

CITY OF SAN JOSE

Report to Those Charged With Governance

For the Year Ended June 30, 2022



Certified
Public
Accountants

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2022

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Honorable Mayor and City Council
City of José, California

In planning and performing our audit of the basic financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information, of the City of San José, California (City), as of and for the year ended June 30, 2022, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, 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 our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control over financial reporting.

In addition to the City's basic financial statements, we audit and separately report on the following financial statements as of and for the year ended June 30, 2022. These entities are included in the City's basic financial statements:

- Successor Agency to the Redevelopment Agency of the City of San José;
- Norman Y. Mineta San José International Airport;
- Parks and Recreation Bond Projects Fund;
- Branch Library Bond Projects Fund;
- Library Parcel Tax Special Revenue Fund;
- Neighborhood Security Bond Projects Fund;
- Pedestrian/Bicycle Facilities Grant;
- Public Safety and Infrastructure Bond Projects Fund;
- San José Clean Energy Enterprise Fund;
- South Bay Water Recycling Program and System; and
- City of San José Deferred Compensation Plans.

We did not audit the financial statements of the City of San José Federated City Employees' Retirement System and the City of San José Police and Fire Department Retirement Plan (collectively, "the Pension Trust Funds"). Those statements were separately reported on by other auditors and the required communications related to those audits were presented to the respective Retirement Boards.

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 a combination of deficiencies, in internal control over financial reporting, 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. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

- *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
- *Probable.* The future event or events are likely to occur.

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 material weaknesses. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this communication, which is an integral part of our audit, is to describe, for management and those charged with governance, the scope of our testing of internal control and the results of that testing. Accordingly, this communication is not intended to be and should not be used for any other purpose.

Macias Gini & O'Connell LLP

Walnut Creek, California
November 17, 2022

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We have audited the financial statements of City of San José, California (City) as of and for the year ended June 30, 2022, and have issued our report thereon dated November 17, 2022. The City's basic financial statements include the other entities we audited as described in the transmittal letter of this communication. Professional standards require that we advise you of the following matters relating to our audit.

Our Responsibility in Relation to the Financial Statement Audit

As communicated in our engagement letter dated July 21, 2022, our responsibility, as described by professional standards, is to form and express an opinion(s) about whether the financial statements that have been prepared by management with your oversight are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America. Our audit of the financial statements does not relieve you or management of your respective responsibilities.

Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, as part of our audit, we considered the internal control of the City solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

We are also responsible for communicating significant matters related to the audit that are, in our professional judgment, relevant to your responsibilities in overseeing the financial reporting process. However, we are not required to design procedures for the purpose of identifying other matters to communicate to you.

Planned Scope and Timing of the Audit

We conducted our audit consistent with the planned scope and timing we previously communicated to you.

Compliance with All Ethics Requirements Regarding Independence

The engagement team, others in our firm, as appropriate, our firm, and our network firms have complied with all relevant ethical requirements regarding independence.

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Qualitative Aspects of the Entity's Significant Accounting Practices

Significant Accounting Policies

Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note I to the financial statements. As described in Note I.E. to the financial statements, during the fiscal year, the City implemented the following Governmental Accounting Standards Board (GASB) Statements:

- **GASB Statement No. 87 – Leases**

This statement establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset as specified in the contract for a period of time in an exchange or exchange-like transaction. Under this statement, a lessee is required to recognize a lease liability and an intangible right to use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources. The required changes are reflected in the City's financial statements and notes to those statements. Adoption of the new standards resulted in restatement of beginning balances for assets, deferred inflows of resources, and liabilities for those funds and activities with leases under the scope of GASB Statement No. 87; however, the only beginning net position restatement was for \$271,000 in the Norman Y. Mineta San José International Airport fund.

- **GASB Statement No. 89 – Accounting for Interest Cost Incurred before the End of a Construction Period**

This statement requires that interest costs incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. As a result, interest cost incurred before the end of a construction period will not be included in the historical cost of a capital asset reported in a business-type activity or enterprise fund, and fiduciary fund. The City previously updated the Capitalized Interest policy to no longer capitalize interest for the Wastewater Treatment System Fund which had an immaterial impact to the financial statements. This statement did not have any effect on the City's financial statements.

