HAYES MANSION
CONFERENCE CENTER
(An Activity of the City of San José)

Independent Auditor's Report and
Financial Statements

For the Year Ended June 30, 2011

MGO Certified Public Accountants.

HAYES MANSION CONFERENCE CENTER
For the Year Ended June 30, 2011

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City Council
City of San José, California

Independent Auditor's Report

We have audited the accompanying financial statements of the Hayes Mansion Conference Center (the Center), an activity of the City of San José (the City), as of and for the year ended June 30, 2011, as listed in the table of contents. These financial statements are the responsibility of the management of the Center. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Center's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of the Center are intended to present the financial position and the changes in financial position and cash flows of only that portion of the City's financial statements that is attributable to the transactions of the Center. The Center is reported within the City's special revenue funds; however, for purposes of this presentation, management reports it as an enterprise fund to comply with contractual requirements. The financial statements of the Center do not purport to, and do not, present fairly the financial position of the City as of June 30, 2011 and the changes in its financial position and its cash flows, where applicable, for the year ended June 30, 2011 in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Center as of June 30, 2011, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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

Macias Gini & O'Connell LLP

Walnut Creek, California
December 7, 2011

HAYES MANSION CONFERENCE CENTER

Statement of Net Assets

June 30, 2011

Assets:	
Current assets:	
Cash and investments	$ 2,959,020
Accounts receivable	375,427
Inventory	86,748
Prepaid expenses	13,100
Total current assets	3,434,295
Noncurrent assets:	
Other assets	100,000
Capital assets:	
Nondepreciable	96,312
Depreciable, net	1,322,916
Capital assets, net	1,419,228
Total assets	4,953,523
Liabilities:	
Current liabilities:	
Accounts payable	201,702
Advance deposits	627,831
Accrued liabilities	755,685
Total current liabilities	1,585,218
Noncurrent liabilities:	
Devcon loan	1,200,000
Total liabilities	2,785,218
Net assets:	
Invested in capital assets	1,419,228
Unrestricted	749,077
Total net assets	$ 2,168,305

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER

Statement of Revenues, Expenses and Changes in Net Assets

For the Year Ended June 30, 2011

Operating revenues:	
Room	$ 5,106,724
Conference services	1,720,947
Food	3,982,318
Beverage	685,464
Spa and gift shop	61,473
Other	387,571
Total operating revenues	11,944,497
Operating expenses:	
Administrative	2,075,937
Beverage	243,426
City of San José management and administrative charges	172,905
Conference	1,072,352
Depreciation	545,042
Food	3,738,677
Insurance	94,075
Lease and rental expense	46,890
Maintenance	940,573
Management fee	358,334
Other	247,625
Room	2,207,176
Sales and marketing	1,235,768
Utilities	562,017
Total operating expenses	13,540,797
Operating loss	(1,596,300)
Nonoperating revenues (expenses):	
Contributions from the City of San José General Fund	5,800,000
Payments to the City of San José	(3,700,000)
Total nonoperating revenues	2,100,000
Increase in net assets	503,700
Net assets:	
Beginning of year	1,664,605
End of year	$ 2,168,305

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER

Statement of Cash Flows

For the Year Ended June 30, 2011

Cash flows from operating activities:	
Cash receipts from customers	$ 12,047,811
Cash payments to suppliers for goods and services	(5,371,818)
Cash payments to employees for services	(7,323,127)
Net cash used in operating activities	(647,134)
Cash flows from noncapital financing activities:	
Contributions from the City of San José General Fund	5,800,000
Payments to the City of San José	(3,700,000)
Net cash provided by noncapital financing activities	2,100,000
Cash flows from capital and related financing activities:	
Additions to capital assets	(512,270)
Net cash used in capital and related financing activities	(512,270)
Net change in cash and cash equivalents	940,596
Cash and cash equivalents, beginning of year	2,018,424
Cash and cash equivalents, end of year	$ 2,959,020

Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	$ (1,596,300)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation	545,042
Changes in assets and liabilities:	
Accounts receivable	235,190
Inventory	7,644
Prepaid expenses	33,079
Other assets	9,000
Accounts payable	(4,291)
Advance deposits	(131,876)
Accrued liabilities	255,378
Net cash used in operating activities	$ (647,134)

See accompanying notes to financial statements.

NOTE 1 – DESCRIPTION OF OPERATIONS

On November 1, 2003, the City of San José (the City) assumed operations, management and reporting of the Hayes Mansion Conference Center (the Center), which includes guest rooms, meeting and conference facilities, food and beverage facilities, surface and underground parking areas and health and fitness facilities located at 200 Edenvale Avenue, San José, California. The City has contracted with Dolce International/San José, Inc. (Dolce) to act as operator of the Center, see Note 8.

