

CITY OF MADISON

REPORT ON INTERNAL CONTROL

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

December 31, 2006



To the Honorable Mayor and Common Council
City of Madison

In planning and performing our audit of the financial statements of the City of Madison as of and for the year ended December 31, 2006, 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.

Our consideration of the city's internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiencies constitute a material weakness.

- Internal Control Documentation
- Financial Reporting – Journal Entries
- Financial Reporting – Financial Statement Preparation

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

Madison, Wisconsin
July 20, 2007

A handwritten signature in black ink that reads "Virchow Krause & Company LLP". The signature is written in a cursive, flowing style.

CITY OF MADISON

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MATERIAL WEAKNESSES – INTERNAL CONTROL DOCUMENTATION & FINANCIAL REPORTING

Recently a new auditing standard was issued that focuses on internal control, and what we communicate to you regarding your controls. Those requirements are set out in Statement on Auditing Standards No. 112, “*Communicating Internal Control Matters Identified in an Audit.*”

The new standard clarifies some definitions and will promote more consistency in how weak areas in internal control are communicated by auditors to their clients.

Internal control is a process – affected by an entity’s governing body, management, and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.

Internal control consists of five interrelated components:

- a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- b. *Risk assessment* is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- d. *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- e. *Monitoring* is a process that assesses the quality of internal control performance over time.

How does this affect your organization? The new standard required us to review many factors to determine if a material weakness exists within your organization. There are three factors in particular which will require us to report a material weakness that affects many governments.

- *Internal Control Documentation* - there is a lack of complete documentation of your system of internal control,
- *Financial Reporting* - the auditor finds material journal entries not detected by the client,
- *Financial Reporting* - the auditor prepares the annual financial statements and footnotes for the client.

**MATERIAL WEAKNESSES – INTERNAL CONTROL
DOCUMENTATION & FINANCIAL REPORTING (cont.)**

INTERNAL CONTROL DOCUMENTATION

Many of our clients do not have adequate written documentation of the various internal control processes that take place within their organization. We, as auditors, have done some amount of high level documentation of your processes for our files. You, on the other hand, should theoretically have all of your major processes contained in written documents in enough detail that another person could come in and fulfill the requirements of a particular process by following the explanations.

The major areas that should be documented are:

Cash Receipts	Interfund Transactions
Cash Disbursements	Inventories
Investment Transactions	Capital Assets – Additions and Retirements
Receivables – Billings	Capital Assets – Depreciation
Receivables – Collections	Debt Transactions
Purchasing	Payroll
Receiving	Financial Reporting
	Information Technology

Other than the computer software instruction manual, most of our clients have little written documentation covering these areas. As a result, this is considered to be a material weakness in your internal control.

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. Most of our clients do a good job of processing and recording monthly transactions. However, very few are capable of preparing annual financial statements.

The new standard makes it clear that the definition of a material weakness in internal control should now include 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. This is very rare for most of our clients.
2. Be capable of preparing a complete set of year end financial statements for the auditor to test. Currently, almost all of our clients have us prepare the financial statement document. This includes drafting the individual fund statements, making conversion entries, drafting the government-wide statements, and preparing footnote disclosures. Your staff would need to be capable of presenting the auditor with a set of complete financial statements in such a condition that the auditor is not able to identify any material changes as a result of the audit.

**MATERIAL WEAKNESSES – INTERNAL CONTROL
DOCUMENTATION & FINANCIAL REPORTING (cont.)**

FINANCIAL REPORTING (cont.)

To accomplish such a high level of internal control over financial reporting is a difficult task for most governments. Many large organizations, such as SEC companies, have been required by law to prepare their own statements for years, and are staffed appropriately to do so. Most governments operate with only enough staff to process monthly transactions and reports, and so rely on us to prepare certain year end audit entries and handle the year end financial reporting. Under the new auditing standards, we must, therefore, inform you that these are material weaknesses in your internal control.

If you have any questions on these new disclosures, please contact your audit team.

