

**CITY OF SAN JOSE**

Public Safety, Finance &  
Strategic Support Committee

Report to Management

Year Ended  
June 30, 2012

**CITY OF SAN JOSE**

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

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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, 2012. 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 for the period July 1, 2011 through January 31, 2012; the Successor Agency to the Redevelopment Agency of the City of San José (Successor Agency) for the period February 1, 2012 through June 30, 2012; 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, the Pedestrian/Bicycle Facilities Grant, the Parks and Recreation Bond Projects Fund, the Branch Libraries Bond Projects Fund, the Neighborhood Security Bond Projects Fund, the Library Parcel Tax Special Revenue Fund, the City of San José Deferred Compensation Plan, and the Diridon Development Authority as of and for the year ended June 30, 2012. 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 29, 2012. Professional standards also require that we communicate to you other information related to our audit as discussed on pages 1 through 4.

Management of the City is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit of the City's basic financial statements as of and for the year ended June 30, 2012, 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 audit procedures that are appropriate in the circumstances 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 was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, therefore material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a deficiency in internal control that we consider to be a material weakness and other deficiencies 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 considered item number 2012-1 to be a material weakness.

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 considered item numbers 2012-2, 2012-3 and 2012-4 to be significant deficiencies.

The City's written responses to the comments identified in our audit are 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 the recommendations.

This communication is intended solely for the information and use of the Public Safety, Finance & Strategic Support 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 & Counsel LLP*

Walnut Creek, California  
November 19, 2012

## CITY OF SAN JOSE

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

### 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.

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

#### 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. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2012.

We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus except for the re-establishment of the receivable balance from the Successor Agency and the related bonds payable, which totaled \$162.5 million and \$164.1 million, respectively upon dissolution of the former Redevelopment Agency of the City of San José (Agency) as discussed in Note III.F.8. to the financial statements. 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.

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### REQUIRED COMMUNICATIONS (Continued)

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
- Estimated valuation of property held for resale
- 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 postemployment benefit plans' employer and employee contribution requirements and funded status of the plans
- 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 allowance for losses on accounts receivable was 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.
- Estimated valuation of property held for resale was based on the most recently available consultant analysis of estimate values performed at the request of a creditor and sales prices previously received from recent solicitations that resulted in purchase and sale agreements.
- Estimated liabilities for workers' compensation claims were based on management's estimate obtained from information derived from the City's claims database system adjusted for a discounted projection of unreported claims at 3.5%. Estimated liabilities for general liability and other claims were determined by City Attorney's judgment about the ultimate outcome of the claim.
- 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.

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**REQUIRED COMMUNICATIONS (Continued)**

- Accrual and disclosures of compensated absences were based on accrued eligible hours of vacation, sick leave and other compensatory time at current pay rates for eligible employees.
- Pension and other postemployment benefit plans' employer and employee contributions requirements were based on actuarially determined contribution rates and funded status.
- 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 obligations.

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 as follows:

- The dissolution of the Agency described in Note I.A., which resulted in extraordinary items reported as discussed in Note I.F.16.
- The City's election to become the Successor Agency as described in Note I.A. and the Housing Successor to the former Agency as discussed and Note I.B.
- The City's Employee Defined Benefit Retirement Plans described in Note IV. A.
- The Special Termination Event under the Continuing Covenant of the 2010 C Housing Set-Aside Tax Allocation Bonds as discussed in Note IV.C.3.
- The uncertainties over the validation of certain obligations and asset transfers of the former Agency to the City and its related entities as discussed in Note IV.D.3.

The financial statement disclosures are neutral, consistent and clear.

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

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

***Corrected and Uncorrected Misstatements***

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. The attached schedule 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.

The material misstatements, as summarized in the attached schedule of corrected adjustments, were detected as a result of audit procedures and corrected by management. We have determined that the misstatements identified resulted from a material weakness in the City's internal controls over financial reporting as discussed in item number 2012-1.

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**REQUIRED COMMUNICATIONS (Continued)**

***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 19, 2012.

***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  
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### SCHEDULE OF COMMENTS AND RESPONSES

#### Item #2012-1 – Material Weakness

##### Internal Control Over Financial Reporting – Preparation of Financial Statements

On June 28, 2011, the Governor signed AB X1 26, which amended the Community Redevelopment Law in California to, among other things, direct the dissolution of all redevelopment agencies in California. On December 29, 2011, the California Supreme Court (Court) issued a decision that upheld the constitutionality of AB X1 26. As a result of the Court decision, as of February 1, 2012, by implementation of AB X1 26, the Redevelopment Agency of the City of San José (Agency) was dissolved and the Successor Agency to the Redevelopment Agency of the City of San José (Successor Agency) came into existence as a separate legal entity.