The financial statements of the Center are intended to present the financial position and the changes in financial position and cash flows of only that portion of the City's financial statements that is attributable to the operating transactions of the Center. The Center's operating transactions are reported within the City's special revenue funds; however, for purposes of this presentation, management reports its operating transactions as an enterprise fund to comply with contractual requirements. The contractual requirements focus on the operations of the Center and as such the City has not included the Center's building and improvements and related debt in the Center's financial statements. These assets and related debt are reported as part of the City's government-wide financial statements. The financial statements of the Center do not purport to, and do not, present fairly the financial position of the City as of June 30, 2011 and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation and Accounting

Basis of accounting refers to when revenues and expenses are recognized in the accounts reported in the financial statements, and relates to the timing of measurements made, regardless of the measurement focus applied. The Center is accounted for using the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989 generally are followed to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board (GASB). Governments also have the option of following subsequent private-sector guidance for their enterprise activities, subject to the same limitation. The Center has elected not to apply subsequent private-sector guidance.

(b) Cash and Cash Equivalents

All highly liquid investments with original maturities of three months or less are considered to be cash equivalents and are carried at fair value.

(c) Accounts Receivable

The accounts receivable balance at June 30, 2011 is reported net of an allowance for estimated uncollectible amounts. At June 30, 2011, management did not report an allowance for uncollectible amounts.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(d) Inventory

Inventory consists of food, beverages and spa supplies that are stated at the lower of cost (first in, first-out method) or market.

(e) Capital Assets

Capital assets are stated at cost, if purchased, or at fair value on the date received, if donated. Management has established a capitalization threshold of $5,000 per item with a useful life greater than one year. Depreciation is provided on a straight-line basis over the estimated useful life of each class of depreciable asset. Estimated useful lives are generally three to ten years for furniture, equipment and smallwares.

(f) Operating Revenues and Expenses

The Center defines its operating revenues as charges for services, which are revenues derived from charges for rooms, conference services, sale of food and beverages, spa, gifts and other services. All other revenues not derived from these sources, such as City operating subsidies, are classified as nonoperating revenues in the accompanying statement of revenues, expenses and changes in net assets.

Consistent with the treatment in the accompanying statement of cash flows, all expenses, with the exception of payments made to other funds of the City for reimbursement of bond expenses paid by the City and interest expense are treated as operating expenses in the accompanying statement of revenues, expenses and changes in net assets.

(g) Net Assets

Net assets are classified in the following two components:

Invested in capital assets, consists of the Center's capital assets net of related accumulated depreciation.

Unrestricted net assets consist of any remaining balance of net assets not subject to the aforementioned categorization.

When both restricted and unrestricted resources are available for use, it is the Center's policy to use restricted resources first and then unrestricted resources, as they are needed.

(h) Use of Estimates

The financial statements are prepared in conformity with accounting principles generally accepted in the United States, which requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

NOTE 3 – CASH AND INVESTMENTS

The Center's cash and investments consist of the following at June 30, 2011:

Petty cash	$ 14,000
Deposits with financial institutions:	
Non-interest bearing	1,004,186
Interest bearing	1,413,597
Funds deposited in the City's cash and investment pool	527,237
Total cash and investments	$ 2,959,020

(a) *Investments*

The Center has adopted the investment policy of the City, which is governed by provisions of the California Government Code and the City's Municipal Code. According to the investment policy, the City's cash and investment pool may invest in the State of California Local Agency Investment Fund, obligations of the U.S. Treasury or U.S. Government agencies, time deposits, money market mutual funds invested in U.S. Government securities, and with various other permitted investments.

Under the terms of the Comerica loan agreement between the City and Comerica bank, which is no longer in effect due to the pay-off of all Comerica loans on October 29, 2008, the Center was required to set aside certain revenues into a furniture, fixture and equipment (FF&E) reserve. Although no longer a requirement for the year ended June 30, 2011, management has decided to continue this practice. During the year, the Center transferred $441,920 into the City's cash and investment pool to fund future capital acquisitions related to furniture, fixtures and equipment. The FF&E reserve monthly contribution is an amount equal to four percent of gross revenues for the previous calendar month to be utilized to pay for (i) costs of any single repair to or at the Center that exceeds $5,000 and (ii) capital expenditures on or at the Center. A reconciliation of the FF&E Reserve Account for the year ended June 30, 2011, is as follows:

FF&E Reserve Account	Amount
Beginning balance, July 1, 2010	$ 404,671
Contributions during the year	441,920
Withdrawals during the year	(319,354)
Ending balance, June 30, 2011	$ 527,237

The Center maintains its investments in the City's cash and investment pool. It is not possible to disclose relevant information about the Center's separate portion of the cash and investment pool, as there are no specific investments belonging to the Center itself. Information regarding the characteristics of the entire investment pool can be found in the City's June 30, 2011 basic financial statements. A copy of that report may be obtained by contacting the City's Finance Department, 200 East Santa Clara Street, 13th Floor, San José, CA, 95113 or can be found at the City's Finance Department Web Site at http://www.csjfinance.org.

