

CITY OF SAN JOSE

Public Safety, Finance &
Strategic Support Committee

Report to Management

Year Ended
June 30, 2011



Certified Public Accountants.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

Table of Contents

	<i>Page</i>
Transmittal Letter	i
Required Communications	1
Schedule of Comments and Responses:	
Comment #2011-1 – Risk Assessment of Internal Controls	5
Comment #2011-2 – Airport Cost Allocation Plan	7
Status of Prior Year’s Significant and Control Deficiency Comments	8
Summary of Uncorrected Financial Statement Misstatements	9

Members of the Public Safety, Finance &
Strategic Support Committee and
San José City Council
San José, California

We have audited the financial statements of the governmental activities, the business-type activities, each major fund and the aggregate remaining fund information (basic financial statements) of the City of San José, California (City), as of and for the year ended June 30, 2011. In addition to the City's basic financial statements, we audited the financial statements of the governmental activities and each major fund of the Redevelopment Agency of the City of San José; the financial statements of the Norman Y. Mineta San José International Airport, the San José Police and Fire Department Retirement Plan, the City of San José Federated City Employees Retirement System, the San José-Santa Clara Clean Water Financing Authority, Pedestrian/Bicycle Facilities Grant, Parks and Recreation Bond Projects Fund, Branch Libraries Bond Projects Fund, Neighborhood Security Bond Projects Fund, Library Parcel Tax Special Revenue Fund, and the City of San José Deferred Compensation Plan as of and for the year ended June 30, 2011. Professional auditing standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and U.S. Office of Management and Budget (OMB) Circular A-133, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our Audit Plan to you dated July 29, 2011. Professional standards also require that we communicate to you other information related to our audit as discussed on pages 1 through 4.

Management of the City is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit of the City's basic financial statements in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

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.

Our consideration of internal control was for the limited purpose described in the second paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses, therefore there can be no assurance that all such deficiencies have been identified.

In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. We did not identify any deficiencies in internal control that we consider to be material weaknesses. However, we identified certain deficiencies in internal control over financial reporting, described on pages 5 through 7 as items 2011-1 and 2011-2 that we consider to be significant deficiencies in internal control over financial reporting. 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.

The City's written responses to the comments identified in our audit are described in the Schedule of Comments and Responses. We did not audit the City's responses and, accordingly, we express no opinion on them. In addition, we have already discussed our comments and recommendations with various City personnel, and we would 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 communication is intended solely for the information and use of the Public Safety, Finance & Strategic Support Committee, City Council, City management, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & Connell LLP

Walnut Creek, California
November 30, 2011

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

REQUIRED COMMUNICATIONS

I. Other Information in Documents Containing Audited Financial Statements

During the year, the City included audited financial statements in various debt offering documents (e.g., Official Statements). We do not have an obligation to perform any procedures to corroborate other information contained in such debt offering documents. We were not associated with and did not have any involvement with such documents. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in the debt offering documents.

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.

II. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. In accordance with the terms of our contract with the City, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the City's basic financial statements. With the exception of the items described below, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2011.

Governmental Funds - As described in Note 1.E to the City's basic financial statements, the City adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

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.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

REQUIRED COMMUNICATIONS (Continued)

The most sensitive estimates affecting the financial statements were:

- Fair value of investments
- Estimated allowance for losses on accounts receivable
- Estimated valuation allowance for loans receivable
- Accrual and disclosure of self-insurance claims liabilities
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Accrual and disclosure of compensated absences
- Pension and other postemployment benefit plans' employer and employee contribution requirements
- Accrual and disclosure of pollution remediation obligations

Management's judgments and estimates were based on the following:

- Fair value of investments traded on a national or international exchange were based on quoted sales price reported on the last business day of the fiscal year at current exchange rates, if applicable. Investments that do not have an established market, such as private equity, commingled real estate funds and certain pooled fund investments are reported at estimated fair value based on the most recently available investor reports or audited financial statements issued by the manager of those funds. The fund manager provides an estimated unrealized gain/loss of the fund based on the most recently available audited financial statements and other fund information. The fair value of the separate real estate properties are based on independent appraisals.
- Estimated allowance for losses on accounts receivable were based on historical experience.
- Estimated valuation allowance for loans receivable is comprised of an allowance for risk and an allowance for present value discount. The allowance for risk was based on the consideration of the changes in the portfolio character, evaluation of current economic conditions and management's estimate regarding the likelihood of collectability based on loan provisions and collateral. The allowance for present value discount was based on management's estimate of the present value of projected net cash flows to the City from the loan portfolio.
- Reserves for workers' compensation were based on management's estimate obtained from information derived from the City's claims database system adjusted for a discounted projection of unreported claims.
- Reserves for general liability and other claims liabilities were determined by City Attorney's judgment about the ultimate outcome of the claim.
- Accrual and disclosures of compensated absences were based on accrued eligible hours of vacation and sick leave at current pay rates for eligible employees.
- Useful lives for depreciable property were determined by management based on the nature of the capital asset. Depreciation was calculated based on the straight-line method.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