The dissolution of the Agency severely impacted the organization's internal controls over financial reporting. In 2011, the Agency had 5 individuals who were involved with accounting, fiscal and financial analysis and financial reporting. During the Agency's close-out audit and the Successor Agency's initial audit, the Successor Agency had one individual assigned to perform these tasks. In addition to these two financial statements audits, the Successor Agency has been responding to and providing information to numerous other auditors, rating agencies and consultants with a total staff of 7 individuals from 58 individuals in 2011.

The current staffing complement is not configured to adequately support the Successor Agency's financial reporting responsibilities resulting in a deficiency in internal controls that provide reasonable assurance that closing transactions (capital assets, accruals, deferred revenue, etc.) and financial statements are accurately prepared under generally accepted accounting principles.

With the increasing audit requests related to the Successor Agency's activities, it is essential that the Successor Agency has sufficient accounting and fiscal personnel to adequately meet and maintain accurate financial records of the former Agency and subsequent Successor Agency.

#### *Recommendation*

We recommend that the Successor Agency obtain additional assistance from the City to reduce the likelihood that errors may occur and not be detected or corrected on a timely basis and therefore improve internal controls over financial reporting. Areas where the City could provide additional support include:

- Monitoring and management of the loan portfolio to ensure accurate receivable balances (e.g., bad debt, allowance for doubtful accounts, and collectability and availability analysis).
- Evaluating the cost basis for redevelopment capital assets and valuation for property held for resale for proper reporting.
- Recording of close-out entries (e.g., interest receivable on loans, intergovernmental payables, and deferred revenue) in the financial statements.
- Recording year-end accrual closing entries (e.g., unearned revenue adjustments, capital asset activity, and interest payable).

#### *Management Response*

The last year has been a fiscally challenging year for the former Redevelopment Agency (Agency). The economic recession took a considerable toll on tax increment revenues and as early as 2010 the Agency began a significant reduction in workforce. At the beginning of fiscal year 2010-11, staffing levels were 92 with 9 devoted to financial operations and affairs of the Agency. By the time dissolution was final on

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### SCHEDULE OF COMMENTS AND RESPONSES (Continued)

#### Item #2012-1 – Material Weakness (Continued)

February 1, 2012, the total staffing was 10 with only 4 devoted to the financial operations and affairs of the former Agency, now the Successor Agency to the Redevelopment Agency (SARA). During the transition period, the SARA staff has been assisted with resources from both the City Finance and Housing Departments to complete the necessary financial statements for the reporting periods ending January 31, 2012 and June 30, 2012.

This past calendar year has been one of transition as the City has worked to develop proper staffing levels and staffing expertise to ensure the orderly “wind-down” of the former Agency’s financial affairs. During the first half of calendar 2013, Management will continue the transition process to ensure appropriate internal controls are met with respect to the financial reporting obligations of SARA and to interface with the various outside agencies. It is Management’s expectation that most or all of the financial operations, including financial reporting will be transferred to the City’s Finance Department by the end of the current fiscal year. The transfer to the Finance Department allows the financial operations to be reviewed and managed by a larger organization, creates more cross-training and knowledge sharing, and ensures the appropriate level of management reviews.

#### Item #2012-2 – Significant Deficiency Risk Assessment of Internal Controls

As discussed in the prior year, internal control is an integral process that is affected by the City’s governing body, management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the organization’s goals, the following general objectives are being achieved:

- Executing orderly, ethical, economical, efficient and effective operations;
- Fulfilling accountability obligations;
- Complying with applicable laws and regulations; and
- Safeguarding resources against loss, misuse and damage.

Internal controls should be continuously monitored in order to adapt to the City’s recent organizational changes, changes in its operating environment and reduced resources available for internal controls. Internal control is a dynamic integral process that should be continuously adapting to the changes the City is facing. Over the past decade, the City has cut 28 percent of budgeted positions. The last two budgets included widespread reductions in services with corresponding reductions in authorized/budgeted positions coupled with reductions in employee total compensation. City Council’s approval of the 2011-2012 Adopted Budget resulted in the loss of 140 employees through layoffs. In addition, through the execution of Civil Service Rules, over 500 employees were budgeted to move into new positions where they are required to learn or re-learn, the skills and knowledge necessary to successfully fulfill the requirements of their new position.