- **GASB Statement No. 92 – Omnibus 2020**

This statement is to enhance comparability in accounting and financial reporting and to improve the consistency of authoritative literature by addressing practice issues that have been identified during implementation and application of certain GASB Statements. This statement addresses a variety of topics and includes specific provisions about the following: The effective date of Statement No. 87, *Leases*, and Implementation Guide No. 2019-3, *Leases*, for interim financial reports; Reporting of intra-entity transfers of assets between a primary government employer and a component unit defined pension plan or defined benefit other postemployment benefit (OPEB) plan; the applicability of Statements No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68*, and *Amendments to Certain Provisions of GASB Statements 67 and 68*, as amended, to reporting assets accumulated for postemployment benefits; the applicability of certain requirements of Statement No. 84, *Fiduciary Activities*, to postemployment benefits; the applicability of certain requirements of Statement No. 84, *Fiduciary Activities*, to postemployment benefits arrangements; measurement of liabilities (and assets, if any) related to asset retirement obligations (AROs) in a government acquisition; reporting by public entity risk pools for amounts that are recoverable from reinsurers

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or excess insurers; reference to nonrecurring fair value measurements of assets or liabilities in authoritative literature; and terminology used to refer to derivative instruments. This statement did not have any effect on the City's financial statements.

- **GASB Statement No. 93 – *Replacement of Interbank Offered Rates***
This statement addresses those and other accounting and financial reporting implications that result from the replacement of an Interbank Offered Rate (IBOR). The City did not have any direct exposure to derivative contracts tied to London Interbank Offered Rate (LIBOR) as of June 30, 2022. This statement did not have any effect on the City's financial statements.

- **GASB Statement No. 99 – *Omnibus 2022***
This statement addresses the following and did not have any effect on the City's financial statements: (i) extension of the period during which LIBOR is considered an appropriate benchmark interest rate for the qualitative evaluation of the effectiveness of an interest rate swap that hedges the interest rate of taxable debt, (ii) disclosures related to nonmonetary transactions, (iii) pledges of future revenues when resources are not received by the pledging government, (iv) accounting for the distribution of benefits as part of the Supplemental Nutrition Assistance Program, (v) classification of provisions in Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – For State and Local Governments*, as amended, related to the focus of the government-wide financial statements, (vi) terminology used in Statement 53 to refer to resource flows statements, and (vii) terminology updates related to certain provisions of Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*.

No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

Significant Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on 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 markedly from management's current judgments.

The most sensitive accounting estimates affecting the financial statements are:

- Measurement of investments at fair value
- Estimated allowance for losses on accounts receivable
- Estimated allowance for losses on loans receivable
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Accrual of compensated absences
- Accrual and disclosure of self-insurance claims liabilities
- Accrual and disclosure of pollution remediation obligations
- Measurement of the pension contributions, net pension liability, pension expense, and pension-related deferred outflows and inflows of resources

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- Measurement of the other postemployment benefits (OPEB) contributions, net OPEB liability, OPEB expense, and OPEB-related deferred outflows and inflows of resources
- Measurement of the lease liability and leases receivable

Management's estimates were based on the following:

- The City's investments are accounted for in accordance with the provisions of GASB Statement No. 72, *Fair Value Measurement and Application*, and accordingly, its fair value measurements are categorized within the fair value hierarchy established by the standard. The following levels indicate the hierarchy of inputs used to measure fair value and the primary valuation methodologies used for financial instruments measured at fair value on a recurring basis:
 - Level 1 – Investments whose values are based on quoted prices (unadjusted) for identical assets in active markets that a government can access at the measurement date.
 - Level 2 – Investments whose values are based on inputs – other than quoted prices including prices included within level 1 – that are observable for an asset, either directly or indirectly.
 - Level 3 – Investments whose values are based on unobservable inputs for an asset and may require a degree of professional judgment.
- Estimated allowance for losses on accounts receivable was based on historical experience.
- Estimated 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 such other factors that, in management's judgment, deserve recognition in estimating potential loan losses. The allowance for risk takes into consideration maturity dates, interest rates, and other relevant factors. The allowance for present value discount gives recognition to the economic cost of providing loans at interest rates below market and represents management's estimate of the present value of projected net cash flows to the City from the loan portfolio.
- 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.
- Accrual of compensated absences was based on accrued eligible hours of vacation, sick leave and other compensatory time at current pay rates for eligible employees.
- Estimated liabilities for workers' compensation claims were based on management's estimate obtained from information derived from Intercare's (a third-party administrator) claims database system adjusted for a discounted projection of the ultimate cost of known claims and unreported claims at 1.5%. Estimated liabilities for general liability and other claims were determined by the City Attorney's judgment about the ultimate outcome of the claims.
- Accrual and disclosures of pollution remediation obligations were determined by the City's engineers and its environmental consultants' judgments about the ultimate outcome of the obligations.
- Pension plans' employer and employee contributions requirements, net pension liability, and related deferred outflows and inflows of resources were based on actuarial valuations prepared by the Pension Trust Funds and CalPERS.
- OPEB plans' employer and employee contributions requirements, net OPEB liability, and related deferred outflows and inflows of resources were based on actuarial valuations prepared by the Pension Trust Funds.

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- The discount rate used for the calculation of the lease liability and leases receivable are based on the City's estimated incremental borrowing rate using the national average fixed-rate loan on July 1, 2021 for the implementation date and on the date of lease commencement thereafter.

Except for the fair value of the Pension Trust Funds investments and the pension and OPEB plans information based on actuarial valuations, we evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the basic financial statements taken as a whole and in relation to the applicable opinion units. The fair value of the Pension Trust Funds investments and the pension and OPEB plans information based on actuarial valuations were agreed to the separately audited financial statements of the Pension Trust Funds, which were reported on by other auditors.

Financial Statement Disclosures

Certain financial statement disclosures involve significant judgment and are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the City's financial statements relate to:

- The City's Defined Benefit Retirement Plans and Postemployment Benefit Plans Other than Pension Plans described in Note IV.A.
- Disclosures regarding the Successor Agency to the Redevelopment Agency of the City of San José described in Note IV.C.

Significant Difficulties Encountered during the Audit

We encountered no significant difficulties in dealing with management relating to the performance of the audit.

Uncorrected Misstatements

For purposes of this communication, professional standards also require us to accumulate all known and likely misstatements identified during the audit, other than those that we believe are trivial, and communicate them to the appropriate level of management. Further, professional standards require us to also communicate the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole and each applicable opinion unit. The attached schedule summarizes uncorrected financial statement misstatements whose effects in the current and prior periods, as determined by management, are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even though the uncorrected misstatements are immaterial to the financial statements currently under audit.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter, which could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

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Representations Requested from Management

We have requested certain written representations from management, which are included in the attached letter dated November 17, 2022.

Management's Consultations with Other Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters. Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Other Significant Matters, Findings, or Issues

In the normal course of our professional association with the City, we generally discuss a variety of matters, including the application of accounting principles and auditing standards, significant events or transactions that occurred during the year, operating and regulatory conditions affecting the entity, and operational plans and strategies that may affect the risks of material misstatement. None of the matters discussed resulted in a condition to our retention as the City's auditors.

Other Information in Documents Containing Audited Financial Statements

Pursuant to professional standards, our responsibility as auditors for other information, whether financial or nonfinancial, included in the City's audited financial statements, does not extend beyond the information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. However, in accordance with such standards, we have we have applied certain limited procedures to the management's discussion and analysis; the schedules of revenues, expenditures and changes in fund balance – budget and actual for the General Fund, Housing Activities Fund, and Low and Moderate Income Housing Asset Fund; the schedule of employer contributions – defined benefit pension plans; the schedule of changes in the employer's net pension liability and related ratios for the measurement periods ended June 30 – defined benefit pension plans; the schedule of investment returns – defined benefit pension plans; the schedule of the City's proportionate share of the net pension liability and related ratios – CalPERS; the schedule of employer contributions – CalPERS; the schedule of changes in the employer's net OPEB liability and related ratios for the measurement periods ended June 30 – postemployment healthcare plans; and the schedule of employer contributions – postemployment healthcare plans, which are required supplementary information (RSI) that supplement the basic financial statements. Our procedures and the other auditors procedures for the Pension Trust Funds consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, the separately audited financial statements of the Pension Trust Funds, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

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We were engaged to report on combining and individual fund financial statements and schedules listed as supplemental information, which accompany the financial statements but are not RSI. With respect to this supplemental information, except for the supplemental information for the Pension Trust Funds, 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 supplemental information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves. The supplemental information for the Pension Trust Funds was agreed to the separately audited financial statements of the Pension Trust Funds, which were reported on by other auditors.

