



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: SEE BELOW

DATE: December 9, 2020

Approved

Date

12/9/2020

SUBJECT: EXTERNAL AUDITOR'S REPORT: REPORT TO THOSE CHARGED WITH GOVERNANCE FOR FISCAL YEAR ENDED JUNE 30, 2020

RECOMMENDATION

Accept the Report to Those Charged with Governance for the fiscal year ended June 30, 2020 as issued by Macias Gini & O'Connell LLP, the City of San José external auditor.

OUTCOME

Provide overview of the recommendations from the external auditors on the City's internal control over financial reporting and compliance for the fiscal year 2019-20 to the City Council.

BACKGROUND

Historically, the Single Audit Report is presented to the City Council concurrently with the Comprehensive Annual Financial Report ("CAFR") and the Report to Those Charged with Governance. The Single Audit is still being prepared, and it is anticipated the final report will be issued in February 2021. Once complete, an informational memo regarding the Single Audit Report will be prepared for the City Council which will highlight any audit findings as well as include a link to the final report.

ANALYSIS

Attached for the City Council's review is the Report to Those Charged with Governance for the year ended June 30, 2020.

Report to Those Charged with Governance

During the course of the audit, the Auditor conducted a limited examination of the City’s internal controls and management practices. The Auditor looked for material weaknesses or reportable conditions that would require immediate disclosure to the City Council in accordance with generally accepted auditing standards. A deficiency 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.

- Material weakness is a deficiency in internal control, such that there is a reasonable possibility that a material misstatement of the City’s financial statements will not be prevented, or detected and corrected, on a timely basis
- Significant deficiency is less severe than a material weakness, yet important enough to merit attention by those charged with governance
- Control deficiency is the least severe deficiency in that potential misstatements are not material. Control deficiencies still warrant identification and remediation

The Auditor’s Report to Those Charged with Governance for fiscal year ended June 30, 2020 contains reportable conditions as listed below:

Finding #	Title	Material Weakness	Significant Deficiency	Control Deficiency
2020-001	Internal Controls Over the Financial Reporting Process ¹ Management Response – pages 10 - 12	X		
2020-002	Application of the Availability Criterion for Revenue Recognition Management Response – page 13			X

Staff responses to the Auditor’s findings and other communications are included in the attached report. Finally, the Auditor’s Report also reports a status of prior year findings for Council consideration. A summary of that status follows:

Finding #	Title	Material Weakness	Significant Deficiency	Control Deficiency	Status
2019-001	Internal Controls Over the Financial Reporting Process Status Update – page 14	X			Corrected
2019-002	Completeness of the Schedule of Expenditures of Federal Award Status Update – page 15		X		Pending completion of Single Audit

¹ Similar to Finding 2018-001 Finding in FY 2017-2018 Governance Report.

CONCLUSION

Acceptance of the Report to Those Charged with Governance for the fiscal year ended June 30, 2020, as issued by Macias Gini & O'Connell LLP, provides recommendations from the external auditors on the City's internal control over financial reporting and compliance for fiscal year 2019-20 to the City Council.

EVALUATION AND FOLLOW-UP

The Single Audit is still being prepared, and it is anticipated the final report will be issued in February 2021. Once complete, an informational memo regarding the Single Audit Report will be prepared for the City Council which will provide status on prior recommendation 2019-02 and highlight any additional audit findings as well as include a link to the final report.

CLIMATE SMART SAN JOSE

The recommendation in this memo has no effect on Climate Smart San José energy, water, or mobility goals.

PUBLIC OUTREACH

This item will be posted to the City Council Agenda website for the December 15, 2020 meeting.

COORDINATION

The departments to which the comments in the Report to Management apply have reviewed the comments and their responses have been incorporated into the Report.

COMMISSION RECOMMENDATION/INPUT

No commission recommendation or input is associated with this action.

