

**HAYES MANSION
CONFERENCE CENTER**
(An Activity of the City of San José)

Independent Auditor's Report and
Financial Statements

For the Period from
July 1, 2018 through February 4, 2019



Certified
Public
Accountants

HAYES MANSION CONFERENCE CENTER
For the Period from July 1, 2018 through February 4, 2019

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Independent Auditor's Report

City Council
City of San José, California

We have audited the accompanying financial statements of the Hayes Mansion Conference Center (the Center), an activity of the City of San José (the City), as of February 4, 2019 and for the period from July 1, 2018 through February 4, 2019, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers the internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion of the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Center as of February 4, 2019, and the changes in its financial position and cash flows for the period from July 1, 2018 through February 4, 2019 in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

Basis of Presentation

As discussed in Note 1 to the financial statements, the financial statements of the Center are intended to present the financial position and the changes in financial position and cash flows of only that portion of the City's financial statements that is attributable to the transactions of the Center. The Center is reported within the City's special revenue funds; however, for purposes of this presentation, management reports it as an enterprise fund to comply with contractual requirements. The financial statements of the Center do not purport to, and do not, present fairly the financial position of the City as of February 4, 2019, and the changes in its financial position and, where applicable, its cash flows for the period from July 1, 2018 through February 4, 2019 in accordance with accounting principles generally accepted in the United States of America.

Sale of the Center

As discussed in Note 10 to the financial statements, the Center was sold to a private party effective February 5, 2019, and accordingly, the City no longer owns and operates the Center.

Our opinion is not modified with respect to these matters.

Other Matters

Required Supplementary Information

Management has omitted the management's discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the financial statements. Such missing information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

Macias Gini & O'Connell LLP

Walnut Creek, California
June 24, 2019

HAYES MANSION CONFERENCE CENTER

Statement of Net Position

February 4, 2019

Assets:

Current assets:

Cash and investments	\$ 3,667,063
Accounts receivable	235,686
Accounts receivable - City of San José	550,000
Inventory	53,230
Prepaid expenses	<u>33,821</u>

Total current assets 4,539,800

Noncurrent assets:

Capital assets, net	<u>832,067</u>
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Total assets 5,371,867

Liabilities:

Current liabilities:

Accounts payable	74,703
Advance deposits	1,070,193
Accrued liabilities	1,285,529
Devcon loan	<u>1,200,000</u>

Total liabilities 3,630,425

Net position:

Net investment in capital assets	832,067
Unrestricted	<u>909,375</u>

Total net position \$ 1,741,442

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER
Statement of Revenues, Expenses and Changes in Net Position
For the Period from July 1, 2018 through February 4, 2019

Operating revenues:

Room	\$ 5,214,890
Conference services	778,719
Food and beverage	2,744,642
Other	<u>76,774</u>
Total operating revenues	<u>8,815,025</u>

Operating expenses:

Food and beverage	2,821,798
Room	1,877,681
Administrative	1,195,152
Sales and marketing	686,122
Maintenance	646,528
Conference	385,116
Utilities	429,894
Management fee	264,455
Depreciation	150,486
City of San José management and administrative charges	63,737
Insurance	33,752
Other	65,293
Lease and rental expense	<u>14,376</u>
Total operating expenses	<u>8,634,390</u>

Operating income	<u>180,635</u>
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Nonoperating revenues (expenses):

Contributions from the City of San José	2,050,000
Payments to the City of San José	<u>(3,456,205)</u>
Net nonoperating revenues and expenses	<u>(1,406,205)</u>

Change in net position	<u>(1,225,570)</u>
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Net Position:

Beginning of period	<u>2,967,012</u>
End of period	<u><u>\$ 1,741,442</u></u>

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER
Statement of Cash Flows
For the Period from July 1, 2018 through February 4, 2019