REQUIRED COMMUNICATIONS (Continued)

- Pension and other postemployment benefit plans' employer and employee contributions requirements were based on actuarially determined contribution rates.
- Accrual and disclosures of pollution remediation obligations were determined by the City's Environmental Compliance Officers and its environmental consultants' judgments about the ultimate outcome of the obligations.

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the financial reporting units that collectively comprise the City's basic financial statements.

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 City's Employee Defined Benefit Retirement Plans described in Note IV. A.; the City's relationship with the Redevelopment Agency of the City of San José described in Note I. A., Note III.G.2., and Note IV.C.2.; and the going concern uncertainty related to the Redevelopment Agency of the City of San José described in Note I. A. and Note IV.D.5 to the basic financial statements.

Difficulties Encountered in Performing the Audit

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

Planned Timing of the Audit

The completion of our audit was delayed because of unexpected issues pertaining to the City's Employee Defined Benefit Retirement Plans described in Note IV.A.3. and the going concern uncertainty related to the Redevelopment Agency of the City of San José described in Note I.A., Note IV.D.2., and Note IV.D.5. to the basic financial statements.

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. The attached Summary of Uncorrected Financial Statement Misstatements 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. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the financial statements taken as a whole.

Disagreements with Management

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

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

REQUIRED COMMUNICATIONS (Continued)

Management Representations

We have requested certain representations from management that are included in the management representation letter dated November 30, 2011.

Management Consultation 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 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 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.

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

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

SCHEDULE OF COMMENTS AND RESPONSES

Item #2011-1 – Risk Assessment of Internal Controls

Internal control is an integral process that is affected by the City's governing body, management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the organization's goals, the following general objectives are being achieved:

- Executing orderly, ethical, economical, efficient and effective operations;
- Fulfilling accountability obligations;
- Complying with applicable laws and regulations; and
- Safeguarding resources against loss, misuse and damage.

Internal controls should be continuously monitored in order to adapt to the City's recent organizational changes, changes in its operating environment and reduced resources available for internal controls. The City has been going through a profound change especially in the number of personnel and the experience level of its finance and accounting personnel since the end of fiscal year 2009. For example, in fiscal year 2010, the Finance Department underwent a reorganization when the two remaining Deputy Director positions were eliminated and replaced with an Assistant Director and four Division Managers (Accounting, Treasury, Revenue Management, and Purchasing). In addition, one Principal Accountant position was eliminated, one Supervising Accountant position was relocated from the Revenue Management Division to the Accounting Division, and one Senior Accountant position became vacant due to a resignation. During the course of our audit work for fiscal year 2011, the Assistant Director of Finance was appointed Acting Director of Finance with the retirement of the former Director in September 2011, the Finance Treasury Division Manager was appointed Acting Assistant Director of Finance, a Principal Accountant in the Revenue Management Division was appointed the Acting Accounting Division Manager when the previous incumbent resigned in October 2011, one Supervising Accounting position was deleted and reallocated to a Senior Accountant, one vacant Senior Accountant position was filled through the bumping process from another City department and one Accountant position was eliminated. These staffing challenges are factors in errors and delays in the City's year-end financial reporting process including:

- Delays in the evaluation and review of the impact to the financial report resulting from the implementation of Governmental Accounting Standards Board Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.
- Errors in the evaluation of the collectability of receivable balances to properly exclude revenue recognition totaling \$5.1 million that fell outside the City's 60-day availability revenue recognition policy.
- Errors in accounts payable year-end cut-off totaling \$4.5 million.
- Lack of documentation identified related to the tasks and responsibilities of individuals who are no longer at the City.
- Delays in the review of the Airport's statement of cash flows.

