**SAN JOSE CONVENTION AND CULTURAL FACILITIES**
(An Activity of the City of San José)

Public Safety, Finance &
Strategic Support Committee

Fiscal Year Ended
June 30, 2007

**SAN JOSE CONVENTION AND CULTURAL FACILITIES**

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2007

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Members of the Public Safety, Finance &
Strategic Support Committee and
San José City Council
San José, California

In planning and performing our audit of the financial statements of the San José Convention and Cultural Facilities (the Center), an activity of the City of San José (the City), as of and for the year ended June 30, 2007, in accordance with auditing standards generally accepted in the United States of America, we considered the Center's internal control over financial reporting (internal control) as a basis for designing our auditing procedures 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 governmental unit's internal control. Accordingly, we do not express an opinion on the effectiveness of the governmental unit's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A control 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or a combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies as listed as items 2007-A, 2007-B, and 2007-C to be significant deficiencies in the Center's internal control. In addition, we noted other matters involving the internal control and its operation that we have reported to management as listed in the table of contents.

A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the deficiencies listed as items 2007-A and 2007-B constitute material weaknesses.

The Center's written response to the findings identified in our audit is described in the Schedule of Comments and Responses. We did not audit the Center's responses and, accordingly, we express no opinion on it. In addition, we have already discussed our comments and recommendations with various Center personnel, and we would be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing these recommendations.

Additionally, we have included in this letter a report on communications with the Public Safety, Finance & Strategic Support Committee (Committee) as required by auditing standards generally accepted in the United States of America.

This communication is intended solely for the information and use of management, the Committee, City Council, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties

Very truly yours,

MACIAS GINI & O'CONNELL LLP

Macias Gini & O'Connell LLP

Certified Public Accountants
Walnut Creek, California

October 30, 2007

**SAN JOSE CONVENTION AND CULTURAL FACILITIES**

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2007

## REQUIRED COMMUNICATIONS

We have audited the financial statements of the San José Convention and Cultural Facilities (the Center), an activity of the City of San José (the City) as of and for the year ended June 30, 2007. Professional standards require that we provide you with the following information related to our audit.

### I. The Auditor's Responsibility Under U.S. Generally Accepted Auditing Standards

As stated in our Engagement Communications section of our General Audit Plan dated June 29, 2007, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free from material misstatements and are fairly presented in accordance with U.S. generally accepted accounting principles. Because an audit is designed to provide reasonable, but not absolute assurance and because we did not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us.

As part of our audit, we considered the internal control of the Center. Such considerations were solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

### II. Significant Accounting Policies

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our contract with the City, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the Center are described in Note 2 to the Center's financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2007. We noted no transactions entered into by the Center during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

### III. Accounting Estimates

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

- Estimated allowance for losses on accounts receivable
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property

Management's judgments and estimates were based on the following:

- Estimated allowances for losses on accounts receivable were based on the direct write-of method.
- Useful lives for depreciable property were determined by management based on the nature of the capital asset.

## REQUIRED COMMUNICATIONS

### III. Accounting Estimates (Continued)

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the financial reporting units that collectively comprise the Center's financial statements.

### IV. Audit Adjustments

For the purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the Center's financial reporting process (that is, cause future financial statements to be materially misstated). In our judgment, none of the adjustments we proposed, whether recorded or unrecorded by the Center, either individually or in the aggregate, indicate matters that could have a significant effect on the Center's financial reporting process except as discussed as items 2007-A and 2007-B. In addition, the attached schedule summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the individual financial reporting units that collectively comprise the Center's financial statements.

### V. Disagreements with Management

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

### VI. Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Center's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

### VII. Issues Discussed with Management Prior to Our Retention

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Center's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

### VIII. Difficulties in Performing the Audit

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

## SCHEDULE OF COMMENTS AND RESPONSES

### INTRODUCTION

In May 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (SAS112). SAS112 was designed to make the standards consistent with those already in place for publicly-traded companies by establishing a standard for determining seriousness of a control issue and classifying it into one of three categories:

- Control deficiency
- Significant deficiency (replaces old term "reportable condition")
- Material weakness.

