



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: SEE BELOW

DATE: November 22, 2021

Approved

Date

11/22/2021

SUBJECT: EXTERNAL AUDITOR'S REPORT: REPORT TO THOSE CHARGED WITH GOVERNANCE FOR THE YEAR ENDED JUNE 30, 2021

RECOMMENDATION

Accept the Report to Those Charged with Governance for the Year Ended June 30, 2021 as issued by Macias Gini & O'Connell LLP, the City's external auditor.

OUTCOME

Provide an overview of the recommendations from the external auditors on the City's internal controls over financial reporting and compliance for the year ended June 30, 2021.

BACKGROUND

The City's external auditor ("Auditor") is responsible for communicating significant matters related to the audit that are relevant to City Council's responsibility in overseeing the financial reporting process. The Report to Those Charged with Governance is presented concurrently with the Annual Comprehensive Financial Report ("ACFR").

ANALYSIS

Attached for the City Council's review is the Report to Those Charged with Governance for the Year Ended June 30, 2021.

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 the Year Ended June 30, 2021 contains reportable conditions as listed below:

Finding #	Title	Material Weakness	Significant Deficiency	Control Deficiency
2021-001	Internal Controls Over the Financial Reporting Process	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
2020-001	Internal Controls Over the Financial Reporting Process	X			Partially Corrected
2020-002	Applicable of the Availability Criterion for Revenue Recognition			X	Corrected

CONCLUSION

Acceptance of the Report to Those Charged with Governance for the Year Ended June 30, 2021, as issued by Macias Gini & O’Connell LLP, provides recommendations from the external auditors on the City’s internal controls over the financial reporting process and the Administration’s response to those recommendations for the year ended June 30, 2021.

HONORABLE MAYOR AND CITY COUNCIL

November 22, 2021

Subject: 2021 External Auditor's Report to Those Charged with Governance

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EVALUATION AND FOLLOW-UP

The Single Audit is currently being prepared and the final report will be issued by the federal reporting deadline of March 31, 2022. Once complete, an informational memorandum regarding the Single Audit Report will be prepared for the City Council to 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 7, 2021 meeting.

COORDINATION

This staff report has been prepared by the Finance Department in coordination with the City Attorney's Office and the City Manager's Budget Office.

COMMISSION RECOMMENDATION/INPUT

No commission recommendation or input is associated with this action.

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

For questions, please contact Julia H. Cooper, Director of Finance, at (408) 535-7011 or via email at julia.cooper@sanjoseca.gov.

Attachment

CITY OF SAN JOSE

Report to Those Charged With Governance

For the Year Ended June 30, 2021



Certified
Public
Accountants

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2021

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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, 2021, 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, 2021. 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;
- 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 preceding 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 2021-001 to be a material weakness.

The City's written response to the finding and recommendation identified is described in the Schedule of Finding and Management Response section. The City's response was not subjected to the auditing procedures applied in our audit of the basic financial statements. We did not audit the City's response and, accordingly, we express no opinion on it. In addition, we would be pleased to discuss the recommendation in further detail at your convenience, to perform any additional study of this matter, or to assist you in implementing the recommendation.

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 July 15, 2021. Professional standards also require that we communicate to you the information related to our audits discussed on pages 3 through 8.

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.



Walnut Creek, California
November 19, 2021

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2021

We have audited the basic financial statements of City of San José, California (City) as of and for the year ended June 30, 2021, and have issued our report thereon dated November 19, 2021. 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 audits.

Our Responsibility in Relation to the Financial Statement Audit

As communicated in our engagement letter dated July 15, 2021, 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.