We were not engaged to report on the introductory and the statistical sections, which accompany the City's basic financial statements but are not RSI. We did not audit or perform other procedures on this other information and we do not express an opinion or provide any assurance on it.

Our responsibility also includes communicating to you any information which we believe is a material misstatement of fact. 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.

Modification of the Auditor's Report

Our report includes an emphasis of matter paragraph to reference to Note 1.E. to the financial statements for the City's implementation of GASB Statement No. 87, *Leases*. Our opinion is not modified with respect to this matter.

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STATUS OF PRIOR YEAR'S FINDING

Finding 2021-001 – Material Weakness
Internal Controls Over the Financial Reporting Process

Internal control is an integral process that is designed 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, regulations, contracts and grant agreements; and
- Safeguarding resources against loss, misuse and damage.

Internal control is a dynamic integral process that should be continuously adapting to the changes the City is facing. The City started to address its staffing challenges by filling vacant positions and adding new personnel in the Finance Department.

While the City has been successful in recruiting professionals to fill vacant positions over the past four years, it has been challenged with retaining these professionals. As such, the City has been continuously training and integrating new personnel into the City's complex accounting and financial reporting process. This rebuilding of staff has increased the workload of the remaining seasoned professionals, which contributed to errors or proposed audit adjustments to the financial reporting such as the following:

- In fiscal year 2019-20, the City's Housing Activities Fund was awarded a State grant in the amount of \$23.8 million. The award was received upfront as an advance, and \$14.9 million was recognized as grant revenue in fiscal year 2019-20. However, only \$2.5 million should have been recognized as revenue in fiscal year 2019-20. The City should only recognize revenue as it incurs eligible costs, and report unearned revenue for the award amount where eligible costs are not yet incurred. An adjustment to the Housing Activities Fund in the amount of \$12.4 million was necessary to properly report fund balance and governmental activities net position and unearned revenue at the beginning of the year for the fiscal year 2020-21.
- Errors made in accounts payable for end of year cut-off analysis, in the amounts of \$5.8 million and \$2.7 million in its governmental and proprietary funds, respectively.
- Errors made in the classification between unearned revenue and deferred revenue in the amount of \$12.9 million in a nonmajor governmental fund.
- Proper asset classification for cash received as of end of year by decreasing accounts receivable and increasing cash for the Low and Moderate Income Housing Asset Fund in the amount of \$7.9 million.

In addition, there were numerous adjusting entries made by the City after the initial close of its financial records for financial statement presentation. This resulted in increased staff effort in re-performing reconciliations to substantiate account balances. This continued practice could cause possible irregularities, delays, and errors without timely identification.

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We recommend that the City continue evaluating the causes for the deficiencies reported above and to incorporate the necessary tasks during its closing process to prevent these types of errors in the future. This includes minimizing manual reconciliations to the General Ledger and manual adjusting entries for financial statement presentation. In addition, the City should continue to develop the skills and experience of its new personnel assigned to key roles in the preparation of the annual financial statements to improve the efficiency of its financial reporting process, including cross-training to minimize the impacts of further turnover.

Status: Corrected.

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SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

		Account / Adjustment Description	Debit	Credit
			(Dollars in thousands)	
1	Governmental Activities	Allowance for Uncollectibles	\$ 2,565	
	Governmental Activities	Expenses		\$ 2,565
	Low and Moderate Income Housing Asset	Allowance for Uncollectibles	\$ 2,565	
	Low and Moderate Income Housing Asset	Loans Reserve		\$ 2,565

To decrease the overstated loan loss reserves balance for the Low and Moderate Income Housing Asset Fund (Fund 346) and for the impact to the Governmental Activities opinion unit.