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, 2009

HAYES MANSION CONFERENCE CENTER
For the Year Ended June 30, 2009

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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, 2009, as listed in the table of contents. These financial statements are the responsibility of 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 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 has elected to report 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, 2009 and the changes in its financial position and its cash flows, where applicable, for the year ended June 30, 2009 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, 2009, 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 is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & O'Connell LLP

Certified Public Accountants
Walnut Creek, California

September 25, 2009

HAYES MANSION CONFERENCE CENTER

Statement of Net Assets

June 30, 2009

Assets:		
Current assets:		
Cash and investments	$	1,824,821
Accounts receivable, net of allowance for doubtful accounts		750,965
Accounts receivable - Dolce International/San José, Inc.		126,354
Inventory		82,207
Prepaid expenses		137,261
Total current assets		2,921,608
Noncurrent assets:		
Other assets		109,000
Capital assets:		
Nondepreciable		165,102
Depreciable, net		1,679,228
Capital assets, net		1,844,330
Total assets		4,874,938
Liabilities:		
Current liabilities:		
Accounts payable		456,465
Advance deposits		649,869
Accrued liabilities		403,731
Total current liabilities		1,510,065
Noncurrent liabilities:		
Advance from the General Fund of the City of San Jos		1,000,000
Devcon loan		1,200,000
Total liabilities		3,710,065
Net assets:		
Invested in capital assets		1,844,330
Unrestricted (deficit)		(679,457)
Total net assets	$	1,164,873

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER

Statement of Revenues, Expenses and Changes in Net Assets (Deficit)

For the Year Ended June 30, 2009

Operating revenues:	
Room	$ 5,147,527
Conference services	1,977,728
Food	4,463,918
Beverage	741,390
Spa and gift shop	80,102
Other	228,541
Total operating revenues	12,639,206
Operating expenses:	
Administrative	2,083,919
Beverage	216,764
City of San José management and administrative charges	207,484
Conference	1,211,735
Depreciation	498,430
Food	3,788,407
Insurance	117,638
Lease and rental expense	48,983
Maintenance	933,042
Management fee	252,717
Other	218,111
Room	1,779,139
Sales and marketing	1,671,207
Utilities	562,892
Total operating expenses	13,590,468
Operating loss	(951,262)
Nonoperating revenues (expenses):	
Revolving loan contributions from the City of San José	5,000,000
Other contributions from the City of San José	4,100,000
Payments to the City of San José	(3,409,754)
Interest expense	(112,168)
Total nonoperating revenues	5,578,078
Increase in net assets	4,626,816
Net assets (deficit):	
Beginning of year	(3,461,943)
End of year	$ 1,164,873

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER

Statement of Cash Flows

For the Year Ended June 30, 2009

Cash flows from operating activities:	
Cash receipts from customers	$ 13,084,762
Cash payments to suppliers for goods and services	(5,244,598)
Cash payments to employees for services	(7,675,387)
Net cash provided by operating activities	164,777
Cash flows from noncapital financing activities:	
Contributions from the City of San José	4,100,000
Payments to the City of San José	(3,409,754)
Net cash provided by noncapital financing activities	690,246
Cash flows from capital and related financing activities:	
Additions to capital assets	(533,657)
Interest paid on debt	(112,168)
Net cash used in capital and related financing activities	(645,825)
Net change in cash and cash equivalents	209,198
Cash and cash equivalents, beginning of year	1,615,623
Cash and cash equivalents, end of yea	$ 1,824,821

Reconciliation of operating loss to net cash provided by operating activities:	
Operating loss	$ (951,262)
Adjustments to reconcile operating loss to net cash provided by operating activities:	
Depreciation	498,430
Changes in assets and liabilities:	
Accounts receivable	888,848
Inventory	9,679
Prepaid expenses	77,011
Accounts and other payables	70,616
Advance deposits	(443,292)
Accrued liabilities	14,747
Net cash provided by operating activitie	$ 164,777
Supplemental disclosures of cash flow information:	
Noncash noncapital financing activities:	
Revolving loan payoff by the City of San Jos	$ 5,000,000

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 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 has elected to report it as an enterprise fund to comply with contractual requirements. The City has contracted with Dolce International/San Jose, Inc. (Dolce) to act as operator of the Center, see Note 8. 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, 2009 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, 2009 is reported net of an allowance for estimated uncollectible amounts. Management has estimated the uncollectible amounts to be $22,114.

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 market 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 (Deficit)

Net assets (deficit) are classified in the following three components:

Invested in capital assets, consists of the Center's capital assets net of related accumulated depreciation. All debt related to the acquisition of capital assets has been repaid as of June 30, 2009.

Restricted for debt covenants, consists of net assets that are subject to restrictions beyond the Center's control. During the year ended June 30, 2009, the $5,000,000 Comerica Bank revolving loans were paid off and as a result, the Center did not have a restricted net assets amount reported at June 30, 2009.

Unrestricted net assets (deficit) consist of any remaining balance of net assets not subject to the aforementioned categorizations. At June 30, 2009, the Center has a deficit balance of $679,457 in unrestricted net assets. The Center is currently unable to meet its debt service obligations based on current and projected revenues and, accordingly, continues to rely on operating subsidies from the City.

