

CITY OF SAN JOSE

Public Safety, Finance &
Strategic Support Committee

Fiscal Year Ended
June 30, 2009

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Table of Contents

	<i>Page(s)</i>
Transmittal Letter	i - ii
Required Communications	1 - 4
Schedule of Comments and Responses:	
Significant Deficiencies:	
#2009-A – Accounting for Variable Rate Demand Obligations	5 - 6
#2009-B – Accounting for Housing Loan Deferred Revenues and Reserves	7
Other Control Deficiencies:	
#2009-C – Accounting for Intra-Entity Sale of Assets.....	8
#2009-D – Internal Control Over Davis-Bacon Compliance Requirements	9
Other Observations:	
Observation #1 - Economic Factors Affecting Financial Reporting	10
Observation #2 - Preparing for the American Recovery and Reinvestment Act of 2009	10 - 12
Observation #3 - Fund Balance Reporting and Governmental Fund Type Definitions	12
Observation #4 - Compensated Absences Accrual Rate	13
Status of Prior Year’s Control Deficiency Comments	14
Summary of Uncorrected Financial Statement Misstatements	15



MACIAS GINI & O'CONNELL LLP
Certified Public Accountants & Management Consultants

WALNUT CREEK
2121 N. California Blvd., Suite 750
Walnut Creek, CA 94596
925.274.0190

SACRAMENTO

OAKLAND

LOS ANGELES

NEWPORT BEACH

SAN DIEGO

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

We have audited the financial statements of the governmental activities, the business-type activities, each major fund and the aggregate remaining fund information (BFS) of the City of San José, California (City), as of and for the year ended June 30, 2009. In addition to the City's BFS, we audited the financial statements of the governmental activities and each major fund of the Redevelopment Agency of the City of San José; the financial statements of the Norman Y. Mineta San José International Airport, the San José-Santa Clara Clean Water Financing Authority, and the City of San José Deferred Compensation Plan as of and for the year ended June 30, 2009. Professional auditing standards require that we provide you with information about our responsibilities under generally accepted auditing standards and *Government Auditing Standards* and U.S. Office of Management and Budget (OMB) Circular A-133, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our Audit Plan to you dated June 12, 2009. Professional standards also require that we communicate to you other information related to our audit as discussed on pages 1 through 4.

In planning and performing our audit of the City's basic financial statements in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses, therefore there can be no assurance that all such deficiencies have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

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 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 the deficiencies in the City's internal control described in the accompanying Schedule of Comments and Responses as findings #2009-A and #2009-B to be significant deficiencies. In addition, we noted other matters involving the internal control and its operation that we have reported to management as listed in the table of contents.

The City's written response to the findings identified in our audit is described in the Schedule of Comments and Responses. We did not audit the City's responses and, accordingly, we express no opinion on them. In addition, we have already discussed our comments and recommendations with various City personnel, 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.

The communication is intended solely for the information and use of the Committee, City Council, City's management, 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

November 4, 2009

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

REQUIRED COMMUNICATIONS

I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards and OMB Circular A-133

As stated in our Engagement Communications Required by *Government Auditing Standards* section of our General Audit Plan dated June 12, 2009, our responsibility, as described by professional standards, is to express opinions about whether the financial statements, prepared by management with your oversight, are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve the City or management of their responsibilities.

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal controls over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatements, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the City's compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* applicable to each of its major federal programs for the purpose of expressing an opinion on the City's compliance with those requirements. In addition, we examined the City's compliance with the *Passenger Facility Charge Audit Guide for Public Agencies* issued by the Federal Aviation Administration and the *Recipient Handbook* issued by the California Emergency Management Agency. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the City's compliance with those requirements.

II. Other Information in Documents Containing Audited Financial Statements

During the year, the City included audited financial statements in various debt offering documents (e.g., Official Statements). We do not have an obligation to perform any procedures to corroborate other information contained in such debt offering documents. We were not associated with and did not have any involvement with such documents. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in the debt offering documents.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

REQUIRED COMMUNICATIONS (Continued)

III. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our contract with the City, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the City's basic financial statements. With the exception of the item described below, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2009.