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2021

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. 84 – *Fiduciary Activities***
This statement establishes criteria for identifying fiduciary activities of all state and local governments and describes four fiduciary funds that should be reported, if applicable: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. A fiduciary component unit, when reported in the fiduciary fund financial statements of primary government, should combine its information with the primary government's fiduciary funds. The statement also provides for recognition of a liability to the beneficiaries in a fiduciary fund when an event has occurred that compels the government to disburse fiduciary resources. The application of this statement had an effect on the City's financial statements for the change of format and name from Agency Fund to Custodial Fund. The impact for Section 457 deferred compensation plans was offset by early implementation of GASB Statement No. 97, *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*. The net position related to the Custodial Fund was restated as a result of implementation of GASB Statement No. 84.
- **GASB Statement No. 90 – *Majority Equity Interests – an amendment of GASB Statements No. 14 and No. 61***
This statement improves the consistency and comparability of reporting a government's majority equity interest in a legally separate organization and to improve the relevance of financial statement information for certain component units. This statement did not have any effect on the City's financial statements.
- **GASB Statement No. 97 – *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans – an amendment of GASB Statements No. 14 and No. 84, and a supersession of GASB Statement No. 32***
This statement requires that for purposes of determining whether a primary government is financially accountable for a potential component unit, except a potential component unit that is a defined contribution pension plan, a defined contribution OPEB plan, or another employee benefit plan (for example, certain Section 457 plans), the absence of a governing board should be treated the same as the appointment of a voting majority of a governing board if the primary government performs the duties that a governing board typically would perform. This statement also requires that the financial burden criterion in paragraph 7 of Statement No. 84, *Fiduciary Activities*, be applicable to only defined benefit pension plans and defined benefit OPEB plans that are administered through trust that meet the criteria in paragraph 3 of Statement No. 67, *Financial Reporting for Pension Plans*, or paragraph 3 of Statement No 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, respectively. The City early implemented this statement to offset the impact of GASB Statement No. 84 for Section 457 plans. The overall net result is to provide a footnote disclosure of the PTC Deferred Compensation Plan.

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- **GASB Statement No. 98 – *The Annual Comprehensive Financial Report***

This statement establishes the term annual comprehensive financial report and its acronym ACFR as the replacement term for comprehensive annual financial report and its acronym addressing references in authoritative literature. This statement was developed in response to concerns raised by stakeholders that common pronunciation of the acronym for comprehensive annual financial report sounds like a profoundly objectionable racial slur. The City early implemented this statement, as a result, all references to the related term and its acronym were replaced.

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.
 - 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.

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- 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 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 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 were 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 estimates and determined that they are reasonable in relation to the basic financial statements taken as a whole and in relation to the applicable opinion units.

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:

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- 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 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 and each applicable opinion unit.

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.

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.

Representations Requested from Management

We have requested certain written representations from management, which are included in the attached letter dated November 19, 2021.

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.

CITY OF SAN JOSE
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For the Year Ended June 30, 2021

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 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 – 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 – 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 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.

CITY OF SAN JOSE
Report to Those Charged With Governance
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SCHEDULE OF FINDING AND MANAGEMENT RESPONSE

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

Criteria and Condition

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.

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 staff turnover, an increase in volume and complexity of new accounting pronouncements issued by the Governmental Accounting Standards Board (GASB), and additional reporting and compliance responsibilities associated with new federal and state grants funds.

Effect or Potential Effect

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.

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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.

Recommendation

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.

Management Response

Management agrees with MGO's comment and acknowledges the need for continuous training and development of accounting professional staff in the Finance Department and within the departments. Additionally, there are opportunities for process improvements in converting the General Ledger to the financial statement presentation which will strengthen the accuracy and efficiency of financial reporting.

The Finance Department's Accounting Division is 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 ACFR, in addition to approximately twenty (20) stand-alone financial reports. Additional work includes producing the City's annual cost allocation plans and filing mandatory financial reports with the State Controller's Office. Further complicating the governmental financial reporting over the past two years was an increase in the volume and complexity of new accounting pronouncements issued by GASB and additional reporting and compliance responsibilities associated with new federal and state grants funds.

Despite these challenges, the Accounting Division is undertaking various steps to address the issues raised in this Report to Those Charged With Governance (Governance Report).