Management Response:

Internal Control Documentation-While City staff has some written documentation of accounting and financial policies and procedures, management is aware that there is a lack of complete written internal control documentation. Additional resources will be allocated during fiscal periods 2007 and 2008 to improve our internal control documentation.

Financial Reporting/Journal Entries-City management takes the accuracy of its financial reporting very seriously and will continue to strive to present books, records, and financial statements to our auditors that are free of material journal entries. City staff makes every effort to review financial transactions, to follow procedures regarding journal entry postings, and to review prior-years adjusting and reclassifying entries to ensure accurate financial statements that are free of material misstatements.

Financial Reporting/Annual Financial Statements-City management is aware that to avoid a material weakness related to its year-end financial reporting process, a complete set of financial statements, conversion entries, and footnote disclosures must be drafted by City staff and presented to our auditors in a condition whereby no material changes result from the audit. Because of the City's size, management does not believe it is cost effective to hire the additional staff that would be needed to complete these tasks in the very near future.

Currently, City staff prepares individual fund statements, conversion entries, and some footnote disclosures. We will continue to make additional efforts to draft the government-wide statements, and to prepare additional footnote disclosures. City management is confident that a new accounting system may also aid staff with these tasks, but expects to rely on the assistance of the external audit firm to prepare selected portions of the annual financial statements.

INFORMATIONAL POINTS

NEW INTERNAL CONTROL AUDIT TESTING FOR 2007

In March of 2006, the American Institute of Certified Public Accountants issued eight new auditing standards (#104-111) that will change the way auditors approach the audit process. These changes are a direct result of the major frauds that have occurred in the United States in the past several years. The new standards are intended to improve the auditors' understanding of you, the client, the environment in which you operate, your internal controls, and the risks involved in the audit. The auditor will be required to make a more rigorous assessment of the risk of material misstatements based on that understanding. The result will be improved linkage between the assessed risks, and the nature, timing, and extent of our audit procedures.

One of the concepts that affects most units of governments is the level of documentation of their internal controls. Most of our clients do not have adequate written documentation of the various internal control processes that take place within their organization. We, as auditors, have done some amount of high level documentation of your processes for our files. You, on the other hand, should theoretically have all of your major processes contained in written documents in enough detail that another person could come in and fulfill the requirements of a particular process by following the explanations.

The major areas that should be documented are:

Cash Receipts	Inventories
Cash Disbursements	Capital Assets – Additions and Retirements
Investment Transactions	Capital Assets – Depreciation
Receivables – Billings	Debt Transactions
Receivables – Collections	Payroll
Purchasing	Financial Reporting
Receiving	Information Technology
Interfund Transactions	

Other than the computer software instruction manual, most of our clients have little written documentation covering these areas.

For the current and past audits, we have been able to complete your audit without asking for such documentation. However, beginning with your calendar year 2007 audit, we will be required to ask you for complete documentation of your internal control systems, due to the new auditing standards. Therefore, you should plan now to complete that documentation during 2007, so that we can evaluate your compliance with the new rules during our audit of your 2007 financial statements. We will be able to provide you with forms and other resources to assist you with meeting the new requirements.

INFORMATIONAL POINTS (cont.)

PROPOSED GASB CHANGES

The Governmental Accounting Standards Board (GASB) continues to propose changes to governmental financial reporting. There are two issues which are being studied at this time which will likely affect your financial statements in the future.

The first is a proposed change to the definition of certain funds and fund balance reporting. GASB is considering tightening up the language in the standards which will not allow governments to report money in special revenue, debt service, and capital project funds, unless that money is truly restricted for such a specific use. In other words, to show such a fund, the money would need to be restricted to a specific purpose by an outside agency or some kind of law. All other funds that are currently reported separately would be combined with the general fund.

This would mean that special revenue funds should not be used if the revenue of that fund were not legally restricted for a particular function. Likewise, capital project funds should not be used for presenting the accumulation of resources for a future fire truck purchase, as there typically is no legal restriction on the use of that money.

The impact of these changes is likely going to be a reduction in the number of funds you present in the annual financial statements. It does not necessarily affect the number of accounting funds you have in your books, but you may need to combine some funds for financial statement purposes. Also, state aid and limits on expenditures could be affected.