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**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**Item #2012-2 – Significant Deficiency (Continued)**

We observed City staff who are facing continual pressures to maintain service levels with fewer resources and have not been provided adequate or sufficient training nor have changes in the City's business processes been implemented to improve work flow efficiencies. These organizational changes can have a significant impact on the effectiveness of internal control system.

The staffing constraints are factors in errors in the City's fiscal year 2012 year-end financial reporting process including:

- Errors in accounts payable year-end cut-off totaling \$0.8 million.
- Lack of understanding of the composition of the pooled cash and investments reconciling entry of \$18 million.
- Inadequate review of complex government-wide reconciling journal entries.

In general, we observed that staff are facing additional pressures to maintain service levels with fewer resources and the City has not adequately assessed the necessary changes in processes to mitigate risk associated with reduced resources available for the City's financial reporting and accounting processes. With these organizational changes, the City should update its documentation, test its internal controls, assess the magnitude of any deficiencies identified and develop a work plan to re-structure the organization to ensure internal controls are adequate for its changed environment and reduced workforce.

*Recommendation*

As a result of organizational changes, the City should identify and quantify the risks of any significant internal control weaknesses that have not been addressed because of insufficient resources or staff capabilities. Once these risks are identified, the City should develop a work plan to mitigate these risks in internal controls.

*Management Response*

Management agrees that the reduction in Citywide positions and the associated impact of executing the Civil Service Rules with these position eliminations have been disruptive to the financial operations of the organization. The City Auditor's Report "Ten Years of Staffing Reductions at the City of San Jose: Impacts and Lessons Learned" stated that in addition to laying-off 337 people over the last ten years (all but 6 were laid-off in the last three years), 2,444 full-time employees retired and 1,507 full-time employees resigned. According to the report, of the 2,130 positions eliminated since 2002-2003, over 1,100 (52%) were eliminated in the last three years. This level of downsizing has had significant service level impacts across the organization including those services related to financial operations.

Management believes opportunities exist for continued improvement in identification of the impacts on the City's financial operations and internal control structure as well as developing a work plan to address these impacts. However, management believes the City has made progress toward stabilizing and improving staffing for the primary financial reporting operations in the City's Finance Department. For

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### SCHEDULE OF COMMENTS AND RESPONSES (Continued)

#### Item #2012-2 – Significant Deficiency (Continued)

example, a permanent appointment has been made for the Director of Finance position. This appointment establishes a continuity of management with a seasoned veteran of the Finance Department who has played a vital role in the CAFR production since 2010. Concurrently, the Finance Treasury Division Manager continues as the Acting Assistant Director bringing his technical expertise to the CAFR production process in the areas of treasury and debt management, pension plan disclosure and his previous work experience. In addition, the Acting Accounting Division Manager continues to bring eight years of prior work experience in the Accounting Division in which he played a key and vital role in preparation of prior CAFRs and currently provides organizational stability to the Accounting Division. It should also be noted that within the last year a Principal Accountant position was restored in the Finance Department's Accounting Division as an initial step in rebuilding critical skills and expertise needed in the Finance Department.

Management acknowledges the impact on the organization of the deficiencies in formalized roles and responsibilities in City departments and the impact it may have on the quality and consistency of financial reporting. The decentralization of finance functions to other City departments has made each department responsible for establishing and maintaining specific and defined roles and responsibilities to assure a seamless transition when positions become vacant and then subsequently filled. Due to the aforementioned reduction and turnover in City staffing, consistencies in how roles and responsibilities are established and maintained within departments and with the Finance Department has diminished.

The Finance Department will work with City departments to identify the reduction in all finance related positions and assess current staffing levels on a Citywide basis. In addition, the Finance Department will work with City departments to assess the consistency of finance procedural documentation to ensure consistency and continuity throughout the organization. It should be noted that the ability to complete this work and to implement solutions may be impacted by current staffing levels in all City departments. In light of staffing constraints, the City will consider its options to utilize consulting services to assist the City in assessing the current consistency and content of finance procedural documentation to ensure best practices, consistency, and continuity throughout the organization.

As the City begins planning for the preparation of the fiscal year 2013 CAFR, the Finance Department is making a concerted effort to assemble the strongest team possible within the staffing constraints of the Department and the organization. This effort will involve more closely aligning staff skills with job duties and responsibilities. The Finance Department remains challenged by recent departures of long-tenured, highly knowledgeable staff and resource reductions over the last several fiscal years. Additionally, the Finance Department has subscribed to an on-line accounting research tool to assist the Accounting staff in performing the necessary research and analysis of accounting rules and regulations as a way to enhance staff's knowledge and efficiency. The City has also initiated research into financial reporting solution packages that could potentially streamline the CAFR process and provide more time for analytical reviews of data.