HONORABLE MAYOR AND CITY COUNCIL

December 9, 2020

Subject: Report to Those Charged with Governance for Fiscal Year Ended June 30, 2020

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CEQA

Not a Project, File No. PP17-010, City Organizational and Administrative Activities resulting in no changes to the physical environment.

/s/

JULIA H. COOPER

Director of Finance

Attachment

For questions, please contact Julia H. Cooper, Director of Finance, at (408) 535-7011.

CITY OF SAN JOSE

Report to Those Charged With Governance

For the Year Ended June 30, 2020



Certified
Public
Accountants

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2020

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Honorable Mayor and City Council
City of José, California

Ladies and Gentlemen:

In planning and performing our audit of the 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, 2020, 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 financial statements, we audit and separately report on the following financial statements as of and for the year ended June 30, 2020:

- Successor Agency to the Redevelopment Agency of the City of San José;
- Norman Y. Mineta San José International Airport;
- San José–Santa Clara Clean Water Financing Authority;
- 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.

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 significant deficiencies or material weaknesses and therefore, significant deficiencies or material weaknesses may exist that have not been identified. However, as discussed below, we identified a deficiency in internal control that we consider to be a material weakness.

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.

We consider item number 2020-001 to be a material weakness.

We also identified a certain other matter involving internal control for your consideration that we have reported in item number 2020-002.

The City's written response to the findings and recommendations identified is described in the Schedule of Findings and Management Responses section. The City's responses were not subjected to the auditing procedures applied in our audit of the financial statements. We did not audit the City's responses and, accordingly, we express no opinion on them. In addition, we would be pleased to discuss the recommendations in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and the Uniform Guidance, 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 the City dated September 15, 2020. Professional standards also require that we communicate to you the information related to our audits discussed on pages 3 through 8.

This 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 and to report to those charged with governance our responsibilities described in the paragraph above. This communication is intended solely for the information and use of the Mayor, City Council, Public Safety, Finance & Strategic Support Committee, City management, and others within the organization and is not intended to be and should not be used for any other purpose.



Walnut Creek, California
November 30, 2020

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2020

We have audited the basic financial statements of the City of San José, California (City), as of and for the year ended June 30, 2020, and have issued our report thereon dated November 30, 2020. 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 September 15, 2020, our responsibility, as described by professional standards, is to form and express opinions 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.

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2020

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. The City implemented Governmental Accounting Standards Board (GASB Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, for the year ended June 30, 2020, as described in Note I. There is no significant impact to the City's financial statements due to the implementation of those new pronouncements. 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 were:

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

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.

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For the Year Ended June 30, 2020

- 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 management’s estimate regarding the likelihood of collectability based on loan provisions and collateral. 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 unreported claims at 2.0%. 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 Environmental Compliance Officers 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.

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 financial statements taken as a whole. The fair value of the Pension Trust Funds investments and the pension and OPEB plans information based on actuarial valuations was agreed to the separately audited financial statements of the Pension Trust Funds, which were reported on by other auditors.

We evaluated the key factors and assumptions used to develop the accounting estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole and in relation to the applicable opinion units.

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For the Year Ended June 30, 2020

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 and Corrected Misstatements

For purposes of this communication, professional standards 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 and each applicable opinion unit.

In May 2020, the U.S. Treasury awarded CARES Act funding to the City under its Coronavirus Relief Fund program. The award was received upfront as an advance and was recognized as revenue in its entirety. However, the City should only recognize revenue as it incurs eligible costs, and report unearned revenue when eligible costs are not yet incurred. An adjustment in the amount of \$115 million was necessary to properly report revenue and unearned revenue of CARES Act funding received during fiscal year 2019/20.

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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For the Year Ended June 30, 2020

Representations Requested from Management

We have requested certain written representations from management, which are included in the attached letter dated November 30, 2020.

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, 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 in documents containing the City's audited financial statements does not extend beyond the financial 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 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; the schedule of employer contributions – postemployment healthcare plans; and the schedule of investment returns – 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.

