the custodial credit risk, credit risk, concentration of credit risk, and interest rate risk as disclosed in the footnotes.

***Status (12/31/05)***

The city implemented GASB No. 40 as of December 31, 2005.

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**PRIOR YEAR'S POINTS (cont.)**

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***GASB No. 45: ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS  
FOR POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS (OPEB)***

As we reported in last year's comments, you will be required to implement the new reporting standards for OPEB's in the future.

The effective date for you to have the information to implement the new requirements is for your year beginning after December 15, 2006.

In order to get ready for GASB No. 45, you should start contacting actuarial firms soon. Since the actuary will be developing an accurate picture of your costs for OPEB, you will most likely find that such information is useful when determining employee wage and benefit packages.

There are also budgetary implications of GASB No. 45. First, you will need to provide funding for the actuarial services (or alternate method if you fit those criteria). Second, you may consider numerous funding options for your OPEB depending on what the actuary determines. (Note that GASB No. 45 does not require you to fund the liability at all; that is strictly up to you). Third, including the new actuarial information in your financial statements and footnotes will take more time for you to gather and for us to audit. The actual date of your valuation must be no more than 24 months before the year of implementation and no later than the beginning of the year of January 1, 2007.

Finally, if you decide that it is appropriate to begin funding this liability, you may set up an OPEB trust fund to handle the segregation of these amounts. If you do that, you will also be required to follow GASB No. 43, which sets reporting standards for the financial statements of OPEB plans, including footnotes and required supplemental information.

The actual details of these standards and the financial reporting requirements are quite complex. Please feel free to discuss the impact of GASB No. 45 with your audit team.

***Status (12/31/05)***

This point is still valid.

***GASB No. 39: DETERMINING COMPONENT UNITS (12/31/03 LETTER)***

In order to improve governmental reporting for component units, the Governmental Accounting Standards Board (GASB) amended GASB No. 14 and issued Statement No. 39. This statement was issued in May 2002 and is effective for fiscal periods beginning on June 15, 2003 and later. For you, this would be your calendar year 2004.

Previously, Statement No. 14 stated that all entities associated with a primary government are potential component units and should be evaluated for inclusion in the financial reporting entity. Now, Statement No. 39 sets up new criteria to determine if an organization should be reported as a component unit. These new criteria will likely result in more component units being included in the reporting entity.

Statement No. 14 defined the financial reporting entity to include other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. Statement No. 39 has expanded those criteria. Entities (including nongovernmental entities) which are legally separate, tax-exempt organizations affiliated with a primary government and meeting *all* of the following criteria should be discretely presented within the primary government's financial reporting entity.

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**PRIOR YEAR'S POINTS (cont.)**

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***GASB No. 39: DETERMINING COMPONENT UNITS (12/31/03 LETTER) (cont.)***

***The Qualifying Criteria***

- The money received or held by the separate organization is entirely, or almost entirely, for the direct benefit of the primary government, its component units, or its constituents.
- The primary government (or its component units), is entitled to, or has the ability to otherwise access, a majority of the money received or held by the separate organization. While access does not necessarily imply control, the focus is on the "ability to access," not whether it did so in the current period. For example, if an affiliated organization historically provides resources to a college, this would indicate that the college can "otherwise access" the resources even if no resources were transferred in the current year.
- The money received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, is significant to the primary government. Significant means at least "material" to the financial statements taken as a whole. This criterion is aimed at concerns expressed that would have required school districts to always include parent teacher organization (PTO) in their reporting entities. Unless the PTO provided "significant" financial support, they need not be included.

Organizations meeting the criteria should be discretely presented within the primary government's financials as a component unit. It is still a matter of professional judgment. Examples of organizations which may need to be audited and included are groups such as "Friend's of the Library", or "Swimming Pool Committee," etc. This may be an annual requirement, or it may only be necessary in the year of a significant construction project. We will continue to work with the city on this matter.

***Status (12/31/05)***

During the 2005 audit, it was determined that the 201 State Foundation, Parks Foundation, Library Foundation, and the Ovation Endowment Foundation, all qualified as component units of the city. All four were included in the 2005 financial statements as discretely presented component units. The city should continue to monitor all agreements and new ventures entered into with outside organizations that could possibly be deemed to be a component unit.

