

CITY OF SAN JOSE

Report to the Making Government
Work Better Committee

Fiscal Year Ended
June 30, 2005



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Members of the Making Government
Work Better Committee and
San José City Council
San José, California

In planning and performing our audit of the basic financial statements of the City of San José (City) as of and for the fiscal year ended June 30, 2005, we considered the City's internal controls in order to determine our auditing procedures for the purpose of expressing an opinion on the basic financial statements and not to provide assurance on internal controls.

However, during our audit we became aware of instances that we consider opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and recommendations regarding these matters. This letter does not affect our report dated September 16, 2005, on the basic financial statements of the City.

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 these recommendations.

Additionally, we have included in this letter a report on communications with the Making Government Work Better Committee (Committee) as required by auditing standards generally accepted in the United States of America.

The accompanying required communications, comments and recommendations are intended solely for the information and use of the Committee, City Council and management of the City and are not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

MACIAS GINI & COMPANY LLP

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

September 16, 2005



CITY OF SAN JOSE

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REQUIRED COMMUNICATIONS

Professional auditing standards require auditors to communicate with the audit committee, or its equivalent, on a number of subjects. The following information satisfies these requirements, and is solely for use of the Committee, City Council and City management.

I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards and OMB Circular A-133

As stated in our engagement communications letter dated June 24, 2005, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free from material misstatements and are fairly presented in accordance with U.S. generally accepted accounting principles. Because an audit is designed to provide reasonable, but not absolute assurance and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us.

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program, in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal controls over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatements, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined, on a test basis, evidence about the City's compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* applicable to each of its major federal programs for the purpose of expressing an opinion on the City's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination on the City's compliance with those requirements.

II. Significant Accounting Policies

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our contract with the City, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the City are described in Note 1 to the City's basic financial statements. With the exception of the two items described below, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2005.

Deposit and Investment Risk Disclosures - As described in Note I to the basic financial statements, the City implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3*. This Statement modifies the custodial credit risk disclosures required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements* and addresses deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk.

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REQUIRED COMMUNICATIONS (Continued)

Estimation Approach for Workers' Compensation Claims Liability – During the year, the City changed its methodology for estimating its workers' compensation claims liability. In prior years the City engaged a professional actuary to develop this estimate. However, in the current year, the City began using a methodology that relies exclusively on information provided by the City's claims database system. The effect of this change was a reduction in the workers' compensation liability from \$126,773,000 to \$105,932,000 at June 30, 2005.

We noted no transactions entered into by the City during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

III. Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- Fair value of investments
- Estimated allowance for losses on accounts receivable
- Estimated valuation allowance on loans receivable
- Estimated liability for self-insurance claims
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Pension plans' employer and employee contribution requirements

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.

IV. Audit Adjustments

For the purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the City's financial reporting process (that is, cause future financial statements to be materially misstated). In our judgment, none of the adjustments we proposed, whether recorded or unrecorded by the City, either individually or in the aggregate, indicate matters that could have a significant effect on the City's financial reporting process. In addition, 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 individual financial reporting units that collectively comprise the City's basic financial statements.

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REQUIRED COMMUNICATIONS (Continued)

V. 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 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.

VI. Consultations with Other 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.

VII. Issues Discussed with Management Prior to Our Retention

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.

VIII. Difficulties in Performing the Audit

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

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CURRENT YEAR RECOMMENDATIONS

The Cascade Effect of Sarbanes-Oxley

As one of the top ten (largest) cities in the United States, with government-wide assets of nearly \$12 billion, both management and the City Council have a significant stewardship responsibility. In fact, the breadth and scope of oversight responsibilities for a top 10 U.S. City dwarfs that of many SEC registrants that are now required to comply with the provisions of the Sarbanes-Oxley Act (SOX). Across the Country, many government stakeholders are beginning to ask the question –

“Why shouldn’t governments be required to establish and maintain the same quality of controls as SEC companies?”

This question goes beyond some of the basic corporate governance reforms and is really directed at internal controls that strengthen financial management. At the federal level, agencies are now required to meet “SOX like” expectations for internal controls. More and more, we hear that bond analysts, ratings agencies, and underwriters are focusing on better governance and stronger internal controls. In our view, it’s only a matter of time before similar requirements will be mandated for local governments.

We recommend the City’s Finance Department, in coordination with the City Auditor, begin developing an internal controls management program similar to the type contemplated by SOX and OMB Circular A-123. The objectives of the program should include: adoption of a control framework, documentation and testing of key process controls, with a focus on fraud prevention and improved financial reporting. Annually, City management should report on this program to the Making Government Work Better Committee and provide an assertion on the status of the City’s internal controls. Remember that this is a “program” not a “project” and should be built upon sustaining mechanisms (e.g., enabling technologies, controls repository and tracking system). NOTE: the City would be the first large local government in the country to adopt this best practice.