Pollution Remediation Reporting - As described in Note 1.E to the City's basic financial statements, the City adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*.

We noted no transactions entered into by the City 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:

- Fair value of investments
- Estimated allowance for losses on accounts receivable
- Estimated valuation allowance for loans receivable
- Accrual and disclosure of self-insurance claims liabilities
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Accrual and disclosure of compensated absences
- Pension and other post employment benefit plans' employer and employee contribution requirements
- Accrual and disclosure of pollution remediation obligations

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

- Fair values of investments were based on quoted market prices, except for real estate, which is based on independent appraisals and for private equities which are based on actual cash flows to/from the Retirement Systems and the transactions and unrealized gain/loss as ascertained from the most recently available investor reports or financial statements issued by the manager of those funds.
- Estimated allowances for losses on accounts receivable were based on historical experience.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

REQUIRED COMMUNICATIONS (Continued)

- Estimated valuation allowance for loans receivable comprised of an allowance for risk and an allowance for present value discount. The allowance for risk was based on the consideration of the changes in the portfolio character, evaluation of current economic conditions and management's estimate regarding the likelihood of collectability based on loan provisions and collateral. The allowance for present value discount was based on management's estimate of the present value of projected net cash flows to the City from the loan portfolio.
- Reserves for workers' compensation was based on management's estimate obtained from information derived from the City's claims database system adjusted for a discounted projection of unreported claims.
- Reserves for general liability and other claims liabilities were determined by City Attorney judgment about the ultimate outcome of the claim.
- Accrual and disclosures of compensated absences were based on accrued eligible hours of vacation and sick leave at current pay rates for eligible employees.
- Useful lives for depreciable property were determined by management based on the nature of the capital asset.
- Pension and other post employment benefit plans' employer and employee contributions requirements were based on actuarially determined contribution rates.
- Accrual and disclosures of pollution remediation obligations were determined by City Attorney, the City's Environmental Compliance Officers and its environmental consultants' judgments about the ultimate outcome of the obligation.

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the financial reporting units that collectively comprise the City's basic financial statements.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were the City's Employee Defined Benefit Retirement Systems in Note IV. A. to the basic financial statements.

Difficulties Encountered in Performing the Audit

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

Planned Timing of the Audit

The completion of our audit was delayed because of the re-prioritization of the Redevelopment Agency's workload related to its extension on its variable rate demand bonds' credit facilities, revisions to the fiscal year 2009/2010 budget to reflect recent State diversions of its property tax increment revenues, and staffing impacts from recent layoffs.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

REQUIRED COMMUNICATIONS (Continued)

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. The following material misstatements detected as a result of audit procedures were corrected by management:

- Housing Activities Major Governmental Fund - Overstatement of \$11.5 million in deferred revenue liability and related community development expenditures associated to the City's inclusionary and developer loans.
- Redevelopment Agency Major Governmental Fund – Understatement of \$5.3 million in short-term liability related to variable rate demand obligations.

In addition, the attached Summary of Uncorrected Financial Statement Misstatements summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

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 November 4, 2009.

Management Consultation 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 City'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 City'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

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

SCHEDULE OF COMMENTS AND RESPONSES

Significant Deficiency Finding #2009-A – Accounting for Variable Rate Demand Obligations

Criteria

Accounting standards require bonds that have *demand provisions exercisable at the balance sheet date* be reported as a liability of the fund used to account for proceeds of the bond issue unless the following conditions are met:

- Before the financial statements are issued, the issuer has entered into an arm's-length financing (take-out) agreement to convert bonds "put" but not resold into some other form of long-term obligation.
- The take-out agreement does not expire within one year from the date of the issuer's balance sheet or statement of net assets.
- The take-out agreement is not cancelable by the lender or the prospective lender during that year, and obligations incurred under the take-out agreement are not callable by the lender during that year.
- The lender or the prospective lender is expected to be financially capable of honoring the take-out agreement.

