

CITY OF SAN JOSE

Public Safety, Finance &
Strategic Support Committee

Year Ended
June 30, 2010

CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee
Year Ended June 30, 2010

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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 (basic financial statements) of the City of San José, California (City), as of and for the year ended June 30, 2010. In addition to the City's basic financial statements, 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 Police and Fire Department Retirement Plan, the City of San José Federated City Employees Retirement System, the San José-Santa Clara Clean Water Financing Authority, Pedestrian/Bicycle Facilities Grant, Park Bond Projects Capital Projects Fund, Branch Libraries Bond Projects Capital Projects Fund, Public Safety Bond Capital Projects Fund, Library Parcel Tax Special Revenue Fund, and the City of San José Deferred Compensation Plan as of and for the year ended June 30, 2010. Professional auditing standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *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 30, 2010. 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.

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.

Our consideration of internal control was for the limited purpose described in the second paragraph and was not designed to 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. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

In addition, we provided a comment related to upcoming accounting and financial reporting standards for the City's consideration. The City's written response to the comment identified in our audit is described in the Schedule of Comment and Response. We did not audit the City's response and, accordingly, we express no opinion on it. In addition, we have already discussed our comment and recommendation 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 the recommendation.

This communication is intended solely for the information and use of the Committee, City Council, City management, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & Connell LLP
Certified Public Accountants
Walnut Creek, California

November 22, 2010

CITY OF SAN JOSE

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REQUIRED COMMUNICATIONS

I. 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.

II. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the 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 items described below, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2010.

Intangible Assets - 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. 51, *Accounting and Financial Reporting for Intangible Assets*.

Derivative Instruments - As described in Note 1.E to the City's basic financial statements, the City adopted the provisions of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*.

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

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REQUIRED COMMUNICATIONS (Continued)

- Pension and other postemployment 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 traded on a national or international exchange were based on quoted sales price reported on the last business day of the fiscal year at current exchange rates, if applicable. Investments that do not have an established market, such as private equity, commingled real estate funds and certain pooled fund investments are reported at estimated fair value based on the most recently available investor reports or audited financial statements issued by the manager of those funds. The fund manager provides an estimated unrealized gain/loss of the fund based on the most recently available audited financial statements and other fund information. The fair value of the separate real estate properties are based on independent appraisals.
- Estimated allowances for losses on accounts receivable were based on historical experience.
- Estimated valuation allowance for loans receivable is 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. Depreciation was calculated based on the straight-line method.
- Pension and other postemployment benefit plans' employer and employee contributions requirements were based on actuarially determined contribution rates.
- Accrual and disclosures of pollution remediation obligations were determined by 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 described in Note IV. A. to the basic financial statements.

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REQUIRED COMMUNICATIONS (Continued)

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 unexpected retirements and personnel absences in the City and other staffing impacts from current year personnel layoffs.

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 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 22, 2010.

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.

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SCHEDULE OF COMMENT AND RESPONSE

Comment #1 – 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 54 significantly changes the accounting and financial reporting for the City's fund balance classifications and categorization of individual funds. Under previous standards, the City's governmental fund balances were organized into three categories: reserved, unreserved, and designated. The new standard replaces these with five classifications, establishing a hierarchy that is based on the extent to which spending constraints restrict how a government can use the funds. The five new classifications are:

- Nonspendable fund balance. This includes amounts that are not in a spendable form, such as inventory or prepaid expenditures. It also includes amounts that are required to be maintained intact, such as the principal of an endowment fund.
- Restricted fund balance. This includes amounts that can be spent only for the specific purposes stipulated by external providers, such as grant providers or bondholders, as well as amounts that are restricted constitutionally or through legislation. In other words, these are funds that are restricted by authorities outside the City itself, and these restrictions may be changed or lifted only with their consent.
- Committed fund balance. This includes amounts that can be used only for specific purposes that are determined by a formal action of the City Council. These commitments may be changed or lifted, but only by the same formal action that was used to impose the constraint originally.
- Assigned fund balance. This classification applies to amounts that are intended for specific purposes, as expressed by the City Council or authorized official. It also applies to the remaining resources in any governmental fund other than the General Fund.
- Unassigned fund balance. This is the residual classification for the General Fund and includes all amounts not contained in the other classifications. Unassigned amounts are technically available for any purpose. In addition, if there is a deficit balance in another governmental fund, it will be reported as a negative amount in that fund's unassigned classification. Positive unassigned amounts are reported only in the General Fund.

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 may be recast. This standard clarifies that special revenue funds are created only to report revenue sources that are restricted or committed to a specified purpose. Additional restrictions related to the classification of a special revenue fund and clarifications of the use of debt service and capital projects funds have been identified and an analysis of the City's funds is recommended.

The City will be required to implement GASB Statement No. 54 for fiscal year ending June 30, 2011. Some steps that the City should perform in order to implement GASB Statement No. 54 include the following:

- Update the City's fund balance policy. The policy should consider items such as the criteria for committed and assigned fund balances; the appropriate level of unrestricted fund balance to be maintained in the General Fund; circumstances for which restricted, committed, assigned, and unassigned amounts will be spent down; and a policy for replenishing deficiencies.

