SAN JOSE CONVENTION AND CULTURAL FACILITIES
(An Activity of the City of San José)

Report to the
Public Safety, Finance &
Strategic Support Committee

For the Year Ended
June 30, 2010

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Members of the Public Safety, Finance &
Strategic Support Committee
and San José City Council
City of San José, California

In planning and performing our audit of the financial statements of the San José Convention and Cultural Facilities (the Center), an activity of the City of San José (the City), as of and for the year ended June 30, 2010, in accordance with auditing standards generally accepted in the United States of America, we considered the Center's internal controls over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing our opinion on the effectiveness of the Center's internal control. Accordingly, we do not express an opinion on the effectiveness of the Center's internal control.

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 combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Center's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control, described as Items #2010-A, 2010-B, 2010-C and 2010-D in the accompanying schedule of comments and responses that we consider to be significant deficiencies in internal control. 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.

The Center's written response to the findings identified in our audit is described in the schedule of comments and responses. We did not audit the Center's response and, accordingly, we express no opinion on it. In addition, we have already discussed our comments and recommendations with various Center personnel and the City's management, and we would be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing these recommendations.

Additionally, we have included in this letter a report on communications with the Public Safety, Finance & Strategic Support Committee (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, the Committee, City Council, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

Macias Gini & O'Connell LLP
Certified Public Accountants

Walnut Creek, California
December 1, 2010

SAN JOSE CONVENTION AND CULTURAL FACILITIES
Report to the Public Safety, Finance & Strategic Support Committee
For the Year Ended June 30, 2010

REQUIRED COMMUNICATIONS

We have audited the financial statements of the San José Convention and Cultural Facilities (the Center), an activity of the City of San José (the City) as of and for the year ended June 30, 2010 and have issued our report thereon dated December 1, 2010. Professional auditing standards require that we communicate to you the following information related to our audit.

I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards

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 in our Engagement Communication section of our General Audit Plan dated June 30, 2010.

II. Significant Audit Findings

Qualitative Aspects of Accounting Practices
Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the Center are described in Note 2 to the Center's financial statements. As discussed in Notes 2(h) to the financial statements, the Center adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. No accounting changes were required by the Center to conform to the provisions of GASB Statement No. 51 and retroactive restatement of prior financial statements was not required. We noted no transactions entered into by the Center during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements 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 estimates affecting the financial statements were:

- Estimated allowance for losses on accounts receivable and
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property.

Management's judgments and estimates were based on the following:

- Estimated allowances for losses on accounts receivable were based on historical write-off rates and industry averages and
- Useful lives for depreciable property were determined by management based on the nature of the capital assets and the straight-line method of depreciation was applied.

We evaluated the key factors and assumptions used to develop the accounting estimates described above in determining that they are reasonable in relation to the Center's financial statements taken as a whole.

REQUIRED COMMUNICATIONS (Continued)

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosure affecting the financial statements was use of the enterprise fund presentation on the Center's operations. As more fully described in Note 1 to the financial statements, the Center's financial statements 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 Center's transactions to comply with contractual requirements.

Difficulties Encountered in Performing the Audit
We received eight Center closing adjustments, including a change in the accounting treatment for a convention exhibit, more than two months after the scheduled completion of the on-site audit fieldwork. Due to the number of adjustments, we spent additional time to complete the 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 trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements other than those that are trivial. The following significant misstatements detected as a result of audit procedures were corrected by management:

- Maintenance costs in the amount of $61,000 were improperly capitalized and renovation costs in the amount of $117,178 were improperly expensed; and
- Advance deposits in the amount of $141,441 were misclassified as accrued liabilities rather than deferred revenues.

Disagreements with Management
For purposes of this letter, professional standards define a disagreement with management as 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 December 1, 2010.