Cash flows from operating activities:	
Cash receipts from customers	\$ 8,515,662
Cash payments to suppliers for goods and services	(5,050,231)
Cash payments to employees for services	<u>(3,484,103)</u>
Net cash used in operating activities	<u>(18,672)</u>
Cash flows from noncapital financing activities:	
Payments from the City of San José	1,500,000
Payments to the City of San José	<u>(3,456,205)</u>
Net cash used in noncapital financing activities	<u>(1,956,205)</u>
Cash flows from capital and related financing activities:	
Acquisition of capital assets	<u>(32,685)</u>
Net change in cash and cash equivalents	(2,007,562)
Cash and cash equivalents, beginning of period	<u>5,674,625</u>
Cash and cash equivalents, end of period	<u>\$ 3,667,063</u>
Reconciliation of operating income to net cash used in operating activities:	
Operating income	\$ 180,635
Adjustments to reconcile operating income to net cash used in operating activities:	
Depreciation	150,486
Changes in assets and liabilities:	
Accounts receivable, net	(25,701)
Inventory	(356)
Prepaid expenses	(23,748)
Accounts payable	(142,486)
Advance deposits	(273,662)
Accrued liabilities	<u>116,160</u>
Net cash used in operating activities	<u>\$ (18,672)</u>

See accompanying notes to financial statements.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 1 – DESCRIPTION OF OPERATIONS

On November 1, 2003, the City of San José (the “City”) assumed operations, management and reporting of the Hayes Mansion Conference Center (the “Center”), which includes guest rooms, meeting and conference facilities, food and beverage facilities, surface and underground parking areas, and health and fitness facilities located at 200 Edenvale Avenue, San José, California. The City has contracted with Dolce International/San José, Inc. (“Dolce”) to act as operator of the Center, see Note 8. During February 2015, the Wyndham Hotel Group LLC, a subsidiary of Wyndham Worldwide, announced it had acquired Dolce International, Inc., the parent company of Dolce. The acquisition by Wyndham has no legal consequences on the Management Agreement between the City and Dolce as well as the accounting and financial reporting of the Center’s financial operations.

The financial statements of the Center are intended to present the financial position and the changes in financial position and cash flows of only that portion of the City’s financial statements that is attributable to the operating transactions of the Center. The Center’s operating transactions are reported within the City’s special revenue funds; however, for purposes of this presentation, management reports its operating transactions as an enterprise fund to comply with contractual requirements. The contractual requirements focus on the operations of the Center and as such the City has not included the Center’s building and improvements and related debt in the Center’s financial statements. These assets and related debt are reported as part of the City’s government-wide financial statements. The financial statements of the Center do not purport to, and do not, present fairly the financial position of the City as of February 4, 2019, and the changes in its financial position and, where applicable, its cash flows, for the period from July 1, 2018 through February 4, 2019 in conformity with accounting principles generally accepted in the United States of America.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) *Basis of Presentation and Accounting*

Basis of accounting refers to when revenues and expenses are recognized in the accounts reported in the financial statements, and relates to the timing of measurements made, regardless of the measurement focus applied. The Center is accounted for using the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred.

(b) *Cash and Cash Equivalents*

All highly liquid investments with original maturities of three months or less are considered to be cash equivalents and are carried at fair value.

(c) *Accounts Receivable*

The accounts receivable balance at February 4, 2019, is reported at estimable collectible amounts. No allowance for doubtful accounts has been set.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(d) *Inventory*

Inventory consists of food and beverages that are stated at the lower of cost (first in, first-out method) or market value.

(e) *Capital Assets*

Capital assets are stated at cost, if purchased or at fair value on the date received, if donated. Management has established a capitalization threshold of \$5,000 per item or project with a useful life greater than one year. Depreciation is provided on a straight-line basis over the estimated useful life of each class of depreciable asset. Estimated useful lives are generally three to ten years for furniture, equipment and smallwares.