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

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For the Year Ended June 30, 2020

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 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.

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For the Year Ended June 30, 2020

SCHEDULE OF FINDINGS AND MANAGEMENT RESPONSES

Finding 2020-001 – Material Weakness
Internal Controls Over the Financial Reporting Process

Criteria and Condition

Internal control is an integral process that is effected 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.

Cause

While the City has made significant efforts in improving its financial reporting process over the past several years, the progress has been hampered by turnover.

Effect or Potential Effect

While the City has been successful in recruiting professionals to fill vacant positions over the past three 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:

- An error in reporting CARES Act funding received in advance. Reporting non-exchange revenues can be complex under generally accepted accounting principles, as revenue recognition depends upon whether the revenues have purpose restrictions or eligibility requirements. For the CARES Act program, revenue is only recognized to the extent the City has incurred eligible COVID-19 related costs. As the City recognized the entire advance received by the U.S. Treasury, an adjustment of \$115 million to unearned revenue was necessary to properly recognize the CARES Act revenues earned during fiscal year 2019/20.
- An error in reporting interfund notes payable, resulting in an overstatement of \$10 million at the government-wide financial statements level.
- Errors made in accounts payable for end of year cut-off analysis, in the amounts of \$4.9 million and \$3.1 million in it governmental and proprietary funds, respectively.
- Timely resolution of bank reconciling items.

In addition, late numerous and significant adjusting entries made by the City after the “initial close” of its financial records and preparation of final financial statements to be audited resulted in increased staff effort in re-performing reconciliations substantiating accounts and balances.

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Recommendation

We recommend that the City evaluate the causes for the deficiencies reported above in an effort to incorporate the necessary tasks during its closing process to prevent these kinds of errors in the future. 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.

Management Response

Management agrees with MGO's comment and acknowledges that staffing turnover resulting from resignations, retirement, and extended leaves in the Specialized Accounting and Financial Reporting Sections of the Finance Department, Accounting Division contributed negatively to the completion of the FY 2019-2020 audit process.

Newly hired or promoted accounting staff had little to no institutional knowledge in the City's accounting processes. Work and training activities were hampered further, due to the COVID-19 pandemic and resulting County of Santa Clara Shelter-in-Place mandate effective March 17, 2020, by the unexpected and subsequently complete remote work environment of the Specialized Accounting and Financial Reporting sections, who have primary responsibility for producing the Comprehensive Annual Financial Report ("CAFR"). The remote work environment severely hindered the usual daily face-to-face collaboration of the CAFR team, as well as constraining management engagement. Review of staff work was challenging and often made for lengthier process times due to the remote work environment. Additionally, managers new to the organization and their roles did not have the opportunity to fully develop a working relationship with their staff prior to the onset of the COVID-19 pandemic. Three (3), key employees – Supervising Accountant, Senior Accountant and Accountant – were concurrently on approved family medical leave ("FMLA"), along with a vacant Accounting Technician position for much of the audit period, which reduced staff time available for CAFR production by approximately 2,300 hours. Given COVID-19 and time restrictions, it was not feasible to hire and train temporary, skilled staff to backfill these positions in a remote work environment. Last, the work units were faced with the resignation of the Accounting Division Deputy Director in September 2020 after only twenty-two months (22) of employment with the City.

In the FY 2017-18 Governance Report, MGO highlighted similar concerns regarding staff turnover and training. As a result of the audit finding, the Finance Department submitted budget proposals to address this finding, adding two (2) Accountant positions and funding for dedicated training for accounting staffing. These positions and funding for training were added to the Finance Department budget in FY 2019-20; positions were filled in October/November 2019 and training commenced. The addition of these two positions increased the staffing to 19 positions as compared to the Accounting Division's 20 positions in 2008 for these two work units, a peak staffing year for the CAFR team. The current 19 positions reflect a reduction of 5% in staffing levels in these two work sections during a period of time where financial reporting has become increasingly complicated with the numerous Governmental Accounting Standards Board ("GASB") pronouncements the City is required to implement.