If these conditions are met, such bonds should be reported by the issuer as a long-term liability.

Condition

Variable rate demand obligations (VRDOs) are bonds that by their terms have *demand provisions exercisable at the balance sheet date* (June 30, 2009) or within one year from the date of that statement (June 30, 2010). At June 30, 2009, the City and the San Jose Redevelopment Agency (RDA) combined had \$411.2 million of VRDOs outstanding. The key elements in determining classification of the VRDOs as current or noncurrent are the standby liquidity agreement (credit facility) and/or the take-out agreement. In order for the VRDOs to qualify as noncurrent obligations under Generally Accepted Accounting Principles (GAAP), the credit facility must provide short-term funds to redeem the bonds "put" by the bondholder pending resale by the remarketing agent and the take-out agreement must provide assurance that the issuer will be able to repay any borrowings under the credit facility in a manner that preserves the long-term nature of the obligation.

At June 30, 2009, the San Jose Redevelopment Agency (RDA) had \$56.6 million of variable rate Tax Allocation Bonds, Series 2003A/B outstanding. These VRDOs were supported by a credit facility provided by JPMorgan Chase, N.A. (JP Morgan) with an expiration date of August 27, 2009. The Series 2003 A/B bonds did not have a take-out agreement in place (as described above). On July 31, 2009, JP Morgan extended the RDA's credit facility for these bonds to November 26, 2009. However, the extension did not meet the requirements under GAAP for continuing to report the bonds as noncurrent obligations. If the bonds were reclassified as current, the RDA would be required to report a fund liability in its capital projects fund of \$56.6 million, which would reduce its fund balance by the same amount. In order to preserve the long-term nature of the bonds, the RDA negotiated a one-year extension of this credit facility to November 26, 2010. However, the terms of the extension included a mandatory reduction of \$5.3 million in the aggregate amount of letters of credit that JP Morgan provided to the RDA. As a result, we proposed an audit adjustment to record \$5.3 million as a fund liability at June 30, 2009. In addition to the mandatory reduction to the credit facility, other terms of the credit facility extension are less favorable as compared with the credit facility's prior terms including:

- Increasing the Series 1996 A/B credit facility fees from 0.45% to 2.10%
- Increasing the Series 2003 A/B credit facility fees from 1.50% to 2.30%
- Requiring a new debt coverage covenant

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Finding #2009-A – Accounting for Variable Rate Demand Obligations (Continued)

- Increasing the interest rates of the amounts drawn on the credit facility from the greater of prime or the sum of the federal funds rate plus 0.5% to an interest rate the greater of 8.5%, prime plus 1.5%, or federal funds rate plus 2.0%.

Cause

Over the past year, the extreme turmoil in the financial markets resulted in considerable pressures on the supply of credit facilities for the VRDO market. As a result, credit facilities have recently been issued for shorter durations and with more stringent terms thereby increasing the risk that the City or RDA may misclassify these potential short-term obligations as long-term.

Recommendation

Given the City's and RDA's reliance on third party VRDO credit facilities and the trends and pressures noted above in the VRDO market, we recommend evaluating the financial and operational implications should conditions related to the availability of such credit facilities worsen in the future. Additionally, we suggest expanding the traditional finance focused monitoring efforts related to bond obligations (e.g., covenant compliance and disclosure) to include coordination with the City's GAAP reporting unit to ensure changes impacting classifications or display are properly considered and reflected in the financial statements.

Management Response

With respect to the City's debt portfolio, Debt Management staff meets with Specialized Accounting staff on approximately a bimonthly basis to coordinate activities related to the City's debt portfolio. These meetings will be updated to include discussions related to the renewal of credit facilities supporting outstanding debt.