Management Response:

Management agrees that internal controls must continually be examined and updated as necessary in order to keep pace with an ever changing organization. Changes, whether driven by economic or other factors, must always be balanced by a realistic risk assessment to determine if the change significantly exposes the City to misrepresentation, misappropriation or fraud. As always, the City will be an active participant in dialogue related to this subject in the coming months.

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Monitoring Reserve Requirements

While testing for compliance with significant debt covenants, we noted the City did not maintain the minimum reserve requirements for the following bonds:

**1. City of San Jose Financing Authority,
Taxable Lease Revenue Bonds, 2000 Series C**

The City is required to have in the reserve account an amount equal to the maximum annual debt service on the bonds. At June 30, 2005, the reserve balance was below the reserve requirement by \$264,359. Upon further discussion with City staff, the required reserve is based upon the City's calculated maximum annual debt service requirement. However, staff inadvertently miscalculated this amount and was therefore unaware that the reserves had dropped below the required level.

**2. City of San Jose Financing Authority,
Subordinated Reassessment Revenue Bonds, 1994 Series B**

At June 30, 2005, the City's reserve requirement was \$772,824. During our analysis we noted the reserve balance was below this requirement by \$312,123. Based on our discussion with City staff, management originally intended to call the 1994 Series B Bonds in 2004 and instructed the Trustee to transfer funds from the reserve account to the redemption account for this purpose. However, the bond call did not occur and the Trustee did not return the transferred funds back to the reserve account, which caused the insufficient reserve position.

**3. City of San Jose Limited Obligation Refunding Bonds
Reassessment District No. 02-219SJ
(2002 Consolidated Refunding) Series 24R**

During the fiscal year, the City called a portion of these bonds. Upon executing the bond call, City staff calculated and released the appropriate portion of the reserve fund. However, the Trustee incorrectly calculated an additional amount to be released as part of the call and transferred this amount to the redemption fund. As a result, the City's reserve balance was below the requirement by \$179,944 at June 30, 2005.

We recommend that compliance with reserve requirements be closely monitored; especially when reserve account transfers are made in anticipation of exercising early call options. Periodic reviews and monitoring of these accounts will provide greater assurance that the City is maintaining compliance with its debt covenants and that defaults are identified and corrected in a timely manner.

Management Response:

Management agrees with the Auditor's recommendation and has instituted a monthly review of reserve requirements and reserve accounts to: (i) identify any needed changes to reserve requirements; (ii) identify any erroneous transactions; and (iii) insure compliance with bond covenants. Of the three bond series noted above, one was called in September 2005 and is no longer outstanding and the reserve balances of the other two have been brought into compliance.

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STATUS OF PRIOR YEAR COMMENTS

Comment:	<i>Post-retirement Health Care Benefits</i>
Condition/Effect:	In February 2003, the Governmental Accounting Standards Board (GASB) issued proposed rules on accounting and financial reporting by employers for post-retirement health care benefits other than pensions. These new rules will require the actuaries of the Federated City Employees' Retirement System (System) and the San Jose Police and Fire Department Retirement Plan (Plan) to project the total cost of these health benefits when developing the annual required contribution (ARC), and this amount will need to be reported and disclosed in the financial statements. This is a significant change from the System and the Plan's past practice of using 15-year and 10-year funding horizons, respectively, for purposes of the ARC.
Recommendation:	We recommend consulting with the System and the Plan's actuaries to develop a better understanding and to quantify the impact of these proposed rules, and to monitor the development of these accounting pronouncements.
Status:	In progress. The City is continuing to receive and review information regarding the implementation requirements for these new rules.
Comment:	<i>Update Claims Liability Guidelines</i>
Condition:	In November 1994, the City adopted guidelines for developing its workers' compensation claims liability estimates. These guidelines did not contemplate the use of outside actuaries when developing such estimates. However, we noted the City uses an actuarial report as the primary basis for both its workers' compensation and general claims liabilities estimates. We also noted the City does not have a specific policy stipulating how often actuarial studies should be performed.
Recommendation:	We recommend the City augment the current guidelines to provide an option for the use of outside actuaries and clarify the frequency and timing of actuarial valuations.
Status:	In progress.