These Accounting work sections are responsible for recording citywide accounting and budget transactions, maintaining the general ledger database, coordinating the City's annual external audit process, and preparing and producing the CAFR, in addition to approximately twenty (20) stand-alone financial reports. Additional work includes producing the City's annual cost allocation plans. Further complicating the governmental financial reporting this year was an increase in the volume and complexity of accounting and reporting for COVID-19 federal grants and Coronavirus Aid, Relief, and Economic Security ("CARES") Act funding, which had continually varying and sometimes conflicting guidance.

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Management believes the staffing challenges are demonstrated by more than half of the employees in these two work groups being either hired or promoted into their position in the last two and half years. During this same period of time, nine (9) employees left City service or the Finance Department for opportunities in other City departments. The table below shows average years of tenure of the Accounting Division’s professional accounting classifications in the Financial Reporting/Special Accounting sections. The statistics indicate that an average tenure of professional accounting staff in their current classification is less than two years for three of the five classifications, which negatively affects staff’s technical growth and the quality of work product as mentioned in the Governance Report.

Finance Department – Accounting Division			
Financial Reporting/Special Accounting Sections			
<i>As of November 30, 2020</i>			
	<u>Number of</u>	<u>Average</u>	<u>Average</u>
	<u>Positions</u>	<u>Years in</u>	<u>Years with</u>
		<u>Classification</u>	<u>City</u>
Accounting Technician	2	1.21	10.96
Accountant I/II	10	2.54	6.56
Senior Accountant	3	1.67	1.67
Supervising Accountant	2	1.96	3.84
Principal Accountant	2	2.13	3.30

Despite these challenges, the Finance Department is undertaking various steps to address the issues raised in the Governance Report.

1. The Department commenced the recruitment to fill the Deputy Director of Finance, Accounting, position which has been vacant since September 2020. Currently this is the only vacant position in the Accounting Division. An area of focus during the recruitment will be identifying a candidate and subsequent hire with strong management, organization and mentoring skills. A person who can develop the team and effectively cross-train to build critical skill sets is essential.

2. In the FY 2017-2018 Governance Report, the Department included several workplan items to institute and implement changes to address internal control issues. Department senior management has reviewed those commitments and recognizes that turnover has affected our ability to fully implement. It is appropriate to re-examine and refocus our efforts. First efforts include a detailed review of the process for developing the FY 2019-20 audit documenting challenges and developing a written workplan to avoid a repeat for FY 2020-21 and beyond.
 - a. The Department anticipates during FY 2020-21, the Division will be able to institute and implement changes to address internal control issues including the following:
 - Ensure proper training and cross training of professional accounting staff in core job assignments; including developing and maintaining detailed desk procedures;
 - Reconcile and review of accounting transactions, including review and approval by Supervising and Principal Accountants in a timely manner;

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For the Year Ended June 30, 2020

- Plan and execute citywide fiscal year-end close activities and recording of accounting transactions in a timely manner;
 - Prepare and review audit documents and draft financial reports for the external auditor’s review; and
 - Prepare a citywide audit completion schedule in consultation with the external auditors and conduct weekly or bi-weekly status meetings to ensure that tasks are completed by the targeted dates.
- b. As the City has decentralized accounting operations, proper coordination among department accounting staff and the Accounting Division staff is critical for the successful execution of the audit process and completion of the CAFR and other reports. The Accounting Division will coordinate and prepare a detailed work plan that will list fiscal year-end milestones to be completed by department accounting staff and delivered to the Accounting Division within the timelines prescribed in the work plan. The Finance Department will ensure department senior management is aware of fiscal year-end close responsibilities and the related deliverables.
- c. The Finance Department continues to research and encourage participation in the training opportunities in the governmental accounting and financial reporting areas to professional accounting staff offered by the Government Finance Officers Association (“GFOA”) and California Society of Municipal Finance Officers (“CSMFO”) and Association of Government Accountants (“AGA”). Finance Accounting staff will be encouraged to attend local CSMFO chapter meetings to maintain professional relationships with their counterparts and to facilitate exchange of professional knowledge. Training in the COVID-19 pandemic environment is largely remote via webinars and self-directed training, which does have its limitations but provides opportunity for more staff to participate.