As part of this project, the GASB is also considering changes to fund balance reporting to make it easier for the reader of financial statements to determine reserved fund balance vs. designated fund balance vs. undesignated fund balance. Three different methods of presenting fund balance are being considered. The final standard for these changes is expected to be issued in the fourth quarter of 2007.

The second project likely to impact your financial statements is a GASB project on intangible assets. Currently, there are almost no rules in the government sector covering intangible assets. This rule would cover such things as water rights, air rights, patents, copyrights, and easements.

The proposed guidance would require that you account for intangible assets the same way you currently account for capital assets. In other words, you would record intangible assets at original cost, and amortize that cost over the expected useful life of the asset. The impact on most general purpose governmental entities would be the need to begin accounting for easements. Almost all governments and their utilities have easements. The proposal includes retroactive accounting for intangible assets, which would be a fair amount of effort in many cases. The new standard is expected to be issued in the second quarter of 2007.

INFORMATIONAL POINTS (cont.)

TAX INCREMENTAL FINANCING (TIF) LAW CHANGES

TIF laws have undergone numerous changes in the past few years. As a result, you should consider the impact of the changes on your own accounting needs and records retention policies.

The rules for auditing TIF districts have not changed. You are still required to have a detailed audit within 12 months of:

1. 30% of project expenditures are made.
2. The end of the expenditure period (100% audit).
3. The termination of the district.

What has changed is when those dates occur. For the 30% requirement, it was common in the past to reach that threshold fairly early in the life of the district and have the necessary compliance audit completed. Under the new law changes, you are allowed to amend your district up to four times. Each time you amend your district, you may increase the estimated project expenditures, which may result in the need for an additional 30% audit when you reach the new threshold. As you monitor your TIF(s) for compliance with this requirement, it will be necessary to factor in the impact of any amendments.

For the second required audit, it is necessary to determine the end of the expenditure period. Under the old rules, the expenditure period was either 7 or 10 years, depending on when the district was formed. Under the new rules, the expenditures period is based on the unextended termination date of the district, minus five years. So, depending on the type of district, the expenditure period may be from 15 to 22 years long, and termination dates range from 20 – 27 years.

The reason this is important is due to records retention. Many of our clients follow a policy of destroying old records, some after seven or ten years, depending on the type of record. Since a 100% TIF audit may not be required until a later date, this could cause audit problems. Generally auditors look at project costs and compliance documents both at the 30% audit date and the 100% audit date. You should consider these needs as you review your records retention policies and procedures. You will need to keep your general ledger and related journals and supporting documents until each of the compliance audits is complete. Some of our clients are choosing to accelerate the detailed TIF audit instead of waiting until the required date. This makes it easier to clear up questions that arise, as the information is much fresher in everyone's mind, and records are still available.

PRIOR YEAR'S POINTS

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 (12/31/06)

The worker's compensation fund incurred a net loss of \$997,253 in 2006. 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.

REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEE OR ITS EQUIVALENT

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 the engagement letter, 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 I to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during 2006. 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.

REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEE OR ITS EQUIVALENT (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 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 liabilities	\$ 23,622
Adjustments to deferred revenue	1,020,387
Adjustments to accounts payable	52,380
Adjustments to special assessment revenue	(214,424)
Adjustments to expenditures	109,266
Adjustments to other revenue	(805,963)

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 WITH AUDIT COMMITTEE OR ITS EQUIVALENT (cont.)

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 finance committee 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, 2006

	Financial Statements Effect – Increase (Decrease) to Financial Statement Total		
	Total Assets	Total Liabilities	Excess of Revenues Over Expenditures/ Expenses
Governmental Activities	\$ 123,404	-	\$ 19,533
Business-type Activities	-	(6,000)	109,871
General Fund	-	(35,290)	35,290
CDBG	-	-	188,049
TIF	-	-	(103,871)
Storm	-	-	103,871
Monona Terrace	-	(6,000)	6,000
Remaining Funds	123,404	-	123,404