A *control 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 misstatements on a timely basis.

A *significant deficiency* is a control deficiency or a combination of control deficiencies such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

A *material weakness* is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

These definitions redefined and/or replaced the old definitions – management letter comment; reportable condition and material weakness as follows.

| Old Definitions | New Definitions |
|---|---|
| **Material weakness** | **Material weakness** |
| **Reportable condition** | **Significant deficiency** |
| **Management letter comment** (under Yellow Book only) | **Other matters related to internal control** |

This new pronouncement significantly increases the likelihood that an auditor may be required to report either a "significant deficiency" or a "material weakness" in conjunction with the financial statement audit.

## SCHEDULE OF COMMENTS AND RESPONSES

### Item #2007 A - Material Weakness #1
### Reconciliation of the City Subsidy

The City provides an operating subsidy to the San Jose Convention and Cultural Facilities (Center) to subsidize the operating losses generated from the Center's activities. The City subsidy is funded from a portion of the City's Transient Occupancy Tax and revenues from City parking garages located at the Center. The Center records the City's subsidy as a direct contribution to its equity accounts thereby understating its annual financial activity. Generally accepted accounting principles require that these subsidies be recorded as part of the Center's financial activity as an addition to net assets. In addition, we noted that the Center's trial balance did not capture fire insurance expenses paid directly by the City as part of the Center's annual subsidy from the City.

We recommend the Center modify the chart of accounts to add operating accounts that record and track the different types of subsidies and withdrawals. In addition, we recommend that the Convention Center perform monthly reconciliations of the City subsidy and expenses paid directly by the City to verify that the amounts recorded in the general ledger agrees to the amounts reported by the City.

*Management Response:*

It has been the Center's practice to record the City's subsidy at the balance sheet level via equity accounts. In order for subsidy transactions to flow through to the operating statement, the Center will add operating accounts to its chart of accounts.

The City does communicate to the Center when funds are transferred from the cash receipts bank account ("Receipts Account") to reimburse the City for costs, primarily City payroll, incurred by the City on the Center's behalf. The City subsidizes the portion of the transfer only to the extent that funds are insufficient in the Receipts Account to transfer to the City. In addition, the City and Team San Jose (TSJ) each perform bank reconciliations on the Receipts Account, and during this process, the City and the Center communicate to each other on transfers in and out of the Receipts Account.

The City will reconcile all expenses paid directly by the City on behalf of the Center, including expenses that will not be reimbursed by the Center (those considered a subsidy or contribution from the City), to assure the transactions are included on the Center's records.

## SCHEDULE OF COMMENTS AND RESPONSES (Continued)

### Item #2007 B - Material Weakness #2
### Reconciliation of Detailed Schedules to the General Ledger

As part of the Center's year end closing procedures, the Center prepares detailed schedules to support its reported financial statement balances. During our audit, we noted that the Center's detailed schedules did not agree to the reported financial statement amounts. For example, the Center's manual capital asset schedules did not agree to the depreciation expense nor to the capital asset classifications (depreciable and nondepreciable capital assets) reported. In addition, the Center does not record recurring financial transactions consistently making it difficult for reviewers to identify the transactions' purpose, prepare financial analysis, and correct unusual items.

We recommend the Center ensure that all detailed schedules are prepared and reconciled to the financial statement balances prior to the audit. In addition, the Center should designate an individual in the organization who is responsible to review these schedules during its monthly and year-end closing process.

*Management Response:*

Management believes the issue is that adjustments to the detailed schedules resulting in the financial statement balances were not clearly documented or readily identifiable on the schedules. The Center will reconcile the detailed schedules to the financial statements in a clear and concise manner, and the reconciliations will be reviewed by the Center's Chief Financial Officer ("CFO") prior to the audit.