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**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**Item #2012-3 – Significant Deficiency  
Housing Department Budgetary Controls**

Under the Redevelopment Dissolution Law, the Redevelopment Agency of the City of San José (Agency) and the Successor Agency to the Redevelopment Agency of the City of San José (Successor Agency) were no longer required to set-aside 20% of property tax revenues to the City's Housing Department for low and moderate income housing activities. In fiscal year 2010-2011, the last full fiscal year of this source of funds, the Housing Activities Fund received \$34.8 million from this revenue source. Commencing February 1, 2012, the Housing Activities Fund's primary sources of revenues will be limited to grant funds from the U.S. Department of Housing and Urban Development and repayments on loans from its loan portfolio. In fiscal year 2011-2012, the Housing Activities Fund final budgeted revenues and other financing sources reported a total \$78.4 million and final budgeted expenditures and other financing uses reported a total \$145.3 million or a deficiency of \$66.9 million. On a budgetary basis, the Housing Activities Fund reported a deficiency of funding sources under its funding uses of \$44.4 million and a deficit fund balance of \$15.2 million.

During our audit, we made inquiries regarding the nature of these budgetary deficits and noted that the primary cause was due to the decrease in the 20% set-aside of property tax revenues. Additionally, upon inquiry, it was noted that there is not a plan in place to remedy the fund deficit on a budgetary basis as all available funding sources are budgeted for current projects. As such, the City may not be properly analyzing the Fund's available funding sources and budgetary accounts.

*Recommendation*

The City should improve monitoring of its Housing budget as compared to actual amounts so that a fund does not close the year in a deficit position.

*Management Response*

The City regularly monitors its budgets to ensure that no fund closes the year in a deficit position. In this particular case, there were extenuating circumstances that made it appear that the Housing Activities Fund had a deficit year-end balance. As previously noted, legislation was passed to dissolve all redevelopment agencies throughout the State effective February 1, 2012. This action directly impacted the City's Housing Activities Fund.

Since 1988, the City's Housing Department has managed the Low and Moderate Income Housing Fund, 20% of all redevelopment funding as required by law, for affordable housing programs. Prior to fiscal year 2011-2012, these funds have been included in the Housing Activities Fund financial statements. With the dissolution of the City's Redevelopment Agency, affordable housing assets, including the existing loan portfolio, were transferred to the Affordable Housing Investment Fund. Tax increment dollars, the former 20% Low and Moderate Income Housing Funds, were transferred to the Successor Agency to the Redevelopment Agency Fund. As a result, two separate Funds now hold the former 20% Fund assets.

As a result, when examining the Housing Activities Fund, it appears that there is a gap in actual amounts on a budgetary basis in the financial statements. However, when examining the \$15.2 million deficit fund balance in the Housing Activities Fund in conjunction with the \$24.7 million surplus fund balance in the Affordable Housing Investment Fund, there is a net surplus balance. The City is currently working to

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**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**Item #2012-3 – Significant Deficiency (Continued)**

resolve the fund balance presentation issue, and plans to have the issue resolved prior to completion of the fiscal year 2012-2013 financial statements.

Many unintended consequences have been identified through the extraordinary event of dissolving the Redevelopment Agency. This identification of a budgetary deficit is an example of an unintended consequence, and as noted earlier management plans to have the issue resolved during the fiscal year 2012-2013 CAFR preparation process.

**Item #2012-4 – Significant Deficiency  
Accounting for Housing Loans Reserves**

Each year for preparation of the City's basic financial statements, the City's Housing Department conducts an analysis of its loan portfolio. The analysis includes a calculation of loan loss reserves to fairly state the value of reserves as of the balance sheet date of June 30 for the City's Major Housing, Community Development Block Grant (CDBG), and HOME loans. From the analysis, an adjustment is recorded to the general ledger to fairly state the value of loan loss reserves for the City's basic financial statements.

During the year, the City implemented a new customer relationship management (CRM) system to track outstanding loans and to compute the present value of the loan loss reserves. This computation is extracted to an excel spreadsheet for further analysis. We noted that the CRM system had a formula error in the calculation of the reserve, which resulted in the understatement of the allowance on the City's loans receivable by \$19.3 million at June 30, 2012. The City subsequently corrected this error in its financial statements.

