

**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, 2014

HAYES MANSION CONFERENCE CENTER

For the Year Ended June 30, 2014

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Independent Auditor's Report

City Council
City of San José, California

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, 2014, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers the internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion of the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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, 2014, and the changes in its financial position and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of a Matter

Basis of Presentation

As discussed in Note 1 to the financial statements, 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, 2014 and the changes in its financial position and, where applicable, its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Management has omitted the management's discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the financial statements. Such missing information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

Macias Gini & Connell LLP

Walnut Creek, California
September 8, 2014

HAYES MANSION CONFERENCE CENTER

Statement of Net Position

June 30, 2014

Assets:

Current assets:

Cash and investments	\$ 4,396,801
Accounts receivable	381,298
Accounts receivable - City of San José	18,835
Inventory	71,407
Prepaid expenses	247,137
Total current assets	<u>5,115,478</u>

Noncurrent assets:

Other assets	<u>100,000</u>
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Capital assets:

Nondepreciable	11,529
Depreciable, net	<u>1,455,171</u>
Capital assets, net	<u>1,466,700</u>
Total assets	<u>6,682,178</u>

Liabilities:

Current liabilities:

Accounts payable	504,468
Advance deposits	1,162,299
Accrued liabilities	<u>889,642</u>
Total current liabilities	2,556,409

Noncurrent liabilities:

Devcon loan	<u>1,200,000</u>
Total liabilities	<u>3,756,409</u>

Net position:

Net investment in capital assets	1,466,700
Unrestricted	<u>1,459,069</u>
Total net position	<u>\$ 2,925,769</u>

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER
Statement of Revenues, Expenses and Changes in Net Position
For the Year Ended June 30, 2014

Operating revenues:

Room	\$ 6,740,530
Conference services	1,754,214
Food	4,568,557
Beverage	711,542
Spa	15,839
Other	328,273
	<u>14,118,955</u>
Total operating revenues	<u>14,118,955</u>

Operating expenses:

Administrative	2,236,720
Beverage	320,527
City of San José management and administrative charges	229,337
Conference	773,274
Depreciation	402,749
Food	3,997,637
Insurance	123,703
Lease and rental expense	66,747
Maintenance	987,681
Management fee	423,569
Other	146,298
Room	2,593,460
Sales and marketing	1,309,510
Utilities	634,176
	<u>14,245,388</u>
Total operating expenses	<u>14,245,388</u>
Operating loss	<u>(126,433)</u>

Nonoperating revenues (expenses):

Contributions from the City of San José General Fund	5,200,000
Payments to the City of San José	(4,412,000)
	<u>788,000</u>
Total nonoperating revenues, net	<u>788,000</u>
Change in net position	661,567

Net Position:

Beginning of year	2,264,202
End of year	<u>\$ 2,925,769</u>

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER

Statement of Cash Flows
For the Year Ended June 30, 2014

Cash flows from operating activities:

Cash receipts from customers	\$ 14,279,067
Cash payments to suppliers for goods and services	(5,720,253)
Cash payments to employees for services	(7,581,061)
Net cash provided by operating activities	<u>977,753</u>

Cash flows from noncapital financing activities:

Contributions from the City of San José General Fund	5,200,000
Payments to the City of San José	(4,412,000)
FF&E subsidy retained by City of San José	(18,835)
Net cash provided by noncapital financing activities	<u>769,165</u>

Cash flows from capital and related financing activities:

Additions to capital assets	<u>(319,883)</u>
Net cash used in capital and related financing activities	<u>(319,883)</u>

Net change in cash and cash equivalents	1,427,035
Cash and cash equivalents, beginning of year	2,969,766
Cash and cash equivalents, end of year	<u>\$ 4,396,801</u>

Reconciliation of operating loss to net cash provided by operating activities:

Operating loss	\$ (126,433)
Adjustments to reconcile operating loss to net cash provided by operating activities:	
Depreciation	402,749
Changes in assets and liabilities:	
Accounts receivable	(59,005)
Inventory	(7,703)
Prepaid expenses	(146,181)
Accounts payable	260,031
Advance deposits	219,117
Accrued liabilities	435,178
Net cash provided by operating activities	<u>\$ 977,753</u>

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements
For the Year Ended June 30, 2014

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, 2014 and the changes in its financial position and, where applicable, its cash flows, 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.

(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*

Management has evaluated accounts receivable for collectability as of June 30, 2014 and has determined that an allowance for uncollectible amounts is not required.

(d) *Inventory*

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

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(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 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 position.

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, are treated as operating expenses in the accompanying statement of revenues, expenses and changes in net position.

(g) Net Position

Net position is classified in the following two components:

Net Investment in Capital Assets, consists of the Center's capital assets net of related accumulated depreciation.

Unrestricted, consists of any remaining balance of net position 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.

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

NOTE 3 – CASH AND INVESTMENTS

The Center's cash and investments consist of the following at June 30, 2014:

Petty cash	\$ 14,000
Deposits with financial institutions:	
Non-interest bearing	3,581,547
Interest bearing	15,450
Funds deposited in the City's cash and investment pool	<u>785,804</u>
Total cash and investments	<u>\$ 4,396,801</u>

(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, fixtures and equipment (FF&E) reserve. Although no longer a requirement for the year ended June 30, 2014, management has decided to continue this practice. During the year, the Center transferred \$564,758 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 summary of activities of the FF&E Reserve Account for the year ended June 30, 2014, is as follows:

<u>FF&E Reserve Account</u>	<u>Amount</u>
Beginning balance, July 1, 2013	\$ 529,396
Contributions during the year	564,758
Withdrawals during the year	<u>(308,350)</u>
Ending balance, June 30, 2014	<u>\$ 785,804</u>

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, 2014 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.sanjoseca.gov>.