Additionally, the City continually monitors the City's credit facilities and counterparty risks. Well in advance of any renewal request date, such as three to six months prior the commitment expiration, staff contacts the credit provider to better understand their willingness to renew a credit facility. Based on the City's very high credit ratings, including a AAA rating from S&P, and its long-standing relationships with numerous credit providers, staff anticipates that it will be possible to either renew existing credit facilities, acquire new credit facilities, or refund debt in a timely manner. For example, staff was able to successfully refund all of the City's long-term variable-rate debt within a 12 month period to address challenges in the financial markets. These refundings included two series of Airport Revenue Bonds, eight series of Lease Revenue Bonds, and one series of Sewer Revenue Bonds.

With respect to the Agency's debt and the related variable rate demand obligations, the Agency began working to extend the Letter of Credit before the expiration date of August 27, 2009. However, the negotiation with JP Morgan was longer than expected due to changes in the Letter of Credit market as a result of the current worldwide economic and financial market disruptions. Negotiations were not completed until October. On October 27, 2009, the Agency Board approved the new terms and conditions for extending the 2003 Bond's Letter of Credit including extending the Letter of Credit for the 1996 Bonds to November 26, 2010.

The new terms and conditions also required a mandatory reduction of \$5.3 million on the outstanding 1996 and 2003 bonds, which required an early redemption of \$5.3 million by November 27, 2009. This redemption required recognition of a \$5.3 million short-term liability for these variable rate demand obligations, which was included in the June 30, 2009 financial statements along with the required disclosures.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Significant Deficiency #2009-B – Accounting for Housing Loan Deferred Revenues and Reserves

Criteria

The City considers Governmental Fund resources to be available if they are collected within 60 days after year-end. The availability criterion principle requires that the related receivable be offset with a liability when the receivable is not collectible within the current period or soon enough thereafter. In addition to the offsetting of the governmental fund's loan receivables, the City also prepares a loan portfolio analysis and computes a valuation allowance using a complex spreadsheet to record against its loans receivable.

Condition

During our audit, we noted that the City recorded both an offset to the inclusionary and developer loans' receivable balance and a valuation allowance in the amount of \$11.5 million. As a result, the fund balance of the Housing Activities Fund was understated by \$11.5 million at June 30, 2009 prior to the audit adjustment posted by the City. In addition, we noted that the Housing Department's loan portfolio analysis included errors in the maturity dates which led to potential understatement of the loan portfolio's discount reserve by \$0.9 million.

Cause

During the past two years, we noted that City departments worked together collaboratively and made significant progress towards improving the Housing Department's loan reserve calculations. The City's loan committee composed of members from the Finance Department and the Housing Department re-analyzed the loan loss reserve calculation with the main goal of re-analyzing the loan loss reserve worksheet to accurately record the maturity date stated on the promissory notes. However, the Housing Department continues to experience accounting and clerical errors and requires additional training on these complex and non-routine year-end loan loss reserve computations and analysis.

Recommendation

We recommend the Finance Department continue to train its financial statement preparers and reviewers on the recording of its loan balances and allowances on these balances and its related deferred revenues and reserved fund balances.

Management Response

As noted above, the Housing and Finance Departments have worked together collaboratively and made significant progress towards improving the Housing Department's loan reserve calculations. In addition, the Housing Department has implemented controls to review the maturity dates of all existing loans in order to ensure that the loan loss reserve calculations are accurate. The conditions noted in this finding were detected through the audit process and the appropriate adjustment was included in the financial statements as of June 30, 2009. The Housing Department will continue to train their staff to prevent clerical errors in the computations from happening in the future. The Housing and Finance Department management will also continue to stress the importance of providing the appropriate level of training and oversight in preparing and reviewing loan loss reserve schedules and fund financial statements.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Control Deficiency #2009-C – Accounting for Intra-Entity Sale of Assets

Criteria

Generally accepted accounting principles (GAAP) state that when accounting for the transfer of capital and financial assets within the same financial reporting entity, the transferee should recognize the assets received at the carrying value of the transferor.

Condition

During the year, the San Jose Redevelopment Agency (RDA) recorded a property received from the City at the property's fair market value of \$1,585,000 instead of the property's cost of \$78,000. In essence the City as a whole recognized a gain of \$1,507,000 when the capital assets are reported at the entity-wide perspective.

