Independent auditor's report on financial statements

completed, see

http://www.sjredevelopment.org/Finance/CAFR2009.pdf

Compliance Audit & Report on Internal Controls

2 complete reports are forwarded;
1 for State Controller and 1 for HCD

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The Board of Directors
Redevelopment Agency of the
City of San José, California

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENT PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

We have audited the financial statements of the governmental activities and each major fund of the Redevelopment Agency of the City of San José (Agency), a component unit of the City of San José, California, as of and for the fiscal year ended June 30, 2009, which collectively comprise the Agency's basic financial statements and have issued our report thereon dated November 2, 2009. Our report contains an explanatory paragraph describing the Agency's adoption of the provisions of Governmental Accounting Standards Board (GASB) Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, and an emphasis of a matter regarding an uncertainty related to a recently passed State legislation. We conducted our audit 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Agency's internal control over financial reporting 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 Agency's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Agency's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

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 combination of control deficiencies, that adversely affects the Agency'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 Agency's financial statements that is more than inconsequential will not be prevented or detected by the Agency's internal control. We consider the deficiency described as 2009-01 in the accompanying schedule of finding and management response to be a significant deficiency in internal control over financial reporting.

A *material weakness* is a significant deficiency, or 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 Agency's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we do not believe the significant deficiency described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. Such provisions include those provisions of laws and regulations identified in the *Guidelines for Compliance Audits of California Redevelopment Agencies* issued by the State Controller's Office and as interpreted in the *Suggested Auditing Procedures for Accomplishing Compliance Audits of California Redevelopment Agencies,* issued by the Governmental Accounting and Auditing Committee of the California Society of Certified Public Accountants. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

The Agency's response to the finding identified in our audit is described in the accompanying schedule of finding and management response. We did not audit the Agency's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Board of Directors, management of the Agency and the State Controller's Office and is not intended to be and should not be used by anyone other than these specified parties.

Macias Gini & O'Connell LLP

Certified Public Accountants

Walnut Creek, California
November 2, 2009

2009-01 Accounting and Financial Reporting for Demand Bonds

Variable rate demand obligations (VRDOs) are bonds that by their terms have demand provisions exercisable at the balance sheet date (June 30, 2009) or within one year from the date of that statement (June 30, 2010). At June 30, 2009, the Agency has $166.7 million of VRDOs outstanding. The key elements in determining classification of the VRDOs as current or noncurrent are the standby liquidity agreement (credit facility) and/or the take-out agreement. In order for the VRDOs to qualify as noncurrent obligations under U.S. generally accepted accounting principles (GAAP), the credit facility must provide short-term funds to redeem the bonds "put" by the bondholder pending resale by the remarketing agent and the take-out agreement must provide assurance that the issuer will be able to repay any borrowings under that credit facility in a manner that preserves the long-term nature of the obligation.

At June 30, 2009, the Agency had $56.6 million of VRDOs, 2003 Merged Area Revenue Bonds (2003 Bonds) outstanding. The 2003 Bonds were supported by a credit facility with JPMorgan Chase, N.A. (JP Morgan) with an expiration date of August 27, 2009. The 2003 Bonds did not have a take-out agreement in place (as described above). On July 31, 2009, JP Morgan extended the Agency's credit facility for the 2003 Bonds to November 26, 2009. However, the extension did not meet the requirements under GAAP for continuing to report the bonds as noncurrent obligations. If these bonds were reclassified as current, the Agency would be required to report the bonds as a fund liability in its capital projects fund of $56.6 million, which would reduce its fund balance by the same amount. In order to preserve the long-term nature of the 2003 Bonds, the Agency negotiated a one-year extension of its credit facility to November 26, 2010. Also included in the extension was the credit facility related to the 1996 Merged Area Revenue Bonds (1996 Bonds). However, the terms of the new credit facility for the 1996 and 2003 Bonds included a mandatory reduction to $100 million in aggregate outstanding 1996 and 2003 Bonds, which required an early redemption of $5.3 million by November 27, 2009. As a result, an audit adjustment was made to the financial statements to record $5.3 million as a fund liability at June 30, 2009.

In order for the Agency to continue treating the VRDOs as long-term, it must, among other things, have a credit facility that expires beyond one year. Given the conditions of the credit market and the difficulty in securing long-term letters of credit, the Agency should include in its internal controls over financial reporting a process to ensure that fund liabilities are recognized for VRDOs that do not meet the criteria for long-term treatment. As it stands now, the current credit facility for the 1996 and 2003 Bonds expires on November 28, 2010, which will require a reclassification to a fund liability in the event that it is not extended before the issuance of the Agency's June 30, 2010 basic financial statements.

Management's Response

The 2003 Bonds were properly reported by the Agency as a fund liability and disclosed in the notes to financial statements in its June 30, 2009 financial statements and the auditor on November 2, 2009 issued an unqualified audit opinion.

2009-01 Accounting and Financial Reporting for Demand Bonds (Continued)

The Agency has always reported the 2003 Bonds as a liability on its government-wide financial statements and is aware of the GAAP requirement to additionally report the 2003 Bonds as a fund liability in the fund financial statements if the Letter of Credit expires within one year at the end of the fiscal year (June 30, 2009). The Finance Staff started negotiating with JP Morgan in early spring of 2009 to extend the Letter of Credit before the expiration date of August 27, 2009. Because the negotiation with JP Morgan was longer than expected, Finance Staff postponed the completion of the audited financial statements until the Letter of Credit extension was obtained. Because the Letter of Credit market has changed significantly due to the current economic situation, negotiations were not completed until October. On October 27, 2009, the Agency Board approved the new terms and conditions for extending the 2003 Bond's Letter of Credit including extending the Letter of Credit for the 1996 Bonds to November 26, 2010. The new terms and conditions also required a mandatory reduction to $100 million on the aggregate 1996 and 2003 outstanding bonds, and further required an early redemption of $5.3 million by November 27, 2009. While the negotiation of the new terms and conditions was still ongoing and nearing completion, Finance Staff on October 21, 2009 notified and provided the auditor an accounting entry to recognize the $5.3 million as a fund liability in the fund financial statements. This accounting entry was later recorded and disclosures regarding the credit facility were added by the Agency on its financial statements. Accordingly, the auditor accepted our entry and our reporting of the $5.3 million in our financial statements and issued an unqualified audit opinion. The Agency believes that it accurately reflected its Letters of Credit liability and disagrees with the auditor's assertion that the above is a significant deficiency in internal control over financial reporting.