In general, we observed that staff is facing additional pressures to maintain service levels with fewer resources and the City has not adequately assessed the necessary changes in processes to mitigate risk associated with reduced resources in the City's financial reporting and accounting processes. With these organizational changes, the City should update its documentation, test its internal controls, assess the

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

magnitude of any deficiencies identified and develop a work plan to re-structure the organization to ensure that its internal controls are adequate for its changed environment and reduced workforce.

Management Response

Management agrees opportunities exist for improvement in the identification of the potential effects on the City's internal control structure with position eliminations and changes in personnel, especially those impacting the preparation of Fiscal Year 2010 Comprehensive Annual Financial Review ("CAFR"). However, Management believes the City made appropriate assessments in relation to the Fiscal Year 2011 Comprehensive Annual Financial Report (CAFR) preparation. For example, upon the Director of Finance's departure in September 2011, the Assistant Director of Finance was appointed to the Acting Director position. This appointment established a continuity of management with a seasoned veteran of the Finance Department who played a vital role in the fiscal year 2010 CAFR. Concurrently, the Finance Treasury Division Manager was appointed the Acting Assistant Director bringing his technical expertise to the fiscal year 2011 CAFR in the areas of treasury and debt management, pension plan disclosure and his previous experience in the preparation of the Fiscal Year 2010 CAFR. Upon the Accounting Division Manager's resignation in October 2011 after only six months of employment with the City, a Principal Accountant from the Revenue Management Division was appointed the Acting Accounting Division Manager. This individual brought eight years of prior work experience in the Accounting Division in which he played a key and vital role in preparation of prior CAFRs and provided organizational stability to the Accounting Division.

Finance staff shares the concern of the impact that a lack of formalized roles and responsibilities in City departments may have on the quality and timeliness of financial reporting. The decentralization of finance functions to other City departments has made each department responsible for establishing and maintaining roles and responsibilities to assure a seamless transition when positions become vacant and then subsequently filled. This, however, may lead to inconsistencies in how roles and responsibilities are established and maintained within departments and with the Finance Department. The Finance Department will engage City departments in conversation regarding the need to, and the importance of, establishing and maintaining roles and responsibilities to assure consistency in financial reporting. It should be noted that the ability to implement solutions may be impacted by current staffing levels in all City departments.

As the City begins planning for the preparation of the Fiscal Year 2012 CAFR, the Finance Department is making a concerted effort to assemble the strongest team possible within the staffing constraints of the Department. This effort will involve more closely aligning staff skills with job duties and responsibilities. The Finance Department remains challenged by recent departures of long-tenured, highly knowledgeable staff and resource reductions over the last several fiscal years. Additionally, the Finance Department is working on evaluating the tools available to assist the Accounting staff in performing the necessary research and analysis of accounting rules and regulations. The Department has initially identified the need to acquire and implement electronic governmental accounting research tools as a way to enhance staff's knowledge and efficiency. These tools should be in place by the end of fiscal year 2012.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

Item #2011-2 – Airport Cost Allocation Plan

It is the City’s policy to identify and allocate appropriate General Fund and certain other central service program costs that indirectly benefit the Airport Department. The Finance Department develops an Airport Cost Allocation Plan (ACAP) using actual allowable costs from the prior two fiscal years. In addition, allocations of these allowable costs are based on various nonfinancial factors such as number of purchase orders processed and number of full-time equivalents (FTE) budgeted.

During our audit, we noted that the fiscal year 2011 ACAP used a factor of 400 FTEs. However, the Airport has approximately 206 FTEs at June 30, 2011. Unlike expenditures, the City does not adjust nonfinancial factors such as FTEs to actual results. As such, the Airport may be burdened with a disproportionate share of overhead costs when they experience dramatic changes in FTEs and other nonfinancial measurements.

We recommend the City develop a more equitable cost allocation methodology that measures and allocates the relative benefit of administrative efforts received by the Airport during a given fiscal year.

Management Response:

Management recognizes that there will be a difference between budgeted and actual data. As such, the City strives to use actual data whenever it’s available. With the exception of the number of FTEs, the ACAP uses all actual financial and nonfinancial data. Because the ACAP is developed a year prior, the City does not have the actual number of FTEs available to use. The number of budgeted FTEs is the best set of information available to use for the ACAP at the time the plan is developed. The City believes that as the number of FTEs decreases for a department, the overall Citywide FTEs count would also decrease, and that it would have a minimal impact to the allocation basis.