NOTE 3 – CASH AND INVESTMENTS (Continued)

(b) Custodial Credit Risk

The Center's uninsured deposits are collateralized in the manner prescribed by State law. The amounts placed on deposit with financial institutions were covered by federal depository insurance or were collateralized by the pledging financial institutions as required by Section 53652 of the California Government Code. Such collateral is held by the pledging financial institutions' trust department or agent in the City's name. Accordingly, the exposure to custodial credit risk is low as of and for the year ended June 30, 2011.

(c) Credit Risk

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This risk is measured by the assignment of a rating by nationally recognized statistical rating organization. The Center has mitigated this risk by placing its investments in the City's cash and investment pool. The City's pool is not rated by a credit rating agency.

(d) Interest Rate Risk

Interest rate risk is the risk that changes in market rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment the greater the sensitivity of its fair value to changes in market rates. The Center's investment in the City's cash and investment pool has a weighted average maturity of 376 days as of June 30, 2011.

NOTE 4 – CAPITAL ASSETS

The following is a summary of the changes in capital assets for the year ended June 30, 2011:

	Balance June 30, 2010	Additions	Reductions	Balance June 30, 2011
Nondepreciable capital assets:				
Construction in progress	$ 1,744	$ 512,270	$ 417,702	$ 96,312
Depreciable capital assets, gross:				
Furniture and equipment	5,336,949	417,702	-	5,754,651
Less accumulated depreciation:				
Furniture and equipment	(3,886,693)	(545,042)	-	(4,431,735)
Total depreciable capital assets, net	1,450,256	(127,340)	-	1,322,916
Total capital assets, net	$ 1,452,000	$ 384,930	$ 417,702	$ 1,419,228

NOTE 5 – LOANS PAYABLE

Devcon Construction Incorporated

Prior to November 1, 2003, Hayes Renaissance, L.P. (HRLP) provided the operations, management and reporting for the Center. The lease agreement between the City and HRLP was terminated due to HRLP's inability to meet the terms and conditions of the agreement. Upon termination, the City agreed to assume HRLP's liability to Devcon Construction Incorporated (Devcon) in the amount of $1.2 million, and entered into a repayment agreement with Devcon, with no payment of interest and no maturity date, on a subordinated basis from the Center's net revenues, as defined in the repayment agreement between the City and Devcon.

NOTE 6 – OPERATING LEASE

Effective January 1, 2010, the Center extended its lease for one year, with an outside contractor regarding the Spa Lease Agreement. The agreement has a fixed rent component and a percentage rent component. The fixed rent component requires the outside contractor to pay the Center a monthly fixed fee of $4,500 for both calendar years 2009 and 2010. The percentage rent component requires the outside contractor to pay the Center a percentage of the amount of gross sales generated by the outside contractor. Percentage rent for calendar year 2010 is $24,000 plus 5% of gross sales exceeding $240,000. Percentage rent earned in fiscal year 2011 totaled $34,473. The agreement was terminated on December 31, 2010.

During fiscal year 2011, the Center entered into various operating agreements for vehicles and phone system equipment for the Center's operations. The terms of the agreements are from September 21, 2010 for the vehicles and July 1, 2011 for the phone system equipment, expiring at various dates from August 21, 2013 through June 1, 2016. Rental expenses for the Center vehicle for the year ended June 30, 2011 was approximately $10,730.

The future minimum payments anticipated under these commitments, as of June 30, 2011 are as follows:

Year Ended June 30,	Amount
2012	$ 27,046
2013	27,046
2014	17,346
2015	15,406
2016	15,406
Total	$ 102,250

NOTE 7 – RELATED PARTY TRANSACTIONS

(a) *Receipts from the City's General Fund*

During the year ended June 30, 2011, the Center reported a $5,800,000 City contribution from the General Fund. $2,291,664 of this contribution is used primarily for operations; and $3,508,336 of this contribution is to make debt service payments on the City's Lease Revenue Bonds.

(b) *Charges to other funds of the City*

During the year ended June 30, 2011, the Center transferred to other funds of the City the following amounts to reimburse the City for expenses incurred on behalf of the Center:

Hayes Mansion bond expenses	$ 3,700,000
General and administration expenses	202,740
Insurance premiums	46,629
Total	$ 3,949,369

Hayes Mansion Bond Expenses - During year ended June 30, 2011, the Center made operating lease payments of $3,700,000 to other funds of the City for reimbursement of bond expenses paid by the City.

