

**CITY OF SAN JOSE  
SOUTH BAY WATER RECYCLING  
PROGRAM AND SYSTEM**  
(A Program of the City of San José, California)

Report to the  
Recycled Water Policy Advisory Committee

Year Ended June 30, 2015



Certified  
Public  
Accountants





Recycled Water Policy Advisory Committee  
City of San José, California

In planning and performing our audit of the schedule of net operating revenues (“Schedule”) of the South Bay Water Recycling Program and System (“Program”), a program of the City of San José (“City”), for the year ended June 30, 2015, in accordance with the terms of the Integration Agreement between the City and the Santa Clara Valley Water District (“District”) dated March 2, 2010 (“Integration Agreement”), we considered the Program’s internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the Schedule, but not for the purpose of expressing an opinion on the effectiveness of the Program’s internal control. Accordingly, we do not express an opinion on the effectiveness of the Program’s internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

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 a 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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

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. We consider item 2015-01 in the accompanying schedule of comment and response to be a significant deficiency.

The City’s written response to the comment identified is described in the schedule of comment and response section. We did not audit the City’s response and, accordingly, we express no opinion on it. In addition, we would be pleased to discuss the comment in further detail at your convenience, to perform any additional study of this matter, or to assist you in implementing this recommendation.

Additionally, we have included in this letter a report on communications with the Recycled Water Policy Advisory Committee as required by auditing standards generally accepted in the United States of America. This communication is intended solely for the information and use of management of the City, the District, the Recycled Water Policy Advisory Committee, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Walnut Creek, California  
May 4, 2016

**CITY OF SAN JOSE**  
**SOUTH BAY WATER RECYCLING PROGRAM AND SYSTEM**

Required Communications  
For the Year Ended June 30, 2015

We have audited the schedule of net operating revenues of the South Bay Water Recycling Program and System (“Program”), a program of the City of San José (“City”), for the year ended June 30, 2015 and have issued our report thereon dated May 4, 2016. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, as well as certain information related to the planned scope and timing of our audit. We have previously communicated such information to you in our engagement letter dated April 8, 2016. Professional standards also require that we communicate to you the following information related to our audit.

**Significant Audit Findings**

*Qualitative Aspects of Accounting Practices*

Management is responsible for the selection and use of appropriate accounting policies. The Program’s significant accounting policies used are described in Note 2 to the Program’s schedule of net operating revenues. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2015. We noted no transactions entered into by the Program during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial schedule in the proper period.

Accounting estimates are an integral part of the financial schedule 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.

The most sensitive estimate affecting the schedule of net operating revenue was the allocation of the Wastewater Treatment System fund’s expenses to the Program. Management’s judgments and estimates were based on the level of effort of Environmental Services Department personnel who worked directly and indirectly in the Program.

We evaluated the key factors and assumptions used to develop the accounting estimate described above in determining that it is reasonable in relation to the Program’s schedule of net operating revenue taken as a whole.

Certain financial schedule disclosures are particularly sensitive because of their significance to financial schedule users. The most sensitive disclosure affecting the financial schedule was the presentation of the Program’s expenses and allocations. As described in Note 1 to the financial schedule, the Program’s schedule of net operating revenues are intended to present the changes in financial position of only that portion of the Program’s revenues and expenses that is attributable to the Program’s transactions to comply with the Agreement.

The financial schedule disclosures are neutral, consistent, and clear.

**CITY OF SAN JOSE**  
**SOUTH BAY WATER RECYCLING PROGRAM AND SYSTEM**

Required Communications  
For the Year Ended June 30, 2015

***Difficulties Encountered in Performing the Audit***

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

***Corrected and Uncorrected Misstatements***

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. 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 schedule taken as a whole.

***Disagreements with Management***

For purposes of this letter, a disagreement with management is 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.

***Management Representations***

We have requested certain representations from management that are included in the management representation letter dated May 4, 2016.

***Management Consultations 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 Program's schedule or a determination of the type of auditor's opinion that may be expressed on this schedule, 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 Program'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**  
**SOUTH BAY WATER RECYCLING PROGRAM AND SYSTEM**  
Schedule of Comment and Response  
Year Ended June 30, 2015

**Item 2015-001            Insufficient Documentation to Support Basis of Cost Allocations  
(Significant Deficiency)**

The South Bay Water Recycling Program and System (“Program”) is a program whereby recycled water is an established component of the non-potable water supply. With pipeline in the cities of San José, Santa Clara, and Milpitas, the Program is the largest of four recycled water systems in Santa Clara County. The City of San José has operated the Program as part of its operation of the San José Regional Wastewater Facility.

As part of our audit, we performed testing procedures over the Program’s revenues and expenses to comply with the Agreement and noted the following:

- The allocation of labor charges for the Recycled Water Facility (RWF) manufacturing operations and program administration support had insufficient documentation to support the basis of the percentage allocation.
- Inconsistencies in the use of the City’s overhead calculations.
- Manual and complex spreadsheet calculations were used to update expenses allocated to the Program.

We recommend that the Program’s management document its accounting procedures as well as its process and internal controls over the allocations of all Program costs. In addition, the City should establish a separate sub-fund in its general ledger to track and record transactions directly related to the program in lieu of the use of manual spreadsheets to better report and account for the Program.

*Management Response*

As part of the joint effort with the Santa Clara Valley Water District, the City has already implemented improved financial tracking procedures for South Bay Water Recycling (SBWR), and revised operational cost management, and rate strategies to appropriately capture costs associated with SBWR. This audit provides a valuable review of the program status and opportunities for continuous improvement.