(f) *Operating Revenues and Expenses*

The Center defines its operating revenues as charges for services, which are revenues derived from charges for rooms, conference services, sale of food and beverages, spa and other services. All other revenues not derived from these sources, such as City operating subsidies, are classified as nonoperating revenues in the accompanying statement of revenues, expenses and changes in net position.

Consistent with the treatment in the accompanying statement of cash flows, all expenses, with the exception of payments made to other funds of the City for reimbursement of bond expenses paid by the City, are treated as operating expenses in the accompanying statement of revenues, expenses and changes in net position.

(g) *Net Position*

Net position is classified in the following two components:

Net Investment in Capital Assets, consists of the Center's capital assets net of related accumulated depreciation.

Unrestricted, consists of any remaining balance of net position not subject to the aforementioned categorization.

When both restricted and unrestricted resources are available for use, it is the Center's policy to use restricted resources first and then unrestricted resources, as they are needed.

(h) *Use of Estimates*

The financial statements are prepared in conformity with accounting principles generally accepted in the United States, which requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 3 – CASH AND CASH EQUIVALENTS

The Center’s cash and cash equivalents consist of the following at February 4, 2019:

Petty cash	\$ 11,733
Deposits with financial institutions:	
Non-interest bearing	1,007,812
Funds deposited in the City’s cash and investment pool	<u>2,647,518</u>
Total cash and investments	<u><u>\$ 3,667,063</u></u>

Under the terms of the Comerica loan agreement between the City and Comerica bank, which is no longer in effect due to the pay-off of all Comerica loans on October 29, 2008, the Center was required to set aside certain revenues into a furniture, fixtures and equipment (“FF&E”) reserve. Although no longer a requirement for the period ended February 4, 2019, management has decided to continue this practice. During the period, the Center transferred \$352,601 into the City’s cash pool to fund future capital acquisitions related to furniture, fixtures and equipment. The FF&E reserve monthly contribution is an amount equal to four percent of gross revenues for the previous calendar month to be utilized to pay for (i) costs of any single repair to or at the Center that exceeds \$5,000 and (ii) capital expenditures on or at the Center. A summary of activities of the FF&E Reserve Account for the period ended February 4, 2019 is as follows:

FF&E Reserve Account	Amount
Beginning balance, July 1, 2018	\$ 2,301,225
Contributions from City during the year	352,601
Withdrawals during the period	<u>(6,308)</u>
Ending balance, February 4, 2019	<u><u>\$ 2,647,518</u></u>

Custodial Credit Risk

The Center’s uninsured deposits are collateralized in the manner prescribed by State law. The amounts placed on deposit with financial institutions were covered by federal depository insurance or were collateralized by the pledging financial institutions as required by Section 53652 of the California Government Code. Such collateral is held by the pledging financial institutions’ trust department or agent in the City’s name. Accordingly, the exposure to custodial credit risk is low as of and for the period ended February 4, 2019.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 4 – CAPITAL ASSETS

The following is a summary of the changes in capital assets for the period ended February 4, 2019:

	Balance July 1, 2018	Additions	Deletions/ Transfers	Balance February 4, 2019
<i>Depreciable capital assets, gross:</i>				
Furniture and equipment	\$ 3,556,354	\$ 32,685	\$ -	\$ 3,589,039
<i>Less accumulated depreciation:</i>				
Furniture and equipment	(2,606,486)	(150,486)	-	(2,756,972)
Total depreciable capital assets, net	<u>\$ 949,868</u>	<u>\$ (117,801)</u>	<u>\$ -</u>	<u>\$ 832,067</u>

NOTE 5 – LOANS PAYABLE

Devcon Construction Incorporated

Prior to November 1, 2003, Hayes Renaissance, L.P. (“HRLP”) provided the operations, management and reporting of the Center. The lease agreement between the City and HRLP was terminated due to HRLP’s inability to meet the terms and conditions of the agreement. Upon termination, the City agreed to assume HRLP’s liability to Devcon Construction Incorporated (“Devcon”) in the amount of \$1.2 million, and entered into a repayment agreement with Devcon, with no payment of interest and no maturity date, on a subordinated basis from the Center’s net revenues (operating income adjusted for depreciation expense, FF&E reserve, and bond and other expenses), as defined in the repayment agreement between the City and Devcon. The \$1.2 million was repaid to Devcon from the proceeds of sale on February 5, 2019.