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.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(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, 2009:

Petty cash	$ 14,000
Deposits with financial institutions:	
Non-interest bearing	1,385,487
Interest bearing	61,095
Funds deposited into City's cash and investment pool	364,239
Total cash and investments	$ 1,824,821

(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, the Center must set aside certain revenues into a furniture, fixture and equipment (FF&E) reserve. Although no longer a requirement, management has decided to continue this practice. During the year, the Center transferred $503,003 into the City's cash and investment pool to fund future capital acquisitions related to furniture, fixture 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, 2009 is as follows:

FF&E Reserve Account	Amount
Beginning balance, July 1, 2008	$ 432,143
Withdrawals during the year	(67,904)
Ending balance, June 30, 2009	$ 364,239

NOTE 3 – CASH AND INVESTMENTS (Continued)

The Center maintains a portion of its unrestricted 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, 2009 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. As of June 30, 2009, the Center's share of the City's cash and investment pool totaled $364,239.

(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 Center's name. Accordingly, the exposure to custodial credit risk is low as of and for the year ended June 30, 2009.

(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 all of 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 market 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 259 days.

NOTE 4 – CAPITAL ASSETS

The following is a summary of the changes in capital assets for the year ended June 30, 2009:

	Balance June 30, 2008	Additions	Retirements	Balance June 30, 2009
Non-depreciable capital assets:				
Construction in progress	$ 179,468	$ 533,657	$ (548,023)	$ 165,102
Depreciable capital assets, gross:				
Furniture and equipment	4,539,251	548,023	-	5,087,274
Smallwares	206,721	-	(206,721)	-
Total depreciable capital assets, gross	4,745,972	548,023	(206,721)	5,087,274
Less accumulated depreciation:				
Furniture and equipment	(2,909,616)	(498,430)	-	(3,408,046)
Smallwares	(206,721)	-	206,721	-
Total accumulated depreciation	(3,116,337)	(498,430)	206,721	(3,408,046)
Total depreciable capital assets, net	1,629,635	49,593	-	1,679,228
Total capital assets, net	$ 1,809,103	$ 583,250	$ (548,023)	$ 1,844,330

NOTE 5 – LOANS PAYABLE

(a) Comerica Bank

On October 21, 2003, Council authorized the City Manager to negotiate and execute a $5,000,000 line of credit and term loan agreement with Comerica Bank (Bank) related to the transition of the operation and management of the Hayes Mansion from the City's lessee, Hayes Renaissance Limited Partnership to Dolce International/San Jose, Inc. (Dolce). The City paid in full the outstanding principal balance of $5,000,000, together with all accrued and unpaid interest on October 29, 2008.

(b) Advance from the General Fund of the City

During the year ended June 30, 2005, the City decided to assist the operations of the Center by advancing three separate payments totaling $1,000,000 from the General Fund. The monies were lent to assist the Center in meeting its monthly debt service requirements, as part of the management agreement with the City. The advance was made with no interest rate or maturity date; however, the City is expecting repayment as soon as any operating surplus exists.

(c) 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 with no payment of interest and no maturity date, on a subordinated basis from the Center's net revenues, as defined in a transition agreement made between the City and HRLP.

NOTE 6 – OPERATING LEASE

Effective January 1, 2008, the Center hired an outside contractor and negotiated a new Spa Lease Agreement (the 2008 Agreement) on December 12, 2007. The 2008 Agreement is for a two-year lease term with the outside contractor. In addition, an amended agreement is being negotiated between the Center and the outside contractor, effective retroactive to January 1, 2009.

The 2008 Agreement and 2009 Amendment have 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 $4,725 and $4,500 for calendar years 2008 and 2009, respectively. 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 2008 is $39,000 plus 5% of gross sales in excess of $390,000. Percentage rent for calendar 2009 is 10% of revenue up to $240,000 plus 5% of gross sales in excess of $240,000. Percentage rent earned in fiscal year 2009 totaled $24,753.

NOTE 7 – RELATED PARTY TRANSACTIONS

(a) Receipts from the General Fund

During the year ended June 30, 2009, the Center reported a $9,100,000 City Contribution from the General Fund. $4,100,000 of this contribution was used primarily to make debt service payments on the City's Lease Revenue Bonds and the remaining $5,000,000 was directly used by the City to pay-off the revolving loans with Comerica Bank.

(b) Charges to other funds of the City

During the year ended June 30, 2009, 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	$	3,409,754
General and administration expenses		207,484
Insurance premiums		50,573
Total	$	3,667,811

Hayes Mansion Bond Expenses - During year ended June 30, 2009, the Center made operating lease payments of $3,409,754 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. Since this transaction is treated as an operating lease expense from the Center's perspective, the Center's building and improvements and related debt are not reported in the Center's financial statements. Instead, they are reported in other City funds.

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
2010	$ 1,966,245	$ 473,558
2011	2,346,083	465,091
2012	2,730,913	454,804
2013	3,020,735	440,915
2014	3,030,005	413,905
2015-2019	18,838,595	1,360,874
2020-2024	19,195,000	462,294
2025-2027	13,580,000	41,965
Future minimum lease commitments	$ 64,707,576	$ 4,113,406

General and Administration Expenses – During year ended June 30, 2009, the Center was allocated total charges of (1) $73,500 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) $88,688 to pay the cost of a City asset management consultant to oversee the management of the Center; (4) $31,240 to pay the cost of City's free use of the Center; and (5) $4,060 for other incidental charges.

Insurance Premiums – The Center paid $50,573 for the cost of insurance premiums for policies maintained by the City with respect to the Center, which are reported as insurance expense.

NOTE 8 – COMMITMENTS

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 one of two required performance measures are not met. For the year ended June 30, 2009, Dolce did not meet either of the two required performance measures and accordingly, the management fee was reduced to $252,717, which represents 2% of gross revenues. At June 30, 2009 the Center reported a receivable of $126,354, which represents the outstanding reimbursement of management fees to be returned by Dolce.

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 fiscal year ended June 30, 2009, Dolce did not meet the performance objectives entitling them to an incentive management fee.