Cause

These types of capital asset accounting transactions are non-routine to the City's staff and involve coordination of Finance staff of both the City and the RDA.

Recommendation

We recommend that the City work with the RDA in identifying these non-routine transactions when the RDA's financial information is blended with the City's basic financial statements.

Management Response

The Finance staff will actively coordinate and work with RDA staff to ensure that these non-routine transactions are appropriately evaluated and accurately reported on a timely basis in financial statements.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Control Deficiency #2009-D – Internal Control Over Davis-Bacon Compliance Requirements

Federal Programs

U.S. Department of Housing and Urban Development – Community Development Block Grants (14.218)

U.S. Department of Transportation – Airport Improvement Program (20.106)

U.S. Department of Homeland Security – Airport Checked Baggage Screening Program (97.100)

Criteria

Per OMB Circular A-133, non-federal entities shall include in their construction contracts subject to the Davis-Bacon Act a requirement that the contractor or subcontractor comply with the requirements of the Davis-Bacon Act and the U.S. Department of Labor regulations (29 CFR part 5, “Labor Standards Provisions Applicable to Contracts Governing Federally Financed and Assisted Construction”). As part of the City’s control activities over this compliance requirement, the City’s Office of Employment Assurance (OEA) policy states that it will follow-up on its contractor or subcontractor who did not submit their certified payroll 15 days after the month end.

Condition

During our audit, we noted that 13 out of 40 certified payrolls selected under the Community Development Block Grant (CDBG) program; 16 out of 40 certified payrolls selected under the Airport Improvement Program (AIP) and 12 out of 25 certified payrolls selected under the Airport Checked Baggage Screening Program (ACBSP) did not submit the certified payroll 15 days after the month-end as stated in the City’s policy whereby the OEA did not perform follow-up procedures to obtain these certified payrolls.

Effect

By not effectively complying with the City’s internal control policy over the Davis-Bacon Act monitoring of its vendor compliance with prevailing wage laws, the City is at risk of incurring unallowable expenditures.

Recommendation

Due to the City’s budget constraints and a limited number of employees at the OEA, the City may not have sufficient resources to perform the necessary follow-ups after the 15 day time period in instances of non-compliance. We recommend the City evaluate its effectiveness of its current internal controls policies in light of its current resource constraints.

Management Response

The Office of Equality Assurance ensures that all workers are paid properly regardless of when certified payroll reports are submitted. Timely submittals are especially difficult when a non-profit organization issues the award of the contract. The non-profit organization has to receive the certified payroll reports and labor compliance documents from the prime contractor and its subcontractors, before submitting the complete documentation to OEA. However, the OEA will review its timelines in light of staff resources and make any necessary changes to perform follow up procedures in a timely fashion.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Observation #1 – Economic Factors Affecting Financial Reporting

The City continues to face a myriad of challenges stemming from the current downturn in the economy. To make matters worse, as the City learns to work with current resource limitations it is facing increasing demands due to increased regulatory and operational requirements. Examples of recent changes on the regulatory front include Governmental Accounting Standards Board (GASB) No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*; Office of Management and Budget's Section 1512 of the American Recovery and Reinvestment Act of 2009 (Recovery Act), New IRS Regulation on Required Withholding on payments greater than \$10,000, and Federal Trade Commission (FTC) "Red Flags" rules on developing, implementing, and administering identity theft prevention programs. Additionally, the City is facing unprecedented fiscal operating challenges related to tightening credit markets, altering employees' roles and responsibilities in response to recent layoffs and staff reductions; and addressing funding challenges with its pension and other postemployment benefit obligations. While we understand the need for service and administrative reductions in the current environment, such actions should be balanced with the City's need for ongoing monitoring and assessment of risks facing the City.

In light of the many regulatory and operational changes facing the City, we recommend performing a comprehensive, coordinated City-wide risk assessment. Risk assessment is a fundamental part of a good internal control system and will help identify areas where the City has significant exposure. The information gleaned from the risk assessment process will prove vital to executive management and the City Council in making decisions and determining how best to deploy the City's limited resources. The effort should be led by the City Manager's office and supported by leadership from the various City departments.