NOTE 6 – OPERATING LEASES

The Center entered into various operating agreements for vehicles and phone system equipment for the Center’s operations. The terms of the agreements expire at various dates through March 1, 2020. Operating lease expenses for the Center’s vehicle and office equipment leases for the period ending February 4, 2019 was \$7,187 and \$7,189, respectively.

NOTE 7 – RELATED PARTY TRANSACTIONS

(a) *Contributions from the City’s General Fund*

For the period ended February 4, 2019, the Center reported \$2,050,000 contributions from the City’s General Fund, which was used to fund debt service payments to the City. \$1,500,000 was received as of February 4, 2019, while \$550,000 was subsequently received by the Center after the sale date.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 7 – RELATED PARTY TRANSACTIONS (Continued)

(b) Charges to Other Funds of the City

During the period ended February 4, 2019, the Center transferred to other funds of the City the following amounts to reimburse the City for expenses incurred on behalf of the Center:

Hayes Mansion bond and other expenses	\$	3,456,205
General and administrative expenses		40,233
Insurance premiums		23,504
Total	\$	3,519,942

Hayes Mansion Bond and Other Expenses - During the period ended February 4, 2019, the Center made nonoperating payments of \$3,456,205 to other funds of the City for reimbursement of bond expenses paid by the City and for repayment of other expenses.

The City of San José Financing Authority (“SJFA”), a component unit of the City, issued lease revenue bonds in 1993 for various capital improvements that in turn made the City funds available for the construction of improvements to the Center known as Phase I improvements in the original aggregate amount of approximately \$11 million. A portion of these bonds in the amount of approximately \$5.8 million (of which approximately \$5.1 million related to the Center) was refunded in June 2007 when SJFA issued Lease Revenue Bonds Series 2007A. SJFA also issued lease revenue bonds in 2001 for the construction of additional improvements to the Center known as Phase III improvements, improvements to the adjacent Edenvale Garden Park and the refunding of the 1995 lease revenue bonds previously issued by the SJFA for improvements to the Center in the aggregate amount of approximately \$53.3 million. These bonds were refunded in June 2008, when SJFA issued Lease Revenue Bonds Series 2008C and 2008D related to the Center in the aggregate amount of \$58.3 million.

The City is obligated to make the lease payments to SJFA that in turn pay debt service on the outstanding bonds, and the Center reimburses the City for such costs.

In December 2013, SJFA purchased in lieu of redemption the SJFA variable rate 2008C Bonds in the amount of \$10,915,000 and the SJFA variable rate 2008D Bonds in the amount \$28,920,000. In addition, SJFA converted all of its outstanding 2008C and 2008D variable rate bonds to index rate bonds and placed them directly with U.S. Bank National Association (“U.S. Bank”). This private placement generates savings for the City and particularly to the Center due to the lower fees charged by US Bank compared to the fees charged for Letters of Credit that previously supported the SJFA 2008C and 2008D Bonds.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 7 – RELATED PARTY TRANSACTIONS (Continued)

On February 6, 2019, SJFA paid off the SJFA 2008C Bonds principal amount of \$10,915,000 and the SJFA 2008D Bonds in the amount of \$17,545,000. The interest payments made were \$142,430 and \$327,502, respectively.

Additional information on the debt related to the Center may be obtained from the long-term debt disclosure in the City's basic financial statements.

General and Administrative Expenses – During the period ended February 4, 2019, the Center was allocated total charges of \$40,233 comprised of: (1) \$6,785 to pay the cost of a City employee to administer and monitor long-term debt as it relates to the Center (not to exceed \$10,000 per contract year) and (2) \$33,448 to pay for other administrative and general expenses.