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Comment #1 – Fund Balance Reporting and Governmental Fund Type Definitions (Continued)

- Analyze the purposes and revenue sources of the City's special revenue funds to ensure that these funds fall within the new special revenue fund type definition. 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 definition given that these funds' revenues are not from external sources.
- Review the purposes of capital projects and debt service funds to ensure that these funds fall within the new fund type definitions.
- Update chart of accounts and begin classifying fund balance amounts and prepare reports for the new financial reporting and disclosure requirements.

Management Response

The implementation of GASB Statement No. 54 is expected to bring significant changes to the City's current fund structure and account groupings. The Finance Department is currently reviewing the pronouncement and identifying the resource requirements necessary to fully implement the required changes. The City's twenty plus years old Financial Management Accounting System (FMS) was not designed for the complexities demanded by recent accounting standards. Finance management realizes that difficult economic times and the budget situation facing the City precludes investing in a new accounting 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. In the meantime, the City will explore alternate options other than implementing a new system in order to begin the implementation of GASB Statement No. 54.

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STATUS OF PRIOR YEAR'S SIGNIFICANT AND CONTROL DEFICIENCY COMMENTS

- 2009 Comment: ***2009-A – Accounting for Variable Rate Demand Obligations***
- Condition/Effect: During FY2008-2009 audit, the Redevelopment Agency's (Agency) extension of its credit facility included a mandatory reduction of \$5.3 million in the aggregate amount of letters of credit that the bank provided to the Agency. As a result, an audit adjustment was proposed to record that amount as a fund liability at June 30, 2009.
- Recommendation: We recommend the City evaluate the financial and operational implications should conditions related to the availability of credit facilities worsen in the future. We also suggest expanding the traditional finance focused monitoring efforts related to bond obligations 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.
- Status: Corrected.
- 2009 Comment: ***2009-B – Accounting for Housing Loan Deferred Revenues and Reserves***
- Condition/Effect: During our FY2008-2009 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.
- 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.
- Status: Corrected.
- 2009 Comment: ***2009-C – Accounting for Intra-Entity Sale of Assets***
- Condition/Effect: During FY2008-2009 audit, the Agency recorded a property received from the City at the property's fair value instead of the property's cost. Generally accepted accounting principles 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.
- Recommendation: We recommend the City work with the Agency in identifying these non-routine transactions when the Agency's financial information is blended with the City's basic financial statements.
- Status: Corrected.

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STATUS OF PRIOR YEAR'S CONTROL DEFICIENCY COMMENTS (Continued)

2009 Comment:	<i>2009-D – Internal Control Over Davis-Bacon Compliance Requirements</i>
Condition/Effect:	During FY2008-2009 audit, we noted that 13 out of 40 certified payrolls selected under the Community Development Block Grant program; 16 out of 40 certified payrolls selected under the Airport Improvement Program and 12 out of 25 certified payrolls selected under the Airport Checked Baggage Screening Program did not submit the certified payroll 15 days after the month-end as stated in the City's policy.
Recommendation:	We recommend the City evaluate the effectiveness of its current internal control policies in light of its current resource constraints.
Status:	Corrected.

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SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

AJE #	Account / Adjustment Description	(Dollars in thousands)	
General Fund			
1	Sales Tax Receivable	\$ 1,780	
	Sales Tax Revenue	\$ 2,813	
	Deferred Revenue		\$ 4,593
	<i>To adjust sales tax receivable based on actual receipt after year-end and defer sales taxes revenue that was not received within 60 days after year-end.</i>		
2	Various Expenditures	\$ 432	
	Prepaid Items	\$ 1,520	
	Cash and Investments	\$ 1,786	
	Various Revenues		\$ 3,738
	<i>To record adjustments to the ending bank balance of the City's operating account at June 30, 2010.</i>		
Housing Major Governmental Fund			
3	Fund Balance	\$ 750	
	Other Assets		\$ 750
	<i>To remove the impact of the write-up of asset value for the Playa Almaden property recorded in FY 2008.</i>		
MuniWater Major Enterprise Fund			
4	Accounts Receivable - MuniWater	\$ 1,135	
	Charges for Service - MuniWater		\$ 1,135
	<i>To recognize revenues for FY 2010 unbilled services.</i>		
	Charges for Service - MuniWater	\$ 1,174	
	Net Assets - MuniWater		\$ 1,174
	<i>To reverse impact of prior year unbilled services.</i>		
Governmental Activities			
5	Various Expenses	\$ 14,629	
	Estimated Liability for Self-Insurance		\$ 14,629
	<i>To adjust the claims liabilities balance and IBNR estimate related to the workers' compensation liabilities balance.</i>		
6	Capital Assets - CIP	\$ 3,422	
	Expenses - Sanitation		\$ 3,422
	<i>To capitalize expenses as capital assets on the governmental activities government-wide financial statements for the year ended June 30, 2010.</i>		