***INTERNAL SERVICE FUND DEFICIT***

The city should consider using another fund type for those internal service funds such as worker's compensation where the intention is not to recover all costs, including depreciation, through user charges.

***Status (12/31/04)***

The worker's compensation fund incurred a net loss of \$3,534,107 in 2005. During 2005, an actuary determined the city's risk at various confidence levels. Once completed, the city chose the highest confidence level, at 95%, which raised the actuarial loss assumptions. This fund should be evaluated on its appropriate classification as an internal service fund. A deficit fund balance in internal service funds is not consistent with generally accepted accounting principles.

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## **REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEE OR ITS EQUIVALENT**

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This letter is to inform the city's audit committee about significant matters related to the annual audit so that it can appropriately discharge its oversight responsibility of the financial reporting process.

### ***OUR RESPONSIBILITY UNDER U.S. GENERALLY ACCEPTED AUDITING STANDARDS, OMB CIRCULAR***

#### ***A-133 AND THE STATE SINGLE AUDIT GUIDELINES***

As stated in our engagement letter dated February 2, 2005, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement and are fairly presented in accordance with U.S generally accepted accounting principles. Because an audit is designed to provide reasonable, but not absolute assurance and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us.

In planning and performing our audit, we considered the City of Madison's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal or major state 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 and the State Single Audit Guidelines.

As part of obtaining reasonable assurance about whether the City of Madison's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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. Also, in accordance with OMB Circular A-133 and the State Single Audit Guidelines, we examined, on a test basis, evidence about the City of Madison's compliance with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* and the State Single Audit Guidelines applicable to each of its major federal and state programs for the purpose of expressing an opinion on the City of Madison's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the City of Madison's compliance with those requirements.

#### ***OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS***

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.

#### ***SIGNIFICANT ACCOUNTING POLICIES***

Management has the responsibility for 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 Madison are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during 2005. We noted no transactions entered into by the City of Madison 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.

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**REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)**

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**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 self insurance claims liability is based on historical claims analysis. We evaluated the key factors and assumptions used to develop the claims liability in determining that it is reasonable in relation to the financial statements taken as a whole.

**AUDIT ADJUSTMENTS**

For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An adjust adjustment may or may not indicate matters that could have a significant effect on the City of Madison's financial reporting process. Matters underlying adjustments proposed by the auditor could potentially cause future financial statements to be materially misstated.

Certain audit adjustments we prepared were included in your financial statements. Copies of these adjustments are available from management.

In addition, the attached schedule summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The following audit adjustments, in our judgment, indicate matters that could have a significant effect on the City of Madison's financial reporting process:

	<u>Amount</u>
Adjustments to cash and investments	\$ (395,568)
Adjustments to accounts receivable	2,156,985
Adjustments to deferred revenue	2,156,985
Adjustments to investment income	(395,568)
Adjustments to other revenue	167,804
Adjustments to expenditures	(53,371)

**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.

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**REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)**

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***CONSULTATIONS WITH OTHER ACCOUNTANTS***

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a “second opinion” on certain situations. If a consultation involves application of an accounting principle to the governmental unit’s financial statements or a determination of the type of 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.

***ISSUES DISCUSSED PRIOR TO RETENTION OF INDEPENDENT AUDITORS***

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

***DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT***

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

This report is intended solely for the information and use of the (governing body, finance committee, or equivalent) and management and is not intended to be, and should not be, used by anyone other than the specified parties.

We welcome the opportunity to discuss the information included in this letter and any other matters. Thank you for allowing us to serve you.

SUMMARY OF PASSED ADJUSTING JOURNAL ENTRIES  
 FOR COMMUNICATION TO MANAGEMENT AND GOVERNING BODY  
 December 31, 2005

Financial Statements Effect –  
 Increase (Decrease) to Financial Statement Total

	<u>Total Assets</u>	<u>Total Liabilities</u>	<u>Excess of Revenues Over Expenditures/ Expenses</u>
Governmental Activities	\$ (34,992)		\$ (34,992)
Business-Type Activities	(103,871)		(103,871)
CDBG Fund	-	188,049	188,049
TIF Districts	103,871		103,871
Stormwater Utility	(103,871)	-	(103,871)
All Remaining Funds Combined	(138,863)		(138,863)