Insurance Premiums – The Center paid \$23,504 for the cost of insurance premiums for policies maintained by the City with respect to the Center, which are reported as insurance expense. The Center is covered under the City's annual all-risk property insurance policy. The policy is a \$1 billion blanket property policy covering all City owned locations, including the Center.

NOTE 8 – COMMITMENTS

Management Agreement

The City entered into a Management Agreement (the "Agreement") with Dolce to operate and manage the Center. The original term of the Agreement was for the period from January 1, 2004 through June 30, 2014. Dolce has the right and option to extend the original term for two successive periods of five calendar years each, provided it meets certain requirements as defined in the Agreement. In November 2013, Dolce elected to exercise the renewal option to extend the term of the Agreement for a period of five years.

As compensation for the services to be rendered by Dolce pursuant to the Agreement, the City pays Dolce a monthly base management fee of 3% of monthly gross revenues. In accordance with the Agreement, the management fee is reduced to 2% if none of the two required performance measures are met. For the period ended February 4, 2019, Dolce met one of the two required performance measures, so the monthly base management fee was calculated based on 3% of the Center's gross revenues, which amounted to \$264,455 for the period ended February 4, 2019.

Dolce is also entitled to an incentive management fee during each contract year, as defined in the Agreement, which is variable based on the Center's profitability. For the period ended February 4, 2019, Dolce did not meet the performance objectives entitling them to an incentive management fee. However, Dolce is entitled to a termination fee of \$480,151, which was caused by the sale of the Center, as discussed more fully in Note 10.

HAYES MANSION CONFERENCE CENTER
Notes to Financial Statements
For the Period from July 1, 2018 through February 4, 2019

NOTE 9 – CONTINGENCIES

The Center was exposed to various risks of losses related to potential lawsuits or claims. The Center maintained commercial insurance coverages through the date of sale of Hayes Mansion. The City is of the opinion that no lawsuits or claims will have a material adverse effect on the Center's financial position. In addition, subsequent to the sale of Hayes Mansion, the City has been involved with ongoing final settlement negotiations with both the buyer and with Dolce, which the City believes is immaterial to the financial statements of the Center.

NOTE 10 – SALE OF HAYES MANSION

On August 7, 2018, the SJFA signed a Purchase and Sale Agreement (PSA) with JMA Ventures, LLC, a Delaware limited liability company ("Purchaser"), to sell and transfer certain improved real property commonly known as the Hayes Mansion, and related rights, personal property, and intangible property. Concurrent with the closing of the sale of the Hayes Mansion to the Purchaser, the SJFA intends to transfer the property to the City and the City will consummate the sale of the Hayes Mansion to the Purchaser for a purchase price of \$30,000,000 plus amounts to be determined in accordance with the PSA for the accounts receivable and food and beverage inventory and less the amount of the closing costs allocated to City under the PSA.

On November 6, 2018, the City Council adopted a resolution authorizing staff to negotiate certain amendments to the terms of the PSA to facilitate Purchaser's property approval and continue toward the close of escrow and completion of Hayes Mansion sale.

On November 6, 2018, the City Council adopted a resolution authorizing staff to negotiate certain amendments to the terms of the PSA to facilitate Purchaser's property approval and continue toward the close of escrow and completion of Hayes Mansion sale.

There were various milestones for the Purchaser to meet, including: reviewing and approving all information related to the property, conducting and approving various property inspections, obtaining an Alcoholic Beverage License (ABC License), and fully executing collective bargaining agreements with the labor unions before the sale could be finalized. The Purchaser completed all milestones and the sale was finalized on February 4, 2019 and effective February 5, 2019, the City no longer owns and operates the Center.

The sale of Hayes Mansion allowed the City to eliminate all outstanding long-term bond debt against the property and eliminate the ongoing General Fund subsidy for debt service, which ranged from \$1,000,000 to \$9,100,000 per year since 2003.