*Recommendation*

We recommend that the Housing Department develop procedures to review its CRM database and system computations in order to ensure that accurate financial information is available to management for analysis of its loan portfolio.

*Management Response*

The City agrees with this recommendation. New procedures are being developed to reconcile the CRM database and Financial Management System to ensure that loans are recorded accurately. In addition, staff is currently testing the computations derived from the CRM database to ensure accuracy in recording the loan loss reserve in the future.

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**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**Item #2012-5 – Other Comment**

**Successor Agency's Investment Policy Compliance**

The Successor Agency follows the investment policy of the City, which is governed by provisions of the California Government Code and the City's Municipal Code. The Successor Agency also has investments subject to provisions of the bond indentures of the former Agency's various bond issues. City of San Jose Investment Policy Section 9.10 Money Market Mutual Fund states that, *No More than 20% of the portfolio shall be invested in money market mutual funds.* The City's policy does have exceptions for investments of bond proceeds and bond reserve accounts. However, it currently does not have an exception for investments held for a short duration to pay upcoming debt service payments.

During our audit, we noted that the former Agency and the Successor Agency was not in compliance with the City's Investment Policy by investing more than 20% of its portfolio in money market mutual funds. As of January 31, 2012, the former Agency invested \$80.6 million in money market mutual funds out of its total investment portfolio of \$130.7 million (61% of the portfolio). As of June 30, 2012, the Successor Agency invested \$95.7 million of the total investment of \$161.0 million in money market mutual funds (59% of the portfolio).

*Recommendation*

We recommend the Successor Agency work with the City in updating its investment policy to consider its short-term investment needs.

*Management Response*

Management acknowledges the considerable stress and resource challenges associated with the financial reporting requirements of the former Redevelopment Agency and the Successor Agency to the Redevelopment Agency. In order to ensure the Successor Agency is in compliance with the City's Investment Policy ("Policy"), Successor Agency staff will meet with the City's Treasury Division to establish an investment schedule for property tax proceeds. City and former Redevelopment Agency staff established an investment schedule for the January 2, 2013 Redevelopment Property Tax Trust Fund ("RPTTF") subsequent to the distribution; however, per the aforementioned procedure, future investment schedules will be established prior to RPTTF distributions. As a result, management does not believe amending the Policy is necessary as the procedures are being amended to comply with the Policy. In addition, the transition of the financial operations to the City Finance Department by June 2013 will help ensure better compliance with the City's Investment Policy.

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### SCHEDULE OF COMMENTS AND RESPONSES (Continued)

#### Item #2012-6 – Other Comment New Pension Accounting Standards

In June 2012, GASB approved Statement No. 67, *Financial Reporting for Pension Plans, an amendment of GASB Statement No. 25*, and Statement No. 68, *Accounting and Financial Reporting for Pensions, an amendment of GASB Statement No. 27*. GASB Statement No. 67 addresses reporting by pension plans (the San José Police and Fire Department Retirement Plan and the City of San José Federated City Employees Retirement System) that administer benefits for governments (City of San José), and is effective for financial statements for periods beginning after June 15, 2013. GASB Statement No. 68, which primarily relates to reporting by governments that provide pensions to their employees (City of San José), is effective for fiscal years beginning after June 15, 2014. Key changes include:

- Separating how the accounting and financial reporting is determined from how pensions are funded.
- Employers with defined benefit pension plans will recognize a net pension liability, as defined by the standard, in their government-wide, proprietary and fiduciary fund financial statements.
- Incorporating ad hoc cost-of-living adjustments and other ad hoc postemployment benefit changes into projections of benefit payments, if an employer's past practice and future expectations of granting them indicate they are essentially automatic.
- Using a discount rate that applies (a) the expected long-term rate of return on pension plan investments to projected benefit payments for which plan assets are expected to be available to make projected benefit payments, and (b) the interest rate on a tax-exempt 20-year AA/Aa-or higher rated municipal bond index to projected benefit payments for which plan assets are not expected to be available for long-term investment in a qualified trust.
- Adopting a single actuarial cost allocation method – entry age normal – rather than the current choice among six actuarial cost methods.
- Requiring more extensive note disclosures and required supplementary information.

The San José Police and Fire Department Retirement Plan (PFDRP) and the City of San José Federated City Employees Retirement System (FCERS) will be subject to the provisions of GASB Statement No. 67 beginning with the fiscal year ending June 30, 2014. GASB Statement No. 67 replaces the requirements of GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and GASB Statement No. 50, *Pension Disclosures*, as they relate to pension plans that are administered through trusts or similar arrangements meeting certain criteria. GASB Statement No. 67 builds upon the existing framework for financial reports of defined benefit pension plans and enhances note disclosures and required supplementary information for both defined benefit and defined contribution pension plans. In addition, it requires the presentation of new information about the annual money-weighted rates of return on pension plan investments in the notes to the financial statements and in 10-year required supplementary information schedules.



