



Terry E. Krieg, CPA
Certified Public Accountant

March 16, 2011

Honorable Mayor and Members of the City Council
City of Calistoga
Calistoga, California

I have audited the basic financial statements of the governmental- type activities, business-type activities, each major fund and the aggregate remaining fund information of the City of Calistoga for the year ended June 30, 2010, and have issued my report thereon dated March 16, 2011. Professional standards require that I provide you with the following information related to my audit.

1. My Responsibility under U.S. Generally Accepted Auditing Standards

As stated in my engagement letter, my responsibility, as described by professional standards, is to express opinions about whether the financial statements prepared by management with your oversight are fairly presented, in all material aspects, in conformity with U.S. generally accepted accounting principles. My audit of the financial statements does not relieve you or management of your responsibilities.

As part of my audit, I considered the internal control of the City of Calistoga. Such considerations were solely for the purpose of determining my audit procedures and not to provide assurance concerning such internal control. My responsibility is to plan and perform the audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement. I am responsible for communicating significant matters related to the audit that are, in my professional judgment, relevant to your responsibilities in overseeing the financial reporting process. However, I am not required to design procedures specifically to identify such matters.

2. Other Information in Documents Containing Audited Financial Statements and Electronic Dissemination of Audited Financial Statements

My responsibility for other information in documents containing the City of Calistoga's financial statements and my auditor's report, such as an official statement for a bond or debt offering, does not extend beyond the financial information identified in the report. I do not have an obligation to perform any procedures to corroborate other information contained in such other documents. To my knowledge, the City of Calistoga's audited financial statements were not incorporated into other documents.

With regard to the electronic dissemination of audited financial statements, including financial statements published electronically on your website, you understand that electronic sites are a means to distribute information and, therefore, I am not required to read the information in any such sites or to consider the consistency of other information in the electronic site with the original documents.



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3. Planned Scope and Timing of the Audit

I performed the audit according to the planned scope and timing previously communicated to the City's Administrative Services Director in the audit engagement letter and discussed with the City's Administrative Services Director. My understanding is that the Administrative Services Director has the responsibility for coordinating the audit process with my firm and for communicating to you significant audit matters.

4. Significant Audit Findings

A. *Qualitative Aspects of Accounting Practices*

Management is responsible for the selection and use of appropriate accounting policies. In accordance with my engagement letter, I will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City of Calistoga are described in Note one to the financial statements.

B. *Changes in Accounting Policies*

No new accounting policies were adopted and the application of existing policies were not changed in the 2010 fiscal year except that the City implemented Governmental Accounting Standards Board Statement Number 45 titled Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions. This new accounting standard requires additional disclosures concerning retiree benefit plans such as retiree medical insurance benefits provided by governmental employers. The accounting standard requires governments with such retiree medical benefit plans to disclose actuarial information, details about the benefits, actuarially determined annual required contributions (ARC) to the plans, amounts contributed, and the reporting of a liability or assets in the governments financial statements depending upon the amounts contributed to the plan.

In addition, the City implemented GASB Statement Number 51 pertaining to accounting and reporting for Intangible Assets such as water rights and similar type assets. This new standard requires governments to amortize to expense each year over the estimate term of the benefit period a portion of the costs of such intangible assets

C. *Significant and Unusual Transactions*

There were no significant and unusual transactions reported in fiscal 2010 in the City's statement of net assets and fund statements other than:

1. Reporting in your 2010 general fund financial statements \$720,154 as an other financing source (inflow of resources) as a result of the City determining that it would not be paying the contract retentions and liquidated damages related to the community pool construction contract.
2. Reporting in the governmental funds \$1,268,936 in HOME grant funds provided to the City to assist in financing the construction of an affordable housing complex.



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3. Reporting in the general fund a \$897,107 transfer out, a \$493,071 transfer out in the equipment internal service fund and a \$136,285 transfer out in the water enterprise fund for a combined total of \$1,526,463 in transfers out of the aforementioned funds. The entire \$1,526,463 was a write down/write off of cash advances previously made to the City's wastewater enterprise fund.

Similarly, in the wastewater enterprise, the \$1,526,463 advances payable to other funds was written off as a liability and booked as a transfer in for financial reporting purposes. There was no exchange of cash relating to this transaction.

The \$1,526,463 write off of interfund advances receivable and payable was made to recognize that the fiscal condition of the wastewater enterprise fund was such that it was highly probable that the wastewater fund would not be able to repay the \$1.5 million to the other City funds within a reasonable period of time.