Targeted Completion Date: June 30, 2021.

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2020

Finding 2020-002 – Control Deficiency
Application of the Availability Criterion for Revenue Recognition

Criteria

The availability principle requires that revenues be recognized when they are collectible within the current period or soon enough thereafter to be used to pay liabilities in the current period. The City considers governmental fund revenues to be available if they are collected within 60 days after year-end.

Condition, Cause, and Effect

We noted that some of the City's departments did not consistently apply the availability criterion in their governmental fund financial statements, which resulted in overstated revenues of \$7.4 million in governmental funds.

Recommendation

We recommend that the Finance Department continue training financial statement preparers in other departments on the application of the availability criterion. In addition, the Finance Department should establish a review process at the end of the 60-day period to compare governmental departments' significant revenue year-end accruals with remittances received. Departments that show significant variances in collections of receivables should provide documentation supporting the validity and propriety of the revenue recorded.

Management Response

The Finance Department will continue training financial statement preparers in other departments on the application of the availability criterion. In addition, the Finance Department will establish a review process at the end of the 60-day period to compare governmental departments' significant revenue year-end accruals with remittances received with those departments showing significant variances in collections of receivables will be required to provide documentation supporting the validity of the revenue recorded.

Targeted Completion Date: June 30, 2021.

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STATUS OF PRIOR YEAR'S FINDINGS

Finding 2019-001 – Material Weakness
Internal Controls Over the Financial Reporting Process

The San José Clean Energy enterprise fund (the Fund) accounts for the City's Community Choice Energy program, which is a new program that began operations during the current fiscal year. This is a locally controlled electricity generation service provider to residents and businesses within the City of San José. This program allows the City to procure electricity for the residents and businesses of the City with more renewable energy options.

As part of our audit procedures, we review a letter from the City Attorney's Office that summarizes potential losses of the City. During our review of this letter, we discovered that a fine was imposed on the City by the State's Public Utility Commission in the amount of \$6,791,155. While the City is appealing the fine, the ultimate outcome of the fine is not yet determined. Under generally accepted accounting principles, the City should recognize a liability for losses that it considers probable. While the actual amount of the loss is not yet known, an estimated loss should be recorded in the financial statements to ensure the financial statements properly reflect this contingency. However, the City had not recorded a provision for this potential loss. Subsequently, the City recorded a claims liability in the amount of \$6,791,155 to reflect this potential loss as of June 30, 2019. The City took a conservative position and recorded the full amount of the fine imposed, even though the City continues to negotiate a lower amount.

We recommend that the City establish a process to identify and record contingent liabilities in the Fund, including a process that incorporates a dialogue between management of the Fund and other departments, such as Finance and the City Attorney's Office, to ensure the proper identification and estimation of contingent liabilities.

Status: Corrected.

Finding 2019-002 – Significant Deficiency
Completeness of the Schedule of Expenditures of Federal Award

During our audit, we noted the City's draft schedule of expenditures of federal awards (SEFA) included federal expenditures that fluctuated through the course of the audit for the Federal Emergency Management Agency's Disaster Grants - Public Assistance grant. The changes included the offsetting of expenditures reimbursed by insurance proceeds and adding additional expenditures identified during the closing of the books. The impact of these changes resulted in significant changes in federal expenditures during the audit process. The Disaster Grants – Public Assistance grant is managed by the City's Department of Parks, Recreation and Neighborhood Services.