**CITY OF SAN JOSE**

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**Item #2012-6 – Other Comment (Continued)**

The City will be subject to the provisions of GASB Statement No. 68 beginning with the fiscal year ending June 30, 2015. GASB Statement No. 68 replaces the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and GASB Statement No. 50, *Pension Disclosures*, as they relate to pensions that are administered through trusts or similar arrangements meeting certain criteria. GASB Statement No. 68 builds upon the existing framework for accounting and financial reporting of defined benefit pension plans and enhances note disclosures and required supplementary information for both defined benefit and defined contribution pension plans.

*Recommendation*

It is likely that these new accounting and reporting standards will dramatically change the City's financial statements and disclosures and will result in the recognition of net pension liability. We recommend consulting with the PFDRP's and FCERS's actuaries to develop a better understanding of and to quantify the impact of these new accounting and reporting on the City's current financial statements.

*Management Response*

The City agrees and acknowledges the likely significant impact to the City's financial statements and disclosures to be brought on by the new accounting and reporting standards. The City is proactively monitoring and researching these standards to assure accurate and timely implementation. This will include, but not be limited to, discussion among peers, inter-departmental coordination with the Retirement Services Department, attending training classes, consulting with the retirement systems' actuaries, and completing pro forma statements to quantify the impact.

**CITY OF SAN JOSE**

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**STATUS OF PRIOR YEAR'S SIGNIFICANT AND CONTROL DEFICIENCY COMMENTS**

2011 Comment: ***#2011-1 - Risk Assessment of Internal Controls***

Condition/Effect: Internal controls should be continuously monitored in order to adapt to the City's recent organizational changes, changes in its operating environment and reduced resources available for internal controls. The City has been going through a profound change especially in the number of personnel and the experience level of its finance and accounting personnel since the end of fiscal year 2009.

In general, we observed that staff is facing additional pressures to maintain service levels with fewer resources and the City has not adequately assessed the necessary changes in processes to mitigate risk associated with reduced resources in the City's financial reporting and accounting processes.

Recommendation: The City should update its documentation, test its internal controls, assess the magnitude of any deficiencies identified and develop a work plan to re-structure the organization to ensure that its internal controls are adequate for its changed environment and reduced workforce.

Status: Not implemented. See comment 2012-2.

2011 Comment: ***#2011-2 - Airport Cost Allocation Plan***

Condition/Effect: During our audit, we noted that the fiscal year 2011 Airport Cost Allocation Plan (ACAP) used a factor of 400 full-time equivalents (FTEs). However, the Airport has approximately 206 FTEs at June 30, 2011. Unlike expenditures, the City does not adjust nonfinancial factors such as FTEs to actual results. As such, the Airport may be burdened with a disproportionate share of overhead costs when they experience dramatic changes in FTEs and other nonfinancial measurements.

Recommendation: We recommend the City develop a more equitable cost allocation methodology that measures and allocates the relative benefit of administrative efforts received by the Airport during a given fiscal year.

Status: Not implemented. The City maintained the same methodology in allocating central service program costs. The ACAP used 305 FTEs compared to the approximate actual of 181 FTEs as of June 30, 2012, and thus the Airport may still be burdened with a disproportionate share of overhead costs. Effective fiscal year 2013-2014, the City will use actual FTEs as the cost allocation basis for the ACAP.

