

City Council
City of San José, California

Independent Auditor's Report

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of San José, California (the City), as of and for the year ended June 30, 2012, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City's management. Our responsibility is to express opinions 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 City'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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of San José, California, as of June 30, 2012, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note I.A. to the basic financial statements, the California State Legislature enacted legislation that dissolved redevelopment agencies in the State of California as of February 1, 2012. On February 1, 2012, the City, as the Successor Agency to the Redevelopment Agency of the City of San José, became responsible for overseeing the dissolution process and the wind down of redevelopment activity.

As discussed in Note IV.C.3. to the basic financial statements, on June 8, 2012, Moody's Investors Service downgraded the former Redevelopment Agency of the City of San José's Senior Obligations Rating to below "Baa1", which triggered a Special Termination Event under the Continuing Covenant Agreement of its 2010 C Housing Set-Aside Tax Allocation Bonds (Bonds). The Bonds has an outstanding balance at June 30, 2012 of \$88.6 million and are reported as a current liability. For the period commencing on August 15, 2012 and ended on November 15, 2012, the bank agreed to forebear from exercising its rights and remedies under the bond documents in respect to the existing default. Negotiations are presently underway to extend the forbearance agreement. The City cannot predict the outcome of the negotiations.

As discussed in Note IV.D.3. to the basic financial statements, in connection with the Redevelopment Dissolution Law, the County of Santa Clara's Auditor-Controller issued its Agreed-Upon Procedures Report on October 5, 2012, which identified three separate issues questioning a total of \$203.0 million of assets held by the City and a component unit, which are currently in dispute by the City and the Successor Agency to the Redevelopment Agency of the City of San José. The City has requested meet and confer meetings with the State Department of Finance and is in the process of other administrative procedures to resolve these issues. Due to uncertainties with the Redevelopment Dissolution Law, the ultimate outcome of these issues cannot presently be determined, accordingly, no provision for any liability that may result has been recorded in the financial statements. It is reasonably possible that a determination may be made at a later date by an appropriate State or judicial authority that would resolve this matter unfavorably to the City.

As described in Note IV.A.1.4. to the basic financial statements, based on the most recent actuarial valuations as of June 30, 2011, the Police and Fire Department Retirement Plan's and the Federated City Employees' Retirement System's independent actuaries determined that, at June 30, 2011, the value of the defined benefit pension plans' actuarial accrued liability exceeded the actuarial value of their assets by \$510.3 million and \$981.6 million, respectively. Also, as described in Note IV.A.2.4., based on the most recent actuarial valuations as of June 30, 2011, the Police and Fire Department Retirement Plan's and the Federated City Employees' Retirement System's independent actuaries determined that, at June 30, 2011, the value of the postemployment healthcare plans' actuarial accrued liability exceeded the actuarial value of their assets by \$943.1 million and \$1,009.9 million, respectively.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis; the schedules of revenues, expenditures, and changes in fund balances – budget and actual for the General Fund, Housing Activities Fund and the Affordable Housing Investment Fund; and the schedules of funding progress listed in the table of contents be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City's basic financial statements. The introductory section, combining nonmajor governmental, internal service, trust and agency funds financial statements and schedules, and statistical section are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining nonmajor governmental, internal service, trust and agency funds financial statements and schedules are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic financial statements as a whole. The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on them.

Macias Gini & Cannel LLP

Walnut Creek, California

November 19, 2012