4. Reporting in the general fund almost \$1.1 million in capital outlay expenditures which were incurred primarily for the fire station improvement project.
5. Reporting in the HOME grant fund a \$1,246,643 expenditure related to the Palisades affordable housing project loan.
6. The City was subject to federal program compliance audits and reporting requirements because aggregated federal grants (the HOME grant and Pre-Disaster Mitigation Grants) expenditures of the City exceeded \$500,000 in fiscal 2010. The City has been provided with a separate set of reports with my report on internal control and compliance matters. The City is required to file a reporting package consisting of required reports, financial statements and a data collection form by electronic means via the internet prior to March 31, 2011.
7. Reporting an OPEB liability of \$134,000 in the government wide financial statements representing the difference between the \$143,000 actuarially determined annual required contribution (ARC) and the premiums paid by the City for retiree medical plans. Disclosing that the City has a \$963,000 unfunded actuarial accrued liability pertaining to its OPEB Plan.

D. Transactions Having a Lack of Authoritative Guidance

No significant dollar value transactions came to my attention where there was a lack of authoritative guidance regarding the application of accounting principles to the transactions except for the reporting of the \$720,154 in contract settlement amounts (the pool construction contract retentions and liquidated damages retentions). These inflows from the reduction of amounts thought to be payable at the end of 2009, were reported as an other financing source (an inflow of resources) rather than as general fund revenues. The main reasoning behind this choice was that this was the settlement of what was originally thought to be a debt and really was unrelated to the general fund revenue stream.

The concept of reporting this as a special item was considered, but was not elected as special items are generally entirely at the discretion of city management, and this liability reduction involved outside third parties. The concept of reporting this as an extraordinary item was also considered, but was not elected as the infrequency of occurrence criteria was viewed as not sustainable given other existing contract matters and that fact that contract disputes are a type of recurring event common in construction projects.



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E. Accounting Estimates

Accounting estimates are an integral part of 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 significant estimate affecting the financial statements was management's estimate of depreciation expense which estimates were based upon subsidiary schedules of capital assets and depreciation calculations using the straight-line method of depreciation. This year, the Annual Required Contribution to the City's OPEB Plan and the related Unfunded Actuarial Accrued Liability are both estimates based upon assumptions that may vary from actual events.

F. Sensitive Financial Statement Disclosures

The disclosures in the financial statements are to be neutral, consistent and clear. Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were:

The lack of a securities rating and average maturities of the City's investments in the Local Agency investment Fund of the State of California (about \$1.17 million combined) and the AAA rating of the \$2.37 million invested in the Goldman Sachs Treasury Obligation money market/mutual funds.

Other disclosures of particular sensitivity may also be the information concerning the pledge of water and wastewater revenues for debt service and the respective coverage ratios in the notes to the financial statements.

The wastewater enterprise fund may not be meeting its debt service coverage ratio requirements because in fiscal 2010 net system revenues were not sufficient to cover the debt service principal and interest payments. A similar situation existed in the water enterprise exclusive of capital contribution revenues.

5. Difficulties Encountered in Performing the Audit

I experienced no significant difficulties in dealing with management in performing and completing my audit.

6. Corrected and Uncorrected Misstatements

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. There were about 15 correcting and reclassifying journal entries proposed for fiscal 2010. About 50 percent of the adjustments related to what ultimately were City originated adjustments after management considered certain financial facts and made decisions about interfund balances and transfers.

The other 50 percent of the adjustments related to booking the OPEB liability (new in fiscal 2010), the HOME grant, and fund transfers.



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The proposed adjusting entries, when considered on a collective basis and viewed in the context of the City annual financial statements, were significant and were material in terms of their collective monetary impact on the City's annual financial statements.

The City has reviewed all known mistakes, errors and inaccuracies in the City's general ledger accounting records and in its 2010 financial statements, and the City has, to my knowledge, corrected all known significant errors, mistakes, and inaccuracies.

7. Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to my 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 the audit.

8. Management Representations

I have requested certain representations from management that are included in the management representation letter.

9. Consultations with Other Independent 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 the application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those financial statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts.

To my knowledge, there were no such consultations with other accountants

10. 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 our retention as the City's auditors or prior to commencement of the financial statement audit.

The discussions this year centered on planning, scheduling, grant accounting and implementation of the GASB 45 Standards for OPEB Plans and Intangible assets. However, these discussions occurred in the normal course of my professional relationship and my responses were not a condition to my retention as the City's independent auditor.

Completion of the financial statement audit for fiscal 2010 was delayed primarily because of the need for the City to obtain an actuarial valuation and related information for its retiree medical plan (OPEB) and the City's evaluation of the wastewater fund's ability to repay interfund loans within a reasonable period of time and the related appropriate accounting treatment for financial reporting purposes.

The logo consists of the letters 'TK' in a bold, white, serif font, set against a solid black square background.

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This information is intended solely for the use of the City Council of the City of Calistoga and management of the City and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely yours

Terry E. Krieg

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