**CITY OF SAN JOSE**

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

**SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS**

PJE#	Account / Adjustment Description	Debit (Dollars in thousands)	Credit
<b>General Fund/Governmental Activities</b>			
1	Unearned Revenue - General Fund	\$ 2,070	
	Business Tax Accounts Receivable - General Fund		\$ 1,215
	Fire Department Accounts Receivable - General Fund		\$ 855
	<i>(To reduce accounts receivable and related unearned revenues recorded for billing in advance at June 30, 2012.)</i>		
2	Sales Taxes Receivable - General Fund	\$ 1,718	
	Sales Taxes Revenue - General Fund	\$ 2,392	
	Deferred Revenue - General Fund		\$ 4,110
	Deferred Revenue - Governmental Activities	\$ 4,110	
	Sales Taxes Revenue - Governmental Activities		\$ 4,110
	<i>(To adjust sales tax receivable based on actual receipt after year-end and deferred sales tax revenue not collected within the period of availability).</i>		
3	Expenditure - General Government	\$ 1,000	
	Allowance for Doubtful Accounts		\$ 1,000
	<i>(To record the write-off of the line of credit of the American Music Theatre as it is uncollectible as of June 30, 2012.)</i>		
4	Expenditure - General Government	\$ 5,890	
	Unrestricted cash and investments		\$ 5,890
	<i>(To reconcile the ending book balance of the City's operating account to the actual balance at June 30, 2012.)</i>		
<b>Housing Successor Major Governmental Fund/Governmental Activities</b>			
5	Restricted 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 FY2008.)</i>		
5.1	Other Revenue (Housing Loans Principal Repayments)	\$ 1,023	
	Fund Balance		\$ 1,023
	<i>(To record the housing loans repayment that was received in FY2011.)</i>		

**CITY OF SAN JOSE**

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

**SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS (Continued)**

PJE#	Account / Adjustment Description	Debit (Dollars in thousands)	Credit
<b>Nonmajor Governmental Funds/ Governmental Activities</b>			
6	Intergovernmental Revenue - nonmajor funds	\$ 868	
	Grants Receivable - nonmajor funds		\$ 642
	Deferred Revenue - nonmajor funds		\$ 226
	Deferred Revenue - governmental activities	\$ 226	
	Intergovernmental Revenue - governmental activities		\$ 226
	<i>(To decrease the grants receivable and intergovernmental revenue for the Federal Highway Administration.)</i>		
<b>Muni-Water Major Enterprise Fund/ Business-Type Activities</b>			
7	Accounts Receivable- MuniWater	\$ 1,455	
	Charges for Services- MuniWater		\$ 1,455
	<i>(To recognize revenue for CY unbilled service.)</i>		
	Charges for Service- MuniWater	\$ 1,323	
	Unrestricted Net Assets- MuniWater		\$ 1,323
	<i>(To reverse impact of PY passed adjustment.)</i>		
<b>Governmental Activities</b>			
8	Interest Expense - Governmental Activities	\$ 2,100	
	Interest Payable - Governmental Activities		\$ 2,100
	Interest Receivable - Governmental Activities	\$ 2,100	
	Interest Revenue - Governmental Activities		\$ 2,100
	<i>(To accrue for SJFA 2001 Revenue Bonds Series F's interest.)</i>		
9	OPEB Liability - Governmental Activities	\$ 2,853	
	Net Assets		\$ 2,853
	<i>(To decrease the beginning OPEB liability and net assets for governmental funds due to change in ARC for FY 2011.)</i>		
10	Various Expenses accounts - Governmental Activities	\$ 12,746	
	General liabilities - Workers' Compensation		\$ 12,746
	<i>(To adjust the workers compensation liability to the amount determined by the actuary at June 30, 2012.)</i>		
11	Claims Liabilities	\$ 2,886	
	Expenses - General Government		\$ 2,886
	<i>(To decrease the accrued claims liability balance at year-end.)</i>		

**CITY OF SAN JOSE**

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Year Ended June 30, 2012

**SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS (Continued)**

<u>PJE#</u>	<u>Account / Adjustment Description</u>	<u>Debit</u>	<u>Credit</u>
		<u>(Dollars in thousands)</u>	
<b>Other funds/Pension Trust funds</b>			
12	Extraordinary loss	\$ 2,162	
	Capital assets, net		\$ 2,162
	<i>(To record the potential invalidation of the Master Lease Agreement with respect to the 4th Street Garage.)</i>		
13	Real assets investments - Federated	\$ 5,235	
	Unrealized gains - Federated		\$ 5,235
	<i>(To adjust real asset investments fair values.)</i>		
14	Opportunistic investments - Police and Fire	\$ 4,136	
	Unrealized gains - Police and Fire		\$ 4,136
	<i>(To adjust real asset investments fair values.)</i>		
15	Real assets investments - Police and Fire	\$ 7,472	
	Unrealized gains - Police and Fire		\$ 7,472
	<i>(To adjust real asset investments fair values.)</i>		