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

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, 2014.

(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 a 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 532 days as of June 30, 2014.

NOTE 4 – CAPITAL ASSETS

The following is a summary of the changes in capital assets for the year ended June 30, 2014:

	Balance July 1, 2013	Additions	Transfers	Balance June 30, 2014
<i>Nondepreciable capital assets:</i>				
Construction in progress	\$ 130,125	\$ 319,883	\$ (438,479)	\$ 11,529
<i>Depreciable capital assets, gross:</i>				
Furniture and equipment	6,644,153	-	438,479	7,082,632
<i>Less accumulated depreciation:</i>				
Furniture and equipment	(5,224,712)	(402,749)	-	(5,627,461)
Total depreciable capital assets, net	1,419,441	(402,749)	438,479	1,455,171
Total capital assets, net	\$ 1,549,566	\$ (82,866)	\$ -	\$ 1,466,700

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

NOTE 5 – LOANS PAYABLE

Devcon Construction Incorporated

Prior to November 1, 2003, Hayes Renaissance, L.P. (HRLP) provided the operations, management and reporting to 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 LEASES

Effective July 4, 2011, the Center extended its lease and revised the terms of the agreement from a fixed rent and percentage of revenue basis to only a percentage of revenue basis, until December 22, 2011, with an outside contractor regarding the Spa Lease Agreement. The agreement requires that InSpa pay Dolce 10% of net revenues by the 10th of each month. Spa revenue for the Center for the year ended June 30, 2014 was \$15,839. This agreement ended December 22, 2011; however, the Center and InSpa agreed to continue business on the same contract terms on a month to month basis.

The Center entered into various operating agreements for vehicles and phone system equipment for the Center's operations. The terms of the agreements expiring at various dates through June 1, 2016. Operating lease expenses for the Center's vehicle and phone system for the year ended June 30, 2014 was \$10,347 and \$15,406, respectively. Other operating lease expenses for the year ended June 30, 2014 were related to various equipment rentals and were \$40,994.

The future minimum payments anticipated under these commitments as of June 30, 2014, are as follows:

<u>Year Ending June 30,</u>	<u>Amount</u>
2015	\$ 25,731
2016	23,581
Total	<u>\$ 49,312</u>

NOTE 7 – RELATED PARTY TRANSACTIONS

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

For the year ended June 30, 2014, the Center reported a \$5,200,000 City contribution from the General Fund, which was used to fund debt service payments to the City, the Center's operating loss, and operating needs for subsequent year.

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

NOTE 7 – RELATED PARTY TRANSACTIONS (Continued)

(b) Charges to Other Funds of the City

During the year ended June 30, 2014, 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 and other expenses	\$ 4,412,000
General and administrative expenses	232,067
Insurance premiums	<u>37,289</u>
Total	<u><u>\$ 4,681,356</u></u>

Hayes Mansion Bond and Other Expenses - During year ended June 30, 2014, the Center made operating payments of \$4,412,000 to other funds of the City for reimbursement of bond expenses paid by the City and for repayment of other expenses.

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.

In November 2013, the City called \$10 million in SJFA 2008D variable rate bonds. In addition the City reissued all of its outstanding variable rate bonds and placed them directly with two qualified investors. These variable rate bonds, including SJFA 2008C, were purchased by US Bank in December 2013. This direct or private placements deal (DPs) will generate savings for the City and particularly to the Center due to lower fees charged by US Bank for the DPs compared to the fees charged for Letters of Credit.

Future minimum lease payments on the outstanding bonds related to the improvements at the Center are as follows:

<u>Year Ending June 30</u>	<u>Principal</u>	<u>Interest</u>
2015	\$ 3,363,206	\$ 207,294
2016	3,590,167	171,231
2017	3,737,416	133,643
2018	3,969,930	94,926
2019	4,177,876	54,405
2020-2024	14,360,000	106,680
2025-2027	<u>10,805,000</u>	<u>12,150</u>
Future minimum lease commitments	<u><u>\$ 44,003,595</u></u>	<u><u>\$ 780,329</u></u>

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

NOTE 7 – RELATED PARTY TRANSACTIONS (Continued)

Additional information on the debt related to the Center may be obtained from the long-term debt disclosure in the City's basic financial statements.

For purposes of calculating the future minimum lease payments (equal to the annual debt service requirements for variable rate debt) as of June 30, 2014, the following June 30, 2014 effective interest rates were used:

<u>Bond Issue</u>	<u>Effective Interest Rate</u>
SFJA Lease Revenue Bonds, Series 2008C	0.59%
SFJA Lease Revenue Bonds, Series 2008D	0.68%

General and Administrative Expenses – During the year ended June 30, 2014, the Center was allocated total charges of \$229,337 comprised of: (1) \$92,426 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) \$81,815 to pay the cost of a City asset management consultant to oversee the management of the Center; (4) \$45,100 to pay for other administrative and general expenses.

Insurance Premiums – The Center paid \$37,289 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 was for the period from January 1, 2004 through June 30, 2014. 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. In November 2013, Dolce elected to exercise the renewal option to extend the term of the Agreement for a period of five years.

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, 2014, Dolce met one of the two required performance measures, so the monthly base management fee is calculated based on 3% of the Center's gross revenues or \$423,569.

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, 2014, Dolce did not meet the performance objectives entitling them to an incentive management fee.

HAYES MANSION CONFERENCE CENTER

Notes to Financial Statements (Continued)

For the Year Ended June 30, 2014

NOTE 8 – COMMITMENTS (Continued)

(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 Center as of June 30, 2014 are summarized as follows:

<u>Year Ended June 30,</u>	<u>Amount</u>
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
2012	5,050,000
2013	4,700,000
2014	5,200,000
Total advances from the City	<u>\$ 44,450,000</u>

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.