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 Center's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, 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 Center's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

SCHEDULE OF COMMENTS AND RESPONSES

Item # 2010-A – Significant Deficiency #1
Lack of Written Policies and Procedures

We noted that the Center lacks written policies and procedures in the following operational areas over a number of transaction streams as follows:

- Differentiating Center expenses from Team San José and San José Convention and Visitors' Bureau (CVB) expenses;
- Processing cash receipts and advance deposits for future events;
- Allocating hours worked by employees between the Center and the CVB;
- Monitoring budgets, including regular reconciliation of budget amounts recorded in the Center's general ledger compared to the City Council approved budget;
- Formally communicating to the City proposed budget amendments for financial statement line items that are trending higher than defined thresholds;
- Validating revenues that are tracked in other accounting systems, how the Center places reliance on those systems, and the supporting documentation used to validate the transactions recorded in the Center's general ledger;
- Applying proper accounting and reporting of events in which management enters into agreement with other entities in a timely manner. For example, in March 2010, the Center entered into an agreement with a third party to hold the Genghis Khan Exhibit at The Tech Museum. However, the accounting treatment for the event was not resolved until November 2010.

A lack of formal policies and procedures increases the risk that errors and omissions may be made in the financial statements. Formal policies and procedures also help maintain business continuity in the event of turnover of key staff.

We recommend that the Center implement comprehensive written policies and procedures over all significant transaction streams. In addition, the Center should consider developing a training plan in coordination with the City so that all employees who are responsible for financial transactions receive regular training over topics such as budget monitoring and the proper recording of revenues and expenses.

Management Response

- Differentiation of the CVB and the Center – TSJ has accounts payable procedures, as well as a second document called the "Team San Jose Chart of Accounts Dictionary" (the Dictionary) that clearly defines the proper classification of expenses. The responsibilities of the CVB and the Center are quite dissimilar. As such, the identification of expenses between these two entities is clearly identifiable. Although TSJ recorded $18.5 million in expenses for FY 2010, it is important to note that no findings were noted in the agreed-upon procedures report dated November 23, 2010 related to the misallocation of expenses between TSJ and the CVB. However, to ensure the continued accuracy of recording expenses between TSJ and the Center, TSJ will revise current procedures to include a clear delineation between expenses related to TSJ and the Center.

- Cash Receipts and Deposits – TSJ will within the next 30 days formally document its current procedures for cash receipts and deposits and submit them to its Finance Oversight Committee for approval and the City Oversight Team for review and comments. It is important to note that besides the lack of written policies and procedures, no findings were noted in the agreed-upon procedures report dated November 23, 2010 related to the handling of cash receipts and deposits.

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

Item # 2010-A – Significant Deficiency #1 (Continued)

- Allocation of Hours between the Center and the CVB – Currently TSJ assigns employees to either the Center or the CVB based on the overall outcome of shared responsibilities. In FY 2010, the split between the Center and the CVB was misallocated, with the CVB carrying higher expenses in relation to the responsibility split. TSJ will work with City Oversight and within the next 30 days develop an agreed-upon allocation process for employees with shared responsibilities.
- Monitoring Budgets – During FY 2010, variance analysis and budget adjustments were done between the prior Chief Financial Officer and City Oversight in a very informal manner. Although monthly meetings to review variances to budget were conducted between the prior Chief Financial Officer and City Oversight, little to no written documentation was completed. During FY 2011, the current Chief Financial Officer has implemented a new Variance to Budget Report that includes a clear comparison of expenses to the budgeted appropriation. This report is now utilized as part of the monthly review with the City. In addition, going forward budget appropriation changes based on annual requests will be accompanied by clear communication between the City Budget Office and TSJ.
- Validating Revenues Tracked in Other Accounting Systems – During FY 2010, one of the 285 events utilized a non-TSJ software system. This event took place at the Tech Museum, which utilizes Tessitura, a ticketing software system that has embedded ticket purchasing controls. TSJ will engage in interviewing the Tech Museum management and conducting a test to formally validate the integrity of their ticketing system and reporting prior to the next Tech Museum event.
- Applying Proper Accounting and Reporting of Events – Although a contract for the Genghis Khan Exhibit was entered into during March 2010, the event did not begin until late May 2010. All revenues and expenses for FY 2010 were recorded timely and accurately. Due to a request from the City in October 2010 related to the reporting of Genghis Khan in FY 2011, late adjustments were recorded as the City Budget Office directed TSJ to change the financial treatment of Genghis Khan for FY 2011. To have consistency in reporting, TSJ revised FY 2010 activity to meet the request of the City Budget Office.