Management Response

The City, along with the rest of the state, has been hit hard with the current recession, experiencing significantly lower levels of revenue collections from revenue streams like sales tax, transient occupancy taxes, businesses licenses, and construction permits. The City has been facing budget balancing challenges for the last eight years and is aware that addressing difficult fiscal budget issues may subject the City to increased risk and/or loss exposure, especially in light of these challenging times. The Risk Management Division of Human Resources, as stated by the Risk Management Policy and under the guidance of the Risk Management Planning Board, will coordinate the city wide efforts to assess risks facing the City in these uncertain times. In addition, the City will continue to enforce its fiscal policies and ensure that appropriate internal controls remain in place to the fullest extent possible given existing resources.

Observation #2 – Preparing for the American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) provides approximately \$300 billion dollars in additional federal funds which will be passed down from federal agencies to state and local governments and institutions of higher education. These federal funds are intended to either supplement existing federal programs, create new programs, or to provide more broad fiscal relief.

The Recovery Act mandates that there be an unprecedented amount of oversight and transparency over the spending of all funds associated with it. The Office of Management and Budget (OMB) set up a web site to be the central point for the transparency part of the mandate. Also, the OMB issued guidance to the federal agencies regarding how they should carry out programs and activities relating to the Recovery Act that promotes timeliness and accountability.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Observation #2 – Preparing for the American Recovery and Reinvestment Act of 2009 (Continued)

The OMB guidance addresses many issues and responsibilities including the following:

- Recipients are generally required to clearly distinguish Recovery Act funds from non-Recovery Act funds.
- New programs or existing programs that have significant changes in compliance requirements will be identified with a new Catalog of Federal Domestic Assistance (CFDA) number.
- Federal agencies designated Recovery Act programs as high-risk for single audit purposes.
- Extensive quarterly reporting to federal agencies required from recipients of Recovery Act funding, which will be due within 10 days of each calendar quarter-end.
- Federal agencies are required to initiate additional oversight to address the unique implementation risks of the Recovery Act. The expectation in this area is that federal agencies will establish defined strategies to prevent or timely detect waste, fraud, or abuse.
- Federal agencies will also use the single audit process as a means of promoting accountability for Recovery Act funds.
- The Federal Audit Clearinghouse (FAC) is also required to make publicly available on the internet all single audit reports filed with the FAC for fiscal years ending September 30, 2009, and later.

Based on the information above, it is clear the Recovery Act funds will have a significant impact on the City's single audit. While the Recovery Act may not have an immediate impact on the City's June 30, 2009 single audit, it is likely that it will have a significant impact over the following two fiscal years. Therefore, the City should begin planning and assessing risks associated with the receipt, spending and reporting of Recovery Act funds. Specifically, the City should consider the following:

- Whether control procedures in place over federal expenditures are appropriate, operating effectively, designed to detect and prevent unallowable expenditures, and designed to detect or prevent fraud and abuse.
- Whether the existing staffing resources are adequate to address the increased reporting and monitoring requirements as a result of the Recovery Act. Also, the City should identify individuals who will monitor requirements and provide consistent guidance to the organization.
- Whether additional controls and system requirements will be needed to ensure that Recovery Act funds can be separately identified and tracked.
- Whether new controls will need to be established to meet the stringent reporting requirements to federal agencies.
- If Recovery Act funds will be passed down to subrecipients, that controls are in place to ensure appropriate subrecipient monitoring and also whether any new controls will need to be established related to new subrecipient reporting responsibilities.