1. The Department recently filled the Deputy Director of Finance, Accounting position, which had been vacant since September 2020. In addition, the Accounting Division has secured temporary funding for a new reporting unit, Finance Recovery. The Finance Recovery unit is focused exclusively on reporting, compliance, and documentation for COVID-19 federal and state grants. The Division has completed the recruitments and onboarded three (3) of the eight (8) dedicated positions within this unit, including the Division Manager. While this unit will provide temporary relief for the additional work assumed by the Accounting Division, the success of the unit will depend on hiring, developing, and retaining skilled accounting professionals. Workload in this new unit will be closely monitored and as this unit continues to expand our expertise in grants reporting, compliance and documentation and the goal will be to utilize their expertise across the organization to enhance our performance in this area.
2. In Management's Response to the FY 2019-2020 Governance Report, the Finance 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 staff turnover as well as the volume and complexity of new accounting standards and new grant funding has affected our ability to fully implement. It is appropriate to re-examine and refocus our efforts.

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2021

The following actionable tasks include:

- a. The Department anticipates during FY 2021-22, the Accounting 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;
 - 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 ACFR 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. Additionally, the Finance Department will engage with department accounting staff to commence an assessment of key accounting functions that could be better performed centrally versus decentralized. Finally, the City Manager’s Office will commence a new procedure requiring departments to coordinate with the Finance Department prior to acceptance of grants to ensure departmental staff are properly trained and informed on appropriate accounting treatment of grant funds and expenditures.

- 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”), 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, 2022

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For the Year Ended June 30, 2021

STATUS OF PRIOR YEAR’S FINDINGS

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

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 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.

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.

Status: Partially Corrected. While the City has improved its internal controls over financial reporting process, we did identify a similar finding in the current year (i.e., Finding 2021-001).

CITY OF SAN JOSE
Report to Those Charged With Governance
For the Year Ended June 30, 2021

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

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.

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.

Status: Corrected.

SUMMARY OF UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

Account / Adjustment Description		Debit (Dollars in thousands)	Credit
1	Business-Type Activities	Accounts Payable	\$ 2,747
	Business-Type Activities	Prepaid Expense	\$ 2,747
	Clean Energy Fund	Accounts Payable	\$ 2,747
	Clean Energy Fund	Prepaid Expense	\$ 2,747
	(To adjust the accounts payable balance to the amount owed at year-end).		
2	Governmental Activities	Unearned Revenue	\$ 12,900
	Governmental Activities	Revenue	\$ 12,900
	Nonmajor Governmental Fund	Unearned Revenue	\$ 12,900
	Nonmajor Governmental Fund	Deferred Inflow of Resources	\$ 12,900
	(To reclass the unearned revenue balance for balances relating to deferral of revenue collected after the availability criterion).		
3	Governmental Activities	Equity in pooled cash and investments held in City Treasury	\$ 7,918
	Governmental Activities	Accounts Receivable	\$ 7,918
	Low and Moderate Income Housing Asset	Equity in pooled cash and investments held in City Treasury	\$ 7,918
	Low and Moderate Income Housing Asset	Accounts Receivable	\$ 7,918
	(To record the cash collection for funds received during the fiscal year).		
4	Governmental Activities	Expenses	\$ 1,235
	Governmental Activities	Accounts Payable	\$ 1,235
	Housing Fund	Expenditures	\$ 1,235
	Housing Fund	Accounts Payable	\$ 1,235
	(To record payable accrual for expenditures incurred during the fiscal year and payments made subsequent to year-end).		
5	Governmental Activities	Expenses	\$ 4,548
	Governmental Activities	Accounts Payable	\$ 4,548
	Nonmajor Governmental Fund	Expenditures	\$ 4,548
	Nonmajor Governmental Fund	Accounts Payable	\$ 4,548
	(To record payable accrual for expenditures incurred during the fiscal year and payments made subsequent to year-end).		