Because the federal expenditures were fluctuating during the audit, we were unable to determine the ultimate number of major federal programs required to be tested until the SEFA was completed. The results of the major federal program determination identified an additional program required to be tested as major, which will delay the completion of the Single Audit for the current year.

The City should continue to improve its process for reviewing expenditures reported in the SEFA by requiring department management to review and submit a detail listing of expenditures prior to being submitted to the Finance Department. In addition, the Finance Department should reconcile the detailed

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listing of expenditures to the SEFA for each significant federal program prior to the City submitting such detailed listing to its external auditors.

Status: The Single Audit for the year ended June 30, 2020 is in progress and, accordingly, this status will be updated upon the issuance of the Single Audit report.

Management is addressing Finding 2019-002 with two different approaches. First, the Specialized Accounting unit within the Accounting Department continued its analytical review of the grants and reached out to Departmental grant managers for explanations of material change(s) in expenditures from the prior year. This analytical review can identify potentially unrecorded expenditures, as the review requires the Departmental grant managers reexamine their reported numbers. This resulted in no unrecorded expenditures identified, and changes were generally attributable to new projects, or projects closed or being closed, which appeared reasonable.

Next, Specialized Accounting management staff worked directly with the Federal Emergency Management Agency (“FEMA”) Disaster Grants - Public Assistance grants manager and respective staff in the City Department of Parks, Recreation and Neighborhood Services (“PRNS”), whose draft schedule(s) of federal awards expenditures was the basis for this finding. Specialized Accounting management staff held regular meetings with the PRNS FEMA grants management team to ensure they were aware of all the items that need to be considered regarding federal award expenditures. After the course of meetings was completed, the PRNS FEMA grants manager seemed confident in the expenditure numbers reported.

SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

PJE#	Account / Adjustment Description	Debit (Dollars in thousands)	Credit (Dollars in thousands)
1	Nonmajor Governmental Fund Intergovernmental Revenue	\$ 7,405	-
	Nonmajor Governmental Fund Deferred Inflow of Resources (To defer the revenue collection received after the City's 60-day period of availability).	-	\$ 7,405
2	Clean Energy Fund Short-term Notes Payable	\$ 10,000	-
	Clean Energy Fund Advances From Other Funds	-	\$ 10,000
	San Jose Financing Authority Advances To Other Funds	10,000	-
	San Jose Financing Authority Notes Receivable	-	10,000
	Business Activities Short-term Notes Payable	10,000	-
	Governmental Activities Notes Receivable (To remove the Clean Energy's Short-term notes payable balance since the San Jose Financing Authority issued the debt and payable is due by the financing authority).	-	10,000
3	Nonmajor Governmental Fund Accounts Receivable	\$ 4,008	-
	Nonmajor Governmental Fund Other Assets (To reclassify the Other Asset balance to Accounts Receivable for collections received subsequent to year end).	-	\$ 4,008
4	Housing Fund Expenditures	\$ 1,982	-
	Housing Fund Accounts Payable (To record payable accrual for expenditures incurred during the fiscal year and payments made subsequent to year end).	-	\$ 1,982
5	Special Assessment Districts Expenditures	\$ 232	-
	Special Assessment Districts Accounts Payable (To record payable accrual for expenditures incurred during the fiscal year and payments made subsequent to year end).	-	\$ 232
6	Clean Energy Fund Expenditures	\$ 3,134	-
	Clean Energy Fund Accounts Payable (To record payable accrual for expenditures incurred during the fiscal year and payments made subsequent to year end).	-	\$ 3,134
7	Clean Energy Fund Accounts Receivable	\$ 3,209	-
	Clean Energy Fund Revenue	-	\$ 3,209
	Clean Energy Fund Bad Debt Expense	3,209	-
	Clean Energy Fund Allowance For Doubtful Accounts (To reverse the A/R direct write off and record allowance for doubtful accounts for consistency with the City's Accounts Revenue and Collection Policy and Procedures).	-	3,209