The City of San José Financing Authority (SJFA), a component unit of the City, issued lease revenue bonds in 1993 for the construction of improvements to the Center known as Phase I improvements in the original aggregate amount of approximately $11 million. A portion of these bonds was refunded on June 12, 2007 when SJFA issued Lease Revenue Bonds Series 2007A related to the Center in the aggregate amount of approximately $5.1 million. SJFA also issued lease revenue bonds in 2001 for the construction of additional improvements to the Center known as Phase III improvements, improvements to the adjacent Edenvale Garden Park and the refunding of the 1995 lease revenue bonds previously issued by the SJFA for improvements to the Center in the aggregate amount of approximately $53.3 million. These bonds were refunded on June 26, 2008, when SJFA issued Lease Revenue Bonds Series 2008C and 2008D related to the Center in the aggregate amount of approximately $58 million. The City is obligated to make the debt service payments and the Center reimburses the City for such costs.

NOTE 7 – RELATED PARTY TRANSACTIONS (Continued)

Refer to the long-term debt disclosures in the City's financial statements for further information on the debt related to the Center. Future minimum lease payments on the outstanding bonds related to the improvements at the Center are as follows:

Year Ending June 30	Principal	Interest
2012	$ 2,730,913	$ 274,376
2013	3,020,735	269,500
2014	3,030,005	251,665
2015	3,363,206	218,253
2016	3,590,167	181,421
2017-2021	18,885,222	379,738
2022-2026	21,205,000	79,616
2027	4,570,000	2,285
Future minimum lease commitments	$ 60,395,248	$ 1,656,854

For purposes of calculating the future minimum lease payments (equal to the annual debt service requirements for variable rate debt) as of June 30, 2011, the following June 30, 2011 effective interest rates were used:

Bond Issue	Effective Interest Rate
SFJA Lease Revenue Bonds, Series 2008C	0.05%
SFJA Lease Revenue Bonds, Series 2008D	0.15%

General and Administration Expenses – During the year ended June 30, 2011, the Center was allocated total charges of $202,740 comprised of: (1) $71,400 to pay for up to 50% of the salary of a full-time equivalent of a principal accountant employed by the City with respect to the Center; (2) $9,996 to pay the cost of a City employee to administer and monitor long-term debt as it relates to the Center (not to exceed $10,000 per contract year); (3) $83,580 to pay the cost of a City asset management consultant to oversee the management of the Center; (4) $37,764 to pay for other administration and general expense.

Insurance Premiums – The Center paid $46,629 for the cost of insurance premiums for policies maintained by the City with respect to the Center, which are reported as insurance expense. The Center is covered under the City's annual all-risk property insurance policy. The policy is a $1 billion blanket property policy covering all City owned locations, including the Center.

NOTE 8 – COMMITMENTS

(a) Management Agreement

The City entered into a Management Agreement (the Agreement) with Dolce to operate and manage the Center. The original term of the Agreement is for the period from January 1, 2004 through June 30, 2014, unless it is extended or sooner terminated, as provided for in the Agreement. Dolce has the right and option to extend the original term for two successive periods of five calendar years each, provided it meets certain requirements as defined in the Agreement.

As compensation for the services to be rendered by Dolce pursuant to the Agreement, the City pays Dolce a monthly base management fee of 3% of monthly gross revenues. In accordance with the Agreement, the management fee is reduced to 2% if none of the two required performance measures are met. For the year ended June 30, 2011, Dolce met one of the two required performance measures, and, accordingly, the monthly base management fee is calculated based on 3% of the Center's gross revenues or $358,334.

Dolce is also entitled to an incentive management fee during each contract year, as defined in the Agreement, which is variable based on the Center's profitability. For the year ended June 30, 2011, Dolce did not meet the performance objectives entitling them to an incentive management fee.

(b) Operating Contributions from the City

Beginning in the year ended June 30, 2005, the City has advanced General Fund money to the Center to subsidize its operations under the City's Hayes Line of Credit appropriation. The City expects repayment of these contributions when the Center generates an operating surplus. Amounts committed to the City as of June 30, 2011 are summarized as follows:

Year Ended June 30,	Amount
2005	$ 1,000,000
2006	2,400,000
2007	4,200,000
2008	4,300,000
2009	9,100,000
2010	2,700,000
2011	5,800,000
Total advances from the City	$ 29,500,000

Due to the Center's operating deficits over the past several years, it is not certain whether or when the Center will be able to repay these General Fund contributions; accordingly, they have been reported as contributions and are not reported as a liability in the financial statements.