Management Response

As of June 30, 2009, the City has been awarded more than \$77 million in American Recovery and Reinvestment Act (ARRA) funds. The City has established accounting controls associated with the receipt, spending, and reporting of Recovery Act funds. Recovery Act tracking and reporting software is being implemented to ensure that the compliance requirements of ARRA are met. In addition, weekly meetings by the ARRA program lead staff are held to address any specific ARRA issues and to discuss on-going reporting and compliance requirements. The City has successfully submitted the first quarter fiscal year 2009-2010 reports by the October 10, 2009 deadline and posted the relevant information on the City's website and the appropriate Recovery Act websites.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Observation #2 – Preparing for the American Recovery and Reinvestment Act of 2009 (Continued)

The City Auditor conducted an audit and issued a preliminary report on internal controls over ARRA funding on June 19, 2009 that reviewed the city's internal controls over ARRA funding (a copy of the report is available on line at <http://www.sanjoseca.gov/auditor/AuditMemos/0695/0695M.pdf>). In addition, the City Auditor's Office issued a follow-up report on November 12, 2009 that tested reported expenditures and basically concludes that the City continues to make progress establishing appropriate internal controls and has met the Recovery Act requirements for reporting for the required reports dated September 30, 2009 (the report is available on line at <http://www.sanjoseca.gov/auditor/AuditMemos/0700/0700M.pdf>).

Observation #3 – Fund Balance Reporting and Governmental Fund Type Definitions

In February 2009, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. GASB No. 54 significantly changes the accounting and financial reporting for the City's fund balance classifications and categorization of individual funds. This standard requires the City to evaluate and recast its fund balance classifications based on a hierarchy weighed on the extent to which the City is bound to observe constraints imposed upon the use of the resources reported in governmental funds. This standard also provides guidance for classifying stabilization ("rainy day") amounts on the face of the balance sheet and would require disclosure of certain information about stabilization arrangements in the notes to the financial statements. In addition, the definitions of individual governmental fund types have been clarified whereby the City's use of special revenue funds and capital project funds would be recast.

GASB No. 54 will dramatically change the City's current fund structure and account groupings. For example, funds such as the Employee Benefits and Stores Vehicle Maintenance and Operations currently classified as special revenue funds may not meet the new definitions given that these funds' revenues are not from external sources. In addition to the potential changes to the City's fund structure, the City's classification of its governmental fund balance would be arranged based on the extent to which the City is bound to honor constraints on the specific purposes for which those funds can be spent. As a result, the City would no longer have fund balance categorized as reserved, designated and unreserved. Due to the complexities of the City's financial reporting system, we recommend that the Finance Department begin working with other departments to evaluate the purpose of established governmental funds and related restrictions on revenues sources. The requirements of this standard are effective for the fiscal year commencing July 1, 2010.

Management Response

GASB Statement No. 54 will dramatically change the City's current fund structure and account groupings. The Finance Department is currently reviewing the pronouncement and identifying the resources necessary to affect the required changes. One ongoing challenge to implementing the changes is the City's aging Financial Management Accounting System (FMS). This nearly twenty years old system was not designed for the complexities demanded by modern accounting standards. Finance management realizes that difficult economic times and the budget situation facing the City precludes investing in a new system in the near term. The City will continue to evaluate the adequacy of its current resource levels to assess the system needs and appropriately prioritize replacing FMS with a new system which would increase efficiency and help meet future financial reporting requirements. The City will also explore more options other than implementing a new system to remain in compliance with GASB standards and prepare the City for implementation of GASB Statement No. 54.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

Observation #4 – Compensated Absences Accrual Rate

Vacation, sick leave, compensatory time, and related benefits liabilities are computed as determined by agreements between the City and its bargaining group. Human Resources Benefits is responsible for inputting and updating the employees' benefit rates in its PeopleSoft payroll system based on the employees' Memorandum of Agreements (MOA) as interpreted by the City's Office of Employee Relations (OER). During our audit, we noted that 7 out of 45 employees selected for testing had a discrepancy between the employee's actual vacation benefit rate and the vacation benefit rate per their MOA.

In order to be consistent with the pay period accrual rates in the MOA, employees may accrue more than their annual allotment (sometimes by as little as 0.5 hours). In order to avoid employees accruing more than their annual vacation rate, an annual maximum limiter was implemented so that the last pay period of the year, employees would be limited to their annual vacation amount. The OER through negotiations has worked on correcting the pay period accrual rates in recent MOAs.