### Item #2007 C - Significant Deficiency #1
### Calculation of Allowance for Doubtful Accounts

The Center uses a direct write-off method for identifying bad debts. Under this method, the actual amount of uncollectible accounts receivable is deducted from the sales revenue in the accounting period in which the Convention Center determines to be uncollectible, instead of creating a provision for them in the period in which those sales occurred. Although this method is based on facts instead of estimates, it goes contrary to the matching concept of accounting and is generally not acceptable for financial reporting purposes.

We recommend that management create a provision for its doubtful accounts during the period in which the sales occur. This provision is normally estimated based on a percentage of sales or percentage of outstanding receivables. As the Center develops a longer collection history, the calculation of the allowance can be modified to reflect its collection trends.

*Management Response:*

Management would like to respond that the direct write-off method is simple to use and in management's opinion does not misstate the value of accounts receivable at year end. However, as the auditors point out this method does not match revenues and expenses properly and is not acceptable for financial reporting purposes. Consequently, based on the auditors observation and recommendation, management will implement an "allowance for doubtful accounts" policy for recognizing bad debt expense and valuing accounts receivable beginning with fiscal year 2007-08.

**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**SAN JOSE CONVENTION CENTER (Continued)**

**Item #2007 D - Other Internal Control Matter #1**
**Journal Entry Process**

The Center's journal entries for recurring items such as insurance do not regularly have supporting documentation to validate the entry. All journal entries should be required to have supporting documentation prior to posting. In addition, journal entries are to be reviewed and approved by the CFO prior to posting. During our testing, we found 1 transaction out of a sample of 25 transactions (or an exception rate of 4%) that did not indicate the CFO's approval.

We recommend that the Center require employees to follow the procedures implemented for the journal entry process. Failure to follow these procedures raises the risk of misstatements.

*Management Response:*

Concerning recurring journal entries, supporting documentation that supports the entry will be present in a file and available for review. Staff believes that this approach is efficient, practical and provides the necessary level of internal control. With respect to Chief Financial Officer (CFO) journal entry approval staff would note that the CFO approves all journal entries prior to posting to the general ledger. Staff is of the opinion that current procedures are adequate, and that the one exception noted by the auditors was an oversight and not a systemic failure to follow procedures.

**Item #2007 E - Other Internal Control Matter #2**
**Application of Discounts**

The Center provides discounts to customers who purchase a sufficient amount of other services such as food and beverage, and internet services. The discounts are recorded to other income rather than building revenues, leading to an overstatement of building revenues and an understatement of other income.

Given that the discounts apply to building revenues, we recommend that the Center record these discounts in building revenues rather than other income. This will prevent the misstatement of other revenue line items.

*Management Response:*

Staff agrees with the auditors finding and recommendation and effective July 1, 2007, the Center started recording discounts provided to customers (clients who purchase a sufficient amount of other services) against building revenues rather than other income.

**SCHEDULE OF COMMENTS AND RESPONSES (Continued)**

**Item #2007 F - Other Comment #1**
**Developing a Disaster Recovery Plan**

The Center's management does not have a well-defined, written disaster recovery plan. While the Center's new management started in July 2004, the time to make contingency plans is before disaster strikes, such as a fire, earthquake or terrorist act. It is important that all personnel be aware of their responsibilities in the event of an emergency to minimize the negative affect on operations.

We recommend that the City require management to develop a disaster recovery plan to better plan for future emergencies.

*Management Response:*

The Center agrees that having a well defined, written disaster recovery plan is important. In addition, the Center agrees that having this plan properly communicated to all personnel is key to a smooth operation during an emergency. The Center will work with the City to develop a well-defined, written disaster recovery plan.

**SAN JOSE CONVENTION AND CULTURAL FACILITIES**

Public Safety, Finance & Strategic Support Committee
Fiscal Year Ended June 30, 2007

## UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

| PJE # | Account Name | Account Number | Debit | Credit |
|---|---|---|---|---|
| 1 | Contributions from the City of San Jose | 999-00-00 | 175,561.00 | |
| | Other expenses | 612-51-10 | | 175,561.00 |
| | To reconcile the City contributions recorded in the Center's general ledger to the detailed schedule provided by the City. | | | |