

CITY OF SAN JOSÉ
POLICE AND FIRE DEPARTMENT
RETIREMENT PLAN
(A Pension Trust Fund of the
City of San José, California)

Report to the Board of Administration

For the Fiscal Year Ended
June 30, 2009

CITY OF SAN JOSÉ
POLICE AND FIRE DEPARTMENT RETIREMENT PLAN
(A Pension Trust Fund of the City of San José, California)

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To the Members of the Board of Administration
Police and Fire Department Retirement Plan
San José, California

In planning and performing our audit of the financial statements of the City of San José Police & Fire Department Retirement Plan (Plan), a pension trust fund of the City of San José, California, administered by the City of San José's Department of Retirement Services (Department), as of and for the year ended June 30, 2009, we considered the Plan's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control. Accordingly, we do not express an opinion on the effectiveness of the Plan'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 first paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, 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.

We have included in this letter a summary of communications with the Board of Administration as required by professional auditing standards. We have also provided a status of our prior year recommendations in the attached schedule. We would also like to thank Department management and staff for the courtesy and cooperation extended to us during the course of our engagement.

The accompanying required communications, comments and recommendations are intended solely for the information and use of the Board of Administration, Department management and others within the organization and are not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & O'Connell LLP
Certified Public Accountants

Walnut Creek, California
November 2, 2009

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REQUIRED COMMUNICATIONS

Professional auditing standards require auditors to communicate with those charged with governance on a number of subjects. The following information satisfies these requirements, and is solely for use of the Plan's Board of Administration and the Department's management.

I. Our Responsibility Under U.S. Generally Accepted Auditing Standards and *Government Auditing Standards*

As stated in our engagement communications presented in our Audit Service Plan dated May 22, 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 you or management of your responsibilities.

As part of our audit, we considered the Plan's internal control over financial reporting. Such considerations are solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we also performed tests of the Plan's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our tests is not to provide an opinion on compliance with such provisions.

II. Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in our audit plan dated May 22, 2009.

III. Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the Plan are described in Note 2 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2009. We noted no transactions entered into by the Plan 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.

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REQUIRED COMMUNICATIONS (Continued)

III. Qualitative Aspects of Accounting Practices (Continued)

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:

- Employer and employee contributions;
- Funded status of the pension and OPEB plans; and
- Net appreciation in fair value of investments.

Management's estimates were based on the following:

- Employer and employee contributions and the funded status of the pension and OPEB plans are based on actuarially determined contribution rates and actuarial assumptions determined by independent actuaries.
- Net appreciation in fair value of investments is based on quoted market prices, except for real estate and private equities. The fair value of real estate is based on independent appraisals. The fair value of private equities is based on actual cash flows to/from the Plan 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.

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

The disclosures in the financial statements are neutral, consistent, and clear. Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were pension benefits and other postemployment benefits. The disclosures about pension benefits and postemployment benefits in Note 5 and Note 6 to the financial statements, respectively, are based on actuarial valuations.

IV. 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. None of the misstatements detected as a result of audit procedures were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

V. Difficulties Encountered in Performing the Audit

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

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REQUIRED COMMUNICATIONS (Continued)

VI. 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.

VII. Management Representations

We have requested certain representations from management that are included in the management representation letter dated November 2, 2009.

VIII. Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Plan'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.

IX. 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 Plan's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

X. Other Information in Documents Containing Audited Financial Statements

If the Plan includes its financial statements in other documents, we are required to describe to you our responsibility related to that other information. The Plan includes its financial statements in its Comprehensive Annual Financial Report (CAFR). Our responsibility for the other information in the CAFR containing the financial statements and our report does not extend beyond the financial information identified in our audit report. We do not have an obligation to perform any procedures to corroborate other information contained in the CAFR. However, we read the other information in the CAFR and considered whether such information, or its manner of presentation, was materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements.

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CURRENT YEAR RECOMMENDATION

None.

STATUS OF PRIOR YEAR RECOMMENDATIONS

2008-01 Contribution Reconciliation

Control Deficiency

Observation:

We noted the City of San José's Payroll Division and the Department of Retirement Services (DRS) did not have a process to proactively identify and communicate new member information prior to the bi-weekly contribution transmittal process. We recommend the DRS work with the Human Resources Department (HRD) to establish a process whereby the HRD provides the DRS with a report of all new eligible members on a regular basis. The DRS should then compare the new eligible members to the transmittal file received from the City's Payroll Division to verify all contributions are captured.

In addition, the contribution amount wired to the DRS's custodian bank may differ from the total contribution amount in the transmittal file due to off-cycle adjustments that are erroneously captured in the transmittal. The DRS should continue working with the City's Payroll and IT Divisions to correct the query used to produce the transmittal file such that it only includes the intended items. Furthermore, the DRS should continue to reconcile bi-weekly contributions to the transmittal file to ensure all contribution amounts are captured and reflected in Pension Gold.

Current Year Status:

Partially implemented. The coordination between the DRS and the HRD to establish a process to notify DRS of new eligible members prior to receipt of the transmittal file has not been completed. DRS had delayed the coordination with the anticipation that other issues may be discovered by an Agreed-Upon Procedures (AUP) review to determine whether the DRS and the City's Payroll Division have systems and controls in place to ensure contributions are properly captured, transferred, and recorded. The completion of the AUP has been delayed due to incomplete information requests and scheduling constraints. DRS will contact HRD to coordinate the new eligible member notification process in fiscal year 2010.