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- Comment: ***Unresolved Bank Reconciliation Activity***
- Condition: While testing the City’s bank reconciliation process, we noted the bank reconciliation completed as of June 30, 2004 included a number of aged reconciling items. While the dollar amount of these items is not material, they should be investigated and resolved. The majority of items are identified on the bank reconciliation as differences between payroll disbursement interfaces and cash disbursements.
- Recommendation: We recommend the City investigate and resolve these aged reconciling items. Failure to resolve identified differences in a timely manner could make them increasingly difficult to trace and may result in potential errors or intentional misstatements going undetected.
- Status: In progress. The City has focused its effort on developing new methods and procedures to record payroll transactions in order to eliminate differences between payroll disbursement interfaces and cash disbursements. Specifically, liability accounts for payroll related disbursements have been established in the City’s financial management system to separate the various payroll related components and facilitate resolving any differences. Payroll staff will commence using the liability accounts to record transactions during FY 2005-06. Aged outstanding items will be addressed when the new method of recording payroll transactions have been stabilized.
- Comment: ***Repayment of Net Pension Obligation***
- Condition: During fiscal year 1997/1998, the City implemented GASB Statement No. 27, Accounting for Pensions by State and Local Governmental Employers. As of July 1, 1997, the City recorded a net pension obligation in the amount of \$2.3 million for the Federated Employees’ Retirement System (System). Since recording this obligation, it has grown from \$2.3 million to \$3.2 million at June 30, 2004.
- Recommendation: We recommend City staff work with the Federated Pension Board to develop a funding plan. Developing a funding plan will demonstrate the City’s commitment to funding this obligation and establish a timeline to accomplish this goal.
- Status: In progress. The City’s Finance Department is working with the Department of Retirement Services to determine the proper amount to be included in its funding plan.

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Comment: ***Completeness of the Schedule of Expenditures of Federal Awards***

Condition: The U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments and Non-Profit Organizations (OMB Circular A-133), requires that the City prepare a schedule showing total expenditures for the year for each federal program (SEFA). During our review of the SEFA, we noted that federal program 97.004 State Domestic Preparedness Equipment Support Program in the amount of \$170,198 had not been included in the SEFA schedules in the current year because the City did not classify the funds as a federal grant.

Recommendation: We recommend that the City provide training and instruction to its departments regarding the importance of properly classifying federal grant expenditures in order to ensure that all federal programs are identified in the SEFA.

Status: Implemented

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SUMMARY OF UNCORRECTED ADJUSTMENTS

Governmental Funds

Impact of Adjustments on Fund Financial Statement Captions (\$000) - Increase (Decrease)

Description (Nature) of Audit Difference	Statement of Net Assets			Changes of Net Assets		
	Assets	Liabilities	Net Assets	Current Year	Prior Year	Total
GENERAL FUND						
Adjust investment to fair value	\$ (145)	\$ -	\$ (145)	\$ (145)	\$ 1,401	\$ 1,256
Adjustment to revenue accruals estimates to reflect actual subsequent receipts	486	1,244	648	648	(896)	(248)
Adjustment to revenue accruals (not available)	-	324	(324)	(324)	-	(324)
Total	\$ 341	\$ 1,568	\$ 179	\$ 179	\$ 505	\$ 684
Financial statement amounts	\$ 233,749	\$ 41,718	\$ 192,031			\$ 8,692
Impact as a percentage of f/s amounts	0.15%	3.76%	0.09%			7.87%
REDEVELOPMENT AGENCY						
Adjust investment to fair value on deposits	\$ -	\$ -	\$ -	\$ -	\$ (38)	\$ (38)
Adjust revenue accruals	-	-	-	-	(36)	(36)
Adjust deferred revenue	-	-	-	-	46	46
Accrual of unrecorded expenditures and accounts payable	-	-	-	-	118	118
Accrual of interest payable on Parking Fund's advance	-	19	(19)	(19)	-	(19)
Total	\$ -	\$ 19	\$ (19)	\$ (19)	\$ 90	\$ 71
Financial statement amounts	\$ 296,859	\$ 67,590	\$ 229,269			\$ (34,292)
Impact as a percentage of f/s amounts	0.00%	0.03%	-0.01%			-0.21%
HOUSING ACTIVITIES						
To adjust book value of investments to reflect actual gain on sale	\$ (27)	\$ -	\$ (27)	\$ (27)	\$ -	\$ (27)
Accrual of unrecorded expenditures and accounts payable	-	-	-	-	924	924
Total	\$ (27)	\$ -	\$ (27)	\$ (27)	\$ 924	\$ 897
Financial statement amounts	\$ 272,963	\$ 12,857	\$ 260,106			\$ 34,573
Impact as a percentage of f/s amounts	-0.01%	0.00%	-0.01%			2.59%
CIVIC CENTER						
Accrual of unrecorded expenditures and accounts payable	\$ -	\$ -	\$ -	\$ -	\$ 2,233	\$ 2,233
Total	\$ -	\$ -	\$ -	\$ -	\$ 2,233	\$ 2,233
Financial statement amounts	\$ 36,534	\$ 12,257	\$ 24,277			\$ (84,266)
Impact as a percentage of f/s amounts	0.00%	0.00%	0.00%			-2.65%
OTHER NONMAJOR GOVERNMENTAL FUNDS						
Record deferred revenue due to amounts not available	\$ -	\$ 2,283	\$ (1,383)	\$ (1,383)	\$ 2,411	\$ 1,028
Adjustment to record cash reconciling items to expenditures and revenue	\$ 3,432	\$ -	\$ 3,432	\$ 3,432	\$ (266)	\$ 3,166
Accrual of unrecorded expenditures and accounts payable	\$ -	\$ 3,298	\$ (3,298)	\$ (3,298)	\$ 271	\$ (3,027)
Adjust overaccrual of a liability	-	-	-	-	(220)	(220)
Accrual of unrecorded expenditures and accounts payable	-	-	-	-	3,077	3,077
Total nonmajor governmental funds	\$ 3,432	\$ 5,581	\$ (1,249)	\$ (1,249)	\$ 5,273	\$ 4,024
Financial statement amounts	\$ 772,099	\$ 152,527	\$ 619,572			\$ 128,109
Impact as a percentage of f/s amounts	0.44%	3.66%	-0.20%			3.14%