Additionally, management reevaluated the impact of the difference in the number of FTEs, and noted the change in the FTE allocation number did not result in any change to the ending percentage in the ACAP. However, management will continue to monitor the changes in FTE count to determine its effect on the ACAP.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

STATUS OF PRIOR YEAR’S SIGNIFICANT AND CONTROL DEFICIENCY COMMENTS

2010 Comment:	<i>2010-1 – Comment #1 – Fund Balance Reporting and Governmental Fund Type Definitions</i>
Condition/Effect:	The City will be required to implement GASB Statement No. 54 for fiscal year ending June 30, 2011.
Recommendation:	Some steps that the City should perform in order to implement GASB Statement No. 54 include the following: <ul style="list-style-type: none">• Update the City’s fund balance policy.• Analyze the purposes and revenue sources of the City’s special revenue funds to ensure that these funds fall within the new special revenue fund type definition.• Review the purposes of capital projects and debt service funds to ensure that these funds fall within the new fund type definitions.• Update chart of accounts and begin classifying fund balance amounts and prepare reports for the new financial reporting and disclosure requirements.
Status:	The City implemented GASB Statement No. 54 in fiscal year 2011 as required. However, the City did not have proper management oversight in evaluating the results of these changes until October 2011. As a result, audit adjustments were proposed to properly account for certain funds and classify governmental fund balance amounts. See comment 2011-1 related to adequacy of the City’s staffing resources.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

AJE #	Account / Adjustment Description	Debit (Dollars in thousands)	Credit (Dollars in thousands)
General Fund			
1	Sales Tax Receivable	\$ 1,552	
	Sales Tax Revenue	2,023	
	Deferred Revenue		\$ 3,575
	<i>To adjust sales tax receivable based on actual receipt after year-end and defer sales taxes revenue that was not received within 60 days after year-end.</i>		
2	Unearned Revenue	2,056	
	Accounts Receivable		2,056
	<i>To reduce accounts receivable and unearned revenues recorded for billing in advance at June 30, 2011.</i>		
Redevelopment Agency Major Governmental Fund			
3	Expenditures - Capital Maintenance	354	
	Accounts Payable		354
	<i>To record the understatement of expenditure and accounts payable during the blending process from Redevelopment Agency's standalone report.</i>		
Housing Major Governmental Fund			
4	Fund Balance	750	
	Other Assets		750
	<i>To remove the impact of the write up of asset value for the Playa Almaden property recorded in FY 2008.</i>		
5	Intergovernmental Revenue	465	
	Deferred Revenue		465
	<i>To defer intergovernmental revenue that was not received within 60 days after year-end.</i>		
Special Assessment Districts Major Governmental Fund			
6	Deferred Revenue	515	
	Special Assessment Receivable		515
	<i>To decrease the special assessment receivable and deferred revenue for the CFD#10 - Hassler - Silver Creek Special Assessment Bonds at June 30, 2011.</i>		
Nonmajor Governmental Funds			
7	Intergovernmental Revenue	4,613	
	Deferred Revenue		4,613
	<i>To defer intergovernmental revenue that was not received within 60 days after year-end.</i>		

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2011

AJE #	Account / Adjustment Description	Debit (Dollars in thousands)	Credit
Muni-Water Major Enterprise Fund			
8	Accounts Receivable - MuniWater	\$ 1,323	
	Charges for Service - MuniWater		\$ 1,323
	<i>To recognize revenues for FY 2011 unbilled services.</i>		
	Charges for Service - MuniWater	1,134	
	Net Assets - MuniWater		1,134
	<i>To reverse impact of prior year unbilled services.</i>		
Governmental Activities			
9	Estimated liability for self-insurance	3,159	
	GW - Governmental Activities - Various Expenses		3,159
	<i>To adjust the workers compensation liability balance at June 30, 2011</i>		
10	Nondepreciable Assets - Land	4,450	
	Expenditures - Capital Maintenance		4,450
	<i>To record land purchase properly accrued at year-end but not reflected as an addition to land on the government-wide financial statement at June 30, 2011.</i>		
Pension Trust Funds			
11	Employer Contributions - Federated	3,925	
	Retirement and Other Benefits - Federated		3,925
	<i>To record the income statement impact for implicit rate subsidy for the Federated Plan.</i>		