**CITY OF SAN JOSE**

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Year Ended June 30, 2012

**SUMMARY OF CORRECTED FINANCIAL STATEMENT MISSTATEMENTS**

PJE #	Account / Adjustment Description	Debit (Dollars in thousands)	Credit (Dollars in thousands)
<b>Housing Activities Fund/Governmental Activities</b>			
1a	Loan valuation adjustment	\$ 6,716	
	Allowance for loans		\$ 6,716
<b>Affordable Housing Investment Fund/Governmental Activities</b>			
1b	Loan valuation adjustment	\$ 12,242	
	Allowance for loans		\$ 12,242
<b>Nonmajor Governmental Funds/Governmental Activities</b>			
1c	Loan valuation adjustment	\$ 318	
	Allowance for loans		\$ 318
	<i>(To adjust allowance to recomputed amount.)</i>		
<b>Governmental Activities (Redevelopment Agency)</b>			
2	Environmental liabilities	\$ 22	
	Community development expense		\$ 22
	<i>(To record payment to vendor as a reduction to the accrued remediation liability at 1/31/12.)</i>		
<b>Governmental Activities (Redevelopment Agency)</b>			
3	Community development expense	\$ 558	
	Construction in progress		\$ 558
	<i>(To expense cancelled projects.)</i>		
<b>Redevelopment Agency/Governmental Activities</b>			
4	Accrued interest receivable	\$ 254	
	Deferred revenue		\$ 254
	<i>(To accrue 7-months of interest on loans.)</i>		
<b>Redevelopment Agency/Governmental Activities</b>			
5	Deferred revenue	\$ 9	
	Interest revenue		\$ 2
	Miscellaneous revenue		\$ 7
	<i>(To record loan repayments.)</i>		
<b>Redevelopment Agency/Governmental Activities</b>			
6	Payment to other governmental agencies	\$ 2,554	
	Due to other governmental agencies		\$ 2,554
	<i>(To accrue 1/2 of the FY2012 costs netted in the June tax distribution.)</i>		
<b>Redevelopment Agency/Governmental Activities</b>			
7	Debt service expenditures	\$ 94	
	Transfers in from the City		\$ 94
	<i>(To record HUD 108 debt service payment activity.)</i>		

**CITY OF SAN JOSE**

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

**SUMMARY OF CORRECTED FINANCIAL STATEMENT MISSTATEMENTS (Continued)**

PJE#	Account / Adjustment Description	Debit (Dollars in thousands)	Credit
<b>Redevelopment Agency/ Governmental Activities</b>			
8	Other financing use	\$ 88,600	
	Demand bonds payable		\$ 88,600
	<i>(To reclassify 2010C Housing TABs to a short-term liability.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
9	Environmental liabilities	\$ 17	
	Community development expense		\$ 17
	<i>(To record payment to vendor as a reduction to the accrued remediation liability at 6/30/12.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
10	Debt service expenditures	\$ 94	
	Transfers in from the City		\$ 94
	<i>(To record HUD 108 debt service payment activity.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
11	Pass-through amounts to the County	\$ 8,177	
	Due to the County		\$ 8,177
	<i>(To record 2nd half of the County's pass-through.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
12	Long-term liability	\$ 625	
	Extraordinary item		\$ 625
	<i>(To reduce City's SERAF loan interest to the LAIF rate.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
13	Pass-through amounts to the County	\$ 7,542	
	Due to the County		\$ 7,542
	<i>(To reverse client reversal of the 1st half County's pass-through.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
14	Payment to other government agencies	\$ 2,554	
	Property tax revenues		\$ 2,554
	<i>To reverse client reversal entries.</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
15	Loss on fair value of property	\$ 27,417	
	Property held for resale	\$ 22,474	
	Accumulated depreciation	\$ 2,051	
	Capital assets		\$ 51,942
	<i>To recategorized property held for resale.</i>		

**CITY OF SAN JOSE**

Public Safety, Finance & Strategic Support Committee  
Year Ended June 30, 2012

**SUMMARY OF CORRECTED FINANCIAL STATEMENT MISSTATEMENTS (Continued)**

<b>PJE#</b>	<b>Account / Adjustment Description</b>	<b>Debit</b>	<b>Credit</b>
		<b>(Dollars in thousands)</b>	
<b>Private Purpose Trust Fund (SARA)</b>			
16	Interest expense	\$ 215	
	Extraordinary item		\$ 215
	<i>(To record reconciling items between the Housing Department and the SARA.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
17	Long-term debt	\$ 35,288	
	Extraordinary item		\$ 35,288
	<i>(To record invalidated loans as an extraordinary item.)</i>		
<b>Private Purpose Trust Fund (SARA)</b>			
18	Deferred revenue	\$ 308	
	Miscellaneous revenue		\$ 308
	<i>(To recognize revenue incorrectly recorded as deferred as full accrual.)</i>		