The City should continue with the annual maximum accrual limits for the end of the payroll calendar year of 2009. For future payroll calendar years, the City should correct all pay period accrual rates to be consistent with the annual accrual rates. In addition, the City should evaluate the integrity of its payroll system's information by performing an extensive review and analysis of the system's benefit rates compared to the effective MOAs.

Management Response

The City will be updating all pay period accrual rates to be consistent with the annual accrual rate effective payroll calendar year 2010.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

STATUS OF PRIOR YEAR'S CONTROL DEFICIENCY COMMENTS

2008 Comment: ***2008-A – Worker’s Compensation Claims Control***

Condition/Effect: During FY2007-2008, the Human Resources Department (HRD) hired 5 additional claims adjusters. However, the HRD was unable to fully integrate the new adjusters into its operating environment at the beginning of the year which resulted in exceptions noted during our test of controls over 45 claims files where 6 files were closed by the adjusters but was not reflected in the Claims Management System; 5 files had reserve amounts modified in the Claims Management System without updating the supporting documentation; and 3 files did not include mandatory documents in the file.

Recommendation: We recommend the City evaluate its process of closing cases to ensure that all closed cases are properly removed from the Claims Management System to avoid overstatement of the reserve balance and the workers’ compensation claims liability. In addition, the City should evaluate its staff training program to ensure that it has the appropriate level of expertise to ensure that the controls over the database system claims information are adequate to meet financial reporting and State compliance requirements.

Status: Corrected.

2008 Comment: ***2008-B –Housing Loan Reserve Calculations***

Condition/Effect: The City’s Housing Department conducts an analysis of its loan portfolio as part of the City’s year-end closing process. During the audit, we noted that the maturity dates of some loans are not supported by underlying documentation which led to an inaccurate computation of the loan portfolio’s discount reserves by approximately \$0.9 million.

Recommendation: We recommend that the Housing Department implement controls to review the maturity dates of all existing loans in order to ensure that the loan loss reserve is calculated properly and accurate financial information is available.

Status: In progress. See Comment #2009-B.

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2009

SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

AJE #	Account/Adjustment Description	Debit	Credit
		(Dollars in thousands)	
General Fund			
1	Sales Tax Revenues Sales Tax Receivable <i>To adjust sales tax receivable based on actual receipt after year-ended.</i>	\$ 2,357	\$ 2,357
Housing Major Governmental Fund			
2	Intergovernmental Revenues Deferred Revenue <i>To defer unavailable intergovernmental revenues that was not received within 60 days after year-ended.</i>	\$ 1,655	\$ 1,655
3	Other Revenues Loan Loss reserve (contra - asset balance) <i>To adjust the estimate on the allowance on the loan portfolio based on the stated maturity date of loans.</i>	\$ 921	\$ 921
4	Expenditure - Community Service Other assets <i>To eliminate the impact of the write up of asset value for the transfer of the Playa Almaden property.</i>	\$ 750	\$ 750
Muni-Water Enterprise Fund			
5	Accounts Receivable Charges for Service <i>To recognize revenue for FY 2009 unbilled services.</i>	\$ 1,174	\$ 1,174
	Charges for Service Net Asset <i>To reverse impact of prior year unbilled services.</i>	\$ 1,219	\$ 1,219
6	Expenses - Utilities Accounts Payable <i>To adjust the Accounts Payable payments not yet recorded in FMS.</i>	\$ 224	\$ 224
Governmental Activities			
7	GW - Expenses - Various Workers Compensation Liabilities <i>To adjust the IBNR estimate related to the workers compensation liabilities balance.</i>	\$ 4,674	\$ 4,674
8	Net Other Post-Employment Benefit Obligation. GW - Expenses - Various <i>To adjust the year-end Net Other Post-Employment Benefit Obligation estimate due to differences in amortization factors used.</i>	\$ 2,573	\$ 2,573