Furthermore, the DRS has implemented a reconciliation to check and ensure the transmittal file received from the City's Payroll Division agrees to the amount wired to the custodian bank. The DRS performed the reconciliation for fiscal year 2009 at year-end, and plans to perform bi-weekly reconciliation in the second half of fiscal year 2010.

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STATUS OF PRIOR YEAR RECOMMENDATIONS (Continued)

2008-02 User Access Set-up and Monitoring

Control Deficiency

Observation:

User access to Pension Gold is controlled by the IT group based on job roles. Although the DRS has created request forms to set up or modify user access, it does not have written procedures describing the set up and modification of user access. Logical access to the DRS's applications enforces a proper segregation of duties so that users are only allowed to perform functions that are necessary for their positions. We recommend that the DRS formally document the policies and procedures on user set up and modifications to ensure user access rights are compatible with the employees' responsibilities. The DRS should also implement procedures to review user authorizations on a regular basis.

Current Year Status:

Implemented. DRS created and implemented clearer documentation and check list regarding the setup and modification of user access.

2008-03 Environmental Hazards to Computer Systems

Control Deficiency

Observation:

The server to the retirement system, Pension Gold, is located in an air-conditioned locked room that is equipped with water sprinklers. In case of fire, the server may be subject to water damages. Although data in the retirement system is backed up daily by the system vendor and stored in an off-site location, damages to the server will cause disruption in business operations and additional costs to recover or replace the damaged equipments. We recommend the DRS consider installing a non-water fire suppression system in the server room. In addition, the DRS should ensure that a viable business continuity plan is in place to address potential disruptions in business operations during server downtime.

Current Year Status:

Recommendation is no longer applicable. The DRS performed a cost-benefit analysis and considered the replacement cost and the impact on business operations.

The staff recommended and the Boards approved \$45,000 in the FY 2009-10 budget for additional image servers and a more virtual solution working with the City's IT Department to minimize any business interruption to a maximum of one day. This alternative is more economical and more portable since it does not require construction in a fixed location. The IT group is working with Levi, Ray, & Shoup (LRS) consultants and the City to utilize their storage area network.

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STATUS OF PRIOR YEAR RECOMMENDATIONS (Continued)

2008-04 New Government Accounting Standard

– **GASB No. 53 *Accounting and Financial Reporting for Derivative Instruments***

Informational

Observation:

The Governmental Accounting Standards Board (GASB) issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* to improve how state and local governments report information about derivative instruments—financial arrangements used by governments to manage specific risks or make investments—in their financial statements. The new rules may significantly change the Plan’s accounting treatment of its derivative instruments. We recommend that the Department of Retirement Services begin its evaluation of the reporting requirements of this new standard. The Plan is required to fully implement GASB Statement No. 53 in the fiscal year ending June 30, 2010.

Management’s Response:

DRS staff continues to attend GASB Statement No. 53 education seminars and training. Staff is in the process of preparing for the required disclosures for FY 2009 as retroactive application is required, and will prepare for the same disclosures for FY 2010 after the end of the audit fieldwork for the FY 2009 financial statements.

2006-02 Password Security

Control Deficiency

Observation:

The policies of the DRS do not address minimum and maximum password ages to require periodic password changes to reduce the risk of unauthorized access to the systems. The policy should be instituted for functional users of the DRS’s benefit system and financial application. Best practices suggest that passwords should be changed every 90 days at a minimum and that the minimum password age should be set to 1 day.

Current Year Status:

Implemented. The DRS’s network security settings are controlled by the City using Active Directory. The City’s current minimum password age remains at 0 days and maximum password age at 730 days. As such, the DRS has implemented procedures to manually force password changes every 90 days at the department level. However, users have the ability to immediately revert back to the old passwords upon the manually forced change.

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STATUS OF PRIOR YEAR RECOMMENDATIONS (Continued)

2006-03 Logical Security

Control Deficiency

Observation:

The automatic lock function is not in place to disconnect a user from the financial application or to lock the current network session (i.e., Windows) after a period of inactivity. Having unattended open connections to the financial application and the network session increases the risk of unauthorized access to the systems.

Current Year Status:

Implemented. The DRS's network security settings (including the lockout function) are controlled by the City using Active Directory. As the DRS does not have access to change these settings at the network level, the DRS has implemented procedures to require a 10-minute lockout period at the department level.

2006-04 Comprehensive Business Continuity Plan

Control Deficiency

Observation:

The DRS does not have a comprehensive business continuity plan to address procedures to operate and maintain normal business functions following unexpected disruptions. Furthermore, while the DRS's Information Technology Division has procedures for the recovery of computer files, it does not have a formal disaster recovery plan.

The DRS should continue its efforts to design a business continuity plan to document policies and procedures to be followed when disruptions occur to mitigate the impact on essential business processes and network functions and to reduce costs or losses arising from such events. Once adopted, the business continuity plan should be clearly communicated to all management and staff to demonstrate a clear commitment to establishing and maintaining an effective business continuity planning process. Management should evaluate and test plan procedures periodically with the results of the tests incorporated as updates to the plan to address changes in business operations.

Current Year Status:

Implemented. DRS has completed a business continuity plan outlines the steps to be performed if a disruptive event occurs. This document specifically addresses Pension Gold data and Pension Gold payroll procedures. On Monday, February 23, 2009, DRS successfully completed a mock event and has developed resolutions to address minor issues that were identified. Training outside of the IT group has not occurred yet.