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Proprietary Type Funds

Impact of Adjustments on Fund Financial Statement Captions (\$000) - Increase (Decrease)

Description (Nature) of Audit Difference	Statement of Net Assets			Changes of Net Assets		
	Assets	Liabilities	Net Assets	Current Year	Prior Year	Total
NORMAN Y. MINITA SAN JOSE INTERNATIONAL AIRPORT						
Accrual of unrecorded expenditures and accounts payable	\$ 530	\$ 530	\$ -	\$ -	\$ -	\$ -
To record claims development estimates	-	689	(689)	(689)	-	(689)
Total	\$ 530	\$ 1,219	\$ (689)	\$ (689)	\$ -	\$ (689)
Financial statement amounts	\$ 924,159	\$ 535,851	\$ 388,308			\$ 13,847
Impact as a percentage of f/s amounts	0.06%	0.23%	-0.18%			-4.98%
WASTEWATER TREATMENT SYSTEM						
Accrual of unrecorded expenditures and accounts payable	\$ 1,987	\$ 1,987	\$ -	\$ -	\$ -	\$ -
To record claims development estimates	-	890	(890)	(890)	-	(890)
Total	\$ 1,987	\$ 2,877	\$ (890)	\$ (890)	\$ -	\$ (890)
Financial statement amounts	\$ 793,031	\$ 163,329	\$ 629,702			\$ 8,364
Impact as a percentage of f/s amounts	0.25%	1.76%	-0.14%			-10.64%
MUNICIPAL WATER SYSTEM						
Record unbilled revenue and reverse prior year accrual	\$ 1,040	\$ -	\$ 1,040	\$ 1,040	\$ (970)	\$ 70
To record claims development estimates	-	10	(10)	(10)	-	(10)
Total	\$ 1,040	\$ 10	\$ 1,030	\$ 1,030	\$ (970)	\$ 60
Financial statement amounts	\$ 84,359	\$ 8,096	\$ 76,263			\$ 2,962
Impact as a percentage of f/s amounts	1.23%	0.12%	1.35%			2.03%
PARKING FUND						
Accrual of interest receivable from RDA's advance	\$ 19	\$ -	\$ 19	\$ 19	\$ -	\$ 19
To record claims development estimates	-	1	(1)	(1)	-	(1)
Total	\$ 19	\$ 1	\$ 18	\$ 18	\$ -	\$ 18
Financial statement amounts	\$ 93,284	\$ 1,099	\$ 92,185			\$ 630
Impact as a percentage of f/s amounts	0.02%	0.09%	0.02%			2.86%
BUSINESS TYPE ACTIVITIES						
Total	\$ 3,576	\$ 4,107	\$ (531)	\$ (531)	\$ (970)	\$ (1,501)
Financial statement amounts	\$ 1,889,556	\$ 703,099	\$ 1,186,457			\$ 25,803
Impact as a percentage of f/s amounts	0.19%	0.58%	-0.04%			-5.82%

In addition, the effects of the uncorrected adjustments on the Government-Wide Statements resulted in a net decrease of \$10,347,000 in the changes in net assets to the Governmental Activities and a net decrease of \$1,501,000 in the changes in net assets to the Business-type Activities.