



Items 3.3 and 3.4

From brian darby <[REDACTED]>
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Subject: 2024-2025 Financial Audit & Annual Report

To: Mayor and City Council

From: Brian Darby

Date: December 8, 2025

After reading through City of San José's **Annual Comprehensive Financial Report (ACFR)** and the **Audit Governance Letter** for the fiscal year ended June 30, 2025. I listed some of my observations. I hope you find them helpful.

The City's financial *housekeeping* is high quality, but the *structure* of the house is under stress. The city received a clean audit opinion with no findings, validating our strong internal controls. However, the financial data shows a widening gap between the service obligations and the revenue capabilities, highlighted by a **\$34.2 million drawdown** in General Fund reserves and a persistent **\$1.7 billion infrastructure backlog**.

I listed some of what I found notable. Again I hope you find it helpful.

Section 1: Audit & Governance Results

1. Operational Integrity

The external auditor, Macias Gini & O'Connell LLP (MGO), issued an unmodified opinion. This is the highest level of assurance possible. For the fourth consecutive year, there were no material weaknesses or significant deficiencies identified in our internal controls. This consistency is a testament to the Finance Department's rigor.

2. New Accounting Standards

The City successfully implemented GASB Statement No. 101 (Compensated Absences). This required a restatement of our beginning net position by approximately \$77.9 million to more accurately reflect liability for unused leave. While this looks like a "hit" to the books, it is simply better accounting that provides a truer picture of our long-term obligations.

Section 2: Financial Health Analysis

1. The "Two Cities" Dynamic

The report paints a picture of two distinct financial realities within the City:

- **Business-Type Activities (Airport, Wastewater, Clean Energy):** These funds are healthy. They generated a **\$156.3 million increase** in net position. The Airport, in particular,
- **Governmental Activities (Police, Fire, Parks, Streets):** These funds are struggling. Net position decreased by **\$79.3 million**. Expenses (\$2.37 billion) exceeded revenues (\$2.2

2. The Long-Term Solvency Challenge

Our Unrestricted Net Position stands at a deficit of \$1.66 billion.

- This number represents what we would have left if we sold all liquid assets to pay all debts today.
- The primary driver is the Net Pension Liability (**\$2.96 billion**) and Net OPEB Liability (**\$883 million**).
- *Encouragement:* The Pension liability actually *decreased* by roughly \$132 million this year due to strong investment returns and contributions. We are chipping away at the mou

3. The Infrastructure Deficit

The ACFR confirms a deferred maintenance backlog of \$1.7 billion.

- Our governmental capital assets (roads, buildings) depreciated by **\$249 million** this year, but we only added **\$161 million** in new value.
 - **Implication:** We are "consuming" our city's infrastructure faster than we are rebuilding it. The decline in Construction and Conveyance Tax revenue (down from peaks in 2022)
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Section 3: Strategic Observations & Frustrations

1. General Fund Structural Deficit

The General Fund balance dropped to \$640.9 million (a decrease of \$34.2 million).

- **Frustration:** Despite a 6% increase in revenues (driven by Property and Utility Taxes), expenditures rose by 7% (driven by personnel costs and liability claims).
- We are seeing a "structural deficit" where the cost of providing the same level of service is rising faster than our natural revenue growth.

2. Construction Market Vulnerability

The report notes a decline in residential and industrial construction valuation.

- While commercial valuation was up (driven by data centers), the broader slowdown in housing permits reduces our fee revenue and future property tax base expansion. This is a

3. Reliance on Grants

We saw a significant drop in Capital Grants and Contributions (down nearly 28%). Our reliance on state and federal grants for housing and homelessness solutions is a risk factor; when these grant cycles end, the General Fund is often left to pick up the operational tab.

Section 4: Recommendations

Based on this review, I recommend the Council consider the following three priorities for the upcoming budget cycle:

1. **Strict Adherence to "One-Time" Rules:** We must stop using one-time funds (like Measure E shifts or vacancy savings) to balance ongoing operational deficits. The General Fu
2. **Infrastructure Preservation Strategy:** With construction taxes slowing, we need a dedicated funding stream for capital renewal. We cannot afford to let the \$1.7B backlog grov
3. **Liability Management:** Continue the aggressive pay-down of the pension liability. The slight decrease this year proves that discipline works; we must maintain our full actuarial

Conclusion

San José is well-managed and transparent, but we are fiscally constrained. The city attained a "clean" audit, but a "messy" balance sheet due to legacy liabilities and infrastructure needs. The focus for 2026 must be on structural alignment—bringing our ongoing expenses down to match our reliable, recurring revenues.

Respectfully,

Brian Darby 

I wish everybody happy holidays and a very happy new year.

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