Item # 2010-B – Significant Deficiency #2
Net Assets Account Postings

We noted that the Center did not reconcile the prior year's ending net assets accounts to the current year's beginning net assets accounts. In addition, the Center made direct adjustments amounting to $52,842 to its net assets accounts to record current year activity. This principle is known as the "clean surplus" theory of equity. As a result, the Center did not record all of the current year's activity in its operating statement. However, it should be noted that during the audit, these adjustments to the net asset accounts were corrected and the activity properly reflected in the FY 2009-2010 audited financial statements. Nevertheless, there are three situations where a change in net assets should properly be reported as a direct change to beginning net assets for an enterprise fund:

- The correction of an error related to a prior period,
- A change in accounting principle, or a change in the application of an accounting principle, and
- A retroactive change mandated in conjunction with the implementation of a new pronouncement.

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

Item # 2010-B – Significant Deficiency #2 (Continued)

The Center should limit access to direct postings to net assets to the three situations noted above and should document this procedure to ensure future compliance with the criteria noted above. In addition, the Center should reconcile its beginning net assets accounts annually to prevent erroneous journal entry postings. This process should be documented as part of the year-end close policies and procedures.

Management Response

A memo has been presented to the finance team instructing the team to limit postings to net assets to the three situations stated above. A copy of the memo has been provided to the City. As part of the year-end close for FY 2010, an extensive reconciliation to beginning net assets was performed. Month-end and year-end procedures have been developed to ensure that the reconciliation is done as part of the year-end close process, which are also part of the memo provided to the City.

Item # 2010-C – Significant Deficiency #3
Proper Recording and Capitalization of Transactions

While reviewing capital asset disclosures and performing substantive analytic procedures over expenses, we identified maintenance costs in the amount of $61,000 that were improperly capitalized and renovation costs in the amount of $117,178 that were improperly expensed. According to GASB Statement Nos. 34 and 51, capital assets are tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period. As such, the maintenance costs should have been expensed and the renovation costs should have been capitalized. Misclassification of such transactions misstates the assets and operating expenses of the Center.

In addition, the Center did not record transactions that were capitalized as capital outlay on a budgetary basis. This led to an understatement of the cash outflows that were required to finance the activities of the Center during the fiscal year.

We recommend that the Center implement a year-end procedure to evaluate the composition of the transactions capitalized in capital asset accounts and expensed in repairs and maintenance. Any misclassifications of transactions within these categories should be reclassified to ensure that assets and operating expenses are properly stated. In addition, the Center should start budgeting capital outlay for planned capital expenditures so that all expected cash outflows are accounted for as part of the budget.

Management Response

As part of the month-end procedures, a monthly step was added to include the monthly review of the repairs and maintenance expense to ensure that these transactions are categorized correctly and operating expenses are properly stated. The memo identified in the response to Item #2010-B includes such procedures.

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

Item # 2010-D – Significant Deficiency #4
Reconciliation of City Contributions with Center Bank Statements

The Center recorded numerous adjustments to reclassify and record transactions to reconcile the City contributions to the City's records after the start of the audit period. One of these adjustments was a $465,000 transaction to transfer funds from the Center's operating account to a City bank account.

We recommend that the City and the Center work together to ensure that the City contributions are reconciled between the City's records and the Center's records in a timely manner. Any adjustments associated with this reconciliation should be recorded prior to the start of the year-end financial statement audit.

Management Response

As part of the month-end and year-end close process, the Center will work with the City as well as the external auditors to ensure that reconciliations are completed prior to the beginning of the audit fieldwork.

STATUS OF PRIOR YEAR RECOMMENDATIONS

2009-A Comment:

Lack of Sufficient Controls Over Certain Year-End Financial Reporting Processes

The Center did not have sufficient internal controls over year-end financial reporting processes. We recommend that the Center establish internal controls over year-end financial reporting, such that all balances and transactions are properly supported and analyzed before the financial statements are submitted for audit.

Status: Partially implemented, see Items #2010-B and #2010-D.

2009-B Comment:

Inadequate Supporting Documentation and Inconsistent Approval Over Journal Entries

The Center did not approve all journal entries prior to recording them into the general ledger. We recommend that the Center only approve journal entries with documentation sufficient to support transaction amounts and descriptions.

Status: Implemented.

2007-F Comment:

Developing a Disaster Recovery Plan

The Center does not have a well-defined, written disaster recovery plan. We recommend that the City require management to develop a disaster recovery plan to better plan for future emergencies.

Status: Partially implemented. The Center has a disaster recovery plan but it does not address contingency plans for re-establishing the financial system in case of a disaster.